

**A CORPORATIVE THEORY OF CORPORATE LAW AND GOVERNANCE**

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## ABSTRACT

This book investigates how a corporation, as a legal entity with certain specific attributes, but lacking human form, can take action in the “real world” of human activity. It contends that a corporation must take such action through, and by means of, an organization, both inside and outside its “corporate” legal limits, consisting of real individual persons and groups of persons. The corporation thus presents itself both as a legal entity assuming the legal form of a corporation and as a social entity taking the form of an organization. One form overlays the other. Those with whom it has legal relations, its legal counterparties, are also, in respect of its organization, participants in that organization. This theory of, or perspective on, the corporation and its governance is explicated here as “corporative”.

The corporation comes into being, is situated, participates, and is “embedded”, in a complex socio-political-economic environment, which includes its legal counterparties and organizational participants. In addition to shareholders, they include employees, customers, suppliers, creditors, local, regional, and national communities, polities and governments, and non-governmental and other organizations, including those whose objectives include the environment, sustainability, governance, and social responsibility. Despite arguments from advocates of shareholder primacy and maximizing shareholder value, neither the corporation nor any of its participants, including shareholders, have any single objective. Instead, such participants have a variety of objectives which may be consistent to varying degrees with those of each other and with those of the corporation. However, the prosperity and well-being of corporations and their organizational participants, and the groups and other organizations of which organizational participants are members, at a macro-level, are, in many ways, interdependent.

Today, prompted by various concerns (including the environment, sustainability, technology, changes in employment and other economic engagement patterns, and increasing income disparities), corporations, industry groups and NGOs, like governments, educational institutions, and other organizations, are facing challenges to the continued viability of contemporary capitalism and of its paradigmatic vehicle, the corporation. Addressing these challenges requires that corporations be considered in the context of the complex socio-political-economic environment in which they are situated and of which they partake.

Drawing on analysis of corporate statutes and other relevant law, and historical, social, political, economic, organizational, business, and other theory, information and analysis, this work elucidates the corporative theory of, or perspective on, the corporation. It outlines how this might be applied in analyzing the corporation and its governance from a legal perspective. It illustrates how organizational participants may, and do, influence the behaviour of the relevant corporations; and how corporations may, and do, influence the behaviour of organizational participants. This contributes to understanding how such relationships may be employed, not only to “save” capitalism and the corporation, but to advance common interests in human prosperity, happiness, meaning, and even simple sustenance.

## DEDICATION

This work is dedicated to Jen, who countenanced its domination of a great part of our lives for years. She made many sacrifices, including holidays (putting lots of travel plans off until its completion), and nights and weekends doing other things, while I worked on it. Most significantly, she provided terrific emotional support during the “ups and downs” that such a project brings. She also gave me great intellectual support, asking, even challenging, me to clarify and simplify explanations, expressions, and examples, to the point where I often felt pushed by her, from one side, and by Peer Zumbansen, my supervisor, from the other. Without her dedication to me and to a project which is both ambitious and summative, in terms of my legal work and education, my energies alone may not have brought it to fruition. I am forever grateful for her love and support and for finding them, and her, at last.

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Peer's legal theory seminars contributed mightily to my background and interest in, and to my attempt at, developing a comprehensive theory or perspective on the corporation. The Association of Transnational Law Schools (ATLAS) Agora conference, which he and Craig Scott convened, enhanced my academic development and generated a paper which his German Law Journal published. A fellowship from his Comparative Law and Political Economy program at Osgoode and York University provided helpful office space and companionship. Peer has also generously extended his friendship and collegiality, inviting my comments on his articles and Business Associations examination papers, and cajoling and encouraging me on the book, as necessary.

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## INTRODUCTION

### WHAT IS A BUSINESS CORPORATION?

As the twenty-first century continues to unfold, the question “What is a (business) corporation?” is perhaps more significant than ever, as a result of its pervasiveness not only as a form of organization; but also in its importance in the economy, society and the polity, to participants in, and analysts of, those domains, and to lawyers and legal scholars in particular; and challenges to: the relationship among the economy, society, and the polity; the modern state and its relationship to the domestic, regional, and transnational economies, societies, and polities; the evolving nature of liberal and post-liberal political economy and late stage capitalism, in a period of massive technological development, and challenges to the relationships among labour, capital, education and training, social welfare, and government action, also characterized by massive imbalances of wealth, income, capital, and personal welfare.

#### **The Importance of Framing the Question**

The question may be answered, as might be said, “legalistically” in terms of the legal attributes of what is established to be a “(business) corporation” in the statute or common law of a particular jurisdiction. It may be answered “economically” in terms of what economic function it performs, what function it has in the economy. It may be answered “teleologically” in terms of what goals it pursues, “politically” in terms of how it fits into political life, “sociologically” in terms of how it fits into society broadly speaking and how it fits into the lives of human beings, and so on. These remarks mean to suggest that the question can be answered not only in terms of various roles, functions, or systems affecting human beings, but also in terms of various academic disciplines and fields which may be brought to bear on, or which might pursue, its analysis.

Just as found by Berle in the early and middle years of the last century, and by Chandler in the middle and late middle years of that century, the corporation today is different from the corporation of previous years. Or is that the case? We must also ask, if it is different, in what ways it is different, and what implications those differences have for the various functions, roles, and systems of, and disciplines and fields examining, the modern corporation, and in particular, the modern business corporation.

Even asking the question “What is a (modern) (business) corporation?” presents us with a conundrum: how will or would we go about developing an answer and how will or would we know if that answer is veridical?

One answer might be to employ a theoretical approach, developing theories about what a corporation is, applying a successive refining or recursive logic, and arriving at various results accordingly. Such a methodology can be tested for internal or logical consistency, and even assessed for its simplicity and elegance. However, if such a theory is to be employed to explain or predict actions, such a theoretical approach requires consideration of its explanatory and predictive power, which requires at least some application of the theory to, and testing the theory in, the “real world”. The theory might then be assessed in terms of its explanatory and predictive capacity.

Depending on the theory itself, it may suffer from a high level of endogeneity, in which many of the consequences would be logically related to assumptions made by the theory. Alternatively, it may appear to be exogenous. This will also affect its utility and efficacy. A theory may even be sufficiently endogenous that its assumptions lack explanatory and predictive capacity “in the real world”, especially if some of its closely related assumptions are not at all present in the “real world” situation, are not as pervasive as the theory assumes, are tautological, or approach being tautological.

When the corporation is considered “from a legal perspective”, how does one proceed? And what does “considering” a corporation “from a legal perspective” mean? Perhaps the answers are different depending on whether the legal perspective considered is that of a practicing corporate or securities or other lawyer, a corporate, securities, or other legal academic, a corporate, securities or other regulator, a legislator, a non-legal academic, a member of the public, a consumer or other observer or affected party.

### **The Corporation as an Object of Legal Research and Theorization**

The position taken in this work is that theorization about what the corporation is, or about the nature of the corporation, as a matter of law, is, in most cases, affected by a number of assumptions extrinsic to law, in terms of both the function of the corporation and the academic disciplines and fields with which it engages. Many of the assumptions currently made in theorizing about the corporation are essentially, and arguably necessarily, economic in nature. In large part, thinking

about the corporation, and, in particular, the modern business corporation, even in the twenty-first century, is affected by assumptions made by political economists in the eighteenth and nineteenth centuries.

Some of those assumptions were developed employing a theoretical approach, and then were applied and tested to varying degrees, and with varying degrees of success, and with varying degrees of successive refinement and development. In some cases, this application and testing was theoretical and non-empirical, being limited to testing logical coherence, or appeals to one's own feelings or sentiments, or to one's own experience. Some of the tests purportedly made of such theories in the "real world" employed unscientific or otherwise unsatisfactory and unreliable methodologies. Some of these assumptions were not applied to and tested in "the real world" at all. Indeed, it will be argued in this work that some of those assumptions of classical political economy are incapable of such application and testing, either because they are considered to be true *a priori*, or are otherwise incorrigible, or because it is not clear what verification of them is possible, or because they are tautological, or because they are otherwise logically or epistemologically incoherent, logically inconsistent, or contradictory.

The nature and impact of those assumptions of classical political economy, and the extent of their explanatory power and predictive capacity, unfortunately, are not susceptible of exact measurement and statistical capture in a scientific or social scientific sense, at least in such as work as the present one; however, the reader may bring to bear his or her own judgement in this regard. Instead, this work aims to articulate such assumptions, to explicate some of their implications and consequences, and to problematize such matters.

### **Generalizations and Assumptions in Legal Research and Theorization**

Accordingly, this work will identify and consider certain assumptions commonly made about, and which relate to, the corporation, and its attributes, functions, and circumstances, speaking broadly; and will seek to consider their logical consistency, analytical integrity, explanatory power and predictive capacity, especially when basing "real world" hypotheses upon such assumptions. This work will demonstrate the shortcomings of theories relying upon such assumptions.

In fact, as argued in Chapters One through Three and in Appendix B of this work, it appears that extant legal theories of the corporation adopt and are significantly modelled on economic

assumptions regarding “the firm” which many modern economists now reject as inadequate, even as theoretical models of “the firm”, in the modern economy. Many economists now consider the modern economy to be significantly different from the model economy posited, or the historical economy described, in classical political economy.

Importantly, when it is assumed that each individual human being acts purely atomistically and perfectly rationally, solely in the pursuit of his or her own well-being, which is to say in a manner which is characterized as “economic”, it is almost a tautology to conclude that such human being behaves only “economically” and lacks or, at least, acts as if he or she lacks, any associative or affiliative needs and impulses. Such a view of human nature may have significant consequences for one’s expectations, and regulation, of human, and hence corporate, behaviour. A less atomistic perspective on human nature, acknowledging such associative and affiliative needs and impulses, and the satisfactions derived by most humans from their pursuit, presenting “a different model of man”, and a methodology that is not burdened by methodological reductionism permit more wide ranging observation, consideration, evaluation, and explication, and even prediction of “real life” behaviour in many spheres of human activity.

Indeed, even many of the greatest utilitarian and like-minded political economists did not assume that behaviour of the nature they posited could be observed with respect to actual human beings in the real world; but, instead, acknowledged that even idealized constructs of behaviour were not thoroughgoing in respect of man’s exclusive rational pursuit of self-interest. The review of assumptions undertaken in this work permits a conclusion, however preliminary and tentative in nature, that the model of man posited by the theorist will be strongly related to the model of organizations derived from or in respect of such theory, including the model of organizations engaged in economic relations, the model of the business firm, and the model of the corporation, including the modern business corporation. In turn, the model of organizations adopted has a determinative effect on the model of the corporation which can be derived, and the relation of the corporation as organization and the corporation as legal entity.

Some further discussion of these subjects appears in Chapter One, particularly under the heading “Assumptions about the Corporation”, mainly concerning how the corporation takes action. Chapters Two and Three focus specifically on how the corporation, as a legal entity, takes action “in the real world” through “real human actors” and the implications of the same. That discussion

is rooted in generalizations and assumptions that concern the nature of man, and the nature and objects of human activity, more generally. In order not to unnecessarily burden the text and the explication of corporativity, detailed examination of those assumptions and generalizations is set forth in Appendix B. It seeks to establish that a new theory of the corporation is required which will have greater logical consistency, analytical integrity, explanatory power, and predictive capacity. It is argued, primarily in Chapters Seven through Ten inclusive, that corporative theory has the capacity, or at least, the potential to meet those requirements.

## ***THEORIA, PRAXIS, AND CORPORATIVITY***

### **A Descriptivist Approach**

Instead of proceeding by a priori reasoning, this work will seek, instead, to apply a more rigorously empirical approach. Starting with a more descriptivist approach, it will inquire into how certain widely used terms, such as the term “corporation” (in Chapter One and in Appendix A), and “the economy” and “society” and “the polity” (by way of additional background, in Appendix B), appear to be used, what they appear to describe, and how the referents of those terms, both alone and in relation to other such terms, are experienced by individuals. This will provide a certain definition in use or taxonomy in use in respect of such terms.

With respect to the corporation and, in particular, the modern business corporation, certain attributes commonly considered by legal experts as characterizing and identifying the corporation and the modern business corporation are identified in Chapter One. In order not to burden the main text, how those attributes are instantiated in modern corporate law is explored in Appendix A. Further explication of how the corporation presents itself and takes action “in the real world” is undertaken in Chapters Two and Three. Those chapters present empirical evidence on the subject through the lens of “business history”, describing the development of the corporation in North America (primarily in the United States) from the mid-nineteenth century to the present day.

This work will then seek to generate a theoretical basis upon which can be constructed hypotheses that are consistent and testable, involving a method that is more “scientific” in nature. Such a scientific method is generally taken to involve the recognition and formulation of a problem or matter to be considered, the collection of data through observation, measurement, and experiment, and the formulation, testing and modification of hypotheses, on an iterative basis, successively

evaluating the explanatory and predictive capacity of those hypotheses or assumptions and refining them progressively.

Such theoretical basis will be sought by examining the corporation as an organization of human beings or persons, in effect, without making the assumptions of the “economic” approach outlined above. Instead, the work will seek to characterize the corporation as an organization of human persons having certain primary goals or objectives, namely, of generating surplus value or profit, as well as other complementary, subordinate, and even sometimes conflicting, goals or objectives. The work will consider some of the characteristics of organizations generally, and of organizations having a dominant or significant economic objective, and of organizations that are considered to be separate legal entities vis-à-vis the individuals who are involved in and with the organization. Such examination of the organization appears primarily in Chapters Four through Six inclusive.

Such a methodology will facilitate consideration of the corporation as compared and contrasted with other organizations or associations having different primary goals or objectives, permitting conclusions to be drawn about the functions and operations of the corporation as compared with those of such other organizations. This comparison is undertaken in Chapters Four and Five, but is particularly concentrated in Chapter Six. This method of proceeding will assist our undertaking in a number of ways, including in evaluating how most effectively to understand, and to approach regulating, the behaviour of the modern business corporation.

### **A Model of Social or Relational Man**

A model of the firm in terms of an atomistic rational individual seeking only optimization or maximization of his or her own utility or gratification of his or her own needs and pleasures is unlikely to be of great assistance in explaining either the behaviour of such an individual in society or the behaviour of society as a whole. This is demonstrated in Appendix B. Some limitations of such atomistic characterization of individuals have been recognized in certain other academic disciplines, such as politics and sociology; however, they appear to be, as yet, recognized insufficiently (as to depth, breadth, and otherwise) in legal fields. These limitations are discussed in the present work in the main text, and in more detail in Appendix B.

A model of the firm which involves individuals forming and acting in relation to social groups is more likely to explain behaviour of human individuals and groups within organizations and the

aggregate behaviour of organizations considered as such, and considered in relation to, their engagement with other organizations and individuals, and within society, and the polity, as a whole. The defining and other attributes of organizations are discussed in Chapters Four through Six inclusive. This engagement may be related to economic, social, political, and other role and functions of the society and polity concerned. Such a model is the corporative theory of, or the corporative perspective on, the corporation presented in Chapters Seven through Ten inclusive.

Surely, the answer to the question how to determine whether an answer to the question “What is a (modern) (business) corporation?” is veridical must be sought in the explanatory power and predictive efficacy of the answer proposed. In this regard, it is proposed that a modern business corporation is an organization of individuals pursuing certain goals and objectives, which are to a significant, but by no means exclusive degree, economic, acting as a separate legal entity in relation to some, but by no means all, of its engagements, which are largely external to it as a legal entity. In respect of those external engagements, it functions as a separate legal entity possessing certain legal attributes. As an organization composed of individuals and groups of individuals collectively pursuing common economic and other goals and objectives, the engagement of the corporation, internally, is that of, and among, individuals and groups of individuals. The present work denominates this as involving the corporative theory of, or the corporative perspective on, the modern business corporation.

### **The Corporation as Organization**

Thus, the present work will demonstrate that the modern business corporation is in, and of, society, and society is in, and of, the modern business corporation. Internally, the corporation is social, in the sense that its function and operations are constituted, at least in part, by individual human beings interacting with other individual human beings.<sup>1</sup> Internally, it may be said to be a situs of

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<sup>1</sup> See the discussion in Chapter Two, notably in the sections entitled "the Neoclassical Firm as a Single Economic Actor" and "History of the Development to the Modern Business Corporation"; and other discussions cited in this paragraph and in the following paragraph.

political behaviour among individuals and groups,<sup>2</sup> of social and interpersonal interaction,<sup>3</sup> of group interaction,<sup>4</sup> of social and personal identity,<sup>5</sup> of search for meaning,<sup>6</sup> of economic attainment,<sup>7</sup> and of many other species of behaviour, instrumental, teleological, and otherwise.

In addition to economic activities, the corporation, internally, is a situs of associative, affiliative, political, and other social activities.<sup>8</sup> As a social group, it may be said to be composed, not only of individuals, but of “groups of groups”.<sup>9</sup> As a political group, it may be composed not only of individuals, but of groups, and “groups of groups”, acting in a manner that may be broadly described as “political”, seeking power and influence, for various reasons, and forming, participating in, adjusting, readjusting, dissolving and re-forming coalitions, to those ends. The composition and nature of those coalitions and their duration may vary temporally.<sup>10</sup>

## **The Corporation as Legal Entity and as Organization**

### ***Separate Legal Entity***

Externally, of course, the corporation presents itself as a separate legal entity (“SLE”).<sup>11</sup> As such, it has a number of attributes, which may be summarized, roughly, as follows: firstly, it can enter

<sup>2</sup> See the discussion in Chapter Three in the section entitled "Organizations as Political Systems" and "Forms of Corporations – Legal and Organizational Variants", particularly under the heading "M-Form Corporations"; in Chapter Five in the section entitled "Organizational Personnel"; and in Chapter Five in the section entitled "Organizational Goals and Intraorganizational Goals"; and in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals".

<sup>3</sup> See the discussion in Chapter Four in the section entitled "Groups of People or Social Units", particularly under the heading "A Social Unit or Group of People"; and in Chapter Five in the sections entitled "Organizational Structure" and "Organizational Personnel".

<sup>4</sup> *Ibid.*

<sup>5</sup> *Ibid.*

<sup>6</sup> See the discussion in Chapter Six in the sections entitled "Existence and Typology of Organizational Goals and Objectives" and, more especially, "Organizational Goals and Intraorganizational Goals".

<sup>7</sup> See the discussion in Chapter Two in the sections entitled "The Neoclassical Firm as a Single Economic Actor" and "History of the Development of the Modern Business Corporation"; and in Chapter Six in the sections entitled "Existence and Typology of Organizational Goals and Objectives" and "Organizational Goals and Intraorganizational Goals".

<sup>8</sup> *Supra* notes 2 through 5 inclusive.

<sup>9</sup> *Supra* notes 3 through 5 inclusive.

<sup>10</sup> *Ibid.* See also the discussion in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals", particularly under the headings "The Dominant Coalition as Intraorganizational Group", "Organizational Goals and Corporate Operations", and "Goals of Corporations".

<sup>11</sup> See the discussion in Chapter One, especially in the sections entitled "The Corporation in Law and in Discourse" and "The Corporation and Corporate Essentialism in Law". As noted there, the attributes of the corporation as an SLE are summarized variously by different commentators but generally much the same effect. One recent discussion of a number of such formulations is that of Christopher M. Bruner, "What is the Domain of Corporate Law?" (December



into contracts, and initiate, maintain, and defend legal actions, and can own assets in its own name (SLE status);<sup>12</sup> secondly, the corporation and its assets are subject only to claims arising in respect of the business of the corporation (limited liability), and are not subject to claims made against persons involved in the corporation as shareholders (asset partitioning);<sup>13</sup> thirdly, contributions to, and interest in, its equity capital are essentially permanent, or “locked-in”, although they are, in many cases, transferable, conditionally or otherwise;<sup>14</sup> fourthly, it is managed centrally, not by independent action of owners or others, and can act through agents;<sup>15</sup> and fifthly, it survives changes in its ownership and management, potentially indefinitely.<sup>16</sup> These characteristics are examined in greater detail in Chapter One under the heading “The Corporation and Corporate Essentialism in Law”, and, with greater specificity, in Appendix A, which explains in some detail how such legal essentialist characteristics are instantiated in modern business corporation law.

### *Organizations as Separate Legal Entities*

Of course, the modern business corporation (MBC) is not the only separate legal entity or SLE which obtains separately from, but in some relation to, human persons implicated by or concerned in it. Others include labour unions, universities, and religious organizations.<sup>17</sup> As such, those

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31, 2018). University of Georgia School of Law Legal Studies Research Paper No. 2019-04. Available at SSRN: <https://ssrn.com/abstract=3308611> or <http://dx.doi.org/10.2139/ssrn.330861>, especially at 13-21.

<sup>12</sup> See the discussion in Chapter One, especially in the section entitled “The Corporation and Corporate Essentialism in Law” and therein under the heading “Essential Attributes of the Corporation Law” and the subheading “Separate Legal Entity”.

<sup>13</sup> See the discussion in Chapter One, especially in the section entitled “The Corporation and Corporate Essentialism in Law” and therein under the heading “Essential Attributes of the Corporation Law” and the subheading “Limited Liability and Asset Partitioning”.

<sup>14</sup> See the discussion in Chapter One, especially in the section entitled “The Corporation and Corporate Essentialism in Law” and therein under the heading “Essential Attributes of the Corporation Law” and the subheading “Transferable Equity Interests and Capital Lock-In”.

<sup>15</sup> See the discussion in Chapter One, especially in the section entitled “The Corporation and Corporate Essentialism in Law” and therein under the heading “Essential Attributes of the Corporation Law” and the subheading “Central Management Independent of Equity Ownership”.

<sup>16</sup> See the discussion in Chapter One, especially in the section entitled “The Corporation and Corporate Essentialism in Law” and therein under the heading “Essential Attributes of the Corporation Law” and the subheading “Indefinite Duration”.

<sup>17</sup> Chapter Four discusses the defining and other attributes of organizations and identifies examples of the disparate nature of the same. In particular, in that regard see the discussion under the heading “Groups of People or Social Units” and Max Weber’s delineation of the organization as a social relationship; and see, also, the discussion in Chapter Five under the heading “Structure, Process, and Personnel”.

organizations have various degrees of similarity with the modern business corporation, some of which are explicated in the following paragraphs.<sup>18</sup>

Even Jensen and Meckling, generally considered classic expositors of the contractarian theory of the firm, acknowledge this, saying: “It is important to recognize that most organizations are *simply legal fictions which serve as a nexus for a set of contracting relationships among individuals*”,<sup>19</sup> which includes “firms, non-profit institutions such as universities, hospitals and foundations, mutual organizations such as mutual savings banks and insurance companies and co-operatives, some private clubs, and even governmental bodies such as cities, states and the Federal government, government enterprises such as TVA, the Post Office, transit systems, etc.”<sup>20</sup> Of course, it is not necessary to accept their characterization of organizations as “simply legal fictions” or “simply a nexus for a set of contracting relationships among individuals” in order to acknowledge the merit of their comparison of corporations with other types of organizations as involving relationships among individuals. However, those relationships are not necessarily only, or even primarily, contractual in the case of most organizations; nor are they only “among individuals”. Instead, they involve relationships between each individual and the organization and, in many cases, between groups of individuals and the organization.

### ***The Corporation as a Nexus of Relationships and as an Organization***

As is more fully discussed below, an organization may be considered to involve a social unit or group of persons who collectively pursue some common goal or objective.<sup>21</sup> As such, the means by which they determine to pursue such goal or objective certainly involves some kind of social relationship which may involve the dispensation of positive sanctions (“rewards”) and negative sanctions (“punishments”) as a means of increasing the likelihood of achieving such goal or

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<sup>18</sup> See the discussion in Chapter Four in the section entitled “Groups of People or Social Units”, particularly under the heading “Max Weber on Organizations and Related Matters”, and under the subheading “Typology of Organizations”.

<sup>19</sup> Michael C. Jensen and William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure (1976)” 3:4 *Journal of Financial Economics* 305 at 310 [emphasis in the original.]

<sup>20</sup> *Ibid.*

<sup>21</sup> See the discussion in Chapter Four in the sections entitled “Working Definitions and Formal Definitions”; and “Groups of People or Social Units”, particularly under the heading “Max Weber on Organizations and Related Matters”, and under each of the subheadings thereunder; and the discussion in Chapter Five in the section entitled “Structure, Process, and Personnel”, especially under the heading “Rational-Legal Authority, Administration, and Bureaucracy”.

objective and decreasing the likelihood of failing to do so.<sup>22</sup> This may involve the application of norms, rules, and, perhaps, appeal to “the agreement” by which the organization is constituted and to which members agree to adhere upon their acceptance into the organization as members.<sup>23</sup> Such “agreement” may or may not involve some aspects which may be considered to be contractual and, in that sense, “legal”.<sup>24</sup>

Jensen and Meckling are, of course, well known for their acknowledgement that “[t]he private corporation or firm is simply one form of a *legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of the visible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals*.”<sup>25</sup> As discussed under the immediately preceding heading, this additional feature is not the sole distinguishing feature of the corporation. As discussed under this heading, it is also not necessary to accept their characterization of the corporation as “simply... a legal fiction” in order to acknowledge that they accept not only corporations, but also other organizations, as involving relationships and, importantly, as having “legal” reality.

Organizations, according to Weber and others, involve social relationships which are not exhausted only between or among its members, or by admission of new members, but which, instead, obtain between the organization and each of its members and between the organization and all of its members, as a kind of “type” relationship. Weber observes that such social relationship can be represented both internally, vis-à-vis its own members (the composition of which is subject to change), and externally, vis-à-vis extraorganizational parties, generally, or subject to some specification.<sup>26</sup> Thus, organizations have both intraorganizational and

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<sup>22</sup> See the discussion in Chapter Six in the section entitled “Organizational Goals and Intraorganizational Goals”, particularly under the headings “Theories of Intraorganizational Power” and “Information and Sanctions as Sources of Intraorganizational Power”. See, also, and the discussion in Chapter Three in the section entitled “Forms of Corporations – Legal and Organizational Variants” and therein under the heading “M-Form Corporations”.

<sup>23</sup> See the discussion in Chapter Four in the section entitled “Groups of People or Social Units”, particularly under the heading “Max Weber on Organizations and Related Matters”.

<sup>24</sup> *Ibid.*

<sup>25</sup> *Supra* note 19 at 311 [emphasis in the original.].

<sup>26</sup> See the discussion in Chapter Four in the section entitled “Groups of People or Social Units”, particularly under the heading “Max Weber on Organizations and Related Matters”, and under each of the subheadings thereunder.

extraorganizational “reality”, the exact nature of which is complex and often imprecisely and differently expressed by various social theorists.<sup>27</sup>

Our reading of social theory suggests, firstly, that one factor at play is the myriad of social relationships which individual and group participants in an organization may have, which may be expressed in some difficulty in establishing the “limits” or “boundaries” of the organization itself; secondly, that these limits or boundaries vary depending, in large part, upon the purpose for which they are sought to be identified; and thirdly, that such limits or boundaries are relative in that they occupy a continuum between highly intimate relationships (“more internal”) and relatively remote relationships (“more external”).

Of course, the corporation itself is not immune from such difficulties of classification. Jensen and Meckling usefully point out that defining a firm or corporation as involving a multitude of relationships (which they maintain are contractual) has the consequence that it may be difficult to determine whether such relationships are within or without the corporation. Consequently, they say, “it makes little or no sense to try to distinguish those things which are “inside” the firm (or any other organization) from those things that are “outside” of it.”<sup>28</sup>

As will be seen, the “corporative” notion of corporate duality has some sympathy with Jensen and Meckling’s “relationship” characterization of the corporation. However, this work maintains that the corporation, as a separate legal entity, requiring human agency in order to take action, engages in legal or contractual relationships with certain persons or entities, or described here as “legal counterparties” of the corporation, while also acquiring human agency by means of an organization which enables it to take action and seek to accomplish its goals and objectives. The organization by which the corporation takes action normally involves some contractual or legal relationships between the corporation as a separate legal entity and those organizational participants (in their capacities as legal counterparties), however, such contractual or legal relationships do not exhaust the relationships between the corporation as organization and its organizational participants.

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<sup>27</sup> See the discussion in Chapter Four in the sections entitled “Working Definitions and Formal Definitions”; and “Groups of People or Social Units”, particularly under the heading “Max Weber on Organizations and Related Matters”, and under each of the subheadings thereunder; and the discussion in Chapter Five in the section entitled “Structure, Process, and Personnel”, especially under the heading “Rational-Legal Authority, Administration, and Bureaucracy”.

<sup>28</sup> *Supra* note 19 at 311.

### ***Trust and Reciprocity Within Relationships and Within the Organization***

This work's characterization of the corporation as a legal entity and also as an organization involving a social unit or group of people working together to achieve common goals or objectives finds support on the latter point from diffuse perspectives. For example, after completion of the main text of this work, an article in business ethics by the philosopher Elizabeth Anderson, entitled "The Business Enterprise as an Ethical Agent", appeared, which argues for the morality and benefits of norms of trust and reciprocity within a business enterprise.<sup>29</sup> Unlike this book, which treats the corporation as both separate legal entity and as organization, she characterizes the firm as an organization, that is to say, in terms of relationships, rather than exclusively in terms of contractual or legal relationships, as do Jensen and Meckling, but uses similar "nexus" language.

In fact, Anderson's theory views the firm as "a *joint enterprise* constituted by a nexus of cooperative relationships in which internal stakeholders commit firm-specific assets to relatively long-term team production arrangements, subject to common governance, and repeatedly interact on the basis of norms of trust and reciprocity, all for *mutual and reciprocal benefit*, the terms of which are *not* exhausted by law and contract." She also notes that "[t]he "firm also typically enters into protracted reciprocal relationships with external stakeholders... which are supported by normative expectations of trust, reciprocity, and mutual gain, not all of which are defined in explicit contracts."<sup>30</sup>

In effect, she argues that many corporations behave "ethically", as well as prudently, going beyond the terms of their contracts with employees, customers, creditors, suppliers "by recognizing that both their day-to-day operation and their legitimacy depends on relations of reciprocity and trust among internal and external stakeholders in the firm". Based on "reasonable, informed expectations that all sides will gain from their relationship", which we might describe as a "shared" understanding, "multiple stakeholders, including not just shareholders but creditors, suppliers, employees, the surrounding community and even customers commit investments to the firm that it is costly or impossible for them to withdraw. Living up to the demands of reciprocity requires

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<sup>29</sup> Elizabeth Anderson, "The Business Enterprise as An Ethical Agent" in Subramanian Rangan, ed, *Performance & Progress: Essays on Capitalism, Business, and Society* (Oxford: Oxford University Press, 2015) 185.

<sup>30</sup> *Ibid* at 188 [emphasis in the original.] As compared with team production theory, Anderson emphasizes relational, rather than purely economic, considerations.

not only that firms not exploit those commitments, but that they conceive of their mission in a positive sense as including the interests of all stakeholders. The firm is not just a nexus of contracts but a nexus of reciprocal relationships.”<sup>31</sup>

Of course, what Anderson describes as “a nexus of reciprocal relationships” is the organization by which the corporation, as a legal entity lacking capacity to act in the real world without human agency, is empowered to take action on its behalf.<sup>32</sup> And, while ethical behaviour can certainly be justified in normative terms, its invocation may be considered by some as superfluous in this case since reasons of practicality alone are invoked in support of such relationships.

### ***The Corporation’s Intraorganizational and Extraorganizational Orientations***

In the case of the modern business corporation, we may express its nature, by analogy to the physical world, as a composite being that has a soft (perhaps even highly permeable) inner core and a hard (although still perhaps somewhat permeable) outer shell. This inner core is “social” in that it is composed of individuals and groups interacting with one another, in pursuit of economic and other objectives. We may describe this as the “inward facing” aspect of the corporation.

Although these individuals and groups may have legal relationships with the corporation, as legal counterparties, which surface at certain times and in certain contexts (including within the organization), those individuals and groups present consistently as participants in the organization through which the corporation operates, as organizational participants. The outer shell of a modern business corporation is “legal”, involving the corporation as a single legal entity with certain fixed legal attributes (as noted above), and pursuing economic and other objectives interacting with other entities as legal counterparties. We may describe this as the “outward facing” aspect of the corporation.

As noted above under the subheading “The Corporation as a Nexus of Relationships and as an Organization”, the relationship between the corporation, as a legal entity, and other human persons

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<sup>31</sup> *Ibid* at 185.

<sup>32</sup> See the discussion in this Introduction in the section entitled “*Theoria, Praxis, and Corporativity*” under the heading “The Corporation as Legal Entity and as Organization”. See, also, the discussion in: Chapter One in the section entitled “The Corporation and Corporate Essentialism in Law” under the heading “The Corporation as an Economic Actor in Law”; Chapter Two in the section entitled “The Neoclassical Firm as a Single Economic Actor”; and Chapter Seven in the section entitled “Separate Legal Entity” under the headings “The Corporation, the Legal Entity, the Organization, and the Participants”, and “The Separate Legal Entity, the Organization, and the Individual Human Actor”.

or entities is always, as a matter of law, "external" to the corporation; however, as between the corporation as organization and other human persons or entities as participants in such organization, the relationship may be characterized, on the one hand, as relatively immediate, direct, proximate, or in that sense, "intimate", or, on the other hand, relatively remote. Relationships of the first description may be characterized as relatively more "internal", while relationships of the second description may be characterized as relatively more "external". For the reasons described above, such relationships may be characterized, more meaningfully, as involving a continuum as between proximate and remote; however, with this background of understanding, it will frequently be simpler to refer to relationships of the first description as "internal" and to relationships of the second description as "external".

### ***The Corporation's Dual Nature – Corporativity, its Goals, and Legal Theory***

The corporation thus engages with other parties in its legal capacity as legal counterparties and in its organizational capacity as organizational participants. This work refers to this dual nature as "corporative" and the characteristic or attribute of possessing such dual nature as "corporativity". An adequate legal theory of the corporation must explain the relationship between the "inner core", or more "inward facing", or intraorganizational, aspect of the corporation, on the one hand; and its "outer shell", or more "outward facing", that is, its legal and extraorganizational, aspect. This work argues that the failure to recognize this relationship has contributed to the failure of extant theorizing about the firm, in formulation, logical consistency and predictive capacity.

Although proof of this proposition is beyond the scope of the present work, this work maintains that existing legal theories of the corporation and of the firm fail to sufficiently take into account the fact that, while the corporation or the firm "in the world" is considered to be a single actor, at least as a matter of law, it does not act externally as a monolithic entity,<sup>33</sup> since that entity is incapable of action per se. Instead, the corporation acts, and can act, externally only by means of individual human actors who animate or vivify the corporation as an entity capable of action.<sup>34</sup>

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<sup>33</sup> See the discussion in Chapter Two in the sections entitled "The Neoclassical Firm as a Single Economic Actor" and "History of the Development of the Modern Business Corporation"; and in Chapter Three in the sections entitled "Barriers to Unified Action", "Organizations as Political Systems" and "Forms of Corporations – Legal and Organizational Variants".

<sup>34</sup> *Ibid*, particularly the discussion in Chapter Two; and see also the discussion in Chapter One in the sections entitled "Assumptions About the Corporation" and "The Corporation and Corporate Essentialism in Law".

Consequently, any legal theory of the corporation must recognize that the corporation is, or, at least, involves, a species of organization, composed of real persons, and not a pure economic or production function. Chapters One through Three explicate how corporations act “in the real world”.

Legal theory must recognize that the corporation, as an organization, involves a group or groups of real persons, who severally may have a multiplicity of ends or goals, working toward the attainment of some particular collective end(s), goal(s), or objective(s).<sup>35</sup> Weber and other authorities explain that an organization is constituted by some order or authority pursuant to which it is established, and by which it is operated and regulated and pursuant to which other rules are adopted and administered, rationally in pursuance of its agreed common interests.<sup>36</sup> In the case of the corporation, a primary goal or objective involves economic activity, but that does not necessarily exhaust all the goals or objectives for the attainment of which it is constituted or operated.<sup>37</sup>

This work argues that concentration of focus on the “outer shell” or “outward facing” aspect of the corporation, the specifically “legal” attributes of the corporation, has inhibited development of a legal theory “of”, as well as “about”, the corporation; a theory about not only what the corporation “is”, from legal and other perspectives, but also what it “does” in the real world, which involves describing how the corporation, both statically and in action through real human actors, is experienced by external parties. Such description of what it is and what it does must acknowledge not only its external presentation as a “single legal entity”, but also its “inner core” or “inward-facing” aspect as an organization, which is also relevant to how it takes action externally. As argued in this work, economic analysis of the corporation or firm, classically, at least, and arguably even latterly, has largely ignored this “inner/outer” and “inward/outward” facing distinction.

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<sup>35</sup> Supra note 21.

<sup>36</sup> See the discussion in Chapter Four in the section entitled "Groups of People or Social Units", particularly under the heading "Max Weber on Organizations and Related Matters", and under each of the subheadings thereunder; and the discussion in Chapter Five in the section entitled "Structure, Process, and Personnel", especially under the heading "Rational-Legal Authority, Administration, and Bureaucracy".

<sup>37</sup> See the discussion in Chapter Three in the sections entitled "Barriers to Unified Action", "Organizations as Political Systems", and "Forms of Corporations – Legal and Organizational Variants"; and in Chapter Six, especially in the section entitled "Organizational Goals and Intraorganizational Goals".



By concentrating on the specifically “legal” attributes of the corporation, extant legal theory has generally failed to go beyond them. That is to say, much extant legal theory of the corporation provides a theory of “why” that particular legal entity has those particular legal attributes, in terms of “what” objectives those attributes accomplish. Often, this involves an answer to the effect that the corporation has those particular attributes “because they work” or “because they are there”, because they allow certain results to be derived, or because the institution of these attributes with respect to (or “in”) the corporation has been borne out as necessary by experience.

A theory of that nature attempts to explain the “why” of the corporation as an entity and as a separate legal entity or SLE, from a perspective that is largely theoretical and ahistorical, without attempting to explain the “what” or “whereof” of the corporation, that of which it consists. Instead, such a theory focuses solely on its external operations. This work maintains, instead, that the (predominantly) “external” legal attributes of the corporation must be interpreted and applied in relation to its (predominantly) “internal” organizational attributes.

A question that arises, or should arise, in theorizing about the corporation as a matter of law, which is to say “in legal theory”, is to what extent it is necessary and desirable to endeavour to reconcile those two aspects, and whether, and, if so, how, this might be effected. This subject will be considered further in this introduction and in the main text, below, particularly in Chapters Seven through Ten inclusive.

### **“CORPORATIVE” AND “CORPORATIVITY” AS USED IN THIS WORK**

As just mentioned, this work refers to this dual nature of the corporation as “corporative” and the characteristic or attribute of possessing such dual nature as “corporativity”. No use of the latter term has been found in mainstream academic literature in the English language, except quite recently (during the late stage of development of the present work) principally in works by Russian authors apparently as a translation of a Russian word, *корпоративность*, where it is apparently used as a synonym of, and is often translated as, “corporate culture” or “organizational culture”.<sup>38</sup>

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<sup>38</sup> Nina A Ivanenko, Elena A Burdukovskaya, Aislul B Yunusova, Rezeda F Mukhametshina, Valeryi A Letyaev, Liliya R Islamova & Tatyana S Yeremeyeva, *Corporativity as a Condition for Developing Teaching Staff*, 7:4 Review of European Studies (2015) 49. While this work uses the expression “corporativity” in the sense explained in the text above, that term is *not* used in any of the literature cited; instead, the terms “organizational culture” or “corporate culture” are used in the English translations of the titles of such literature. Certain aspects of the usage of this term in this literature coincides with the use of the term in the present work, including the feature of the stability of the group

It is used in connection with solidarity in professional goals and values, and otherwise relating to joint activity or synergism, and competitiveness, in the context of educational institutions.

The use of “corporative” and “corporativity” in this work is not to be confused either with that usage or with “corporatism”, sometimes referenced as “corporativism”, the socioeconomic and political doctrine in which major interest groups or “corporate” groups in society represent their members in society at large, such that the society or polity is organized, and characterized by the actions and interactions of, corporate groups, rather than by individuals. Those major interest groups or corporate groups may be based on common interests characterized in terms of business, agriculture, labour, military, scientific, clan, ethnic, patronage, religious, or other affiliations.<sup>39</sup>

In this work, the terms “corporative” and “corporativity” refer to the dual nature of corporations and other separate legal entities, and not to the social/political world exclusively, namely, the division of the state, polity, and society, into, or their composition by, interest groups exclusively representing a particular interest at the state or sociopolitical level.

In effect, in this work, corporativity refers to a characteristic of the corporation or the organization itself, rather than to a characteristic of the society or polity in which it resides.

### **“CORPORATIVISM” AND “CORPORATISM” DISTINGUISHED**

The principal expositor of corporatism, Howard J. Wiarda, traced the origins of modern corporatism to a commission established by Pope Leo XIII in 1881 to study corporatism. It reported in 1884 in Freiburg, defining “corporatism” as a “system of social organization that has at its base the grouping of men according to the community of their natural interests and social functions, and as true and proper organs of the state they direct and coordinate labor and capital in matters of common interest.”<sup>40</sup> Wiarda traces this, in turn, to passages of the Bible, principally, I

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over time. See also the later article by Nina A Ivanenko, Elena A Burdukovskaya, Aislu B Yunusova, Rezeda F Mukhametshina, Valeryi A Letyaev, Liliya R Islamova & Tatyana S Yeremeyeva, *Basic Principles for Forming Teaching Staffs' Competitiveness in Vocational Training Institutions* 7:5 Review of European Studies (2015) 118. Perhaps derived from the French adjectives “corporatif” and “corporative”, there appears to be some recent minimal, non-paradigmatic, and non-specific, use of the term “corporative” to mean simply “corporate”, or, more specifically, “of or relating to a corporation”.

<sup>39</sup> Howard J Wiarda, *Corporatism and Comparative Politics: The Other Great “Ism”* (Armonk New York: M. E. Sharpe, 1997) at 22-23.

<sup>40</sup> *Ibid* at 35.

Corinthians 12:12-31, in which Paul discusses politics and society as an organic whole, like the human body, the organs of which are functional elements within the polity and society.<sup>41</sup>

According to Wiarda, what is generally described as “progressive” corporatism developed, commencing in the 1850s as an antidote to classical liberalism and Marxism,<sup>42</sup> partly as a way in which the Catholic church and clergy could ameliorate the threat of social disturbance with a more pacific and collegial outlook on society and the polity. Emile Durkheim hoped that a variant he called “solidarism” would effect a change in the role of labour, and promote conflict resolution, by creating an organic social solidarity with other elements of society, as a collective, thereby avoiding social dislocation and *anomie*.<sup>43</sup> Liberal corporatism, attributed to John Stuart Mill, as a counter-balance for labour and other economic organizations to management power and influence<sup>44</sup>, was an influential element in “progressivism” and “progressive corporatism” in the United States in the early twentieth century, including in the New Deal.<sup>45</sup>

Importantly, corporatism was discredited in practice, in the opinions of many social theorists, commentators, and observers as a result of its significant association with Fascism, especially in Italy. Its prominence there was influenced by an early constitution which was proclaimed in Fiume in Italy in 1920, which established a corporatist state in which nine corporations (plus one representing “superior individuals”) represented various sectors of the economy.<sup>46</sup> Italian Fascism aggregated separate economic spheres represented individually in a governing apparatus the level of the state or polity, which coordinated and harmonized those spheres in that unity.<sup>47</sup> The fascist state corporatism in Italy, in turn, influenced Fascists in other countries, such as Austria, Portugal, Estonia, and Latvia, where Fascist governments were established, and also in Fascist political groups in Britain and elsewhere.

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<sup>41</sup> *Ibid* at 28.

<sup>42</sup> *Ibid* at 35.

<sup>43</sup> Anthony Black, *Guilds and Civil Society in European Political Thought from the Twelfth Century to the Present* (London and New York: Methuen, 1984) at 226 and 228.

<sup>44</sup> Samuel Gregg, *The Commercial Society: Foundations and Challenges in a Global Age* (Lanham, USA., and Plymouth, UK., Lexington Books, 2007) at 109.

<sup>45</sup> Wiarda, *supra* note 39 at 134.

<sup>46</sup> Stanley G Payne, *A History of Fascism, 1914-1945* (London: Routledge, 1996) at 64.

<sup>47</sup> Philip Morgan, *Fascism in Europe, 1919-1945* (London: Routledge, 2003) at 170.

Jurisdictions as varied as Germany, Ireland, the Netherlands, Italy, Switzerland, Belgium, Luxembourg and the Scandinavian countries have been considered to exemplify “neo-corporatist” political economies in which labour, employers, and national governments would negotiate and manage a national economy. Nobel laureate Edmund Phelps has also described what he calls “new corporatism” in which he claims that modern states subordinate the individual to the community and state.<sup>48</sup> This characteristic of “new state corporatism” will be shown to be antithetical to the corporative organization and to the corporativity and corporativism delineated in this work.

As explained above, the present work employs the term “corporative” and “corporativism” in relation to the dual nature of the corporation as both a separate legal entity and an organization, rather than in relation to the composition of the state or polity itself.

With this statement of the objectives of the present work, the assumptions of modern corporate law, corporate governance, and legal theory present themselves for consideration. In this regard, a common sense or everyday life identification of such assumptions must suffice for the purposes of the present inquiry, at least if an extensive, even if not infinite, regression of facts and circumstances is to be avoided. This introduction will make certain prefatory remarks in this regard and, in order not to burden such preface, without attribution or discussion of sources. A more thorough examination appears in Chapters Two and Three.

## **ASSUMPTIONS OF LIBERAL ECONOMICS AND OF LEGAL THEORY**

### **Economy, Society, and Polity Distinguished**

This work positions the modern business corporation within a framework which is relatively undifferentiated in respect of its economic, social, and political characteristics. That is to say, it considers “economic activities”, “social activities”, “political activities” as situated within a broad spectrum of human activity, activity which the humans engaging in it do not consciously separate into different spheres of action, whether “economic”, “social”, or “political”. Their perceived sphere of action is, instead, “human”, expressed in the broadest possible way.

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<sup>48</sup> Edmund Phelps, *Mass Flourishing: How Grassroots Innovation Created Jobs, Challenge, and Change* (Princeton and Oxford: Princeton University Press, 2013).

Of course, this is not the position adopted by classical and neoclassical economics, which has had, historically, an extremely significant influence on discussion of the “firm” and the “corporation”, in disciplines and fields other than economics, including law. As just indicated, this work advocates a holistic approach to the “firm” and the “corporation”, but not one which would embrace only learning from one discipline or field and exclude others. While this perspective is extremely important to the corporative theory or corporative perspective developed in this work, an explication of its dimensions, even summarily, would distract significantly from the articulation of the corporative theory or corporative perspective. Accordingly, the exploration of those issues is presented in Appendix B.

### ***Disembeddedness of the Economy***

Classical liberal economics assumes, firstly, that the economy, the society, and the polity are strictly separated.<sup>49</sup> Secondly, it considers the economy to be largely a “private” sphere,<sup>50</sup> which is assumed, thirdly, to be divorced from other “public” spheres.<sup>51</sup> Thus, fourthly, the community, society, and polity can each be analyzed, as such, separately, employing a methodology appropriate for each. Thus, analysis of the economic sphere would proceed in a manner which is intrinsically different from the method of analysis which is appropriate to the society and polity. The method of analysis appropriate to the economic sphere would, instead, be appropriate to the economic sphere alone.<sup>52</sup> Fifthly, classical liberal economics thus envisions a relationship between society and the economy in which the economy is part of the society, but operates largely independently. Similarly, the relationship between society in the polity is one in which the economy and the polity are largely separated from one another. Indeed, the principal relationship between the two involves the polity intervening in the economy, principally to promote aggregate social welfare.<sup>53</sup>

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<sup>49</sup> See the discussion in Appendix B, particularly in Chapter B1, especially in the section entitled "Separation of Economic, Social, and Political Functions".

<sup>50</sup> See the discussion in Appendix B, particularly in Chapter B1, especially in the section entitled "The Situation of the Economy in the "Private" Sphere".

<sup>51</sup> See the discussion in Appendix B, particularly in Chapter B1, especially in the section entitled "Actual and Analytical Separation of Private and Public Spheres".

<sup>52</sup> See the discussion in Appendix B, particularly in Chapter B2.

<sup>53</sup> See the discussion in Appendix B, particularly in Chapter B3.

### *Embeddedness of the Economy and History*

Many of these assumptions harken back to, and perhaps even beyond, Ancient Greece and Ancient Rome.<sup>54</sup> At such time, the word “economy” referred to household and other activities that were essentially “life-supporting” in that they enabled a citizen to live, and to live a certain kind of life appropriate to that status, a status not then widely enjoyed within the polity. Such “economic” activity enabled a citizen to engage in the kind of discussion, debate, and other aspects of public affairs that were considered to be the proper activity of citizens, who were, at those times, mainly members of the landed aristocracy and current and former civil and military authorities.<sup>55</sup>

Such “household” activity, being primarily conducted within the household itself and its environs, and thus out of “public” view, was considered to be “private” as opposed to “public” in nature.<sup>56</sup> Of course, in Ancient Greece and in Ancient Rome, the “household”, considered geographically, embraced lands appurtenant to the country dwelling of the citizen-aristocrat. Thus, it frequently involved activities that today would be considered agricultural or industrial pursuits, such as the manufacture of wine or oil, operation of mines, the conduct of other metallurgical activities, and other manufacturing. It seemed not to involve trading, however, as that pursuit was not then considered as a suitable activity for citizens and aristocrats, as in Britain and much of Europe in more recent periods.<sup>57</sup>

Activities that were “economic” in this sense were considered to relate to facilitating life as a human being, and not to “public” life as a citizen. Economic life enabled and was essential to civic, social, and political life and activity. Thus, such economic activity was conducted apart from social and political activity. It was, moreover, considered to deal almost exclusively with matters not considered suitable for public discussion or action. Thus understood, “economic” matters were both implicitly and explicitly segregated from “social” and “political” matters, which allowed a simplified conception of the nature of “economic” man which was abstracted from his social and

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<sup>54</sup> See the discussion in Chapter B1, notably in the section entitled "Separation of Economic, Social, and Political Functions".

<sup>55</sup> See the discussion in Chapter B1, especially in the sections entitled "The Situation of the Economy in the "Private" Sphere", and "Actual and Analytical Separation of Private and Public Spheres".

<sup>56</sup> See the discussion in Chapter B1, particularly in the sections entitled "The Situation of the Economy in the "Private" Sphere" and "Actual and Analytical Separation of Private and Public Spheres".

<sup>57</sup> *Ibid.*

political contexts.<sup>58</sup> The historical background to the separation of economic life (or aspects or elements of economic life) from other life (or aspects or elements of life), including social and political, and to the public/private distinction is important in explaining the origins and content of those concepts; however, those concepts are no longer thought to operate in that fashion.<sup>59</sup>

Like other historically generated opposites, pairs or binaries, the public/private distinction has been the subject of considerable contestation in the last two or three centuries and, most especially, in the past half century, not only in law, but also in other fields.<sup>60</sup> This is also the case with respect to the economic/social, economic/political, and social/political “distinctions”.<sup>61</sup> However, although contested, the involvement of the society or polity in the economy has been assumed to be justified in terms of seeking to promote aggregate social welfare, whether by means of competition, addressing inequality of bargaining power, compensating for information asymmetries, or otherwise.<sup>62</sup>

Classical liberal political economy did not dispute, but instead, assumed the reasonableness of such distinctions.<sup>63</sup> This work will argue that the separation of the economy from its ambient society and polity is not justified theoretically, historically, or empirically; with the result that the methodology of sociopolitical/socioeconomic analysis can be treated as a more acceptable alternative to classical economic theory, particularly when combined with later developments in economic theory, such as institutional economics and behavioural economics, than has historically been the case to date.<sup>64</sup>

Further, just as this work embraces a holistic conception of human activity involving combined economic, social, political aspects,<sup>65</sup> this work disputes the assumptions made by classical neoclassical economics with respect to the nature of man, including atomistic utilitarianism,<sup>66</sup> and

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<sup>58</sup> See the discussion in Chapters B1 and B2.

<sup>59</sup> *Ibid.*

<sup>60</sup> See the discussion in Chapter B1 in the section entitled "Actual and Analytical Separation of Private and Public Spheres", discussing, in particular, the positions taken on this issue by Habermas, Arendt, and others.

<sup>61</sup> *Ibid.*

<sup>62</sup> See the discussion in Chapter B2.

<sup>63</sup> *Ibid.*

<sup>64</sup> See the discussion in Chapter B3.

<sup>65</sup> See the discussion in Chapters Four through Six inclusive.

<sup>66</sup> See the discussion in Chapter B4 in the section entitled "Atomistic Utilitarianism"; and in Chapter B5 in the sections entitled "Individual Determination of Utility", "Similarity of Desires and Utility", and "Atomism and Methodological Individualism".

atomistic and methodological individualism,<sup>67</sup> absolute rationality,<sup>68</sup> utilitarian independent market transactions,<sup>69</sup> and the tendency of market prices towards equilibrium values.<sup>70</sup>

### **The Firm as Production Function – The “Black Box”**

In classical liberal economics, economic activity is much more broadly construed, and includes production, distribution and consumption of goods and services, also including such activities as manufacturing and trading. The goods and services thus produced would be consumed or sold, traded, or bartered for something considered by the producer to be of value. In that classical liberal model, the economic actor, characterized as “the firm”, is a single actor who acts in the economy, which is within the private sphere and separate from the public sphere of society and the polity. The firm is typically characterized by an owner, often an entrepreneur who establishes and provides capital for its operations, a manager who directs the operations of the firm on a day-to-day basis (at least if this function is not performed by the owner), and perhaps a few employees of the owner/firm. On these assumptions, all of the actions and operations of the firm and of its owner, managers and employees can be analyzed in purely economic terms. Such analysis proceeds by measuring inputs, often consisting of labour, materials, and capital, and outputs.<sup>71</sup>

Thus, the analysis of the firm is limited to its role in producing goods and services for use or sale, most often on a market. The firm is profitable and, ordinarily, successful, in cases in which the value of the outputs as priced in the market is greater than the value of the inputs in terms of the price paid by the firm therefor. As such, the firm is a “black box” with respect to which the inputs and outputs can be determined but which is otherwise uninteresting. Instead, its operations are principally affected by, and affect, supply and demand.<sup>72</sup> As will be noted, this analysis of the firm

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<sup>67</sup> See the discussion in Chapter B2 in the sections entitled "Socialization and Models of Man", Thomas Hobbes's Conception of Man" and "Adam Smith's Conception of Man"; and in Chapter B4 in the sections entitled "Atomistic Utilitarianism", and "Atomism and Methodological Individualism"; and in Chapter B5 in the sections entitled "Individual Determination of Utility", "Similarity of Desires and Utility", and "Desire and Availability Mismatch".

<sup>68</sup> See the discussion in Chapter B5, particularly in the section entitled "Independent Rational Informed Actors".

<sup>69</sup> See the discussion in Chapter B5, particularly in the section entitled "Utilitarian Independent Market Transactions".

<sup>70</sup> See the discussion in Chapter B5, particularly in the section entitled "Market Prices Tend Towards an Equilibrium".

<sup>71</sup> See the discussion in Chapter One, particularly in the section entitled "Assumptions about the Corporation"; and in Chapter Two, especially in the section entitled "The Neoclassical Firm as a Single Economic Actor".

<sup>72</sup> *Ibid.*



as a production function, or as a supply and demand function, not only occludes what makes the firm interesting in socioeconomic and political terms, but even “invisibilizes” the firm *in toto*.<sup>73</sup>

The legal theory of the corporation and of corporate governance, and academic and public discourse relating to the same, to date, has, in the main, employed approaches to the nature of the corporation that are generally congruent with classical economic theory. For example, it has assumed, frequently without examination, that the corporation is a single actor. It has often treated the corporation as a “black box”, devoid of organizational attributes.<sup>74</sup> Corporate law and corporate governance have generally incorporated, or, at least, have not significantly contested, such assumptions. In particular, from the perspective of regulation, corporations have been treated as a single actor pursuing a single objective of maximization of profit in the short term, and arguably disregarding or minimizing considerations incompatible with that single objective.<sup>75</sup>

To be sure, certain aspects of the “input” and “output” of the firm have been regulated by legislative, administrative, or other legal or regulatory action. For example, certain materials forming part of the “input” in a manufacturing process may be subject to quality, safety, and other standards; and certain practices, such as resale price maintenance and other anticompetitive practices, may be proscribed on the “output” side. With respect to the “human” factors involved in the “input”, employment and other standards may be applicable as a matter of law. Such restrictions may be considered as equalizing inequalities of bargaining power, as promoting competition, or as restraining acts tending to reduce or limit competition; however, such restrictions may be seen as comporting with the production model of the firm, as envisioned in classical political economy. This is assumed in the present work for purposes of discussion here.

This work will challenge these conventional assumptions.

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<sup>73</sup> See, in particular, the discussion in Chapter Two in the section entitled “The Neoclassical Firm as a Single Economic Actor” and therein under the headings “The “Black Boxes” of Economic Theory”, “The Model of the Firm and Its Lack of Organizational Attributes”, and “The Entrepreneurial Model of the Neoclassical Firm and Economic Action”.

<sup>74</sup> *Ibid.*

<sup>75</sup> These arguments are controverted in Chapter Six throughout the chapter; however, see, in particular, the discussion in the sections entitled “Existence and Typology of Organizational Goals and Objectives”, especially under the heading “Official or Explicit Goals and Operative or Implicit Goals” and therein under the subheadings “Profit as Superordinate Goal – Official or Operative Goal” and “Alternatives to Profit as Superordinate Goal”.

### **The Firm as a Single Rational Economic Actor and as a Moral Actor**

As a single economic actor, modelled on the “firm” as a single entrepreneur, it has generally been assumed that the actions of a corporation vis-à-vis its external environment are univariate, being determined solely by a decision of the corporation. Each external activity is undertaken by, and is determined by, a decision of, “the corporation” acting independently and unambiguously as one actor, acting rationally, based on full and complete information, with the goal of maximizing profit, usually assumed to be determined in the short term. In effect, this singularity of action by a corporation is thought to result, at least in part, from its structure and process as a “top-down” or “command and control” organization.<sup>76</sup> As such an organization, decisions are said to be made at the top of the corporate hierarchy and are successively communicated “down” to successively lower levels of the hierarchy.<sup>77</sup> It is assumed that all decisions or determinations are made on a solely economic basis, taking into account only economic benefits to the corporation.

Further, it is assumed that it is possible to identify the makers of particular decisions within the hierarchy and to identify those charged with implementing those decisions at each successive level of the hierarchy. It is assumed, also, that those at lower levels of the hierarchy are aware of decisions and determinations made at levels above them in the hierarchy; and that decisions are implemented by organizational “fiat” or mandate at successively lower levels of the hierarchy.<sup>78</sup> Those at the highest levels of the hierarchy “command” and “control” those at successively lower levels. Similarly, those persons at a superior level of the hierarchy “command” and “control” someone at a lower level and may do so even respect to persons at successively lower levels.<sup>79</sup>

Further, it is assumed that all decisions and determinations made at higher levels of hierarchy are communicated to all of those lower levels. It is also assumed that decisions and determinations made at various levels of the hierarchy are decisions or determinations of, and which bind, the corporation, and those at various levels of its hierarchy. Consequently, it is assumed that failure or

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<sup>76</sup> As already explained, this flows from the model of the “firm” as involving a single entrepreneur who provides the capital and makes the decisions, directing servants or employees accordingly.

<sup>77</sup> The legal position of employees vis-à-vis the corporation, derived from master and servant law and from agency law, as discussed in some detail in Chapter A3 in the sections entitled “Organizational Liability for Acts of Corporate Actors” and “The Corporation as Principal”.

<sup>78</sup> *Ibid.*

<sup>79</sup> *Ibid.*

refusal to act in accordance with decisions made at higher levels of the hierarchy will incur sanctions, possibly even extending to dismissal. These assumptions are recognized and under various legal principles, including agency, vicarious liability, and *respondeat superior*.<sup>80</sup>

Applicable legal principles, it is thought, generally assume that the firm of classical economics, the production function firm or the supply and demand function firm, is an accurate description of the business corporation in modernity; that the firm can act only through agents; and that the agents enact its business pursuant to authority delegated to them from higher order agents of the firm or corporation, up to and including the highest authority in the corporation. Such legal principles also assume, generally speaking, that only actions within such delegated authority (which may, in some cases, include apparent or ostensible authority) are acts of, and bind, the corporation.

However, many of these assumptions have been challenged in the past century, both in general and, in particular, with reference to the corporation. One example is rationality. Challenges to the rationality of human and organizational decision-making has not been limited to those involving corporations.<sup>81</sup> Similarly, assumptions concerning complete information have been challenged by leaders in various disciplines, again not limited to decisions made by corporations or even by organizations generally.<sup>82</sup> Further, the assumption that all decisions made by an organization having economic objectives are made in view of economic considerations is only now being challenged more specifically, including with respect to corporations, and including with respect to profit, and more specifically short-term, profit seeking. As this work will demonstrate, decision-makers and decision-influencers within corporations may take into account various other factors than economic ones and, in particular, short term profit objectives.<sup>83</sup>

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<sup>80</sup> See the discussion in Chapter Five, notably in the sections entitled "Structure, Process, and Personnel", "Organizational Structure", "Organizational Process", and "Organizational Personnel"; and in Chapter A3 in the sections entitled "Organizational Liability for Acts of Corporate Actors" and "The Corporation as Principal", especially under the headings "Agency Law Duties", "Officer Status", "Intracorporate Agency", "Liability and Indemnification of Directors, Officers, and Others", and "Conclusion – The Intracorporate Organization of the Corporation in Law".

<sup>81</sup> See the discussion in Chapter Five, particularly in the sections entitled "Structure, Process, and Personnel" and "Organizational Structure"; in Chapter B4, especially in the section entitled "Atomistic Utilitarianism"; and in Chapter B5, especially in the sections entitled "Individual Determination of Utility", "Independent Rational Informed Actors" and "Utilitarian Independent Market Transactions".

<sup>82</sup> *Ibid.*

<sup>83</sup> *Supra* note 75.

Often, only scant consideration is given, in law, to the effect of unauthorized actions, including the question whether the agent or employee is liable for such acts, not only to counterparties (which, for present purposes, is assumed to include any party affected by an act or omission of the corporation), but also to the corporation. This lack of full consideration may result from the inherent difficulties in determining and assigning responsibility for acts or omissions within the corporation itself, but it may also result from the frequent lack of a readily available means by which the counterparty or the corporation itself may seek redress. Apart from questions of proof, and apportionment of liability, including any contributory liability, even in cases in which it is not difficult to assess the resultant damages, there may be no adequate means of recovering them. Simply put, the loss may exceed the ability of the agent or agents involved to indemnify the injured party (the corporation itself) therefor. It may be too great for them to bear.<sup>84</sup>

As the present analysis will demonstrate, these difficulties are not unexpected or inappropriate, in theory, since a significant attribute of the corporation, as a matter of law, involves it operating as a single legal entity, characterized by limited liability and asset partitioning, subject to central management authority, and surviving changes in ownership and management. In effect, the outer legal shell of the corporation is intended to internalize the decision-making process and operations of the corporation among its participants, such that its outward face is that of the corporation itself, and of the corporation alone.

It is an artifact of corporativity that it presents the following paradox: the same characteristics that invisibilize the internal workings of the corporation vis-à-vis outsiders allow those outsiders to reify the corporation and by means of such “entification” to consider the corporation as wholly separate and apart from the organization by which it is constituted or instituted, and which it constitutes or institutes. This reification or “entification” permits outsiders to characterize the corporation itself as possessing moral character, often as being “evil” (or, for those who chose to do so, as “good”). Only recognition of the corporativity of the corporation will resolve this paradox.

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<sup>84</sup> See the discussion in Chapter A3, particularly in the sections entitled "Organizational Liability for Acts of Corporate Actors"; and "The Corporation as Principal", especially under the headings "Agency Law Duties and "Intracorporate Agency".

Of course, the corporation is, in itself, neither good nor evil, but can be an instrument of either, in particular circumstances, if by that is meant “performing” acts or omitting to perform acts which have positive or negative effects, as the case may be. Those acts or omissions are determined and instituted in accordance with its organizational structure and processes, which may themselves be conducive to the attainment of some objectives or others. The nature of those objectives may be assessed by those inclined to do so as “good” or “bad” in the same sense. However, the question whether an organization, as such, is “good” or “bad” does not appear to be apt for consideration. In general, corporations are far too numerous, diffuse, and diverse to permit verification of such a statement.

Instead, a corporation is like any other organization in this respect. Other organizations are not by reason only of their external legal attributes characterized as “good” or as “evil”. Instead, any such characterization of other organizations is based on the conduct of the organization in relation to the society and polity generally and over time, and is not ordinarily determined *ab initio* by its particular legal attributes alone. This should be admitted to be true of corporations, as well.

### **Acts or Omissions of the Corporation**

#### ***Externalities and the Pursuit of Profit***

It can readily be seen that these classical assumptions, however erroneous, are not inconsistent with the imputation of responsibility to the corporation for acts or omissions emanating from its activities. In particular, where loss is occasioned in a situation in which corporate actors are involved, it is often assumed by some that the corporation (as a “bad” actor) has some responsibility for such loss eventuating. Once that assumption, however justified, is made, it may be assumed, in turn, that some person or body within the corporation must have done something which occasioned such loss or failed to do something which might have prevented such loss from transpiring. The effect of such thinking would be to impose strict liability for all corporate actions.

It is also generally assumed that a corporation, as the sole economic actor, at least in relation to external parties, is the exclusive beneficiary of such actions or inactions, as measured by immediate profit generated or immediate cost avoided. Hence, it is often considered that such actions or inactions attributable to the corporation are motivated solely by greed and the pursuit of private

interests of the corporation and its owners,<sup>85</sup> and, consequently, that such greed and pursuit of private interest must be restrained by government action, imposing liability on the corporation and, in certain cases, on the persons and bodies within the corporation considered to have been responsible for taking or implementing the relevant decision or decisions.

### ***Group Decision Making, Information, and Responsibility***

This work will demonstrate the inadequacy of these assumptions. For example, it will be shown that the modern business corporation cannot be considered as a “top-down” or “command and control” organization.<sup>86</sup> Of course, all decisions are not made at the highest level of the corporate hierarchy. Instead, in some corporations, decisions are taken at the lowest possible level of the hierarchy at which such decisions could effectively be taken; and such decisions are not necessarily communicated to superior levels of the hierarchy. More generally, often decisions are not immediately referable beyond the level or group at which, and by whom, the decision is taken, and thus are not disseminated beyond those affected. In other cases, only a relatively modest distribution of the decision may be required for purposes of instituting it as an act of the corporation, implementing it, and giving it effect otherwise. Such distribution may be effected laterally or hierarchically, and in such case, across or up or down the chain of hierarchy, or both.<sup>87</sup>

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<sup>85</sup> *Supra* note 75.

<sup>86</sup> See the discussion in: Chapter Three in the section entitled "Forms of Corporations – Legal and Organizational Variants" under the heading "M-Form Corporations", particularly under the subheadings "Relationships among SBUs" and "Multinational Enterprise Organizational Structure"; Chapter Four in the section entitled "Working Definitions and Formal Definitions", particularly under the heading "Formal Definitions" and therein under the subheading "Philip Selznick Definition"; Chapter Five in the section entitled "Structure, Process, and Personnel" under the heading "Rational-Legal Authority, Administration, and Bureaucracy", and under the heading "Individual Bounded Rationality, and Rulemaking" and therein under the subheading "Bounded Rationality, and Organizational and Personal Meeting", and in the section entitled "Organizational Structure" under the heading "Fayol and Modern Business Management" and therein under the subheading "Fayol on Process"; and under the heading "Organizational Process" under the heading "Assessments of Behaviour".

See, also, the discussion below in this Introduction in the next following heading "Making and Implementing Decisions"; and in the section entitled "A Corporative Analysis of Organizational Structure and Process" under the heading "Participation, Responsibility, and Private and Public Regulation" and therein under the subheading "Corporate Culture, "Tone at the Top" or "Tone Throughout".

<sup>87</sup> See the discussion in: Chapter Two in the section entitled "History of the Development of the Modern Business Corporation" under the heading "Strategy and Structure" and therein under the subheading "Distribution of Decision Making Authority"; Chapter Three in the section entitled "Barriers to Unified Action under the heading "Diffusion of Rationality, Information, and Decision Making"; and in Chapter Ten in the section entitled "Short-Termism, Long-Termism, and Indefinite Existence" under the headings "The Problem Stated", "Short-Termism and Long-Termism – On the Merits", and "Relationships between the Organization and Short-Termism"; and in the Conclusion in the section entitled "The Breadth and Scope of This Book" under the heading "Management Ownership Separation and Intraorganizational Decision Making".

Frequently, in actual situations “in the real world”, however, it is difficult to determine who is responsible for making and for implementing a particular decision. Among other things, even in circumstances in which it is, or is thought to be, reasonably clear by whom, or at what level, a decision has been made or should have been made (at least in accordance with the rules of the formal organization), not all decisions are recorded. Such failure to record decisions may arise deliberately, as a result of the prevalence of higher priorities of time and attention, or as a result of inattention, inaction, misadventure or negligence.

Consequently, the difficulties of ascribing responsibility for particular decisions to particular persons, or even to functions, groups, units and sub-units of the corporation, are very often considerable, even for the corporation itself. That is to say, the diffuse nature of organizational decision-making and decision-influencing in a complex organization, with its particular structure and processes, may prevent even those within the corporation from being able to clearly assign responsibility for particular decisions or to implement positive or negative sanctions therefor.<sup>88</sup>

Often, where decisions are made at a superior level of the hierarchy, the information presented to the decision-maker is heavily influenced by the selection of such information by someone at a lower level of the hierarchy. Information selection can sometimes be determinative of the result of the decision sought. The selection of information itself involves a decision.<sup>89</sup> For such a selection to be considered rational and likely to produce the “best” decision, the subordinate charged with presenting the information must select the elements considered to be of greatest salience with respect to the instant decision.

In turn, the choice of information made by such subordinate may be affected by decisions of others as to the derivation of such information, including its content, as to its availability, the format and other conditions in which it is available, and other factors. However, sometimes relevant information is suppressed, deliberately or otherwise, and, on some occasions, sometimes

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<sup>88</sup> *Ibid.*

<sup>89</sup> See the discussion in Chapter Six, particularly in the sections entitled "Organizational Goals and Intraorganizational Goals" and therein under the heading "Intraorganizational Goals, Power, and Loyalty and the subheading "Information in Sanctions as Sources of Intraorganizational Power".

information of lesser relevance or probity to the decision or to the decision that is perceived to be more desirable (to some, and on some basis) is presented in lieu of information having superior relevance and utility.<sup>90</sup> In other cases, it may not be possible to identify the decision makers and decision influencers with any real precision.

### ***Making and Implementing Decisions***

Similarly, it cannot always be assumed that a decision, once made, will be implemented in accordance with its terms. In some cases, the implementation of a decision can be delayed or deferred. In other cases, a real or constructed misapprehension of the nature and effect of the decision may result in its misapplication or even in its non-application. It is often assumed that failure to implement properly made decisions of the corporation will invoke sanctions (even dismissal of employees in appropriate cases) against those who are required to implement them, but this may not transpire.<sup>91</sup>

Of course, problems of proof arise. Often, as was noted above, it is difficult to establish that decisions were made in accordance with appropriate authorities and procedures. A party affected might argue that the decision was not properly made. Such party might argue that the decision was not communicated in an appropriate fashion to become known to, and binding upon, the party involved. A rule may be thought to be inapplicable to the particular group, function, unit or sub-unit concerned, or, even if applicable to that group, to be otherwise inapplicable, in the circumstances of the case, such as by reason of extenuating or other circumstances differentiating the instant situation from that to which the rule applies or for which it was devised.

Individuals and groups making or implementing the decision may appropriate rents from the decision-making or decision implementation process, deriving benefits to themselves. In so doing, they are not acting on behalf of the corporation but are acting, instead, on the basis of economic self-interest.<sup>92</sup> Such rent appropriation may take the form of non-economic benefits captured by the decision-maker or decision implementer. For example, the result of the decision may be to

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<sup>90</sup> See the discussion in Chapters Three, particularly in the section entitled "Barriers to Unified Action" and "Organizations as Political Systems"; and in Chapter Five, particularly in the section entitled "Structure, Process, and Personnel".

<sup>91</sup> See the discussion in Chapter Five, in each of its constitutive sections.

<sup>92</sup> *Supra* note 90.



increase the prestige or influence of the individual or group concerned. Again, the basis on which the decision is made or implemented may not involve economic considerations at all, but may involve considerations of power, prestige, influence, or other social benefits. Considerations of fairness and justice may also enter into this process.<sup>93</sup>

As is the case with other types of organizations, whatever the formal organization of the corporation under consideration, its informal organization must also be considered in seeking to describe how it operates as a matter of fact. That is to say, against the formal structure and processes and personnel of the corporation must often (if not invariably) be overlaid a structure, and processes and personnel of an informal, but no less relevant, nature.<sup>94</sup> A complete description of both formal and informal structure, processes, and personnel, is required to assemble a veridical characterization of the corporation as it is instituted and operated “in the real world”.

Of course, it is the corporation as instituted and operated in that real world that is, or should be, of interest to analysts of the ambient economic, social, and political environments, and to promoting efficacious, and reducing inefficacious, behaviours and results by and from the activities of such corporations.

### **Structure and Process of Organizations – Negotiation and Development**

As this work will seek to demonstrate, the modern business corporation, like other organizations, is characterized by considerable complexity, not only with respect to its structure and processes and those of its participants, but also with respect to its goals and objectives, and those of its participants. Except in the broadest possible terms, such as seeking to generate surplus value, the extent to which the overall goals and objectives of the corporation as a whole are shared by and among its participants may be extremely problematic.<sup>95</sup>

#### ***Intraorganizational Conflicts of Goals and Objectives***

As will be seen, the goals and objectives of a particular functional, product, or geographic unit or sub-unit within the corporation may sometimes conflict with those of other units or sub-units, and

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<sup>93</sup> *Ibid.*

<sup>94</sup> See the discussion in Chapter Five, particularly in the section entitled "Organizational Structure".

<sup>95</sup> See the discussion in Chapter Six. See also the discussion in Chapter Five, particularly in the section entitled "Organizational Structure" and under the headings "Specialization and Delegation, and Goals", "Intraorganizational Organizations", and "Goals of Intraorganizational Organizations".

even, from time to time, with the superordinate, dominant, or “over-arching” goals and objectives established by, and at, the highest (formal) levels of the corporation and its hierarchy.<sup>96</sup> The salience of those goals and objectives, at the various functional, corporate, unit, and sub-unit levels may be different as among such functions, units and sub-units and, even within one particular function, unit or sub-unit, and, furthermore, may be subject to variance from time to time in accordance with various parameters.<sup>97</sup>

The actions of individuals situate in a functional, group, or other unit or sub-unit may be subject to such differing, and even inconsistent, and sometimes even competing, goals and objectives at other levels.<sup>98</sup> The prioritization of such goals and objectives within the functional or other group or unit, and then within the sub-unit, may or may not be the subject of overt determination by persons having authority. Indeed, the formal organization may refrain from, or even be incapable, of making such determinations. Instead, such matters may be decided in accordance with informal rules, or, as one might say, rules of the informal organization.<sup>99</sup>

### ***Intracorporate Power***

Corporate participants engage in competition, within the corporation, for access to and control of resources which have varying degrees of scarcity.<sup>100</sup> Consequently, the corporation, in its internal processes, is itself an economizing organization, in the sense of one compelled to employ and prioritize the employment of the resources available to it.<sup>101</sup> The availability of those resources

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<sup>96</sup> See the discussion in Chapter Six, especially in the section entitled "Organizational Goals and Intraorganizational Goals", and notably under the heading "Intraorganizational Goals, Power, and Loyalty"; and in Chapter Five, particularly in the section entitled "Organizational Personnel".

<sup>97</sup> See the discussion in Chapter Six in the sections entitled "Intraorganizational Goals, Power, and Loyalty", "The Dominant Coalition as Intraorganizational Group", "Organizational Goals and Corporate Operations", and "Goals of Corporations".

<sup>98</sup> *Ibid.*

<sup>99</sup> See the discussion in Chapter Five in the section entitled "Organizational Structure", particularly under the headings "Formal Structure and Relationships", "Informal Structure and Relationships", and "Formal Organizations and Informal Organizations".

<sup>100</sup> See the discussion in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals" especially under the heading "Intraorganizational Goals, Power, and Loyalty", and therein under the subheadings "Theories of Intraorganizational Power", "Information and Sanctions as Sources of Intraorganizational Power".

<sup>101</sup> See the discussion in Chapter Three in the section entitled "Organizations as Political Systems", particularly under the headings "The Firm as a Socio-Political Conflict System", "The Firm as a Conflict System for Internal and External Conflicts", "Joint Reference Bordering in Economic Theory" and "Organizations as Polities".

may be affected by external factors.<sup>102</sup> For example, the size or prestige of a particular corporation may facilitate its procurement of essential employees or influence in the polity or in society at large.<sup>103</sup> Thus, the corporation is itself a situs of political activity which takes place internally and is also a participant in political activity externally within the polity and society at large.<sup>104</sup>

It is sometimes argued that a corporation has a “governing coalition”, a constellation of individuals, groups, and interests that dominates the decision-making process of the organization.<sup>105</sup> Similarly, it may be argued that units, sub-units, and other finer gradations of groups within the corporation are characterized by such “governing coalitions”. It is often maintained, however, that the “governing coalition” is not permanent, but, rather, is fluid and impermanent, composed of different elements and interests from time to time, and even with respect to different issues over time or from time to time.<sup>106</sup> In this respect, such analysis may be applicable to organizations of other types and with different objectives, such as labour unions, educational institutions, administrative apparatus of governments, or religious organizations.<sup>107</sup>

As argued elsewhere in these introductory remarks, this “political” analysis of the corporation, and of organizations in general, emphasizes the degree to which internal contestations may eventuate, often over access to and control of resources, which are generally not unlimited.<sup>108</sup> The power and influence of a particular individual, group, and functional or other unit, or sub-unit may increase, be consolidated, and even diminish over time.<sup>109</sup> In this sense, the corporation, like any other

<sup>102</sup> See the discussion in Chapter Six in the section entitled “Intraorganizational Goals, Power, and Loyalty”, especially under the heading “Organizational Goals and Intraorganizational Goals”, and therein under the subheadings “Theories of Intraorganizational Power”, “Information and Sanctions as Sources of Intraorganizational Power”.

<sup>103</sup> *Ibid.* See, also, the discussion in Chapter Three in the section entitled “Organizations as Political Systems”.

<sup>104</sup> *Ibid.*

<sup>105</sup> See the discussion in Chapter Three in the section entitled “Organizations as Political Systems”, notably under the headings “Competing Preferences Within the Firm, and Formation of Coalitions”, “Continuing the Coalition”, and “Business Coalitions and the Economic Theory of the Firm”. See, also, the discussion in Chapter Six in the section entitled “Organizational Goals and Intraorganizational Goals” and therein particularly under the heading “The Dominant Coalition as Intraorganizational Group”.

<sup>106</sup> *Ibid.* See, also, the discussion in Chapter Six in the section entitled “Organizational Goals and Intraorganizational Goals” and therein under the heading “Organizational Goals and Corporate Operations”, particularly under the subheadings “Changes in Coalitions and in the Environment” and “Changes in Goals and in Monitoring”.

<sup>107</sup> *Ibid.*

<sup>108</sup> See the discussion in Chapter Six in the section entitled “Organizational Goals and Intraorganizational Goals”, particularly under the heading “Intraorganizational Goals, Power, and Loyalty” and therein especially under the headings “Power and Organizations”, “Power, Organizational Stability, and Change”, “Internal and External Threats to Organizational Stability”, and “Theories of Organizational Power”.

<sup>109</sup> See the discussion in Chapter Six in the section entitled “Organizational Goals and Intraorganizational Goals”, particularly under the heading “Intraorganizational Goals, Power, and Loyalty” and therein especially under the

organization, may be analyzed as involving a “political” coalition, which may be operative at various functional and other levels.<sup>110</sup>

### ***Negotiation and Power – Constitutive and Continuing***

Indeed, the basis upon which participants participate in the activities of the corporation itself may be considered to involve political, as well as economic action. It can be argued that a participant-actor, such as a provider of equity capital or a lender, bargains, implicitly or explicitly, with the corporation as represented by the board of directors or with the corporation’s agents or, directly or indirectly, with some or all of the other participants, to establish the basis upon which that participant-actor will participate in the business of the corporation, including such matters as the nature of the participant’s contribution, the degree of control by the participant with respect to the constitution and operations of the business, and the benefits, or basis upon which benefits will be, distributed to participants, including the subject-actor concerned.<sup>111</sup>

Notionally, it may be considered that each participant, as participant-actor, will engage in such negotiations as a predicate activity to becoming involved in the corporation in the relevant capacity. As noted, however, such “bargains” and such “bargaining” may be subtle and diffuse in some cases, or deliberate and defined in other cases; and the degree to which such bargaining is implicit or explicit may be characterized by a kind of continuum.<sup>112</sup> Likewise, such “bargains” and such “bargaining” may be conducted formally or as part of the process and structure of the formal organization, or informally, as part of the process and structure of the informal organization.<sup>113</sup>

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headings "Power and Organizations", "Power, Organizational Stability, and Change", "Internal and External Threats to Organizational Stability", and "Theories of Organizational Power". See, also, the discussion in Chapter Three in the section entitled "Forms of Corporations – Legal and Organizational Variants" under the heading "M-Form Corporations" and, in particular, under the subheadings "Power and SBUs", "Power, MBC's, and MNEs", and "Power and SBU Evolution".

<sup>110</sup> See the discussion in Chapter Three in the section entitled "Organizations as Political Systems" and in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals".

<sup>111</sup> See the discussion in Chapter Seven in the section entitled "Separate Legal Entity" and therein under the headings "The Corporation, the Legal Entity, the Organization, and the Participants" and "The Separate Legal Entity, the Organization, and the Individual Human Actor".

<sup>112</sup> *Ibid.*

<sup>113</sup> See the discussion in Chapter Five in the section entitled "Organizational Structure" and therein under the headings "Formal Structure and Relationships", "Informal Structure and Relationships", and "Formal Organizations and Informal Organizations".

Such politicized bargaining may be expected to obtain in various other kinds of organizations, and not just in those having economic, business or financial objectives.

Depending on the nature and degree of commitment made and resources furnished by a participant, the prospects of other alternatives, and other relevant factors, it may be, or may become, in his or her interests, or in the interests of other participants in the coalition which is the organization or corporation, to re-negotiate such elements of participation at some later stage in the life of the organization or corporation. In fact, such negotiation may be more than episodic, even regular, and perhaps even continuous, in some cases.<sup>114</sup>

Such negotiations or renegotiations may be considered as arising, in part, from the incompleteness or indeterminacy of the arrangements originally enacted,<sup>115</sup> but generally arise, as well, from changes in the external or internal environment of the corporation concerned.<sup>116</sup> Importantly, these constitutive and continuing negotiations and renegotiations may be considered to involve relational contracts, in effect, contracts in which legal relationships are supplemented by “organizational” relationships as posited by Jensen and Meckling, and by Anderson.<sup>117</sup> Such relational contracts are aptly described by Gibbons and Henderson as referring to “collaboration sustained by the shadow of the future as opposed to formal contract enforced by the courts.”<sup>118</sup>

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<sup>114</sup> See the discussion in Chapter Six in the sections entitled "Organizational Goals and Intraorganizational Goals" and therein under the heading "Intraorganizational Goals, Power, and Loyalty" and, in particular, under the subheading "Changes in the Dominant Coalition or Top Management Team"; under the heading "Organizational Goals and Corporate Operations" and therein under the subheadings "Changes in Coalitions and in the Environment" and "Changes in Goals and in Monitoring"; and under the heading "Goals of Corporations" under the subheadings "Changes in Power and Goals" and "Pursuit of Multiple Goals in Corporations".

<sup>115</sup> *Ibid.*

<sup>116</sup> See the discussion in Chapter Six in the sections entitled "Organizational Goals and Intraorganizational Goals" and therein under the heading "Intraorganizational Goals, Power, and Loyalty" and, in particular, under the subheadings "Power in Organizations", "Power, Organizational Stability and Change" and "Internal and External Threats to Organizational Stability"; and under the heading "Changes in the Dominant Coalition or Top Management Team"; under the heading "Organizational Goals and Corporate Operations" and therein under the subheadings "Changes in Coalitions and in the Environment" and "Changes in Goals and in Monitoring"; and under the heading "Goals of Corporations" under the subheadings "Changes in Power and Goals" and "Pursuit of Multiple Goals in Corporations".

<sup>117</sup> See the discussion in this Introduction above in the section entitled "*Theoria, Praxis* and Corporativity", especially under the heading "The Corporation as Legal Entity and as Organization" and therein particularly under the subheadings "The Corporation as a Nexus of Relationships and as an Organization" "The Corporation as a Nexus of Relationships and as an Organization" and "Trust and Reciprocity Within Relationships and Within the Organization".

<sup>118</sup> Robert Gibbons and Rebecca Henderson, "Relational Contracts and Organizational Capabilities"(2012), 23 *Organization Science* 1350. See also the discussion in Chapter A2 in the section entitled "Shareholder Rights Beyond Voting", notably under the heading "Aligning Participants' Reasonable Expectations and Legal and Organizational Form" and the sources cited therein.

## A CORPORATIVE ANALYSIS OF ORGANIZATIONAL STRUCTURE AND PROCESS

### Organizational Structure and Process

#### *Adjustment and Readjustment*

Considering, in this manner, an organization and, in particular, a modern business corporation, as corporative illuminates a number of relevant considerations. If the participants in the organization, in this case the corporation, are engaged, whether constantly or from time to time, in negotiations concerning the basis and terms of their respective participation in it, it may be expected that certain observable and non-observable factors affecting or emanating from such negotiations may be operative. At least to the extent to which such factors are observable, variances may be observed and even, to some extent or other, predicted, in at least some cases. Other factors may not be observable, but their variances may or may not remain observable, and, consequently, may or may not be predictable to some degree.

For example, an increase in market interest rates may encourage a lender to renegotiate the interest rate on a term or other loan, while it may encourage the borrower corporation to "lock in" at historical or present levels; or, depending on the increase involved, may motivate the corporation to seek to raise additional debt in other markets, or to raise additional equity capital. The dilution effected by the possible issuance of additional equity may be expected to have some effect on the market price of equity and on dividend policy. Again, a dramatic and unexpected increase in the profit contribution from one unit or division of the corporation may be expected to lead to that unit or division demanding additional resources, including compensation.<sup>119</sup> If an existing compensation plan does not sufficiently weight unit or divisional profit contribution, the newly highly profitable unit or division may be expected to demand a change in the compensation system, retroactively, by way of bonus or otherwise, and very possibly prospectively as well.<sup>120</sup>

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<sup>119</sup> See the discussion in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals" and therein under the heading "Intraorganizational Goals, Power, and Loyalty" and, in particular, under the subheadings "Power in Organizations", "Power, Organizational Stability and Change" and "Internal and External Threats to Organizational Stability"; and under the heading "Goals of Corporations" under the subheadings "Changes in Power and Goals" and "Pursuit of Multiple Goals in Corporations".

<sup>120</sup> *Ibid.*

As the continuance and terms of the continued participation of one participant are put into question, so may be those of others. That is to say, a regular, even possibly continuous, rebalancing of the terms of participation by some or all participants may eventuate. The political nature of such process may “impossibilize” its continuing effectiveness; in the sense that achieving some steady state, whether involving Pareto optimality or otherwise, for any or any significant period of time may simply be impossible.<sup>121</sup> If this is perceived by participants in the process, who have a degree of relevant knowledge and experience not readily available to outsiders, the difficulty that such a task presents to outsiders may be considered as almost insuperable.

Thus, the structure and process of an organization may be subject to regular, and even continuous, readjustment. Chester Barnard conceived as organizations and systems of “cooperative human activities” whose primary functions are the creation, transformation, and exchange of utilities.<sup>122</sup> For a cooperative process to be efficient, Barnard considered that it had to create “a surplus of satisfaction” for each participant, in order to provide an incentive for cooperation to such participant. It also had to provide a surplus of satisfaction to the organization itself, generating a satisfactory exchange.<sup>123</sup>

Malcolm Salter indicates that such exchanges, whether employment contracts or “deal structuring between an organization and collaborating parties where “dividing the pie” or sharing benefits and costs are paramount” require that “some kind of surplus or slack has to be put on the table and traded so that the eventual return so all contracting parties are mutually satisfying.”<sup>124</sup> In addition, following Barnard, he maintains that “such exchanges require some degree of compromise or mutual sacrifice in order to achieve “the surplus of satisfactions” that can be *efficiently* distributed.”<sup>125</sup> Otherwise, “there will be individual or group defections (including shirking of responsibilities) from the cooperative efforts, which in turn will threaten the continuance of the organization.”<sup>126</sup> Salter notes that “each of these parties have different minimum thresholds of fair

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<sup>121</sup> Malcolm S Salter, “Rehabilitating Corporate Purpose” (2019) Harvard Business School Working Paper 19-104 at 33.

<sup>122</sup> Chester I Barnard, *The Functions of the Executive* (Cambridge: Harvard University Press, 1938) at 240-244.

<sup>123</sup> *Ibid.*

<sup>124</sup> *Supra* note 121 at 32.

<sup>125</sup> *Ibid* [emphasis in the original].

<sup>126</sup> *Ibid.*

returns and fair treatment that must be met to keep them as cooperative participants in the enterprise”,<sup>127</sup> or, in our terminology, as “organizational participants”.

Efficient distribution of the “surplus of satisfactions” depends, in turn, upon the integrity of the cooperative system itself, which is highly dependent upon trust and reciprocity in the underlying relationships to justify sacrifice by participants today in the expectation of reaping reciprocal benefits in the future.<sup>128</sup> William James acknowledged that a “social organization of any sort whatever, large or small, is what it is because each member proceeds to his own duty with a trust that the other members will simultaneously do theirs. Whenever a desired result is achieved by this cooperation of many independent persons, its existence as a fact is a pure consequence of the precursive faith in one another of those immediately concerned. A government, an army, a commercial system, a ship, a college, an athletic team, all exist on this condition, without which not only is nothing achieved, but nothing is even attempted.”<sup>129</sup>

Following Barnard, Malcolm Salter maintains: “Since cooperative systems need to be continually adapted to changing conditions, a key executive function is to ensure that the bases of cooperation (exchanges) continually readjust as necessary to retain the structural integrity of the organization.”<sup>130</sup> Salter argues that “Barnard's and James's conception of efficient cooperative systems gives practical relevance to the principal of Pareto efficiency in economics... Pareto efficiency can be achieved in a number of ways that illustrate the benefits of cooperation and reinforce the stability of cooperative systems.”<sup>131</sup>

In our view, such readjustments may complicate the analysis of such structure and process, which itself becomes “a work in process”. Knowledge of what happens within the organization, such as knowledge of how to get something done or other “how to” knowledge, involving informal as well as formal structure and process, may be considered to be essential to comprehending such structure and process. As noted elsewhere in this Introduction, this presents a formidable task for the

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<sup>127</sup> *Ibid* at 34.

<sup>128</sup> *Ibid* at 36.

<sup>129</sup> Cited by Salter, *supra* note 121 at 33.

<sup>130</sup> *Ibid* at 32.

<sup>131</sup> *Ibid* at 33. As noted by Salter there, Joseph Heath cites as benefits of cooperation: 1. economies of scale; 2. gains from trade; 3. pooling of risk; 4. self-control; and 5. Information transmission. See: Joseph Heath, *Morality, Competition and the Firm* (Oxford: Oxford University Press, 2014) at 234-243.



executives of the organization, which is still more formidable for outsiders.<sup>132</sup> Gibbons and Henderson indicate that such process requires not only task knowledge but also “relational knowledge”, which they say “may be substantially more difficult to develop than task knowledge, both because there is much more of it and because its acquisition is contemplated by incentive problems.”<sup>133</sup> Consequently, acquiring, maintaining, and employing relational knowledge is essential to readjusting the basis of cooperation among participants, or, as we may say, adjusting the explicit and implicit agreements and understandings among them, which is a key executive function.

### *Lack of Universal Structure and Process*

This indicates one dimension of instituting and operating, and, accordingly, of regulating, an organization, such as the corporation: there is no certain way of producing reliable and predictable results by reason of its operations, nor is there a single method of effectively regulating the corporation. There is no single universal structure and process which is effective in all circumstances, and indefinitely, to ensure its effective operations or to ensure its effective regulation.<sup>134</sup>

In effect, one consequence of the foregoing is that there is no dependable way of regulating organizations effectively “from on high”, such as by means of central planning. This has been commonly observed by organizational theorists, from Weber and Hayek to Berle, Chandler, March and others. Instead, results, however configured and measured, are affected by many aspects of the internal structure and processes of the organization in ways not always necessarily or immediately apparent to insiders (and still less so to outsiders). At the same time, the possible

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<sup>132</sup> See the discussion in Chapter Seven in the section entitled "Separate Legal Entity" under the heading "The Separate Legal Entity, the Organization, and the Individual Human Actor", particularly under the subheadings "Authority and Limitations on Authority" and "Effect of Separate Legal Entity Status on Organizational Structure" in the section entitled "Multilayered Subsidiary Forms (MLSFs); in Chapter Nine in the section entitled "Central Management Independent of Equity Ownership" under the heading "Management Ownership Separation and Organizational Participants" and especially under the subheading "Distributors and customers, Suppliers, and Others"; and in Chapter Ten in the section entitled "Short-Termism, Long-Termism, and Indefinite Existence" under the heading "Short-Termism, Earnings Reporting, and Earnings Guidance" under the subheading "Frequency of External Disclosure".

<sup>133</sup> *Supra* note 118.

<sup>134</sup> See the discussion in Chapter Two in the section entitled "History of the Development of the Modern Business Corporation" under the heading "Strategy and Structure", including under the subheading "Separate Development Trajectories". In that book, Chandler elucidates how each of four major business corporations developed their business operations by methods particular to them, influenced by their history of operations and by their perceived prospects, goals and objectives.

consequences of misperception and error with respect to such structure and processes may be significant, possibly enormous, and perhaps even catastrophic, both to the organization and to the society and polity in which it is situated.

Consequently, devising a particular combination of participations requisite for success may be highly individual and situation-dependent. It may vary considerably from one organization or corporation to another. It seems to depend not only on determining of what “success” would consist with respect to that organization or corporation, but on deriving a “formula” apt for the instant organization or corporation, as well as on adjusting that formula from time to time, as required, in accordance with whatever standards of rationality and information specification are adopted, to respond to changes in the organization’s external and internal environment. Of course, as “success” may be a matter of degree, so may the structure and process requisite for its attainment: there may be various combinations that may be expected to produce different gradients of success, however determined.

To emphasize the point again, just as the means of instituting and operating a corporation effectively are necessarily ungeneralizable to a considerable extent, and, even more, are essentially particularistic to a significant extent, so is promoting the achievement of certain intrinsic and extrinsic goals with respect to the instant corporation and regulating that corporation in relation to the same. While not underestimating the importance of regulating corporate behaviour in a responsive or reflexive manner, such regulation must also be principled, flexible, and relatively immediate temporally. A “light touch” may also be most effective and least counter-productive.

### ***Short-Termism, Long-Termism, and Organizational Participants***

Recent discussions of “short termism” have drawn attention to the fact that, even considering profit maximization as a dominant, if not the dominant, goal or objective of the modern business corporation, the determination of whether such profit maximization should be assessed from a long-term perspective or from a short-term perspective is an issue of considerable importance. Of course, prioritizing profit maximization, whether in the short-term and long-term, may be seen to be prioritizing the participation of equity investors in the corporation over the participation of other participants. Another view that may be taken is that achieving an optimal level of profit that is

sustainable and balanced over the long-term is conducive to attaining the interests of all participants.<sup>135</sup>

Such participants may include employees, suppliers, trade creditors, lenders, holders of financial instruments derivative of, or based on, investments in the capital of the corporation, whether debt or equity capital, pensioners, purchasers of the corporation's products or services, governments and residents of locations at which the corporation maintains plants or offices, governments having corporate or other legal jurisdiction over the subject-corporation, and other stakeholders. Some of these may be regarded as relatively more internal, and others, as relatively more external, participants. The "internal" participants may be considered as the "real" participants "in" the corporation in that they may be considered to be "inside" its structure and processes. The "external participants" may be considered as engaging with the corporation as "outsiders", or as dealing with it subject to its external legal attributes. All of these may be regarded, in respect of their economic participation, at least, as "stakeholders" as that term is used in common parlance today.<sup>136</sup>

Barnard references, outside the organization, "relationships with other organizations and individuals not connected with the organization" who interact in ways that are both cooperative and have utility for each party.<sup>137</sup> This suggests that those "unconnected" organizations and individuals may also be regarded as "connected" in certain respects. Hence, while they may be considered as outside the subject organization, at least for some purposes, they may possibly be considered as within some larger organization, at least for certain other purposes. This recalls the observation by Jensen and Meckling that it "makes little or no sense to try to distinguish between those things which are "inside" the firm (or any other organization) from those things that are "outside of it", and that, instead, what constitutes the organization is simply a "multitude of complex relationships",<sup>138</sup> which they regarded as purely contractual, but which this work considers as both legal and organizational. In that sense, the "boundaries" of the organization may be determined, as just noted, by the salience or intimacy of the relationship or connection, on the one hand, or, on the other hand, by the purpose for which such boundaries are sought to be defined.

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<sup>135</sup> See the discussion in Chapter Ten in the section entitled "Short-Termism, Long-Termism, and Indefinite Existence".

<sup>136</sup> *Supra* note 116.

<sup>137</sup> *Supra* note 118.

<sup>138</sup> *Supra* note 19.

### ***Financialization***

The obscurity or invisibilization of the interests of many such stakeholders has accompanied what has been characterized recently as the “financialization” of the corporation. Such “financialization”, in turn, treats the corporation solely in terms of its financial inputs and outputs, and treats the financial markets themselves solely in terms of financial inputs and outputs. In effect, the “financialized” corporation is a financial “black box”.<sup>139</sup> It remains to be seen whether the “black box” which is the “financialized corporation” is more or less coherent as a model of the corporation than is the “black box” which is the “production function corporation” of classical economic theory.

However, by “invisibilizing” the organization and its structure and process, “financializing” the corporation commits a category error which is similar in that regard to treating the corporation solely as a production function, with production inputs and outputs. Both focus on a single aspect of the corporation and treat that aspect as the sole significant aspect, element, function, utility, and even (in some cases) purpose for, and by, which it is constituted, instituted, and operated.

Of course, obfuscation of the organizational aspects of the corporation also occludes recognition and discussion of its goals and objectives, which this work argues are not simply limited to the “economic” production of classical and neoclassical economics and, even then, is narrowly construed in relation to other economic objectives.<sup>140</sup> Even more, however, such an approach may have the result that questions do not arise about the situation of the corporation in social and political spheres and of the social and political aspects of the corporation which are internalized in its organization.

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<sup>139</sup> See the discussion in Chapter Eight in the section entitled "Asset Partitioning and Policy Considerations", most notably under the heading "Capital Requirements, Characteristics of Investors, and Capital Markets"; in Chapter Nine in the section entitled "Central Management Independent of Equity Ownership", particularly under the heading "Commoditization of Equity Interests"; and in the Conclusion in the section entitled "Challenges to Capitalism and the Corporation", particularly under the heading "Contemporary Challenges to Capitalism" and therein under the subheading "Challenges to, and the Blaming of, the Corporation".

<sup>140</sup> See the discussion in Chapter Six in the section entitled "Existence and Typology of Organizational Goals and Objectives", particularly under the heading "Official or Explicit Goals and Operative or Implicit Goals" and therein under the subheadings "Profit as Superordinate Goal – Official or Operative Goal" and "Alternatives to Profit as Superordinate Goal"; and in the section entitled "Organizational Goals and Intraorganizational Goals" under the heading "Goals of Corporations" and therein under the subheading "Profit Maximization is Superordinate Goal"; and in Chapter B4 in the section entitled "Atomistic Utilitarianism" under the heading "criticism" and therein under the subheading "Profit Maximization as Primary Goal".

### ***Voluntary Participation and Risk***

It is important, of course, to recognize that participants in the corporation “participate” in it, and in its life and activities, under the influence of various degrees of voluntarism or compulsion and, in so doing, assume various degrees of risk, in part consequent upon such voluntarism or compulsion, as well as other factors, in anticipation of some benefit.<sup>141</sup> Both risk and benefit are not limited to solely economic, or financial, elements. The imposition of financial, regulatory, and other burdens on the corporation should, it is argued, take into account the interests and circumstances of participation of its various participants and stakeholders, including the relative presence or absence of voluntarism. These interests and circumstances will include the relationship between risk and benefit, in all relevant aspects (economic or financial, and non-economic or non-financial in all relevant senses of those terms), as perceived objectively and subjectively, as it relates to participation in the corporation.

It should be noted that some participants in the corporation who may be regarded as “internal” to the corporation are affected by its external legal attributes.<sup>142</sup> For example, in becoming shareholders of the corporation, such participants rely on the fact that their risk or liability with respect to the corporation as such a shareholder (that is to say, absent other involvements) is limited to the amount of their investment. Other “external” participants, such as lenders and trade creditors, also take the external legal attributes of the corporation into account in considering the risk and terms of their participation.<sup>143</sup> A lender may determine that the limitation of liability principle otherwise applicable warrants, in the instant circumstances, obtaining some guarantee of a related corporation or other party. If such a guarantee is secured by assets of the related corporation or

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<sup>141</sup> See the discussion above in the section entitled "A Corporative Analysis of Organizational Structure and Process", particularly under the heading "Organizational Structure and Process" and therein under the subheading "Adjustment and Readjustment".

<sup>142</sup> *Ibid.*

<sup>143</sup> *Ibid.* See the discussion in Chapter Seven in the section entitled "Separate Legal Entity", particularly under the heading "The Corporation, the Legal Entity, the Organization, and the Participants" and therein under the subheading "Categories of Organizational Participants"; in Chapter Eight in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning"; in Chapter Nine in the section entitled "Capital Lock-In with Transferable Equity Interests" under the heading "Organizational Analysis, Capital Lock-In, and Transferable Equity Interests"; and in the section entitled "Central Management Independent of Equity Ownership" under the heading "Management Ownership Separation and Organizational Participants"; and in Chapter Ten in the section entitled "Short-Termism, Long-Termism, and Indefinite Existence" under the heading "Interaction of Short-Termism with Organizational Participants".

other party, the principle of asset partitioning may be avoided. Similarly, a lender may require that one or another business be separated, by external legal attributes, from another which may be less attractive to it as a borrower.

In substance, the “boundaries” of the corporation, in terms of its external legal attributes may be subject to some notional adjustment to accord with the arrangements on which participation of desired parties may be agreed. That is to say, recognition of external legal attributes may sometimes affect internal, as well as external, participation arrangements.<sup>144</sup> For example, the position of a bank lender to a corporation which is entitled to representation on the board of directors may be considered to be more “internal” in its relationship to the corporation than otherwise. Close assessments of its detailed loan agreements, particularly concerning their positive and negative covenants, may increase the degree to which it is seen as relatively more “internal” than “external”, which may weaken the bank’s “strict” legal position. In such case, it may be considered to have opportunities to observe and affect the lender’s compliance with legal agreements, and, to the extent that it exercises declared or undeclared forbearance from compliance with their terms, it may be seen as effecting modifications in the legal contract by reason of relational considerations.<sup>145</sup>

A corporative approach will facilitate considering the implications of such external legal attributes on either “inside” or “outside” participants; and on the effect of internal structure and process on the nature of the participation involved.<sup>146</sup> For example, when a lender agrees that the borrower should maintain a certain level of cash or of reserve for accounts receivable, subject to some variance not exceeding a certain level as determined by the board of the corporation acting reasonably, the lender will likely, and would be well-advised to, consider how the internal structure and processes of the corporation may affect such determination. Similarly, the board, in such a case, would consider not only the external effect on the lender and the loan, but also what other

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<sup>144</sup> *Supra* note 140. See, also, *supra* note 142 for references to the main text.

<sup>145</sup> *Supra* note 142. See, also, the discussion above in the section entitled "*Theoria, Praxis* and Corporativity" under the heading "The Corporation as Legal Entity and as Organization" and therein under the subheadings "The Corporation as a Nexus of Relationships and as an Organization", "Trust and Reciprocity Within Relationships and Within the Organization", and "The Corporation’s Intraorganizational and Extraorganizational Orientations".

<sup>146</sup> See, for example, the discussion above in the section entitled "*Theoria, Praxis* and Corporativity" under the heading "The Corporation as Legal Entity and as Organization" and therein under the subheading "The Corporation’s Dual Nature – Corporativity, its Goals, and Legal Theory".

“internal” effect or effects that determination might precipitate or make more likely, possibly including any consequential or “knock on” effects.

Experience confirms that lenders and borrowers actually engage in such considerations; however, the corporative element of such considerations may be unnoticed. As a matter of “theorizing the corporation”, however, these factors must be noticed and taken into account. It is desirable not only that theory be consistent with experience “in the real world”, but also that it explain or account for more, rather than less, of what is so experienced or observed.

## **Participation, Responsibility, and Private and Public Regulation**

### *Changes in the Basis of Participation*

It can readily be seen that assignment to the corporation of responsibility for certain actions, as related to alleged benefits and disbenefits relating to its activities, may have significant effects on participants in the corporation, whose own participation in the corporation involves a combination of risk and benefit (considered with respect to all relevant parameters) and their several assessments of the same, as previously discussed. Indeed, the nature of such participation may itself be relevant to the effect on a participant and on the allocation of benefits and disbenefits which is thought to be optimal.<sup>147</sup>

This kind of cost-benefit analysis may be specific to the corporation in question or may be generalized at the market level. If such changes in the cost-benefit relationship result or are perceived to result from changes in “the market”, they may subsequently be translated into particular corporations indirectly, at which point a more specific cost-benefit analysis may eventuate.

Changes in expected or actual allocations of such burdens and benefits, either in particular cases or generally, may contribute to adjustment or readjustment of the cost-benefit analysis of participants, in terms of their targets, expectations, and assessment of the effect of new developments, and the effect of the same on their respective expectations, which may lead to adjustment, readjustment, or realignment of participation arrangements. Those participation

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<sup>147</sup> See the discussion in this Introduction above in the present section entitled "A Corporative Analysis of Organizational Structure and Process" under the heading "Organizational Structure and Process" and the references in the notes appearing there.

arrangements, as constitutive and as operationalized, may be considered to be successively iterative.<sup>148</sup>

A corporative perspective entails that, when significant changes in the internal or external environments transpire and require consideration by the corporation as to what responses by it may be appropriate, suitable attention should be paid to effects of the external change, and of possible responses to it, on the corporation's internal organization, in terms of structure, process, and personnel, as well as to iterative effects of each,<sup>149</sup> and their effects on different classes of organizational participants.<sup>150</sup>

### ***Private and Public Restraint of Action***

It is frequently argued that corporate action may be restrained by private action, through private litigation and the prospect of such litigation, and by public action and the prospect of such action, taken by public bodies pursuant to certain legislative and administrative authority. Some comment on this subject is in order.

In situations involving loss occasioned by the corporation, by way of act or omission, it is often considered, rather reflexively, that the board of directors of the corporation, as the highest legal authority within the corporation, must be held responsible for such loss, in some cases, even

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<sup>148</sup> *Ibid.* See, also, the discussion in Chapter Seven in the section entitled "Separate Legal Entity", particularly under the heading "The Corporation, the Legal Entity, the Organization, and the Participants" and therein under the subheadings "The Corporation, Organizational Participants, and Intraorganizational Relations" and "Categories of Organizational Participants"; and in Chapter A2 in the section entitled "Shareholder Rights Beyond Voting" under the heading "Aligning Participants' Reasonable Expectations and Legal and Organizational Form".

<sup>149</sup> See the discussion in Chapter Two: in the section entitled "History of the Development of the Modern Business Corporation" under the heading "Strategy and Structure" and therein under the subheadings "The Relationship between Strategy and Structure" and "Aligning Strategy, and Structure, and Growth"; and in the section entitled "The Visible Hand: The Managerial Revolution in American Business" and therein under the heading "Administrative Responses to Technological Developments"; in Chapter Five in the section entitled "Organizational Structure" and therein under the heading "Organizational Continuity and Cooptation"; in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals" and therein under the heading "Intraorganizational Goals, Power, and Loyalty", especially under the subheadings "Power, Organizational Stability, and Change", and under the heading "Organizational Goals and Corporate Operations, especially under the subheading "MDC's and MNEs"; and in Chapter Seven in the section entitled "The Separate Legal Entity, the Organization, and the Individual Human Actor", particularly under the heading "Extraorganizational Action and the Corporation".

<sup>150</sup> *Supra* note 144. See, also, the discussion in Chapter Four in the section entitled "Groups of People or Social Units" under the heading "Max Weber on Organizations and Related Matters" and therein under the subheading "Typology of Social Relationships"; and in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals" under the heading "Intraorganizational Goals, Power, and Loyalty" and therein under the subheading "Power, Organizational Stability, and Change".



incurring personal liability.<sup>151</sup> It is frequently argued that the business judgment rule has historically protected, and even insulated, boards of directors, and management, of the corporation from the consequences of their decisions. This work has already argued, and will continue to maintain, that the assignment of responsibility for decision-making and implementation within the modern business corporation is such as to make it impossible to prove, or even significantly justify, imposing liability on the board in many, if not most, and possibly even in almost all, circumstances.

It goes without saying, of course, that a corporative perspective will consider the ways in which assignment of responsibility affects the corporation's internal organization, as well as its relations with external parties. Likewise, it will consider the effect of changes in the assignment of responsibility in these respects.

### *Causation*

Those favouring the assignment of personal liability have sometimes argued that ascertaining actual causation in these situations is complex and unnecessary, such that causation and motive may not be proven, but may be assumed from the relevant circumstances. Those circumstances would include having actual or ostensible authority over the activity or activities involved in the loss. This would be determined by the position occupied by the person concerned. In those circumstances, some commentators argue that personal liability should be imposed upon the individual having actual or ostensible authority in the circumstances. Some argue that these directors and officers should incur strict liability in cases where, as a result of their position in the corporation, they have actual or ostensible authority over the activity or activities involved. The arguments set forth above indicate that such imposition of strict, and personal, liability will often be inappropriate and ineffective.<sup>152</sup>

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<sup>151</sup> See, for example, the discussion in Jennifer Hill, "Legal Personhood and Liability for Flawed Corporate Cultures" (2019) European Corporate Governance Institute (ECGI) - Law Working Paper No. 431/2018; Sydney Law School Research Paper No. 19/03. Available at SSRN: <https://ssrncom/abstract=3309697> or <http://dxdoiorg/10.2139/ssrn.3309697>.

<sup>152</sup> See the discussion in this Introduction above in the section entitled "Assumptions of Liberal Economics and of Legal Theory" under the headings "The Firm as a Single Rational Economic Actor and as a Moral Actor"; "Acts or Omissions of the Corporation"; and in the present section entitled "A Corporative Analysis of Organizational Structure and Process" under the heading "Organizational Structure and Process" and under the present heading "Participation, Responsibility, and Private and Public Regulation". See, also, the discussion in this Introduction below in the present section under the headings "Corporative Responsibility", "A Corporative Analysis of Corporate Behaviour, Success, and Failure" and "Corporative Regulation".

Moreover, it cannot be assumed that the persons or bodies having authority and responsibility in the formal organization “on the organization chart” are able to exercise such authority and responsibility in reality. Among other things, it is not clear that they have such authority or responsibility considering the informal organization.<sup>153</sup> This is particularly true of officers, whose title may suggest a more (or even less) comprehensive responsibility than the incumbent actually exercises.<sup>154</sup> Instead, others may share in, or exercise, authority or responsibility informally in ways not apparent from the organization chart.<sup>155</sup> Similarly, others may be able to counteract certain aspects of official authority, in various ways, formally or informally, often without assuming any official responsibility for the relevant actions or decisions. In short, it cannot be assumed that the persons or bodies formally invested as “leaders” actually perform that function in the organization as instituted and operated.<sup>156</sup> The “real” leaders who make and influence decisions, or at least, those that are important or significant to the organization, may not be the “official”, but instead, may be “unofficial”, leaders.

Of course, as this suggests, the structure and processes of the informal organization may be quite different from that of the formal organization. In certain cases, it is argued that informal organization permits a kind of “institutionalized deviance” from paradigmatic behaviour which may contribute to the stability of the formal organization and of the organization more generally.<sup>157</sup> Thus, possession of actual, apparent, or ostensible authority may not be determinative of “real”, and not purely positional and formal leadership, decision-making, or decision-influencing ability, within and in respect of the firm. Of course, sometimes “real” authority will exactly conform to the organizational characterization and to the “org chart”.

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<sup>153</sup> *Ibid.* See, also: Chapter Five in the sections entitled "Structure, Process, and Personnel", particularly under the heading "Rational-Legal Authority, Administration, and Bureaucracy"; and "Organizational Structure" and therein, in particular, under the headings "Formal Structure and Relationships", "Informal Structure and Relationships", and "Formal Organizations and Informal Organizations"; and Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals" under the heading "Intraorganizational Goals, Power, and Loyalty" and therein under the subheading "Distribution of Intraorganizational Power – Formal and Informal".

<sup>154</sup> *Supra* note 152. See, also, the discussion in Chapter A1 in the section entitled "Duties of Officers and Employees"; and in Chapter A3 in the sections entitled "Organizational Liability for Acts of Corporate Actors" and "The Corporation as Principal".

<sup>155</sup> *Supra* note 153.

<sup>156</sup> *Ibid.*

<sup>157</sup> See, in particular, the discussion of Philip Selznick’s observations in this regard in Chapter Five in the section entitled "Organizational Personnel", notably under the heading "Organizational Changes in Behaviour and Relationships".

These phenomena are recognized and taken into account in a corporative perspective on the corporation. As noted above, such a perspective will take into account both the formal and informal aspects of the corporation's internal organization in these respects.

### ***Corporate Culture – “Tone at the Top” or “Tone Throughout”***

#### *“Tone at the Top”*

In certain cases, the basis upon which commentators argue that those at the highest levels of the corporation, namely the board of directors, Chief Executive Officer and Chief Financial Officer, and other members of its top management team and senior management must be held accountable for the actions of the corporation, it is that they are responsible for its ethical culture by creating the appropriate “tone at the top” and ensuring that such tone is prevalent throughout the organization.<sup>158</sup> Accordingly, they argue that legal liability may be imposed on such parties for deficiencies in such corporate culture.<sup>159</sup> Some argue that this justifies imposition of strict liability for corporate acts and omissions at the “top” level.<sup>160</sup>

This perspective is complicated by evidence that CEOs and CFOs consider the CEO to be responsible for corporate culture, with the responsibility of the board being limited to the choice of CEO.<sup>161</sup> The 2018 edition of the UK Corporate Governance Code requires the board of directors to “assess and monitor culture” and “where it is not satisfied that policy, practices or behaviour throughout the business are aligned with the company’s purpose, values and strategy, it should

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<sup>158</sup> See the review by Nien-he Hsieh, Benjamin Lange, David Rodin and Mira LA. Wolf-Bauwens, "Getting Clear on Corporate Culture: Conceptualisation, Management and Operationalisation" (2018) 6:s1 *Journal of the British Academy*.

<sup>159</sup> See the discussion of relevant provisions of The UK Corporate Governance Code in Alice Belcher, "Corporate Culture: Changing Board Responsibilities and Changing Governance Rhetoric" (2018) *Research Association for Interdisciplinary Studies Conference Proceedings* November 2018.

<sup>160</sup> *Ibid.* See, also, the discussion of the Volkswagen diesel emissions scandal ("dieselgate"), *ibid* at 5-6. See, also, the discussion of the General Motors engine ignition switch scandal in Marianne Jennings and Lawrence J Trautman, "Ethical Culture and Legal Liability: The GM Switch Crisis and Lessons in Governance" (2016) 22 *BU J Sci & Tech L* 187. See, also, the discussion in this Introduction above under the heading "Acts or Omissions of the Corporation"; and see, also, the discussion in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals" under the heading "Intraorganizational Goals, Power and Loyalty" and therein under the subheading "Information and Sanctions as Sources of Intraorganizational Power", especially concerning the GM Switch Crisis.

<sup>161</sup> See John R Graham, Campbell R Harvey, Gillian Popadak and Shiva Rajgopal, "Corporate Culture: Evidence from the Field" (June 26, 2019). 27th Annual Conference on Financial Economics and Accounting Paper; Duke I&E Research Paper No. 2016-33; Columbia Business School Research Paper No. 16-49. Available at SSRN: <https://ssrn.com/abstract=2805602> or <http://dx.doi.org/10.2139/ssrn.2805602>.

seek assurance that management has taken corrective action”.<sup>162</sup> The concept of “organizational culture” involves a model of man as a social or, at least, socialized, being.<sup>163</sup> As such, it is considered to involve an ongoing process.<sup>164</sup> Paying attention to “corporate culture” has been found to generate significant benefits. Jillian Grennan finds a link between corporate culture and firm performance.<sup>165</sup> Firm performance is stronger when employees consider top managers to be trustworthy and ethical.<sup>166</sup>

### *The Concept of Corporate Culture*

The Financial Reporting Council in the United Kingdom defines corporate culture “as a combination of the values, attitudes and behaviours manifested by a company and its operations and relations with its stakeholders [including] shareholders, employees, customers, suppliers and the wider community and environment which are affected by a company’s conduct.”<sup>167</sup> In this sense, “corporate culture” may be said to reflect its goals and objectives and their means of achievement. Experts, such as Ashworth, Mael, and Turner, consider organizational culture to involve the cognitive mechanisms that make group behaviour possible, in effect, as the “shared understanding of the central, distinctive and enduring character or essence of the organization among its members”.<sup>168</sup> As such, organizational culture is a kind of “binding agent” for intraorganizational behaviour. Its contribution can be positive, negative, or mixed in its effects. For example, an organizational orientation towards short-term, rather than long-term, performance may be expected to have significant effects on intraorganizational decision-making.<sup>169</sup> The

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<sup>162</sup> Financial Reporting Council, *The UK Corporate Governance Code* (London: The Financial Reporting Council, 2018).

<sup>163</sup> See the discussion in Chapter B2 in the section entitled “Socialization and Models of Man”; and in Chapter. See, also, the discussion in B4 in the sections entitled “Atomistic Utilitarianism” and “Atomism and Methodological Individualism”.

<sup>164</sup> See the discussion in Chapter B3 in the section entitled “Mark Granovetter’s Embeddedness”.

<sup>165</sup> Jillian Grennan, “A Corporate Culture Channel: How Increase Shareholder Governance Reduces Firm Value” (March 29, 2019). Available at SSRN: <https://ssrn.com/abstract=2345384> or <http://dx.doi.org/10.2139/ssrn.2345384>. See, also, Jillian Popadak, *Balancing Governance and Culture to Create Sustainable Firm Value* (Washington: The Brookings Institution, 2016).

<sup>166</sup> Luigi Guiso, Paola Sapienza, and Luigi Zingales, “The Value of Corporate Culture” 117 *J Fin Ec* 60.

<sup>167</sup> Financial Reporting Council, *Corporate Culture and the Role of Boards: Report of Observations* (London: The Financial Reporting Council, 2016) at 6.

<sup>168</sup> See the discussion in Chapter Four in the section entitled “Groups of People or Social Units” under the heading “a Social Unit or Group of People” and therein particularly under the subheadings “Intragroup Aspects of Social Identity, “Individual and Intragroup Aspects of Social Identity” and “Organizational Socialization”.

<sup>169</sup> See the discussion in: Chapter Eight in the section entitled “Implications of Organizational Analysis for Limited Liability and Asset Partitioning” under the heading “Shareholders”; Chapter Ten in the section entitled “Short-

negative effects of a short-term orientation have been evaluated by many “think tanks” as representing existential threats to contemporary capitalism and to the contemporary business corporation.<sup>170</sup>

### *Corporate Culture and Liability*

As noted above, it cannot be assumed that those at the “top” are, or will be, able to translate even the most beneficent “tone at the top” into an ethical culture throughout the organization which is reflective of such “tone at the top”.<sup>171</sup> Such ability will be dependent, at least in part, on the effectiveness of certain aspects of the structure and process of the organization itself.<sup>172</sup> It also involves processes of socialization and integration aimed at securing identification and commitment of group members.<sup>173</sup> Importantly, this also involves aligning incentives so as to support and encourage behaviours consistent with the corporation’s “purpose, values, strategy and business model”.<sup>174</sup> Jennifer Chatman and her colleagues find that where there is a high consensus among organizational members across a broad set of culture norms (a “strong culture”) can contribute to better financial performance, even if in a dynamic environment (one subject to rapid change) as long as the culture norms intensely emphasize adaptability.<sup>175</sup>

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Termism, Long-Termism, and Indefinite Existence”, particularly under the heading “The Problem Stated” and therein under the subheadings relating to intertemporal decision-making; and under the heading “Short-Termism, Earnings Reporting, and Earnings Guidance” under the subheading “Earnings Guidance and Short-Termism”.

<sup>170</sup> See the discussion in the Conclusion in the section entitled “Contemporary Responses to Challenges” under the heading “Initiatives to Recognize and Report “Value Drivers of Contemporary Corporations”. The groups examining such issues include The Kay Review of UK Equity Markets and Long-Term Decision Making, The Oxford Martin Commission for Future Generations and The British Academy project entitled “The Future of the Corporation”.

<sup>171</sup> *Supra* note 157 at 14. See, also, the discussion in Donald C Langevoort, “Cultures of Compliance”(2017) 54 Am Crim L Rev 933; and in Donald C Langevoort, “Opening the Black Box of “Corporate Culture” in Law and Economics” (2006) 162 J Institutional and Theoretical Economics 80.

<sup>172</sup> *Ibid.*

<sup>173</sup> See the discussion in Chapter Four in the section entitled “Groups of People or Social Units” under the heading “A Social Unit or Group of People”, especially under the subheadings concerning social comparison theory, social identity theory, and organizational socialization; and in Chapter Five in the sections entitled “Organizational Structure”, particularly under the headings “Formal Structure and Relationships”, “Informal Structure and Relationships” and “Formal Organizations and Informal Organizations”; “Organizational Process”, and “Organizational Personnel”, particularly under the heading “Organizational Changes in Behaviour and Relationships”. See, also, Edgar H Schein, “Organizational Culture” (1990) 45:2 American Psychologist 109, particularly at 114.

<sup>174</sup> *Supra* note 158 at 6.

<sup>175</sup> Jennifer A Chatman, David F Caldwell, Charles A O’Reilly and Bernadette Doerr, “Parsing Organizational Culture: How the Norm for Adaptability Influences the Relationship between Culture Consensus and Financial Performance in High-Technology Firms”(2014) 35 J Organizational Behavior 785.

Of course, both direct communication (top to bottom or bottom to top) and indirect communication (including emphasis and incentives) can involve miscommunication.<sup>176</sup> Indeed, organizational culture can be seen as “ultimately being a substitute for explicit communication” or as “an unspoken language giving directors to the members of an organization.”<sup>177</sup> Considered in that sense, organizational culture provides a context and system of meaning (or sense-making) which guides the interpretation of explicit and implicit communications.<sup>178</sup> Such culture will also be affected by the personnel of the organization and their general and more particular characteristics, including the degree of identification with, and commitment to, the organization, and to the functions, groups, units, and sub-units of which it is composed.<sup>179</sup> It is clear that perceptions of the corporation as a monolithic entity subject to “command-and-control” from top to bottom are not, at present, realistic.<sup>180</sup> Instead, making and implementing (including enforcing) decisions is subject to diffuse sources and influences.<sup>181</sup>

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<sup>176</sup> See Marianne M Jennings, "'This Is Not Our Culture'. Oh, But It Is, and Has Been For Some Time" (2014) *Corporate Finance Rev* 37 at 38-39.

<sup>177</sup> See Benjamin E Hermalin, "Economics & Corporate Culture" (April 1999). Available at SSRN: <https://ssrn.com/abstract=162549> or <http://dx.doi.org/10.2139/ssrn.162549>.

<sup>178</sup> See the discussion in Chapter Three in the section entitled "Forms of Corporations – Legal and Organizational Variants" under the heading "M-Form Corporations", particularly under the subheading "Development as Organizational Response to Bounded Rationality"; and in Chapter Five in the section entitled "Structure, Process and Personnel" under the heading "Individual Bounded Rationality, and Rulemaking" and therein under the subheading "Bounded Rationality, and Organizational and Personal Meaning". As noted in the latter section, Daft and Weick describe organizations as "interpretation systems". See: Karl E Weick and Robert L Daft, "The Effectiveness of Interpretation Systems" in KS Cameron & DA Whetten, eds, *Organizational Effectiveness: A Comparison of Multiple Models* (New York: Academic Press, 1983) 71; and Robert L Daft and Karl E Weick, "Toward a Model of Organizations as Interpretation Systems" (1984) 9:2 *Academy of Management Rev* 284.

<sup>179</sup> *Ibid.*

<sup>180</sup> *Supra* note 86. See, also, the discussion in this Introduction accompanying that footnote, namely, in the section entitled "Assumptions of Liberal Economics and of Legal Theory" under the heading "Acts or Omissions of the Corporation" and therein under the subheadings "Group Decision-Making, Information, and Responsibility" and "Making and Implementing Decisions". See, also, the discussion in: Chapter Three in the section entitled "Forms of Corporations – Legal and Organizational Variants" under the heading "M-Form Corporations", particularly under the subheadings "Relationships among SBUs" and "Multinational Enterprise Organizational Structure"; Chapter Four in the section entitled "Working Definitions and Formal Definitions", particularly under the heading "Formal Definitions" and therein under the subheading "Philip Selznick Definition"; Chapter Five in the section entitled "Structure, Process, and Personnel" under the heading "Rational-Legal Authority, Administration, and Bureaucracy", and under the heading "Individual Bounded Rationality, and Rulemaking" and therein under the subheading "Bounded Rationality, and Organizational and Personal Meeting", and in the section entitled "Organizational Structure" under the heading "Fayol and Modern Business Management" and therein under the subheading "Fayol on Process"; and under the heading "Organizational Process" under the heading "Assessments of Behaviour".

<sup>181</sup> *Supra* note 8.

Further, it is not clear that certain elements of an ethical culture are not more rooted in smaller organizational units than at the level of the corporation itself. The degree to which members of the organization identify with groups as more or less salient to their personal, social and economic, situation, objectives, and attributes may be expected to significantly affect their responsiveness to “top-down” or “commanded and controlled” cultural initiatives.<sup>182</sup> Incentives are, of course, highly relevant to these matters.<sup>183</sup> This includes the extent to which incentives are determined and distributed at various levels of the hierarchy, and the criteria on which they are based, including the extent to which the incentives are based on corporate, functional, group, unit, or sub-unit performance.<sup>184</sup>

The considerable importance attached to the culture of strategic business units (“SBUs” or “BUs”), particularly in relation to incentives, is illustrated by those analyzing situations threatening the

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<sup>182</sup> *Supra* notes 171 and 173.

<sup>183</sup> See the discussion in Chapter Three in the section entitled “Forms of Corporations – Legal and Organizational Variants” under the heading “M-Form Corporations” especially under the subheadings “Relationships among SBUs”, “The Headquarters-Strategic Business Unit Relationship” and “Headquarters Functions, Strategy, and Structure”; Chapter Six in the section entitled “Organizational Goals and Intraorganizational Goals”, particularly under the heading “Intraorganizational Goals, Power, and Loyalty”; Chapter Eight in the section entitled “Implications of Organizational Analysis for Limited Liability and Asset Partitioning”; Chapter Nine in the section entitled “Central Management Independent of Equity Ownership” under the headings “Management as a Separate Organizational Component and Constituency” and “Directors”; Chapter Ten in the section entitled “Short-Termism, Long-Termism, and Indefinite Existence” under the heading “Short-Termism, Goal Incongruence, and Value Corruption” under the subheading “Short-Termism and Intraorganizational Incentives”; and in the Conclusion in the section entitled “The Breadth and Scope of This Book” under the heading “The Corporative Corporation” and in the section entitled “Contemporary Responses to Challenges” under the heading “Initiatives to Recognize and Report “Value Drivers” of Contemporary Corporations”.

<sup>184</sup> See the discussion in Chapter Five in the section entitled “Formal Organizations and Informal Organizations”; Chapter Six in the section entitled “Organizational Goals and Intraorganizational Goals”, particularly under the headings “Organizational Control of Intraorganizational Groups by Corporations” and “Intraorganizational Goals, Power, and Loyalty”; Chapter Nine in the section entitled “Central Management Independent of Equity Ownership”, especially under the heading “Top Management Team Stability and Organizational Stability”; Chapter Ten in the section entitled “Short-Termism, Long-Termism, and Indefinite Existence”, notably under the heading “The Problem Stated” and therein under the subheading “Intertemporal Decision Making, Short-Termism, and Myopia”; and in the Conclusion in the section entitled “How, Instead, to Analyze the Corporation: a Corporative Theory of Corporate Law and Governance” under the heading “The Organization and the Corporation” and therein under the subheading “Theorization and Research of the Organization and the Corporation Compared”; and in the section entitled “Contemporary Responses to Challenges” under the heading “The Unlimited Responses of Corporative Theory”.

continued existence of the subject organization, such as the General Motors ignition switch crisis,<sup>185</sup> the Volkswagen “Dieselgate” crisis,<sup>186</sup> and the J.P. Morgan “London Whale” crisis.<sup>187</sup>

### *Corporate Liability “At the Top”*

While existing research has been able to illuminate many of these issues significantly, at least on a general level, determining their application in a concrete situation is quite another matter entirely.<sup>188</sup> The effect of the instant structure and processes, formally and informally, is just one of the relevant factors. Basing legislation and regulation on assumptions as to their effects does not accord with modern social science methodology and practice. It may also have significant unanticipated, counterproductive, and unpredictable effects, both within and without the organization. Recognition of the corporative nature of an organization motivates use of that “lens” to consider such matters, to generally positive effect. Such use of the corporative “lens” supports “responsive regulation”.<sup>189</sup>

Assuming that corporations, or any other organizations, will be able to align their behaviour so as to avoid the imposition of strict liability “at the top” (although they may attempt to do so) is not only unscientific but also unrealistic, and not broadly consistent with experience. The effectiveness of *ex post facto* imposition of penalties in terms of motivating or restraining behaviour is now doubted in many fields of regulation, even in criminal law.

In fact, consideration of the matter in principle, now supported by some recent research, suggests that external regulation may, in some cases, conflict with internal regulation, such as that expressed in the “culture” of the corporation concerned, and that such conflicts may impair the performance of the corporation in some respects. The corporative perspective invites further elucidation of how

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<sup>185</sup> *Supra* notes 157 and 158. See the discussion in Chapter Six in the section entitled “Organizational Goals and Intraorganizational Goals”, particularly under the heading “Intraorganizational Goals, Power and Loyalty” and therein under the subheading “Information and Sanctions as Sources of Intraorganizational Power”.

<sup>186</sup> *Ibid.*

<sup>187</sup> See the discussion in Chapter Eight in the section entitled “Implications of Organizational Analysis for Limited Liability and Asset Partitioning” under the heading “Organization and Intracorporate Boundaries”.

<sup>188</sup> See the discussion *supra* notes 158-160.

<sup>189</sup> See the discussion in Christopher Hodges, “Corporate Behaviour: Enforcement, Support or Ethical Culture?” (2015) University of Oxford Legal Research Paper Series Paper No. 19/2015. Available at SSRN: <https://ssrn.com/abstract=2599961> or <http://dx.doi.org/10.2139/ssrn.2599961>.



the structure, processes, and personnel of the organization may be affected by, and may affect, internal and external regulatory initiatives, mechanisms, and developments.

### **Corporative Responsibility**

One challenge that presents itself, once it is realized that the corporation is the situs of considerable psychological, social and political, as well as economic, activity, is to consider the nature of its responsibility for its undertaking and related activities, consequences, and externalities, whether psychological, social, political, economic, or otherwise. It is apparent from the foregoing discussion that liability may be assigned to the corporation; however, assigning liability to specific persons or groups within the corporation presents difficulties. The sheer numbers of actors and groups, internally, and the importance of structure and process to this task complicate any such an undertaking.<sup>190</sup> Such intracorporate undertakings typically involve both positive and negative sanctions, including, for example, allocation of “bonuses” for performance, as well as imposition of negative sanctions for non-performance, sub-target performance, or imposition of legal penalties by external regulators and others with respect to the same, whether criminal, administrative or otherwise. The intracorporate challenge may be compared to an endeavour to assign “responsibility” for some action taken by or on behalf of the society or polity at large.

### ***Social and Political Responsibility***

The assignment of responsibility for organizational action can be extremely complex indeed. Can the invasion by one country of another contrary to international law be attributed entirely to the head of state in a presidential system, or the head of the political function, such as a prime minister in a Westminster type democracy? While the president of a republic or the prime minister of a Westminster style democracy may have had a high degree of involvement in the decision-making process, normally, decisions of such nature involve the involvement of the cabinet and other advisors, internal and external. We might ask about the nature of the cabinet (and advisors), of its composition, and of its authority. If it was selected by the prime minister or head of state, we might ask how that person was selected, perhaps by some party machinery or other, perhaps by some more deliberately “democratic” process, or perhaps otherwise.

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<sup>190</sup> See, in particular, the discussion in the immediately preceding section entitled "Participation, Responsibility, and Private and Public Regulation".

Can responsibility for an invasion decision be exclusively assigned to the head of state or prime minister? To the Cabinet? To those who briefed the head of state, prime minister, or cabinet, chose the information and framed the policy alternatives put before them and thereby influenced or may have influenced the decision or the decision-maker(s) in some manner or other? Can responsibility be assigned, in the alternative, or in whole or in part, to the legislature to which the cabinet must be accountable to some or other degree, or which may even have been required to approve such action? To some or other legislative committee or committees having oversight of the subject? To the electorate that elected the relevant decision-makers or decision-influencers? To those within the polity who influence the choices of personnel, involving, perhaps, “the party”, its leaders and members, who participated in the selection of the “party leader”? Or those who otherwise affect the framework and subjects of public discourse? Or those who might prevent realization of the mandate, whether by means of action or by inaction?

This example, which invites consideration of various formulations of causation, as a matter of law and otherwise, demonstrates the difficulty of determining causation and of assigning responsibility in such a complex sociopolitical environment. That description characterizes a large modern business corporation, just as it does other types of organizations.<sup>191</sup>

Consideration of the corporation from a corporative perspective facilitates examination of issues of moral and legal responsibility of the corporation as a legal entity vis-à-vis its external environment and external actors, and of the corporation as an organization vis-à-vis its internal constituents.<sup>192</sup> The relationship between the corporation as legal actor and the animating or instituting internal participants cannot be ignored in, or by, a theory of the corporation which seeks to have integrity and explanatory power.

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<sup>191</sup> *Ibid.* See also the discussion section entitled "Assumptions of Liberal Economics and of Legal Theory" under the headings "Acts or Omissions of the Corporation" and "Structure and Process of Organizations – Negotiation and Development."

<sup>192</sup> As indicated above in the section entitled "*Theoria, Praxis, and Corporativity*" under the subheadings "The Corporation as a Nexus of Relationships and as an Organization" and "The Corporation's Intraorganizational and Extraorganizational Orientations", the relationship between the corporation, as a legal entity, and other human persons or entities is always, as a legal matter, "external" to the corporation; however, as between the corporation as organization and other human persons or entities as participants in such organization, the relationship may be described as placed in the continuum as between immediate or internal, on the one hand, and remote or external, on the other hand. Based upon this understanding, and for reasons of simplicity, the characterization of these relationships will often be abbreviated in this work as either "internal" or "external".

### ***Responsibility in a Complex Environment***

The conclusion drawn here is that, while it may occur occasionally, it will be relatively infrequently that the outcome of such political and complex processes in an organization with a complex structure can be credited or blamed with a high degree of certainty on some one or more individuals, groups, units, or sub-units. Similarly, this may be expected to be the case with respect to the reasons, reasoning, and information collection and formation processes forming part of the overall decision-making process. Further, adjustment and readjustment of structure, processes, and participation arrangement may result in changes in authority and responsibility from time to time which, obviously, has the capacity to affect assignment of responsibility in particular situations. When the corporation operates in a volatile or dynamic environment, particularly one which is characterized by rapid, discontinuous, and significant change, such a task may become virtually impossible.

Thus, with relatively rare exceptions, given the range of decisions (and indecisions) made (or avoided) by and within such an organization, the corporation is the logical party to be assigned the credit or blame for positive or negative consequences of such decisions and indecisions. In some cases, it may be possible to justifiably credit or blame the Chief Executive Officer, Chief Financial Officer, the top management team or some one or more of its members, senior management or some one or more of its members, or some other level or function within management, and, in others, the board of directors, but it is submitted that such cases will, again, be relatively infrequent on the whole; that is, provided that such allocations are sought to be imposed on some reasonable realistic basis, rather than on the basis of some absolute, strict, or positional liability.

Objection to this may be taken on the ground that failure to allocate responsibility leaves the benefits and burdens to be shared among the participants in the corporation in accordance with the constitutive or other underlying arrangements for such participation, as adjusted from time to time or otherwise. In this way, the burden or benefit is shared by and among such participants or, at least, some of them. This may be characterized as an unfair allocation from the perspective of causation and blameworthiness. But, of course, it is the difficulty attendant on attempting to assign causation and responsibility which makes such an allocation to the corporation itself, primarily or exclusively, realistic, even reasonable, and perhaps, in some circumstances, all but inevitable. That argument may be particularly persuasive where the alternative is allocation of the burden or benefit

to some uninvolved party, such as the society or polity generally, or to specific groups within the society or polity.

Of course, it is not only with respect to the assignment of responsibility for actions or omissions attended by negative consequences or attributes that psychological, social, political, and economic processes and considerations may be relevant, with respect to the corporation, as well as to the polity. The case is the same with respect to positive consequences or attributes. Asking who is responsible for the unprecedented success of a particular corporation has something in common with asking who is responsible for the unprecedented economic and social well-being of a polity. Why was Japan such a “success story” in the 1970’s and early 1980’s, but not later? What about the United States in the period after the Second World War? What about Germany in the later years of the twentieth century? Surely, the answers to each of the questions in the preceding paragraphs are complex and diffuse in nature. Assuming that the Chief Executive Officer of a corporation is wholly responsible for its successes or failures is obviously in some ways as simplistic and problematic as such assumption would be with respect to the head of state or prime minister of a modern Westphalian state functions as a Westminster style democracy.

It can be seen from the present discussion that leadership in a modern complex business corporation, as in a modern society or polity, is multi-dimensional, and multivariate. Important consequences attend this realization. For example, the composition, and exercise, of “leadership” within the corporation is not determined solely by the organizational chart of the formal organization, but may be influenced by informal structures and processes which is not often capable of being described in this way. Informal “leadership” is not necessarily exhausted or even concentrated at one or at a relatively few levels of the hierarchy. In fact, real “leadership: may not be consequent solely or primarily upon position or function, but may be consequent, in whole or in part, upon personal qualities, such as charisma or some other enigmatic quality.<sup>193</sup> A corporative theory of the corporation acknowledges these important considerations.

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<sup>193</sup> See the discussion in: Chapter Four in the section entitled "Groups of People or Social Units" under the heading "Max Weber on Organizations and Related Matters" and therein under the subheading "Mutual Responsibility in Representation"; and Chapter Five in the sections entitled "Structure, Process, and Personnel"; and "Organizational Structure" under the headings "Formal Structure and Relationships", "Informal Structure and Relationships" and "Formal Organizations and Informal Organizations".

## **A Corporative Analysis of Corporate Behaviour, Success, and Failure**

A corporative approach to the corporation acknowledges the extent to which its structure and processes, like those of any other organization, engage with various aspects of human behaviour, encompassing both individual and group behaviour. The operations of other organizations and their effectiveness, whatever their objectives, are affected by interaction by, between, and among groups, as well as individuals, at different levels, and with respect to different functions, of the organization. Organizations must recognize and attempt to account for the manifold complexities of human behaviour in an organization.

Within the corporation is a society and polity that may be compared with the society and polity within which the corporation is situated. In that sense, the corporation is within society and society is within the corporation. As such, a corporative approach to the corporation acknowledges not only that it occupies a space or place within the greater society and polity, but, also, that such society and polity animates and institutes the corporation as an organization.

By avoiding reductive individualism, while also avoiding sociological reductionism, the corporative perspective seeks to recognize the social aspects of the human behavior that impact the behaviour of the corporation as a legal actor in the world. The legal and social construct that is the corporation as legal entity and institution does not exhaust the aspects with respect to which its organization is also socially constructed and instituted.

### ***Effects on Participants***

The participants in the corporation also occupy spaces or places within that greater society and polity, as well as within the corporation itself. The participant in the corporation, as an actor, does not shed other aspects of his or her being as an individual within the world, within a particular society and within a particular polity when, and by means of, entering into that corporate space, life, or role. That participant is not just a worker in, supplier to, or customer of, that corporation, but is also a parent, child, member of social, religious or other groups, a voter, a sports player, reader, or intellectual. While the corporation provides some measure of identity to the participant, this must be considered against other measures and species of identity and identification.

For example, when a corporation “blows up”, the identity of its participants is affected: they “lose” their identity as employee, supplier, or customer. That loss of identity may express itself in a

variety of ways in the wider society and polity. A high-flying employee at a widely-respected organization such as Enron and hence someone proud of being “one of the smartest in the room” may subsequently be subject to criticism for that same involvement. Further, the employee may not be able to replace such employment or such prestige. Even if this is possible, such employee must reconstruct his or her package of social identities (perhaps with loss of income, prestige, physical relocation, work-related friendships and outside activities, or otherwise), while the greater society and polity may have to engage in some reconstruction, too, as it suffers work force dislocation, unemployment, and dissatisfaction, and other economic, social, and political effects.

The scale of many modern business corporations is such that when one “blows up”, the effects are very widespread. Instead of a single “entrepreneur”, as originator of the enterprise and provider of its capital, with a manager and a few employees, as in the classical model of the firm, the “blow up” of a modern business corporation may involve equity and debt capital providers, employees, suppliers, customers, pensioners, municipal, state and national governments, members of communities in which the corporation operates, accounting, legal, and financial advisors, and others. For example, the collapse of Enron had enormous effects, including the collapse of one of the leading “Big Five” accounting firms, Arthur Andersen, thereby affecting its partners, employees, clients, suppliers, and affected communities, states, regions, and countries.

The probability that all of the participants will be equally well situated after the “blow up” as they were before then is likely insignificant. Accordingly, the “loss” involved in the corporate blow-up affects the broader society and polity. In the case of a threatened “blow up” of a very large influential corporation, whose activities are extensive, widely dispersed and significant, such as Enron, Worldcom, Bear Stearns, or Lehman Brothers, considerations such as these may be thought to justify intervention, by the society or polity, to prevent or lessen the likelihood of such a “blow up” taking place, and to mitigate its effects, if its eventuation cannot be prevented.

### *Non-Economic Aspects of Corporate Life*

It is argued in this work that corporative theory or the corporative perspective involves an analytical perspective wherein a corporation is not seen as involved only in generating profits for its owners and others, including members of its senior management. As the discussion here demonstrates, the function of the modern business corporation is not limited to generating surplus value or profit in economic terms alone. It is also implicated in many associative, affiliative, social,

and political activities, at least some of which may be considered as positive aspects of its operations. A corporative approach would recognize that corporations are not “bad” in and of themselves. Instead, as well as being economic actors seeking to generate surplus value, they are organizations and present places and spaces for human action and interaction, which may have positive, as well as negative, aspects from time to time.

We need not detain ourselves long considering why corporations have been perceived negatively by many social commentators. The Industrial Revolution in Great Britain and in Europe, in the last half of the eighteenth century to the middle of the late nineteenth century, provided many opportunities for criticism, such as offered by Weber, Marx, Hayek, and Polanyi, among others. Likewise, we need not detain ourselves considering the benefits which the corporation afforded to social, economic, and even political development, as chronicled by Hayek, Polanyi, Chandler, and Berle, among others. Criticism of the activities of the “robber barons” in the United States and or similar actors in other jurisdictions, as well as other factors, motivated changes, over time, in the social and economic fabric of society and nations, as mentioned below.

However, the time is apt, now, to recognize that the activities of corporations can be highly beneficial to society and to the polity at large. Recognizing the corporative aspect of these activities and of the modern business corporation itself should assist in this undertaking and in re-constructing and re-imagining the corporation as a matter of law and governance. This work is but a single step on the way to this goal.

## **Corporative Regulation**

### ***Cyclical Evolution***

Corporate law and corporate governance have sometimes been characterized as involving cyclical evolution. Significant developments in corporate law and corporate governance have resulted from crises and related public outcry, especially where these crises have been seen as resulting from failures of corporate law and corporate governance.<sup>194</sup>

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<sup>194</sup> See, for example, the discussion in William W Bratton and Adam J Levitin, "A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs" (2013) 86:4 S Cal L Rev 783.

The New Deal may be seen by some as a response to the Great Depression. The Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, and the Investment Company Act of 1940 effected major changes in the regulatory landscape for corporations and, in particular, for publicly traded corporations. The collapse of Long-Term Capital Management and of the so-called “thrifts” (savings and loan companies) created further demand for additional regulation in the 1990s. The collapse of Enron, WorldCom, and other large corporations and organizations, such as Arthur Andersen LLP, were attended by the adoption of the Sarbanes-Oxley Act. The failures of AIG, Bear Stearns, and Lehman Brothers led to a groundswell of demand for further regulation, which significantly contributed to the adoption of the Dodd-Frank Act.

In this way, development of corporate law and corporate governance is seen by some as a linear progression in which crises and failures are seen to result from inadequate penalties, the response to which crises and failures often takes the form of increased penalties and the imposition of personal liability. Yet, if the progression is linear, and teleological, it might be expected that the achievement of the goal would be achieved or more closely achieved as each new stage of regulation eventuates. If, on the other hand, as seems to be the case, successive iterations of additional regulation do not necessarily have such results, some explanation must be sought. Perhaps this explanation lies in the nature of the corporation itself.

### ***Corporative Regulation of the Corporative Corporation***

It is argued here that failure to acknowledge the corporative nature of the corporation complicates its regulation, among other things. The recognition that the inward-facing aspect of the corporation involves complex psychological, social, and political, as well as economic, behavioural, processual, and structural considerations, must be essential to any effective regulatory scheme. Some behaviours may be subject to external influence to various degrees, but others may not; some may be completely impervious to external influence, but others may not; some may be restrained only, primarily, or to significant degree, by overtly political processes, or by social dynamic processes, or by psychological processes, but others may not. A corporative approach invites commentators, legislators, regulators, and courts, as well as other observers, to consider these issues in relation to the behaviour of the corporation in its external and legal aspect, as a legal actor in the economic, social and political realms, as well as in respect of its internal organization.



What rules, signals, influences, threats, penalties, and other possible means of motivating certain behaviour may be most beneficial, preferable and even optimal, as measured in relation to effectiveness and cost, in promoting a desired goal must be considered in relation to the internal structure and processes, formal and informal, of the target organization or corporation. The consequences, whether expected or unanticipated, of such “regulation”, both within and without the organization, must be considered. As always, seeking to eliminate one disbenefit or externality while possibly contributing to the occurrence of another but more significant disbenefit or externality is normally sought to be avoided. At another level, the effect on the internal or inward-facing aspect of the organization, may be critically related to its capacity to create surplus value, which is highly sought by society and the polity. The diminution of the likelihood of such surplus value creation may, in some cases, outweigh some or all of the cost of the externally-arising disbenefit or externality, thereby promoting a solution balancing such benefits and disbenefits.

Historical developments in corporate law and corporate governance, at least in the twentieth century, have been characterized by a reluctance, in practice, to reassess the fundamental approach to regulation and governance generally, and to regulation and governance of the modern business corporation in particular. New theoretical approaches to regulation, such as reflexivity, or responsivity, applied widely with respect to other areas of regulation have been applied to regulation of corporations in some concrete situations, but not always broadly and in a thoroughgoing manner. Some of the failure to apply reflexive or responsive regulation in the corporate context has been justified in light of the “fact” (contested here) that such regulated corporations and persons seek only, and their actions are based entirely on, economic self-interest.

Accordingly, public, legislative, and regulatory reaction has taken into account primarily, if not exclusively, learning from economics, and has failed to apply learning from non-legal fields, such as organizational behaviour, strategy, management theory and practice, and other business disciplines, organizational psychology, social psychology, sociology, philosophy, and others. As we have argued above, such reaction has failed, by and large, to consider to any significant degree, the extent to which existing forces exist which might moderate the behaviour of corporations, their participants, and internal structures and hierarchies, both formal and informal, and how these may be directed, with or without intervention by government mechanisms, towards more positive outcomes. Such reaction has failed to acknowledge and to take into account the corporative nature

of the modern business corporation. Instead, regulation of corporations and of corporate governance has been based largely, if not predominantly, on assumptions, rather than on empirical evidence, research, and empirically-derived reasoning and theorizing.

Such lack of attention to these disciplines and fields, and to corporativity, and to the lessons thereby made available in respect of the regulation and governance of corporations, has tended to lead to regulation at the margin, often dealing only or primarily with “excess”, namely, overt or excessive greed, outright crime, and fraud. In the absence of detailed knowledge of organizational structure and process, either generally or with respect to particular industries and corporations, such as might facilitate amelioration by means of behavioural intervention or influence, there has been a tendency to adopt “check the box” governance within the corporation, in which apparent process, as stipulated by regulators, dominates the agendas of boards of directors and senior management, often at the expense of attention to the structure and process of the corporation itself.

***“Deep”, and “Check the Box”, Regulation Distinguished***

This “check the box” process is pursued at the expense of seeking to develop a richer process that might be more effective and more conducive to attaining the objectives of the corporation, the society, and the polity, generally. A richer process would be attentive to the structure and processes not just of corporations generally, but of the subject-corporation in particular. Thus, in respect of regulation imposed on corporations in generally, and in respect of regulation self-imposed by a subject-corporation itself, more pervasive and nuanced governance and regulation often seems to go by the wayside.

In one sense, “check the box” regulation has a somewhat perverse effect in that it may persuade regulators and corporations, as well as the public, that this constitutes effective regulation. In turn, this may inhibit examining the real issues of corporate regulation and governance, in part, by challenging conventional assumptions and assessing the “real” position of the corporation itself, including its structure, process and personnel. Real regulation and governance of corporations “in the real world”, if it is to be effective, must involve application of the knowledge and methodologies of all disciplines and fields having something to contribute to the discourse on those issues.

In turn, the pursuit of wealth and value creation, however it is to be shared within the corporation, society and polity, is frequently thereby inhibited. Instead, “good governance” is considered as a cost to be borne by the corporation and its participants, rather than as a means to achievement.

## **Corporative Theory, Perspectives, and Alternative Theories**

### ***Perspectives***

A corporative theory of the corporation must, does, and will, consider the corporation from perspectives of various academic and practical disciplines and fields, including those just mentioned. It is considered that such corporative theory will may assist in and encourage consideration of development and appraisal of encouragement that is thoughtful, as well as, where appropriate, reflexive and responsive. As well as making it more productive, those applying a corporative approach will ask how to make the corporation “better”, more responsive to human needs, more productive of meaning, more beneficial to salient identity; in effect, more effective in accomplishing the goals and objectives with which it is charged by its participants, including the society and polity at large.

Those goals and objectives are not exclusively economic, but also relate to society and the polity more broadly. While Berle’s corporate City of God may be beyond conception in relation to the corporation, at least as presently envisioned, a more positive image, and certainly a less negative image, of the corporation may attend a corporative approach to the corporation as a matter of legal theory. Legal theory should not, alone, be left without resources of other disciplines, as well as those of the legal discipline, in fashioning such beneficial changes. A corporative approach avails itself of such resources. Other factors also argue for this approach.

### ***Disintermediation***

It is sometimes observed that the modern society and modern polity exhibit significant disintermediation of the individual and the society or polity, as the case may be, at large. The individual may lack various associative and affiliative bonds that formerly intermediated the relationship of a person in his or her position to the society or polity at large. Formerly, labour union, religious, social and other organizations at various levels of the society or polity furnished an individual not only with a framework for purely social interaction, but also with a means of asserting common interests in the larger society or political whole. The individual could consider

that the “gulf” between that individual and society at large or the nation state (or subsidiary polity) at large was ameliorated by his or her inclusion in those other organizations.

As those other organizations have apparently increased in scope and significance in society and the state at large, the benefits of intermediation seem to have been lost, to at least some extent. Some social commentators call for a resurgence of organized labour, of religious organizations, of fraternal, social service, or other social organizations. There can be but scant doubt that such reintermediation might provide significant benefits to individuals. It might provide them with a further basis of identification with, and identity with respect to, such organizations. However, the form of organization which we recognize as the modern business corporation, should, at least, be considered as a source of possible social and political reintermediation.

As noted here and in the main text, the corporative perspective enables such an approach.

### *Social and Political Salience*

As argued here and in the Conclusion, the collapse of a large modern business corporation, whether from nefarious or other causes, may be catastrophic for many of its participants. The social, political, and economic dislocation effected thereby is such that many commentators, social, political, economic, and other, are found to opine that such a collapse cannot be justified as a result of competitive factors alone; and that boundaries must be established for competition that avoid such collapses. This apparently recognizes, at least to some extent, that the classical political economy model of the firm cannot be justified as a model for, and as a basis of action with respect to, the modern business corporation.

As argued in this work, the modern business corporation is corporative: it is within society and society is within the modern business corporation. It is intra-social and society is intra-corporate. Collapses of huge corporations should be avoided, and, if they cannot be avoided, must be managed to minimize the damage to the society and polity at large. Such loss minimization may frequently include an assessment of “lessons learned” from such events. This procedure has been adopted, to some extent, with respect to such catastrophic failures as Long-Term Capital Management, the “thrifts”, Enron, WorldCom, and Lehman Brothers.

It is necessary, however, to recognize that, in the absence of the wealth and surplus value created by the activities of the modern business corporation, the benefits otherwise created by economic

activity would be unavailable, not only to the participants in the corporation, but also to the society and polity at large. Quite apart from questions of distribution of surplus value, modern societies and polities depend upon corporations, as principal economic actors, to generate surplus value. Quite apart from economic benefits, the modern business corporation meets other needs and accomplishes other goals and objectives of the society and polity, many of which are not limited exclusively to participants in the corporation. A corporative perspective recognizes this.

### ***Extant Legal Theory of the Corporation***

This work argues that a legal theory of what the corporation “is” must have a degree of explanatory and predictive capacity which exceeds conventional extant theorizing. This work establishes that the “corporative” theory of the corporation meets these requirements, at least provisionally, and thus is worthy of further exposition, attempted verification, refinement and development, in a scientific and empirical fashion. Corporative theory has many affinities with the behavioural theory of the firm of the Carnegie School.<sup>195</sup>

Consequently, many conventions attending the legal theory of, and many legal theories of, the corporation must be discarded.<sup>196</sup> For example, the notion of “legal personality”<sup>197</sup> is “off the

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<sup>195</sup> Some business theorists of the firm identify the “behavioral theory of the firm” as a distinct theory, beginning with such authors as Chester I Barnard, *The Functions of the Executive* (Cambridge: Harvard University Press, 1938); Herbert A Simon, *Administrative Behavior: A Study of Decision-Making Processes in Administrative Organization*, 4<sup>th</sup> ed (New York: Free Press, 1997); James T March and Simon, *Organizations* (New York: John Wiley and Sons, Inc, 1958); and Herbert A Simon, *Models of Bounded Rationality: Behavioral Economics and Business Organization* (Cambridge, Mass: MIT Press, 1982). Discussion of their work appears in: Chapter Three of the main text in the section entitled “Barriers to Unified Action” under the heading “Diffusion of Rationality, Information, and Decision Making”; Chapter Four in the section entitled “Groups of People or Social Units”; Chapter Five at numerous places; and Chapter Six in the sections entitled “Organizational Goals and Intraorganizational Goals”. A behavioural theory of boards and board behaviour is articulated in Hans van Ees, Jonas Gabrielsson and Morten Huse, “Toward a Behavioral Theory of Boards and Corporate Governance” (2009) 17:3 Corp Gov Intl Rev 307. A recent article analyzing the corporation as organization (rather than as simply a “legal person”, is June Carbone and Nancy Levit, “The Death of the Firm” (2017) 101Minn L Rev 963. See also Luh Lan & Loizos Heracleous, “Rethinking Agency Theory: The View from Law” (2010) 35:2 Academy Management Rev 294.

<sup>196</sup> Excellent reviews of the subject include: David Millon, “Theories of the Corporation” (1990) Duke LJ 201; Thomas Lee Hazen, “The Corporate Persona, Contract (and Market) Failure, and Moral Values (1990) 69:1 NCL Rev 273; William Bratton, “The New Economic Theory of the Firm: Critical Perspectives from History” (1989) 41:6 Stan L Rev 1471; and Margaret M Blair, “Corporate Personhood and the Corporate Persona” (2013) U Ill L Rev 785. See also Oliver Hart, “Corporate Governance: Some Theory and Implications” (1995) 105 Econ J 678; and Eric W Orts, “Corporate Law and Business Theory” (2017) 74 Wash & Lee L Rev 1089.

<sup>197</sup> See, for example, the discussion of the subject by Jennifer Hill, *supra* note 151; and its relation to corporatism, *supra* note 41. Other reviews of “corporate personhood” theory include: David Millon, “The Ambiguous Significance of Corporate Personhood” (2001) 2:1 Stanford Agora: An Online Journal of Legal Perspectives 39 – reviewing communitarian, contractarian, natural entity, property, “legal person” and other theories; Kent Greenfield, “From

table”, as lacking significance and predictive capacity, as an analogy to the human person, in favour of a description of the real interaction of real persons (and groups, and groups of groups, of such real persons) implicated in the corporation. Comparing the body having ultimate responsibility for directing the corporation to the “mind” or “brain” of a human person, with the “body” of such person being constituted by every other human person or group of persons within the corporation, no longer has any purchase.<sup>198</sup> Even if that analogy meant something before the discovery of the relationship between the brain and other parts of the body, such a simple analogy is inadequate today. However, an analogy which employed knowledge of modern neurological, vascular, and other medical knowledge might make the analogy more apt, albeit significantly more complex. The brain depends on other organs and systems of the body, including its neurological system, vascular and circulatory, and other systems and organs, not all of which are dependent for their effective functioning on the brain. Similarly, while the brain might direct certain of the body’s activities, that is not the case for some other activities.

Symbolist, and collective theories, and realist accounts such as advanced by Dicey, Maitland, or von Gierke, are to like effect, with respect to their significance and predictive capacity.<sup>199</sup> The concept of the corporation as a “legal fiction” also fails to engage with its content and

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Metaphor to Reality" (2001) 2:1 Stanford Agora: An Online Journal of Legal Perspectives" 59 – criticizing contractual theory; Thomas A Smith, "The Use and Abuse of Corporate Personality" (2001) 2:1 Stanford Agora: An Online Journal of Legal Perspectives" 69 – advocating analysis of the corporation as a relationship; Lyman P Q Johnson, "Law and Legal Theory in the History of Corporate Responsibility: Corporate Personhood" (2012) 35 Seattle U L Rev 1135; and Stefan J Padfield, "A New Social Contract: Corporate Personality Theory and the Death of the Firm" (2017) 101 Minn L Rev Headnotes 363.

<sup>198</sup> *Ibid.* The subject of corporate legal personality was extensively discussed during the first quarter of the twentieth century. Many experts regarded the classic exposition of the subject as: John Dewey, "The Historic Background of Corporate Legal Personality" (1926) 35:6 Yale L J 655. Other leading texts and articles which appeared during that period include: W M Geldart, "Legal Personality" (1911) 27 L Q Rev 219; Arthur Machen, "Corporate Personality" (1910) 24:4 (Part 1) 253 and 24:5 (Part 2) 347; Frederic William Maitland, "Moral Personality and Legal Personality" (1905) in H A L Fisher, ed, *Frederic William Maitland: Collected Papers* (Cambridge: Cambridge University Press 1911); Felix Cohen, "Transcendental Nonsense and the Functional Approach" (1935) 35 Colum L Rev 809; Harold Laski, "The Personality of Associations" (1916) Harv L Rev 404; George F Canfield, "The Scope and Limits of the Corporate Entity Theory" (1917) 17:2 Colum L Rev 128; and Bryant Smith, "Legal Personality" (1928) Yale L J 283.

<sup>199</sup> *Supra* notes 196 and 197. See the discussion in: Otto Gierke, *Political Theories of the Middle Ages* 1900 (Cambridge: Cambridge University Press, 1913); Steven M Bainbridge, "Participatory Management Within a Theory of the Firm" (1996) 21:4 J Corp L 658; Ron Harris, "The Transplantation of the Legal Discourse on Corporate Personality Theories: From German Codification to British Political Pluralism and American Big Business" (2006) 63 Wash & Lee L Rev 1421. With respect to the "real entity" theory, see, in particular, Mark M Hager, "Bodies Politic: The Progressive History of the "Real Entity" Theory of the Corporation (1989) 50 U Pitt L Rev 575.

significance.<sup>200</sup> “Concession” theory explains only how the outer shell or outward-facing aspect of the corporation eventuates governmentally.<sup>201</sup>

The “nexus of contracts” theory is likewise subject to many of these criticisms.<sup>202</sup> Perhaps most significantly, it treats the corporation as a production function, and even arguably as a finance function, while invisibilizing it, even eliminating it, as an organization, thereby preventing consideration of many of its most interesting and important features, not all of which relate only to matters of contract. Further, it does not usually differentiate adequately between “internal” and “external” relationships or contracts. At least as most often framed, it deals exclusively with “economic” matters, and does not consider affiliative and associative, as well as other, human needs. It may be said to rule out such considerations almost *ex hypothesi* as a result of its characterization of “economic man”.

Even the theory of team production offers only a partial and incomplete explanation.<sup>203</sup> It seeks to dispense with claims of “shareholder primacy” as a guiding principle of corporate law and

<sup>200</sup> See the discussion in Chapter Seven in the section entitled “Separate Legal Entity” under the heading “The Corporation, the Legal Entity, the Organization and the Participants” under the subheading “The Corporation, Organizational Participants, and Intraorganizational Relations”; and the discussion of the same in the excellent article: Jean-Philippe Robé, “The Legal Structure of the Firm” (2011) 1:1 Accounting, Economics, and Law Article 5 at 37. Other prominent and recent articles on the subject include: Simeon E Baldwin, “A Legal Fiction with Its Wings Clipped” (1907) 41 Am L Rev 38; Frederick Pollock, “Has the Common Law Received the Fiction Theory of Corporations?” (1911) 27 L Q Rev 233; Sanford A Schane, “The Corporation is a Person: The Language of a Legal Fiction” (1986-1987) 61 Tul L Rev 563; and Mary G Condon, “Of Butterflies and Bitterness: Fictions in Corporate and Securities Law” in Ysolde Gendreau, ed, *Fictions in the Law/les fictions du droit*, (Montreal, QC: Les Editions Themis, 2001).

<sup>201</sup> See, for example, Stefan J Padfield, “Rehabilitating Concession Theory” (2014) 66:2 Okla L Rev 327, supporting concession theory as against aggregate theory and real entity theory. See also Stefan J Padfield “Corporate Social Responsibility & Concession Theory” (2015, 6 Wm & Mary Bus L Rev 1. For criticism from a stakeholder perspective, see Joseph T Mahoney, “Towards a Stakeholder Theory of Strategic Management” (2012) in Joan Enric Ricart Costa, Josep Maria Rosanas Marti, eds, *Towards a New Theory of the Firm: Humanizing the Firm and the Management Profession* (Bilbao, Spain: BBVA, 2012) 153.

<sup>202</sup> *Supra* note 118. See the discussion in Chapter Three in the section entitled “Organizations as Political Systems” under the heading “Business Coalitions and the Economic Theory of the Firm” and the sources referenced therein. Some additional prominent or recent discussions include: William J Bratton, “The “Nexus of Contracts” Corporation: A Critical Appraisal” (1989) Cornell L Rev 407; Henry N Butler, “The Contractual Theory of the Corporation” (1989) 11:4 George Mason L Rev 99; and Michael Klausner, “The Contractarian Theory of Corporate Law: A Generation Later” (2006) J Corp L 779.

<sup>203</sup> See the discussion in the Conclusion in the section entitled “The Breadth and Scope of This Book” under the heading “The Distinctiveness of the Corporative Corporation” and the sources cited therein; and in the section entitled “Contemporary Responses to Challenges” under the heading “Relation of These Initiatives to Corporative Theory” and the sources cited therein; and in Chapter Eight in the section entitled “Implications of Organizational Analysis for Limited Liability and Asset Partitioning” under the headings “Shareholders” and “Board of Directors” and the sources cited therein. See, also, *supra* note 117. See, in particular, Margaret M Blair and Lynn A Stout, “A Team Production Theory of Corporate Law” (1999) 85 Va L Rev 247.

corporate governance, recognizes the role of participants in the corporation as claimants to participation in its operations and governance, and views the board of directors as the “mediating hierarch” adjudicating such claims, which are considered to be purely (or at least primarily) economic or financial in nature. It also acknowledges and applies learning from disciplines other than law to theorizing about law, in part by challenging assumptions of the nature of man as seeking to satisfy only rational self-interest, and recognizing that human beings engage in “prosocial” behaviour.

In the latter respect, team production theory effects some of the same results as the corporative theory outlined in this work. However, while it invites consideration of the decision-making process, it employs, rather than challenges, many of the assumptions of classical and neoclassical economics concerning the nature of the firm. It also limits its consideration to the economic objectives and interests of the members of the team. In summary, it fails to challenge economic assumptions underlying corporate law theory in as thoroughgoing a manner as does the present work. Thus, it may be thought that it contributes more significantly to the theory of governance of the corporation than it does to the theory of the corporation as such.

Stakeholder theory,<sup>204</sup> similarly, takes into account only (some would argue primarily) economic objectives and interests of the “stakeholders” identified. Their identification as stakeholders, in effect, takes into account only their economic, but not their other significant, objectives and interests. It is often argued that it takes into account ethical and other evaluative considerations; however, unless those considerations are extended to include non-economic and non-financial considerations, objectives, and interests, real equanimity in terms of “welfare” or “well-being” in a more holistic sense may not be promoted. Indeed, without employing such extended criteria or

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<sup>204</sup> See the discussion in this Introduction above in the section entitled "*Theoria, Praxis*, and Corporativity" under the heading "The Corporation as Legal Entity and As Organization" and therein under the subheading "Trust and Reciprocity Within Relationships and Within the Organization", and the sources referenced therein; Chapter Seven in the section entitled "The Corporation, the Legal Entity, the Organization, and the Participants" under the heading "Organizational Participants, Stakeholders, and Corporate Social Responsibility", and the sources referenced therein; and in the Conclusion in the section entitled "The Breadth and Scope of This Book" under the heading "The Distinctiveness of the Corporative Corporation"; and in the section entitled "Contemporary Responses to Challenges" under the heading "The Limited Responses of Existing Corporate Legal Theory", and the sources cited therein. Prominent and recent discussions of stakeholder theory include: R Edward Freeman, Andrew C Wicks, Bidhan Parmar, "Stakeholder Theory and "The Corporate Objective Revisited"" (2004) 15:3 *Organization Science* 364; and Robin W Roberts, "Determinants of Corporate Social Responsibility Disclosure: An Application of Stakeholder Theory" (1992) 17:6 *Accounting, Organizations and Society* 595.



considerations, the result may be only to promote a more satisfactory distribution of economic or financial costs and benefits, without a real increase in aggregate stakeholder “satisfaction” considered more broadly. Insofar as stakeholder theory recognizes the interests of “stakeholders” other than shareholders, it may be considered to be in conflict with maximizing shareholder value and shareholder primacy.<sup>205</sup>

The theory (or, some would say, doctrine) of “relational” or “incomplete” contracts is not, of course, a theory of the firm as such;<sup>206</sup> however, its analysis of relationships and reasonable expectations of the parties to such relationships aligns well with corporative theory, as well as with certain elements of team production theory and stakeholder theory and, to a lesser extent, with “a nexus of contracts”, contract, or contractarian theory.<sup>207</sup>

Theories of management dominance and of shareholder dominance may be viewed as conclusions based on some evidence, at least if derived empirically, or as teleological or moral principles, if otherwise derived. In the first case, the evidence may be presented to justify the conclusion

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<sup>205</sup> See the discussion in Michael C Jensen, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function" (2001) 7:3 *European Financial Management* 297.

<sup>206</sup> *Supra* notes 117 and 118 and the sources cited therein. Such arrangements are often referred to as involving "extralegal contracting", which may be considered by some as an oxymoron, at least if the term "contract" is intended to refer not to agreements having moral, but to those having legal, efficacy. Alternatively, of course, it can be regarded as simply customary law or the *lex mercatoria*. See Greg Buchak, "Valuing Reputation in Extralegal Contracting" (October 14, 2016). Available at SSRN: <https://ssrn.com/abstract=2852110> or <http://dx.doi.org/10.2139/ssrn.2852110>. Buchak's examples include the famous cases of diamond dealers, whalers, and Maghribi traders, referenced in, respectively, Lisa Bernstein, "Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry" 21:1 *J Leg Stud* 115; Robert C Ellickson, "A Hypothesis of Wealth-Maximizing Norms: Evidence from the Whaling Industry" 5:1 *JL Econ & Org* 83; and Avner Greif, "Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition" (1993), *American Ec Rev* 525. For a discussion of customary, rather than legal, regulation, Buchak cites Lisa Bernstein and Francesco Parisi, "Customary Law: An Introduction" (2014) in Lisa Bernstein and Francesco Parisi, eds, *Customary Law and Economics* (Cheltenham UK and Northampton MA: Edward Elgar Publishing Limited, 2014).

<sup>207</sup> A leading, if not the leading, originative article in this regard is Stewart Macaulay, "Non-Contractual Relations in Business: A Preliminary Study" (1963) 28:1 *American Sociological Rev* 55. An empirical study conducted by business academics is reported in Laura Poppo and Todd Zenger, "Do Formal Contracts and Relational Governance Function as Substitutes or Compliments?" (2002) 23 *Strategic Management J* 707. The distinction between ordinary contracts and "relational" contracts is discussed by some economists as relating to discrete trading contracts and what is described in the present work as intraorganizational relationships, understandings, agreements, and expectations. See Ronald H Coase, "The Nature of the Firm" (1937) 4:16 *Economica* 386; Oliver D Hart, "Incomplete Contracts and the Theory of the Firm" (1988) 4:1 *JL Econ & Org* 119; Scott E Masten, "A Legal Basis for the Firm" (1988) 4:1 *JL Econ & Org* 181; and Peer Zumbansen and Simon Archer, "The BCE Decision: Reflections on the Firm as a Contractual Organization" (2008) *Comparative Research in Law & Political Economy Research Paper No. 17/2008*.

reached. That is not often the case, however. In the second case, no evidence is necessary, other than argument or appeal to reason or passion, both of which are often presented as experience.

To the extent, however, that a management primacy theory<sup>208</sup> or a shareholder primacy theory<sup>209</sup> is empirical, it may be regarded by a corporative theorist as a way to characterize corporations generally, or a particular corporation, in effect, with respect to the dominant coalition, whose existence and operation depends, in part at least, on internal structure and processes, and in another part on external legal attributes. The continuing interrelation of those elements, not just those operating internally, and not just operating externally, affects the existence and effect of such dominance. If, on the other hand, such dominance by either management or shareholders is considered to be an expression of what should prevail, the argument is a normative or moral one which must proceed on a rather different footing. Of course, ascribing dominance to either group may be factually erroneous, or may be morally and normatively unjustified.

In effect, theories of management dominance and shareholder dominance are not theories of the corporation, but are descriptions of where power and influence within the corporation does, or should, reside. Thus, they do not engage with a corporative theory, which is not so derived, but

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<sup>208</sup> For example, see Allen Kaufman and Lawrence Zacharias, "From Trust to Contract: The Legal Language of Managerial Ideology, 1920-1980" (1992) 66:3 *Business History Rev* 523. Managerial primacy, expressed as "director" primacy has been extensively discussed by Stephen M Bainbridge, including in Stephen M Bainbridge "Director Primacy: The Means and Ends of Corporate Governance" (2002) 97 *Nw UL Rev* 547; Stephen M Bainbridge, "Participatory Management Within a Theory of the Firm" (1996) 21:4 *J Corp L* 658; and Stephen M Bainbridge, "Director Primacy and Shareholder Disempowerment" (2006) 119:6 *Harv L Rev* 1735. Bainbridge cogently argues the merits of decision-making by boards of directors, as the ultimate authority within the corporation, in: Stephen M Bainbridge, "Why a Board? Group Decision-Making in Corporate Governance" (2002) 55:1 *Vand L Rev* 1.

<sup>209</sup> Many discussions of shareholder primacy theory also reference management (or director) primacy theory, discussed *supra* note 208. Some relatively prominent or recent reviews include: those by Stephen Bainbridge *supra* note 204; Lynn A Stout, "Bad and Not-So-Bad Arguments for Shareholder Primacy" (2002) 75 *S Cal L Rev* 1189; Jill E Fisch, "Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy" (2006) *J Corp L* 637; Lynn A Stout "The Mythical Benefits of Shareholder Control" (2007) 93:3 *Va L Rev* 789; Lynn A Stout "New Thinking on Shareholder Primacy" (2012) 2 *Accounting, Economics, and Law* xix; Lynn A Stout, "On the Rise of Shareholder Primacy, Signs of Its Fall, and the Return of Managerialism (in the Closet)" (2012-2013) 36 *Seattle L Rev* 1169; William W Bratton and Michael L Wachter, "Shareholder Primacy's Corporatist Origins: Adolf Berle and *The Modern Corporation*" (2008) 34:1 *J Corp L* 99; Fenner L Stewart, "Berle's Conception of Shareholder Primacy: A Forgotten Perspective for Reconsideration During the Rise of Finance" (2011) 34 *Seattle L Rev* 1457; Robert J Rhee, "A Legal Theory of Shareholder Primacy" (2017) 102 *Minn L Rev* 1951; Stephen M Bainbridge, "The Geography of Revlon-Land" (2013) 81 *Fordham L Rev* 3277; Lenore M Palladino, "Ending Shareholder Primacy in Corporate Governance" (2019) Roosevelt Institute Issue Brief (New York: Roosevelt Institute, 2018), available at: <https://rooseveltinstitute.org/ending-shareholder-primacy-corporate-governance/>; and Kent Greenfield, "The Third Way: Beyond Shareholder or Board Primacy" 37 (2015) *Seattle UL Rev* 749.

which attempts to engage with issues of power and influence within the corporation having regard to the nature of the “within”, as well as the “without”, with respect to the corporation itself.

### ***Transnational Law***

A corporative theory of the corporation also addresses the challenges of transnational law.<sup>210</sup> A concern of international law and of transnational law has been, and continues to be, the extent to which the adoption, legitimacy and application of international and transnational law, the legitimacy of representation of people, societies and polities by international and transnational legal institutions, and their subjection to international and transnational law and legal institutions, are, and are perceived by their putative subjects as, legitimate. Attempts have been made to justify subjection of citizens of one country to rules adopted by non-governmental organizations constituted by that country and others acting collectively, or by organizations such as the United Nations or the European Economic Community, themselves constituted in such manner. It is argued that such transnational organizations are legitimized by action by those entrusted with authority within the country or polity and by delegation of certain authority to the international (IO) or transnational organization (TO) concerned.

Of course, issues of disintermediation arise in this regard. For example, questions arise about how a citizen and member of the electorate of Canada makes his or her view known with respect to the IO or TO concerned; and how that IO or TO takes account of views expressed by the citizenry and electorate of its member countries. The very remoteness of the IO or TO causes concerns, not only about the legitimacy of such regulation, but about respect for it and for its enforcement, which often engages the states and citizens themselves. An IO or TO purporting to embrace states whose

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<sup>210</sup> See the discussion transnational law in: Peer Zumbansen, "The Conundrum of Corporate Social Responsibility: Reflections on the Change in Nature of Firms and States" in R Bratspies & R Miller, eds, *Transboundary Harm in the 21st Century: Lessons from the Trail Smelter Arbitration* (Cambridge: Cambridge University Press, 2006) 240; Peer Zumbansen, "Introduction – Private Ordering in a Globalizing World: Still Searching for the Basis of Contract" (2007) 14:2 *Indiana J Global Legal Studies* 181; Peer Zumbansen, "The Law of Society: Governance Through Contract" (2007) 14:2 *Indiana J Global Legal Studies* 191; Peer Zumbansen, "Rethinking the Nature of the Firm: The Corporation as a Corporate Governance Object" *Seattle UL Rev* 1469; Peer Zumbansen, "The New Embeddedness of the Corporation: Corporate Social Responsibility in the Knowledge Society" in Peer Zumbansen and Cynthia Williams, eds, *The Embedded Firm: Corporate Governance, Labour, and Finance Capitalism* (Cambridge: Cambridge University Press, 2011); Benedict Reinke and Peer Zumbansen, "Transnational Liability Regimes in Contract, Tort and Corporate Law: Comparative Observations on "Global Supply Chain Liability"" (January 9, 2019) in Sophie Schiller (ed.), *Le Devoir de la Vigilance* (Lexis Nexis, 2019); TLI Think! Paper 4/2019. Available at SSRN: <https://ssrn.com/abstract=3312916>.; and Andrew Sanger, "Transnational Corporate Responsibility Still Out of Reach?" (2019) 113 *Am J Intl Law Unbound* 4.

populations are numbered in the hundreds of millions or even billions may seem very remote indeed from members of one of those states or populations. Even within the European Union, many citizens of member countries apparently share such concerns, such as in the United Kingdom, where they apparently underlay the electoral dissatisfaction which found expression in Brexit, the proposal that the United Kingdom exit the European Union. Similar expressions of dissatisfaction have obtained in other member countries.

Consider, then, the modern business corporation. Limiting attention only to employees initially, it is generally recognized that many large MBCs have tens or even hundreds of thousands of employees. Many of these modern business corporations are multinational or transnational business corporations (TNCs), which have employees and operations in a number of different nation states. Certain aspects of the social identities of many of these employees, retirees, and pensioners, are related to the corporation.

Often, the corporation provides many employees with benefits which are, to some greater or lesser degree, fungible or transferable when the employee moves from one state in which it operates to another. For expatriate or international employees whose employment takes them into a number of different states over the period of their careers, these benefits and pension rights may be of greater value to them, perhaps only due to short periods of service in each nation state, than governmental benefits or pension rights provided by national or subordinate governments of the jurisdictions in which they have resided over time. Their benefits as “citizen employees” of the TNC may sometimes approach, rival, or even exceed, those provided by such governments.

Employees of such a TNC may also participate in several social identities within the TNC, including those related to function (for example, part of the sales or the finance function) or geography (part of the North American region) or unit or sub-unit (for example, part of the transformer manufacturing division or, in a different corporation, part of the cable television division). Of course, as demonstrated above, such individual units and sub-units, and separate functions, within the corporation may share certain common goals and objectives that are not coterminous or coextensive with those of the corporation as a whole or with those of other units, sub-units, and functions. Accordingly, internal political activities aimed at control of resources or other goals and objectives may transcend domestic national boundaries.

As might be expected, the nature and degree of such internal political activity may be affected by the nature and degree of control which each unit, sub-unit or function is able to exercise over its resources and over its activities generally. Existing research suggests that this degree of control depends, in turn, upon such factors as the goals, objectives, nature, stage of development, and timing of the activities of the corporation beyond its centralized base of operations.

Regulation of TNCs should be expected to take these complicating factors into account. This may present significant difficulties. Again, however, a corporative theory of the corporation makes apparent, and does not occlude or “invisibilize”, such problems. They may, accordingly, present themselves for attention by corporative theory, which might not otherwise be the case, to the same extent, in the same way, or, perhaps, at all.

For example, national laws may affect the relationships between such TNCs and their employees. In some cases, TNCs may provide benefits at a level greater than that required by local domestic law. In some cases, TNCs may be required to do so as parties to agreements or arrangements that are not limited by territorial jurisdiction. For example, a forestry products organization that adheres to certain common harvesting standards wherever they operate might also provide or insist that its members provide a common level of employment, pension or other benefits. An agricultural organization, for example, one involving agricultural producers, might require its members to adhere to certain other labour standards, such as maximum hours of work, overtime pay, avoidance of child or unfree labour, and other similar requirements. In the result, employees of a TNC may be affected by a plethora of rights and restrictions imposed by various schemes. These may be of considerable importance to the employees concerned. Of course, they may also be of considerable importance to the TNC employer, as well.

Apart from employment relationships, of course, many TNCs also have public shareholders and debtholders, lenders, suppliers, trade creditors, customers, landlords, tenants, licensees, and other stakeholders, including nation state and subordinate level and municipal, and other governments, in various countries. Compliance with applicable standards, as required, may involve complex and transnational legal and other considerations.

### *Deconstruction and Reconstruction of the Corporation in Legal Theory*

A legal theory of the corporation that recognizes its economic and, as well, its other significant functions, as well as the complexity that may attend its structure and processes, must both examine, challenge, and criticize, and, also, ameliorate the assumptions of classical and neoclassical economics that underlie conventional approaches to corporate law and corporate governance, and must seek new approaches to corporate law and corporate governance involving learning from other disciplines and fields. This involves a deconstruction and reconstruction of the corporation as a matter of corporate law and corporate legal theory. The methodology by which this is sought to be effected in the present work, as well as the justification therefor, is discussed in considerable detail in this Introduction and in Chapter One.

In effect, this methodology involves, first, asking, in Part 1 of the book, the question: What is? Or, explained more fully, what is the basic nature of modern corporate law and corporate governance regimes today? And what does this tell us about the modern business corporation: what it is and what it does? These questions are sought to be answered by identifying the essential attributes of the corporation as a matter of law, and by describing and discussing both the interrelationship among those attributes, and how those attributes are instantiated in several major modern business corporation statutes, in general terms in Chapter One and, in greater detail, in Appendix A, in Chapters A1, A2 and A3. Chapters Two and Three explicate how the corporation takes action in the real world of human beings and related entities. Thus, Part 1 of the book attempts to describe what the modern business corporation is, in terms of how it is instantiated in the “real world” and not simply as a matter of legal theory. That is the data which is sought to be described in Part 1.

Part 2 of the book asks: Why this? Or, explained more fully, what are the assumptions identified in legal and other relevant discourse which are thought to underlie how the modern business corporation is perceived by academic and other practitioners and analysts; why is the modern business corporation perceived in this way; and does this tell us anything about why the modern business corporation is instantiated in modern corporate statutes in the way that it is. That is the data sought to be described in Part 2.

The assumptions considered in Part 2 relate to the description of the corporation as a single economic actor (Chapters Two and Three). Those assumptions, in turn, involve underlying assumptions (explicated, in order not to burden the main text, in Appendix B) about the place of

the economy as a sphere of action in relation to the society, the polity, and the state (Appendix B, Chapters B2 to B3 inclusive); and assumptions of classical and neoclassical economics generally (Appendix B, Chapters B4 and B5). Such assumptions are identified, explained, criticized and discussed from a variety of analytical perspectives, including, as might be expected, from the foregoing discussion, economic, social, political, historical, and philosophical perspectives.

Part 3 of the book asks: How, instead, can the corporation be analyzed? The book identifies and discusses the essential, as well as other relevant, characteristics of organizations, as identified by academics and practitioners from various disciplines and fields, including those disciplines and fields mentioned in the immediately preceding paragraph in relation to Part 2 of the book. In this regard, Chapters Four to Six inclusive discuss the essential and other salient characteristics of organizations, and endeavour to relate these characteristics to the modern business corporation insofar as it presents itself as involving a species of organization.

Finally, the book essays an explanation of the possible relationship between and among the essential legal characteristics of the modern business corporation as a separate legal entity and the essential characteristics of the modern business corporation as, or as implicating, an organization (in Chapters Seven through Ten inclusive).

Those chapters explicate the corporative theory of, or corporative perspective on, the modern business corporation, which is further explicated in the first part of the conclusion of the work. The second part of the conclusion of the work asks the question: why now? Why is there a need for a holistic economic/social/political/legal theory of the corporation which better recognizes its role in the modern world in creating value which is beneficial in economic/social/political terms?

Challenges abound at the present time, both to capitalism, and to the modern business corporation as the primary vehicle of present-day productive activity.<sup>211</sup> Responses to these challenges have been undertaken by a multitude of groups involved in various economic/social/political, academic, and other educational and institutional activities many of which have proceeded by more closely examining how corporations create surplus value by employing various resources, and how they

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<sup>211</sup> See the discussion in the section entitled "Challenges to Capitalism and the Corporation".

report surplus value so created, as well as the resources used in such creation, to organizational participants and others.<sup>212</sup>

It is demonstrated there that these initiatives share significant affinities with the corporative perspective on, or theory of, the modern business corporation.<sup>213</sup> In addition to contributing to the standard of living and the well-being of individuals, groups, societies and polities, the modern business corporation presents opportunities to improve their intellectual, moral, and psychological well-being, including contributing to their search for approbation, affiliation, and meaning.<sup>214</sup> The corporative corporation, understood as involving the interaction of both legal elements and organizational elements, is expected to present new opportunities in this regard. Some of these are delineated in the present text; others await subsequent development. With that, we start.

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<sup>212</sup> See the discussion in the section entitled "Contemporary Responses to Challenges", especially under the headings "Integrated Reporting", "Positive Social Change", "Shared Value, Corporate Strategy, and Corporative Theory" and "Initiatives to Recognize and Report "Value Drivers" of Contemporary Corporations". Many of these initiatives were begun within the last decade, some within the last five years; many have achieved significant progress, especially within the last five years; and many are contemplated to continue their endeavours for some years to come.

<sup>213</sup> See the discussion under the headings "Relation of These Initiatives to Corporative Theory", "The Limited Responses of Existing Corporate Legal Theory" and "The Unlimited Responses of Corporative Theory".

<sup>214</sup> The latter may be especially important in a world in which many individuals describe themselves as lacking belief systems, and in which those professing such belief systems find them in dramatic, and even violent or potentially violent, conflict with those professing other belief systems.



**PART 1 – WHAT IS?  
CORPORATE LAW AND CORPORATE GOVERNANCE REGIMES TODAY**

**CHAPTER ONE – CORPORATE ESSENTIALISM**

**PART A –THE CORPORATION IN LAW AND IN DISCOURSE**

As indicated above, this work proceeds from a descriptivist perspective. Rather than proceeding from a purely hypothetical or theoretical perspective and generating and then seeking to apply a theory of the corporation and of corporate governance, it proceeds by attempting to describe the corporation “in the real world” and seeking to generate a theory that is or may be empirically verifiable.

This procedure differs from others in which, as David Millon says, legal theories of the corporation assert “what corporations *are*”, normative implications are derived from such theories, and the theory of the corporation advanced provides “a standard for evaluating actual or proposed legal rules”<sup>1</sup>, and even proposed approaches to regulation, as Horwitz suggests.<sup>2</sup> Millon argued that those assertions are based “in large part on perceptions of what corporations look like”,<sup>3</sup> that is to say, they are based largely on what the theorist in question sees when confronting the idea of the corporation. Consequently, it can be argued that much legal theory of the corporation seeks to explain these perceptions, which reflect, in turn, the beliefs of the theorist.

Proceeding, instead, firstly, from a description of those attributes which are generally agreed to be characteristic of the corporation; and, secondly, from descriptions of the characteristics and behaviour of what are generally agreed to possess those generally agreed defining attributes; allows the corporate theorist to attempt to minimize the influence of legal theory, legal doctrine, and normative assessments of the corporation in occluding the perceptions of the theorist of the corporation itself, or, to clarify further, perceptions of that which is generally agreed to conform to these essential or paradigmatic characteristics, and, hence, to be a corporation.

Those attributes, denominated here as “legal essentialist attributes”, are a product of positive or declarative law,<sup>4</sup> as examined, summarily, in this chapter and, in greater detail (so as not to burden

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<sup>1</sup> David Millon, “Theories of the Corporation” [1990] Duke LJ 201 at 241 [emphasis in the original].

<sup>2</sup> Morton J Horwitz, “*Santa Clara* Revisited: The Development of Corporate Theory” (1985) 88:2 W Va L Rev 173 at 174.

<sup>3</sup> Millon, *supra* note 1 at 243.

<sup>4</sup> This is conceded by Millon. *ibid* at 242.

higher level discussion of these attributes), in Appendix A of the book. It is readily conceded that it is not likely to be possible to exclude all such occlusive extraneous influences from such perceptions; however, it is hoped that the effort to do so will fasten attention on the essential characteristics, and on the essential legal characteristics, of the corporation. In the result, the attributes identified here as “legal essentialist attributes are demonstrated in this chapter and in Appendix A, to be instantiated in modern business corporation law statutes.

### **Corporate Essentialism and Corporate Essentialist Discourse**

Attempting to describe the corporation “in the real world” from a legal perspective is both complex and somewhat problematic. As noted, this book responds to this challenge by, firstly, seeking to identify those essential, characteristic, defining, identifying, or paradigmatic, attributes of the corporation which are or may be said to be essentially legal in nature, and characteristics emanating from or relating to the same; and, secondly, by seeking to describe the discourse surrounding those essential attributes of the corporation which are or may be said to be essentially legal in nature, and characteristics emanating from or relating to the same.

The first task relates to the determination of what is here denominated as “corporate essentialism”, and, more particularly, as “corporate legal essentialism” or “corporate essentialism in law”; while the second relates to what is here identified as “the discourse of corporate essentialism” or “corporate essentialist discourse”. Each task concerns the examination of data from “the real world”, albeit the “real world” of law applicable to, and distinctive of, the corporation, in the case of the first task; and the “real world” of discourse, in the case of the second task. These tasks are undertaken in Part 1 and Appendix A, in relation to the “real world” of corporate law, and in Part 2 and Appendix B of this book, in relation to the “real world” of discourse, respectively.

Specifically, this chapter summarizes, and Appendix A details, how the legal essentialist attributes of the corporation are instantiated in declarative law. Chapters Two and Three then describe how the corporation takes action in the real world, from the perspective of economy theory, and otherwise (as described by business historians and others), while Appendix B reviews corporate discourse underlying how such action is taken, and investigates the assumptions and generalizations, from economic and other fields, which appear to underlie such discourse.

### **Corporate Essentialism in Law or Corporate Legal Essentialism**

Attributes that are conferred, or recognized, explicitly or implicitly, by law would seem to qualify as attributes which are “essentially legal in nature”. This would include attributes which are the subject of specific statutory enactment, as well as others which are the subject of express or implied rules, practices, and processes of common, or non-statutory, law, “law” where used here in being generally limited to, man-made law. Consequently, “essential legal attributes of the corporation” or “essential attributes of the corporation in law”, conferred or recognized in the manner just described, are those regarded as essential, characteristic, defining, identifying, or paradigmatic attributes that are unique, either individually, or collectively, or both, to the corporation.

Expressed differently, each of the corporation and, most particularly, the modern business corporation would not be what it is today without those legal characteristics or attributes; nor would it be what it is today in law, or as a matter of law, without those legal characteristics or attributes; however, such characteristics or attributes are not found identically and in their totality in some other form of business organization or in some other business entity. Such characteristics or attributes “identify” the entity possessing them as a corporation and as a modern business corporation. They may be described as “corporate essentialist attributes” or corporate legal essentialist attributes”.

In respect of these characteristics or attributes, this work will proceed, firstly, by identifying what are generally agreed to be the essentialist characteristics of the modern business corporation, which are distinctive to it; secondly, by demonstrating their presence, interrelationships and other aspects of their operations in certain significant statutes providing for the establishment of modern business corporations in certain significant legal jurisdictions; and, thirdly, by relating such “corporate essentialism” to “the discourse of corporate essentialism” or “corporate essentialist discourse”.

### **Investigating Corporate Essentialism and Corporate Essentialist Discourse**

The data involved in the investigation of corporate essentialism differs, in kind, from the data involved in investigating the discourse of corporate essentialism. The first involves data which are characteristically “legal” in nature, including statutes, and rules, procedures and processes of corporate law, common law, and otherwise. For the purposes of this book, data of this nature will be considered to express “positive law” or “declarative law” in the sense of man-made law duly

enacted by or pursuant to the authority of a political body having authority to make such law. This book will assume that courts and regulatory bodies constituted by the polity act pursuant to, and in accordance with, the authority of the relevant body of the political authority.

This use of the term “positive law” is not intended to adopt any theory about positive law as opposed to natural law, such as advocated by Thomas Aquinas and others, or about “legal positivism” as adopted by Thomas Hobbes, Jeremy Bentham, and John Austin, and in later iterations by Herbert Hart, and Joseph Raz, and others. Consequently, it may be advantageous to use the alternative term suggested, “declarative law”, as expressing the concept of “law declared by competent and recognized promulgators or declarants”. Accordingly, to avoid confusion with legal positivism and otherwise, this work will generally employ the phrase “declarative law”, rather than “positive law”.

The second investigation, that relating to what is here called “the discourse of corporate essentialism” or “corporate essentialist discourse” involves data which consist of, are based in, or otherwise relate to, discourse concerning the essence of the corporation. Discourse concerning the essence of the firm, which is here called “the discourse of firm essentialism” or “firm essentialist discourse”, involves data which consist of, are based in, or otherwise relate to, discourse concerning the essence of the firm, the “firm” being a construct largely derived from economics.

Thus, it is apparent that not all of this latter discourse is necessarily, or even primarily, or perhaps even significantly, “legal” in its nature. Indeed, this work will argue that much of corporate essentialist discourse is not principally, or perhaps even, significantly, “legal” in its nature; instead, it and other related discourse may be said to emanate from, and be characterized by assumptions and processes of, other disciplines, principally that of economics. However, such discourse may affect discussion of corporate essentialism, in terms of legislation, administrative rules and policies, case law, and corporate essentialist and corporate legal essentialist discourse.

### **“Legal” versus “Non-Legal” Corporate Essentialism and Corporate Essentialist Discourse**

To the extent that “the firm” is operationalized in legal fields, rather than economic or other fields, it may be considered as including, in addition to corporations, other business entities, such as partnerships, limited partnerships, limited liability partnerships, business trusts, and others. Accordingly, “the firm” when used in legal discourse, may be considered to embrace business entities which are recognized as having various attributes as a matter of law, but as all pursuing

some business, profit, or other economic objectives. The “firm” in law, or “the legal firm”, that is to say the firm considered, defined, and operationalized, in each case, exclusively from a legal perspective, has “legal” attributes, arising from declarative law (as such term is used herein) appropriate to the legal classification specified.

Corporate essentialist discourse and other discourse relating to theorizing of, and about, the corporation may thus involve assumptions, terms, methods, procedures, and processes that are not distinctively “legal”, but may involve firm essentialist discourse, which may proceed from other disciplines, such as economics. Accordingly, our examinations of such discourse cannot be limited solely to discourse which is “legal” in its nature. Differently expressed, neither corporate essentialist discourse nor firm essentialist discourse are exclusively “legal” in orientation.

By commencing its account with the “legal” characteristics of the corporation, this book seeks, among other things, to identify what may be considered to be, when properly considered, “legal” corporate essentialist discourse, as distinguished from “non-legal” corporate essentialist discourse. Effecting such distinction involves separating firm essentialist discourse emanating from legal fields from that emanating from non-legal fields, much of which is unvariegated firm essentialist discourse.

It is immediately obvious, of course, that the intrusion of non-legal discourse into corporate essentialist discourse of the legal nature (or, as called, here, corporate legal essentialist discourse), may thereby introduce assumptions, terms, methods, procedures, and processes characteristic of those non-legal fields. Simply put, each of those fields may have its own distinctive vocabulary and grammar. The lexicon and rules of linguistic usage of a field may be well known to its participants but less well known to participants in other fields. For example, the vocabulary and grammar of economics, or, more particularly, of classical or neoclassical economic theory, may be shared among participants in such field, and, as a result, may be susceptible of precise usage in that field; however, this may not be the case when such “economic” vocabulary and grammar is employed in another discipline or field, such as that of the law.

This is not, of course, to argue that interdisciplinary discourse should be minimized or ignored; instead, this book argues quite the opposite perspective. This book’s deconstruction of the assumptions underlying non-legal corporate essentialist discourse, which are principally economic, and underlie non-legal firm essentialist discourse, which is largely or significantly

economic, involves criticism from, and consideration of, discourse from other disciplines and fields, including their own homogeneous or other assumptions. It is argued that the differences in lexicon and linguistic usage of heterogeneous academic disciplines or fields should be constantly and acutely kept in view.

Borrowing the example of linguistics once more, this work maintains that fulsome translations from one language to another, which may be effected by users of both, benefit from a complete understanding of the relationship among vocabulary, grammar, and other linguistic subject areas, and not only with respect to the particular languages at hand, but with respect to languages generally. In the case of linguistics, of course, much more than vocabulary and grammar are involved, including phonetics, phonology, morphology, syntax, semantics, pragmatics, and historical (or diachronic) linguistics. For purposes of simplicity, however, the references to linguistics here are abbreviated here as vocabulary or lexicon, on the one hand, and grammar or linguistic usage, on the other, but should be understood to include the other subject-matters of linguistics as well.

It may be expected that similar methodologies may be relevant to a study of the language of the law, as compared with the language of economics, for example. Legal theorists, academics, commentators, and practitioners, among others, who seek to apply arguments from other disciplines, such as economics, must maintain awareness of the “language” differences from one discipline to another, although arguably not at the level of detail applied in the study of linguistics as a discipline.

This can be particularized as follows. One of the most important such matters, certainly in relation to the modern business corporation, is awareness of the assumptions underlying economic theory, whether classical, neoclassical, or otherwise. For example, a theory of the firm, in economics, may involve significant unarticulated assumptions and other background considerations. Conceptualizing that theory of the firm as, or transforming it into, a legal theory of the corporation engages assumptions and background considerations that are different as between the two disciplines. Yet the discourse relating to the economic theory of the firm and the legal theory of the corporation or, as it is expressed in this work, the (non-legal, or undifferentiated) firm essentialist discourse from the (specifically) legal corporate essentialist discourse, is often not sensitive to these differences of vocabulary and grammar. Among other things, this book

investigates some of these differences. In order not to bring the main text, this investigation is undertaken primarily in Appendix B.

Many, if not most, of the modern theories of the firm and, to the extent that they exist separately, modern theories of the corporation, rely significantly upon assumptions that derive from economics. These include nexus of contracts theory, team production theory, and others. Instead of explicating separately the modern theories of the firm and of the corporation, and then identifying, evaluating, and criticizing the assumptions of each, in order to demonstrate the incompleteness, inadequacies, or fallaciousness of each such theory, an undertaking which would be of enormous proportions and far beyond the scope of the present work, this work will present for discussion the assumptions which seem, from a review and analysis of such discourse, to underlie most modern theories of the firm and of the corporation, and hence which feature importantly in modern corporate essentialist discourse.

It must be conceded that it would be impossible to review of all items within such body of discourse, to summarize them cogently into an accessible document, and to incorporate items within such body of discourse into a viable theory of corporate law. Moreover, for present purposes, it would be unnecessary. The point of our discussion of the “common” assumptions of firm essentialist discourse or of non-legal corporate essentialist discourse is not to prove that they are “common” but, instead, to attempt to prove that various assumptions which many, perhaps even most, participants would acknowledge are made in such discourse, whether invariably (doubtful), frequently, or, more simply, often, are problematic, incomplete, inadequate, or fallacious. In order not to burden the book’s theoretical exposition, this is effected in Appendix B.

### **Corporate Legal Essentialism to Corporate Legal Essentialist Discourse, to Legal Theorizing**

The process by which this work proceeds is to identify attributes that are generally considered to be essential, characteristic, defining, identifying, or paradigmatic attributes of the corporation. Objection may be taken as to whether the attributes described in this work are accurately identified and described as such. However, reviews of academic, practitioner, and judicial writings on corporate law and corporate legal theory too exhaustive to chronicle here seem to be in general agreement as to the same. This is the task of describing what a corporation is, or the question: what is that which we refer to as a corporation? It has already been acknowledged in this work that the lack of empirical rigour which attends such a manner of proceeding must be conceded. However,

it is also acknowledged that certain basic assumptions or generalizations attend any empirical, or even theoretical, investigation, which purports to attain any level of utility whatsoever.

Accordingly, the present work asks, empirically and, insofar as is possible, non-normatively, what a corporation is, and what it can do, as a matter of what is considered here to be declarative law, that is to say, actual law as presently applied in real circumstances currently obtaining. Providing some preliminary answer to this question involves examining how the attributes identified here as those that are essential, characteristic, defining, identifying, or paradigmatic with respect to the corporation are instantiated in the corporate statutory law, and in other declarative law, of jurisdictions whose corporate law has real factual significance.

This chapter and, in more detail, Appendix A of this book examine how central management is instantiated and how separation of management from ownership is instantiated in leading corporate statutes. They establish that the existence of central management, especially when considered in connection with its separation from ownership, has a myriad of consequences with respect to the other key attributes of the corporation. This chapter, together with Appendix A, establishes that the assignment of central management authority to the board of directors (subject to certain exceptions not usually relevant to publicly traded corporations) is not only accompanied by the rights and powers of equity owners, shareholders, to approve fundamental changes in the corporation, but also by rights and powers to question, oppose, or seek variations in, the manner of exercise of such management prerogatives; and, sometimes, to exercise rights to transfer equity ownership to the corporation in certain circumstances in which the equity owner disagrees with the manner of exercise by the board of its rights and prerogatives.

Such rights and prerogatives, whether exercised by the board of directors alone or exercised by it through officers of the corporation, often collectively referred to as “management”, are often referred to as “management” rights. Such rights are extensive, however, they are not unlimited; but, instead, are constrained by shareholder rights as aforesaid. The rights of the board with respect to the structure, processes, and personnel by which the corporation is managed are shown to be very extensive. The statutory limitations placed on the board’s rights of management as to these matters, other than with respect to shareholder reporting and public disclosure, are chiefly those relating to the board’s duties of loyalty, care and compliance, as chronicled in this chapter.



Certain statutory provisions relating to management deal with officers, but, for the most part, the declaratory law affecting other levels of management as a matter of corporate law proceeds from common law, especially the law of agency. This chapter and Appendix A demonstrate some of the ways in which such common law rights and obligations affect the duties and responsibilities of the board of directors and the operation of the corporation as a single legal entity. They also demonstrate how internal agency relationships within the corporation can affect such matters.

Part 2 of this book, together, in order not to burden the main text, with Appendix B, then seeks to juxtapose that observed reality of the firm and the corporation with discourse concerning the nature of the firm and of the corporation, as a matter of law and otherwise, as such discourse emanates from, or is grounded upon, basic or fundamental assumptions common to current theories of the firm and of the corporation. It then seeks to propose variations to such discourse and assumptions which might be more consistent with, firstly, what the corporation has been found empirically to be, as a matter of positive law or declarative law, and, secondly, the implications of such variations for its operation and governance, which are further examined in Part 3 of the book. Some of this corporate essentialist discourse or firm essentialist discourse emanates from, and involves, assumptions pertaining to disciplines or fields outside law, and outside economics, or, at least, outside classical or neoclassical economics, which are also discussed in the present work.

This book will then proceed to apply the results of that inquiry to fashioning or attempting to fashion a new hypothesis or theory of the corporation, denominated here as the “corporative” theory or as the “corporative” perspective. Consequently, this work is less concerned with establishing conclusively that the assumptions discussed here are invariable and omnipresent in discourse than with attempting to prove that, to the extent they are common to various theories of the firm and to various theories of the corporation, economic or otherwise, and are, accordingly, reflected in discourse concerning such theories, those assumptions lack explanatory power and predictive capacity; thereby providing a space or place for consideration and evaluation of corporative theory and practice.

Thus, this work seeks to generate a corporate essentialist discourse that conforms to what the corporation is “in the real world”, and which is characteristically “legal” in nature. This process leads the present work to seek and, ultimately, to unfold, a new theory or perspective that qualifies as “legal” as so described.

While the case may, of course, be otherwise, the present author is not aware of any other work concerning the legal theory of the modern business corporation (or, for that matter, the legal theory of the firm, or of some other legal artifact) which proceeds in the same manner as does the present book. In fact, many such works proceed by generating a theory of the corporation and then applying it as a normative guide to what modern corporate law should be and should do. The present work proceeds in the reverse direction.

### **Task and Scope of This Chapter**

This chapter attempts to identify, summarily, certain conventional assumptions that have been, or appear to have been, made in corporate essentialist discourse about the modern business corporation, its roles and functions, and its relationship to a given society and polity. These are discussed in greater detail in Appendix B. It then proceeds to review the statutory law applicable to business corporations in an effort, among other things, to determine if and to what extent this and other assumptions are embodied in the statutory framework applicable to corporations. This review of statutory law continues in greater detail in Appendix A. In accordance with these objectives, this review of statutory law does not attempt to be an exhaustive statement of the declarative corporate law applicable in those instances. Instead, it ignores aspects of such law that do not instantiate corporate essentialist attributes. How statutory law instantiates the same is the principal subject of interest and commentary in this chapter and in Appendix A.

The principal assumption identified in this regard is the assumption that the corporation acts in the economy as a single economic actor. In connection with the single economic actor assumption, this chapter and Chapter A1 explore the statutory corporate and related common, principally agency, law frameworks underlying lawful action by and on behalf of such corporations.

The present book does not deal with corporations that are not “business” corporations, including not-for-profit corporations, and corporations with mixed business and other objectives, which are sometimes called “hybrid” corporations or “benefit corporations”. Although such other corporations may also be usefully analyzed as organizations, they are beyond our present scope.

For the purpose of this work, we have limited our discussion to corporate law in Canada and the United States, and it is this to which we refer as “Anglo-American law” and to “Anglo-American corporate law” when discussing such corporate law generally. In a work that concerns itself with

corporate legal theory as approached from a descriptivist perspective, references to statutes and common law cannot hope or attempt to be exhaustive.

Instead, such references will often be generic. The principal reasons for this are threefold: firstly, to do otherwise would engage discussion of levels of detail which are not sufficiently relevant to our scope and purpose that they should detain us or distract us from the principal matters under consideration; secondly, detailed examinations of such statutes abound; and, thirdly, while a detailed examination of such statutes in the light of the arguments in this work might be useful, this would unduly lengthen the work and can await later exposition.

Detailed references to securities law have been determined to exceed the scope of this work, largely for similar reasons. References to securities law will normally be generic and by way of general remarks only. Furthermore, this approach is taken, in part, because in the case of Canada, there is presently no federal securities law, as a result of which securities law is the purview of thirteen separate provincial or territorial legislatures, as modified by agreement among the administrators of such statutes; and in the case of the United States, because of the complexity of the federal securities law, principally in the Securities Act of 1933,<sup>5</sup> which regulates the primary market, and the Securities Exchange Act of 1934,<sup>6</sup> which regulates the secondary market; which complexity is further compounded by “blue sky” or state securities laws in force in the various states; and, in each of these cases, because of the complexity of the case law.

Where this work does address the detail or text of specific corporate statutes in Canada and in the United States, these are limited to those discussed in this paragraph. Canada has a federal corporate statute and each of the provinces and territories have corporate statutes. In the United States, each state has a corporate statute, but there is no federal corporate law as such. The principal corporate legislation to which we will refer includes the Canada Business Corporations Act (“CBCA”)<sup>7</sup> and the Ontario Business Corporations Act (“OBCA”)<sup>8</sup> in Canada, and the Delaware General Corporation Act, also known as the Delaware General Corporation Law or the Delaware Code

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<sup>5</sup> 15 USC § 77a *et seq.*

<sup>6</sup> 15 USC § 78a *et seq.*

<sup>7</sup> *Canada Business Corporations Act*, RSC 1985, c C-44 [CBCA].

<sup>8</sup> *Business Corporations Act*, RSO 1990, c B.16 [OBCA].

“DGCL”),<sup>9</sup>, and the Model Business Corporation Act (“MBCA”)<sup>10</sup> in the United States. These statutes will be those to which we refer when we refer to Anglo-American corporate statutes and to Anglo-American corporate law or to corporate law without other specification.

The first two are the corporation statutes applicable to many, if not most, of the largest corporations, and the listed and publicly traded corporations, in Canada. Both statutes were originally significantly influenced by the company law statutes of the United Kingdom and by the corporation law of the state of New York. The DGCL governs the largest number of listed and publicly traded corporations incorporated in the United States. It differs from the other statutes considered in this regard insofar as its purview is not limited to business corporations. The MBCA was, and continues to be, the model for the corporate law statutes in force in a majority of the remaining states.

While this initial presentation may seem overly simplistic and lacking in its identification of the numerous further assumptions and conditionalities that underlie its summary outline, this is intended to be remedied in later discussions. It is considered, however, for the present purpose that even an unrefined and tentative outline may be of assistance in providing a framework for further discussion.

### **Conclusions on Corporate “Legal” Essentialism, *Theoria*, and *Praxis***

This chapter argues that the essential, characteristic, defining, identifying, or paradigmatic, attributes of the corporation which are or may be said to be essentially legal in nature are interrelated. That is to say, each of these attributes bears some relationship to each of the others.

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<sup>9</sup> Delaware General Corporation Law, 8 Del Code, c 1, § 101 [DGCL]. In his extensively cited article discussing managerial and shareholder power, Lucien Bebchuk discusses only the DGCL and the MBCA, for the same reasons: See Lucien Arye Bebchuk, “The Case for Increasing Shareholder Power” (2005) 118:2 Harv L Rev 833 at 844. The Delaware corporate statute is variously referred to simply as the “Delaware Code”, of which it is Title 8, for that reason, although this may be considered misleading inasmuch as, strictly speaking, it refers to the whole Code and not just the specific provision concerning corporations and general corporations; and the Delaware General Corporation Law, for the heading used in Chapter 1 of Title 8 of the Code, for that reason, although it is nowhere in the statute referred to as the Delaware General Corporation Law; or the Delaware General Corporation Act. However, this abbreviation avoids the complications aforesaid and is commonly used, apparently because such nomenclature accords with that of other state corporation statutes. The relevant provision appears to be most frequently abbreviated as the “DGCL”, which, for that reason, is the one used in the present work.

<sup>10</sup> American Bar Association, *Model Business Corporation Act Annotated*, 4th ed, (Chicago: American Bar Association, 2008) [MBCA]. A useful discussion of the history, development, interrelationship, and comparison of the DGCL and the MBCA appears in Jeffrey Gorris, Lawrence A Hamermesh & Leo E Strine, Jr, “Delaware Corporate Law and the Model Business Corporation Act: A Study in Symbiosis” (2011) 74:1 Law & Contemp Probs 107.

For example, the free transferability of equity interests is accommodated by limited liability and asset partitioning, as well as by the existence of central management separated from ownership. Again, the separation of central management from ownership is facilitated by limited liability and asset partitioning. The attribute which is characterized by the lowest order of interrelationships and hence by less centrality of, and to, those interrelationships, namely, the possibly indefinite duration of the corporation, is perhaps the one that developed latest historically, as well as the one that, according to some commentators, might most readily be eliminated in some circumstances in corporations existing “in the real world”. However, it also has considerable significance.

Our review of the important statutes discussed in this work will establish that the attributes of the corporation which are generally considered to be essential, characteristic, defining, identifying, or paradigmatic are, in fact, provided for in the statutes, at least as a default mechanism, if not more generally. Accordingly, corporate legal essentialism will be proven to obtain as a matter of fact.

This review will also demonstrate that some of these corporate legal essentialist attributes receive a high degree of attention, while others receive very little attention, in the statutes. The centrality of management and its separation from equity ownership is obviously extremely important in the statutes, however, both aspects of that attribute are accorded little direct, but vast indirect, statutory attention. Providing the board of directors with the power to manage or supervise the management of the business and affairs of the corporation, or like expression, establishes both the centrality of management authority and its divorcement from equity ownership per se. The fundamental relationship between central management, which is given to the board of directors, and “equity ownership”, in the form of shares in the capital of the corporation held by its “shareholders”, involves the selection of the highest authority of central management, the board of directors, by shareholders.

This review will demonstrate the plenary nature of the management powers assigned to the board of directors; albeit subject to significant commensurate duties; and always subject to certain powers of the shareholders, including the powers: to elect and remove directors; to approve, or disapprove, or vary the terms of, certain fundamental transactions; and, in the case of some such transactions, to force the corporation to “buy them out” of their equity positions at fair value.

Based on our review, corporate legal essentialism does not specifically embrace or expressly adopt either managerial primacy or shareholder primacy as such terms are usually understood as

privileging one group vis-à-vis the other in terms of power with respect to the corporation. Instead, it assigns different rights and duties to the board of directors and others to the shareholders.

However, the assignment of plenary management rights and duties to the board of directors, subject to certain shareholder rights and (a limited number of) duties does invest the board, often referred to as “management”, with plenary authority in relation to the ongoing management of the corporation. This is consistent with “central management” and with the separation of the management authority and activities from those of the equity owners, those being shareholders, who, in the case of the public corporation, change from time to time.

One can imagine the difficulties that would attend a system in which the authority of the board of directors automatically ceased once a certain threshold of equity ownership, say a simple majority of the shares, changed hands. Without some kind of default rule, there would be a lacuna in management authority; and the specification of a default rule which might operate in such a case appears problematic. Moreover, such a rule might cause the membership of the board of directors to change in situations in which this was not desired by the majority of the shareholders. For example, all of the “public float” amounting to a majority of the shares might change ownership gradually over time, but the corporation may be controlled, de facto, by a shareholder whose shareholdings remained unchanged. In that case, the controlling shareholder might have the greatest influence in the election of the directors, and might not wish to see any change in the board at all.

In effect, the division of authority between the board and shareholders may be considered as an artifact of corporate legal essentialism. If such assignment of management authority to the board of directors is considered by some to give management “primacy” in relation to its management and operations, this is simply a consequence or artifact of the essential legal characteristics of the corporation, or of legal essentialism in relation to the corporation, or of corporate legal essentialism.

The present chapter and Appendix A to the book summarize some of the manners in which the essential characteristics of the corporation, as a matter of law, are concretized in corporate statutes and, to some extent, in the common law of agency as it appears in, and is applied to, the corporation and its organization. Parts 2 and 3 of, and Appendix B to, the book, will describe how corporate essentialist discourse, and particularly, corporate legal essentialist discourse, may be implicated in

the common law, including agency law, and in other legal areas, such as securities and other regulatory law and policy.

In pursuance of its management rights and duties, the board may, and in some cases is required to, appoint committees or sub-committees to perform certain delegate duties and responsibilities, and may also appoint officers. Generally speaking, however, the statutes do not otherwise deal to any significant degree with the structure and processes by which the corporation is organized and operated.

As in other respects, as regards its structure and processes, the corporation, generally acting by and through the board of directors (and in some exceptional cases by the stockholders in the American statutes), is empowered to adopt structures and processes considered appropriate in that regard. Consequently, it may be said that the structure and processes by which the corporation is organized are affected by corporate statutes only at the very highest level, principally concerning directors and officers and, in certain cases, shareholders, primarily in situations relating to management of the corporation by the directors and by its officers.

While statute law operates, in effect, only at the highest organizational levels of the corporation, common law, notably agency law, applies more generally. Indeed, some of the duties and responsibilities imposed on directors and officers by statute are similar to, and seem to derive from, the common law of agency. This is demonstrated here and in Appendix A, Chapters A1 to A3. Those chapters also demonstrate some of the complexities arising from manifold agency relationships within the corporation and the structure, processes, and personnel of its internal organization.

The focus of this chapter and Appendix A is on the corporation as a matter of law today. For that reason, the principal texts discussed in this part are those of the statutes concerned. In order not to burden the focus on the statutory instantiation of corporate legal essentialism, references to secondary sources, and, in particular, case law, have been minimized.

## **PART B – ASSUMPTIONS ABOUT THE CORPORATION**

The question discussed in this section is what assumptions are conventionally made about the corporation in corporate essentialist discourse, in firm essentialist discourse, and, more generally, in discourse concerning the corporation and the firm. This question can be explicated in several

dimensions. The present chapter will introduce these assumptions, without supporting them in the first instance, with respect to either their existence or their validity as such assumptions, in order that their relationship to the corporate law statutes constituting and governing the modern business corporation may be considered while the statutes themselves are investigated. These assumptions will be explicated and examined further in the chapters following and in Appendix B.

### **The Economy, and Society, the Polity, and the State**

The first principal assumption involves the separation of economic roles and functions from other functions in a society or polity. That is to say, it is assumed that the production of goods and services for present or future consumption is intrinsically distinct from other aspects of the social and political life of a given society or polity, although it may be conceded that the economy has some relationship to its social and political environs.

A second related assumption is that the economy engages, overlaps with, or is part of, the “private” sphere. That is not to say that there may not be other spheres of action which are also part of the “private” sphere, but, instead, may be considered to assert that the economy is fundamentally “private” in nature. For the present, this can be understood as connoting that it is not so intrinsically related to that society or polity that it can be regarded as “public” in nature.

It is assumed, further, that in this private sphere, parties interact with considerable freedom, largely by way of contract in the case of economic matters. Such contracts are essentially private in nature, relating to matters between the parties, and are essentially unaffected by public interests. It is considered that as long as the parties have contractual capacity, and contract freely, and meet other standards stipulated as necessary for contractual probity and efficacy, the arrangements that the parties devise, by means of contracts or otherwise, should be given full effect within their limits to accomplish the purposes sought.

This leads directly to the third principal assumption, which is that the private sphere is, and must be, somehow separate and distinct from the public sphere. Matters of public interest include the constitution of the political entity or state, and any subdivisions, the manner of its exercise of authority, and any limitations on it, elections, regulation of crime, and protection of certain human, political or social rights, including economic rights, welfare rights, and the authorization and exercise of distributive or redistributive functions, such as taxation and provision of public goods and services. It is conventionally assumed in classical liberal law and political economy that the



economy does not engage those matters sufficiently directly to be considered otherwise than as part of the private sphere. This, in turn, leads to a fourth assumption, namely, that the economy, as such, can be analyzed in a manner which is distinctive to it, and to the private sphere generally. A fifth assumption is that the economy, while related to the ambient society and polity, is distinct from, and its operation is intrinsically independent of, the instant society and polity.

In order not to burden the main text, all of these assumptions are discussed in greater detail in Appendix B to this work.

### **The Corporation as an Economic Actor**

These assumptions about the economy, the society, and the polity are accompanied by, and are the foundation for, assumptions about the corporation as an economic actor; that is, as an agent taking action within a sphere denominated as the economic sphere. These assumptions about the corporation as economic actor will be identified here, but are explicated and examined further in the chapters following, especially in Chapters Two and Three, and in Appendix B.

It is assumed, firstly, that the principal actor in the economy, which is usually denominated in classical liberal economics as “the firm”, acts in the economy as a single actor. In effect, it acts as an independent entity vis-à-vis other economic actors, each of whom also acts as an independent entity. This book maintains that such reification or entification of “the firm” or the “corporation” occludes or “invisibilizes” the organization within the firm or the corporation which institutes and animates the firm or corporation as an actor vis-à-vis other actors “in the real world”.

Secondly, it is assumed that the firm’s actions are primarily, if not exclusively, in the economic sphere. It interacts with other participants in the economy, which are primarily, if not exclusively, other firms.

Thirdly, it is assumed that that the firm’s actions are primarily, if not exclusively, in the private sphere, which includes, but is not limited to, the economy. It interacts with other participants in the private sphere, which are primarily, although not exclusively, other firms.

Fourthly, it is assumed that the firm’s actions should be confined, primarily, if not exclusively, to the economic and to the private spheres.

Fifthly, it is assumed that firms pursue only their private economic interests; and that when firms operate in other spheres, such as the public sphere, they do so only in furtherance of their economic activities.

These assumptions are discussed in greater detail in Part 2 of, and Appendix B to, this work. These assumptions, in turn, provide a foundation for the economic model of the firm, which is outlined in the immediately following section and in Chapters B4 and B5 of Appendix B.

### **The Economic Model of the Firm**

The economic actor, the firm, is modelled in traditional classical economics, politics and theory as a single entrepreneur who determines to undertake some economic activity, invests capital in certain means of production or stock in trade, and may hire employees to work for him. This model will be explicated, for purposes of emphasis, in a number of short paragraphs under the present heading.

The simplest firm comprises only the entrepreneur. In a more complex undertaking in which a number of employees are engaged, the entrepreneur may manage the operation personally or may engage a manager to do so. In such more complex undertaking, the firm is comprised of the entrepreneur or owner (of the firm), the manager (of the firm), and the employees (of the firm).

The operations of the firm generate revenues. These revenues, after deduction of costs of factor inputs, such as costs of raw materials, wages of employees, shipping costs, etc., generate profits (or incur losses) which belong to (are borne by) the entrepreneur exclusively.

The actions of the firm, the entrepreneur or owner (of the firm), the manager (of the firm), and the employees (of the firm), respectively, are taken in pursuit of purely economic interests and can be veridically analyzed in purely economic terms.

An analysis of the firm and of its owner, manager(s) and employees can proceed by measuring its inputs and outputs.

The economic significance of the firm is characterized by those inputs and outputs.

The firm, as such, is a “black box” with respect to which inputs and outputs can be determined, but which is otherwise uninteresting.

To the extent that the process of its economic activity is of interest, it is of interest in terms of the combinatorial factoring of inputs and outputs, and their consequential determination of the profits and losses of the firm.

The entire objective of every firm is to generate profits and, by such means and otherwise, to enhance the wealth of its owner(s) or shareholder(s).

Consequently, it may be said that the entire objective of every corporation is to enhance the wealth of its owners or shareholders.

This objective of wealth enhancement is intrinsically unlimited, in the sense that the owners of the firm or corporation who pursue it are unrestrained by any intrinsic limitation or self-limitation. Thus, this objective may be characterized as “greed”. As noted, such greed is not subject to any intrinsic or owner-internal limitations.

Consequently, the pursuit of wealth by the firm or corporation and by its owners, or their greed, can be restrained only externally.

Managers and employees may avail themselves of the opportunities to capture “rents”, which are, broadly speaking, returns to such party that exceed the economic value of what is provided, and, in effect, divert to the manager or employee returns that otherwise would represent profits to the owner (s).

In situations in which the firm takes the form of a corporation, it may have a board of directors (the “board” or “BOD”) that may include persons other than the entrepreneur or owner. In that event, the board and its members, individually and collectively, or the members, individually and collectively, may each seek to appropriate rents. In larger firms, there may be more than one manager, and even several “layers” of managers interposed between the entrepreneur or owner of the firm and the non-managerial employees. These managers may be described as the “management” of the firm. Often, directors are referred to as “managers” irrespective of whether they are engaged in the actual management of the firm. Similarly, the board and the managers are often conflated in discourse as “management”.

Consequently, it may be said that the corporation, its board, its members, individually and collectively, its managers, individually and collectively, and its employees, individually and collectively, may each seek to appropriate rents.

This objective of rent seeking is intrinsically unlimited, in the sense that the board, the managers and the employees of the firm or corporation who pursue it are unrestrained by any intrinsic limitation or self-limitation. Thus, this objective may be characterized as “greed”. As noted, such greed is not subject to any intrinsic or internal limitations.

Consequently, it is argued that the pursuit of rent seeking by management and the employees of the firm or corporation, or their greed, can be restrained only externally. This “agency problem” is considered to be fundamental in economic analysis of the corporation.

All in all, the pursuit of economic interests and greed by the entrepreneurs or owners of the firm, its management and its employees, must be restrained externally.

Chapters One to Three, together with Appendix A and Appendix B, will demonstrate that the economic model of the firm, which is highly subject to contestation, as discussed in Chapters Two and Three and Appendix B, underlies modern corporate essentialist discourse, and firm essentialist discourse, but is not adopted to any significant extent in corporate law statutes.

### **The Roles of Government and Economic Actors**

The economic model of the economy and the firm, at least as explicated in classical and neoclassical economics, also involves certain assumptions concerning the role of government, which exercises certain authority derived from society and the polity, vis-à-vis the firm and other economic actors.

One assumption made about the role of government is that there is a public interest in certain, if not all, aspects of the economy. Classical liberal or political economics assumed that this interest principally involved ensuring that the market operated fairly and without unduly advantaging or disadvantaging particular participants.

A related assumption is that since the participants in the economy are economic actors who are motivated principally, if not exclusively, by economic interests, they would not be expected to take into account any economic interests of other participants in the economy, or any non-economic interests, whether their own or those of others, including interests of the public at large.

Consequently, it is assumed that the state, or government, must act to safeguard public interests as against the economic interests of participants in the economy. Those public interests include, but are not limited to, economic interests. In particular, the role of the state or government is to protect

the state, government, and society from private economic interests causing damage to public interests.

This includes protecting the state, government, and society from and against economic actors, such as corporations, and other private interests, whose pursuit of their own greed and other economic interests might otherwise cause such damage. Those economic actors are assumed to be indifferent to damage to others which may be occasioned while pursuing their own economic interests.

It is assumed that only the state or government can so restrain such greed and private interests.

It is assumed, further, that government knows how to implement such restraint.

Finally, it is assumed that such restraint is a proper objective of government.

These assumptions concerning the role of government with respect to economic actors will be discussed, incidentally, in connection with the more general assumptions identified under the immediately preceding heading “The Economic Model of the Firm”.

As previously mentioned, the foregoing assumptions with respect to the corporation as an economic actor will be considered in greater detail in Chapters Two and Three and Appendix B.

## **PART C - THE CORPORATION AND CORPORATE ESSENTIALISM IN LAW**

### **The Corporation as an Economic Actor in Law**

The economic model of the firm of the corporation discussed above under the heading “The Corporation as an Economic Actor” engages in a highly significant manner with what is here described as corporate essentialism and, in particular, corporate legal essentialism. This engagement is worthy of discussion before proceeding to “unpack” how the essential attributes of the corporation in law are reflected in the corporate statutes selected for examination here.

For the moment, we leave aside the discussion of whether the corporation, as an economic actor in law, acts differently from how it acts as an actor in some other capacity. The immediate question, for consideration, then, is how the corporation acts “in the real world” vis-à-vis other actors in that world.

This chapter has established that the corporation acts as a single legal entity which possesses certain essential, characteristic, defining, identifying, or paradigmatic attributes. The remainder of this chapter considers how it is that the corporation can, or how it is enabled to, act, legally, as one actor vis-à-vis other extraneous legal actors. For example, we may ask how a corporation is

enabled, as a matter of law, to enter into an amalgamation or merger agreement, and to amalgamate or merge, with another corporation acting as a separate legal actor. This question, and many others like it, is answered, for the most part, in the relevant corporate statute or statutes.

In general terms, such corporate statute will ordinarily stipulate the precise acts required for the corporation to enter into an amalgamation or merger agreement and complete an amalgamation or merger. In many cases, this requires approval of an amalgamation or merger agreement by the board of directors, its approval by shareholders, and the completion of other governmental formalities. Approval of the agreement by the board of directors commits the corporation, subject to shareholder approval, to amalgamate or merge with the other corporation. Approval of such agreement by the board and shareholders of each corporation generally enables the amalgamating or merging corporations to file documents with the relevant corporate authority certification of which generally makes that amalgamation or merger effective. At that point, the amalgamated or merged corporation constitutes a new legal actor. This is but one example of the legal acts required to be taken by a corporation vis-à-vis other external legal actors, as well as internally, in order to effect a particular legal result.

Consequently, the statutory review undertaken in this chapter and in more detail in Appendix A indicates how a corporation acts, as a matter of law, with respect to other actors, when undertaking or engaging in acts or activities intended to create legal rights and obligations. That review demonstrates how acts of a corporation may be legally instituted by it; and, expressed differently, what acts may be regarded as the legal acts of the corporation. In effect, the investigation concerns how the corporation may be said to act as a single legal entity as a matter of law.

### **Corporate Essentialism**

Unfortunately, limitations of time and space forestall inquiry into the historical foundations of the modern business corporation. Similar limitations affect consideration of various alternative legal theories of the nature of the corporation. Both of these subjects are mentioned only in passing. However, consideration of both of these subjects, however interesting and valuable, are not in accord with the “descriptivist” methodology outlined here.

Instead, in accordance with that methodology, our inquiry will begin with a description of how the corporation presents itself “in the real world”, which involves an investigation of the treatment accorded to the corporation as a matter of law. In that regard, the first task to be undertaken is to

describe the attributes of the corporation as a matter of law. It is generally accepted that the attributes of the corporation as such, without ranking their respective importance, are as summarized above and as further described below.

As described above, this inquiry proceeds by identifying characteristics or attributes of the corporation that are considered, in the corporate essentialist discourse and other discourse concerning the corporation and the firm, as essential, characteristic, defining, identifying, or paradigmatic. In effect, those corporate essentialist attributes will be presented as a hypothesis, which will then be tested against the selected leading statutes to determine if and to what extent such attributes are essential to corporate status within those corporate statutes. This chapter, together with Appendix A, will investigate these matters. They will also investigate the extent to which those essentialist attributes are complemented by the application of common law, most especially agency law, principles.

### **Essential Attributes of the Corporation in Law**

In order to determine whether the subject statutes invest a corporation with the attributes considered to be essential, characteristic, defining, identifying, or paradigmatic of a corporation as a matter of law, rather than assuming this to be the case which would be contrary to a more rigorous empirical methodology, it is necessary to investigate in some detail the attributes conferred upon incorporation. This will require greater attention to the specific terms of the statutes in some cases than in others.

#### ***1. Separate Legal Entity***

The corporation is a separate legal entity (“SLE”), that is to say, a rights-and-duty-bearing entity, a party or an entity that possesses rights and bears duties. These include the capacities to own property, to enter into contracts, and to maintain and defend legal actions. Its property is free of any claims of creditors of the shareholders of the corporation. Its shareholders are not generally liable, as such, for its obligations, or to its creditors. Its capacity to enter into contracts is, at first instance (absent some specific statutory or other law), generally unlimited. Limitations on the powers of a corporation may be contained in the statute providing for incorporation or may be permitted thereby to be contained in its charter documents.

1) *Rights, Powers, and Privileges in English Law*

In his excellent review of the subject, “The Company as a Separate Legal Entity”,<sup>11</sup> Murray Pickering lamented the relative lack of attention by writers on English company law to the topic of separate legal entity and the nature of corporate personality (except for Professor Gower),<sup>12</sup> and suggested that the formulation of the concept of separate legal entity “only in the most general terms may have very undesirable consequences”.<sup>13</sup> However, “corporations, at an early stage in the development of English company law, were viewed as having general power similar to those of natural persons”;<sup>14</sup> and any chartered corporation, once created, was considered to have full powers, and clauses defining its objects were not necessary, but only declaratory in effect.<sup>15</sup>

Pickering explains that the doctrine of ultra vires, which apparently originated in proceedings instituted in 1720 by the South Sea Company, limited the powers of statutory companies to those necessary, either necessary or by implication, to enable them to carry out their expressed objects.<sup>16</sup> This doctrine was applied to the powers and limitations of powers of registered companies in their memoranda of association in *Ashbury Railway Carriage & Iron Co. v. Riche*.<sup>17</sup>

Street’s treatise on ultra vires explains that references to a corporation as a “legal person” is by way of analogy, since “this legal person is wanting in much that belongs to a natural person”, and such person has been “called into being for certain special purposes” and has “all the powers and capacities, and only those, which are expressly given to it, or are absolutely requisite for the due carrying out of those purposes.”<sup>18</sup> However, as Pickering notes “English law refuses to impute to companies those characteristics of natural persons which appertain to their human and social nature, and which may form the basis of a vast range of individual rights and duties.”<sup>19</sup> As stated by Lord Justice Buckley of the Court of Appeal in *Continental Tyre and Rubber Co. (G.B.) Ltd. v. Daimler Co.*, “the artificial legal person called the corporation has no physical existence. It exists

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<sup>11</sup> Murray A Pickering, “The Company as a Separate Legal Entity” (1968) 51:5 Mod L Rev 481. Although dated, the article presents a useful review of the subject, including its history in English law; for which purpose it is used as a convenient guide in the present work.

<sup>12</sup> *Ibid* at 482.

<sup>13</sup> *Ibid* at 483.

<sup>14</sup> *Ibid* at 484-5.

<sup>15</sup> *Case of Sutton’s Hospital* (1612), 10 Co Rep 23a at 23a, 30b, 77 ER 960 (Ex).

<sup>16</sup> *Supra* note 11 at 485, citing *Eastern Counties Ry Co v Hawkes* (1855), 5 HL Cas 331, 10 ER 928 (PC).

<sup>17</sup> (1875), LR 7 HL 653.

<sup>18</sup> HA Street, *A Treatise on the Doctrine of Ultra Vires* (London: Sweet & Maxwell, 1930) at 4.

<sup>19</sup> *Supra* note 11 at 486.



only in contemplation of law.” Moreover, “apart from its incorporators, it can have neither thoughts, wishes, nor intentions, for it has no mind other than the minds of the corporators.”<sup>20</sup> According to the Lord Chancellor, Viscount Haldane, a company “has no mind of its own any more than it has a body of its own.”<sup>21</sup> Blackstone commented that, lacking any attributes of mind or body, a “corporation cannot commit treason, a felony or other crime, in its corporate capacity”.<sup>22</sup> It was, of course, established in the leading case of *Salomon v. Salomon & Co. Ltd.*<sup>23</sup> in the House of Lords that a company is “a different person altogether” from its shareholders;<sup>24</sup> that a company is not in law an agent of, or trustee for, its shareholders by reason only of the shareholder relationship; and that the mere fact of ownership of all of the outstanding shares of a company does not entail that the assets and liabilities of a company belong to the shareholder or shareholders. Instead, if the limited company was a legal entity, then “the business belonged to it and not to Mr. Salomon”; otherwise it was not a legal entity.<sup>25</sup> In circumstances in which the sole shareholder was also the sole director, sole manager, and sole employee of a company, the Privy Council recognized that each of these involved a separate relationship between the individual and the company, with the result that the individual’s widow could, and did, succeed in a claim for workmen’s compensation under relevant New Zealand legislation.<sup>26</sup>

Equally well, just as the assets and liabilities of the business belonged to the company, so the property of its shareholders belonged to those shareholders, and not to the company, which had “no interest in that property”, with the result that shareholder property was not available to satisfy the claims of creditors of the limited company.<sup>27</sup> Of course, in exceptional circumstances, Pickering concludes that it may be “established substantively”, that is to say, by clear evidence

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<sup>20</sup> [1915] 1 KB 893 at 916, aff’d [1916] 2 AC 307 (UKHL).

<sup>21</sup> *Lennard’s Carrying Co v Asiatic Petroleum Co*, [1915] AC 705 at 713 (UKHL).

<sup>22</sup> William Blackstone, *Commentaries on the Laws of England in Four Books. Notes selected from the editions of Archibald, Christian, Coleridge, Chitty, Stewart, Kerr, and others, Barron Field’s Analysis, and Additional Notes, and a Life of the Author by George Sharswood. In Two Volumes.* (Philadelphia: J.B. Lippincott Co., 1893). Vol. 1 - Books I & II at 298. Available at <http://oll.libertyfund.org/title/2140>.

<sup>23</sup> [1897] AC 22 (UKHL) [*Salomon*].

<sup>24</sup> *Ibid* at 51.

<sup>25</sup> *Ibid* at 31.

<sup>26</sup> *Lee v Lee’s Air Farming Ltd*, [1960] UKPC 33, [1961] AC 12.

<sup>27</sup> *Salomon*, *supra* note 23.

that the company is acting on behalf of the shareholders such that the shareholders have legal or beneficial interests in property in the possession of the company.<sup>28</sup>

As a separate legal entity, the question arises how a corporation may, firstly, acquire, hold, and dispose of property; secondly, enter into contracts; and thirdly, initiate, maintain, and defend legal actions and other proceedings. As will be discussed in more detail in Part 2 of this book, a corporation cannot act except through one or more individual human actors. Accordingly, an important question is what actor or actors are authorized or empowered to act on behalf of the corporation.

The rule adopted in *Foss v. Harbottle*<sup>29</sup> is “that the company’s members have no capacity to act themselves, or in the company’s name, on its behalf or for its benefit.” In effect, who may act in the company’s name, on its behalf or for its benefit must be determined by the statute and charter documents applicable to the instant corporation. As to such matters, it was established in *Royal British Bank v. Turquand*<sup>30</sup> that “outsiders dealing with the company may rely on its capacity to act itself as a party to any transaction within its powers and need not inquire as to either the legal capacity of its members or the regularity of its internal affairs.”<sup>31</sup>

Further, as established in *Foss v. Harbottle* and in *Mozley v. Alston*,<sup>32</sup> “the proper plaintiff in an action in respect of the wrong alleged to be done to a company or association of persons is prima facie the company or association... itself.”<sup>33</sup> Pickering maintains that “the company and the company alone must act, and be acted against, to enter into and enforce its rights and obligations. The rule applies to actions by and against the company and *vis-à-vis* both outsiders and its own shareholders. It establishes another facet of the concept that a company has an independent and separate legal existence.”<sup>34</sup>

This affirms that outsiders contract with “one independent legal person, the company” and not with the shareholders collectively; such that “the parties cannot deal with, or institute proceedings against, the members of the company, *qua* members, and usually have no need to do so, and

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<sup>28</sup> *Supra* note 11 at 496.

<sup>29</sup> (1843), 67 ER 189, 2 Hare 461 (Ch).

<sup>30</sup> (1856), 119 ER 886, 6 El & Bl 327 (Ex).

<sup>31</sup> *Supra* note 11 at 500.

<sup>32</sup> (1847), 41 ER 833, 1 Ph 790 (Ch).

<sup>33</sup> *Edwards v Halliwell*, [1950] 2 All ER 1064 at 1066 (CA), Jenkins LJ.

<sup>34</sup> Pickering, *supra* note 11 at 501.

members cannot act, such against third parties. The rights of both, in or against the company, are separate from and independent of each other and from the rights of the company itself.”<sup>35</sup>

In effect, as will be shown in more detail later in this chapter and in Chapter A1, powers relating to owning property, entering into contracts, and maintaining legal proceedings are part of the general management authority assigned to the board of directors, which, accordingly, is the “first-order actor” having what might be described as primary authority to take action on behalf of the corporation.

Pickering indicates that, subject to limitations of their individual objects clauses and ancillary powers allowed at common law, “all companies possess identical legal capacity or legal capacity of the same nature” which “exists entirely separate from and otherwise totally unrelated to the status of the members, either individually or collectively.”<sup>36</sup> He maintains, however, that “both the Legislature and the courts have found it necessary, or desirable, to make certain exceptions and to deal with some companies for certain purposes as if they were not entity separate from and independent of their members.”<sup>37</sup>

Pickering finds that two principles underlie these exceptions. These include exceptions “to the principles which delimit the scope of the company’s legal capacity” insofar as its lack of “mind or body or other physical attributes” entail that it cannot be liable “for any tort which requires actual fault on the part of the tortfeasor or any crime which requires proof of *mens rea*, or any act requiring evidence of, for example, intent.”<sup>38</sup>

In order to achieve a measure of justice “where acts take place which are clearly within the scope of the commercial or other proper activities of the company but the nature of the act, and the scale or effect of damage or other resulting consequences, are such that justice cannot be done unless the company itself is held responsible”, then “either the necessary elements of such acts or offenses had to be modified when the defendant was a company, or alternatively the state of mind necessary to establish liability had to be attributed to the company.”<sup>39</sup> This abrogation of separate legal entity

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<sup>35</sup> *Ibid* [emphasis in the original].

<sup>36</sup> *Ibid* at 502-03.

<sup>37</sup> *Ibid* at 503.

<sup>38</sup> *Ibid*.

<sup>39</sup> *Ibid*.

status is more easily done by a legislature, which can define the type of company affected and can specify precisely the circumstances invoking such action, than by the courts.

The second principle underlying other exceptions involves deeming the members or shareholders of the company, for the purposes or purposes in question, “to have some interest in the assets, rights or obligations of the company”, either by treating the company as the agent or trustee of its members (shareholders),<sup>40</sup> or, in the case of legislation, by resorting to an incident of ownership of members (shareholders) with respect to the company, namely their “control” of the company<sup>41</sup>

In the case of powers of control, Pickering asserts that the “types of control and the consequences of their existence can be precisely defined by the legislature when this method is used” such that “the law does not lose certainty. Rights or obligations can be created with apply with precision only to some companies and not to others.”<sup>42</sup> He cites examples such as various tax, exchange control, and enemy control, legislation, in which holding companies and subsidiaries or companies under common control are grouped together. In those cases, “where the relevant legislative provisions apply, the company is no longer regarded as a legal entity entirely separate and distinct from shareholders. Instead for certain stipulated purposes the nature of its membership is taken into account and the company’s rights and obligations altered in consequence.”<sup>43</sup>

## 2) *Rights, Powers, and Privileges in Modern Corporation Statutes*

Most modern business corporations are created by means of general corporate law statutes that entitle applicants to establish a corporation upon compliance with prescribed conditions. Once incorporated pursuant to the corporate statute, the corporation possesses the powers stipulated in the statute. Most modern corporate statutes take one of two alternative approaches to the conferral of rights, powers, and privileges on the corporation.

One approach is to grant the legal power and authority to do anything that a natural person could do, whether or not a corporation could as a factual matter, do or perform the act in question, that is to say, whether or not the exercise of that power or authority is something that, as a matter of

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<sup>40</sup> *Ibid* at 504.

<sup>41</sup> *Ibid* at 505.

<sup>42</sup> *Ibid*.

<sup>43</sup> *Ibid* at 507.

fact, only a natural person can do (say, jump). Another approach is to enumerate in the statute the powers that are thereby granted to the corporation established by its instrumentality.

a) CBCA and OBCA

For example, under the CBCA and the OBCA, the corporation has the rights, powers and privileges of a natural person.<sup>44</sup> However, in both cases, the articles of incorporation may restrict the business that the corporation may carry on. Thus, a corporation has the legal capacity to engage in any activities which may be undertaken by a natural person. That does not entail, of course, that the corporation is a person in the view of the law, or that a corporation has legal personality, or that a corporation is possessed of legal personhood.

Discussion of those matters will have to await exposition later in this text, however, we will not engage in discussion of the “legal personality” of the corporation or the corporation’s status as a “legal person”, which we consider to be modes of expression that signify the corporation’s status as a rights-and-duty bearing entity. Those expressions complicate discussion of the latter, and focus attention, instead, on anthropomorphic analogies that may personify and animate the corporation but, by and large, do so speciously and inaccurately or, at any rate, problematically.

As a corporation which has the rights, powers and privileges of a natural person has no inherent statutory restrictions on its rights, powers and privileges (other than otherwise effected by law that is otherwise applicable generally, not merely to corporations), then, unless such restrictions are specifically contained in its charter documents or other applicable provisions, there can be no question whether certain activities exceed its legal capacity.

Formerly, where a corporation was incorporated to carry on a certain business, the doctrine of *ultra vires* held that it could not carry on another business, and that acts which exceeded the powers of the corporation were not binding upon the corporation.

Leon Getz, citing Brice on *Ultra Vires*, indicates that the first prominent mention of the doctrine in cases of equity was in *Colman v. Eastern Counties Rly. Co.*,<sup>45</sup> in 1846, and, at law, in *East*

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<sup>44</sup> CBCA, *supra* note 7, s 15; OBCA, *supra* note 8, s 15. For reasons of economy, this work does not employ footnotes when sections of statutes are cited in the text expressly, by statute and by section number, however, it inserts footnotes in other cases.

<sup>45</sup> (1846), 50 ER 481, 10 Beav 1 (Ch).

*Anglian Rly. Co. v. Eastern Counties Rly. Co.*,<sup>46</sup> in 1851.<sup>47</sup> Getz indicates that the first application of the doctrine to a company incorporated under the Joint Stock Companies Act of 1844,<sup>48</sup> which established the system of incorporation by registration alone, was the House of Lords decision in *Ashbury Railway Carriage & Iron Co. v. Riche*.<sup>49</sup>

The application of the doctrine was gradually restricted commencing with the decision of the House of Lords in *Attorney-General v. Great Eastern Railway Co.*,<sup>50</sup> limiting the application of the doctrine by including in the powers of the corporation “whatever may fairly be regarded as incidental to or consequential upon the specified objects... unless expressly prohibited”,<sup>51</sup> adopted, as Getz says, by the Supreme Court of Canada in *Charlebois v. Delap*<sup>52</sup> in 1896.<sup>53</sup> The doctrine of ultra vires is no longer operative under the CBCA and the OBCA, and in many other jurisdictions with modern corporate law.<sup>54</sup>

Although both Canadian statutes employ the term “business corporation” in their names and otherwise, neither statute defines that term or the term “business”. Instead, s.4 of the CBCA recites that its purpose is to revise and reform the law applicable to business corporations incorporated to carry on business throughout Canada, to advance the cause of uniformity of business corporation law in Canada and, in effect, to subject certain federal companies incorporated under various acts of Parliament to a common statute, the CBCA. The CBCA is not expressly stated to apply to “business corporations” but, instead, applies, by virtue of subsection 3 (1) to “every corporation incorporated and every body corporate continued as a corporation under this Act that has not been discontinued under this Act.”

With respect to the term “business and affairs”, which is used in both statutes, section 2 (1) of the CBCA and section 1 (1) of the OBCA, instead, define the term “affairs” to mean, in effect, “the relationships among the corporation, its affiliates and the shareholders, directors and officers of such bodies corporate but does not include the business carried on by such bodies corporate”. The

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<sup>46</sup> (1851), 138 ER 680, 11 CB 775 (CP).

<sup>47</sup> Leon Getz, “Ultra Vires and Some Related Problems” (1969) 3 UBC L Rev 30 at 30.

<sup>48</sup> (UK), 7 & 8 Vict, c 110.

<sup>49</sup> *Supra* note 17.

<sup>50</sup> (1880), 5 App Cas 473 (UKHL).

<sup>51</sup> *Ibid* at 478.

<sup>52</sup> (1896), 26 SCR 221 at 238, <<http://canlii.ca/t/1ttcf>>, retrieved on 2018-11-11.

<sup>53</sup> Getz, *supra* note 47 at 34.

<sup>54</sup> CBCA, *supra* note 7, ss 15-16; OBCA, *supra* note 8, ss 15-18.

term “business” is likewise used, but not defined, in both the DGCL and the MBCA. The latter defines each of the terms “Corporation”, “domestic corporation” or “domestic business corporation” in section 1.40 (4) to mean “a corporation for profit, which is not a foreign corporation, incorporated under or subject to the provisions of this Act.” The term “corporation for profit”, however, is not defined. The inference, then, is that a “business corporation” is one that seeks profit.

Jurisdictions which do not grant a corporation the powers of a natural person but, instead, enumerate the powers it possesses pursuant to the relevant statute usually specifically abrogate the doctrine of *ultra vires* in the corporate statute. Some statutes provide for exceptional circumstances in which that doctrine still applies. However, for the purposes of this work, we will assume that the doctrine of *ultra vires* has no application to MBCs or to corporations generally.

However, both Canadian statutes permit the articles to restrict the powers of the corporation. The CBCA states that: “A corporation shall not carry on any business or exercise any power that it is restricted by its articles from carrying on or exercising, nor shall the corporation exercise any of its powers in a manner contrary to its articles.”<sup>55</sup> This provision prohibits three things: firstly, carrying on a proscribed business; secondly, exercising a proscribed power; and thirdly, exercising any of its powers in a proscribed manner, in each case, where such proscription is effected by way of its articles. One suspects that the third proscription, which may be quite important, is often overlooked.

For example, it would seem to allow the drafters of the articles of incorporation to create “bespoke” or “customized” restrictions on the exercise of power in at least three respects; firstly, generally (e.g., provided that two-thirds of the directors approve); secondly, with respect to a category of actions (e.g., in allocating shares); and thirdly, in particular cases (e.g., in allocating shares in circumstances in which such allocation would create or increase the legal or de facto control over the corporation by any person). The OBCA also permits the articles to restrict the powers of the corporation, whether in respect of the business carried on or otherwise. Its provisions are effectively the same.<sup>56</sup>

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<sup>55</sup> CBCA, *supra* note 7, s 16(2).

<sup>56</sup> OBCA, *supra* note 8, s 17(2).

However, both statutes specifically negative the application of the doctrine of *ultra vires* where such restrictions are operative. The CBCA provides that “No act of a corporation, including any transfer of property to or by a corporation, is invalid by reason only that the act or transfer is contrary to its articles or this Act.”<sup>57</sup> The OBCA provision is substantially identical.<sup>58</sup>

In modernity, generally, a natural person of appropriate age and capacity is considered to be capable of possessing certain rights and assuming certain duties. Such natural person is a rights-and-duty bearing entity as a matter of law. In fact, John Dewey, in his magisterial 1926 article “The Historic Background of Corporate Legal Personality” argues that the word “person” as a legal conception signifies what the law makes it signify,<sup>59</sup> and that its legal meaning is, accordingly, synonymous with “a right-and-duty-bearing unit”.<sup>60</sup> In any event, a natural person is frequently considered to be the paradigmatic rights-and-duty-bearing unit.

Consequently, the recognition that a party or entity has the legal capacity to engage in any activities which may be undertaken by a natural person must be considered to constitute recognition of the entity possessing them as a separate rights-and-duty bearing entity in law and, thus, as a separate legal entity.

#### b) DGCL

In respect of the powers of the corporation, the CBCA and OBCA provisions are somewhat more modern than those of the DGCL. In that statute, the certificate of incorporation is required to set forth “the nature of the business or purposes to be conducted or promoted”; however, that business or those purposes may be “to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware, and by such statement all lawful acts and activities shall be within the purposes of the corporation, except for express limitations, if any.”<sup>61</sup> Of course, the application of the DGCL is not limited only to corporations which carry on business.

In effect, there is no invariant statutory limit on the nature of the business of the corporation or the purposes to be promoted or conducted by it, provided only that this is expressly stated in the

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<sup>57</sup> CBCA, *supra* note 7, s 16(3).

<sup>58</sup> OBCA, *supra* note 8, s 17(3).

<sup>59</sup> John Dewey, “The Historic Background of Corporate Legal Personality” (1926) 35:6 Yale LJ 655 at 655.

<sup>60</sup> *Ibid* at 656.

<sup>61</sup> DGCL, *supra* note 9, § 102(a)(3).



certificate of incorporation. Absent such statement, the business or purposes of the corporation are restricted to those stipulated in the certificate of incorporation.

The powers of a Delaware corporation are expressed by listing them, rather than by analogizing them to the powers of a natural person. Such enumeration was formerly effected in Canadian federal and provincial statutes, with consequent complications. Section 121 of the DGCL provides that “[i]n addition to the powers enumerated in S 122 of this title, every corporation, its officers, directors and stockholders shall possess and may exercise all the powers and privileges granted by [that statute] or by any other law or by its certificate of incorporation, together with any powers incidental thereto, so far as such powers and privileges are necessary or convenient to the conduct, promotion or attainment of the business or purposes set forth in its certificate of incorporation.”<sup>62</sup>

Such grant of powers and privileges expressly granted by the DGCL, any other law, or by a certificate of incorporation, and its grant of incidental powers “necessary or convenient conduct, promotion or attainment” of its declared business and purposes must be considered to approach those of a natural person, except as limited by its declared business and purposes.

It is interesting that the powers and privileges are granted not only to the corporation, but also to its officers, directors, and stockholders (called “shareholders” in Canadian law and otherwise). Thus, it is possible to argue that the powers and privileges of, and which may be exercised by, officers, directors, and shareholders of Delaware corporations are not solely derivative of those of the corporation itself but actually inhere in those officers, directors, and shareholders as a result of the terms of the statute itself. This is not the case with respect to CBCA and OBCA corporations.

Such persons possess and exercise the same powers and privileges as the corporation itself, although, it must be assumed, each such person, whether officer, director, or shareholder, cannot possess and exercise alone the full powers and privileges of the corporation. That is to say, those powers and privileges must be those of officers as a class, directors as a class, and shareholders as

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<sup>62</sup> *Ibid*, s 121. Under Section 102 (b) (1), the certificate of incorporation may contain “any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders... If such provisions are not contrary to the laws of this State.” See discussion in Edward P Welch & Robert S Saunders, “Freedom and Its Limits in the Delaware General Corporation Law” (2008) 33:3 Del J Corp L 845 at 848-849.

a class, being collective in nature rather than individual. As such, the powers and privileges of individual members of each class are not complete or plenary.

Indeed, it is logical to assume that the powers and privileges of each such class cannot exhaust those of the corporation; and that, instead, the most that could be maintained is that the powers and privileges of all three classes together exhaust the powers and privileges of the corporation. On the other hand, perhaps this is not the intent of the statute at all. It may be that the intention, instead, is to focus attention on the human actors who take action in relation to the corporation or, as we may say, animate or institute the corporation as an organizational actor. In any event, this discussion anticipates arguments that we will make later in this and subsequent chapters.

Specific powers are enumerated in the next following section of the DGCL, section 122. These include the power to “[h]ave perpetual succession by its corporate name, unless a limited period of duration is stated in its certificate of incorporation”, to “[s]ue and be sued in all courts and participate, as a party or otherwise, in any judicial, administrative, arbitrate or other proceeding, in its corporate name”, to “[p]urchase, receive, take by grant, gift, devise, bequest or otherwise, lease, or otherwise acquire, own, hold, improve, employ, use and otherwise deal in and with real or personal property, or any interest therein, wherever situated, and to sell, convey, lease, exchange, transfer or otherwise dispose of, or mortgage or pledge, all or any of its property and assets, or any interest therein, wherever situated”, to “[a]ppoint such officers and agents as the business of the corporation requires and to pay or otherwise provide for them suitable compensation”, to “[c]onduct its business, carry on its operations and have offices and exercise its powers within or without this State”, and to “[m]ake contracts, including contracts of guaranty and suretyship, incur liabilities, borrow money at such rates of interest as the corporation may determine, issue its notes, bonds and other obligations, and secure any of its obligations by mortgage, pledge or other encumbrance of all or any of its property, franchises and income”<sup>63</sup>

These enumerated powers are limited, however, not only to those granted by the DGCL or other statute or in its certificate of incorporation, together with any powers incidental to such powers, but are possessed and may be exercised by the corporation only “so far as such powers and privileges are necessary or convenient to the conduct, promotion or attainment of the business or

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<sup>63</sup> DGCL, *supra* note 9, § 122. Certain specific powers with respect to securities of other corporations or entities are further enumerated in s. 123.

purposes set forth in its certificate of incorporation”. As a result of conferring specific, rather than plenipotentiary, powers (although with any “necessary or convenient” ancillary powers) the Delaware statute has to statutorily reverse the common law doctrine of *ultra vires*, which is done in Section 124.<sup>64</sup>

As previously noted, although their construction might be criticized as inelegant, difficult, and even slightly confusing, a careful reading of the legal powers and privileges so granted demonstrates their extensive nature, very much like that of a natural person. The corporation endowed with such legal powers and privileges and such duties and responsibilities is, consequently, a rights-and-duty bearing entity or party, as a matter of law.

The power to sue and be sued and participate in all manner of legal proceedings and to acquire, own, hold, and dispose of any property or interests therein, and to enter into and perform any contracts must be considered to constitute recognition of the entity possessing them as a separate entity in law and, thus, as a separate legal entity.

#### c) MBCA

The Model Business Corporation Act is similar in these respects to the Delaware statute. It lists a number of provisions that the articles of incorporation may (but are not required to) set forth, including provisions not inconsistent with law regarding the business or purposes for which the corporation is organized.<sup>65</sup>

In effect, that corporation may engage “in any lawful business unless a more limited purpose is set forth in the articles of incorporation”.<sup>66</sup> The MBCA says that every corporation “has perpetual duration and succession in its corporate name and has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs, including with limitation” a number of specific enumerated powers.

These include power “to sue and be sued, complain and defend in its corporate name”; “to purchase, receive, lease, or otherwise acquire, and own, hold, improve, use, and otherwise deal with, real or personal property, or any legal or equitable interest in property, wherever located”; “to sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of all or any part of its

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<sup>64</sup> *Ibid*, s 124.

<sup>65</sup> MBCA, *supra* note 10, s 2.02(b)(2)(i).

<sup>66</sup> *Ibid*, s 3.01(a).

property”; “to purchase, receive, subscribe for, or otherwise acquire; own, hold, vote, use, sell, mortgage, lend, pledge, or otherwise dispose of; and deal in and with shares or other interests in, or obligations of, any other entity”; “to make contracts and guarantees, incur liabilities, borrow money, issue its notes, bonds, and other obligations (which may be convertible into or include the option to purchase other securities of the corporation), and secure any of its obligations by mortgage or pledge of any of its property, franchises, or income”; “to lend money, invest and reinvest its funds, and receive and hold real and personal property as security for repayment”; “to conduct its business, locate offices, and exercise the powers granted by this Act within or without this state”; and “to elect directors and appoint officers, employees, and agents of the corporation, define their duties, fix their compensation, and lend them money and credit”.<sup>67</sup>

The MBCA also eliminates for the most part the doctrine of *ultra vires*, except in certain shareholder injunction, and derivative, receivership, trustee and other proceedings.

As in the case of the CBCA and the OBCA, the recognition that an entity has the legal capacity to engage in any activities which may be undertaken by “an individual” must be considered to constitute recognition of the entity possessing them as a separate entity in law and, accordingly, as a separate legal entity.

This is been demonstrated to be the case with respect to each of the statutes discussed.

### 3) *Date, Effect, and Duration of Incorporation*

#### a) CBCA and OBCA

Under the CBCA, one or more individuals (natural persons) or bodies corporate may incorporate a corporation by signing and filing articles of incorporation in prescribed form<sup>68</sup> on receipt of which a certificate of incorporation is issued. Each individual incorporator must be not less than

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<sup>67</sup> *Ibid*, s 3.02.

<sup>68</sup> *CBCA*, *supra* note 7, ss 5-6. The much-anticipated Bill C-25 was enacted as *An Act to amend the Canada Business Corporations Act, the Canada Cooperatives Act, the Canada Not-for-profit Corporations Act and the Competition Act*, SC 2018 c 8, and received Royal Assent May 1, 2018. It amended s 5 to permit incorporation by “bodies corporate”. It also substituted the second qualification of not being incapable for the previous qualification of not being found by a court to be of unsound mind. The term “incapable” is defined in the amending statute, in s. 1, to mean “that the individual is found, under the laws of a province, to be unable, other by reason of minority, to manage their property or is declared to be incapable by any court in a jurisdiction outside Canada”. This status is more modern, more susceptible of determination, and more frequently determined. Certain amendments thereby effected, many of which are not yet in force, are discussed in more detail in Chapter Three in relation to voting for directors, which is its principal emphasis. The amendment allowing “corporate” incorporators became effective upon royal assent.

18 years of age, not incapable, and not bankrupt.<sup>69</sup> It is then provided that “[a] corporation comes into existence on the date shown in the certificate of incorporation.”<sup>70</sup>

The OBCA preceded the CBCA in permitting corporations to act as incorporators. One or more individuals, bodies corporate or any combination thereof may incorporate a corporation by filing articles of incorporation and any other required documents and information in prescribed form<sup>71</sup> on receipt of which a certificate of incorporation is issued.<sup>72</sup> A body corporate is “any body corporate with or without share capital and whether or not it is a corporation to which [the OBCA] applies”.

Consequently, both statutes permit a corporation to act as incorporator of another corporation. This avoids use of fictive incorporators who act upon the instruction of a particular corporation or one or more corporations. Under the OBCA, an individual may not be an incorporator if less than eighteen years of age, if found under the *Substitute Decisions Act, 1992* or under the *Mental Health Act* to be incapable of managing property or found to be incapable by a court in Canada or elsewhere, or if such individual has the status of bankrupt. Upon issue, “[a] certificate of incorporation is conclusive proof that the corporation has been incorporated under this Act on the date set out in the certificate, except in a proceeding under section 240 to cancel the certificate for cause.”<sup>73</sup>

Neither statute has any provision terminating the existence of the corporation after any period of time prescribed in the statute or otherwise; nor any provision specifically declaring, in effect, that its existence is unlimited as to duration. Instead, both statutes have provisions continuing the existence of the corporation in other specified manners, such as by way of amalgamation, arrangement, and permitting its existence to be terminated in other specified manners, such as by way of liquidation and dissolution winding-up, in both cases whether voluntary or by court order.

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<sup>69</sup> CBCA, *supra* note 7, s 8.

<sup>70</sup> CBCA, *supra* note 7, s 9.

<sup>71</sup> OBCA, *supra* note 8, ss 4-5. The words “and any other required documents and information” were added as part of amendments effected pursuant to Bill 154, *An Act to cut unnecessary red tape by enacting one new Act and making various amendments and repeals*, SO 2017, C. 20, which received Royal Assent November 14, 2017. Those amendments included provisions conforming the OBCA treatment of shareholder proposals to those of the CBCA, as discussed in Chapter Three.

<sup>72</sup> OBCA, *supra* note 8, s 6.

<sup>73</sup> OBCA, *supra* note 8, s 7. The references to these two statutes were added by amendment to the statute effected by Bill 154, *An Act to cut unnecessary red tape by enacting one new Act and making various amendments and repeals*, *supra*, note 71. They replaced a reference to being adjudged mentally incompetent, which was arguably less precise.

## b) DGCL

The DGCL also does not limit incorporators of a corporation to natural persons. Instead, “[a]ny person, partnership, association or corporation, singly or jointly with others, and without regard to such person's or entity's residence, domicile or state of incorporation, may incorporate or organize a corporation under this chapter by filing...a certificate of incorporation which shall be executed, acknowledged and filed in accordance with [the statute].”<sup>74</sup>

Consequently, not only individual persons and corporations, but also partnerships and associations may incorporate and organize a corporation, alone or with others. Further, “[a] corporation may be incorporated or organized under this chapter to conduct or promote any lawful business or purposes, except as may otherwise be provided by the Constitution or other law of this State.”<sup>75</sup>

Consequently, the application of the DGCL is not limited to business corporations. Apart from conducting any lawful business, a corporation may be incorporated to conduct or promote any other lawful purposes. This may be thought to underlie the widening of the characteristics of possible incorporators. For example, an association with some charitable or affiliative purpose, such as supporting a hospital or facilitating the affiliation and interests of a particular professional group or one or more such associations together may seek to acquire the benefits of incorporation, perhaps including limited liability and various readily understood legal characteristics, and so might directly incorporate a corporation, without the necessity and attendant difficulties of employing “office” or “accommodation” incorporators.

Importantly, the DGCL applies not only to corporations that issue shares, or “stock corporations”, but also to corporations that do not issue shares or stock, called “nonstock corporations”. The DGCL thus permits “any person, partnership, association or corporation, singly or jointly with others” with “any lawful business or purposes” to incorporate and organize a corporation. This would include a broad range of religious, fraternal, philanthropic, educational, professional, business, labour and other organizations. Unlike other modern corporate statutory frameworks, the DGCL regulates all of these corporations, as well as business corporations, in a single statute. Many other jurisdictions create separate statutes for non-business corporations.

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<sup>74</sup> DGCL, *supra* note 9, § 101(a).

<sup>75</sup> *Ibid*, s 101(b).

Under the DGCL, upon due filing of the certificate of incorporation, “the incorporator or incorporators who signed the certificate, and such incorporator's or incorporators' successors and assigns, shall, from the date of such filing, be and constitute a body corporate, by the name set forth in the certificate, subject to S 103(d) of this title and subject to dissolution or other termination of its existence as provided in this chapter.”<sup>76</sup>

Thus, such filing constitutes the incorporator or incorporators as a body corporate. This language is more traditional than the language used in the Canadian statutes mentioned. It specifically acknowledges that a number or group of incorporators have combined as a body corporate. In effect, it stipulates that the incorporators and their successors and assigns are and constitute the body corporate. Each of the incorporators retain their separate existence but, by filing the certificate of incorporation, they and their successors and assigns together are, and constitute, a body corporate subject, among other things, to dissolution or other termination of its existence in accordance with the statute.

While some legal theories of the corporation may focus on this language as supporting one or other legal theory of the corporation, for our purposes, it is sufficient to note that this language recognizes that the corporation is constituted or instituted, as such, by other persons or entities and, ultimately, by real individual or natural persons, who, alone or with others, may take action in its name and on its behalf. Delaware law specifically acknowledges this process and this reality. Accordingly, it draws attention to the nature of corporations as organizations bringing together, that is, associating, affiliating, or organizing, persons or groups of persons in order to accomplish some purpose or to attain some result. This recognition, together with recognition of the corporation as a separate legal entity with particular legal attributes, constitutes what is referred to here as the “corporative” perspective.

The certificate of incorporation creates a new entity. At the same time, the body corporate is not constituted only and in perpetuity by the original incorporators, but also by their successors and assigns. Consequently, changes in the identity of the “incorporators” by means of succession and assignment do not terminate the existence of the body corporate. However, although the body corporate continues as an entity unaffected by such successions, its composition as an entity changes. For example, if none of the original incorporators continue to be shareholders of the

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<sup>76</sup> DGCL, *supra* note 9, § 106.

corporation, their successors and assigns, a wholly new group of parties with B and would constitute the body corporate. The nature of a body corporate constituted by its incorporators or originators will be discussed further in due course.

As noted previously, under s. 122 a corporation has power to “[h]ave perpetual succession by its corporate name, unless a limited period of duration is stated in its certificate of incorporation”. Consequently, the incorporators may provide for a limited period of its duration, at which point its existence, separate from that of its incorporators, and without terminating their existence, is terminated.

### c) MBCA

Under the MBCA, one or more persons may act as the incorporator or incorporators of a corporation by delivering articles of incorporation for filing.<sup>77</sup> Since the term “person” is defined to include an individual and an entity,<sup>78</sup> and the term “entity” is defined to include a “domestic and foreign business corporation; domestic and foreign nonprofit corporation; estate; trust; domestic and foreign unincorporated entity; and state, United States, and foreign government”<sup>79</sup>, incorporation is not available only to natural persons or even only to groups of natural persons.

The MBCA provides that unless a delayed effective date is specified, the corporate existence begins when the articles of incorporation are filed.<sup>80</sup> It provides that unless its articles of incorporation provide otherwise, every corporation has perpetual duration and succession in its corporate name. It appears, then, that the incorporators can choose to limit the existence of the corporation by inserting appropriate provisions in its articles; otherwise, it has “perpetual duration and succession in its corporate name”. The Official Comment on this provisions notes that “nearly every corporation today is formed with perpetual duration , but a corporation may elect a shorter duration under section 2.02(b) (2)(iii)”, which provision permits the articles to set forth “provisions not inconsistent with law...defining, limiting, and regulating the powers of the corporation, its board of directors, and shareholders”.

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<sup>77</sup> MBCA, *supra* note 10, s 2.01.

<sup>78</sup> *Ibid*, s 1.40(16).

<sup>79</sup> *Ibid*, s 1.40(9).

<sup>80</sup> *Ibid*, s 2.03(a).



The words chosen are apt, and may seek, to express the idea that the corporation survives changes in its shareholders, directors, officers, management and employees. This distinguishes such a corporation from other forms of business organizations, such as certain types of partnerships. Moreover, none of these changes require any change in the name of the corporation. Such a corporation thus presents itself to the outside world as a single legal entity that survives changes that might be considered by outsiders to be highly significant, if not fundamental.

This summary of leading corporate statutes has demonstrated the import and significance of characterizing the modern business corporation as a separate legal entity, one separate from parties who are involved in its constitution and operation, such as directors, officers, management and employee, and shareholders.

## ***2. Limited Liability and Asset Partitioning***

The shareholders of a modern business corporation do not generally incur any liability, as such, in respect of the corporation's actions or inactions. That is to say, their ownership of shares in the capital of the corporation does not in itself impose on them any liability nor does it confer on them any rights in respect of the property, contracts, or actions or inactions of the corporation. The liability of the shareholder is said to be limited to the value of the shares held. This is often expressed by saying that the shareholder enjoys or that the corporation has limited liability.<sup>81</sup> The nature of such limited liability under modern corporate statutes is discussed below.

### **a) CBCA and OBCA**

Section 45 of the CBCA provides that the shareholders of a corporation are not, as shareholders, liable for any liability, act or default of the corporation except as specifically enumerated in s. 45.<sup>82</sup> Section 92 of the OBCA is substantially similar but adds the word "obligation" to the list of items in respect of which shareholders are not, as such, liable.<sup>83</sup>

### **b) DGCL**

The DGCL deals with this matter from the perspective of the contents of the certificate of incorporation. S. 102 (b) (6) provides that such document may contain "[a] provision imposing personal liability for the debts of the corporation on its stockholders to a specified extent and upon

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<sup>81</sup> Horwitz, *supra* note 2 at 185.

<sup>82</sup> CBCA, *supra* note 7, s 45(1).

<sup>83</sup> OBCA, *supra* note 8, s 92(1).

specified conditions; otherwise, the stockholders of a corporation shall not be personally liable for the payment of the corporation's debts except as they may be liable by reason of their own conduct or acts". Thus, the DGCL default rule is that shareholders have no personal liability, but personal liability may be imposed by the certificate of incorporation "to a specified extent and upon specified conditions". This permits the incorporators to create a "bespoke" or "custom made" liability provision which may obviate the necessity for certain contractual or other arrangements, such as guarantees of bank borrowings or other credit facilities.

c) MBCA

Section 6.22 of the MBCA states that: "unless otherwise provided in the articles of corporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct." The Official Comment notes that this is "the basic rule of nonliability of shareholders for corporate acts or debts that underlies modern corporation law." It says that Section 2.02 (b) (2) (v) "[n]evertheless permits a corporation to impose that liability under specified circumstances [the actual text says] to a specified extent and upon specified conditions", which is the same as the DGCL] if that is desirable." Consequently, the MBCA permits the incorporators to vary the normal principle of shareholder immunity.

The effect of limited liability is, firstly, that the corporation is protected against claims by creditors of the shareholders of the corporation and against seizure of the corporation's assets to satisfy claims by such creditors of shareholders. For example, they cannot seize property of the corporation in execution of a judgment against any shareholder, by reason only of such shareholding. However, if the corporation guarantees certain obligations of the shareholder, the corporation may be subject to execution for those debts. This type of asset partitioning is described by Hansmann and Kraakman as "affirmative asset partitioning"<sup>84</sup> and by Hansmann, Kraakman and Squire as "entity shielding".<sup>85</sup>

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<sup>84</sup> Henry Hansmann & Reinier Kraakman, "The Essential Role of Organizational Law" (2000) 110:3 Yale LJ 387 at 387, 393-395.

<sup>85</sup> Henry Hansmann, Reinier Kraakman & Richard Squire, "Law and the Rise of the Firm" (2006) 119:5 Harv L Rev 1333 at 1337.

What is commonly referred to as “limited liability” is the principle that the personal assets of the shareholders of the corporation are not subject to claims of the creditors of the corporation as a result solely of the shareholder holding shares in the corporation. However, if the shareholder of the corporation guarantees certain obligations of the corporation, the shareholder becomes liable for those debts. This type of asset partitioning is described by Hansmann and Kraakman as “defensive asset partitioning”<sup>86</sup> and by Hansmann, Kraakman and Squire as “owner shielding”.<sup>87</sup> Hansmann and Kraakman consider that there are different degrees of defensive asset partitioning but that only complete exclusion of such liability constitutes conventional “limited liability”.<sup>88</sup> Because the shareholder has no liability in respect of acts of the corporation, such shareholder’s liability in respect, or on account, of his or her investment in the corporation is limited to the amount he or she invested to acquire the shares of the corporation.

However, a shareholder may incur liability in respect of actions he or she undertakes otherwise. For example, it is common for banks and other lenders to closely held (not publicly traded, or “private”) corporations to request that shareholders furnish personal guarantees of the indebtedness of the corporation, in which case the shareholder incurs liability in respect of the guarantee, but not in respect of his or her shareholding as such. Similarly, if a shareholder takes any action in his personal capacity which extends beyond exercising rights as a shareholder, he or she may incur liability. However, he or she does not incur any liability by reason only of holding shares in the corporation.

Limiting the exposure of the corporation’s assets to its own liabilities seems important to claiming status as a separate legal entity. As a separate legal entity, the corporation and its assets are not exposed to liabilities of its shareholders nor are the shareholders of the corporation exposed, as such, to the liabilities of the corporation. Instead, there is a separation of the liabilities of the corporation and its shareholders, at least where the subscription amount for the shares is fully paid. Where statutes, such as the DGCL (in section 156) and the MBCA (in sections 6.20 to 6.22 inclusive, in certain circumstances) allow shares to be issued without being fully paid, the protection of shareholders from liability is available only in respect of amounts in excess of the full subscription amount.

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<sup>86</sup> *Supra* note 84 at 393.

<sup>87</sup> *Supra* note 85 at 1337. See also Henry Hansmann, Reinier Kraakman & Richard Squire, “The New Business Entities in Evolutionary Perspective” (2005) 2005:1 U Ill L Rev 5 at 11-13.

<sup>88</sup> *Supra* note 84 at 395.

### ***3. Transferable Equity Interests and Capital Lock-In***

The common shares of the corporation represent interests in the capital of the corporation. They confer rights on the holders that may be exercised in accordance with statutory and other corporate law. These rights typically include the right to vote; the right, if accorded to the relevant class of shares, to receive dividends (if any, as and when declared by the board of directors); and the right to receive the remaining property of the corporation upon dissolution.<sup>89</sup> As such interests are subordinate to other claims and possible claims against the corporation, they are considered to bear the greatest risk of any investment in it, and accordingly, are considered to be part (or, in some cases, all) of its capital and are often described as “equity” interests or “residual” interests.

Where the corporation has more than one class of shares, each of these rights must be attached to at least one class of shares, but all such traits are not required to be attached to one class of shares.<sup>90</sup> Under the CBCA and OBCA, all such shares are without nominal or par value<sup>91</sup>, are non-assessable, and cannot be issued until the consideration therefor, in money or its fair equivalent (as determined by the directors) in property or past services, is fully paid.<sup>92</sup>

Section 6 of the CBCA requires the articles of incorporation to set out any restrictions on the issue, transfer, or ownership of shares and s. 46 make special provisions for constrained shares of corporations, the constraints upon which relate to attaining and maintaining a specified level of Canadian ownership or control in order to receive certain benefits or to otherwise comply with any prescribed law. Under section 41 of the OBCA, where the corporation is an “offering corporation” as defined in subsections 1(1) and 1(6) as offering its securities to the public, any restrictions on the transfer or ownership of shares (called “restricted shares”) must be contained in the articles and must be necessary, in effect, for reasons similar to those applicable to constrained shares under the CBCA.

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<sup>89</sup> For example, see *OBCA*, *supra* note 8, s 22; *CBCA*, *supra* note 7, s 24. All such rights need not be assigned to one class but must be allocated among all such classes. S. 6.01 of the MBCA is to similar effect with respect to voting and receipt of property on dissolution but does not mandate any dividend right. DGCL s. 151 (a) provides that the classes or series of stock may have such voting rights, full or limited, or no voting rights as stated in the certificate of incorporation or any amendment thereto or in any resolutions providing for the issue of such stock adopted by the board pursuant to authority expressly vested in it by the certificate of incorporation.

<sup>90</sup> *OBCA*, *supra* note 8, s 22; *CBCA*, *supra* note 7, s 24.

<sup>91</sup> *OBCA*, *supra* note 8, s 22; *CBCA*, *supra* note 7, s 24.

<sup>92</sup> *OBCA*, *supra* note 8, s 23; *CBCA*, *supra* note 7, s 25.

Absent permitted restrictions in the charter documents of the corporation (which are commonly inserted in the case of “private”, that is to say, “non-distributing” (CBCA) or “non-offering” (OBCA) corporations), the shares of the corporation are generally freely transferable, as a matter of corporate law. That is to say, they can be transferred by the shareholder freely and without incurring any liability as a matter of corporate law, either at the time of transfer or subsequently. However, the statutes generally permit restrictions on the transfer of shares to be contained in the corporation’s charter documents.<sup>93</sup>

The transfer rights of the shareholder may be constrained by applicable provisions of any shareholders’ agreement or other agreement to which such shareholder may be a party or by applicable securities laws. Specific obligations may be imposed on majority shareholders in certain cases, for example, where the corporation whose shares are being transferred is subject to the corporate law of Delaware, the jurisdiction of preference for the largest number of corporations incorporated in any of the states of the United States of America.

The funds subscribed by shareholders to the capital of the corporation are intended to be employed by the corporation in its business and, as such, are “locked in” permanently and cannot generally be withdrawn as a matter of right.<sup>94</sup> Importantly, as Hansmann, Kraakman and Squire argue, this provides liquidation protection to creditors as the shareholders do not have a unilateral right to withdraw “their share of firm assets”.<sup>95</sup> Margaret Blair and Lynn Stout argue that capital lock-in is important to investment in specialized assets and in development of a specialized organization whose benefits are expected to be realized over a long term.<sup>96</sup> We maintain that capital lock-in and transferability are concomitants of one another: because the capital subscribed by the shareholder

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<sup>93</sup> *OBCA*, *supra* note 8, s 5; *CBCA*, *supra* note 7, s 6(1)(e).

<sup>94</sup> Some statutes permit shares to be redeemed at the option of the holder (often called “retracted”) in which case the exercise of such retraction rights will be subject to general redemption conditions, such as those relating to solvency. See, for example, s. 2 (1) of the CBCA, which defines the term “redeemable share” not only to include share redeemable at the option of the corporation, but also shares “that the corporation is required by its articles to purchase or redeem at a specified time or on the demand of a shareholder”; and s. 1 (1) of the OBCA to like effect.

<sup>95</sup> *Supra* note 85 at 1341.

<sup>96</sup> They have explored these issues in a number of articles written separately and together, two of the most significant of which are Margaret M Blair, “Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century” (2003) 51:2 *UCLA L Rev* 387 at 388-89; Lynn A Stout, “On the Nature of Corporations” (2005) 2005:1 *U Ill L Rev* 255 at 255-6. In her article, Lynn Stout credits Margaret Blair as first using the term in this connection in the first-mentioned article. Space does not permit a full discussion of this issue; however, it is extremely meaningful, especially when considered in relation to the other paradigmatic attributes of the corporation, as described here.

cannot be removed at the will of the shareholder, the only way that the shareholder can “get out” of being “locked in” to his or her investment in the corporation is to sell his or her shares.

In turn, limited liability is virtually essential to transferability, otherwise a shareholder who disposed of his or her shares and thereby terminated the potential gains that might be derived from such shares would not be relieved of potential liability to creditors of the corporation and, as such, would continue to be subject to continuing risk of loss. That would require a complex risk-reward calculation as to whether the benefit that the shareholder expected to derive before selling the shares would exceed, by a margin sufficient to make the investment worthwhile, the potential loss during the period in which such shares were held and for a potentially indefinite period afterwards. The expected gain might have to be very considerable to warrant such an assumption of risk. Of course, observations to like effect have been made variously in the past.<sup>97</sup>

Of course, corporations that engaged in certain types of business were permitted to have these attributes in Great Britain during the eighteenth and nineteenth century expansion of its economy and infrastructure. For example, many banks and insurance companies, and companies developing canals and railways were permitted attributes similar to the MBCA. These companies were developing financial and transportation infrastructure thought to be essential to the nation, which involved the expenditure of considerable sums of money substantially in advance of any returns. The sums of capital required were much larger than generally had been required previously for commercial or industrial undertakings of various natures. Consequently, these attributes were thought to be beneficial to securing such capital. Eventually, these were adopted more generally in various stages, with limited liability being extended to all incorporated companies in the Companies Act of 1866.

Important for our purposes is the fact that with respect to corporations which are publicly traded, including “listed” corporations (which, for our purposes, may be said to mean corporations whose shares are listed and posted for trading on a stock exchange or regularly quoted on a market having certain prescribed attributes), the identity of their shareholders may change relatively quickly, perhaps daily or even more frequently. Thus, the “relationship”, legal or otherwise, among the corporation and its shareholders, and among the corporation, its shareholders and other

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<sup>97</sup> See, for example, Hansmann & Kraakman, *supra* note 84; Hansmann, Kraakman & Squire, *supra* note 85.

constituents, may be significantly different from the economic model of the firm which, today, we would describe as being more like a “closely held” corporation.

#### ***4. Central Management Independent of Equity Ownership***

Unlike partnerships, in which commonly partners are entitled, and even expected, to take part in the management of the business of the partnership, the modern business corporation requires no fixed relationship between those who provide the capital of the enterprise and who may be entitled to a return from the operation of its business, and the actual operation of that business. In effect, there is a complete separation between those who provide capital for its operation and those who manage its business. A shareholder is not entitled, as such, to take part in management of the business of the corporation, nor is such shareholder expected or obligated to do so; although taking part in management may entitle the shareholder, as management, but not as a shareholder, to some compensation, and may result in that shareholder, as management, but not as a shareholder, incurring some concomitant liability.

Of course, this separation of management from ownership (or “management ownership separation”) facilitates both the locking-in of capital and the free transferability of shares. Changes of management do not necessarily result in changes of “ownership” of the business entity, as might be the case of the general partnership. Likewise, changes in “ownership” do not result in the return of the capital of the particular owner concerned. Instead, the transfer of shares in the corporation, whether or not owned by, or involving someone involved in, management of the corporation, does not necessarily or automatically entail any changes in its management, as such.

The legislation creating MBCs, which term refers in this text only to Anglo-American corporations, generally provides that the board of directors shall manage or supervise the management of the business and affairs of the corporation,<sup>98</sup> manage or direct such management,<sup>99</sup> or simply “direct such management”.<sup>100</sup> Section 141 of the DGCL states that unless otherwise provided in the statute or articles, its business and affairs “shall be managed by or under the direction of the board of directors”. Section 8.01 (B) of the MBCA provides, in effect, that “[a]ll

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<sup>98</sup> *BCA*, *supra* note 7, s 102; *OBCA*, *supra* note 8, s 115.

<sup>99</sup> DGCL, *supra* note 9, § 141. However, section 102 (b) (1) states that a certificate of incorporation may contain “any provision for the management of the business and for the conduct of the affairs of the corporation... not contrary to the laws of this State.” Thus, while management by the board of directors is the default position, the DGCL accords extremely wide latitude for alternative arrangements. See the discussion in Welch & Saunders, *supra* note 62.

<sup>100</sup> MBCA, *supra* note 10, s 8.01.

corporate powers shall be exercised by or under the authority of the Board of Directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors” subject to limitations in its articles or in any unanimous shareholder agreement under section 7.32 (which ceases to be effective when the corporation becomes a public corporation).

The only management rights conferred in the paradigmatic and default case in respect of the corporation are conferred on the board of directors in its collective capacity, subject to delegation; and, in such case, shareholders and others have no management authority whatever. Persons who are shareholders may, of course, act as directors or officers of the corporation, in which case they have the rights and duties appurtenant to those positions. The shareholders may also limit the rights of the board of directors by means of a unanimous shareholders’ agreement,<sup>101</sup> in which case the statute may stipulate that, to the extent provided in such unanimous shareholders’ agreement, the shareholders thereby assume the rights, powers, duties and liabilities of the directors.<sup>102</sup> Such agreements, even if permitted under corporate law (which is often not the case for corporations that are “public”), are not normally extant with respect to corporations that are publicly listed or traded.

The allocation of plenary management rights to the board of directors and its designees, on the one hand, is subject to the rights of shareholders to elect and replace directors, and to exercise some general supervisory authority in approving or disapproving of certain fundamental transactions or changes proposed by the board of directors. We will deal with this subject in more detail below under the heading “The Organization of the Corporation in Law”.

### ***Indefinite Duration***

When a corporation comes into existence is variously expressed in diverse legislation.<sup>103</sup> In some modern statutes, the corporation comes into existence on the date set forth in its articles of

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<sup>101</sup> For example, as defined in s. 146 of the CBCA, and in s.108 of the OBCA. In both statutes, the term applies only to agreements that, in effect, restrict the power of the directors.

<sup>102</sup> For example, s. 146 (5) of the CBCA and s. 108 (5) of the OBCA. The MBCA does not use the term “unanimous shareholder agreement” but its definition has similar elements. It also provides for the share certificates to be “lettered” or “legended” to note that persons acquiring such shares are subject to such provisions. Under s. 7.32 (d) such agreement ceases to be effective when the corporation “becomes a public corporation”. Thus, it applies only to close corporations as that term is used in the United States.

<sup>103</sup> See discussion under the preceding entitled “Separate Legal Entity”, citing *CBCA*, *supra* note 7, s 8; *OBCA*, *supra* note 8, s 7; *DGCL*, *supra* note 9, § 106; *MBCA*, *supra* note 10, s 2.03(a).



incorporation.<sup>104</sup> Other statutes do not refer to it coming into existence but, instead, simply say that it is incorporated on that date.<sup>105</sup> As noted above, the Delaware statute provides that upon the date of filing of the certificate of incorporation, the incorporator or incorporators and their successors and assigns “shall, from the date of such filing, be and constitute a body corporate”.<sup>106</sup> The Model Business Corporation Act states that that unless a delayed effective date is specified, the corporate existence begins when the articles of incorporation are filed.<sup>107</sup>

Formerly, it was common for corporate statutes to permit a corporation to have a limited duration of existence, usually by stipulating in its articles of incorporation that it would cease to exist at a certain date. Indeed, in some jurisdictions in early general incorporation statutes, such provisions were required.<sup>108</sup> For example, Schwartz notes that “early nineteenth-century state corporate statutes required the certificate of incorporation to include a limited term of corporate existence, with a maximum term of twenty, thirty, or fifty years.” The State of New York limited the duration of all business corporations to fifty years.<sup>109</sup> In the United States, “[b]y the turn of the twentieth century, however, legislators amended their corporate law statutes to permit perpetual existence”.<sup>110</sup>

However, such has been the change in practice that some modern statutes no longer provide for or permit limited duration provisions to be contained in the articles. In effect, parties dealing with a corporation assume that it has an indefinite duration or lifespan, as a result of which imposing an automatic termination date of which creditors and others might not be aware and which might operate to their detriment would not be conducive to public expectations of fairness. As discussed above, both Delaware<sup>111</sup> and the MBCA<sup>112</sup> permit the articles to limit the duration of the

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<sup>104</sup> See *CBCA*, *supra* note 7, s 8.

<sup>105</sup> See *OBCA*, *supra* note 8, s 7.

<sup>106</sup> *DGCL*, *supra* note 9, § 106.

<sup>107</sup> *MBCA*, *supra* note 10, s 2.03 (a).

<sup>108</sup> See Andrew A Schwartz, “The Perpetual Corporation” (2012) 80:3 *Geo Wash L Rev* 764 at 774.

<sup>109</sup> *Ibid* at 774, citing Franklin A Gevurtz, *Corporation Law*, 2d ed, (St. Paul, MN: West, 2010) at 20.

<sup>110</sup> *Ibid*, citing Gevurtz note 109 at 21, and Douglas M Branson, (2001) “Corporate Governance “Reform” and the New Corporate Social Responsibility”, 62 *U Pitt L Rev* 605 at 615.

<sup>111</sup> *DGCL*, *supra* note 9, § 102(b)(5). This section permits the articles to contain “a provision limiting the duration of the corporation’s existence to a specified date”.

<sup>112</sup> *MBCA*, *supra* note 10, s 3.02. Interestingly, s. 2.02 (b) which sets forth provisions that may be included in the articles does not specifically mention a limit on the duration of the corporation. Thus, the introductory words of s. 3.02 are the only specific reference to a limit on duration in this regard.

corporation. Apparently, such provisions are rare.<sup>113</sup> This characteristic of indefinite duration is not necessarily shared by other legal forms of business entities, such as partnerships, limited partnerships, business trusts, and others, which may provide for, or for voting by participants with respect to, termination of the entity's existence at some point or points in time, or upon the occurrence of certain stated events.

The existence of corporations in most modern statutes is terminated by means of voluntary or court-ordered winding up, liquidation or dissolution.<sup>114</sup> In effect, these mechanisms endeavour to ensure equitable treatment of interested parties. This is discussed further below. Absent a limited duration provision in jurisdictions in which such provisions are permitted, modern business corporations generally have perpetual existence. One commentator notes that “[today, the corporate code of every state expressly provides for corporate perpetuity.”<sup>115</sup> This potentially unlimited lifespan is relevant to its other legal attributes, notably capital lock-in and transferability of shares, as well as centralized management.

One consequence of potentially unlimited life span is that the corporation may survive well beyond the lives of any of its shareholders. Of course, an attribute of transmissibility would permit the shares of the corporation to be passed to the heirs or other successors in interest of any individual shareholder. However, just as the merits or assessment of the merits of an investment in the corporation's shares by the individual shareholder might vary over time, the interests of one or more heirs or successors in interest might differ from that of the original shareholder, and such interest might also differ as among the heirs or successors in interest as a group.

This might especially be the case if the original shareholder, or one or more of the heirs or successors in interest, had some involvement in management of the corporation, while others did not. Accordingly, the potentially unlimited lifespan of the corporation, as one of its legal attributes, and capital lock-in, as another of its legal attributes, tends to reinforce the appropriateness of share transferability as yet another such legal attribute. The relationships among the attributes provided here, of course, are but examples of those which might be cited in this regard.

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<sup>113</sup> Schwartz, *supra* note 108 at 774, citing William A Klein, *Business Organization and Finance: Legal and Economic Principles*, 11th ed (New York: Foundation Press, 2010) at 109.

<sup>114</sup> See e.g. *CBCA*, *supra* note 7, s 207ff; *OBCA*, *supra* note 8, s 191ff.

<sup>115</sup> Schwartz, *supra* note 108 at 774.

The advantage of unlimited life is often contrasted to a partnership. Generally, at common law, a partnership may be dissolved at the instigation of any partner and is dissolved by the death of any partner. Most modern statutes provide that subject to any partnership agreement, a partnership is dissolved by the expiration of any fixed term for which it is entered, by the termination of the adventure or undertaking for which it is entered, or, if entered into for an undefined term, by any partner giving notice of intention to dissolve the partnership. In any event, unless the partnership agreement provides otherwise, every partnership is dissolved as regards all partners by the death or insolvency of a partner.<sup>116</sup>

The prospects, at common law, of voluntary dissolution of a partnership, at the instigation of any partner and of automatic termination of the partnership on the death of a partner meant that the partnership, as a form of business organization, was not suitable for businesses involving significant commitment of capital, or of time, in order to recoup and earn a return on the invested capital. While the capital was locked in, the lack of transferability of a partnership interest meant that the only way to repatriate one's capital was to dissolve the partnership, thereby terminating its rights, as well as its liabilities and obligations (which continued to be borne by the partners individually).

Instead, as Margaret Blair argues, the corporation provided liquidation protection to creditors against owners, and enabled owners to lock in their investments without risk of their involuntary termination by reason of the acts of another such owner.<sup>117</sup> This protected each "owner" from becoming subject to involuntary termination of ownership solely as a result of the action of another "owner". It is generally accepted that the unlimited lifespan of the corporation facilitates longer term investment horizons than would otherwise be possible. Further discussion of this matter appears below in Part 3 of this book.

### **Conclusions on the Corporation and Corporate "Legal" Essentialism**

As explained above, this chapter, together with Appendix A, explicates what are considered to be the essential or paradigmatic attributes of the corporation as a legal entity, while Part 2 of, and Appendix B to, this work relate these attributes to the discourse concerning the "firm" and the

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<sup>116</sup> See e.g. *Partnerships Act*, RSO 1990, c P.5, ss 32-33.

<sup>117</sup> See Hansmann, Kraakman & Squire, *supra* note 85 at 1342; Blair, *supra* note 96 at 446.

“corporation” in legal and other disciplines. With respect to the first task, this chapter has identified these attributes, which have sometimes been described as corporate “legal” essentialism. With respect to the second task, this chapter has identified some of the assumptions underlying “firm” and “corporation” discourse in legal and other fields.

Chapters A1 and A2 of Appendix A explain how these corporate legal essentialist attributes are instantiated in corporate law statutes; including how the corporate legal essentialist attributes result in a concrete instantiation of management rights in the board of directors, on the one hand, and of management appointment, monitoring, and other rights in the equity owners, the shareholders, in consequence of their having no rights, as such equity owners and shareholders, to participate directly in management of the corporation. They also seek to further develop an understanding of the interrelationship among the corporate legal essentialist attributes. Chapter A3 examines how the corporation, as a legal entity, is animated and vivified, as a matter of declarative law, by persons operating the corporation as a human organization and how its structural, processual, and personnel aspects are affected by statutory law and common law.

**PART TWO:  
WHY THIS? – ASSUMPTIONS ABOUT  
THE CORPORATION AS AN ECONOMIC ACTOR**

**CHAPTER TWO – THE CORPORATION IN ACION**

**PART A – PURPOSE AND SCOPE OF THIS CHAPTER AND CHAPTER THREE**

**Chapter One and Appendix A of This Book**

Chapter One of this book examined, in brief, and Appendix A examines, in more detail, the essential attributes of the modern business corporation and investigated the ways in which they were instantiated in several important modern corporate statutes. In effect, it asked the question: What is the modern business corporation today as a matter of law? The present part of the book, Part 2, as well as Appendix B, considers the question: Why is the corporation “the way it is” today? How did this come about? What influences may have contributed to the present stage of its legal development and theorization? These questions involve the discourse and theorization of, and relating to, the firm, in general, and the modern business corporation, in particular.

As observed previously, such discourse and theorization of, and relating to, the firm and the modern business corporation addresses how the firm and the modern business corporation, as a matter of law and otherwise, fit into conceptions of: firstly, their macroenvironment: the economy, the society, the polity, and the state; secondly, conceptions of classical and neoclassical economics concerning economic action; and, thirdly, conceptions of classical and neoclassical economics concerning economic actors. These matters are discussed here and, in more detail, in Appendix B. As previously noted, discourse concerning the firm and, latterly, the modern business corporation, including legal discourse, has long been significantly influenced by economic discourse, including generalizations and assumptions (in the “everyday” or “common” sense not only of premises or hypotheses, but also of beliefs, presumptions and suppositions) proceeding from economic discourse and most especially from classical and neoclassical theory.

Thus, Part 2, together with Appendix B, of this book, constitute an analysis of certain discourse and theorization of, and relating to, the firm, and the modern business corporation. Although the discourse and theorization concerning the macroenvironment and microenvironment of the firm and the modern business corporation are important with respect to understanding conceptions of

classical and neoclassical economics with respect to their role as economic actors, and alternative conceptions with respect to the same, investigation of these matters represents a significant digression from discourse and theorization more purely concerned with the firm and the modern business corporation as economic actors. Thus, the discussions of the classical and neoclassical description of the macroenvironment and microenvironment of economic actors is left to Appendix B, while the discussion of conceptions of the firm as an economic actor appears in the remainder of this Part 2 of the book.

The early chapters of Appendix B, Chapters B1 to B3, deal with five assumptions or generalizations concerning the macroenvironment of the firm, and the modern business corporation, thus concerning the relationships among the economy, the society, the polity, and the state. Chapter B1 of Appendix B examines three assumptions concerning this macroenvironment: firstly, that economic roles and functions are intrinsically distinct from other functions in a society, polity, or state; secondly, that the economy engages, overlaps with, or is part of, the “private” sphere, in the sense that it is fundamentally “private” in nature, as opposed to “public”, in the sense of being intrinsically related to the ambient society or polity; and, thirdly, that the private sphere is intrinsically separate and distinct from the public sphere, namely, the society and the polity. Chapter B2 of Appendix B considers the fourth assumption, namely, that the economy, as such, must be analyzed in a manner which is distinctive to it, and to the private sphere. Chapter B3 investigates the fifth assumption, namely, that the economy, while related to the ambient society and polity, is distinct from, and operates intrinsically independently of, such society and polity. Criticism of these arguments from various perspectives and fields, as summarized in those chapters of Appendix B, demonstrates that they are highly contestable and problematic, and not suitable for framing a theory which can be verified “in the real world” of actual experience, whether by strict empirical testing, or otherwise.

Chapters B4 and B5 of Appendix B examine a number of assumptions or generalizations of classical and neoclassical economics concerning economic action, namely the assumptions that: 1. Atomistic individuals who are motivated to seek their own good, satisfaction, or utility engage in economic activity to maximize (or, in some later writing, optimize) their own good, satisfaction, or utility. 2. Such behaviour proceeds in isolation from, and absolutely independent of, others; and all economic behaviour can be explained based on these principles. 3. Such individuals are capable,

acting independently, of determining what will afford them satisfaction, and what will maximize (or, in some later writing, optimize) their satisfaction. 4. The goals and desires sought to be satisfied, or the utility sought to be derived, from their satisfaction are either identical from one individual to another, in the strong form of the assumption, or similar, in the weaker form of the assumption. 5. The goals and desires of individuals are, that is to say, the utility they seek is, effectively unlimited, subject, however, to any limits imposed by the “law of supply and demand”, which requires that supply and demand at any particular price must be in equilibrium. As a result, the goals and desires of consumers may be limited by the availability of their resources to pay for additional commodities they seek; and the goals and desires of producers may be limited by their ability to produce additional commodities at prices which purchasers are willing to pay. 6. Such individuals, whether as consumers or as producers, make their choices independently and rationally, based on relevant and complete information. 7. The results of these choices are sought to be implemented by such individuals through independent market transactions. 8. As posited by General Equilibrium Theory, supply and demand at each particular price point are equal, that is to say, in equilibrium, in any particular market at any particular time. Consequently, it may be said that the “market price” of any commodity is determined invariantly by supply and demand.

These conceptions of the rational, atomistic, asocial, utility seeking individual discussed in those chapters, like the conceptions of the macroenvironment discussed in the earlier chapters of Appendix B, are demonstrated, by research and theorization in more modern economics, and in other disciplines and fields, to be highly problematic and unsatisfactory as a basis for theorization and empirical testing. We may say, speaking broadly, that these assumptions or generalizations of classical and neoclassical economics involve, at the highest level, assumptions of atomism, utility seeking, rationality, and independence. The atomistic individual seeks utility by making decisions conducive to that utility in a rational manner, with full information, and independently. When acting in the economic sphere, alone or with others, this atomistic individual is often referred to in neoclassical economics as “the firm”.

## **This Chapter and Chapter Three**

### *Assumptions or Generalizations Examined*

Chapters Two and Three consider, in general, assumptions or generalizations relating to the firm and the modern business corporation as an economic actor, as follows: firstly, that the principal actor in the economy, which is usually denominated in classical liberal economics as “the firm”, acts in the economy as a single actor; in effect, as an independent entity vis-à-vis other economic actors each of whom also acts as an independent entity; secondly, that the firm’s actions are primarily, if not exclusively, in the economic sphere, and that its interactions are with other participants in the economy, which are primarily, if not exclusively, other firms; thirdly, that the firm’s actions are undertaken primarily, if not exclusively, in the private sphere, which includes, but is not limited to, the economy, which entails that it interacts with other participants in the private sphere, which are primarily, if not exclusively, other firms; fourthly, that the firm’s actions should be confined, primarily, if not exclusively, to the economic sphere and to the private sphere; and fifthly, that firms actually pursue only their private economic interests, which entails that when firms operate in other spheres, such as the public sphere, they do so only in furtherance of their private economic interests and activities.

### *Atomism, Methodological Individualism, and the Firm*

More generally, however, all of the preceding assumptions assume that the firm, as an economic actor, behaves in exactly the same way as if it was a single individual person. This assumption is investigated further in this chapter. Among other things, such assumption ignores the fact that the firm is an organization which seeks certain goals or objectives, and that the firm is instantiated or instituted by individual persons, each of whom has his or her own goals or objectives, some of which may be identical with, or approximate, or may be consistent, to a greater or lesser degree, with those of the organization itself.

As an economic actor, the firm may have a variety of goals and objectives, some of which are ultimate goals, some proximate, and others purely instrumental. Classical and neoclassical economic theory posits that individual persons who are economic actors may find it necessary to prioritize among their goals and desires. Such theory purports to treat economic actors which are firms, in the same way as it does economic actors who are individual persons. Thus, it might be



expected that firms may also have to prioritize among their goals and objectives. In general, the assumption of classical and neoclassical economic theory is that firms prioritize in exactly the same way as do individuals.

In effect, in situations in which the economic actor is only a single individual person, attaching the nomenclature of the “firm” to that single individual person signifies only that such single individual person is acting as an economic actor. The use of that nomenclature in economic theory contributes no further information. However, in situations in which the economic actor, the “firm”, embraces more than a single individual person, the “firm” is reified or “entified” based on the model of the individual person. The “firm” is thereby “anthropomorphized”, in the sense that its goals and desires are expected to be generated, expressed, and operationalized in the same way as are those of individual persons.

### ***Invisibilizing the Organization***

Consistent with the analysis above, this can be seen as involving the fallacy of “atomism” or “methodological individualism”, and related problems of aggregation, lack of inter-subjective activity, and goal identity. As more particularly delineated in Appendix B, these problems are both pervasive and problematic in classical and neoclassical economic theory. It is apparent that conceptualizing the firm as if it was an individual person “invisibilizes” the “organization” which itself animates and vivifies the “more-than-one-individual” firm, as discussed previously in this work, consisting of the structure, processes, and personnel which constitute that “more-than-one-individual” firm, in effect, as an organization. Yet, more than half a century ago, no less a social commentator than Adolf Berle observed that: “Corporations are organizations of human beings.”<sup>1</sup> Further, he noted that “[l]egalistics aside, any large corporation is first and foremost an institution.”<sup>2</sup> Berle’s reference to “legalistics” should be taken as referring to the legal form and other attributes of the corporation. Thus, Berle should be taken as acknowledging that corporate law and corporate legal theory should recognize this dualist nature of the corporation as both a legal entity and as an organization, as advocated in the present work.

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<sup>1</sup> Adolf A Berle, Jr, *The 20th Century Capitalist Revolution* (New York: Harcourt, Brace and Company, 1954) at 17.

<sup>2</sup> *Ibid* at 18.

Accordingly, for convenience, it will be assumed here, except where noted otherwise, that the “firm” does involve more than one individual person. The “firm” involving only one individual person, acting as owner, manager and sole employee, which is usually denominated in law as a “sole proprietorship”, may not be described, properly, as an “organization”. Such a “one-individual-person” firm has no goals or objectives beyond those of the individual, and no structure, process, or personnel, in each case, that survive the one individual person concerned. It follows necessarily that a “more-than-one-person” firm which is wholly owned by one individual person, which may be said for that reason to constitute a “sole proprietorship” as a matter of law, but which may involve many other persons as managers or employees, may properly be described as an organization.

The anthropomorphization of the firm as a “single individual person” not only “invisibilizes” the organization, but also “invisibilizes” the consequences of “invisibilizing” the organization. These include consequences relating to the behaviour of the organization and its constituents, whether units, subunits, groups, or individual persons. The panoply of consequences so “invisibilized” include possible conflicts among the goals and objectives of the organization; those of its units, subunits and other groups within the organization, at whatever level; and those of the individual persons or groups of persons within the organization, at whatever level.

Virtually all such matters are discussed in the Appendix B in the course of our examination of the macroenvironment of the economy and the basic assumptions and generalizations of classical and neoclassical economics. A matter which is not discussed in Appendix B is the role of the firm as an economic actor, which is, instead, discussed as a separate issue in the present chapter.

Consequently, this chapter and the following chapter consider only the first assumption or generalization about the firm identified above. This is the assumption or generalization that the principal actor in the economy, which is usually denominated in classical liberal economics as “the firm”, acts in the economy as a single actor. In effect, it acts as an independent entity vis-à-vis other economic actors, each of whom also acts as an independent entity. The discussion below will demonstrate that this assumption or generalization involves classical and neoclassical economic principles which may be said to theorize primarily the market, and only secondarily the firm.

## THE NEOCLASSICAL FIRM AS A SINGLE ECONOMIC ACTOR

### Introduction

To the extent that “the firm” is theorized at all in classical and neoclassical economics, it is theorized either as a sole proprietorship operated by the entrepreneur alone, or as an entrepreneur possibly hiring a labourer, or hiring a manager and one or more labourers, in order to produce a commodity for sale in the market. Both entrepreneurs and labourers engage in the activities of the firm or “work” in order to secure their own utility. The evolutionary economist Sidney Winter asserts that the “dominant view of the firm” in classical economics, reflecting the historical context, was “that of the small enterprise organized as a sole proprietorship”.<sup>3</sup> Winter points out, however, that for such “orthodox theory of the firm”, even as a theory about individual entrepreneurs, to be viable, its theory of profit maximization would have to “be adapted to allow for the income-leisure trade-off of a utility-maximizing consumer whose work is running his business”.<sup>4</sup>

As noted by Roy Weintraub, neoclassical economics theorizes that “individuals provide labor to firms that wish to employ them, by balancing the gains from offering the marginal unit of their services (the wage they would receive) with the disutility of labor itself – the loss of leisure”, while “[f]irms also hire employees up to the point that the cost of the additional hire is just balanced by the value of output that the additional employee would produce.”<sup>5</sup>

The present section considers the proposition that the classical or neoclassical firm within the classical or neoclassical paradigm constitutes a single economic actor. This section argues that this generalization or assumption is a logical consequence of the conception of the firm in classical and neoclassical economics. The present discussion under the heading “The Neoclassical Firm As A Single Economic Actor” advances arguments which are relatively unencumbered by discussions of sources and by footnotes in order to get these arguments “on the table” preparatory to discussing sources and texts, with appropriate footnotes, which takes place primarily in Chapter **Eleven** and employs concepts, services, and text explicated in greater detail in Appendix B, in Chapter B5.

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<sup>3</sup> Sidney G Winter, "On Coase, Competence, and the Corporation" (1988) 4:1 *JL Econ & Org* 163 166. Winter's major work, of course, co-authored with Ralph Nelson, is RR Nelson and S G Winter, *An Evolutionary Theory of Economic Change*. (Cambridge: Belknap Press of Harvard University Press, 1982).

<sup>4</sup> *Ibid* at 167.

<sup>5</sup> E Roy Weintraub, "Neoclassical Economics" in *The Concise Encyclopedia of Economics*, available at: [http://www.econlib.org/library/Enc1/Neoclassical\\_Economics.html](http://www.econlib.org/library/Enc1/Neoclassical_Economics.html).

### The “Black Boxes” of Economic Theory

In this regard, we may recall Terry Moe’s statement that, “[t]he neoclassical theory of the firm is not in any meaningful sense a theory of economic organization”<sup>6</sup> but, instead, “[t]he model firm is simply a black box that produces optimal choices automatically as a function of any given environment.”<sup>7</sup> The present work maintains that such a perspective ignores or “invisibilizes” what happens in “the firm” which is, instead, seen as a “black box” into which inputs (economic factors of production) are introduced and from which outputs (products for sale, or commodities) emanate. Moe suggests that “[a]ssumptions about the firm and perfect competition are simply vehicles by means of which these ends [deriving formal implications for market prices and outputs, resource allocation, equilibria, and other aggregate properties of economic systems] are pursued.”<sup>8</sup> Thus, the formal and mathematical reasoning of neoclassical economics generally takes no account of the process by which economic results are effected by the firm. Indeed, as observed by Fligstein and Dauter, neoclassical economics treats such major elements of the economic process as production, exchange, and competition as other “black boxes”<sup>9</sup> that are also not “unpacked” by neoclassical theory.

Sidney Winter maintains that while orthodox economic theory “recognizes two aspects of coordinating economic activity, the interfirm aspect and the intrafirm aspect”, and posits markets as the answer to the first aspect, it does not explicitly address the answer to the second, intrafirm, aspect. Accordingly, “textbook orthodoxy provides no basis for explaining the organization of economic activity.”<sup>10</sup>

As economic activity is, *ipso facto*, “activity”, it is therefore irrelevant to a theory that ignores or “invisibilizes” all “activity”. Consequently, economic activity, as activity, is not usually considered to be a proper subject of investigation for neoclassical economic theory. *Ex hypothesi*, processes, which do involve activity, must, therefore, also be beyond its purview. In consequence,

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<sup>6</sup> Terry M Moe, "The New Economics of Organization" (1984) 28:4 American J Political Science 739 at 740.

<sup>7</sup> *Ibid.*

<sup>8</sup> *Ibid.*

<sup>9</sup> Neil Fligstein and Luke Dauter, "The Sociology of Markets" (2007) 33 Annual Rev Sociology 6.1 at 6.9.

<sup>10</sup> *Supra* note 3 at 167-8.

many of the questions that arise for consideration in connection with economic activity are questions not readily amenable to answers, or even to investigation, within neoclassical theory, and, in particular, within the neoclassical theory of the firm.

This lack of attention to, or “invisibilization” of, process reduces the predictive efficacy and utility of such a theory, not only at macro-economic, but also at micro-economic, levels. Indeed, a signal criticism that can be made of neoclassical economic theory is that, in general, it ignores the processes by which its theorized assumptions may be said to be operationalized. Surely, the failure to explicate processes of such importance to economic theory demonstrates the lack of completeness, predictive capacity, and salience, of such theory.

### **Theory and Empirical Investigation**

We would note, however, that the exclusion of processes, *ex hypothesi*, from neoclassical economic theory is not in any way characteristic only of “the firm”. For example, the theory does not attempt any explanation, beyond aggregation, of how demand arises, or of how suppliers choose what level of production to achieve in an environment in which there are many possible suppliers. The posited achievement of, or tendency towards, equilibrium does not sufficiently explain how producers of goods act so as to maximize their respective profits in the presence of other alternative producers seeking the same result. Consequently, the failure to explain the means by which the firm engages necessary inputs, including raw materials and labour, and employs them to generate equilibrium outputs, in order to maximize profit, is not the only failure to explicate process that characterizes neoclassical theory.

It is interesting that theory, in other social sciences and cognate disciplines, is not generally elevated to such a level of dominance that it is considered to preclude consideration of how such theory may be applied “in the real world”. For example, a political theory is frequently subjected to analysis in terms of its predictive efficacy and utility. This is also the case with respect to social theory, whether in philosophy, political science, sociology, anthropology, or psychology; or in more specific fields of investigation such as business strategy, organizational behaviour, management, strategy, and other business and management disciplines. Instead, those social sciences and organizational and business disciplines maintain some equanimity between theory, on the one

hand, and activity, including process, on the other. In such disciplines and fields, activity and process are thought to be proper subjects not only for theorizing, but also for empirical investigation and, in accordance with scientific method, to further refinement and testing of theory, in effect, as an iterative process.

A common view in those disciplines is that theory without empirical investigation of the subject-matter (so as to frame the questions for theoretical analysis) and testing of the theory at hand is without significant merit, other than as an analytic exercise, as it generates no actions (other than logical analysis, debate, and further theorizing), verifiable or otherwise, in the academic sphere; and thus generates no resulting actions “in the real world”; and, accordingly, is without consequences or, at least, significant meaningful consequences, in the real world. Analysis without verification is a logical, but not a practical, course of action. At the same time, it must be recognized that analysis of real world phenomena must proceed to at least some degree from some examination of real world phenomena, and not from pure logic alone.

It is obvious to even a neophyte observer, however, that empirical investigation without theory is, if not impossible, then at least somewhat pointless, since even the performance, categorization, and retention of the proceeds of such investigations must proceed according to some rational and theoretical taxonomy. That is clearly the case with respect to the derivation of conclusions, testable hypotheses, and specification of questions for further research.

It may be argued that it is almost beyond credulity to maintain that a theory which is, by its own terms, incapable of advancing beyond theory, is satisfactory. Such a theory may be interesting from analytical, logical, coherence, and argumentational perspectives, but if it lacks explanatory power, it is highly unsatisfactory as a guide to living in the real world. It can readily be seen that humans regularly compare theory and theoretical constructs to their experience in the real world. Even many of the most abstract discussions by philosophers make reference to “real world” experience.

### **The Model of the Firm and Its Lack of Organizational Attributes**

The present work has already suggested that the assumption that each economic actor is an “atomistic individual” acting alone ignores or “invisibilizes” the firm as a social construct; thereby ignoring or invisibilizing social activities and processes both within and without “the firm”. When

that atomistic individual or entrepreneur acts monadically in the economy as a “firm”, such atomistic individual person is reified or “entified”. The reified individual or entrepreneur, now a “firm”, which results from this process is, however, devoid of personal or social attributes. This is surely fallacious, even on neoclassical grounds alone.

In this process of reification, the atomistic individual who seeks to satisfy or satisfice his or her own wants and needs seems to disappear. Yet it is still the wants and needs of that atomistic individual that are said to motivate the behaviour of the neoclassical “firm”. Somehow, those wants and needs do not continue in the firm as simple wants and needs of the individual concerned, but, instead, the single concept of “profits”, alone and without accompaniment or qualification, stands in for them, in terms of the desiderata of the individual who is now reified as “the firm”. While individuals may seek to maximize or optimize the satisfaction of their wants and needs, or their “utility”, it is not those wants and needs that become the object of economic action by the firm which is, instead, profit, and only profit, in neoclassical theory. Armen Alchian, an early leader in evolutionary economics and new institutional economics, differs from the neoclassical position in concluding that the proper object of the economic activity of the firm, in the face of uncertainty, is not profit maximization or utility maximization but, instead, is, simply, the generation of positive profits.<sup>11</sup>

Somehow, as the individual becomes reified as “the firm” in neoclassical theory, the multiplicity of that individual’s wants and needs become unified, homogeneously, as “profit”. Thus, it becomes unnecessary and even impossible to prioritize or to attach different weightings to the individual’s wants and goals, as might have been the case if one were considering such several wants and needs as appurtenant only to the individual concerned. Similarly, in neoclassical theory, other distinctions among an individual’s wants and goals may be eliminated and, instead, treated as homogeneous when considered at the aggregate level.

For example, an individual may express wants or goals that are intrinsically physical or personal, such as reducing weight, improving strength or conditioning, learning to play a musical instrument, learning a new language, or achieving a working comprehension of behavioural economics. The

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<sup>11</sup> Armen A Alchian, "Uncertainty, Evolution, and Economic Theory" (1950) 58:3 J Political Economy 211 at 212 and 213.

mere aggregation of these wants and goals, as a single goal, namely, utility, even if considered solely in relation to economic matters, namely, as “profit”, may not adequately address the individual’s wants and goals.

In fact, even an aggregation of these wants and goals, not just in terms of economics, but quantified in terms of overall “utility”, that is, the aggregate number of “utiles” received or expected or contemplated to be received by that individual, may not satisfy his or her wants and goals in any meaningful sense. The individual may evaluate certain particular wants or goals as being of independent importance. However such determinations may be evaluated at the level of the individual, when that individual is reified as “the firm” whose only object, *ex hypothesi*, is the pursuit of profit, such considerations disappear.

The result may be the same when an individual’s wants or goals are teleologically distinct. Some wants or goals may be instrumental, in the sense that they are conducive to the attainment of certain higher order wants and goals; however, the individual may also derive some satisfaction from the realization of the instrumental goal which is independent of the achievement of the higher order want or goal. In this way, aggregation of wants and goals at a high level may not produce the result(s) sought by the individual concerned; instead, disaggregation may be more representative of such result(s).

Admittedly, since the ultimate want or need of an atomistic individual is self-preservation, which utilitarians consider necessary for the satisfaction of all other wants and needs, then consequent upon the reification of the individual as the “firm”, it might be thought that the continued perpetuation of the firm would be a prerequisite for its generation, and hence maximization or optimization, of profit(s). The continuous objective of self-perpetuation is, of course, a feature that is observed in connection with most, if not all, organizations and institutions.<sup>12</sup> The continued existence of the firm, as a reified atomistic individual person, may, however, raise questions that would be difficult for neoclassical economics to consider, let alone answer.

Of course, since the firm, *ex hypothesi*, is not considered as an aggregation of individuals (even of those individuals who participate in its operations), the aggregation of the wants and needs of such

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<sup>12</sup> For example, see discussion of political institutions in Stephen D Krasner, "Approaches to the State: Alternative Conceptions and Historical Dynamics" (1984) 16:2 Comparative Politics 223 at 234.



atomistic individuals, which are considered in political and social contexts, such as with respect to political pluralism and Parsonian sociology, does not properly or logically arise for consideration in the neoclassical economic theory of the firm. Thus, the personal and social characteristics of the atomistic individual who enters into economic activity as an entrepreneur cannot be attributed, logically, to the firm, which is, in the case of a sole proprietor working alone, purely the reified self of that entrepreneur.

Instead, his or her reification, in the form of the firm, is devoid of personal and social attributes, including, for example, any relating to gender (as word usage in this sentence implies). It can be readily seen that this eliminates consideration of the firm as an organization for economic purposes, although perhaps not necessarily for other purposes. The divorcement of neoclassical economics from politics and society would thereby be assured.

Fortunately, as we have shown, even those who are regarded as the founders of classical, neoclassical, and liberal economics have not been so thoroughgoing in their exclusion from the motivations driving individuals of the personal and social wants and needs of individuals, or in the purity of their “atomistic” assumptions. This is demonstrated in the discussion in Appendix B, in Chapter B2, under the headings “Thomas Hobbes’s Conception of Man” and “Adam Smith’s Conception of Man”.

More recently of course, economists of varying degrees of orthodoxy have taken it upon themselves to consider the “organization” of business activities in terms of both interfirm and intrafirm aspects, in Sidney Winter’s terminology,<sup>13</sup> or extraorganizational and intraorganizational aspects,

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<sup>13</sup> *Supra* note 10, and accompanying discussion under the heading “The “Black Boxes” of Economic Theory”.

as discussed in the present work. Such economists notably have included Coase,<sup>14</sup> Alchian,<sup>15</sup> Alchian and Demsetz,<sup>16</sup> Williamson,<sup>17</sup> Grossman and Hart,<sup>18</sup> and Hart and Moore,<sup>19</sup> each in enormously influential works. The emphasis of the present work, of course, is on classical and neo-classical economics and theory of the firm, which has underlain relevant discourse in various disciplines and fields, legal and other.

### **The Entrepreneurial Model of the Neoclassical Firm and Economic Action**

Again, the neoclassical theory of the firm, as Terry Moe indicates, “centers around the entrepreneur, a hypothetical individual who, by assumption, makes all decisions for the firm and is endowed with a range of idealized properties defining his knowledge, goals, computational skills, and transaction costs”<sup>20</sup> As we have already indicated, by definition, such an atomistic rational individual does not constitute an “organization” and, as such, the processes of making and implementing decisions within an organization do not even arise for consideration. In the result, only circumstances relating to decision-making by individuals are apt for consideration in relation to decision-making by such a firm. As indicated in this work repeatedly, such a procedure, *ex hypothesi*, excludes inter-subjective, subject-to-group, and group-to-subject dynamics.

That the firm acts in the economy as a single economic actor follows, *ex hypothesi*, from the neoclassical model of the firm. As discussed earlier in this chapter, the firm of neoclassical economics is a representation, reification, or entification of the single individual person taking economic action, that is to say, acting in the economic sphere. Thus conceived, it is logically impossible for “the firm” to take economic action otherwise than singly, or as a single economic actor. To say that that the firm is a single economic actor is, effectively, to express a tautology.

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<sup>14</sup> Ronald H Coase, "The Nature of the Firm" (1937) 4:16 *Economica* 386.

<sup>15</sup> *Supra*, note 11. The approach and methodology of evolutionary economics is consistent with examination of business entities and activities from both extraorganizational and intraorganizational perspectives.

<sup>16</sup> Armen A Alchian and Harold Demsetz, "Production, Information Costs, and Economic Organization" (1972) 62:5 *American Economic Rev* 777.

<sup>17</sup> Oliver E Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations" (1979) 22:2 *JL & Econ* 233.

<sup>18</sup> Sanford J Grossman and Oliver D Hart, "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration" (1986) 94:4 *J Political Economy* 691.

<sup>19</sup> Oliver Hart and John Moore, "Property Rights and the Nature of the Firm" (1990) 98:6 *J Political Economy* 1119.

<sup>20</sup> *Supra* note 6 at 740.

The present chapter and the following chapter will further criticize the neoclassical model of the firm as economic actor and will contrast this with alternative explanations of that role.

### *The Example of Competition*

Similarly, neoclassical economics assumes that firms act independently of each other in the market. As Terry Moe mentions, “[i]ndustries are assumed populated by large numbers of firms that take prices as given and make choices without any reference to the behavior of others.” Instead, following Demsetz, he says that the neoclassical theory of perfect competition “is less a theory of competition than a theory of decentralization - that is, a theory of how atomized decisional units, without any mechanism of central coordination other than the free-market system of prices, can produce outcomes that are optimal for the collective. The lessons to be learned are lessons about prices and markets, not about competition.”<sup>21</sup> That competition may involve interaction among market participants, whether between buyers on the one hand and sellers on the other, or among buyers among themselves or sellers among themselves, is assumed, *ex hypothesi*, to be beyond consideration.

Markets and competition are examined by Harrison White in his much-cited 1981 article “Where Do Markets Come From?”<sup>22</sup> To answer this question, he proposed “embedding economists’ neoclassical theory of the firm within a sociological view of markets.”<sup>23</sup> White finds that production markets have two sides, producers on one side and buyers on the other side, and that each side “continually monitors reactions of the other through the medium of a joint social construction, the schedule of terms of trade.”<sup>24</sup> As White maintains, this is consistent with the “signalling” theory of Nobel laureate George Akerlof.<sup>25</sup>

White argues that each individual producer, however, acts purely on self-interest to determine its own volume of production based on observations of the volume of production of other producers

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<sup>21</sup> *Supra* note 6 at 741. He cites Harold Demsetz, *Economic, Legal, and Political Dimensions of Competition* (Amsterdam: North Holland, 1982).

<sup>22</sup> Harrison C White, “Where Do Markets Come From?” (1981) 87:3 *American J Sociology* 517.

<sup>23</sup> *Ibid* at 518.

<sup>24</sup> *Ibid* at 517.

<sup>25</sup> Harrison White cites: George Akerlof, “The Economies of Caste and of the Rat Race and Other Woeful Tales” (1976) 90:4 *Quarterly Journal of Economics* 599. However, an earlier explication of signaling theory is presented in Akerlof’s massively cited classic article, “The Market for “Lemons”: Quality Uncertainty and the Market Mechanism” (1970) 84:3 *Quarterly J Economics* 488.

as observed in a constant feedback process, which is summarized in a “terms-of-trade schedule” which includes, but is not normally limited to, price. In this way, each individual producer takes action, independently and rationally, based upon information then available, and adjusts future individual actions in accordance with the actions of other individual producers, also acting independently and rationally, based upon information then available to them. This results in an iterative process involving action by economic actors and reaction by them to the actions of other economic actors, a process which is not, however, identified or explicated by neoclassical theory.

As White explains, “pressure from the buyers creates a mirror in which producers see themselves not consumers. Heterogeneous producers with their differentiated products may find and maintain stable rules or niches”, based on self-interested optimizing by each producer, and in accordance with trade-offs between costs and tastes. “Thus markets are shaped by trade-offs between dispersions, not by averages as suggested by the cliché that supply equals demand.”<sup>26</sup> Correspondingly, it could be argued that any hypothesized equilibrium would be an equilibrium of dispersions, not of averages, of prices and quantities of the relevant products or services. This argument was discussed in Appendix B, in Chapters B1 and B2, in relation to Assumptions One and Four, under the headings “The Problem of Aggregation” And “Identity or Similarity of Desires and Utility”, respectively.

### ***The Neoclassical Firm and the Market***

Consequently, says White, the “market emerges as a structure of rules with a differentiated niche for each firm” such that each firm has a “distinctive product”.<sup>27</sup> In effect, a variety of attributes, such as product quality, location, and plant investment, may distinguish one producer from another in terms of cost structures and in terms of attractiveness of their products to buyers.<sup>28</sup> White explains that “a market is an “act” which can be “got together” only by a set of producers compatibly arrayed on the qualities which consumers see in them.”<sup>29</sup>

That description of the market, which is based on empirical investigation, is quite different from the description of the market in neoclassical economics. Whether or not such consciousness is

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<sup>26</sup> *Supra* note 22 at 544.

<sup>27</sup> *Ibid* at 517.

<sup>28</sup> *Ibid* at 519.

<sup>29</sup> *Ibid*.

actually attributed to the firm, or is considered simply to inhere in the model itself, each firm may be said to “learn” from instantiations of action by others, and to “learn” to anticipate their possible actions to actions by the subject firm itself, on a recursive or iterative basis.

In one sense, White’s description of the market advances a description which might be considered as Darwinist, evolutionary, or, at least, developmental, insofar as it concerns the firm itself. In order to generate profit and hence to ensure itself of survival, the firm seeks a product, quality, and price “niche” or intersection at which the type of product, having a certain level of quality and certain other attributes, which it offers for sale, is one which it is able to produce, offer for sale, and sell at a price generated “in the market” which is, moreover, ideally one that will ensure its survival. In this way, White’s analysis of the firm and of the market represents an advance on classical and neoclassical economic theory.

### **Conclusion**

The argument advanced in this section is that the proposition that the firm acts, vis-à-vis other economic actors, always and only, as a single economic actor is largely, if not exclusively, a consequence of the neoclassical concept of the firm. As Terry Moe maintains, the neoclassical firm “is simply a black box that produces optimal choices automatically as a function of any given environment”.<sup>30</sup> Fligstein and Dauter take this further, arguing that neoclassical economics also treats major elements of the economic process, such as production, exchange, and competition, as “black boxes” that are not “unpacked” by neoclassical theory.<sup>31</sup> Just as the “neoclassical theory of the firm is not in any meaningful sense a theory of economic organization”<sup>32</sup>, as Moe maintains, neoclassical theory fails to provide an adequate theory of the economic process generally.

This section has maintained that the neoclassical “black boxes” identify elements of economic “input” and “output”, but do not identify or explicate what transpires inside each “black box” beyond making generalized assertions of neoclassical theory, such as the posited interactions of supply, demand, price, quantity, and asserting the existence of an equilibrium. On the one end, the

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<sup>30</sup> *Supra* note 6 at 740, and accompanying text.

<sup>31</sup> *Supra* note 9 at 6.9, and accompanying text.

<sup>32</sup> *Supra* note 6 at 740, and accompanying text.

neoclassical firm engages in interaction by means of supply and demand with suppliers of production inputs, while, at the other end, it engages in interactions by means of supply and demand with purchasers of the firm's production outputs.

Such interaction, "at the back end", however, is limited to stipulation of the prices and quantities of goods. Similarly, "at the front end" such interaction is also limited to stipulation the prices and quantities of goods. In neoclassical theory, however, some combination of this double-ended and extremely limited "interaction", however, effects the assumed equilibrium at both ends of the production and sale process. The details of how products are produced by the firm and offered for sale and sold by it to generate profit and continue carrying on business are ignored, or, as is maintained in the present work, "invisibilized", as if they are of no interest to neoclassical economic theory. In this regard, Harrison White's "embedding" the "economists' neoclassical theory of the firm within a sociological view of markets"<sup>33</sup> seeks to provide some guidance in "unpacking" these actions and interactions and, in particular, "unpacking" the nature of markets.

In effect, then, the present section maintains that neoclassical theory "invisibilizes" the processes or activities of the economy: not only the processes or activities which are carried on within the neoclassical "firm", such as those involved in manufacturing or producing some good or in producing some service, but also those which are carried on without the neoclassical "firm" in selling its products or services and in competing with other suppliers of similar products or services, and in competing more generally with suppliers of all other products and services for allocations of funds available for purchases of goods and services in general.

In modelling the neoclassical "firm" as an atomistic individual entrepreneur, neoclassical theory reifies or entifies the atomistic individual who acts independently and monadically. Thus reified or entified, the "firm" is devoid of personal or social attributes except those attributed to the atomistic individual in neoclassical economic theory. Those attributes include not only atomism and independent action, but also rational action based on perfect information, and perfect knowledge of all available alternatives, and the respective likelihoods of their eventuating, and the concomitant risks of the same.

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<sup>33</sup> *Supra* note 22 at 518.

In other words, the entrepreneur as firm does not possess or, as a result of aggregation, acquire any additional attributes that reflect its aggregation of atomistic individuals, in their several capacities as entrepreneur, manager, employee, and so on, their interaction as individuals with others as individuals, the interactions of each individual with groups within the firm, the interactions of each individual with each other individual as members of such groups, and the respective interactions of groups, as such, with other groups, as such.

As argued in this section and elsewhere in this work, such a hypothetical with respect to, and such analytical construction of, the firm not only occludes or invisibilizes its operations, including its structure, processes, and personnel, but also occludes or invisibilizes any characteristics or attributes that are distinctive as a result of its aggregation of individuals in performing economic actions. As mentioned here, these include intra-firm and inter-firm actions.

As has also been noted here, the identification of “utility” for the individual with “profit” for the firm thereby eliminates the operation of multiple, complementary or conflicting, instrumental, and non-firm-level goals. Thus, for example, such a hypothetical and construction of such a model eliminates, logically, the possibility that a division, department, or function within the “firm” might have goals distinctive of or peculiar to that division, department or function, which might be held and pursued independently of the firm-level goals and which might be pursued at different levels of congruity with firm-level goals.

As discussed earlier in this section, the neoclassical theory of the firm and of economic action generally contemplates its advancement by logical and mathematical investigation, rather than by means of the “scientific method” of empirical investigation involving advancement of hypotheses which are then subjected to testing, recording and observation results, and any necessary refinement, alteration, or rejection, by means of an iterative process. In this regard, the investigative procedure adopted by Harrison White with respect to competition and markets provides a salutary example.

Not only does his analysis represent an advance on neoclassical theory but, even more importantly, for our purposes, his analysis contrasts with the neoclassical “model” of the firm and of non-iterative action by the firm, neither of which, of course, accord with an investigation of the economy, and of the firm, which proceeds empirically, rather than purely abstractly. In this respect, we must

agree with Polanyi that some investigation of such phenomena, as is the case generally, is in order before the processes of categorization, consideration, and analysis can effectively proceed. To this, we turn in the next section.

### **EMPIRICAL OBSERVATION OF THE FIRM IN ACTION**

We now proceed to examine whether observations support the propositions that the actors in the economic sphere are firms, that firms act as in the economy as a single actor, and that these firms act independently of each other. This is in accordance with our declared descriptivist methodology and our investigations up to this point.

In this regard, Chapter One and Appendix B of the book examined various generalizations and assumptions advanced in academic literature and otherwise concerning the essential attributes of the firm, and, more specifically, of the modern business corporation, as a matter of law. It then considered, as an empirical matter, whether and to what extent those essentialist legal attributes were instantiated in modern corporate law statutes. In effect, the aim of this procedure was to determine whether what was advanced in the literature as essentialist legal attributes really were regarded and adopted as such in modern corporate law statutes.

As explained earlier, this part, Part 2, together with Appendix B, examines discourse concerning the firm and concerning the corporation, including, in particular, discourse from classical and neoclassical economics, as well as from other disciplines and fields, in that behalf. As noted above, Chapters B1 through B3 of Appendix B examine the macroenvironment of the firm and the modern business corporation as related to society, the polity, and the state, while Chapters B4 and B5 consider a number of generalizations and assumptions advanced in economic and other discourse concerning what might be described as the “microenvironment” of the firm and the modern business corporation, in the sense of the immediate environment in which the firm and the modern business corporation take economic action. Those chapters are commended to the reader’s attention, at least as highly important background for the present discussion, but their reading should not be absolutely necessary to understanding the basic presentation of this chapter and the following chapter.

The present chapter and the next chapter examine whether, and if so, how, these generalizations and assumptions have been instantiated in the recent past and currently. In a work of such a nature



as the present one, such examination must, necessarily, rely on summaries and reviews of empirical research, some in the nature of literature reviews, and some in other forms. As in the case of this work's consideration of relevant discourse, this will include, but not be limited to, economic discourse, and will include, but not be limited to, corporate legal essentialist discourse.

As explained in further detail below, it is both appropriate and useful to this purpose to consider some history of the firm, of the corporation, and, in particular, of the modern business corporation, in this regard. This investigation is intended to place the current instantiation of the modern business corporation, as a matter of corporate law and otherwise, and the current state of discourse concerning the firm and the corporation, in some historical context. In this regard, limitations affecting the present work require the use of works of business history.

Consequently, this examination will proceed by considering the observations made by the eminent (and, arguably, founding) business historian Alfred D. Chandler, Jr., with respect to the development of business organizations, primarily in the United States, beginning about 1850. Among other things, Chandler chronicles the development of integration, geographic expansion and diversification; multi-level management in unitary corporations; multi-divisional (or "M form") corporations; strategy, as a business method and as a management discipline, including the separation of strategic and operational decision-making, and the relationship between strategy and structure; and the importance of management activities to organizational performance.

We will then proceed to examine further refinements, challenges, and theorizations by later commentators from management<sup>34</sup>, political<sup>35</sup>, sociological,<sup>36</sup> anthropological,<sup>37</sup> economic,<sup>38</sup> and legal<sup>39</sup> perspectives. Among other things, this examination will reveal the ways in which business units (“BUs”) function in relation to their controlling organization and in relation to each other; and the ways in which internal competition and cooperation may develop among them; the ways in which strategic objectives influence the organizational structure of the overall enterprise; the political nature of internal behaviour of organizational constituents within the organization itself; and the ways in which corporations function as social organizations.

As our present concern is whether or not the firm acts as a single economic actor and independently, we will leave for later consideration issues relating to the distribution and exercise of power, as well as their effects, within the firm; issues relating to employment within the firm, including the nature of the relationship between employees and the firm; the differences between actual and apparent authority; the differences between actual and apparent positional authority and power; and similar issues.

## **PURPOSE AND METHODOLOGY OF BUSINESS HISTORY**

### **A Note on Methodology**

In keeping with the purpose and scope of the present work, it will not undertake a methodological survey of descriptions of the modern business corporation; but, instead, will assume that readers

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<sup>34</sup> For example, James March, who has held appointments in such fields as psychology, political science, sociology, industrial administration, and management; and his sometime co-author Johan P Olsen, who has held appointments in public administration and organization theory, sociology, and political science; Richard M Cyert, whose doctorate was in economics but who taught economics, statistics and industrial administration, including organization theory; Herbert A Simon, Nobel laureate in economics, whose doctorate was in political science, but who held appointments in political science, administration, industrial management, psychology, social and decision sciences, and computer science; and Theodore T Herbert.

<sup>35</sup> For example, Terry M Moe, *supra* note 6.

<sup>36</sup> For example, Neil Fligstein, and his sometime co-author Luke Dauter, *supra* note 9, and Charles B Perrow. See Charles Perrow, “The Analysis of Goals in Complex Organization” (1961) 26:6 *American Sociological Rev* 854.

<sup>37</sup> For example, Greg Urban and Kyung-Nan Koh, “Ethnographic Research on Modern Business Corporations” (2013) 42 *Annual Rev Anthropology* 139.

<sup>38</sup> For example, Nobel laureates Ronald Coase and Oliver E Williamson. See RH Coase, “The Nature of the Firm” (1937) 4:16 *Economica* 386. See also Oliver E Williamson, “The Economics of Organization: The Transaction Cost Approach” (1981) 87:3 *American J Sociology* 548; and Williamson (1979), *supra* note 17.

<sup>39</sup> For example, Adolf A. Berle, Jr and Eric W Orts. See Berle, *supra* note 1. See Eric W Orts, *Business Persons: A Legal Theory of the Firm* (Oxford: Oxford University Press, 2013).

share a general familiarity with the modern business corporation. Of course, this general familiarity may have been amplified by the discussion, in Part 1, of the essential attributes of the modern business corporation, and how they have been instantiated in four major corporate law statutes.

For present purposes, the work also will not chronicle the development of business organizations prior to modern times. Instead, it is proposed that a subsequent work would set forth some of the historical background to modern business corporations research which has assisted in corroborating preliminary conclusions as to the associative or corporative nature of the modern business corporation that are enunciated in the present text.

Of course, many histories of the development of business organizations commence with the Industrial Revolution and the Second Industrial Revolution in Great Britain and elsewhere, while others start their review with the charter or monopoly companies established to undertake exploration and trading on behalf of their respective monarchs. Still others initiate their discussions with the development of guilds, trading markets and the development of the *lex mercatoria* in the Middle Ages.

It is the considered estimate of this author, based upon extensive review of secondary sources, many of which involve extensive consideration of primary source materials that business organizations, having many, if not all, of the features of the modern business corporation are much more ancient than many conventional reviews suggest, and that such business enterprises were operative, at least, by Ancient Roman times. Indeed, it can be conjectured based on available evidence discussed in relevant literature that such business organizations may have operated in Ancient Greece and even beyond those times to even older Ancient Middle Eastern civilizations. It is also the considered opinion of this author, based upon extensive review of secondary sources, that the historical record as explicated to date corroborate the author's view as to the associative or corporative development and constitution of modern business organizations, including the modern business corporation.

### **Business History and This Work**

Consistent with the purpose and scope of this work, however, it will not seek to examine the historical development of business organizations from earliest times to the present. Instead, it will

consider the development and present state of the modern business corporation or MBC as described by one its foremost expositors and historians, Alfred D. Chandler, Jr. At present, we will limit this examination to matters that affect or may affect the issue of whether the modern business corporation acts as a single economic actor. However, many of his insights with respect to other matters will be mentioned in Part 3 of the book, especially insofar as they relate to other assumptions of modern corporate law and corporate governance theories.

Chandler is generally credited with having been a pioneer in organizational studies and, in particular, with having conducted the first real empirical studies of modern business enterprises, especially modern business corporations, by means of his study of the history of the development of the modern business corporation. The first of his two major works, *Strategy and Structure: Chapters in the History of the Industrial Enterprise*<sup>40</sup>, was published in 1962. A poll of the Fellows of the Academy of Management placed it as the eleventh most influential management book of the twentieth century,<sup>41</sup> cited in more than 20,000 academic works.<sup>42</sup>

This chapter will review Chandler's empirical work for three principal purposes: firstly, to ascertain the principal features of the modern business corporation "in the real world" in recent history and today, as an economic actor and otherwise; secondly, to compare and contrast Chandler's observations with classical and neoclassical economic models of the firm; and, thirdly, to examine the relationship between the modern business corporation as instantiated "in the real world" and corporate essentialism, particularly corporate legal essentialism, as instantiated in modern corporate law.

This procedure is in accordance with the overall "descriptivist" or "empirical" orientation of the present work. This work began with an exposition of the features of the corporation, as a single legal entity or "rights-and-duty bearing" entity, which have been generally considered to constitute its principal attributes: limited liability or assets partitioning, transferable equity interests, capital lock-in, central management independent of ownership of "owners", and indefinite and possibly unlimited duration. Chapter One and Appendix A of this work then examined the extent, if any, to

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<sup>40</sup> Alfred D Chandler, Jr, *Strategy and Structure: Chapters in the History of the Industrial Enterprise* (Boston: MIT Press, 1962).

<sup>41</sup> Arthur G Bedeian, and Daniel A Wren, "Most Influential Management Books of the 20<sup>th</sup> Century" (2001) 29:3 *Organizational Dynamics* 221.

<sup>42</sup> A "Google" search of the article conducted by the author on February 24, 2018, indicated 20376 cites to that date.

which those principal attributes were instantiated in modern corporate law. In this way, it considered the question: what, as a matter of law, is the corporation?

The preceding part of the present chapter, together with Appendix B, considers discourse from various academic disciplines or fields concerning the firm and, where applicable, the corporation and the modern business corporation, in relation to the economy, the society, the polity, and the state. In this way, that part of the book considers the discourse relating to the macroenvironment, as well as the microenvironment, of the firm or the corporation. Thus, it endeavours to ascertain the extent, if any, to which such discourse might be expected to influence the firm and the corporation, as a matter of law, and otherwise. That part of the book proceeds in this investigation by considering generalizations or assumptions of relevant discourse and by subjecting them to examination, criticism, comparison, and assessment of their explanatory and predictive values. Thus, it has a somewhat different purpose than the remainder of this Part 2 of the book. Hence, the chapters in Appendix B can be read somewhat discretely from the balance of Part 2.

The remaining section of Part 2 of this work, being this chapter and the next following chapter, bears comparison with Part 1 and Appendix A of this work inasmuch as the present chapter and Appendix B investigate the question: what is the modern business corporation today? Put another way, what are its features as we experience them “in the real world”? How does that description and how do those features compare with the essential legal attributes of the corporation discussed in Part 1 and Appendix A of this work? At the same time, the present section, together with Appendix B, compares the empirical description of the modern business corporation with relevant academic discourse, including discourse concerning the essential attributes of the firm and the essential legal attributes of the corporation, most particularly, those of the modern business corporation.

The ambition of the present work is to demonstrate: what the corporation is, in reality, including “legal reality”; and in discourse, principally in relation to economic, organizational, social, and political theory; what it is that a legal theory of the corporation must seek to explain; and to advance a legal theory of the corporation that takes the foregoing considerations into account.

## HISTORY OF THE DEVELOPMENT OF THE MODERN BUSINESS CORPORATION

### Strategy and Structure

While now more than fifty years old, *Strategy and Structure* is still considered a seminal work in the study of the modern business corporation and the classic, albeit not unchallenged, exposition of the history of its development. As an introduction to an empirical examination of the modern business corporation and many of the issues we seek to examine, it has an extremely high level of utility.

### *Post-Civil War Vertical Integration and Diversification*

A previously unpublished paper that Chandler presented to the 1959 meeting of the Business History Conference the University of Illinois, which was published in 1990 as "Integration and Diversification as Business Strategies – An Historical Analysis",<sup>43</sup> gives some indication of his prior thinking on the development of American industry. There, Chandler defines strategy as "a company's basic business objectives and policies" and refers to it as being defined by the answer to the question "what exactly is our business or what should it be?"<sup>44</sup>

Chandler maintains that American industrial companies since their beginnings in the years after the American Civil War had followed four types of business strategies: first, vertical integration (whether only to market or also to distribute, and control, its supplies), which was then, followed by three sorts of diversification, which he called full-line (selling more than a single line of products, for example, not just tires but rubber products generally); which was sometime extended to multi-line (for example, selling not just rubber products, but also chemical products); and finally the policy of continuing product turnover (introducing new products based on continuous and systematic research).<sup>45</sup> He suggested that the tactics and routine activities, as well as the

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<sup>43</sup> Alfred D Chandler, Jr., "Integration and Diversification as Business Strategies – An Historical Analysis" (1990) 2 *Business and Economic History* 65. According to a note to the paper, the then-editor of that journal, William J. Hausman, discovered the paper among the files of the Business History Conference and requested and received Chandler's permission to publish it.

<sup>44</sup> *Ibid* at 65.

<sup>45</sup> *Ibid* at 65-66. Ronald Coase conducted a program of research in 1931-32 for his dissertation which involved discussions with business personnel in order to compare acquisition as a business strategy and as a method of "bounding" the firm, with the development of a long-term contractual relationship such as that between General Motors and A. O. Smith and Co. Sidney Winter discusses this, commenting that such a research program would *not* likely "pass muster in most economics departments today. Indeed, even a much more structure plan of inquiry into actual business practice would be likely to confront great skepticism regarding the value of such research." He says

management structure, of each company reflected the company's basic strategy and its evolution, and that its strategic shifts seemed to respond, in each case, to fundamental changes in the nation's economy and technology.<sup>46</sup>

Chandler sought to demonstrate that producers seeking to increase their profits pursued quite distinct strategies. It is clear that achievement of optimal cost, profit, production, and profit levels are of concern in "the real world". However, beyond seeking profit, lowering cost, and achieving input costs and output prices and a level of output that will achieve an optimal quantum of profit and cost, the details of strategy are not, *ex hypothesi*, addressed in neoclassical theory. While some later developments attempt to deal with such matters, such refinements are not part of the classical and neoclassical model extant at the time at which modern corporate law and legal theory and related corporate governance theory and practice developed and upon which they may still rely.

### ***Innovation and Organizational Complexity***

Chandler seeks to derive some lessons from the divergent methods of strategy pursued by his exemplar companies and asks: "What then do changes in strategy suggest about America's industrial past?"<sup>47</sup> He identifies three principal developments that are so suggested. The first concerns the "major underlying innovating forces in the industrial economy", considering "innovating in Schumpeter's sense of encouraging the creation of new products, processes, markets, supplies, and forms of organization." He identifies those major forces as "successively, the creation of the national and increasingly urban market, the coming of new sources of power, and the application of science to industry."<sup>48</sup>

The second development which he identifies is the change in entrepreneurial decision-making and organizational structure as a result of these social and technological developments. According to Chandler, the task of industrial entrepreneurs prior to the growth of a national market was thought

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the reason is not an accumulation of "so many good observations about how firms work that we do not need any more." See *supra* note 3 (1988) at 168-9. Winter opines that Coase was right in maintaining that the boundaries, and hence inner workings, of firms are within the purview of economics. Similarly, Coase evinced an appreciation for the "realism of assumptions" with respect to the theory of the firm. Of course, Chandler's doctoral dissertation was submitted in history.

<sup>46</sup> *Supra* note 43 at 66.

<sup>47</sup> *Ibid* at 73.

<sup>48</sup> *Ibid*. Criticism of Chandler as treating development of market demand and an increasingly urban and national market as completely endogenous, rather than "furthered", "developed" or even "created" by manufacturers is beyond our present scope. Instead, we focus on the implications of such developments upon management of the enterprise.

to involve primarily manufacturing for an impersonal market over which the entrepreneur had little control. Pursuing a strategy of vertical integration, however, involved the entrepreneur not only in the manufacturing function, but in other industrial functions as well, including “the needs and ways of the purchasing and production of raw materials, of the distribution and marketing of finished products, and of finance and organization”, as well as working out “the ways and means for carrying on a new economic function of coordinating product flow.”<sup>49</sup> A strategy of diversification extended the entrepreneurs’ horizons still further, from multi-functional to multi-industrial, and from national industry to the national economy. As such, “[i]n time his decisions became primarily to determine what businesses his firm should enter, which it should leave, and which it should maintain.”<sup>50</sup>

Chandler identifies the third major development as a change in the structure of the industrial corporation arising from diversification, namely, decentralization.<sup>51</sup>

Chandler seeks to investigate how innovation occurs. We have seen that such a question does not readily arise, nor is it readily a subject for discussion and, as such, for resolution, in the neoclassical paradigm. Still less does the question arise how producers respond to demographic and technological developments in seeking to develop their strategy and to structure the organization to best effect. It is not necessary for this purpose to inquire whether the innovations Chandler describes resulted from entrepreneurial activity; instead, the comments he makes above focus attention on the challenges that such innovations present to the “industrial entrepreneur”.

At this point, Chandler is considering only the “industrial entrepreneur”, who is much like the neoclassical owner-manager, and he has not yet introduced the complexities of an organization embracing hundreds, thousands, or hundreds of thousands of individuals, and of coordinating their activities. Even at this point, however, it can be seen that the complexity of the information relevant to, and required to be considered in connection with, the decision-making Chandler describes as required to be made by the “industrial entrepreneur” is massive indeed.

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<sup>49</sup> *Ibid.*

<sup>50</sup> *Ibid.*

<sup>51</sup> *Ibid.*



It would be impossible for the “industrial entrepreneur” to have perfect information concerning all these matters and to be able to apply such information cogently and rationally. Chandler’s readers may infer that the industrial entrepreneur will have to make decisions with imperfect information, under conditions of uncertainty, from some one or more perspectives, including the background and experience of the relevant decision-maker, which perspective(s) may introduce bias and further indeterminacy into his or her decision-making. Thus, the neoclassical assumption of perfect rationality is not seen as obtaining outside of theory.

Chandler finds, then, that the strategy of industrial companies in the United States responded to changes in their external environment, including the development of new technology and other resources requisite or appropriate to their business, and that their responses changed the nature of decision-making in, and the structure of, the organization itself. In effect, his “entrepreneur decisions” (discussed further below) and their implementation became vastly more complex and, we may conjecture, required vastly greater (albeit imperfect) information, and presumably much more in the way of management, entailing a more elaborate and specialized management structure. These findings seem to be based upon the research which Chandler had been conducting which was later reflected in his book *Strategy and Structure*.

### *Separate Development Trajectories*

In *Strategy and Structure*, Chandler published the results of his investigations of organizational innovation in four major companies: E. I. du Pont de Nemours & Co., General Motors Corporation, Standard Oil Company (New Jersey), and Sears, Roebuck and Company, concluding that they developed independently of each other, and without imitation, seeking solutions to problems that each considered unique, and producing what each of them thought to be genuine innovations.<sup>52</sup>

His investigation disclosed a number of important facts. The first of these was that “a meaningful analysis of the creation of the new administrative form called for accurate knowledge about the firm's previous organization and in fact about its entire administrative history.”<sup>53</sup> Thus, apart from issues of path dependence, he concluded that the present organizational structure of a corporation

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<sup>52</sup> *Supra* note 40 at 2-3.

<sup>53</sup> *Ibid* at 3. The extent to which development of management structure may be said to be influenced by the historical development of the enterprise and even “path dependent” is a subject that is pursued in his work.

could not be understood without appropriately individuated historical context. The second, but related, point was that “changes in organizational structure were intimately related to the ways in which the enterprise had expanded”, an evaluation of which “demanded a detailed understanding of the company's methods of growth.”<sup>54</sup> This points to the importance of organizational history as an element of overall business history.

Chandler’s remaining points related to “the history of the American business economy”.<sup>55</sup> The third point was that the patterns of growth of each company “reflected changes in the over-all American economy, particularly those affecting the market or demand for the enterprise's products.” His fourth point was that the changes made in the organization of the company concerned “were influenced by the state of the administrative art in the United States at the time they were being carried out.”<sup>56</sup> That is to say, just as technological developments affect strategic orientation, so developments in organizational methodology across a broad spectrum may affect changes in the organization of a particular business enterprise.

Changes in structure, according to Chandler, reflected not only changes in strategy, by means of which the company adapted to changes in demand, the market, and in the economy generally, which we may describe as changes in the external environment; but also changes in administrative demands, methods, and capabilities, which may involve, at least partly, changes in the internal environment of the organization. While beyond the neoclassical theory of the firm, evolutionary theory in economics, as developed by Nelson and Winter, recognizes “the firm within established routine possesses resources on which it can drop very helpfully in the difficult task of attempting to apply that routine on a large scale”;<sup>57</sup> and, this author would maintain, in other circumstances to which such routine might be relevant.

As mentioned earlier, we would characterize some of these as changes in resources. They also involve processes and their analysis, implementation, assessment, and monitoring, which we have

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<sup>54</sup> *Ibid.*

<sup>55</sup> *Ibid.*

<sup>56</sup> *Ibid.*

<sup>57</sup> *Supra* note 3 (1992) at 119. See also Winter’s 1988 article, *supra* note 3 at 176. These texts, and others in the area of evolutionary economics, examine both intraorganizational and extraorganizational aspects of business entities and activities. See also *supra* notes 11 and 13 to 19 and accompanying discussion.

seen to be absent from the neoclassical model of the firm. Such processes may themselves be considered to constitute resources of the subject-corporation.

Further, we may infer from Chandler's description that the multiplicity of influences on the enterprise, the extent and salience of such influences, and the nature, effectiveness, and quantum of responses to them create a pattern of development of the enterprise that has a certain individuality or even "uniqueness". This developmental "footprint", in turn, may be said to exhibit a tendency towards some kind of path dependence. Slight differences in the nature or impact of these four influences might be expected to have a significant effect on the future path of development of the organization concerned.

### ***Enterprise Development and the Economic Model of the Firm***

Chandler demonstrates that the development path or trajectory of one corporation may be uniquely different from that of another, even if they are operating in the same industry and geographic area. In turn, this suggests that previously determined methods of analyzing organizational development, at least those which are based on strategic congruence within companies in the same industry ("industry dependence"), may not yield accurate results in the case of any particular enterprise concerned. Such patterns of development, of course, since they relate to characteristics of the organization and structure of the firm, are, in consequence, external to neoclassical assumptions.

Chandler was sensitive to actual and possible effects that the nature of business conducted by the corporation might have on its methods of organization. As he studied only four major industrial corporations in depth, he purported to limit his conclusions to the industrial enterprise, which he described as the "large private, profit-oriented business firm involved in the handling of goods in some or all of the successive industrial processes from the procurement of the raw material to the sale to the ultimate customer",<sup>58</sup> thereby excluding utilities and companies involved in transportation, and purely financial, activities.

While Chandler studied in detail only four major industrial corporations, he "briefly examined" the administrative histories of close to one hundred of America's largest industrial enterprises, including the fifty with the largest assets in 1909 and seventy of the largest by assets in 1948.<sup>59</sup> In

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<sup>58</sup> *Supra* note 40 at 8.

<sup>59</sup> *Ibid* at 3-4.

order that the sample might reflect a broader range of industries, he included an additional twenty of the next largest companies. Consequently, his study involved considerable breadth and depth.

Chandler treated industrial enterprises as a subspecies of capitalistic enterprise, as defined by the German economist and sociologist Werner Sombart to mean “an individual economic organism... created over and above the individuals who constitute it” which “entity appears as the agent [in the sense of “actor”] in each of these transactions and leads, as it were, a life of its own, which often exceeds in length that of its human members.”<sup>60</sup> Without digressing to consider the exact meaning and history of the words “individual economic organism” in this context, it is clear that it is considered to be: an entity, which itself takes action; which is separate from the individuals who create or constitute it; which is constituted, represented, or, as we might say, “animated” or “vivified” by human individuals; which exists separately from those individuals; and which may continue to endure beyond the lifetime of any such individuals.

These characteristics conform to our discussion of legal essentialist attributes in Chapter One and Appendix A of the present work. Although not specifically discussed, the transferability of shares and the prospect of wholesale replacement of shareholders, and even employees, over time, and from time to time, are consistent with Sombart’s and Chandler’s other descriptive elements of the modern business corporation, especially separate existence and indefinite duration. Their lack of discussion of the principles of asset separation (or asset partitioning) as between the corporation and its shareholders is not critical to recognizing such general consistency and may be thought to be, at least in part, reflective of the time at which they were writing.

Importantly, however, this description acknowledges, as a matter of business management and business history, the existence of a relationship between the enterprise, or the “firm” of the economists, and the individual persons who create and constitute it. It may be expected, accordingly, that the perspective advanced by Chandler will be, to at least some extent, in accordance with the corporative perspective which is advanced in the present work.

Chandler, implicitly, at least, acknowledges the separation between the corporation, as a legal entity, on the one hand, and as an organization, on the other. Indeed, he considers the organization

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<sup>60</sup> *Ibid* at 8. He cites: Werner Sombart, *Capitalism*, in *Encyclopedia of the Social Sciences* (New York, 1930) III at 200.

so important to the continuance of the legal entity that “[w]hile the enterprise may have a life of its own, its present health and future growth surely depend on the individuals who guide its activities.”<sup>61</sup> At the highest level of the enterprise, these individuals are the executives or, as Chandler calls them, the “entrepreneurs”.

Chandler thus recognizes that his “enterprise”, the “firm” of the economists, or the “corporation” as a legal entity, is dependent for action, including executive and managerial action, upon individual persons, and may be affected, as such, by certain characteristics, and other aspects, of their behaviour. Such recognition is not generally part of neoclassical economic theory, but is endemic to corporative theory. It is important to emphasize, however, that, while business, management, and organizational disciplines may concentrate a great deal of attention on organizational aspects of the business entity, the legal aspects of the business entity, and the importance of the same, are also acknowledged by academics and practitioners in those disciplines.

### ***Functions and Activities of Management***

The complexity of managing such an enterprise may be enormous, involving many different functions and activities. Consequently, we may conclude that the multiplicity of influences on the enterprise, and the extent and salience of such influences, and the nature, effectiveness, and quantum of possible responses by management of the enterprise to such influences may have significant effect on the health, growth or decline, and duration or longevity, of such enterprise. Management of such an enterprise must regularly, if not continuously, adapt to changes in the external environment, including adapting its strategy and structure, as well as processes, accordingly. Chandler is generally credited with originating such perceptions.

Chandler maintains that “the functions of the executives responsible for the fortunes of the enterprise... [are to] “coordinate, appraise, and plan”, which, in many cases involves administering the duties of other executives.<sup>62</sup> As to the first and third such functions, in “planning and coordinating the work of subordinate managers or supervisors, [the executive] allocates tasks and makes available the necessary equipment, materials, and other physical resources necessary to carry out the

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<sup>61</sup> *Supra* note 40 at 8.

<sup>62</sup> *Ibid.*

various jobs.” The second function, appraisal, involves deciding “whether the employees or subordinate managers are handling their tasks satisfactorily” and, if the answer is in the negative, “[the executive] can take action by changing or bringing in new physical equipment and supplies, by transferring or shifting the personnel, or by expanding or cutting down available funds.”<sup>63</sup> Of course, the executive level controls and allocates resources. Here, Chandler draws attention to the effect that supplying additional resources or removing existing resources may have on the capabilities, scope of activity, authority, actions, and conformity to executive direction, of the manager and his subordinates. Changes in resources may also be used to discipline managers.

Resource allocations are prerogatives of the executive of the enterprise. Chandler explains that the “term, administration, as used here, includes executive action and orders as well as the decisions taken in coordinating, appraising, and planning the work of the enterprise and in allocating its resources.”<sup>64</sup> Thus, Chandler finds that functional actions, such as selling or manufacturing, are separate from administrative actions. As to the latter, some executives coordinate, appraise and plan, while others administer the duties of other executives. Some executives do both.

When Chandler says that the top-level executives who guide the activities of the enterprise are responsible for the fortunes of the enterprise, it is not immediately clear whether he is saying that the nature of such guidance determines the fortunes of the enterprise, or that such guidance falls to those responsible for its fortunes, or whether he is making both statements.

Whatever interpretation is placed on these observations, however, it is immediately apparent that the observed industrial corporation is significantly more complex than the neoclassical model of the firm; which cannot be seen as having any descriptive relevance to such corporation. As suggested here, the modelled single-person economic actor, the firm, does not require much in the way of internal activities or processes other than individual decision-making, the parameters of which are dealt with in its assumed parameters. Consequently, the abilities of the leaders and others involved in administrative and functional roles, and differentials within them, at differing levels of the organization, and as compared with those in other organizations, are not relevant to the

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<sup>63</sup> *Ibid.*

<sup>64</sup> *Ibid.*

neoclassical model assumptions. In that model, there simply are often no others other than the entrepreneur.

### ***Executive Management and Senior Management Roles***

As we have seen, Chandler distinguishes between functional activity and administrative activity. Functional activity involves essential tasks in the manufacturing process which are typically left to employees in functional areas, such as buying (buyers), selling (salesman), advertising, accounting, manufacturing (production supervisors and foremen), and engineering and research (engineers, designers, and technicians).<sup>65</sup> Administration, on the other hand, is an identifiable activity distinct from functional work. In a smaller company, the same individuals or groups of individuals may perform both administrative work and functional work; in a large company, however, “administration usually becomes a specialized, full-time job.”<sup>66</sup>

Administration, that is to say, coordinating, appraising, and planning the activities of the enterprise, says Chandler, involves two types of administrative tasks: firstly, defining basic goals and the course of action, policies, and procedures necessary to achieve them, which activity focuses on long term planning and appraisal and the long-run health of the company; and, secondly, activity focused on the smooth and efficient day-to-day operation of the business, meeting both anticipated problems and needs and unexpected contingencies or crises, all in accordance with the broader framework of goals, policies, and procedures directed towards long-term success.<sup>67</sup> He says that in real life the distinction between these two types of activities or decisions is often not clear cut, such that some activities and decisions involve both aspects, and in differing degrees.

Chandler acknowledges that even in small firms, coordination, appraisal and planning are essential activities. However, in the larger industrial enterprises he examined, those activities, which he calls “administration”, may become so specialized and intensive that it may engage the whole time and attention of the highest level of management.<sup>68</sup> These activities, which we may consider as meta-activities (although not so denominated by Chandler), determine, facilitate, and enable the other activities involved in the day-to-day work or operations of the business.

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<sup>65</sup> *Ibid.*

<sup>66</sup> *Ibid* at 8-9.

<sup>67</sup> *Ibid* at 9.

<sup>68</sup> *Ibid.*

In addition, planning, coordinating and appraising takes place on long-term, medium-term, and short-term temporal horizons, and at different management levels. It is then executed in accordance with long-term, medium-term, and short-term implementation and measurement horizons. It is apparent from this that the nature of the task of Chandler's "administration" or management may depend to a significant degree upon such factors as the age, size, and scope of the business enterprise concerned.

Goals must be prioritized and their achievement planned, coordinated, and appraised. Some of these tasks may be viewed as strategic, and others as tactical. Presumably, this entails, in some cases, re-prioritizing goals, whether long-term, medium-term, or short-term, over time as may be appropriate. Some goals may be instrumental, in the sense of being intermediate, as being necessary to or facilitative of higher order goals.

Administration also involves responding to immediate problems and needs, and to unexpected contingencies or crises. It is apparent that these tasks involve complex decision-making and implementational processes. Chandler's description would lead us to expect that the actual division of, and time spent on, long-term planning and appraisal activities, as opposed to day-to-day operating activities, will vary with the size of the organization and the level of the administrator or executive.

### *Administrative Levels and Activities*

Rather than the owner-manager of neoclassical theory, the modern corporation engages a great many managers, who are situated at different levels, which are also differentiated by task, authority and means of control. These managers engage in activities and processes relevant to the business of the organization. They occupy "positions" or "offices" within the organization, which can be identified on the corporation's "organizational chart" or "org chart", a chart depicting how the corporation is "organized" to carry on its business, which may involve various levels of subsidiary corporations. Such organization of business may be highly dependent upon legal structure or relatively independent of the same; that is to say, in terms of how the presence of separate corporations, as separate legal entities, affects the organization by which the ultimate parent corporation carries on its business. The legal structure of the overall enterprise is not expressed by Chandler as being significant, but, of course, his objective is to describe the operating business, not the legal



forms employed in such operations. Consequently, our discussion of the effects on business organization of the legal forms by which business may be carried on (and vice versa) must await later discussion, principally in Part 3, in Chapters Seven through Ten inclusive.

Chandler finds that executives in a modern “decentralized” company carry out their administrative activities from four different types of positions, each type having a different range of administrative activities and being on a different level of authority.<sup>69</sup> “The four types of administrative positions in a large multidivisional enterprise are thus: the field unit, the departmental headquarters, the division’s central office, and the general office.”<sup>70</sup>

At the top is a general office, “head office”, or headquarters, where “general executives and staff specialists coordinate, appraise, and plan goals and policies and allocate resources for a number of quasi-autonomous, fairly self-contained divisions.”<sup>71</sup> It may deal with several industries or with one industry in several broad and different geographical areas.<sup>72</sup>

Each division “handles a major product line or carries on the firm’s activities in one large geographical area” and its divisional central office administers a number of departments.<sup>73</sup> It deals with one industry, rather than one function, and thus is concerned with “all the functions involved in the over-all process of handling a line of products or services.” Consequently, the professional horizons and contacts of such managers are determined by industry rather than by functional interests.<sup>74</sup>

Each department “is responsible for the administration of a major function – manufacturing, selling, purchasing or producing of raw materials, engineering, research, finance and the like”,<sup>75</sup> generally on a broad regional or on a national scale. Their frames of reference, contacts, and sources of information are normally related to that specialized function.<sup>76</sup> “The departmental headquarters, in its turn, coordinates, appraises, and plans for a number of field units.”<sup>77</sup>

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<sup>69</sup> *Ibid.*

<sup>70</sup> *Ibid.*

<sup>71</sup> *Ibid.* See also p. 12.

<sup>72</sup> *Ibid* at 12.

<sup>73</sup> *Ibid* at 9.

<sup>74</sup> *Ibid* at 12.

<sup>75</sup> *Ibid* at 9.

<sup>76</sup> *Ibid* at 12.

<sup>77</sup> *Ibid* at 9.

The lowest level, the field unit or field office, deals with a single function, such as marketing, manufacturing, and engineering, only in one local area.<sup>78</sup> It “runs a plant or works, a branch or district sales office, a purchasing office, an engineering or research laboratory, an accounting or other financial office, and the like.”<sup>79</sup> Only at this level are the managers primarily involved in carrying on or personally supervising day-to-day-to-day activities.<sup>80</sup> However, if the volume of activity is large, they may spend much of their time on administrative duties. These are “largely operational, carried out within the framework of policies and procedures set by departmental headquarters and the higher offices.”<sup>81</sup>

### *Distribution of Decision-Making Authority*

As described by Chandler, the head office “makes the broad strategic or entrepreneurial decisions as to policy and procedures and can do so largely because it has the final say in the allocation of the firm’s resources – money, men, and materials – necessary to carry out these administrative decisions and actions and others made with its approval at any level.”<sup>82</sup>

The departmental and divisional offices “may make some long-term decisions, but because their executives work within a comparable framework determined by the general office, their primary administrative activities also tend to be tactical or operational.”<sup>83</sup>

He explains that field offices deal with one function; that department offices deal with one function on a regional or national scale; that division offices deal with one industry, rather than a function; and that the general (or head) office may deal with several industries or with one industry in several broad and different geographical areas, with the result that “their business horizons and interests are broadened to range over national and even international economies.”<sup>84</sup>

According to Chandler’s findings, functions performed at lower levels are subject to policies and procedures established at higher levels. At higher levels, decisions vary in their effect as between those having short term, and those having long term, effects; and the higher the level, the greater

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<sup>78</sup> *Ibid* at 12.

<sup>79</sup> *Ibid* at 9.

<sup>80</sup> *Ibid* at 11.

<sup>81</sup> *Ibid*.

<sup>82</sup> *Ibid*.

<sup>83</sup> *Ibid*.

<sup>84</sup> *Ibid* at 12.

the quantum (or, we may say, percentage) of decisions having long term effects. Chandler distinguishes the nature of such decisions further, as strategic or tactical, as described in the next section.

### ***Strategic Decisions and Tactical Decisions***

Chandler distinguishes between strategic decisions, which “are concerned with the long-term health of the enterprise”, and tactical decisions, which “deal more with the day-to-day activities necessary for efficient and smooth operations.” Strategic plans may be formulated at lower levels of the enterprise, however, because they “usually require *implementation* by an allocation or reallocation of resources – funds, equipment, or personnel”, which is effected by a higher office, the head office is in control of strategic decisions. Tactical decisions also require allocations of resources, however, executives at the lower levels carry out tactical decisions, provided that they are in accordance with the broad policy outlines, and the allocation of resources, which are determined by the head office.<sup>85</sup>

Chandler distinguishes between executives and managers on the basis of the nature of the decisions which they make. The key personnel in any enterprise are the executives, who actually allocate available resources. Because of this “critical role in the modern economy” he denominates them as “entrepreneurs” and, accordingly, denominates as “*entrepreneurial* decisions and actions” those decisions and actions “which affect the allocation or reallocation of resources for the enterprise as a whole.”<sup>86</sup> He denominates as managers “those who coordinate, appraise, and plan within the means allocated to them”. They make operating decisions and take operating actions, which are defined, respectively, as decisions and actions “which are carried out by using the resources already allocated”.<sup>87</sup>

From this, it may be concluded that strategic decisions will tend to be made at higher levels of the enterprise than tactical decisions, although some tactical decisions may be made at higher levels

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<sup>85</sup> *Ibid* at 11 [emphasis in the original].

<sup>86</sup> *Ibid* [emphasis in the original]. As can be readily seen, Chandler adapts the "entrepreneur" terminology used in the theory of the firm to more modern usage in connection with the organizational structure of modern business corporations.

<sup>87</sup> *Ibid*.

of management. While decisions even at the field office may involve certain commitments of resources, as decisions proceed to successively higher levels, the commitments of resources involved in the bulk of decisions made at such levels increase concomitantly.

For present purposes, we will adopt the view that the distinction between strategic and tactical decisions is best modelled as a continuum, as is the level of resources engaged in decisions. At the extreme, some decisions that are highly strategic may involve a very high level of resource commitment, while others that are highly tactical may involve a very low level of resource commitment.

### ***Resource Allocation and Entrepreneurial Activity***

Chandler thus considers the distinctive function of the highest level of decision-making to be, not only formulating strategy at the highest level, but also allocating resources at the highest level. He denominates the resource allocation decision as “entrepreneurial”. Thus, he says that the performance of entrepreneurs, in the sense of executives allocating and reallocating resources for the enterprise as a whole, may vary considerably and may impact the success or failure of the enterprise. He considers that such high level or entrepreneurial activity has a significant effect on the economy:

Just because the entrepreneurs make some of the most significant decisions in the American economy, they are not all necessarily imbued with a long-term strategic outlook. In many enterprises the executives responsible for resource allocation may very well concentrate on day-to-day operational affairs, giving little or no attention to changing markets, technology, sources of supply, and other factors affecting the long-term health of their company. Their decisions may be made without forward planning or analysis but rather by meeting in an *ad hoc* way every new situation, problem, or crisis as it arises. They accept the goals of their enterprise as given or inherited. Clearly wherever entrepreneurs act like managers, wherever they concentrate on short-term activities to the exclusion or to the detriment of long-range planning appraisal, and coordination, they have failed to carry out effectively their role in the economy as well as in their enterprise. This effectiveness should

provide a useful criterion for evaluating the performance of an executive in American industry.<sup>88</sup>

The necessity of a strategic outlook is immediately apparent. A strategic outlook facilitates coordination of decision-making in accordance with goals and objectives, whether long-range, medium-range, and short range, and a corresponding allocation of resources. Decision-making which lacks such forward planning and analysis may result in misalignment of short-, medium-, and long-term goals and objectives with each other and a corresponding misallocation of resources. Decision-making which is not strategically aligned in these manners may increase the number of non-strategic, or tactical, decisions required to be made at successively higher levels of the enterprise; may also increase the number of such decisions required to be made in general; and, in part as a result of the foregoing, may also fail to provide sufficiently rational grounds to guide such decision-making. All of the foregoing circumstances create opportunities for error.

As Chandler has indicated, the decisions made by such entrepreneurs, including prioritizing short-term or tactical issues over longer-term or strategic issues, or vice versa, or, in effect, balancing such considerations in some optimal or other satisfactory way may determine whether the enterprise involved continues or fails. As he says, failures of entrepreneurship may have an effect on American industry and on the overall economy, and, the present writer would suggest, in appropriate cases, on the society and polity at large. We would hasten to note that not all these “entrepreneurial” decisions are of this nature, implicating success or failure of the organization. Indeed, there may be very few decisions that are of this nature, considered in themselves. Similarly, there may be many decisions that, when aggregated with others, are highly relevant to organizational success or failure.

Chandler says that entrepreneurs must determine the strategy of the enterprise and allocate and reallocate resources so as to effectuate it. In the present author’s opinion, one may consider the structure, processes, activities, and personnel involved in the enterprise as resources in this regard. Thus, the allocation of structure, processes, activities, personnel, and other resources within the organization must be aligned and realigned as often as necessary to the strategy. In short, one must

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<sup>88</sup> *Ibid* at 11-12. The importance of adaptation to the external environment is critical to the perspective of modern evolutionary economics as advanced by Alchian, *supra* note 11; Nelson and Winter, and Winter, *supra* note 3; and others as noted, *supra*, note 57.

align structure, processes and personnel with each other and with strategy, including the external environment and changes within it as they may be expected to affect, may affect, or may, sooner or later, come to affect the enterprise.

### *Strategy and Tactics*

Chandler's study of the history and development of four major enterprises led him to conclude that: "*Strategy* can be defined as the determination of the basic long-term goals and objectives of an enterprise, and the adoption of courses of action and the allocation of resources necessary for carrying out these goals."<sup>89</sup> Such goals and objectives may include expanding the volume of the enterprise activities, setting up distant plants and offices, entering into new economic functions, and diversifying along some or many lines of business. Development of such new strategy may require determination of new courses of action and allocation and reallocation of resources "in order to achieve these goals and to maintain and expand the firm's activities in the new areas in response to shifting demands, changing sources of supply, fluctuating economic conditions, new technological developments, and the actions of competitors." Chandler thus emphasizes that a new strategy may require regular, frequent, or even continuous readjustment of action plans and resource allocations. Thus, "[a]s the adoption of a new strategy may add new types of personnel and facilities, and alter the business horizons of the men responsible for the enterprise, it can have a profound effect on the form of its organization."<sup>90</sup>

Of course, strategy is dependent on the availability of resources to the enterprise, as Jeffrey Pfeffer and Gerald R. Salancik have demonstrated.<sup>91</sup> Such resources may be external or internal to the enterprise. As noted here, such resources may include administrative, informational, technological, personnel, and other resources and capacities. It would appear even to casual observers that accessing either internal or external resources must involve some knowledge as to the existence, extent, and nature of such resources, and of the processes and procedures required to be pursued in order to access those resources. This is assumed by "rational" decision-making in economics and otherwise. For Chandler, this is part of what he denominates as "structure".

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<sup>89</sup> *Supra* note 40 at 13 [emphasis in the original].

<sup>90</sup> *Ibid* at 13-14.

<sup>91</sup> J Pfeffer and GR Salancik, *The External Control of Organizations: A Resource Dependence Perspective*. (New York, NY: Harper and Row, 1978).

### *Structure*

Chandler asserts that: “*Structure* can be defined as the design of organization through which the enterprise is administered” and he indicates that this design can be defined and effected either formally or informally.<sup>92</sup> The latter suggests, at least, that structure may evolve in such a way that it lacks formal definition; that is to say that, that while social structure is acknowledged, it may never have been formally adopted or otherwise formally recognized by or within the formal organization, at least by those having formal authority over such matters, but, nevertheless, still characterizes the actual organization.

Chandler’s comment may also be taken, however, to suggest that in addition to a structure that has been formally adopted, there may also be a kind of informal structure which is operative, one may say, outside of, or alongside, the formal structure, which does not appear on any formal organizational charts, and which, therefore, may not be accorded specific “legal” recognition, which ordinarily concerns itself with “formal” or “legal” structure. Yet it may be important in how the overall organization operates and to its compliance with applicable legal requirements. While Chandler does not explicitly suggest this, such a suggestion has, of course, been made by other organizational theorists. Indeed, it may be contended that the formal/informal dichotomy may reach the point at which it can be cogently observed that outside of, or alongside, the formal organization there may often be a type of informal organization. The relative importance of the formal and informal organizations may depend upon a number of relevant circumstances.

Chandler says that structure has two aspects: firstly, “the lines of authority and communication between the different administrative offices and officers”; and, secondly, “the information and data that flow through these lines of communication and authority.” Both aspects of structure “are essential to assure the effective coordination, appraisal, and planning” and the development and allocation of resources necessary to carry out the basic goals and policies of the enterprise. Chandler notes that “[t]hese resources include financial capital; physical equipment such as plants, machinery, offices, warehouses, and other marketing and purchasing facilities, sources of raw materials,

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<sup>92</sup> Chandler, *supra* note FN 40 at 14 [emphasis in the original].

research and engineering laboratories; and, most important of all, the technical, marketing, and administrative skills of its personnel.”<sup>93</sup>

The present author would argue, again, that structure may also be described as a species of resource. The design of the organization, the lines through which authority and communications flow, and the methods of collecting, processing, and evaluating, information, and employing it in decision processes provide essential resources to, and constitute an essential resource of, the enterprise.

Because Chandler’s concept of “structure” involves not only the lines of authority and communication, but also the content of such communications, it is clear that Chandler’s “structure” of the organization may also be taken to comprehend, at least, the processes by which authority is exercised and communicated, and by which information is generated and transmitted. In fact, the processes endemic in structure may be much more far-reaching than this. Of course, all such activity involves the personnel of the organization. Importantly for our purposes, both the lines of authority and the lines of communication may affect the possibility of assigning legal responsibility for particular decisions, just as those factors affect the imposition of sanctions, both rewards and punishments, by the organization itself. These factors, of course, are not the only ones that affect collective decision-making, or even individual decision-making within organizations.

Accordingly, we may conclude that Chandler’s outline of the business enterprise, as an organization, comprehends structure, process, and personnel. This work will maintain that these three elements, namely, structure, process, and personnel, characterize organizations generally, and the modern business corporation, in particular. These matters will be further discussed in Part 3 of this work.

However, as discussed already, neoclassical theory of the firm, consisting of an entrepreneur or owner, perhaps a manager, and possibly one or more worker-employees, does not inquire into the nature, structure, processes, operations, or personnel of the firm. Consequently, it ignores or invisibilizes some of the most important issues of economic organization. Similarly, it does not inquire

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<sup>93</sup> *Ibid.*



into the strategy of the firm. Instead, behaviour of firms, as previously discussed, is treated as a function of the market, and of supply and demand.

As noted, structure, for Chandler, involves authority, communication, information, and decision-making, also involves the organization and operation of processes. As observed previously, processual issues are excluded from the neoclassical theory of the firm. Thus, questions as to the relationship, if any, between strategy and structure, do not arise in neoclassical theory of the firm. However, Chandler observes such relationship at work, as indicated in the immediately following section.

### *The Relationship between Strategy and Structure, and Performance*

Chandler indicates that “[t]he thesis deduced from these several propositions is then that structure follows strategy and that the most complex type of structure is the result of the concatenation of several basic strategies.”<sup>94</sup> Administrative offices to handle a single function in one locality resulted from a strategy of expanding volume. A departmental structure and departmental offices to administer several field units arose from a strategy of growth through geographical dispersion. The strategy of expanding into new types of functions, which he describes as “a strategy of vertical integration”, gave rise to the adoption of a central office or head office, and a multidepartmental structure. The strategy of achieving growth by developing new lines of products or by geography, this time on a national or international scale, which he describes as “a strategy of diversification”, led to the creation of the multidivisional structure with a general office (today, generally called a “head office”) to administer the various divisions.<sup>95</sup>

Chandler thus argues that when the organization makes a choice among different strategies, such choice has implications for its structure. As he shows, growth effected by different means in accordance with different strategies requires different organizational adjustments. As previously observed, “structure”, for Chandler, includes the organization and operation of processes and of personnel. Accordingly, it is suggested here, and it is reasonably clear, that the interposition of additional structural elements and levels will usually require some adjustment to the process of the

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<sup>94</sup> *Ibid.*

<sup>95</sup> *Ibid.*

organization, and to its personnel, at least in terms of requiring additional staffing, and often requiring different talents and experience.

As noted, neoclassical theory of the firm precludes consideration of strategy (beyond such matters as interfirm competition) and of process (beyond the operation of interfirm markets and related matters), which entails that questions concerning the relationship of strategy and structure do not even arise within it. The assumptions of neoclassical economics and, in particular, of its theory of the firm, ignore or invisibilize considerations of individual and social action and behaviour. In fact, Chandler's work advanced criticism of neoclassical economics on this footing significantly. In a later work, Chandler observed that "[t]he neoclassical theory views the firm as a legal entity with a production set (a set of feasible production plans) from which a manager, acting rationally with full information, chooses the set most likely to maximize profits or present value of the firm."<sup>96</sup> The "process" of decision-making is reduced to price/volume interactions by market participants in the market.

### ***Organizational Structure, Legal Structure, and Performance***

Chandler's work thus represents a significant advance in the theory of the firm, by theorizing it as involving an organization. As noted previously, as Chandler still acknowledges the corporation as a legal entity carrying on the enterprise, he simultaneously recognizes both its organizational and its legal status.

Oliver Williamson, Nobel laureate and principal mover of transaction cost economics, including its theory of the firm, conceded the accomplishments of, and his indebtedness to, Chandler's *Strategy and Structure*.<sup>97</sup> He observed that "Chandler clearly established that organization form had important business performance consequences, which neither economics nor organization theory had done (nor, for the most part, even attempted) before. The mistaken notion that economic efficiency was substantially independent of internal organization was no longer tenable after the book

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<sup>96</sup> Alfred E Chandler, Jr, "What is A Firm? A Historical Perspective" (1992) 36 *European Economic Rev* 483 at 488. He cites O Hart, "An Economist's Perspective on the Theory of the Firm" (1987) 89 *Colum L Rev* 1757 at 1758.

<sup>97</sup> In "A Biographical Memoir of Alfred D. Chandler" (2009) 153:2 *Proceedings of the American Philosophical Society*, Williamson describes how the research agenda he had contemplated in his 1963 dissertation and resulting book *The Economics of Discretionary Behavior: Managerial Objectives in a Theory of the Firm* (Englewood Cliffs, N.J.: Prentice-Hall, Inc. 1964) underwent a major change after he read Chandler, who had demonstrated that managerial discretion varied with the organizational structure of the firm, not just with competition. See p. 226. Williamson's dissertation, was, of course, on the subject of managerial discretion.

appeared.”<sup>98</sup> Williamson claimed that this concept was revolutionary.<sup>99</sup> He indicated that “the latent lesson” of the book was that “[i]f organization form was a decision variable, then provision for that should thereafter be made in the theory of the modern corporation.”<sup>100</sup> The revolutionary nature of this lesson is indicated by Williamson’s observation that “[i]n many respects [Chandler’s] historical account of the origins, diffusion, nature, and importance of the multidivisional form of organization ran ahead of contemporary economic and organization theory.”<sup>101</sup>

Williamson thus credits Chandler with demonstrating: firstly, that organizational performance and organizational structure were closely related; secondly, that organizational form is a decision variable; and, thirdly, that the theory of the modern corporation must provide for the form of the organization. Indeed, Williamson may even be interpreted as saying that modern corporate theory must provide a theory of organizational form.

This is important for the legal theory of the corporation. If organizational (including, legal) form is a decision variable relevant to organizational performance, then matters affecting such legal form would, ipso facto, be relevant to such performance. Consequently, it is possible that choices made concerning the legal consequences attendant upon a particular legal form may affect the performance of such form of organization, and the organizations adopting such legal form. One such organizational form, of course, is the corporation. Thus, Chandler and Williamson may be taken to support the argument made in this work that the incidence of legal attributes may have consequences for the performance of corporations, which should, accordingly, be considered by those assigning those legal attributes. Those legal attributes, of course, include, but are not limited to, legal essentialist attributes. Chandler and Williamson can, therefore, be cited in support of the proposition that the merits or demerits of various legal attributes can be assessed, at least in part, in terms of how such legal attributes affect corporate structure (including process and related matters) and corporate performance.

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<sup>98</sup> Oliver E Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*. (New York, NY: The Free Press, 1985) at 11.

<sup>99</sup> *Supra* note 97 at 226.

<sup>100</sup> *Ibid.*

<sup>101</sup> *Ibid.*

*Classical Economic Theory, Organization Theory, and Transaction Theory Compared*

Chandler's exposition thus provides useful empirical information, as well as theory, concerning the nature of the modern business corporation. As demonstrated in this work, classical and neo-classical economic theory effectively ignored the organization of the firm as a subject of discussion. As we have noted, instead, economic theory "invisibilized" such organization. In his examination of economic history, Chandler furthered the discussion of organizational structure as a subject relevant to economic performance and, in that behalf, relevant to economic theory. Williamson, with his theory of managerial discretion, contributed to this. His discussion of managerial discretion at least made some effort to open the "black box" of the firm in that respect.

In turn, Chandler paid tribute to Williamson's contribution when he later noted that "[t]ransaction cost theory is more relevant to the historical story and explanatory concept of organizational capabilities [than neoclassical theory or agency theory] because it does incorporate investment in facilities and skills"<sup>102</sup>, as well as its employment of external resources by means of contracts with outsiders. Indeed, it may be observed with considerable accuracy that organizational capabilities are not addressed in any significant way by classical and neoclassical economic theory, although they are recognized in institutional economic (and other) theory, evolutionary economic (and other) theory, and otherwise. Yet the position that organizational capabilities affect organizational performance is easily accepted by many organizational theories and theorists. Such capabilities determine, at least in part, the extent to which the organization is capable of identifying, and capable of addressing, by concrete action, inaction or otherwise, changes and threats to its continued operations and its very existence. A simple thought experiment can persuade observers that certain developments in a corporation's environment may be beyond its capacity to meet, and hence to survive. Another simple thought experiment can persuade observers that developments in the corporation's environment may include legal developments, and that some legal developments may threaten its continued viability and its existence.

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<sup>102</sup> *Supra*, note 96 at 489. Evolutionary economic theory also acknowledges the facilities, skills, and knowledge, often incorporated into operational routines, and the ability to adjust the same, which inhere in a modern business enterprise. See Winter (1988), *supra* note 3 at 174-179, especially at 177. Winter also rejects the notion of the transaction as the unit of analysis, for somewhat similar reasons, also at 177.

However, Chandler claims that he parts ways with Williamson concerning the “basic unit of analysis” which is, for Williamson, the transaction, while, for Chandler, “it is the firm and its physical and human assets.” This has important consequences: “If the firm is the unit of analysis, instead of the transaction, asset specificity still remains significant; but the specific nature of the facilities and skills are more significant than bounded rationality and opportunism to the shaping of decisions as to internalizing transactions and, therefore, in determining the boundaries between firm and market.”<sup>103</sup> Of course, the firm may also provide means by which the boundaries of rational decision making may be extended, including facilitating generation and communication of information requisite or appropriate in that behalf, as maintained by other organizational theorists.

Chandler maintains, then, that organizational capacity, including such aspects as physical and human assets, is relevant to determining whether to internalize transactions within the business enterprise itself or to continue with market transactions instead. Such organizational capacities are also highly relevant to the future course and prospect of success of such enterprises, he maintains, based on his historical review (in all of his main works). He argues: “Thus in analyzing the continued development of existing industries and the building of new ones, the firm would seem to be a more promising unit of analysis than the transaction, and the concept of the organizational capabilities that permit it to remain competitive, and therefore profitable, in national and international markets more pertinent than those of bounded rationality and opportunism.”<sup>104</sup>

Thus, while transaction cost analysis, like agency theory, may discard the assumption of perfect rationality in favour of one of bounded rationality, and also acknowledges opportunism, which Chandler concedes are improvements over neoclassical theory, he maintains that transaction cost analysis, like agency theory, fails to provide an account of productive and decision-making processes, of resource utilization, and of competition.

### ***Aligning Strategy, and Structure, and Growth***

As Chandler notes, in the enterprises he surveyed, developing strategy involved a complex process of decision-making. He explains that changing population, income and technology in the period under review created opportunities and needs to employ existing resources more profitably, and to

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<sup>103</sup> *Supra* note 96 at 489. He cites: Williamson, *supra* note 98 at 41.

<sup>104</sup> *Supra* note 96 at 490.

increase resources to be so employed as well, awareness of which might lead to development of a new strategy which might entail growth. He found that such new strategy and consequent strategic growth in the size of the enterprise required “a new or at least refashioned structure if the enlarged enterprise was to be operated efficiently.”<sup>105</sup>

Chandler considered it a mistake to ignore the necessity of such possible changes, saying that “growth without structural adjustment can only lead to economic inefficiency. Unless new structures are developed to meet new administrative needs which result from an expansion of a firm’s activities into new areas, functions, or product lines, the technological, financial and personnel economies of growth and size cannot be realized. Nor can the enlarged resources be employed as profitably as they otherwise might be.”<sup>106</sup>

Chandler maintains that such expansion requires an administrative office or head office to coordinate operations, without which the individual units, whether field units, department, or divisions, might be as efficient or more efficient if operated as separate independent units. “Whenever the executives responsible for the firm fail to create the offices and structure necessary to bring together effectively the several administrative offices into a unified whole, they fail to carry out one of their basic economic roles.”<sup>107</sup> That role seems to consist, at least in part, of realizing the technological, financial, and personnel economies of growth and size.

According to Chandler, then, in order to be successful, strategic adaption of the enterprise has both an external (we may say, more clearly extraorganizational or extralegal) and an internal (intraorganizational and intracorporate) aspect; and neglect of the latter may negatively affect success of the strategy itself, however sound may be its implications externally. Chandler says that, in his observation of the subject enterprises, the “failure to develop a new internal structure, like the failure to respond to new external opportunities and needs, was a consequence of overconcentration on operational activities by the executives responsible for the destiny of their enterprises, or from their inability, because of past training and education and present position, to develop an

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<sup>105</sup> *Supra* note 40 at 15.

<sup>106</sup> *Ibid* at 6.

<sup>107</sup> *Ibid*.

entrepreneurial outlook.”<sup>108</sup> Chandler’s “entrepreneurial outlook” requires not only that the entrepreneur engage adequately with strategy, but also that the entrepreneur ensure continuous alignment between strategy and structure, including within the latter both processes and personnel.

### ***Entrepreneurial Strategy and Resourcing***

Chandler leaves no doubt that management of such enterprises involves the fulsome application of the talents and abilities of the entrepreneurs concerned. As we have seen, among other things, these involved two types of administrative decisions: firstly, strategic, which “dealt with the long-term allocation of existing resources and the development of new ones essential to assure the continued health and future growth of the enterprise; and, secondly, tactical, which “was more involved in ensuring the efficient and steady use of current resources whose allocation had already been decided.”<sup>109</sup>

Consequently, tactical decisions would not necessarily or invariably entail any adjustments to administrative structure or process. However, as indicated under the preceding heading, with respect to strategic decisions, at least some of them, namely, those which involve strategic growth, may require such adjustments. “If the need to use resources provided the dynamic force that changed structure and strategy, the nature of the investment in these resources helped to determine the course and direction of growth and of subsequent structural change. The type of investment, in turn, depended on the technology of production and the techniques of marketing of the individual companies’ original product line or lines. Finally, the rate of growth and the effectiveness in the use of the enterprise’s resources rested on the ability and ingenuity of its administrators to build, adjust, and apply its personnel and facilities to broad population, technological, and income changes.”<sup>110</sup>

In the conclusion of *Strategy and Structure*, Chandler’s observations recall those made earlier in his text about the health and growth of an enterprise depending on the ability and ingenuity of its entrepreneurs and administrators. He says: “Although the enterprise undoubtedly had a life of its

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<sup>108</sup> *Ibid* at 15-6.

<sup>109</sup> *Ibid* at 383.

<sup>110</sup> *Ibid* at 384.

own above and beyond that of its individual executives, although technological and market requirements certainly set boundaries and limits to growth, nevertheless, its health and effectiveness in carrying out its basic economic functions depended almost entirely on the talents of its administrators.”<sup>111</sup>

As indicated above, ability and ingenuity, individual or collective, of management, as with management itself, is not within the purview of the neoclassical theory of the firm, yet Chandler’s investigations convinced him that such ability and ingenuity is critical to the health, growth, and even survival, of the subject enterprise. Arguments about the methodological effectiveness and limitations of case studies generally and in this case in particular notwithstanding, Chandler’s empirically-derived observations resonate with us even today.

### ***Conclusion***

Chandler’s 1959 study, “Integration and Diversification as Business Strategies – an Historical Analysis”,<sup>112</sup> identified vertical integration (whether only to market or distribute its products, or to control its sources of supply), followed by one or more of three types of diversification, as characterizing the development of American industrial companies since the American Civil War. He identified the major innovating forces which spurred these developments as the creation of a national and increasingly urban market, new sources of power, and the application of new technology to industry. These changes in the external environment of the enterprise and in the resources available in that environment to the enterprise, and to its actual and possible competitors, might be expected by the resource dependence perspective<sup>113</sup> to constrain the operations of an enterprise and, as a result, to affect its strategy, at least if it is acting or seeks to act prudently.

Chandler found that, by pursuing vertical integration, entrepreneurs gained greater control over manufacturing and industrial functions, while by pursuing a strategy of diversification, the entrepreneur’s functions were extended dramatically by means of one or more of three diversification strategies, namely, extensions to full-line, multi-line, and continuous new product, offerings. Such

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<sup>111</sup> *Ibid.*

<sup>112</sup> *Supra* note 43.

<sup>113</sup> See note 91 and accompanying text, and further discussion, *infra*.



integration and diversification required changes in entrepreneurial decision-making and organizational structure, including decentralization.

In effect, Chandler was able to observe changes that had taken place in American business enterprises in response to both externally generated and internally generated developments. He attempted to chronicle each of these types of developments and to endeavour to explain their interrelationships. Chandler's description of these enterprises indicates the complexity of the information affecting entrepreneurial decision-making in these circumstances. Among other things, he found that entrepreneurial responses to changes in the external environment significantly involved making changes to the structure and decision-making processes of the organizations concerned. The additional span of activities internalized within the enterprise necessitated additional management capabilities, structures, and processes, as well as a much greater body of personnel.

Chandler's extensive research for his groundbreaking study, *Strategy and Structure*,<sup>114</sup> led him to conclude that an appreciation of the current state of a subject-corporation's administration had to be based upon complete knowledge concerning its past administrative history, and its methods of growth, which, in turn, affected its administrative or organizational structure. We would say that it similarly affects its processes. Further, he concluded that the patterns of growth of the corporations which he studied reflected changes in the overall economy, which we would say forms part of its ambient external environment. In turn, adaptation of the corporation's structure (and, we would say, processes, and personnel) to its methods of growth in response to such external economic changes was necessarily affected by the state of development of administrative or organizational methodology at the relevant times.

Chandler demonstrated that the development path or trajectory of corporations operating in the same industry and geographic area might be uniquely different from one another, and that these differences were affected by strategies for growth, the methods and timing of such growth, and the methods of administration and organization prevailing at the relevant times. The very consideration of these matters, of course, falls outside the boundaries of classical economics, its theory of the firm, and its theory of price-quantity-equilibrium determination which constitutes its explication of economic action.

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<sup>114</sup> *Supra* note 40.

Thus, Chandler's work acknowledges the necessity to explain economic action and the economic actors, economic processes, and the economic structure, both in terms of the structure of market or other action, as between economic actors, and in terms of the structure of action within the firm as economic actor, which are relevant to each of the same. Chandler's willingness to investigate the internal structure and processes, as well as the personnel, of the enterprise or economic actor represents, among other things, a recognition that the "firm" posited by neoclassical economics as a single economic actor acting monadically in pursuit of a single goal, namely, profit, offers no meaningful explanation of economic action and processes, and no meaningful explanation of how individual persons interact with, or on behalf of, the "firm" or enterprise, in order to effect economic results.

Chandler clearly distinguishes between the enterprise and the individual human persons of whom it is comprised and by whom it is made active. He maintains that, although the enterprise "may have a life of its own, its present health and future growth surely depend on the individuals who guide its activities".<sup>115</sup> Thus, he recognizes that the business enterprise is, or, at least, involves, an organization of individual human persons who are not themselves, as such, the business enterprise as a legal entity, but are essential to its operations and activities. He also recognizes that the life of the business enterprise might be expected to extend well beyond the lives of the individual human persons concerned in it at any particular time or times.

All in all, Chandler clearly recognizes the significance of the "organization", apart from the legal form, of the business enterprise. In *Strategy and Structure*, his focus is on the organization of the enterprise, and on the history of its development. In terms of what has been described in this book as the essentialist attributes of the corporation as a matter of law, his focus is on the centrality of management, the respective durations of particular management teams and of the corporation itself, and on management's construction of corporate goals. Discussion of other legal essentialist attributes of the corporation, particularly the separation of management from ownership and the transferability of equity ownership appears in his later work. In such later work, he makes much of the extent to which the separation of management and ownership result in the concentration of practical power and authority over the corporation in the hands of its management.

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<sup>115</sup> *Ibid.*

Importantly, Chandler devotes considerable attention to the structure and processes by which the business enterprise, as an organization, seeks to conduct its activities in order to achieve desired goals. He describes the nature of the hierarchy concerned, in terms of head offices, divisions, departments, and field offices; the nature of the work conducted by managers at each level; the types and relative dispersion of decision-making as between strategic decision-making, and tactical decision making; and the flows of information relevant to such decision-making.

Chandler's basis of differentiation between executives and managers involves the distinction between strategic decisions, which are made in the exercise of executive authority, and tactical or operating decisions, which are made in the exercise of managerial authority. Strategic decisions involve the allocation or reallocation of resources of the enterprise, while tactical or operating decisions are made within, and subject to, existing resource allocations. Chandler recognizes, however, that decisions not involving the allocation of resources may be distributed throughout various levels of the hierarchy of the subject enterprise.

Likewise, functional decisions and administrative decisions may be required to be made at various levels in the hierarchy. Functional decisions relate to essential tasks in the functional areas of the manufacturing process. Administrative decisions relate to both defining basic long-term goals and implementing strategies, policies and procedures to achieve them; and, as well, conducting the short-term operations of the business in accordance with prescribed goals, policies and procedures. Again, Chandler notes that some activities and decisions partake of both functional and administrative aspects and to differing degrees.

### **The Visible Hand: The Managerial Revolution in American Business**

Chandler's second great work was *The Visible Hand: The Managerial Revolution in American Business*,<sup>116</sup> for which he was awarded the Pulitzer Prize in History.

#### ***Enterprise Coordination Replaces the Market***

Chandler introduces the subject of this book as follows: "The theme propounded here is that modern business enterprise took the place of market mechanisms in coordinating the activities of the

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<sup>116</sup> Alfred D Chandler, Jr, *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, Mass., The Belknap Press of Harvard University Press, 1977).

economy and allocating its resources. In many sectors of the economy the visible hand of management replaced what Adam Smith referred to as the invisible hand of market forces. The market remained the generator of demand for goods and services, but modern business enterprise took over the functions of coordinating flows of goods through existing processes of production and distribution, and of allocating funds and personnel for future production and distribution.”<sup>117</sup>

When Chandler says that “the visible hand of management replaced...the invisible hand of market forces”, this seems to indicate that “modern business enterprise acquired functions hitherto carried out by the market” not as to generating demand, but, in effect, as to supplying that demand, and, perhaps, as to stimulating demand or creating additional demand. According to Chandler, it was the coordination and allocation functions of the market posited by neoclassical economics that were replaced by this “visible hand of management”.

This can be seen as a clear rejection of the neoclassical model, as Chandler seems to be arguing, implicitly, at least, that supply is not mechanically derived from input cost and output price calculations, but involves processes within and without the particular supplier, including access to, and competition for, resources the availability of which is restricted (contrary to neoclassical theory), and also involves the method of employing such resources to derive the product concerned. Equally, it can be argued that, while Chandler acknowledges that the market generates demand for goods and services, his account, in both books, suggests otherwise, at least in part. He describes how producers were able to stimulate demand or, in effect, to “create” additional demand, by the use of technology, such as railway transportation and communications, and by pricing their products advantageously, as a result of such improved transportation and communication methods, and by employing mechanically assisted production methods.

Further, Chandler’s replacement of the invisible hand of the market by the visible hand of management does not necessarily entail that all of the functions of the market were “internalized” in the corporation or, in a word, “replaced” by the hierarchy of the firm as Oliver Williamson suggests.<sup>118</sup> In fact, Chandler’s comments about the ways in which production, distribution, and financial, personnel, and other resources were coordinated by “the visible hand” seem to suggest

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<sup>117</sup> *Ibid* at 1.

<sup>118</sup> *Supra* note 98.

that inter-firm allocation might also be involved in these processes. In effect, he may be implying that extra-market coordination of such matters involving determinants otherwise having an effect in the market implies that more than one “visible hand” might be operative. This may also be implied by the rise of what Chandler calls “managerial capitalism”, a subject which is discussed further below.

### ***Post-Civil War Developments in Business Organization***

In the first part of the work, Chandler chronicles the development of business enterprises in the United States between the post-colonial years of the 1790s and the 1840s, prior to the American Civil War, in commerce, manufacturing, and agricultural production. He found that between 1790 and 1840, the size and nature of business enterprises changed little, being mostly small, single-unit enterprises that were personally owned, and personally managed.<sup>119</sup> In fact, he cites evidence that the forms of organization and management by which merchants then carried on business “relied almost entirely on practices and procedures invented and perfected centuries earlier by British, Dutch, and Italian merchants”.<sup>120</sup> In addition, of course, such commercial devices as bills of exchange, bills of lading, and letters of credit had also been the subject of judicial adjudication, as a result of which established legal precedents were available to guide business parties and courts in their conduct.

Chandler indicates that “[b]efore the 1840s there was no revolution in the ways of doing business in the United States”; instead, inherited practices remained quite satisfactory.<sup>121</sup> These included corporate and commercial law. “They made increasing use of the incorporated stock company developed in the sixteenth century by the British to promote overseas trade and colonization and used in the eighteenth century to manage ancillary or utilities operations such as docks, water works, and the like.”<sup>122</sup> They also refined, but did not fundamentally alter, traditional forms, and “practices, instruments and institutions of commercial capitalism which had evolved to meet the growth of trade and the coming of market economies in the Mediterranean basin in the twelfth and

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<sup>119</sup> *Supra* note 116 at 14.

<sup>120</sup> *Ibid* at 16.

<sup>121</sup> *Ibid*.

<sup>122</sup> *Ibid*.

thirteenth centuries.” They also adjusted commercial law “to meet the needs of a rapidly expanding economy and a federal polity.”<sup>123</sup>

However, Chandler found that: “The great transformation was to await the coming of new technologies and markets that permitted a massive production and distribution of goods. Those institutional changes which helped to create the managerial capitalism of the twentieth century were as significant and as revolutionary as those that accompanied the rise of commercial capitalism a half a millennium earlier.”<sup>124</sup> Chandler underlined its significance and revolutionary nature by using the phrase “the great transformation”, as Polanyi had done before him.

### *Administrative Responses to Technological Developments*

As in *Strategy and Structure*, in *The Visible Hand* Chandler attributes much of the development of business practices in the fifteen years immediately preceding the Civil War to advances in technology, transportation, and communications.<sup>125</sup> Also of great importance, however, was the expansion of markets, both in terms of the rapid growth and spread of population over great distances, and in terms of expansion of demand by reason of increasing per capita income.<sup>126</sup>

Chandler explains that the increased availability of, and ability to use, coal as a result of improvements in technology provided abundant sources of energy which, among other things, facilitated the operation and expansion of railways. The development of the telegraph provided a new means of fast and dependable communication. Together, they transformed the processes of production and distribution.<sup>127</sup> They facilitated the flow of raw materials into, and the flow of finished product out of, the factory site steadily, reliably, in volume, and on schedule. This allowed the factory to maintain steady, even continuous, and high, levels of production. The railroads facilitated distribution of goods in unprecedented volume and at unprecedented speed to jobbers, other middlemen, and marketers, and by them to others.<sup>128</sup>

In summary, Chandler finds that “[t]he new sources of energy and new speed and regularity of transportation and communication caused entrepreneurs to integrate and subdivide their business

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<sup>123</sup> *Ibid.*

<sup>124</sup> *Ibid.*

<sup>125</sup> *Ibid* at 77.

<sup>126</sup> *Ibid* at 484.

<sup>127</sup> *Ibid* at 77.

<sup>128</sup> *Ibid.*

activities and to hire salaried managers to monitor and coordinate the flow of goods through their enlarged enterprises. The almost simultaneous availability of an abundant new form of energy and revolutionary new means of transportation and communication led to the rise of modern business enterprise in American commerce and industry.”<sup>129</sup>

As can be readily appreciated, these changes in production and distribution required significant adjustments to the administration of the enterprises concerned. Administration became a highly necessary and specialized function, eventually involving coordinating, controlling and evaluating operating units which were not only numerous, but also physically disparate. Chandler indicates that such activities were made possible by the new transportation and communications facilities.

### ***The Advent of the Multiunit Managerial Corporation***

Of course, the creation and operation of railroad and telegraph systems themselves necessitated significant advances in the administrative capacities of those enterprises if they were to be established and operated effectively. As Chandler explains, it was not only that “[t]he railroad and the telegraph provided the fast, regular, and dependable transportation and communication so essential to high-volume production and distribution – the hallmark of large modern manufacturing or marketing enterprises”, but also that the far-flung operations of railroad and telegraph systems and the need for safe, dependable, cost-effective, efficient, and effective operation of such systems required a high degree of administrative coordination.<sup>130</sup>

Consequently, “the rail and telegraph companies were themselves the first modern business enterprises to appear in the United States”, and “the first to require a large number of full-time managers to coordinate, control and evaluate the activities of a number of widely scattered operating units.”<sup>131</sup> Accordingly, “they provided the most relevant administrative models” for enterprises which sought to produce and distribute goods and services across widely extended geographical areas and through a number of business units, employing such rail and telegraph networks.<sup>132</sup>

The application of these new administrative models contributed significantly to revolutionizing production and distribution of products, and to integrating mass production and mass distribution,

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<sup>129</sup> *Ibid* at 77-8.

<sup>130</sup> *Ibid* at 79.

<sup>131</sup> *Ibid*.

<sup>132</sup> *Ibid*.

leading eventually to the development of modern industrial enterprises, as chronicled in *The Visible Hand*. Chandler mentions, as leading examples, two of the companies mentioned in *Strategy and Structure*: Standard Oil Trust, and the E. I. Du Pont de Nemours Powder Company, and two new examples, General Electric Company and United States Rubber Company, replacing General Motors Corporation and merchandiser Sears, Roebuck and Company from his previous review. Each of these companies developed as a “multiunit enterprise administered by a set of salaried middle and top managers”,<sup>133</sup> a modern development which, although it did not exist in the United States in 1840, had become “the dominant business institution in many sectors of the American economy” by World War I.

In fact, the scale of this development was enormous, as Chandler chronicles: “By the middle of the twentieth century, these enterprises employed hundreds and even thousands of middle and top managers who supervised the work of dozens and often hundreds of operating units employing tens and often hundreds of thousands of workers. These enterprises were owned by tens or hundreds of thousands of shareholders and carried out billions of dollars of business annually. Even a relatively small business enterprise operating in local or regional markets had its top and middle managers. Rarely in the history of the world has an institution grown to be so important and so pervasive in so short a period of time.”<sup>134</sup> The development of this type of multiunit enterprise and of the related phenomenon of “managerial capitalism” is further chronicled in *The Visible Hand*.

### ***Chronicling the Development of the Multiunit Managerial Corporation***

In *The Visible Hand*, Chandler reviews the history of business, and its development, in America. His study commences with the review of traditional processes of production and distribution, proceeds to discuss the “revolution” discussed above in transportation and communication, goes on to discuss that revolution in terms of distribution of production, and then describes the integration of mass production and mass distribution.

In his description of the management and growth of modern industrial enterprise, he discusses the function and structure of top management, the function and structure of middle management, and what he describes as the “maturing” of modern business enterprise since World War I. Many of

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<sup>133</sup> *Ibid* at 3.

<sup>134</sup> *Ibid* at 3-4.



the elements of his conclusion, denominated as “The Managerial Revolution in American Business” have been discussed earlier in this chapter. Accordingly, even if alternatives were available, Chandler’s treatment of the history and development of the modern business corporation recommends itself to the attention of readers for a number of reasons, including the breadth and depth of his review. To some of his conclusions we now turn our attention.

### ***Administrative Development and Business Expansion – Fundamental Observations***

Consequent upon his review, Chandler derives a number of propositions, including those in the following quotations, which are here immediately followed by the present author’s comments:

The first proposition is that modern multiunit business enterprise replaced small traditional enterprise when administrative coordination permitted greater productivity, lower costs, and higher profits than coordination by market mechanisms.<sup>135</sup>

As discussed further above, it was not only advances in administration that enabled business enterprises to operate through more than one unit, but also other technological advances, such as in transportation, energy, communications, and machinery; however, administrative coordination facilitated taking advantage of these other advances and, without it, the other advances alone would not have generated greater productivity, lower costs, and higher profits, as compared with market transactions. Chandler thus explains how changes in administration, or organization, affect supply and demand, thereby opening the black boxes of the neoclassical economist. In summary, these changes alter the supply curve.

The second proposition is simply that the advantages of internalizing the activities of many business units within a single enterprise could not be realized until a managerial hierarchy had been created.<sup>136</sup>

Like external or market transactions, internal activities incur a cost, attributable not only to the activity itself, but also to the coordination and planning made necessary when that activity is internalized. The costs attendant upon, and hence the choice between, “market or hierarchy” for a

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<sup>135</sup> *Ibid* at 6.

<sup>136</sup> *Ibid* at 7.

particular product or service, is, consequently, affected by the availability of suitable means of administration, as Chandler calls it.

The third proposition is that modern business enterprise appeared for the first time in history when the volume of economic activities reached a level that made administrative coordination more efficient and more profitable than market coordination.<sup>137</sup>

The cost of administrative coordination must be included in the cost of the product or service, and must be distributed, like other costs, among the quantity of products or services sold. According to Chandler, and, of course, Williamson,<sup>138</sup> it is only when the aggregate of those (hard) costs and all other costs are lower than the costs of transacting in the market plus those (hard) costs, when distributed among the forecast volume of production, that a certain economic activity will be expected to, or, more correctly, should, be internalized. Of course, there may be cases in which forecast demand and production may make such internalization advantageous in the near term in order to adjust to anticipated demand and production before their eventuation, and, as such, this alone may justify internalization at an earlier stage.

The fourth proposition is that once a managerial hierarchy had been formed and had successfully carried out its function of administrative coordination, the hierarchy itself became a source of permanence, power, and continued growth.<sup>139</sup>

While this is explicated in greater detail below, it may be said that the more effective and efficient is the administrative capacity and operations of an organization, the greater is its opportunity to generate profits, over various time horizons, to maintain and enhance its competitive position, to grow, and to sustain its existence. As Chandler explains, this also accrues power to the hierarchy.

The fifth proposition is that the careers of the salaried managers who directed these hierarchies became increasingly technical and professional.<sup>140</sup>

As the ambit of the organization's activities increased, Chandler says that its management became increasingly specialized, functionally and otherwise. Managers were elevated to successively

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<sup>137</sup> *Ibid* at 8.

<sup>138</sup> *Supra* note 98.

<sup>139</sup> *Supra* note 116 at 8.

<sup>140</sup> *Ibid*.

higher levels of the organization based, at least in part, on possessing the necessary technical and professional education and experience. Technical and professional considerations thus become part of the administrative and decision-making process, and accordingly, a source of power.

The sixth proposition is that as the multiunit business enterprise grew in size and diversity and as its managers became more professional, the management of the enterprise became separated from its ownership.<sup>141</sup>

As noted below, the diversity of such an enterprise, and of the skills necessary to manage it, were such that an owner or owners could no longer be expected to possess the necessary skills, and, consequently, to undertake such management themselves. Specialist skills and experience, including that involved in coordinating the activities of other managers, were required.

The seventh proposition is that in making administrative decisions, career managers preferred policies that favored the long-term stability and growth of their enterprises to those that maximized current profits.<sup>142</sup>

As noted below, organizations generally seek their continuance; however, Chandler also makes the point that changes in strategy, at least, and, perhaps, other matters of high policy, may require changes in the structure and processes of the organization which, in turn, incur costs that must be defrayed based on current and anticipated activities. In addition, planning and coordination are facilitated by predictability. Successfully managing the enterprise may thus involve prioritizing “steady” and predictable growth and profits over higher levels of growth and profits involving greater volatility, particularly if the latter may be expected to incur periodic declines, and, especially, declines of significant magnitude.

The eighth and final proposition is that as the large enterprises grew and dominated major sectors of the economy, they altered the basic structure of these sectors and of the economy as a whole.<sup>143</sup>

Of course, these consequences are outlined in greater detail in Chandler’s work. As activities previously subject to the market are internalized, and as the benefits of internalizing costs reduce the

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<sup>141</sup> *Ibid* at 9.

<sup>142</sup> *Ibid* at 10.

<sup>143</sup> *Ibid*.

number of competitors in the market, and perhaps subject all or most competitors to cost structures that differ from those to which they might have been previously subject, the scope and nature of operation of the market may be expected to be affected.

As Harrison White indicates and as discussed above under the heading “The Entrepreneurial Model of the Neoclassical Firm and Economic Action”, this may sometimes involve market participants seeking out particular niches in which they might have certain advantages over others, the observation of which affects the strategy and actions of other market participants. In this way, the “visible hand” may affect markets and competition.

One might attempt to apply Chandler’s analysis of the relationship between strategy and structure to sectors of the economy. In doing so, one might expect Chandler to say that the structure of a sector of the economy may be expected to adjust to the strategy of that sector. If one considers the strategy of the sector to involve the strategy of participants in the sector in some way, it may be expected that the strategy of significant participants may determine the structure appropriate to the operations of the sector, and, concomitantly, that a failure to adjust the structure to the operations of the sector would affect the viability of the sector itself. Of course, one could also seek to apply Chandler’s strategy-structure mantra to the economy as a whole, using sectors of the economy as units of analysis.

### ***Recapitulating Historical Analysis of Administrative or Organizational Development***

In his Conclusion, Chandler reiterates that: “This study does more than trace the history of an institution. It describes the beginnings of a new economic function – that of administrative coordination and allocation - and the coming of a new subspecies of economic man - the salaried manager - to carry out this function. Technological innovation, the rapid growth and spread of population, and expanding per capita income, made the processes of production and distribution more complex and increased the speed and volume of the flow of materials through them. Existing market mechanisms were often no longer able to coordinate these flows effectively. The new technologies and expanding markets thus created for the first time a need for administrative coordination.”<sup>144</sup>

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<sup>144</sup> *Ibid* at 484.

The matter could be put another way, namely: the complexity of coordinating certain principal activities became too great to sustain the risk of market abnormalities, irregularities, dysfunctions, discontinuities, and even market failures. The principal activities required to be coordinated involved, at least, the following: firstly, the supply of inputs, including labour, materials, and capital; secondly, the production process itself; thirdly, the distribution process; fourthly, managing the collection, control, accounting, reporting, treasury, and other financial processes associated with all of these principal activities; and, fifthly, the strategic and tactical process. In many cases, the activities of the enterprise extended beyond one region or one country.

In the result, “[t]o carry out this function entrepreneurs built multiunit business enterprises and hired the managers needed to administer them. Where the new enterprises were able to coordinate current flows of materials profitably, their managers also allocated resources for future production and distribution. As technology became both more complex and more productive, and as markets continued to expand, these managers assumed command in the central sectors of the American economy.”<sup>145</sup> Chandler might have said, aphoristically, that complexity begat managerial capitalism.

The success of a multiunit business enterprise generated opportunities for, and challenges to, continuing its growth. Chandler says that “[o]nce such a hierarchy had successfully taken over the function of coordinating flows, the desire of the managers to assure the success of their enterprise as a profit-making institution created strong pressures for its continuing growth.”<sup>146</sup> As with other types of organizations, as discussed previously, the continuance of the organization becomes a key goal or objective.

To respond to such pressures for growth, corporate managements engaged in “two quite different strategies of expansion. One [, which] was defensive or negative... [and] stemmed from a desire for security [sought] to prevent sources of supplies or outlets for goods and services from being cut off or to limit entry of new competitors into the trade. The other strategy [, which] was more

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<sup>145</sup> *Ibid.*

<sup>146</sup> *Ibid* at 486.

positive [, aimed] to add new units, permitting by means of administrative coordination a more intensive use of existing facilities and personnel.”<sup>147</sup>

Chandler found that negative or defensive growth was generally “nonproductive expansion” and rarely lowered unit costs, but that positive growth, which might be considered as “productive expansion”, normally did increase productivity by lowering unit costs.<sup>148</sup> Of course, that is not to say that even nonproductive expansion might not be effective in ensuring the survival of the enterprise, for example, by securing sources of supply, denying such sources to other competitors, or by establishing barriers to entry into the relevant market. Chandler indicates that expansion of marketing enterprises was generally productive not defensive, but that backward integration into acquiring control of materials was generally motive more by defensive than productive considerations.<sup>149</sup>

### **Administrative or Organizational Development and Economic Theory**

Chandler maintains that “[a]lthough administrative coordination has been a basic function in the modernization of the American economy, economists have given it little attention.” Instead, “[m]any have remained satisfied with Adam Smith's dictum that the division of labor reflects the extent of the market. Like George Stigler, they see the natural response to improved technology and markets as one of increasing specialization in the activities of the enterprise and vertical disintegration in the industries in which these enterprises operate.”<sup>150</sup> He argues that for increased specialization to be successful, a high volume of output is required which, in turn, requires “more carefully planned coordination” of the activities of the enterprise.

Chandler shows that specialization of economic activities did not entail that they could not be undertaken by firms that integrated specialist operations into one enterprise; instead, advances in what Chandler calls “administrative coordination” made this possible. This aspect of firm activities has also been ignored, he says, in the theory of the firm: “Economists have also often failed to relate administrative coordination to the theory of the firm.”<sup>151</sup> The firm is highly dependent upon

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<sup>147</sup> *Ibid* at 487.

<sup>148</sup> *Ibid*.

<sup>149</sup> *Ibid* at 487-8.

<sup>150</sup> *Ibid* at 490.

<sup>151</sup> *Ibid*.

such administrative coordination of its activities, including, but not limited to production and distribution. Consequently: “any theory of the firm that defines the enterprise merely as a factory or even a number of factories, and therefore fails to take into account the role of administrative coordination, is far removed from reality.”<sup>152</sup>

While acknowledging that the speed, regularity and method of organization of production and distribution affects the volume and unit cost of goods, he maintains that “[u]ntil economists analyze the function of administrative coordination, the theory of the firm will remain essentially a theory of production. The institution through which the factors of production are combined, which coordinates current flows, and which allocates resources for future economic activities in major sectors of the economy deserves more attention it has yet received from economists.”<sup>153</sup>

Thus, Chandler maintains that economists do not advance a theory of the firm, but only a theory of production. It is the institution or organization, the firm, which combines factors of production, coordinates it, and allocates resources not only for present, but also for future, economic activities. Thus, he maintains that a theory of the firm that does not address these issues, is not a theory of the firm in any meaningful sense.

### *Ascension of Managerial Capitalism*

Chandler chronicles the ascension of managerial capitalism over family and financial capitalism over the twentieth century, both in *The Visible Hand*<sup>154</sup>, and in his later article, “The Emergence of Managerial Capitalism.”<sup>155</sup> In particular, he describes how family or entrepreneurial capitalism, in which a founding family or entrepreneur or family or such founder or entrepreneur exercised control of an enterprise, and financial capitalism, in which financiers did so, gave way to managerial capitalism, in which managers made the most important decisions. This resulted, in large part, from the complex nature of multiunit business enterprises.

Chandler explains that in “such large, complex organizations, decisions as to both current production and distribution and the allocation of resources for future production and distribution came to

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<sup>152</sup> *Ibid.*

<sup>153</sup> *Ibid.* The present work has maintained that even a theory of production requires opening its own “black box”.

<sup>154</sup> *Ibid* at 491-498.

<sup>155</sup> Alfred D Chandler, Jr., “The Emergence of Managerial Capitalism” (1984) 58:4 *Business History Rev* 473.

be made by full-time salaried managers”.<sup>156</sup> He indicates that by World War I “owners who still worked on a full-time basis with their hierarchies continued to have an influence on such decisions” but by World War II further increases in the size and complexity of the enterprise and further dispersion of stock ownership resulted in a situation in which “owners rarely participated in managerial decisions”.<sup>157</sup>

In effect, then, by the First World War, neither the founder or entrepreneur nor their families, on the one hand, nor the financiers of the enterprise, who supplied funds for its facilities and growth, on the other, were able to make, or even to influence, managerial decisions. In fact, Chandler says that: “Even in top management decisions concerning the allocation of resources, their power remained essentially negative. They could say no, but unless they themselves were trained managers with long experience in the same industry and even the same company, they had neither the information nor the experience to propose positive alternative courses of action.”<sup>158</sup>

Chandler maintains that only founders, entrepreneurs or other controlling or significant shareholders, or financiers, who had long experience in the same industry, and (ideally) in the subject-company, could effectively propose alternatives to the courses of action proposed by top management. In fact, the applications of Chandler’s assertion are even broader than that: namely, that without such training and long experience, as well as information, such enterprise capitalists or financing capitalists would not even be able to make a rational decision between or among alternatives presented by management. Thus, the owners or financiers would have only a limited capacity to judge proposals put forward by top management. Accordingly, their decision-making capacity would, in effect, be limited to deciding whether to accept or to reject a particular proposal made by top management.

At the same time, the influence of the “owners” or the “financiers” began to be exercised on a less continuous and immediate basis. Instead of consulting directly with the owners or financiers, as needed, with respect to managerial decisions, top management presented high level matters to the board of directors for their approval on a much less frequent basis.

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<sup>156</sup> *Ibid* at 494.

<sup>157</sup> *Ibid* at 494-5.

<sup>158</sup> *Ibid* at 495.



Chandler indicates that, although the “owners” were, or were represented by, “outside” directors who met with the “inside” or “management” directors between four and twelve times a year, this did not reflect a real distribution of power and authority. Instead: “For these meetings the inside directors set the agenda, provided the information on which decisions were made, and of course were responsible for implementing the decisions.” Accordingly, while the outside directors still had veto power over such decisions, “they had neither the time, the information, nor the experience, and rarely even the motivation, to propose alternate courses of action.”<sup>159</sup> Chandler concludes that by World War I, managerial capitalism had become firmly entrenched in the major sectors of the American economy.

In *The Visible Hand*, Chandler attributes significant shifts in power within the corporation and within the economy as a whole to the acquisition by modern business enterprises of allocative functions previously carried out by the market, with the result that the “rise of modern business enterprise in the United States, therefore, brought with it managerial capitalism.”<sup>160</sup>

### ***Mid-Managerial Capitalism***

Even more than this, however, the same observation might be made with respect to top management decisions vis-à-vis top management and its immediate subordinates. The complexity of the organization might be such that top management, because of specialization or otherwise, might lack the training and experience in the fields relevant to the decision at hand which might be possessed by the immediately lower management level or levels. At the same time, although perhaps circumscribed by training and experience, top management would also be dependent upon that reporting management level for information requisite to top management decision-making.

The inference, although not explicitly drawn by Chandler, is that managerial capitalism, even by that time, may have already become “mid-managerial capitalism”, insofar as efforts to actively manage the enterprise, and proposals with respect to the same, were reliant upon information and experience of managers at levels subordinate to the top or executive level.

In reality, the exercise of authority at successively higher levels of the enterprise depended upon information and analysis generated at subordinate levels. Thus, the decisions made at higher levels

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<sup>159</sup> *Ibid.*

<sup>160</sup> *Supra* note 116 at 1.

could be shaped and influenced by decisions made at lower levels of the enterprise. Among other things, this suggests the possibility that subordinate level decisions might be made according to criteria not specified or not shared by the enterprise as a whole.

While this will be pursued in later discussions, we must notice that the very structure and processes of organizations and organizational decision-making introduce the possibility of internal conflicts between different levels and functions of the enterprise. This logical possibility may, in some cases, lead to different segments of the enterprise pursuing different, and, in some cases, even conflicting, objectives.

### *Managerial Capitalism Matures*

Chandler indicates that by the middle of the century the descendants of the founders and early investors of major industrial enterprises were the primary beneficiaries of managerial capitalism but were not participants in operating the enterprise, while the involvement of financiers, who were influential when funds were needed, also eventually abated. He concludes that by “mid-century even the legal fiction of outside control was beginning to disappear. A study of the 200 largest nonfinancial companies in 1963 indicates that in none of these firms did an individual, family, or group hold over 80 percent of the stock. None were still privately owned. In only 5 of the 200 did a family or group have a majority control by owning as much as 50 percent of the stock. In 26 others a family or group had minority control by holding more than 10 percent of the stock (but less than 50) or by using a holding company or other legal device.”<sup>161</sup>

In effect, Chandler asserts that the lack of majority control of the ownership of shares of a public corporation rendered such a corporation subject to control by its management, although such control might be considered to be “soft” control in the sense of management capacity to influence voting by shareholders. Chandler boldly concluded that in “1963, then, 169 or 84.5 percent of the 200 largest nonfinancial companies were management controlled.” He concluded that thus, “by the 1950s the managerial firm had become the standard form of modern business enterprise in major sectors of the American economy. In those sectors where modern multiunit enterprise had

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<sup>161</sup> *Ibid* at 492-3.

come to dominate, managerial capitalism had gained ascendancy over family and financial capitalism.”<sup>162</sup>

Chandler describes how the mobilization of the war economy in World War II involved one of the most complex pieces of economic planning in history,<sup>163</sup> by federal government bodies and agencies. He indicates that managers of large enterprises were recruited to government for this purpose, but Chandler fails to conclude that the scale and scope of the administrative activities required, in aggregate, may have significantly enhanced the development of administrative processes and capacities that could later be employed in such private enterprises. It might be suggested, further, that the experiences of such recruited managers may have enhanced their capacity to contemplate broader international operations after, as compared to prior to, World War II, however, Chandler does not actually suggest this.

Chandler explains that managers of large enterprises might wield significant power in society and in the political realm, but that such managers were not required to explain or be accountable for their uses of such power.<sup>164</sup> Indeed, we would maintain that the diffusion of power as a result of diffusion of decision-making inputs and authorities might entail a lack of accountability of managers in their several exercises of decision-making power and authority even within the enterprise.

Chandler argues that managerial capitalism, involving the growth of the modern business enterprise, had little political support and, in fact, met public and government opposition, both because of the concentration of economic power and because of a perceived dampening of entrepreneurial opportunity in many sectors of the economy.<sup>165</sup> He maintains that the, of modern business enterprise “brought strong political reaction and legislative action”, especially with respect to the control and regulation of railroads, mass retailers, and large industrial enterprises, to such an extent that “in the first decade of the twentieth century, the control of the large corporation was, in fact, the paramount political question of the day.”<sup>166</sup>

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<sup>162</sup> *Ibid* at 493.

<sup>163</sup> *Ibid* at 496.

<sup>164</sup> *Ibid* at 497.

<sup>165</sup> *Ibid*.

<sup>166</sup> *Ibid*.

Berle and Means engaged in their famous debate concerning the objectives and powers of modern business corporations.<sup>167</sup> Legislation restraining trusts and other anticompetitive devices was adopted and, following the Great Depression, the “New Deal” legislation sought to regulate investment, as well as utilities, holding companies, and to regulate the issuance, and secondary market trading, of securities.<sup>168</sup>

In this sense, Chandler’s allusion to Polanyi’s “great transformation” may have been particularly apt: Polanyi’s “double movement” of the “marketization” of the economy, including the commoditized nation of non-commodities, was considered by him to be accompanied by the introduction of legislation intended to ameliorate the worst excesses of those practices.<sup>169</sup> Chandler’s “great transformation” involved a “double movement” in which the growth of the modern business enterprise and the related rise of managerial capitalism also encountered social and political initiatives to moderate their adverse effects. Chandler’s “great transformation” and “double movement” may be considered to continue to the present day.

## Conclusion

In *The Visible Hand*, Chandler chronicled the “great transformation” of the economy and of business enterprise commencing in the latter half of the nineteenth century as new technologies and markets permitted the production and distribution of goods on a much greater scale than ever before as a result of a transformation which he described “as being as significant and as revolutionary as that those that accompanied the rise of commercial capitalism a half a millennium earlier.”<sup>170</sup> In this great transformation, “the visible hand of management replaced what Adam Smith referred to as the invisible hand of market forces” as modern business enterprise took over the function of

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<sup>167</sup> As is well known, this debate involved, among others, the following works: Adolf A Berle & Gardiner C Means, *The Modern Corporation and Private Property*, 2d ed, (New York: Harcourt, Brace & World, 1968); AA Berle, Jr, “Corporate Powers as Powers in Trust” (1931) 44 Harv L Rev 1049; E. Merrick Dodd, Jr, “For Whom Are Corporate Managers Trustees?” (1932) 45 Harv L Rev 1145; AA Berle, Jr, “For Whom Corporate Managers Are Trustees: A Note” (1932) 45 Harv L Rev 1365; E Merrick Dodd, “Book Review of *Bureaucracy and Trusteeship in Large Corporations* by Marshall E Dimock & Harold K Hyde”, (1942) 9 U Chicago L Rev 538; and Adolf A Berle, Jr, *The 20<sup>th</sup> Century Capitalist Revolution* (New York: Harcourt, Brace & Company, 1954).

<sup>168</sup> Among the principal statutes introduced as part of the New Deal were: *The Securities Act of 1933*, (May 27, 1933, Ch. 38, title I, Sec. 1, 48 Stat. 74); *The Securities Exchange Act of 1934*, (June 6, 1934, Ch. 404, title I, Sec. 1, 48 Stat. 881); *The Public Utility Holding Company Act of 1935*, (Aug. 26, 1935, Public Law No. 333); and *The Investment Company Act of 1940*, (Aug. 22, 1940, Ch. 686, title I, Sec. 1, 54 Stat. 789).

<sup>169</sup> Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* [1944] (Boston: Beacon Press, 1957 and 2001) discussed *supra*, especially in Chapter Seven.

<sup>170</sup> *Supra* note 116 at 16.

the market in coordinating production and distribution and allocating funds and personnel for future production and distribution.<sup>171</sup> Chandler says that this originated a new economic function, namely, administrative coordination and allocation, and, in addition, “a new subspecies of economic man – the salaried manager – to carry out this function.”<sup>172</sup>

It may be, of course, that the new “great transformation” was not as significant and as revolutionary as the rise of commercial capitalism but, on the other hand, it may be seen as having similar significance to the great transformation described by Polanyi in so far as it concerns what Polanyi regards as the disembedding of the market from the economy and society, the creation of “artificial commodities”, and the “marketization” of the economy in the sense of the market achieving dominance over the economy, society, and the polity. Instead, it may be more reasonable to regard Chandler’s “great transformation” as a significant modification to, or even as the complete or partial abrogation of, the dominance of the market posited by Polanyi.

As has been argued here, Chandler describes the displacement of the allocative mechanisms of the market, the “invisible hand” posited by Adam Smith, by managerial action, the “visible hand” of management, and even, as we have maintained here, the several “visible hands” of management of a plurality of business enterprises in their several capacities as market actors. The actions of such “visible hands” with respect to the market and competition invites comparison with Harrison White’s theories of the firm and of the market.

Expressing Chandler’s “great transformation” alternatively, one may say that the overt, open, or visible action of the market, the “invisible hand” posited by Smith in the late eighteenth century, and contemplated by Polanyi as dominating the economy and society from and after the late nineteenth century, is considered by Chandler to have been replaced, in the late nineteenth century and early twentieth century, by the somewhat more covert, less obvious, or less visible action of corporate managers, the “visible hand”. Chandler’s choice of unit for examination, the firm, has some effect on this perception, particularly when compared with neoclassical theory.

Chandler explains that increase in population, its dispersion more widely across the United States, and an increase in per capita income resulted in dramatically increased demand. At the same time,

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<sup>171</sup> *Ibid* at 1.

<sup>172</sup> *Ibid* at 484.

improvements in technology, such as the advent of the telegraph, and methods of mining and employing coal which facilitated the operation and expansion of railways, as well as manufacturing, permitted communication and distribution of goods over long distances. In turn, this permitted the flow of raw materials into, and the flow of finished product out of, production facilities reliably, in volume, and on schedule which, in turn, permitted factories to sustain reliable, steady, and high production levels, and permitted distribution of goods at speeds, in volume, and over distances, that were previously not possible.<sup>173</sup>

Such activity required a high degree of administrative coordination. This is the case, in particular, with the rail and telegraph companies which became the first modern business enterprises in the United States. They developed large numbers of full-time managers to coordinate their fire-flung operations in a manner that was safe, dependable, cost-effective, efficient, and effective. Among other things, this require them to coordinate, control and evaluate the operations of a number of widely scattered operating units.<sup>174</sup>

Such transportation and communication companies became models for other business enterprises. The scale and scope of their operations and of the business enterprises whose operations they facilitated was such that modern business enterprises became characterized by extremely large workforces, extensive numbers of management personnel and levels of management, large numbers of units within business enterprise, and vast numbers of shareholders.<sup>175</sup>

The managerial hierarchy became a source of permanence, power and continued growth and its need for specialized expertise was such that its members increasingly possessed technical and professional qualifications and experience, which contributed to the separation of management of the enterprise from its ownership. The decision-making of such career managers was observed to favour long-term stability and growth, rather than maximizing current profits.<sup>176</sup>

In effect, innovation, in the form of the advent of new (and, in a sense, disruptive) technologies in mining, communications, and transportation, enabled new production and distribution processes,

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<sup>173</sup> *Ibid* at 77.

<sup>174</sup> *Ibid* at 79.

<sup>175</sup> *Ibid* at 3-4.

<sup>176</sup> *Ibid* at 8-10.

which increased the scale, scope, and geographic dispersion, of the operations of business enterprises, thereby requiring administrative coordination which was some orders of magnitude greater than previously required. Such coordination required a panoply of personnel, and levels of, management whose primary objective was the continuity of the business enterprise, and whose significant subordinate objectives, to that end, included its long-term stability and growth.

The priority of objectives of this professional management are quite consistent with those of long-established family-owned enterprises. Chandler notes that the longer time span over which British enterprises adopted such professional management, as compared with American enterprises, allowed American enterprises to accelerate their growth and market participation, as compared with British companies.<sup>177</sup>

Professional management and new management structures also permitted increases in the number of business units which might be administered by the new modern business enterprise. This permitted it to pursue both positive, and negative (i.e. defensive) growth strategies,<sup>178</sup> in an effort to secure the stability, growth, and continued existence of the enterprise.

The need for relevant and specialized training and experience disadvantaged management by founding families or entrepreneurs, or by finance providers, whether providing debt or equity. Professional management of this nature also had the result that management decisions became difficult, if not impossible, for founding families or entrepreneurs, or for finance providers, to controvert and, accordingly, rendered management decisions effectively final with respect to the enterprise as a whole.<sup>179</sup>

Chandler considered the non-continuous or intermittent review of high-level management decisions by the board of directors to be largely inefficacious due to the fact that normally management failed to present any alternatives to its proposed course of action, and due to the board's lack of information and expertise to evaluate management's proposal and any posited alternatives.<sup>180</sup> Accordingly, he considered that entrepreneurial capitalism and finance capitalism had been replaced by managerial capitalism.

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<sup>177</sup> *Ibid* at 495-498.

<sup>178</sup> *Ibid* at 486-487.

<sup>179</sup> *Ibid* at 491-493.

<sup>180</sup> *Ibid* at 495.

Chandler's exposition of the rise of managerial capitalism is revolutionary in a number of respects. He endeavours to relate innovation, in terms of the development of technology, not only to an increase in demand, but also to the dependence of the business enterprise upon resources. As technological developments in mining, communications, transportation facilitated access to greater resources in the form of external production inputs, thereby enabling a business enterprise to increase its scale and scope, that increase in scale and scope required specialized technical and professional expertise, an input resource of a somewhat different nature, and one which was generally internalized, within the business enterprise itself.

The development of that resource accelerated the ability of the business enterprise to engage in various growth strategies, but the need to maintain access to such internal management resources, as well as external resources, facilitated the prioritization of longer-term objectives, such as continued existence, stability, and growth, over shorter-term objectives, such as maximization of short-run profits.

As Chandler himself observed in a somewhat later work, his unit of analysis was not the transaction, as it was for Williamson, but "the firm and its physical and human assets".<sup>181</sup> Similarly, of course, his unit of analysis was not the monadic individual of neoclassical economics, whether as consumer or producer, reified in neoclassical economic theory as "the firm", completely devoid of personal or organizational attributes. Instead, Chandler's firm is a business enterprise, a legal entity which possesses physical and human assets, and other attributes, and which acts by means of, and through, its human assets, who conduct its operations, including making its decisions.

Consequently, Chandler's firm has organizational attributes. It pursues certain goals and objectives, strategic and tactical, and instrumental and otherwise, having differing temporal proximities, and aligning its structure and processes to such strategies. Its operations involve different functions. Such firm is also organized into many units and sub-units, and has a complex hierarchy consisting of many levels, including field offices, department offices, divisional and functional offices, and head office, each of which may have their own respective combinations of goals and

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<sup>181</sup> *Supra* note 96 at 489.



objectives. For example, a field office may have its own goals and objectives, but may also participate in the goals and objectives of each superior hierarchical level, namely, departments, divisions and, the enterprise or head office.

### **Conclusion – Theory of the Firm, and Development of the Modern Business Corporation**

This chapter has considered the proposition of neoclassical economics that the firm, as theorized therein, acts in the economy as a single actor. This chapter is maintained that this proposition is, in effect, tautologous, as a result of the way in which the firm is conceptualized and neoclassical economics. In effect, the firm of neoclassical economics is a “black box” into which inputs are introduced and from which outputs emanate.

At the same time, such major elements of the economic process as production, exchange, and competition are also treated as “black boxes” that are not “unpacked” by neoclassical theory. Market exchange is theorized in terms of the interaction of supply and demand and the derivation of an appropriate equilibrium. Competition is largely theorized in terms of comparative cost of the factors of production. Production is considered in terms of the cost of input factors and the production process, to the extent that it is theorized, is considered in respect of how to reduce the cost of input factors, so as to generate, or increase, profit. These subjects are considered in greater detail in Appendix B.

It has been argued here that such a perspective ignores, obscures, or invisibilizes economic activity, as a result of which questions or concerns which arise for consideration in connection with such economic activity are not readily amenable to investigation or solution within neoclassical theory and within the neoclassical theory of the firm. To the extent that the firm is theorized in neoclassical theory, it is as a reification of the atomistic individual, devoid of social or personal attributes, acting completely independently, and completely rationally, in pursuit of his or her own utility. Accordingly, the neoclassical firm lacks organizational attributes.

It is argued, in this chapter and, in greater detail, in Appendix B, that methodological individualism, the focus on the individual as the unit of analysis, imposes certain consequences, many of which are disadvantageous, upon neoclassical theory. Accordingly, this chapter has compared neoclassical theory with other theorizations of markets, and of the firm, that impose less stringent limitations upon the monadism of the individual and the choice of such individual as the basic unit

of analysis. In keeping with the descriptivist or empirical nature of the present work, this chapter then turned to the examination of the firm, and, more particularly, the modern business enterprise, as undertaken by the signally important business historian, Alfred D. Chandler, Jr.

Chandler employs the firm as the unit of investigation, and of analysis. While acknowledging the firm as a rights-and-duty-bearing entity, separate from the individuals who constitute it, Chandler also recognized it as animated as an organization, one having economic objectives, by the individuals who create and constitute it. Chandler's description of the modern business corporation accords generally with the discussion of legal essentialist attributes in Chapter One and Appendix A of this book.

In *Strategy and Structure*, Chandler provides evidence that the goals and objectives of a business enterprise, as an organization, have implications for the strategy of their attainment and for the structure and processes of the enterprise as an organization. In particular, these goals and objectives influence the resources required for their accomplishment, the allocation of such resources, and the structure and processes by means of which they are pursued by the organization. Pursuing those objectives involves both functional work and administrative work. The latter involves coordination, appraisal, and planning the work of the enterprise and the allocation of its resources.<sup>182</sup> Allocations of resources are the prerogative of the executive level of management.

The primary task of the executive in terms of administration is to define basic goals and the course of action, policies, and procedures necessary to achieve them; while a secondary task of administration is to focus on smooth and efficient day-to-day operation of the business in accordance with its long-term goals, policies and procedures, and, as well, responding to both anticipated and unanticipated problems and needs.<sup>183</sup>

Chandler describes how the development and execution of various growth strategies resulted in a management hierarchy with the head office at the apex, divisional offices, department offices, and field offices, each reporting to the level above, with different balances of functional decision-making and administrative decision making, shifting towards more and more administrative decision making at higher levels of hierarchy. He also described the difference between strategic decision-

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<sup>182</sup> *Supra* note 40 at 8.

<sup>183</sup> *Ibid* at 9.

making, which involves the allocation or reallocation of resources, and tactical or operating decision-making, which involves making decisions within, and subject to, existing resource allocations.

In *The Visible Hand*, Chandler describes the replacement of the market as a mechanism for the coordination and allocation of financing, personnel, and other resources, and the coordination and allocation of goods and services by the “visible hand” of management of the modern business enterprise, thereby giving rise to “managerial capitalism”.<sup>184</sup>

It is clear that Chandler’s methodology is not monadically individualistic, as is neoclassical economics, but, instead, endeavours to take the organization or, in the case of a business enterprise, the firm or corporation, as the basic unit of analysis. Chandler’s methodology, unlike methodological individualism, is not reductionist at the firm level but, instead, permits examination of data at successively lower levels of disaggregation, including, ultimately, to the individual. In this sense, Chandler may be said to adopt some type of social unit as the basic irreducible unit of analysis at a more granular level than that of the firm but at a higher level than that of the individual. Appendix A be consulted for a discussion of the advantages of Chandler’s method of proceeding.

Chandler’s exposition of the history of the development of, and the present state of, the modern business enterprise acknowledges the duality of the corporation as a legal entity and as a species of organization; however, in consequence of its objectives, its description emphasizes the latter more than the former. The next chapter will consider the modern business enterprise, as described by such business history, from the perspective of organizational theory.

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<sup>184</sup> *Supra* note 116 at 1 and 16.

## **CHAPTER THREE ASPECTS OF THE CORPORATION IN ACTION**

### **BARRIERS TO UNIFIED ACTION**

#### **Diffusion of Rationality, Information, and Decision Making**

As our investigation of Chandler's research has demonstrated, decision-making as to strategy and tactical matters inheres at different levels of the organization. In a simple unitary enterprise structure, decision-making takes place at field, department, division, and head office or general office levels. In some cases, decision-making authority may also be diffuse, in that certain aspects of a decision may be the purview of one individual, group or organizational level or function, while other aspects of the same decision may be the purview of others. This may make it difficult, if not impossible, to impute a particular decision to particular individuals (or groups of individuals), to a particular level, or to a particular function.

Again, these considerations are not part of neoclassical theory, nor, are they necessarily only limited to economic theory or theory of the firm. All complex organizations specify and adopt processes and structures that recognize limitations on decision-making by individuals. For example, Nobel laureate Oliver Williamson concedes that "complex organizations of all kinds - corporate and noncorporate, capitalist and noncapitalist, within and between nation states and political systems, and over time - discloses strong common features that are increasingly generally acknowledged."<sup>1</sup> He identifies these, in effect, as: (1) the need to come to terms with the attributes of human nature as we know it; (2) institutional structures, which differ but may be compared by institutional analysis; (3) hierarchy, which promotes efficiency; (4) the need for system integrity, which is promoted by separating operating from strategic decisions and controls; (5) the need to identify relevant dimensions with respect to which transactions differ, and of which dimensions asset specificity appears to be the most important; and (6) the efficacy of competition in the capital market is conditional on organization form.<sup>2</sup>

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<sup>1</sup> Oliver E Williamson, "Organization Form, Residual Claimants, and Corporate Control" (1983) 26:2 JL & Econ 351 at 365.

<sup>2</sup> *Ibid.*

As Williamson indicates, complex organizations, including, but not limited to economic enterprises, employ a knowledge of the attributes of human nature, a hierarchy, a separation of strategic and operating decisions, and the application of controls, in fashioning their decision making and implementation structure and processes. Of course, these findings do not align with neoclassical economic principles which, as demonstrated here, generally fail to identify and consider attributes which are common to all organizations, not only those with economic objectives, including hierarchies of goals, structure and process.

Williamson said that the propositions “that organization matters and that it is susceptible to analysis were long greeted by scepticism by economists”,<sup>3</sup> saying that one reason for this “is that it is much easier to say that organization matters than it is to show how and why” while another is “the prevalence of the signs of choice approach to economics”.<sup>4</sup>

Considering the development of neoclassical theory over the late nineteenth and early twentieth centuries, Oliver Hart described it as viewing “the firm as a set of feasible production plans”, admitting that “to many lawyers and economists, this is a caricature of the modern firm; it is rigorous but rudimentary” in describing how firms function, and conceding that it “contributes little to any meaningful picture of their structure.”<sup>5</sup>

### **Complex and Multiple Goals**

Although economic organizations may have goals that are specific to economic functions, all organizations, whatever their goals must engage in certain activities. Charles Perrow, a leading sociologist of organizations, drew attention to these in 1961, as Chandler was writing: “Every organization must accomplish four tasks: (1) secure inputs in the form of capital sufficient to establish itself, operate, and expand as the need arises; (2) secure acceptance in the form of basic legitimization of activity; (3) marshal the necessary skills; and (4) coordinate the activities of its members, and the relations of the organization with other organizations and with clients or

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<sup>3</sup> Oliver E Williamson, "The Theory of the Firm as Governance Structure: From Choice to Contract" (2002) 16:3 J Economic Perspectives 171 at 171. He credits as "conspicuous exceptions": Alfred Marshall, Joseph Schumpeter, Friedrich Hayek; institutional economists like Thorstein Veblen, John R. Commons, and Ronald Coase; and organization theorists like Robert Michels, Chester Barnard, Herbert Simon, James March and Richard Scott, all arguing the case for greater prominence of organization in economics.

<sup>4</sup> *Ibid.*

<sup>5</sup> Oliver Hart, "An Economist's Perspective on the Theory of the Firm" (1989) 89 Colum L Rev 1757 at 1758.

consumers.”<sup>6</sup> He notes that the relative of importance of these tasks: (1) may differ; (2) may change over time; (3) will vary with (i) the nature of the work the organization does, and (ii) the technology appropriate to it, and (iii) the stage of development within the organization.<sup>7</sup>

As our examination of Chandler’s work showed, these tasks involve securing internal and external resources, including personnel and structure, which are necessary or appropriate to the goals pursued by the organization, and to the strategy by which those goals are pursued, adopting tactics conducive to those goals, and adapting the strategy, tactics and resources, including structure, over time. Perrow suggests that reducing or controlling dependency upon the environment may increase the power of the organization, such as by maintaining a favorable image of the organization in the salient publics, which may enable it to more easily attract personnel, influence relevant legislation, wield informal power in the community, and insure adequate number of clients, customers, donors, or investors.<sup>8</sup> As Perrow’s language suggests, this resource dependency, and the effect of such prestige on resource dependency, is shared by all types of organizations, including social organizations, educational institutions, and even government institutions.<sup>9</sup>

### **Official Goals and Unofficial Goals**

Perrow indicates that all organizations, including business enterprises, have official goals, which “are the general purposes of the organization as put forth in the charter, annual reports, public statements by key executives and other authoritative pronouncements”, such as, for a business corporation, “to make a profit or adequate return on investment, or provide a customer service, or produce goods.”<sup>10</sup>

Official goals may be relatively uninformative by themselves, as they do not necessarily identify or prioritize all goals, which we (but not Perrow, at least here) will distinguish as either “superordinate” or as “subordinate”, and the means of achieving such goals (which we will call “instrumental” goals): “Official goals are purposely vague and general and do not indicate two

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<sup>6</sup> Charles Perrow, "The Analysis of Goals in Complex Organizations" (1961) 26:6 *American Sociological Rev* 854 at 856.

<sup>7</sup> *Ibid* at 857.

<sup>8</sup> Charles Perrow, "Organizational Prestige: Some Functions and Dysfunctions" (1961) 66:4 *American J Sociology* 335 at 335.

<sup>9</sup> The study reported in this article concerned a 300-bed voluntary general hospital.

<sup>10</sup> Perrow, *supra* note 6 at 855.

major factors which influence organizational behavior: the host of decisions that must be made among alternative ways of achieving official goals and the priority of multiple goals, and the many unofficial goals pursued by groups within the organization.”<sup>11</sup> In effect, following Perrow, it may be said that often only superordinate goals will be considered to be among the organization’s official goals. Subordinate and instrumental goals may frequently not be included among the official, but only among the unofficial, goals.

Importantly, Perrow observes that “groups within the organization” may pursue their own unofficial goals. We may note that officially recognized groups, such as those recognized by the organizational hierarchy, for example, field offices, departments, functions, divisions, may be assigned certain official goals, which may be superordinate goals for them, but which may be subordinate goals in terms of the organization as a whole. However, like the organization as a whole, they may also adopt different, often standardized, ways of achieving official goals, and, in that regard, may also adopt instrumental goals, that is to say goals whose achievement is instrumental to the achievement of official, superordinate, or high level, goals. These processual standards and instrumental goals may be considered to be unofficial goals of the relevant hierarchical level.

It is also possible, of course, that not all groups within the organization may be characterized by hierarchical or other official criteria. For example, the organization may be characterized by the presence of “professional” groups, such as lawyers, accountants, engineers, and actuaries, who may be engaged in various hierarchical levels and functions, whose unofficial goals may include adherence to professional standards of competence, integrity, and other matters. This may also be the case with respect to individual members of such professions vis-à-vis their participation in an instant group: their adherence to professional standards may be considered as unofficial goals vis-à-vis their membership in the group. In fact, it is possible that such external “professional” standards may be superordinate goals for them personally, as being necessary to maintain their professional affiliations.

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<sup>11</sup> *Ibid.*

Perrow says that the means of achieving official goals, and the relative priority of such goals, are addressed by means of "operative goals": "Operative goals designate the ends sought through the actual operating policies of the organization; they tell us what the organization actually is trying to do, regardless of what the official goals say are the aims. Where operative goals provide the specific content of official goals they reflect choices among competing values."<sup>12</sup> Such operative goals provide the "specific content" of official goals, which are often are often vague or expressed at such a high level of generality as not to be very meaningful.

Reflecting "choices among competing values", they may involve choosing among goals at different levels of importance or generating or applying "instrumental" values, some of which may be processual in nature. That is to say, operative goals may reflect the way in which the organization goes about pursuing its goals. Adherence to such processes, as an operative goal, may be ranked according to priority and, as such, may be superordinate, subordinate, instrumental, or otherwise.

Perrow says that operative goals "may be justified on the basis of an official goal, even though they may subvert another official goal. In one sense they are means to official goals, but since the latter are vague or of high abstraction, the "means" become ends in themselves when the organization is the object of analysis."<sup>13</sup> While the level of abstraction at which official goals are expressed may not make this apparent, the infusion of specific content into those official goals may reveal the incoherence of those official goals, when considered collectively. Unofficial goals, by providing such content for official goals, may thereby seek to resolve such incoherence by ordering the official goals in some way. This may frequently have the result of masking conflict over such goals.

In this regard, Perrow explains that with respect to an official goal of making a profit, operative goals will "specify whether quality or quantity is to be emphasized, whether profits are to be short run and risky or long run and stable, and will indicate the relative priority of diverse and somewhat conflicting ends of customer service, employee morale, competitive pricing, diversification, or liquidity. Decisions on all these factors influence the nature of the organization, and distinguish it

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<sup>12</sup> *Ibid.*

<sup>13</sup> *Ibid.*



from another with an identical official goal.”<sup>14</sup> Unofficial operative goals, on the other hand, are tied more directly to group interests and while they may support, be irrelevant to, or subvert, official goals, they bear no necessary connection with them.<sup>15</sup>

It may be expected that persons and groups within an organization generally adopt its official, or principal official, goal or goals, and that they would be expected to adhere, if not to actually accept, internalize, or “believe in” its operative goals, or most of them. However, because such operative goals are often means to official goals, or generate or apply means of prioritizing among official goals, they reflect choices among competing values, which may not be unanimously shared among constituent individuals and groups within the organization.

Consequently, while it may be expected that official, operative, or instrumental goals will be shared by all constituent individuals and groups, this may not be the case. Still less may it be the case with regard to unofficial operative goals. Perrow notes that unofficial operative goals may support, or subvert, or be irrelevant to, the official goals of the organization. Accordingly, some constituents of an organization may be committed to operative goals, official (that is to say, declared) or unofficial, that conflict with those of other organizational constituents. It can readily be seen that such goal conflict may lead some members of the organization to select means to other goals that will be conducive to the operative goals of such members, but inimical to the operative goals of other members. Considered in the abstract, this goal conflict may inhibit attainment of certain official or unofficial goals, depending on their nature and adherents.

As our examination of Chandler’s work has shown, changes in resources, technology, or growth, may make necessary the adjustment of some aspect of the organization’s structure. Such adjustments may also be required as a result of changes in goals. As to these, Perrow says, that there “are many critical variables influencing the selection of key problem areas and thus the characteristics of the controlling elite and operative goals. They will be applicable to the analysis of any complex organization, whether business, governmental, or voluntary.”<sup>16</sup> Perrow’s examples of these variables relate primarily to business organizations, including capital needs and

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<sup>14</sup> *Ibid* at 855-6.

<sup>15</sup> *Ibid* at 856.

<sup>16</sup> *Ibid* at 865.

legitimization, the amount of routinization possible, adaptability of technology to market shifts and consumer behavior, possible or required professionalization, and the nature of the work force.

The choice of operative goals and ways in which they are pursued within an organization may be affected by many factors, including the breadth, depth, and dispersion, of their acceptance in the organization, most especially at higher and other critical levels of its hierarchy. Some levels of the hierarchy or units within an organization may pursue operative goals that are not generally shared, or, as we have suggested, that are inconsistent with strategic or higher order operative goals.

As a purely theoretical matter, it can be readily seen that this may entail that certain parts of the organization may act separately in the organization's external environment. For our purposes, it may be that the firm, as such an organization, does not act completely unequivocally in the economy as a single actor. That this is at least a logical possibility compels the admission that this particular assumption of neoclassical economics may not be readily conceded. As a matter of fact, empirical verification substantiates that this logical possibility is observed in "the real world". Some salient research concerning these matters is reviewed in Part 3 of the present work.

### **ORGANIZATIONS AS POLITICAL SYSTEMS**

We have already introduced the notion that units and sub-units of organizations, including the firm, may operate in a coherent fashion within the organization. A division of a large corporation often pursues its strategic and operative goals with a relatively high degree of independence from what Chandler has called the general or head office of the corporation.

We will discuss particular forms of this in more detail below; however, for the present, we will note that groups, however situated within the corporation, may interact as groups with other groups within the focal group. This intragroup interaction within the focal group may be seen as engaging social and political considerations that may be quite distinct from the intergroup action of each particular group outside the focal group. Just as the goals sought by, and actions taken within, a particular group within the organization, such as a corporation, cannot be accurately described by merely aggregating goals and actions of individual members of the group, the goals sought by, and actions taken within, the larger organization, including the firm or corporation, cannot be accurately described by merely aggregating goals and actions of groups constituting the

organization as a whole. As discussed below, this associative effect may arise in connection with the very nature of association, or engagement in social intercourse.

Early discussions of this subject appear in the work of the organizational theory leader James G. March, a founder of the Carnegie School.<sup>17</sup> He and his colleagues developed a behavioural approach to organization theory<sup>18</sup>, which was expounded in his seminal work with Richard Cyert, *A Behavioral Theory of the Firm*, in 1963.<sup>19</sup> At this point, we will not engage in a general discussion of such approach, but will limit the discussion to matters affecting whether the firm acts in the economy as a single actor.

### **Firms, The Polity, and Economic Theory**

In James March's seminal 1962 article, "The Business Firm as a Political Coalition",<sup>20</sup> he maintains that "[t]he modern business firm is an organization for making and implementing decisions within a market economy." He says: "In most major industries of well-developed economies, most firms are large, complex organizations. These organizations render a set of key decisions for the economy. They establish prices, determine outputs, make investments, and allocate resources. These decisions and the consequences ensuing from them are the focus for the economic study of the firm. The economic theory of the firm attempts (1) to specify the decisions that business firms will make (as a basis for more aggregate predictions of the economy) and (2) to prescribe appropriate decision rules for a rational firm operating in a market economy."<sup>21</sup>

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<sup>17</sup> March first taught at the Carnegie Institute of Technology, now Carnegie Mellon University. The other founders of the Carnegie School were Herbert A. Simon, polymath and Nobel Laureate in Economics, and Richard M. Cyert (then President of that university), and economist, statistician, and organization theorist. Among its numerous achievements, the group may be considered to have established Organizational Behaviour as a management discipline. The first principal, and perhaps primordial, work of the group, which was cited as "epoch-making" in his Nobel citation was Simon's *Administrative Behavior: A Study of Decision-Making Processes in Administrative Organization*, (4<sup>th</sup> ed.) (New York: Free Press, 1997).

<sup>18</sup> The first step in the development of the behavioral model is said to have been Simon's 1955 article, "A Behavioral Model of Rational Choice" (1955) 69:1 *Quarterly J Economics* 99.

<sup>19</sup> Richard M Cyert, and James G March, *A Behavioral Theory of the Firm* (2d ed) (Englewood Cliffs, N. J.: Wiley-Blackwell, 1963). As at May 28, 2017, this work has reportedly been cited 26939 times. A poll of the Fellows of the Academy of management rated it as the twelfth most influential management book of the twentieth century. See Arthur G Bedeian and Daniel A Wren, "Most Influential Management Books of the 20<sup>th</sup> Century" (2001) 29:3 *Organizational Dynamics* 221.

<sup>20</sup> James G March, "The Business Firm as a Political Coalition" (1962) 24:2 *J Politics* 662.

<sup>21</sup> *Ibid* at 662.

In pleading for less “division of labour” between economics and political science, March argues that economists have generally ignored political systems except as they impinge on the market, while political scientists have excluded business firms from their domain, in both cases to the detriment of understanding the firm, predicting its activities, and exercising political control and direction over the firm. He maintains that “the business organization is properly viewed as a political system and that viewing the firm as such a system both clarifies conventional economic theories of the firm and...suggests some ways of dealing with classical problems in the theory of political systems generally.”<sup>22</sup> These arguments supporting close examination of March’s political coalition theory of the firm, to which the text will now turn.

### **The Firm as a Socio-Political Conflict System**

March claims that “some recent work in organization theory seems to indicate the utility of applying political concepts to the study of economic systems, particularly to the study of economic organizations”, including some of his earlier work, with Herbert Simon<sup>23</sup>, and also with Richard Cyert<sup>24</sup>, saying that such works, in many respects, “view the business organization as a socio-political conflict system subject to economic constraints”.<sup>25</sup>

March describes a conflict system as a system which lacks a preference ordering. In effect, it is one in which preferences conflict, and in which the system seeks a resolution of such conflict, either by means of adherence to a superordinate goal, such as “profit”, as in the case of theories of business firms, or by means of adherence to a superordinate process of conflict resolution not involving an explicit comparison of utilities, as in the case of theories of political coalitions.

Conflict arises when the preference orderings of the basic units are mutually inconsistent relative to the resources of the system, such that the most preferred state chosen by all elementary units cannot be simultaneously realized.<sup>26</sup> March indicates that these postulates underlie “a wide variety

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<sup>22</sup> *Ibid* at 663.

<sup>23</sup> James G March and Herbert A Simon, *Organizations* (New York: John Wiley and Sons, Inc., 1958). As at May 28, 2017, this book has reportedly been cited 5319 times. Bedeian and Wren, *supra* note 19, report that it was ranked as the seventh most influential management book of the twentieth century.

<sup>24</sup> *Supra* note 19.

<sup>25</sup> *Supra* note 20 at 666. March also references, as another example, VA Thompson, *Modern Organization* (New York: Random House, 1961).

<sup>26</sup> *Supra* note 20 at 663.

of theories about conflict resolution, choice, or the allocation of scarce resources”, including such situations as “the behavior of individuals in a simple learning experiment, the internal dynamics of a small group solving a problem, the interaction of parties and pressure groups in a legislative setting, or the pricing of commodities in a market system”.<sup>27</sup>

March says that a superordinate goal can be imputed based on two assumptions: firstly, that there exists a joint preference ordering for the system at any particular point in time (in effect, a “resolvability” or “satisfiability” assumption); and secondly, that the system always chooses an alternative which is not less good than others, in effect, the most preferred alternative.<sup>28</sup> March explains that the process approach to a conflict system, on the other hand, does not attempt to “identify a joint preference ordering with respect to the ultimate decision” but assumes, instead, firstly, “that the ultimate decision results from a series of elementary decisions”; and, secondly, “that some sort of joint preference ordering exists for the elementary decisions”.<sup>29</sup> We may note that both the superordinate goal and the superordinate process methods of joint preference ordering assume that the joint preference determination operates in a manner which is, generally speaking, rational, colloquially and otherwise, although not necessarily without other relevant influences.

March explains that a theory of conflict systems must, firstly, treat elementary decision processes as consistent basic units and, secondly, be susceptible to investigation by analytic procedures.<sup>30</sup> In this sense, the level of analysis is highly significant: “One feature of studies of conflict systems that is puzzling from the point of view of the postulates of conflict is the extent to which the elementary units in one study are the conflict systems of another. The individual is treated as the system in some cases (e.g., in learning) and as the elementary unit in other (e.g., studies of small groups). Similarly, small groups are treated both as systems and as elementary units (e.g., in studies of organizations).”<sup>31</sup>

March’s point here is a methodological one: the same study cannot consider a unit as both an elementary unit and as a conflict system. Instead, he maintains that it must treat a unit as either an

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<sup>27</sup> *Ibid* at 664.

<sup>28</sup> *Ibid* at 666. We might also describe this as the “least *non*-preferred alternative”.

<sup>29</sup> *Ibid* at 667-8.

<sup>30</sup> *Ibid* at 668.

<sup>31</sup> *Ibid* at 664.

elementary unit within a conflict system, or as a conflict system on its own right. This has considerable logical coherence. For example, a division of a corporation might be considered to be an elementary unit within the conflict system constituted by the corporation as a whole. When considering the division of the corporation as a conflict unit itself, other units must be identified as elementary units, which might be departments or functional units within the division.

However, March argues that “[s]ince the first postulate of conflict is essentially that the basic units themselves not be conflict systems, it seems awkward to be able to view a single system as either an elementary unit or a conflict system depending on the level of aggregation involved.”<sup>32</sup> At the same time, however, adherence to this “first postulate” disables an investigator from investigating anything but “primary level” conflict systems. This approach is neither efficacious nor commonly adopted, for March concludes that “[i]n fact, most systems studied in the social sciences are apparently conflict systems of conflict systems.”<sup>33</sup>

As noted above, conflict may arise in an organization where the resources available to the organization do not permit attainment of the goals of all component units. Such conflict may arise with respect to unit goals even though there may be agreement on organization-wide goals. Such unit may pursue such unit goals both internally and externally. In the case of a business organization, the latter may result in the organization, the firm, or the corporation, acting in the economy as more than one actor. This presents problems not only for economic theory, but also for conflict system theory.

### **The Firm as a Conflict System for Internal and External Conflicts**

March argues that economic theory does not permit investigation of the firm as a conflict system: “The assumption of consistent basic units is justified by asserting either of two other characteristics of the macro-system involved. We may assert that the preference ordering of the subsystem (which we wish to identify as the elementary unit) is causally antecedent, and independent of, the decisions of the larger system. In such a case, we treat the preference ordering of the subsystem as given without considering the way in which that ordering is derived.”<sup>34</sup> The immediate practical effect

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<sup>32</sup> *Ibid.*

<sup>33</sup> *Ibid.*

<sup>34</sup> *Ibid.*

of this assertion is that it ignores the way in which decisions as to preferences are reached within the subsystem or elementary unit. Another practical effect is that it ignores even the possibility of any interaction between preference ordering at the subsystem or elementary unit level and preference ordering at the macro-system or focal unit level. We comment on this further below.

March says: “Alternatively, we may assert that variation in system behavior due to conflict within the subsystem is trivial because of scale differences between the conflict within the subsystem on the one hand and conflict among subsystems on the other. In such a case, we take the preference ordering of the subsystem as subject to some minor error without attempting to eliminate the error entirely.”<sup>35</sup> In effect, on this argument, joint preference ordering operates independently of the content of the preference concerned, and, perhaps, also independently of the absolute or relative prioritization, or weighting, of the preference concerned by the subsystem members.

On this latter assumption, discrepancies between the joint preferences generated by the macro-system, as opposed to those generated by each subsystem, are purely scalar or quantitative, rather than qualitative. Accordingly, on this assumption, joint preference ordering can proceed by simple aggregation of subsystem preferences. The nature of such aggregation is similar to the generation of demand curves in neoclassical economics by aggregating the demands of individual consumers. In both cases, the subject of such aggregation can be treated purely quantitatively, which is to say, mathematically.

Both of these arguments, March suggests, are suspect, in view of the complexities of interaction between the resolution of conflict within the subsystems and the resolution of conflict within the larger system.<sup>36</sup> In consequence, he finds that the “assumption of consistent basic units” is problematic. The extent to which this assumption relies upon further assumptions or generalizations relating to methodological individualism are discussed in the section following.

For present purposes, we may take the assumption of consistent basic units as indicating, at least, that any interposition of units of a firm (sub-units within a conflict system, the firm) into the economy “outside” the firm (a different, and higher order, conflict system) would likely complicate

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<sup>35</sup> *Ibid.*

<sup>36</sup> *Ibid* at 665.

both the internal resolution of conflict among units inside the firm as the immediate conflict system, and the resolution of conflict in the economy (the higher order conflict system) generally. This might occur if the sub-unit of the firm was to pursue its economic and any other goals among economic actors, including the firm under consideration, in the economy generally. The sub-unit of the firm could be considered to be competing among such economic actors, including with the firm of which it is a sub-unit.

Among other things, the resources sought by such sub-unit may be sought by it on its own right, and not simply as part of the firm. Thus, the sub-unit of the firm seeks resources within the firm, as to which it may compete with other sub-units, but also seeks resources and profits outside the firm in the overall economy, as to which it may compete with other economic actors in the economy generally. Such sub-unit is still, however, ultimately affected by resource allocation within the firm. This is not the case with competitors outside the firm, or at least those which are not units or sub-units of other economic actors. The competition for resources and customers is, by hypothesis, purely external to the firm, in the overall economy, or in the market. The internal unit may, in some cases, thus be subject to, or, in others, may avoid, constraints arising from the nature of the organization itself, and which are not shared by outside organizations with which it interacts in the higher order conflict system.

The exposition advanced here gains support from March's criticism that "[e]conomic treatment of the firm as a conflict system is heavily influenced by the fact that the firm in economic theory is more commonly treated as the basic unit of a larger conflict system (industry, market, economic system) than as a conflict system itself."<sup>37</sup> The present work has demonstrated the accuracy of this remark in regard to neoclassical theory. It can be seen that such theory would disregard preference ordering within the firm itself, considered as a sub-system, or basic unit, of the larger economic system. This permits the invisibilization of the process of determining joint preferences within the firm itself. Analysis of the firm as a conflict system, however, would not permit this.

As a result of ignoring the firm as a conflict system, March says, "the economic theory of the firm is almost invariably constructed by explicitly imputing a superordinate goal to the conflict system

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<sup>37</sup> *Ibid* at 668.



represented by a business firm. In its classic form the theory asserts that the objective of the firm is to maximize long-run expected profits. The objective is accomplished by determining an output to be produced given a production function, a cost function, and a price. Given a set of factor prices, the firm determines the minimum cost factor mix and the optimum output.”<sup>38</sup> Criticism of the neoclassical economic theory of the firm in this regard has been considered earlier in this work.

It can still be seen that neoclassical theory of the firm asserts, as a characteristic of the economic system, that the preference ordering within the firm, as a sub-system or basic unit of the macro-system, “is causally antecedent, and independent of, the decisions of the larger system”<sup>39</sup>, and that the preference ordering of the firm, as a sub-system, can be treated “as given without considering the way in which that ordering is derived.”<sup>40</sup> This is the first of the two alternatives which March says are used to justify the assumption that a conflict system involves consistent basic units, discussion of which begin the present section. Again, this occludes recognition of the behaviour of the firm as involving decisions and processes relating to the determination of goals and objectives.

### **Joint Preference Ordering in Economic Theory**

Whether the joint preference ordering for the firm is expressed in the economic theory of the firm as profit maximization, a more general utility function, or as some other goal, such as revenue maximization, March observes that: “For the most part, the theory suppresses as outside its domain the process by which an organization composed of a rather complex mixture of people with considerable heterogeneity of individual goals generates a single preference ordering. It is assumed that conflict is resolved by the employment contract, or – more generally – by the factor prices and that the result is a joint preference ordering of some sort or other.”<sup>41</sup> The present work has criticized this approach, in part by presenting criticisms from the perspectives of other commentators. It has been emphasized here that this perspective represents a failure to explicate the processes by which economic determinations are made, by economic actors and otherwise, such as by the economic

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<sup>38</sup> *Ibid* at 668- 669.

<sup>39</sup> *Ibid* at 664.

<sup>40</sup> *Ibid*.

<sup>41</sup> *Ibid* at 669.

system itself, and thereby fails to instantiate the means by which such theory is interpolated into, or instantiated in, reality.

The assumption which March makes concerning the economic theory of the firm is one which has been described here as critical to neoclassical theory generally, namely, methodological individualism. Methodological individualism as applied in neoclassical theory holds that the basic unit of economic analysis is the monadic individual, lacking individual characteristics, acting independently, with complete rationality, and with complete relevant information, making decisions solely on the basis of his or her personal utility. As argued earlier in this work, this assumption or generalization raises such difficulties that it cannot be maintained, at least as a guide to actual human behaviour, whether expressed in terms of economic behaviour or otherwise, including with respect to social and political theory and behaviour.

It is easy to see, however, that March's description of the economic theory of the firm considers the individual, as just described, as the "basic unit" of "the firm", acting as a conflict system. His description is consistent with the critique of aggregation of individual supply, or individual demand, as the case may be, generating aggregate supply or demand, as the case may be, and producing equilibrium. As argued in the present work, especially in Appendix B in Chapters B4 and B5, such methodological individualism, at least in the form in which it is employed in neoclassical economics, *ex hypothesi* occludes or invisibilizes observation of one economic actor by another, as well as any other interaction among such economic actors. Such methodological individualism and such simple generation of supply and demand by means of aggregation alone have each been criticized earlier in this work.

In the case of the firm, employment of the monadic individual as the invariant unit of analysis affords no possibility of interaction among individuals, or of intermediation of behaviour at some "group" level between the individual and the firm, or among such groups. Instead, March suggests that the firm is an organization "composed of a rather complex mixture of people", thereby drawing attention to the fact that the individuals within the organization possess distinctive characteristics, and implying that such heterogeneity may have some effect on generating a single preference ordering for the firm. Indeed, he states that the individuals composing the firm may be expected to have "considerable heterogeneity of individual goals". In other words, the heterogeneity of goals

possessed by such a complex mixture of individuals may be considerable and, as such, may require complex processes in order to resolve conflicts among these diverse goals.

March says that economic theory simply assumes that joint preference ordering takes place, without explaining how this is effected. Of course, if the posited single joint preference ordering is not achieved, either fully or partially, there may be more than one preference ordering, at the firm level or at other levels within the firm. For example, a single preference ordering may be generated in respect of the most general level of preference, the superordinate goal of the firm at the firm level, but not at lower levels of preference, such as those concerning operative or instrumental goals, or at organizational levels below the firm level, in effect, at the level of sub-systems within the firm level meta-system. At such levels, joint preference ordering may be said to be incomplete or indeterminate, inasmuch as several preferences may enjoy support among various organizational constituents at the relevant level, requiring further joint preference ordering by political action, including use of influence processes, coalition building, bargaining, or otherwise.

Similarly, a single preference ordering at the most general operative level may be generated at the highest level of the firm or, but not at other, subordinate, levels. In effect, those at subordinate levels of the firm may not share the single preference ordering of operative goals at the most general level of the firm as a whole. In turn, this may have the effect that some individuals or groups at that subordinate level may determine to pursue their own collective goals. The logical possibility thus arises that some of those goals may be expressed outside the firm, that is, by economic action in the wider economy or economic meta-system; in short, that the goal conflict may result in the firm not acting outside the firm as a single actor, as posited by economic theory.

Although we have not in this work previously considered the firm expressly as a conflict system, we have previously noted that processes within the firm, including goal derivation and harmonization, although not dealt with by neoclassical economic theory, are worthy of investigation. March argues: "This implicit assumption that the firm represents a conflict system susceptible to useful description in terms of a superordinate goal (whether profit maximization or some other) is shared by most economists. It is apparently convenient for the construction of theories of macro-economic systems. Most economic theories build upon it (although not all

necessarily depend upon it). It is relatively amenable to theoretical manipulation. It lends itself to the geometry and calculus familiar to economic thought.”<sup>42</sup> It is not, he says, that economics fails to recognize the firm as a conflict system, which is assumed. What is left unsaid by March is that because the nature of the firm as a conflict system is an implicit, rather than an explicit, assumption held by most economists, it is insufficiently analyzed, operationalized, or explained, in theory and in practice.

In addition to the criticisms advanced by March which are discussed above, he advances a signal criticism of profit as the superordinate goal of the firm, as follows: “Nevertheless, the assumption is almost certainly wrong as a micro-description of a business firm. It was proved extremely difficult to define a superordinate goal for a business firm that meets the two technical requirements of stability and meaningfulness as well as the empirical requirement of validity. Generally speaking, profit maximization can be made perfectly meaningful (with some qualifications); but when made meaningful, it usually turns out to be invalid as a description of firm behavior. To achieve validity, we can substitute utility maximization; but this turns out to be either not stable or not meaningful.”<sup>43</sup>

As an example of this, March cites Machlup’s attempt to generalize, by construing profit as utility maximization, the assumption that firms seek to maximize profit, but claims that this “ended by reducing it largely to a definition insofar as a micro theory is concerned.” March concludes that “[w]ith few exceptions, modern observers of actual firm behavior report persistent and significant contradictions between firm behavior and the classical assumptions.”<sup>44</sup> As has been seen, March’s conclusion is shared by many other commentators.

March reports, then, that observations of the behaviour of firms is not consistent with the superordinate single goal of profit maximization. However, he concludes that “[d]espite their inadequacies, the assumptions have persisted... for a simple but compelling reason. The alternative

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<sup>42</sup> *Ibid* at 669.

<sup>43</sup> *Ibid* at 669-670.

<sup>43</sup> *Ibid* at 670.

<sup>44</sup> *Ibid*.

mode of theory - the process description of a conflict system – also has generally failed to satisfy its technical requirements.”<sup>45</sup>

March builds a case for examining the internal processes of the firm and, in these excerpts, at least, for investigating the goals that the firm pursues and how it resolves conflicts among its internal units. Writing at a time, in the early 1960s (published in 1962), when Chandler was writing his *Strategy and Structure*, (also published in 1962), and making an early attempt to outline the development and structure of the business corporations then dominating the American economy, March began to explore the implications of decision processes within the firm.

As he says, while empirical investigation and description of those decision processes was not at that time entirely absent, an analytical apparatus was absent. The implication, he says, is that if an analytical apparatus to delineate the implications of the process could not be devised, a revised process-theoretical model of the firm could not be built, with the further result that “a revised theory of the firm could not satisfactorily be grafted to existing economic theory”.<sup>46</sup> It is not clear, even at the present, that such grafting has eventuated.

For present purposes, however, we must take notice that March certainly identifies the possibility that the firm might not always act “as a single actor” with respect to those outside of the firm. Lest it be thought that only units or sub-units of “the firm” may pursue goals that are not uniformly those of “the firm” as a whole, some reference to organizations of a different nature may be useful.

### **Organizations as Polities**

Meyer Zald’s 1966 article, “Organizations as Polities: An Analysis of Community Organization Agencies”,<sup>47</sup> considered community organization (CO) agencies, such as welfare councils, neighbourhood block clubs, settlement houses, community centers, adult education centres, family service agencies, research agencies, and health agencies, and analyzed them as “miniature polities”, considering the distribution and utilization of authority and influence and how subgroup

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<sup>45</sup> *Ibid.*

<sup>46</sup> *Ibid.*

<sup>47</sup> Meyer N Zald, "Organizations as Polities: An Analysis of Community Organization Agencies" (1966) 11:4 Social Work 56.

loyalties and power affected their operations.<sup>48</sup> Such community organizations, of course, are not primarily engaged in economic activity, and are not business organizations, but are, instead, organizations with various goals and objectives that can be considered to be of a broadly social or, perhaps, political, nature.

Zald avers that he employs the general approach of organizational analysis, which “takes the total organization, not some subpart, as its object”.<sup>49</sup> Characteristic of this approach, he says, is a focus on “the relation of goals to structure and the pressures to change goals arising from both the environment and the internal arrangements of the organization”, and “on the allocation of power to different groups and the manner in which subgroup loyalties and power affect the operation of organizations.”<sup>50</sup> The ways in which the structure and processes of organizations are adapted in view of, and to reduce, or organizational dependencies on external and internal resources have been discussed earlier in this work. In the organizational analysis approach, “organizations are seen as developing distinctive characters — styles and strategies of coping with recurring problematic dilemmas of the organization.”<sup>51</sup> As Zald says, its recursive dilemmas include resource dependencies.

As Zald’s references to organizational analysis indicate, the relationship between an organization, its requisite resources and other environmental considerations, on the one hand, and the relationship between its goals and its organizational structure, on the other hand, are not essentially affected by the “nature of the organization”, considered in the sense of the goals which it pursues. However, although not mentioned by Zald, it is likely that the expressed preference ordering of a CO agency may be more amenable to variance than that of a business enterprise. This depends, of course, on the manner in which that preference ordering is expressed.

As March indicates, preference ordering in term of profit maximization is not likely to be meaningful as a basis for decision-making. Some lower level objectives may perform this function. The superordinate goals of a CO agency, on the other hand, may be more readily employable as decision-making determinants. Zald maintains that an organization has a constitution, which

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<sup>48</sup> *Ibid* at 56-57.

<sup>49</sup> *Ibid* at 57.

<sup>50</sup> *Ibid*.

<sup>51</sup> *Ibid*.

“represents its social contract — the basic purposes and modes of procedure to which the major supporters and staff of the organization adhere”<sup>52</sup>, which constitution “is made up of the agency's commitments to major programs and modes of proceeding (goals and means).”<sup>53</sup>

Zald explains that such constitution “is, of course, more than just the formal or written statement of goals and procedures, for these may have little to do with the organization's actual constitution. On the other hand, many patterned aspects of agency operation may not be part of the constitution, for these patterns may not deal with basic agreements about goals and means.”<sup>54</sup> Thus Zald seems to recognize that the formal constitution, and the informal, or operative, constitution may co-exist.

As with Chandler and Perrow, Zald distinguishes official or stated strategies (Chandler) or goals (Perrow) from operative or actual goals, and superordinate goals from subordinate goals, including instrumental goals or means of attaining goals. Like Chandler and Perrow, he claims that changes in strategies or goals require corresponding adjustments in structure: “Organizations come into being to pursue collective ends. A central part of the constitution of any organization is the sets of agreements about goals that are understood by major constituents. Not only do goals represent a set of constituting agreements, they focus organizational resources on a problem field. That is, organizational goals along with beliefs about how to attain them set tasks and problems for agency personnel.”<sup>55</sup>

Accordingly, changes in organizational resources, including the extent to which the organization is dependent with respect to such resources upon external or internal sources, may affect its ability to achieve its goals and objectives as the organization is constituted of the relevant time, which may require some adaptation of its structure and processes. In some cases, it may be necessary to refocus, re-emphasize, de-emphasize, or re-prioritize, certain subordinate goals or objectives. As organizations pursue shared goals or objectives, when considered in their political aspect, as “miniature polities”, it can be seen that “attempts to shift the objectives of the organization can threaten its body politic”.<sup>56</sup>

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<sup>52</sup> *Ibid.*

<sup>53</sup> *Ibid* at 58.

<sup>54</sup> *Ibid.*

<sup>55</sup> *Ibid.*

<sup>56</sup> *Ibid.*

For Zald, then, the constitution of an organization involves not only agreement about goals, or, at least, about a superordinate goal or goals, but also agreement about the means or processes of attaining such goals. As in the case of statal polities, some processes or means of attaining goals may be approved or explicitly authorized, while others may be prescribed, in whole or in part, or reserved for only certain exceptional circumstances.

The agreement about the means or processes of attaining the organization's goals and objectives may obtain only at a very high, that is, "constitutional" or, at least, "strategic" level, and may not extend to intermediate and lower, that is to say, tactical or functional, levels. This, of course, introduces the possibility, logically, at least, if not otherwise, that some of the constituents or groups of constituents, may agree with very high order principles respecting the means or processes of attaining the organization's goals and objectives, but may not agree with medium or lower order principles concerning such means and processes.

As with other organizations, continuance of the organization becomes a goal or objective of CO agencies. Zald says that "[a]s a working assumption it is reasonable to assert that most organizations will attempt to maintain autonomy and increase their scope" even, in the case of COs "when it is obvious that one agency is more capable of achieving a shared goal than another", which is rare."<sup>57</sup> He claims that "[o]ne of the basic premises of organizational analysis is that only under very special conditions do organizations purposely attempt to decrease their scope, actually admit that they are ineffective, or willingly give up 'turf'", for example, where staff of the organization has a low ideological or career commitment to it, where fund raising becomes increasingly difficult, or where the organization's constituency increasingly finds better alternative uses of time and money.<sup>58</sup>

An organizational theorist or practitioner might endeavour to apply similar observations to units of an organization, which may normally be expected to seek to maintain their existence, purview, and influence with respect to the organization as a whole.

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<sup>57</sup> *Ibid* at 64.

<sup>58</sup> *Ibid*.



### **Competing Preferences Within the Firm, and Formation of Coalitions**

In the sections above entitled “The Firm as a Socio-Political Conflict System” and “Organizations as Politics”, the subject-matters referenced were discussed with a particular focus on the perspectives of March and Zald, respectively. March indicated that theories of business firms claimed that such firms resolve conflict by means of and adherence to a superordinate goal, namely “profit”, whereas theories of coalitions in politics generally adopted the alternative method of conflict resolution, namely, adherence to a superordinate process of conflict resolution not involving an explicit comparison of utilities.<sup>59</sup>

March argues that analysis of politics as conflict resolution systems face the same problems as in the case of business and other organizations, namely, that of seeking to derive a superordinate goal, such as the “public interest”, which is simultaneously meaningful, stable, and valid.<sup>60</sup> He indicates that, accordingly, studies of conflict resolution in political systems became focused on process descriptions such that “the basic outline of a process-oriented political theory of conflict resolution can be detected”, in effect, theorizing conflict resolution by means of a superordinate process, rather than by means of a superordinate goal.

March explains that the theory assumes that: various interest groups exist within the system; and make various demands with respect to the allocation of the system’s resources; decisions as to which allocations are made by coalitions of interest groups; that various potential coalitions of interest groups may have a certain degree of potential control over the system; with respect to which a broker, the politician, attempts to organize a coalition of interests that is viable in the sense that it allocates no more resources than are available to the system.<sup>61</sup> Of course, we would argue that in order to maintain this theory, it is not necessary to assume that all resource allocations are determined by one macro-coalition which subsists over time. Instead, bargaining may take place among one or more macro-coalitions. Further, any macro-coalition may be subject to regular, or even continuous, recomposition and realignment. Decisions as to the allocation of sub-sets of

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<sup>59</sup> *Supra* note 20 at 671.

<sup>60</sup> *Ibid.*

<sup>61</sup> *Ibid* at 671- 672.

system resources may be made by coalitions other than the macro-coalition which is dominant at the particular time.

March distinguishes this theory from descriptions of political systems which emphasize power, internal struggle, and expediency, and de-emphasize order, cooperation and problem solving, and claims that this interest group theory of political decision making “ordinarily highlights phenomena such as bargaining, compromise, negotiation, inconsistency, and more or less continual conflict.”<sup>62</sup> He describes it as “a theory with modest analytic pretensions but rather impressive generality as a framework for observation” which is well accepted in one form or another by students of political organizations “despite the obvious fact that the theory neither is particularly well-defined nor has a particular powerful language.”<sup>63</sup> March’s description of the interest group theory of decision-making in politics is useful insofar in the present context as he relates it to organizations pursuing other objectives, such as the firm, or the corporation.

March’s 1962 article goes on to examine the ways in which competing preferences operate within the firm. He relates those competing preferences to the theory of the firm employed in the seminal 1958 work that he co-authored with Robert Cyert <sup>64</sup>, which assumes, firstly, that a business firm is a political coalition; secondly, that the executive in the firm is a political broker; thirdly, that the composition of the firm is not given but, instead, is negotiated; and, fourthly, that the goals of the firm are not given but, instead, are the result of bargaining.<sup>65</sup> In this regard, March maintains that profit must be rejected as a superordinate goal of the firm in resolving conflict because it lacks meaning, stability, and validity; and, consequently, he proposes examining a processual goal as a superordinate goal of the firm, instead.

This theory assumes that potential participants in the firm initially include “such classes of potential participants as investors (stockholders), suppliers, customers, governmental agents, and various types of employees” but may be extended to include investment analysts, trade

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<sup>62</sup> *Ibid* at 672.

<sup>63</sup> *Ibid*.

<sup>64</sup> *Supra* note 19.

<sup>65</sup> *Supra* note 20 at 672. The explication referenced in the present work draws upon that contained in March's 1962 article, which is relatively more succinct than that of the joint 1958 book.

associations, political parties, and labor unions.<sup>66</sup> On this analysis, “[e]ach potential participant makes demands on the system”, which “are essentially the price required for participation in the coalition”; and that these demands “are partly in the form of payments commonly assumed in economic theories (e.g., money) but they also are partly in the form of demands for policy commitments, personal treatment, etc.”<sup>67</sup> Where these demands are quantified monetarily, or monetized, their valuation and comparison with other such demands may be greatly simplified, as compared with demands relating to policy, or personal treatment or status.

Importantly, “each set of demands can be characterized as having some degree of consistency with each combination of other demands. Some pairs of demands may be strictly inconsistent (under no circumstances can they both be satisfied). Some pairs of demands may be more or less consistent depending on external conditions (e.g., so long as the resources available to the coalition are substantial they may be consistent). Some pairs of demands may be completely complementary (e.g., if one demand is satisfied so also is the other one necessarily and without additional resource expenditure). As a result of this complementarity, we can describe the marginal "cost" of any participant to any given coalition.”<sup>68</sup>

March’s description of this perspective reveals that the commitment made by firm with its constituents, or by the constituents of the firm with each other, are not only monetary, quantified, or even quantifiable. Commitments made by the “system” in response to demands for policy commitments or certain personal treatment, two of the examples which March gives, are of this nature. Moreover, such commitments are both incomplete, in as much as they require further stipulation in order to be actionable, and executory, insofar as they are required to be performed over a period of time.

The completion of such general commitments, on the one hand, and their effectuation or execution, on the other hand, may be expected to give rise to differences of opinion as to whether those commitments have been satisfied. These differences of opinion may be expressed as conflicts, but also may give rise to secondary, that is to say, perceived or operative, commitments not necessarily

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<sup>66</sup> *Ibid* at 672-673.

<sup>67</sup> *Ibid* at 673.

<sup>68</sup> *Ibid*.

shared by all members of the firm or coalition. As we have argued, these may, in turn, be operationalized by being independently pursued by the individual or group, unit, or sub-unit, self-considered as the beneficiary of such commitment. This operationalization may take the form of action within or without the firm separately from the firm as a whole, that is to say, as a separate economic actor.

### **Continuing the Coalition**

It may be said that the commitments made in connection with forming the coalition, participating in the system, or establishing the firm are not only incomplete, generalized or diffuse, often requiring further particularization, and are often also executory in nature, requiring performance over a period of time, but such commitments are also subject to change, as a result of internal as well as external factors. In particular, March assumes that the level of demands of the potential participants shifts “in response to experience (both actual and vicarious)” and that the extent to which demands receive attention or are seen as relevant to action “shifts in response to the perception of problems.”<sup>69</sup> March assumes, in turn, that each possible coalition of participants can gain a certain return from its environment, which represents the “value” of the coalition with respect to such environment.

Discussing the value of such a coalition in a polity, March suggests that “an over-simple model of a governmental coalition in a parliamentary democracy might assume that any coalition including more than 50% of the voters would be able to do anything permissible within the system (thus would have maximum power) and that any coalition including less than 50% of the voters would be able to do nothing (thus would have minimum power).”<sup>70</sup> This example suggests that March assumes that each possible coalition has a single superordinate goal, namely, the achievement of maximum possible power, instead of a single superordinate processual goal, namely, the maximum (or optimal) satisfaction of the aggregate goals of coalition participants. In a sense, although March argues that political systems themselves do not have single superordinate goals, he attributes that characteristic to participants in the political system. This conflicts with his stated position that modern political systems, in which disparate interest groups each seek their own objectives, seek

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<sup>69</sup> *Ibid* at 673.

<sup>70</sup> *Ibid*.

to attain some goal which is at once meaningful, stable, and viable; namely, some sort of effective coalition.

It is arguable that March maintains a similar position with respect to business coalitions when he says that “[i]n a similar way, alternative business coalitions can gain different returns from the economic system in which they operate; and we can (at least approximately) specify the marginal value of a particular given participant to a particular given coalition.”<sup>71</sup> March appears to be maintaining not only that a particular given coalition has a specific “value” in terms of the return which it can derive from its environment, but also that the “marginal value of a particular given participant to a particular given coalition” can likewise be ascertained. These arguments are more readily maintainable if all possible economic organizations are considered to have a single superordinate goal, for example, profit, a view which March criticizes elsewhere, as noted above.

Notwithstanding the merits of these arguments, however, it must be conceded that there is considerable utility in considering a firm, that is, a modern business corporation, as notionally involving a coalition of participants the selection of whom, and the basis of whose participation is determined, as a result of bargaining among the possible participants concerning their respective demands. It is recognized, of course, that any such notional bargaining takes place seriatim, and sequentially, rather than contemporaneously and multilaterally. The utility of the theory is enhanced if it is recognized as purely “notional” or conjectural; that is to say, it is considered that the “bargaining” is idealistic or typological, and that the “bargain” is, more realistically, implicit and tacit, rather than explicit and overt.

As noted previously, once such enterprise is actually operating, the performance of executory bargains and other factors, including, changes in participant demand, may be expected to transpire. Accordingly, as the demands of participants are required to become more concrete or definite in order to ascertain whether or not they are satisfied, and as commitments are required to be satisfied over a period of time, the salience of certain demands and commitments may be, may be required to be, or may be perceived to be required to be, adjusted; not only to conform to actual, expected

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<sup>71</sup> *Ibid.*

future, and possibly even possible future experience, but also to the requirements of the organization itself, including changes in resources, strategy and structure.

March suggests some of these considerations can be assessed from the perspective of the executive (or, in the present author's supposition, the executive group), who wishes to maximize his own utility as a result of his participation in the organization, whose "problem then is (insofar as he is able) to select a coalition so as to maximize the difference between the demands of his coalition members and the potential return from the environment of the coalition."<sup>72</sup> In this way, he might hope to appropriate that difference by way of return to him for his "executive" participation, by way of appropriation of "rent", or by way of some combination of the two.

In order to generate this surplus or return, "[o]n the one hand, he must select a coalition that has relatively low "costs" of maintenance and relatively high returns from the environment. On the other hand, he must so structure the payments made to coalition members as to make the shifts in demands conducive to increasing the difference between total demands and total resources."<sup>73</sup>

March indicates that the further definition of the theory requires specification of "the dimensions of participant demands, some measure of their complementarity, the functions by which they change over time, and the short run internal constraints on the bargaining process by which goals are formed."<sup>74</sup>

March's "executive" is reminiscent of the single owner-manager of neoclassical theory. Rather than a single individual, an owner-manager in neoclassical theory, and an "executive" in March's theory, March's executive may be a team of individuals, or an executive team. His executive functions as a broker of the demands of potential coalition participants.

In addition, the executive must continue to broker the demands of actual coalition participants, taking into account the matters we have identified here, including the incompleteness, executory nature of such commitments, as well as the varying actual and potential salience of the resources supplied by the participant to the firm and the returns it derives from the deployment of all of its resources and the alternative employment of the same or similar resources by the firm. As such, it

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<sup>72</sup> *Ibid* at 674.

<sup>73</sup> *Ibid*.

<sup>74</sup> *Ibid*.

may be expected that an important function of March's executive (or delegate) will be to minimize or resolve conflicts among all these commitments and related imperatives.

Of course, coalition formation and maintenance can be assessed from the perspective of coalition participants other than the "executive" or "entrepreneur". Indeed, the coalition theory is not necessarily incompatible with someone other than the executive or entrepreneur acting as the broker of demands made by potential and, later, actual coalition participants. March's theory does, however, involve the executive or entrepreneur acting as broker.

### **Business Coalitions and the Economic Theory of the Firm**

March explains that there are four critical ways in which this theory of business coalitions, although close to economic theory, deviates from conventional economic views in the direction of a more "political" treatment. "First, the focus of attention shifts from the owners (and their objectives) to the actual, operating organizers of the coalition - whoever they may be. In general, we view stockholders much as a theory of political systems might view citizens. Their demands form loose constraints on the more active members of the coalition. Their initiative in policy formation and in determining the nature of the coalitions is small."<sup>75</sup>

The analogy, of course, is somewhat imperfect. The citizenry of a particular polity may be said to be much more tightly bounded than the shareholder body of the corporation. Shareholders "self-select" to a much greater degree than do citizens. Citizenship qualifications may include such matters as family history, place of birth, residence, immigration, and various other legal determinants. These qualifications for citizenship are likely to be much more restrictive than those relating to those relevant to holding shares in a particular corporation. Interestingly, these shareholder qualifications may be most restrictive in circumstances in which citizenship or residence is relevant, such as in the case of requirements for majority ownership of companies operating in certain cultural, military, or national security industries.

Part 1 of this work demonstrated the types of constraints imposed by shareholders on management of a corporation and on the corporation itself; generally relating to the ability to approve or reject certain management initiatives, to bring certain proposals to the attention of management and other

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<sup>75</sup> *Ibid.*

shareholders, to organize with respect to the election of directors and other matters requiring, facilitated by, shareholder attention, and to transfer, or to require the acquisition by the corporation of, shares held by the particular shareholder. The price at which transfers of shares can be effected significantly affects the exercise of such rights. As previously discussed, holders of shares of a corporation are, as such, are highly susceptible to substitution, even wholesale or complete substitution.

Such a possibility is much reduced in the case of an electorate. While shareholders may enjoy heightened influence with respect to the corporation from time to time, such as with respect to an initial public offering of its equity securities, at which time shareholders may be said to engage in some meaningful “bargaining”, even if intermediated by the capital markets, it may be difficult to identify a similar situation of engagement with respect to an electorate, except perhaps with respect to the adoption, or amendment of, a constitution for the polity, or with respect to constitutionally required referenda. Nevertheless, the remoteness from power of those whose interests are purportedly represented by the governing bodies of the association or organization are not entirely dissimilar as between a public corporation and a polity constituted as a democracy.

The second way in which the coalition theory differs from conventional economic theory is that the coalition theory “emphasizes the non-uniqueness of short run solutions to the coalition problem. At any point in time, there are a number of possible coalitions that are viable (that is, their total value exceeds their total cost of maintenance).”<sup>76</sup> Immediately relevant to this observation are two questions: the first relating to what the expression “short run” signifies for this purpose; and the second relating to what viability signifies in this regard.

Presumably, the duration of solutions to the coalition problem will be affected by the respective demands of possible coalition participants as they are instantiated temporally and otherwise. One can speculate that points of disjuncture or fissure may arise at which the coalition at hand might fracture and be replaced, in whole or in part, by some substitute or alternative coalition. Likewise, viability may be assessed in terms of the degree of satisfaction of the demands of the relevant participants at a particular point in time and obtaining over some duration of time. Nonetheless,

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<sup>76</sup> *Ibid.*



identification of these two problems, non-exhaustively, does not thereby eliminate the utility of the theory.

Perhaps even more persuasive is March's third critical difference; namely, that "the theory does not solve the problem of conflict by simple payments to participants and agreement on a superordinate goal. Rather it emphasizes the importance of policy demands and payments and of sequential rather than simultaneous mediation of demands."<sup>77</sup> Thus, the coalition theory does not pretend to resolve conflicts by reference to the superordinate goal of maximizing profit; instead, it seems to adopt a more processual goal, namely, seeking to attain an optimal level of achievement of participant objectives.

This is in accordance with our discussion of March's overall discussion of conflict systems in the immediately preceding section of this work under the heading "Competing Preferences Within the Firm, and Formation of Coalitions". Accordingly, an overall commitment to address participant demands and interests, whether or not all "put on the table" simultaneously or otherwise, permits participants whose demands and interests are not immediately addressed to maintain some confidence that their demands and interests will be addressed appropriately and "in due course". In turn, that might permit demands and interests that are more immediate or, if not more immediate, then at least more susceptible of being addressed and resolved more immediately, to be resolved at an earlier point in time, and thereby permitting some rational and orderly approach to resolution of these conflicts.

Fourthly, March argues that the coalition theory "emphasizes the importance of institutional constraints on the solution of the coalition problem" and, most conspicuously "constraints imposed (1) by the institutionalization of commitments through the organizational structure, precedents, and budgetary agreements, (2) by the reification of attachments through identification and indoctrination, and (3) by the limitations in coordination and control imposed on an executive".<sup>78</sup> The first point, the institutionalization of commitments, refers to ways in which commitments are instantiated in the structure and process of the organization. For example, revenue or profit targets of a particular division or business unit may be considered to be "stretch targets" aimed at

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<sup>77</sup> *Ibid.*

<sup>78</sup> *Ibid* at 675.

motivating the division or unit but considered to be realizable in ideal conditions, or they may be considered to be “soft” or “hard” commitments, failure to realize which may result in actions of different intensity, perhaps expressed in top-down imposition of remedial efforts, and perhaps expressed in actions of a more penal nature.

The reference to reification of attachments through identification and indoctrination addresses means of securing commitment of individuals and intra-organizational groups, such as divisions or business units, to more and less immediate reference groups. March’s reference to the limitations on an executive’s ability to exercise coordination and control refers not only to bounded rationality itself but also to the boundedness implied by information asymmetries as between one organizational level and another, including the “filtering” of information by information providers and the failure of information seekers to identify adequately the information being sought.

March’s coalition theory implicates the nature of human action in ways in which the neoclassical model of the firm does not. The firm is constituted by individuals, members of a coalition, not just by a reified atomistic individual. Assumptions of complete rationality and full information, while not excluded from this model, are not explicitly included, and may be considered to be implicitly absent. Hierarchies of demands and goals are implicitly recognized. Social interaction is not only not irrelevant to this model, but is actually assumed.

Bargaining may take into account non-monetary considerations: that is to say, it is recognized that non-economic goals and objectives may motivate the behaviour of actual and potential coalition participants. In fact, these goals and objectives may include “personal treatment” and possibly other “personal” considerations. These may even extend to social or affiliative motivations, including desires for social association, and for the formation and continuation of personal and professional relationships.

We have previously remarked upon the logical gulf between neoclassical theory of the firm and empirical observation of the firm, or, as we may say, between the firm as theorized and the firm in action. March claims empirical support for the coalition theory, indicating that it is “more consistent than other available theories with the following widely observed attributes of business decision making”, indicating that “1. Organization goals seem to be a series of more or less

independent constraints.”<sup>79</sup> This suggests that many organizations do not appear to have superordinate goals, but, instead, appear to have a number of official and operative goals, as well as instrumental goals, without necessarily appearing to be obviously arrayed in some more or less permanent hierarchy. As discussed, some of these goals may appear or disappear or require greater or lesser salience over time.

Indeed, March’s second claim, which he asserts provides support for the political coalition theory, is that “2. Business firms seem to tolerate a rather large amount of apparent inconsistency in goals and decisions, both over time and from one part of the organization to another.” Further, “3. Goals and decisions tend to be paired and decentralized with loose cross connections.” That is to say, goals and decisions purportedly made in pursuit of the same are often goals of, and decisions relating to, the subject-group under consideration. In short, various intraorganizational components and constituents may adopt goals and may take decisions in behalf of such goals that are not shared by the organization as a whole, by higher-order components and constituents, at least widely, perhaps, or that may be shared only by components and constituents having direct contact with the subject-group, either by responding to, or having responsibility for, the sharing group (i.e., immediately above or below it in the hierarchy), or on the same level in the hierarchy.

March also draws attention to a subject already identified in our discussion: “4. The extent to which decisions within the firm involve extensive conflict and "marginal" decisions varies with the munificence of the environment.” Again, as we have observed previously, resources which are more widely in demand by organizational components and constituents are likely to be the subject of greater contestation than others.

Finally, March notes that “5. The goals and commitments of business firms shift slowly over time in response to shifts in the coalition represented in the firm.” In other words, changes in goals and commitments tend to be made incrementally, as expressions of shifting consensus of the relevant coalition. For example, an increase in the power of one component or constituent group, perhaps by reason of its control of a resource of critical and increasing importance to the firm, may result in a change in goals and commitments that might be amended or reversed if that resource ceases

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<sup>79</sup> *Ibid.* The remaining four points which March mentions, and which are quoted here, also appear on that page.

to be controlled by the instant group, or if the importance of that resource the firm reduces, or if that resource ceases to be critical to the firm.

March concludes that “The fact (if it is one) that a description of a business firm as a political coalition is a more valid description than the classic economic description of the firm as an entrepreneur does not, however, solve the theoretical dilemma posed by the classic problems of analysis. For many years, economists as well as others have belabored the point that firms are organizations rather than entrepreneurs; only in the last few years have such strictures had any impact on the theory of the firm.”<sup>80</sup> In effect, more than fifty years ago, March was lamenting the failure of the theory of the firm to incorporate organizational analysis.

March avers that “we are now in a position to explore the implications of viewing the firm as such a coalition” by means of process-descriptive models (often computer-based modelling) and to “introduce such ‘political’ features as unremediated conflict, multi-dimensional goals, and sequential attention to sub-unit pressures.”<sup>81</sup> In his view, at that time, analytical and computational tools had become available to investigate the internal processes of the firm. Of course, the political coalition model advanced by March has some similar elements to the “nexus of contracts”<sup>82</sup>, evolutionary economics,<sup>83</sup> and “team production”<sup>84</sup> theories of the firm advanced by later authors; however, these are beyond our present scope of discussion.

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<sup>80</sup> *Ibid* at 675.

<sup>81</sup> *Ibid* at 677.

<sup>82</sup> As explicated by Michael C Jensen and William H Meckling, for example, in “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure” (1976) 3 J Financial Economics 305. Others dispute whether this is a theory of the firm or “a theory of agency costs within firms”: Edward B Rock and Michael L Wachter, “Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation” (2001) 149 U Pa L Rev 1619 at 1624. Still others argue that nexus of contracts theory is a theory of agency costs within a certain type of firm, whose boundaries it fails to define. See Oliver Hart (1989), *supra* note 5 at 1759.

<sup>83</sup> As explicated in early work by Armen A Alchian in “Uncertainty, Evolution and Economic Theory” (1950) 58 Journal of Political Economy 211; and Arman A Alchian and Harold Demsetz, “Production, Information Costs, and Economic Organization” (1972) 62 American Economic Review 777; and by other leaders in the field, such as Richard Nelson and Sidney Winter, whose contributions are discussed under the next heading of the present work.

<sup>84</sup> As explicated in early work by Alchian, *supra* note 83, and by Alchian and Demsetz, *supra* note 83; and in later work by Margaret M Blair and Lynn A Stout, such as “A Team Production Theory of Corporate Law” (1999) 85 Va L Rev 247.

## FORMS OF CORPORATIONS – LEGAL AND ORGANIZATIONAL VARIANTS

Chapter Two investigated the origins, development, and characteristics of the multidivisional corporation, sometimes referred to as the “multidivisional enterprise”, the “M-form corporation”, and as instantiating the “M-form” characterizing many modern business corporations. The earlier part of the present chapter has considered the extent, if any, to which those descriptions conform to neoclassical and classical economic theory of the firm. Alternative social and political perspectives have been considered, by way of comparison to the economic theory of the firm and otherwise, in an attempt to determine the extent, if any, to which such alternative theories of the firm conform with the description of the modern business corporation and, in particular, the MDC, presented in the previous chapter.

A work such as the present one cannot hope to do justice to the various theories which have been developed to date concerning the operations of the modern business corporation and the research related to various theoretical streams which has been conducted to date. However, some of these theoretical and research streams are mentioned below for the purpose of demonstrating the underpinnings of the theory or perspective advanced in this work, namely, that which is referred to here as “corporate theory” and as “corporate governance”. This perspective, which will be more fully addressed in the next chapter, acknowledges that the corporation as a separate legal entity is, at the same time, a grouping of human beings, that is, an organization, which adopt certain structure and processes in an effort to accomplish certain goals and objectives.

### Unitary or U-Form Corporations

#### *Unitary Corporations and Economic Theory*

The basic “form” of the firm and the one closest to that posited in neoclassical theory is the unitary corporation. Sidney Winter, a leading exponent of evolutionary economics, discusses what he identifies as the “orthodox view” of the firm,<sup>85</sup> a perspective of orthodoxy employed in the book that he co-authored with Richard R. Nelson,<sup>86</sup> namely, that: "Orthodox economic theory is the theoretical view that dominates the leading textbooks of intermediate microeconomics, together

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<sup>85</sup> Sidney G Winter, "On Coase, Competence, and the Corporation" (1988) 4 JL Econ & Org 163.

<sup>86</sup> RR Nelson and Sidney G Winter, *An Evolutionary Theory of Economic Change*. (Cambridge: Belknap Press of Harvard University Press, 1982).

with the extensions and elaborations of that basic viewpoint found in more advanced work.”<sup>87</sup> This definition of “orthodoxy” is similar to the rough working perspective adopted in the present work, as is his summary of the orthodox view of the firm.

Winter identifies the basic elements of that orthodox view of the firm as follows: “Firms are characterized by the technological transformations of which they are capable - formally, by production sets or production functions. Like consumers, firms are unitary actors and are economically rational; more specifically, they maximize profit or present value. They deal in markets for homogeneous commodities; in almost all cases these appear to be contemporaneous spot markets for inputs and outputs. Contractual arrangements and other institutional supports for the functioning of the business firm are, one infers, assumed to be sufficiently close to being flawless and costless so as to justify the virtually total absence of discussion of these topics.”<sup>88</sup>

As previously mentioned in this work, this classical or neoclassical, that is to say, “orthodox”, view of the firm is, in essence, an explanation of the production function. It relates to the generation of the “supply” curve in orthodox economics. Winter arrives at a similar conclusion, observing that “[t]he discussion focuses on how firms, guided by market forces, make the production decisions that form a part of the answer to the overall social resource allocation problem. It is about inputs and outputs and how they relate to the given technology, to each other, and to market forces.”<sup>89</sup> As maintained previously in this work, this emphasis on input and output factors generally excludes attention to organizational structures and processes. It should be noted, however, that even that “production function” explanation of the firm has to take account of technological development, certainly a human artifact.

A slightly different perspective is taken by Harold Demsetz, who focuses on the importance, to the point of preoccupation by economists, he says, of traditional price theory to the theory of the firm.<sup>90</sup> He argues: “[The] “Firm” in the theory of price is simply a rhetorical device adopted to facilitate discussion of the price system”, in which the only real task of management, “which is the

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<sup>87</sup> *Supra* note 85 at 64. Taking account of developments then in process, he refers to such theory, at p. 165, as what the orthodox theory of the firm *has been*.” Emphasis in the original.

<sup>88</sup> *Ibid.*

<sup>89</sup> *Ibid.*

<sup>90</sup> Harold Demsetz, “The Theory of the Firm Revisited” (1988) 4:1 *JL Econ & Org* 141 at 141.

focus of attention in the firm of traditional price theory, is the selection of profit-maximizing quantities of outputs and inputs".<sup>91</sup> These subjects have been discussed in previous chapters and, in more detail, in Appendix B.

The present section investigates the assumption that firms are unitary actors. It has been argued, *inter alia*, that this assumption is integral to the assumption of neoclassical economics, or as what Nelson and Winter describe as the "orthodox viewpoint in economic theory", namely, that firms are, in effect, or, at least, may be treated for analytical purposes as if they were, reified individuals.

We have previously argued that an assumption of atomistic individuals rationally pursuing their own needs and desires constitutes a formidable barrier to considering individual behaviour as involving associative or affiliative aspects and aspirations. We have argued that authors making such an assumption often cite utilitarian sources; however, we have provided arguments that cast doubt on the veracity of such authority. We have argued that even Hobbes, Locke and other utilitarians did not deny or even doubt that humans need the society of others.

Our arguments find support from Winter and others. Winter claims that Western economic thought generally adheres to the principle of methodological individualism, which "disallows, or at least warns against, the practice of grounding theories on assumptions about the behavior of social groups, organizations, or institutions."<sup>92</sup> He cites as a "careful and restrained explication of the principle" the fact that "Although in modern economics, collections of individuals are sometimes treated as "entities" for analytical purposes (examples of "the household," "the firm," and even occasionally "the state" spring to mind) the *ultimate* unit of analysis is always the individual; more aggregative analysis must be regarded as only provisionally legitimate. In other words, the economist is always sensitive to the possibility that the holistic treatment of groups of individuals may mislead greatly, or involve overlooking dimensions of reality that are extremely important."<sup>93</sup>

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<sup>91</sup> *Ibid* at 143.

<sup>92</sup> *Supra* note 85 at 165.

<sup>93</sup> *Ibid* at 166 [note omitted] [emphasis in the original]. The quote is attributed to: G Brennan and G Tullock, "An Economic Theory of Military Tactics: Methodological Individualism at War" (1982) 3 *Journal of Economic Behavior and Organization* 225 at 225.

In the result, economists generally consider group demand to be the aggregate of the individual demands of the individual members of the group. Criticisms of methodological individualism and the difficulties which it presents in relation to aggregation of demand are discussed above. Winter argues that economists routinely avoid discussing the demand behavior of “the household”, presumably as an aggregation of consumers who are its members, preferring instead to discuss that of “the consumer”. However, he maintains that “[i]n the case of the firm, however, the opposite choice is made and often with little or no apology”, saying that “[t]his dedication to methodological individualism - and, relatedly, to the study of noncooperative equilibria - is abruptly suspended when the workings of the firm itself are discussed. There, fully cooperative relations among the diverse economic interests organized in the firm are routinely, though implicitly, assumed to be easily achieved through voluntary exchange.”<sup>94</sup>

The present work has objected to exactly this aspect of neoclassical theory. If the firm is only the individual operating in the economic sphere or with respect to economic activities, then we have asked why a separate identity should be created for that person in that sphere or with respect to such activities. Of course, we have previously critiqued the notion that the economic sphere of activities is distinct from other spheres of activities, including social and political activities.

Why should A be considered as AA or as B when the only logical distinction that can be identified is the sphere or field in which that person acts? And if this is the case with respect to the economic sphere, one might expect it to be the case in each separate sphere or with respect to each activity in which the individual concerned may be said to act. This conflicts not only with the principle of self-identity, but also philosophical economy (Ockham’s razor) and runs the risk of abandoning abstraction and generalizable knowledge in favour of nominalism.

### ***The Sole Proprietorship, the Monadic Individual, and the Theory of the Firm***

Winter points to a particular trajectory in the development of the concept of the firm as a result of the historical dominance of methodological individualism: “In classical economics, individualism reigned supreme in the theory of the firm as it did elsewhere. The dominant view of the firm, reflecting the historical context, was that of the small enterprise organized as a sole proprietorship

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<sup>94</sup> *Supra* note 85 at 166.



– or, if not that, at least in a form in which "the firm" is no more problematic in its relation to individualism than is "the household." As much care was taken in uncovering the different economic roles that might be combined in "the entrepreneur" as in discussing the problems that arise if the roles are divided among many individuals."<sup>95</sup>

In effect, the dominance of the sole proprietorship as a form of business enterprise over many years made it so difficult to conceive of the "separation of ownership and control," that Winter says that "there was so much skepticism regarding the viability of such arrangements as to make detailed discussion of them unnecessary."<sup>96</sup> As an example, he references John Stuart Mill, who said that: "Management, however, by hired servants, who have no interest in the result but that of preserving their salaries, is proverbially inefficient, unless they act under the inspecting eye, if not the controlling hand, of the person chiefly interested: and prudence almost always recommends giving to a manager not thus controlled a remuneration partly dependent on the profits; which virtually reduces the case to that of a sleeping partner". Winter encourages readers to "[n]ote that it is the owner who becomes the "sleeping partner," and the enterprise itself is thus associated directly with the individualistic interests of the hired management."<sup>97</sup>

Of course, as indicated previously in this work, the suspicion, not to say hostility, of utilitarian and related theorists towards non-manager owners of firms and towards nonowner managers of firms pre-dates John Stuart Mill, and extends at least as far as Adam Smith, whose remarks on the subject accord with the quotation above. It will be recalled that he expressed a similar concern about joint stock companies.<sup>98</sup>

Winter's comparison of the relationship between the individual (who is not a sole proprietor) and the firm with that obtaining between the individual and the household is telling. The ways in which the term "household" are employed, as previously discussed, suggest that the term refers to more than one individual, with the result that a household cannot be composed of a single individual;

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<sup>95</sup> *Ibid.* He cites: JS Mill, [1848: 1899]. *Principles of Political Economy*, v. 1. (New York: The Colonial Press), Book II, Ch. XV.

<sup>96</sup> *Supra* note 85 at 166.

<sup>97</sup> *Ibid* at 166-167.

<sup>98</sup> Indeed, Winter there (in footnote 6) cites Smith's comments in *The Wealth of Nations* on joint stock companies, saying, in effect, that where directors have little or no capital at stake, negligence and appropriation of benefits "must always prevail, more or less, in the management of the affairs of such company".

however, the very concept of “the firm” in neoclassical theory suggests exactly the opposite. It as if some subtle elision of meaning was involved.

In terms of what Winter calls the orthodox view of the firm, he argues that: “No major technical difficulty stands in the way of developing the theory of the firm explicitly as a theory about individual entrepreneurs. There are a few unfamiliar issues to be dealt with – such as how the idea of “profit maximization” is to be adapted to allow for the income-leisure tradeoff of a utility – maximizing consumer whose work is running his business. Minor modifications to the familiar structure of general equilibrium theory would be required. Production sets would enter the theory associated with consumers; presumably there would be an axiom denying the possibility of output without an input of some of the consumer's own time - that is, without a positive level of “entrepreneurial activity” by that consumer.”<sup>99</sup> This certainly involves significant complexity as compared with the simple device of reification of the individual entrepreneur as the “firm”. Of course, that is not to say that it is not more efficacious.

In final, Winter concludes that “[t]his development of the theory of the firm would be consonant with methodological individualism – not to speak of the nonmethodological aspects of economic theory's association with individualism.”<sup>100</sup> Thus, consistently with his evolutionary economics perspective, Winter asserts that the theory of the firm could have developed as a theory about individual entrepreneurs.

In that case, the behaviour of the firm could have been readily attributable to the individual and there would have been no need to assert a separate identity to that individual when acting in the economic sphere. Moreover, the assumptions of perfect rationality and complete information could have been more readily questioned. A supposition that individual entrepreneurs hired employees, or that individual entrepreneurs, acting as owners, hired other individuals to act as managers and as employees might also have more readily surfaced questions about the nature of the relationship between owner and manager, between manager and employees, and between owner and employees. Questions about firm behaviour, and about the boundaries of the firm, might have been

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<sup>99</sup> *Ibid* at 167.

<sup>100</sup> *Ibid*.

simplified by such an approach. However, such approach did not find favour sufficiently widely to become generally accepted; instead, neoclassical theory dominated.

### ***Characteristics of the Unitary or U-Form Corporation***

It is clear, however, that neoclassical theory does not assist much in interpreting the behaviour of even a relatively simple firm. The “unitary corporation” or “U-form corporation”, as described by Alfred Chandler<sup>101</sup> and Oliver Williamson<sup>102</sup>, is an enterprise that operates in a single product line, or in multiple but related product lines. As described in Chandler’s studies, it is vertically integrated and has a structure that involved central administration through various functional departments.<sup>103</sup> As we have observed previously, even Chandler’s empirical characterization of such a relatively simple corporation engaged such concepts as administration, strategy, structure, and processes, which are outside the purview of neoclassical economics, or of Winter’s “orthodox viewpoint” of the economic theory of the firm.

A simple corporation might be expected to have field units, department offices, divisional offices, and a general or head office. The separate functions, such as manufacturing, sales and marketing, purchasing, engineering, research, finance, might have separate field units or some one or more of the separate functions may be co-located with others in a local office. These functions may have departmental offices at a higher level. Similarly, they may have divisional offices based on geographic considerations, for example, country or regional (more than one country) offices.

Neil Fligstein treats organizations that are divided functionally or geographically as distinct from simple unitary forms, saying: “The unitary form implies an organization divided into manufacturing, sales and marketing, and finance departments. Functional organization implies departmentalization along discrete task lines. An example is oil companies, which were often organized into drilling, shipping, refining, and retail departments which reflect the flow of the

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<sup>101</sup> Neither expression is used in either of Chandler’s two main works.

<sup>102</sup> Oliver D Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications*. (New York: The Free Press, 1975).

<sup>103</sup> While described by Chandler in his earlier works, Chandler credits Oliver Williamson as originating the expressions “unitary corporation” or “U-form”, in Chapter 3 of his book *Markets and Hierarchies*, *supra* note 53. See Alfred D Chandler, Jr, “The M-Form: Industrial Groups, American Style” (1982) 19 *European Economic Rev* 3 at 5. That article contains a useful discussion of what Chandler describes as a variation on the M-form: the conglomerate.

product through various stages. Geographical forms reflect businesses demarcated into departments along geographical divisions.”<sup>104</sup>

Accordingly, the considerations of goal differentiation and goal congruity among different levels and functions of the organization are significant even with respect to the simple unitary or U-form corporation. Still more significant are they with respect to M-form corporations, to the discussion of which we now turn.

## **M-Form Corporations**

### *Characteristics of M-Form Corporations*

Writing in 1985, and surveying the development of multidivisional corporations during the period from 1919 to 1979, Fligstein presented evidence that the multidivisional form, or M-form, corporation had become the “preferred organizational form for the large firms that dominate the American economy”.<sup>105</sup> About it, he said: “The multidivisional form (hereafter “MDF”) is a decentralized management structure. Firms are organized into product divisions and each division contains a unitary structure. There also exists a central office where long-range planning and financial allocations are located. These are, of course, ideal-typical descriptions and some firms contain multiple structures, for instance, functional and divisional or geographic and divisional.”<sup>106</sup> That is to say, in an MDF or M-form corporation, each division is organized into functional departments such as, manufacturing, sales and marketing, and finance, as if each division was a separate unitary corporation, but not necessarily possessing separate legal form.

Fligstein neatly summarizes Chandler’s observed relationship between strategy and structure, saying that “Chandler identifies three basic strategies: horizontal: vertical: and diversification (of which there are two types, product related and unrelated). A horizontal strategy implies growth in markets which can be local, national, or multinational. A vertical strategy implies absorbing functions that are either backwards toward suppliers or forwards toward ultimate consumers.

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<sup>104</sup> Neil Fligstein, "The Spread of the Multidivisional Form Among Large Firms, 1919-1979" (1985) 50:3 *American Sociological Rev* 377 at 378.

<sup>105</sup> *Ibid* at 377.

<sup>106</sup> *Ibid* at 378. His cite is to Alfred D Chandler, Jr, *Strategy and Structure: Chapters in the History of the Industrial Enterprise* (Boston: MIT Press, 1962) at 13.

Diversification is the decision to enter into related or unrelated markets. Chandler's thesis is that a horizontal strategy produces a unitary structure, while a vertical strategy produces a functional structure. Finally, the decision to enter into related or unrelated product lines produces the multidivisional structure.”<sup>107</sup>

### ***Historical Development of M-Form Corporations***

Chandler had described the advent of what he called “the multidivisional enterprise” (which we will sometimes abbreviate here as “MDE”) and is often, today, called “the multidivisional corporation” (or “MDC”), largely by reference to the expansion of, and advances in, technology, including power generation, transportation and communications, expansion of urban concentration of population, and continuous process manufacturing. “In these new industries (the electrical automobile, chemical and electronic) and in the older industries which were revolutionized by changing population and technology (the rubber, petroleum, agricultural implement and other power machinery, and the chain-store and mail-order businesses), the leading enterprises became faced with increasingly complex administrative problems. And it was in these industries that the leading firms turned to managing their activities through the new multidivisional, "decentralized" structure.”<sup>108</sup>

Chandler indicated that the “inherent weakness in the centralized, functionally departmentalized operating company” involved the resulting increase in the administrative load placed on senior executives “to such an extent that they were unable to handle their entrepreneurial responsibilities sufficiently”. He claims: “This situation arose when the operations of the enterprise became too complex and the problems of coordination, appraisal, and policy formulation too intricate for a small number of top officers to handle both long-run, entrepreneurial, and short-run operational administrative activities.”<sup>109</sup> Accordingly, “the innovators built the multidivisional structure with a general office whose executives would concentrate on entrepreneurial activities and with autonomous, fairly self-contained operating divisions whose managers would handle operational ones.”<sup>110</sup> Removing them from operational duties gave the executives “the time, information and

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<sup>107</sup> *Supra* note 104 at 378.

<sup>108</sup> *Supra* note 103 at p. 42.

<sup>109</sup> *Supra* note 106 at p. 299.

<sup>110</sup> *Ibid.*

even psychological commitment for long-term planning and appraisal” for the organization as a whole, and changed the lens through which such executives viewed the corporation as a whole, for: “Relieved of operating duties and tactical decisions, a general executive was less likely to reflect the position of just one part of the whole.”<sup>111</sup>

These leading companies, of course, were closely studied and their development described in *Strategy and Structure*. As Chandler indicated there: “In those industries most affected by the new markets and new technology, growth came more by going overseas and still more by diversification. Of these two strategies, diversification was far more responsible for the adoption of the “decentralized” structure than overseas expansion. Diversification came when leading companies in these technologically advanced industries realized that their facilities and the scientific knowhow of their personnel could be easily transferred into the production and sale of new goods for new markets. For those enterprises whose energies were concentrated primarily in merchandising, diversification came because of the changing markets in the city and then in the suburbs.”<sup>112</sup>

Here, Chandler asserts that leading companies responded to changes in the environment; however, he also advances the theory that these leading companies developed demand in order to facilitate the continuous production of which their factories were then capable, and to derive concomitant efficiencies. As we have previously noted, he described how: “Growth through diversification into several lines increased the number and complexity of both operational and entrepreneurial activities even more than a world-wide expansion of one line. The problems of obtaining materials and supplies, of manufacturing and of marketing a number of product lines for different types of customers or in different parts of the world made the tasks of departmental headquarters exceedingly difficult to administer systematically and rationally. The coordination of product flow through the several departments proved even more formidable.”<sup>113</sup>

As well as coordinating resource operations, manufacturing, sales and distribution, higher order management activities, such as analyzing and improving operational performance, which he refers

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<sup>111</sup> *Ibid* at 310.

<sup>112</sup> *Ibid* at 42-3.

<sup>113</sup> *Ibid* at 44.

to as “appraisal”, also became requisite and much more complex: “Appraisal came to involve not only a constant intelligent analysis of the operating performance in the different economic functions, including engineering and research as well as production, distribution, transportation, the procurement of supplies, and finance, but the making of these appraisals in several very different industries or lines of business. Long-term strategic planning not only called for decisions and action concerning the future use of existing facilities, personnel, and funds, and the development of new resources in the company's current lines, but also involved decisions on entering into new lines of products and dropping or curtailing old ones.”<sup>114</sup>

Chandler draws attention to the fact that what he calls “appraisal”, or analysis of operating performance, came to embrace, in the case of the MDE, not only different functional areas, but also different lines of business and even different industries. Consequently, it required highly developed and specialized skills. This is also the case with respect to strategy. Not only were decisions required with respect to the application of existing, and acquisition of new, resources, but also with respect to products, lines of business, and industry exposure. Development of strategy progressed to the level at which management and Board of Directors had to consider the threshold question: what business or businesses should we be in?

Despite these challenges, “by placing an increasing intolerable strain on existing administrative structures, territorial expansion and to a much greater extent product diversification brought the multidivisional form. Du Pont, General Motors, Jersey Standard, and Sears, Roebuck first devised the new type in the 1920's.”<sup>115</sup> Chandler indicates that adoption of this structure became widespread in the massive economic expansion following World War II.

### ***Development as Organizational Response to Bounded Rationality***

In effect, Chandler indicates, without specifically identifying the mechanisms concerned, that this development, the MDF, responded to limitations of human behaviour, both individual and collective. The atomistic perfectly rational entrepreneur possessing all relevant information and acting upon it with full knowledge of how to maximize his profits (or utility) posited by

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<sup>114</sup> *Ibid.*

<sup>115</sup> *Ibid.*

neoclassical economics had been left well and truly behind in the instantiation of “the firm” in the empirically observed economy by the time Chandler wrote. Chandler forecast, in 1962, the extension of some variation of the multidivisional structure to many large American enterprises. This actually eventuated, as Fligstein demonstrated.

Putting aside for later discussion the complications introduced by operating in different countries, as many M-form corporations actually do, we may observe that other explanations have been introduced for the introduction and spread of the M-form corporation. Fligstein investigated these and found that the most likely explanation was that “those in control of large firms acted to change their organizational structures under three conditions: when they were pursuing a multiproduct strategy; when their competitors shifted structures; and when they had a background in the organization such that their interests reflected those of the sales or finance departments.”<sup>116</sup>

Fligstein concluded that Chandler’s view was supported by his results, but thought that Chandler underestimated the role of actors within an organization in advancing a particular model of its growth; that he overestimated the ability of actors to interpret the external environment and develop rational and efficient responses; and that he ignored the tendency of organizations operating in a particular environment to examine others and to adopt similar responses.<sup>117</sup> In effect, Fligstein argues that the expansion of the MDF depended, in part, on something which Chandler would consider to be part of the structure of the organization, namely, the lines of authority, communication, information, and decision making, which we have described here as involving the organization, implementation and operation of processes.

Again, such analysis of empirically derived observations suggests that there are multiple actors within the firm, interpreting information, and generally acting, with limited or bounded rationality,

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<sup>116</sup> *Supra* note 104 at 388.

<sup>117</sup> *Ibid* at 388. The second finding supported theories about the use of power in organizations, as expressed by authors such as Meyer Zald and Charles Perrow, Pfeffer and Salancik, previously mentioned in this work. The third finding supported the organizational homogeneity or mimesis theory advanced by Paul DiMaggio and Walter Powell in their influential article “The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields” (1983) 48:2 *American Sociological Rev* 147. Fligstein found no support for Oliver Williamson’s transaction cost approach or for the population-ecology theory of Michael Hannan and John Freeman, as expressed in their article “The Population Ecology of Organizations” (1977) 92 *American J Sociology* 929, and their article “Structural Inertia and Organizational Change” (1984) 49 *American Sociological Rev* 149, concerning the effect of the age of organizations on their receptivity to organizational change.



and exercising power or authority, in order to effect a preferred result. The options for action and for organizational change that are available to these organizational actors will, among other things, position the organization, as a matter of interpretation, within its environment: “First, someone in the organization must interpret the internal and external environment of the organization... Second, these actors' interpretations will reflect their structural positions, and their solutions will reflect the interests of those structural positions... Third, the actors must have some resource base either within the organization or the environment whereby they have the power to enforce their solution in the organization.”<sup>118</sup>

It is apparent that interpretation of the internal and external environment may not be entirely veridical: this is assured by limitations on perfect rationality, including limitations on information and calculative capacity. Further, the structural positions of relevant actors affects not only the information available to them, but also their interpretation of such information, including their respective biases and interests. For example, Chandler mentions background and interests as one of the three determinants of the likelihood of adoption of the M-form structure. Fligstein indicates that this “model of organizational change does not imply that the most important organizational problems are being solved. Instead, it suggests that actors have to construct such problems, have the claim to solve those problems, and be able to implement their solutions.”<sup>119</sup>

In effect, the background and experience of participants in the relevant decisions may affect the interests that they seek to advance or accommodate in connection with the decision. Someone has to interpret internal and external environments, decide when the organization should take some action, and determine what action to take. These observations indicate the necessity of considering the dispersal of power and influence within the organization, which topic is left for later discussion.

### ***Mimesis and Institutional Isomorphism***

One factor which Fligstein mentions as conducive to the spread of the MDF was the adoption of that form by competitors. It is often considered that adoption of certain practices widely within a particular industry may represent a determination as to the appropriateness of the particular

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<sup>118</sup> *Supra* note 98 at 389.

<sup>119</sup> *Ibid* at 388-9.

practice in that industry, such that departure from that practice may be seen as idiosyncratic or aberrant behaviour, and which may, in turn, affect widely held perceptions as to the quality of management. In their classic work, "The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields",<sup>120</sup> Paul DiMaggio and Walter Powell described how this mimetic tendency among organizations would often lead to what they called "institutional isomorphism".

Fligstein neatly summarizes their position as arguing "that large organizations are likely to come to resemble one another due to three kinds of pressures in their environments. First, organizations may be forced to conform structurally because of the cultural expectations of competitors, suppliers, or the state. Second, when organizations face uncertainty in the environment, they may self-consciously mimic other, more successful, organizations. Finally, the professionalization of managers tends to create a particular world view of appropriate organizational behavior. This could act as a force to produce organizational homogeneity."<sup>121</sup>

DiMaggio and Powell's "institutional isomorphism" thesis also receives support from Fligstein's research, particularly as to the behaviour of key actors. He claims: "Any theory of organizational change must also take into account the fact that the leaders of organizations watch one another and adopt what they perceive as successful strategies for growth and organizational structure. The picture one obtains is that organizational change will occur in a murky environment guided by what key powerful actors perceive and their abilities to implement change. Their ideas will be disseminated if key actors in other organizations perceive that the innovation is successful."<sup>122</sup>

In effect, the information considered by leaders of organizations in assessing the environment, identifying changes in the environment requiring a response, and in deciding the nature of the response, including possible changes in the strategy and structure of the organization, includes information relating to how leaders of similar organizations, then successful, are adapting their organizations to similar ambient changes. One leading interpreter of Chandler's work, Mira Wilkins, attributes the diffusion of the M-form partly to American management consultants

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<sup>120</sup> Paul J DiMaggio and Walter W Powell, "The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields" (1983) 48 *American Sociological Rev* 147.

<sup>121</sup> *Supra* note 104 at 380.

<sup>122</sup> *Ibid* at 389.

familiar with it.<sup>123</sup> Fligstein also notes that the MDF became the accepted form of organization for large corporations, and that business schools taught the MDF as an important organizational tool.<sup>124</sup> In effect, the MDF was seen as having contributed to the success of leading organizations and was emulated for that reason.

Fligstein's study of the dispersion of the M-form from 1919 to 1979 showed that while the percentage of the largest American firms which had adopted the MDF reached 84.2 percent by 1979,<sup>125</sup> the rate of its adoption varied by decade and by industry. Thus: "The relationship between the spread of the MDF and Chandler's argument is confirmed. Industries where product-related strategies dominated, like machine, chemical, and transportation industries, adopted the MDF in large numbers relatively early; while industries that were more likely to be vertically integrated, like mining, metalmaking, lumber and paper, and petroleum, adopted the MDF later and to a lesser extent. Except for mining, metalmaking, and miscellaneous industries, all industries had high rates of adoption by 1979.... Food, lumber and paper, and petroleum industries all adopt the MDF, though they do so at a later date."<sup>126</sup> Fligstein concluded that his evidence supports the conclusion that "organizations actually come to resemble those around them" and that further "empirical analysis should establish whether the causes of the shift are due to strategy or mimicry."<sup>127</sup>

At least with respect to such a fundamental change as the adoption of an M-form structure, there is reason to believe that perfect rationality is not operative, but that, instead, decisions within the organization are affected by various aspects of human behaviour, included limited or bounded rationality, often operationalizing itself as mimesis, or either spontaneous and unconscious, or conscious, parallelism.

### **The Headquarters-Strategic Business Unit Relationship**

This chapter has maintained that organizations, including firms, or business corporations, may adopt formal and informal goals and objectives which are accepted by organizational constituents to varying degrees. In particular, groups within the organization may generate their own goals and

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<sup>123</sup> Mira Wilkins, "Chandler and Global Business History" (2008) 82:2 Business History Rev 251 at 251.

<sup>124</sup> *Supra* note 104 at 380.

<sup>125</sup> *Ibid* at 385.

<sup>126</sup> *Ibid* at 386.

<sup>127</sup> *Ibid*.

objectives which are, again, accepted by group members to different extents. This may also be the case with respect to subgroups.

In the case of a corporation which has adopted a functional form of organization, the various functions and subfunctions by which the corporation is organized into departments may be characterized as groups or subgroups. In the case of a corporation which has adopted a multidivisional form, each component strategic business units (“SBU”) or business unit (“BU”) may be characterized as a group within the organization, and the various functions and departments within the SBU may be characterized as subgroups, perhaps arrayed at various levels of the organization’s hierarchy. While a work such as the present one cannot thoroughly investigate organization-group-subgroup interaction, the discussion here of organizations as polities, joint preference determination, and of social and political action within organizations seems to require that at least a few modest examples be presented.

In this regard, a question which arises in respect of the management of an MDC concerns the optimal relationship between headquarters and individual SBUs. A related question concerns the optimal relationship among the SBUs as such. A 1987 study by Anil Gupta examined the relationship between different strategies pursued by SBUs and the nature and effectiveness of different relationships between the corporate or HQ level and the SBU level.<sup>128</sup> In effect, the study found that a decentralized relationship between the corporate level and the SBU was positively associated with SBU effectiveness, regardless of what strategy the SBU was pursuing. However, Gupta also found that the extent of the contribution of decentralization to performance was affected by the nature of the SBU strategies. That is to say, decentralization, while generally positive, could be more or less positive, depending on the strategy pursued by the SBU.<sup>129</sup>

Greater openness and transparency in the relationship between the corporate or HQ level and the SBU level, and greater subjectivity in the assessment of SBU performance (that is, not wholly quantitative but, rather, more qualitative, and nature) were factors found to be positively associated with SBU performance if the SBU was pursuing a competitive strategy of building market share

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<sup>128</sup> Anil K Gupta, "SBU Strategies, Corporate-SBU Relations, and SBU Effectiveness in Strategy Implementation" (1987) 30:3 *Academy of Management J* 477.

<sup>129</sup> *Ibid* at 495.

or of pursuing differentiation within the market. Where the SBU's strategy was to maximize short-term earnings or to pursue low cost, openness and subjective performance assessment were negatively associated with SBU performance.

These results suggest that a decrease in control over the SBU by HQ may often have positive results, while excessive control may produce negative effects. Similarly, where corporate executives find it difficult to fine-tune the degree of openness across all SBU so as to match the strategic context of individual SBUs, the results suggest that it is preferable to adopt a greater, rather than lesser, degree of openness across the board.<sup>130</sup> At the same time, because performance assessment and bonus determination is sensitive to the strategy of the SBU, the mix of formula-based assessment and subjective assessment should be fine-tuned with respect to each SBU. The present author suggests that a decrease in centralized control, signalling a greater level of autonomy and responsibility, particularly when combined with powerful SBU level incentives, may produce a high degree of motivation in the SBU to achieve a high level of performance in terms of results for BU goals, which are likely more immediate and the subject of greater identification by BU members.

Importantly, the present writer suggests that the business strategy assigned to, or selected by, management of the SBU may be a more important determinant of the optimal relationship between the SBU and HQ than is the preference of corporate or HQ level management. These results also suggest that overall corporate strategy may have some influence upon, but need not (and, often, should not) determine the strategy of each individual SBU. A corollary of this is that the particular strategies pursued by individual SBU's may not, and, perhaps, should not, be the same. As previously discussed, that SBU strategy must be responsive to the internal and external environment in which it is situated.

## **Relationships among SBUs**

### ***SBU Cross-Collaboration***

In 2010, Jeffrey A. Martin and Kathleen M. Eisenhardt reported on their study of six publicly-held software firms, each with multiple BUs (between two and six), with two firms in each of the three

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<sup>130</sup> *Ibid.*

industry segments: consumer, enterprise (business to business, or “B2B”), and infrastructure.<sup>131</sup> One of their key insights was that high-performing MDCs operate as complex adaptive systems in which effective collaborations emerge from small events within BUs, which are then honed by self-interested BU managers, and then implemented by loosely coupled modules. They say that this “rewiring” is likely to yield high-performing cross-BU collaborations.<sup>132</sup> That is to say, one ingredient in the success of MDCs is often that they function as highly effective learning organizations.

They found that a complex adaptive system of modular, unique, and partially connected BUs can be advantageous, especially in environments in which the pace of change normally occurs a relatively high level (“high-velocity environments”). This enables executives and MDCs to adapt to changing markets by adding, removing, and recombining resources of the corporation, both as the individual BUs evolve, and as corporate executives create new BUs, to shift mandates between BUs, and to eliminate, split, and combine existing BUs. It was found that cross-BU collaboration can facilitate this type of adaptation.<sup>133</sup>

Martin and Eisenhardt found that the most successful BU collaborations involved multibusiness teams of general managers, rather than HQ executives, as previously thought. HQ executives tended to propose multibusiness collaborations that addressed firm-wide issues, which are likely to provide less motivation to BU general managers than issues of more immediate concern to their own BU.<sup>134</sup> These general managers are motivated by formal incentives which reward BU performance and, as such, are relatively high-powered incentives, rather than firm-wide incentives, which reward performance at the corporate level and, as such, are relatively low-powered incentives.<sup>135</sup> They also found that positive social relationships among BU general managers aided in cross-BU collaboration but were not sufficient to ensure such collaboration. The same general managers participated in both high-performing and low-performing collaborations.<sup>136</sup>

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<sup>131</sup> Jeffrey M Martin and Kathleen M Eisenhardt, "Rewiring: Cross-Business-Unit Collaborations in Multibusiness Organizations" (2010) 53:2 *Academy of Management J* 265 at 268-269.

<sup>132</sup> *Ibid* at 266. See also 294.

<sup>133</sup> *Ibid*.

<sup>134</sup> *Ibid* at 278 and 277.

<sup>135</sup> *Ibid* at 293.

<sup>136</sup> *Ibid*.

Collaborative ideas that originated in a particular BU worked better. Often, they involved developing solutions to specific issues in their own business units. They were seen to improve quality, increase motivation, and improve the nature of the collaboration decision.<sup>137</sup> Among other things, unlike corporate executives, BU general managers lacked authority to “order” other BU general managers to collaborate and, accordingly, have to build support for collaboration in order for it to occur. Martin and Eisenhardt found that decisions to collaborate which are chosen by a decentralized multibusiness team are more likely to be high-performing. Similarly, collaborations which are implemented by a reconfigured team with few ties to particular BUs are more likely to be high-performing, as participants are highly motivated, and are able to refocus their attention from the BU to which they were previously attached and to the new collaborative team. These, and other factors improve collaboration quality and decision-making.<sup>138</sup>

Corporate, or HQ, executives were not effective in leading collaborations, although they contributed to collaboration where they removed barriers to collaboration, such as by contributing additional resources, or by eliminating incentives that pitted the general managers against each other.<sup>139</sup> Collaborations led by multibusiness teams of BU general managers played a central role in creating high-performing cross-BU collaborations, contributing not only the most current and relevant information, but also collective authority to lead such collaborations.

For purposes of the present work, this study is useful insofar as it demonstrates that superior hierarchical authority is not necessarily determinative of results. Orders “from on high” to collaborate were less effective than collaborations proposed by BU general managers. The study also shows that sub-corporate level goals and objectives, at least where related to compensation, can be much more effective determinants of sub-corporate level group behaviour, that is to say, BU behaviour, than corporate-level goals and objectives. Instead, it cannot be assumed that directives issued by higher organizational levels will necessarily be implemented in accordance with their terms at subordinate levels. Among the factors that may contribute to non-

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<sup>137</sup> *Ibid* at 266 and 293.

<sup>138</sup> *Ibid* at 293.

<sup>139</sup> *Ibid* at 295.

implementation are differences in goals and objectives at group and sub-group goals, and differences in motivations and incentives at the focal levels.

### ***SBU Coordination and Competition***

As has been suggested previously, BUs, in most cases, compete with other BU's in the instant MDC for resources, extensions of their mandates, certain types of exclusivity, and in other respects. However, MDCs often find it appropriate to coordinate BU activities in certain respects, including, as indicated in the previous section, sharing knowledge among BUs. As mentioned here, in some cases, in addition to competition for resources, BUs actually compete with other BUs within the same MDC for customers. This raises the question as to how external competition among BU's affects intraorganizational knowledge sharing.

Of course, it is not possible to investigate this matter thoroughly. However, a 2002 study by Wenpin Tsai may permit a glimpse of some of the issues involved.<sup>140</sup> His investigation involved a large MDC comprised of twenty-four BUs, in a variety of businesses. He found that formal hierarchical structure, represented by centralization, had a negative impact on intrafirm knowledge sharing, and, in particular, that the more control HQ exercised on its BUs, the less those BUs were willing to share knowledge with other BUs.<sup>141</sup>

This contradicted conventional wisdom that centralization enables coordination and integration throughout the organization and that, in a vertical structure, most information flows are mediated at the corporate or headquarters level. Tsai found that centralization imposed certain identifiable costs on the MDC, including, firstly, a tendency towards excessive or inappropriate headquarters intervention; secondly, a reduction in organizational productivity, due to the amount of time and effort required to be spent in influencing activities (that is, primarily in attempting to influence HQ); thirdly, poor decision-making due to the distortion of information in connection with influencing activities; and, fourthly, a loss of efficiency associated with the adaptation of structure and policies to increase control activities.<sup>142</sup>

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<sup>140</sup> Wenpin Tsai, "Social Structure of "Coopetition" Within a Multiunit Organization: Coordination, Competition, and Intraorganizational Knowledge" (2002) 13:2 *Organization Science* 179.

<sup>141</sup> *Ibid* at 186.

<sup>142</sup> *Ibid* at 187.



As previously noted, where lower levels in a hierarchy are charged with selecting, organizing, and transmitting information to superior levels, such as from a BU to HQ, or from a division to HQ, this information collation activity may have a significant effect on decision-making at the superior level. In this case, Tsai suggest that BUs not only expend time and effort in efforts to influence HQ towards the BU-preferred decision, but, as part of the process of influencing HQ, may also distort the information supplied to HQ, no doubt by selecting or emphasizing information favourable to the BU-preferred decision or by suppressing information unfavourable to such decision.

We can speculate that such BU preference may be expected to align in BU-preferred ways with BU goals and objectives and with high-powered incentives provided to BU members and managers, such as bonuses significantly focused on BU performance, rather than corporate level goals and objectives and lower-powered incentives intended reward performance of the corporate level. Again, we note that formal hierarchical power and authority may not always achieve the results anticipated, either by actors at the superior level, or by external observers and regulators.

Tsai also found that “informal lateral relations manifested in inter-unit social interaction show a significant positive effect on inter-unit knowledge sharing. Organizational units that interact with each other socially are likely to share knowledge with each other. The results confirmed the importance of inter-unit social interactions as an effective coordination mechanism in a multiunit organization.”<sup>143</sup> He indicates that sharing information or knowledge require social interaction to promote trust, increase cooperation, and reduce uncertainty about the merits of providing the knowledge of other units or acquiring new knowledge from other units.

Personal relationships between or among general managers of BUs participating in collaborations may facilitate relationships between or among such BUs, that is to say, such personal relationships may foster intraorganizational relationships. As has been observed in other studies discussed here such relationships may tend to diminish uncertainty in the instant situation, as well as in future situations, concerning the likely actions and motivations of such other BU general manager (s).

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<sup>143</sup> *Ibid.*

The study also investigated whether competition between or among BUs for internal resources and competition in the market external to the MDC had different effects on knowledge sharing. It found that intrafirm knowledge sharing in a decentralized environment was significantly strengthened by external (market) competition between BUs, but that centralization decreased knowledge sharing between such BUs.

We may observe that this might be expected, since the corporate level would lack proximate knowledge of the relevant bases on which the BUs compete and, thus, might share or “give away” BU knowledge that is relevant to those factors, thereby making it more difficult for the BU possessing such knowledge to compete with the knowledge-receiving BU. The BU possessing such knowledge may regard it as self-generated and, to that extent, proprietary to it alone. Further, the disclosure of such knowledge may adversely affect the knowledge-possessing BU’s performance and consequent receipt of incentives. On the other hand, BU-level determination as to what knowledge to share with other BU’s would not present this problem. The information-possessing BU would likely be in a better position than HQ to assess what information is already possessed by the BU proposed to receive such information, and, accordingly, what results may arise from disclosure of such information on the disclosing BU’s performance and incentives.

On the other hand, Tsai found that internal competition for resources of the MDC did not significantly affect coordination and intrafirm knowledge sharing, perhaps because in a highly diversified company, the knowledge of a particular BU concerning the extent of competition for internal resources may be less relevant to that BU than the factors affecting that BU and one or more other BUs in competing in the external environment. In effect, he found that MDCs, especially if highly diversified, “have to pay more attention to coordinating external market competition into coordinating internal resource competition.”<sup>144</sup>

Tsai indicates that “this research represents one of the first attempts to provide a structural view of cooptation and to explore the role of such cooptation in the context of a multiunit organization” which is itself conceptualized as a “social structure of cooptation”. Indeed, he maintains that scholars “have yet to carefully examine the structure of competition within firms”, that his research

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<sup>144</sup> *Ibid.*

as an initial step in this regard, and that the history and strategic priorities of the relevant organizations may affect the relative importance of external market competition versus internal resource competition.<sup>145</sup>

For the purposes of the present work, Tsai's study is notable in that it acknowledges that both competition and collaboration between or among business units are influenced not only by the formal structure of the MDC, as an organization, itself, but also by formal and informal structures and processes as between or among separate business units. As such, it acknowledges that MDCs are not commonly successful when they issue "top-down" or "command and control" type orders from the headquarters or corporate level, which are highly dependent upon social structures and processes, including cooperation and other forms of social interaction at the business unit level. Instead, as demonstrated by the Gupta, Martin and Eisenhardt, and Tsai studies, the goals and objectives of the several business units significantly impact the implementation of "orders from above", which is to say from the headquarters or corporate level.

Of course, an important factor relevant to the degree of deference shown by a business unit to the headquarters or corporate level of the organization is the power of the business unit with respect not only to the headquarters or corporate level, but also with respect to other business units. This factor will be discussed in the following section.

### **Power and SBUs**

The power which a business unit enjoys within the corporation as a whole, as well as its influence with respect to the corporate or headquarters level, and with respect to other business units, has been shown to depend upon a number of variables. As demonstrated previously, the power of a particular business unit is affected by the extent to which it exercises control over one or more resources critical to the corporation generally or to one or more other business units. The power of the particular business unit affects the extent to which the business unit can pursue its own goals and objectives while simultaneously pursuing those of the corporation as a whole. That is to say,

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<sup>145</sup> *Ibid* at 188.

groups or subgroups within the corporate organization may exhibit behaviours observed with respect to groups or subgroups within other types of organizations.

Thus, as maintained by Bouquet and Birkinshaw, a multinational enterprise or MNE can be seen as “an economically integrated economic institution that encourages members to continuously justify their existence within an emerging global hierarchy” and, the same time, as “a socially constructed community of subsidiary members that can only advance their cause with corporate headquarters if they are believed to adhere to a common set of strategic goals, norms, and values.”<sup>146</sup> It goes without saying that, generally speaking, a multinational corporation is normally a multidivisional corporation which has operations in jurisdictions other than that in which the multinational parent corporation is situated. Accordingly, it is expected that this characterization of the MNE would also apply, in general, to an MDC.

Bouquet and Birkinshaw, considering data with respect to 283 subsidiaries of multinational enterprises, investigated how business units weight goals, take initiative, pursue relationships, seek resource allocations, and change priorities, by seeking and attaining attention, power, and influence in ways similar to those employed by individuals in groups. They found that decisions of the corporate or headquarters level to “pay attention to” a subsidiary are based upon: firstly, the structural position of the subsidiary unit within a corporate system, which they call its “weight”; secondly the effectiveness of the subsidiary and exercising its own “voice” to attract attention at the corporate or headquarters level; and, thirdly, the moderating effect of the historical situation of the subsidiary, in terms of geographic distance and downstream competence, upon that voice-attention relationship.<sup>147</sup>

The first element, key components of the subsidiary’s weight in the MNE power structure are considered the strategic significance of its local market and the strength of the subsidiary within the MNE network.<sup>148</sup> As discussed, in an MDC which is not an MNE the strategic said significance of the “local” market served by the subsidiary may not be significant; instead, other factors may be relevant. The second element, voice, refers to the voice which the subsidiary is able to use in

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<sup>146</sup> Cyril Bouquet and Julian Birkinshaw, "Weight Versus Voice: How Foreign Subsidiaries Gain Attention from Corporate Headquarters" (2008) 51:3 *Academy of Management J* 577 at 581.

<sup>147</sup> *Ibid* at 578.

<sup>148</sup> *Ibid* at 580.

its relationship with headquarters to more significantly position its achievements within the corporate system, irrespective of weight considerations.<sup>149</sup>

Bouquet and Birkinshaw employ the concept of “positive headquarters attention” which they define as the “extent to which a parent company recognizes and gives credit to a subsidiary for its combination to the MNE as a whole”.<sup>150</sup> They found that this positive attention had three aspects: firstly, “relative attention”, which is “the perceived level of recognition and credit given to a focal subsidiary relative to the level given to other subsidiaries in an MNE” (often seen as a competition in a zero-sum game); “supportive attention”, namely, “the provision by a corporate parent of discretionary resources as a way to facilitate a subsidiary’s development”; and thirdly, “visible attention”, which is the “explicit recognition from its corporate parent of a subsidiary’s existence and achievements, expressed in media that are transmitted to a broad body of stakeholders.”<sup>151</sup>

They found that positive attention is likely to be more subjective and less stable than the strategic role of the subsidiary, defined as “activities a subsidiary performs and has responsible for within an MNE... [which] is typically established over a number of years, is widely communicated and understood in the organization, and changes relatively rarely”.<sup>152</sup> While there would be expected to be some correlation, on some occasions, a subsidiary might receive more or less attention than would be expected in view of its formal role within the organization, “perhaps because of recent changes in the subsidiary’s marketplace, or because of the specific initiatives it is pursuing”. Such positive attention can be distinguished from headquarters attention, generally having negative connotations, with respect to control and compliance. They also noted that “the subsidiary may receive *too much attention*”.<sup>153</sup>

They identified two complementary processes which shape headquarters attention: “a *top-down structural process* whereby attention is allocated according to a subsidiary’s weight in an MNE, and... a *bottom-up relational process* whereby attention is earned according to the subsidiary’s

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<sup>149</sup> *Ibid* at 581.

<sup>150</sup> *Ibid* at 579.

<sup>151</sup> *Ibid*.

<sup>152</sup> *Ibid* at 580.

<sup>153</sup> *Ibid* at 594 [emphasis in the original].

voice in the MNE.”<sup>154</sup> They also found that “to be successful in shaping the perception that it is a reliable, credible, and trustworthy actor in an MNE organization, a subsidiary not only needs to maintain a basic track record of success, but also needs to reaffirm its commitment to the parent’s objectives; and then, finally, it needs to take deliberate steps to manage impressions with power brokers at the head office. Achieving all three sets of objectives is by no means straightforward.”<sup>155</sup>

Allocation of headquarters or corporate level attention, according to Bouquet and Birkinshaw, like other MNE (or, as we would say, MDC) resources, is effected only partly on a rational basis, and is also affected by political and other considerations, including power, influence, and their judicious employment by the relevant subsidiaries. In this regard, they analogize the HQ or corporate level allocation function to a brokerage function, assessing, among other things, the needs and demands of subsidiaries as components of the organization, their perceived entitlements, and the strategic considerations relating to the same. This puts one in mind of the political or processual method of conflict resolution described by March as taking place with respect to the overall organization as a whole.

As organizational components, subsidiaries may not be as free as are many organizational participants *ex ante* to “opt out” of the process of bidding with respect to the terms and conditions to be attached to their participation in the overall enterprise. However, in some circumstances, they may be free to seek their own divestment by the MDC or MNE, to exercise influence in that regard (whether by shortfall from corporately imposed objectives or otherwise), or, as in the case of a management buyout, to actually “bid for” the withdrawal of their participation and exit from the overall enterprise. Thus, while continued subsidiary participation can normally be assumed, at least as long as it is desired by the overall enterprise, this may not always be the case.

### **Power, MDCs, and MNEs**

The previous section has presented the argument that the relationship between business units of multinational enterprises and the parent, corporate, or headquarters level of the MNE can be affected by action by the BU and by action at the HQ level. Of course, in the case of MNEs, the

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<sup>154</sup> *Ibid* [emphasis in the original].

<sup>155</sup> *Ibid*.

scope of the business units may be determined geographically, rather than strategically or functionally (generally speaking, “SBUs”).

It should be noted, however, that, like other multidivisional corporations, multinational enterprises often adopt a “matrix” structure in which divisional relationships may be, at the same time, strategic or functional and also geographic. That is to say, a country manager of an MNE may report to a superior in a division to which the local operation is assigned in relation to strategic or functional matters in respect of those matters and, simultaneously, to a superior in any division to which the local operation is assigned as a result of its geographic location, although linguistic and other cultural factors may also be relevant to such assignment. Matrix reporting may also be instituted in MDCs which are not MNEs, but, of course, the “matrix” would be determined in accordance with other factors, for example, industry, on the one hand, and function, on the other hand.

While a significant discussion of matrix reporting is beyond the scope of this work, it is important to note that the business unit concerned is subject to the authority of two different “higher” levels, raising the possibility that instructions issued pursuant to such authorities may be consistent or may be partially or wholly inconsistent with each other unless, of course, some coordination between the two higher levels is implemented and eventuated. The possibility of inconsistent instructions raises the possibility, in turn, that the business unit may either seek further instructions to resolve any consistency or may, on the other hand, make a determination itself. That determination may involve ignoring both sets of instructions, for example, on the grounds that they cannot be deconflicted in the time available. This may result in an increase in the power of the business unit concerned when compared with a business unit at a similar level in the hierarchy which is not subject to matrix reporting, that is to say, which reports only to one superior in the organization.

As indicated otherwise in this work, it cannot be assumed that higher-level instructions by the relevant subordinate level will always be observed. In the result, it can readily be seen that circumstances attendant upon matrix reporting will prevent accurate assignment of responsibility for the actions taken and for the consequences, either with respect to the business unit itself or with respect to the two different levels superior to the business unit but in different respects.

### **Power and SBU Evolution**

As previously discussed, business units may have some flexibility in pursuing their own goals and objectives and in pursuing the goals and objectives of the organization as a whole. Julian Birkinshaw and Neil Hood considered this issue in 1998 by way of extensive literature review and theory development in connection with the evolution of multinational subsidiaries.<sup>156</sup> Accordingly, their review affords access to a range of research in theorization.

While their review is limited by its terms to multinational subsidiary evolution, many of their observations also relate to MDCs generally. For these purposes, they considered a subsidiary as “a value-adding entity in a host country”, in effect, as a totality of the MNC’s holdings in a host country, regardless of whether the subsidiary was a separate legal entity or, in effect, a division or branch of the MNC, and whether or not it involved more than one enterprise or holding, and whether or not it involved a single activity or an entire value chain of activities.<sup>157</sup>

In a work such as the present which concerns the modern business corporation as a legal entity and as an organization, it is particularly noteworthy that the legal attributes of the business unit, namely, whether it operates as a division or branch of the MNE or is actually a separate legal entity having the status of a corporation in its own right, are so occluded or eliminated for these purposes. In effect, for the purposes of examining the structure and operations of the organization, internally, whether or not business units possess the status of separate legal entities is considered to be quite unimportant to organizational analysts and theorists. In this respect, they differ from legal analysts and theorists. For the time being, in order to benefit from the insights of the former, the latter must accede to their perspectives. Indeed, this is a fundamental argument of the present work.

Birkinshaw and Hood indicate that evolution of a subsidiary involves both the enhancement or atrophy of subsidiary capabilities over time and the explicit establishment or loss of the subsidiary’s charter, which are closely tied to the subsidiary’s capacity to add value. They consider the charter of the subsidiary as “the business or elements of the business in which it participates and for which it is recognized as having responsibility within the MNC... [which] can be defined

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<sup>156</sup> Julian Birkinshaw and Neil Hood, "Multinational Subsidiary Evolution: Capability and Charter Change in Foreign-Owned Subsidiary Companies" (1998) 23:4 *Academy of Management Rev* 773.

<sup>157</sup> *Ibid* at 773, and 774.



in terms of markets served, products manufactured, technologies held, functional areas covered, etc.”<sup>158</sup>

They note that where there are several subsidiaries in a particular country, they may function independently of each other, and may have separate evolutionary paths. Further, the development of a particular subsidiary may not always be in the interests of the MNC, which may prefer to expand operations elsewhere, however, “our definition of subsidiary evolution accounts for the possible lack of alignment between subsidiary and parent company goals.”<sup>159</sup> They indicate that three broad mechanisms interact to determine the role of a subsidiary at any given point in time and the changes in its role over time: firstly, assignment of roles by head office; secondly, choice by the subsidiary; and thirdly, local environment determinism: the constraints and opportunities of the subsidiary in the local market.<sup>160</sup> For the purposes of the present work, it is noteworthy that the authors specifically include in subsidiary evolution types of evolution which are not aligned with, and we may suggest might even, in some ways, disfavour MNC interests, as a whole, or as expressed at its top levels.

Assignment of roles by headquarters is explained in terms of two models. The first is the product life cycle model, in which the MNC produces at home for domestic consumption and export to certain foreign markets, with demands for low-cost production arising as the product matures, leading to overseas production initially for host country, and later for export, markets, and eventually possibly eliminating production in the home market in favour of lower-cost host country or countries.<sup>161</sup> The second is the internationalization process model, in which firms move beyond their national borders as they increase their levels of knowledge about and existing commitment to the foreign market, and then make further decisions about additional commitment to the market. This commitment decision is based, firstly, on market knowledge of the subsidiary’s strengths and weaknesses in the market and, secondly, on market commitment, the desire to increase the quality

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<sup>158</sup> *Ibid* at 782.

<sup>159</sup> *Ibid* at 774.

<sup>160</sup> *Ibid* at 775.

<sup>161</sup> *Ibid*.

of investment in the relevant country.<sup>162</sup> The second model is founded on assumptions about the cognitive limitations and behaviour of individual managers.

With respect to subsidiary choice, Birkinshaw and Hood identify two models: a network model, which relates to resource dependence and power; and a decision process model, which, again, involves assumptions of bounded rationality on the part of individual managers. The network model recognizes that subsidiaries often develop specialized capabilities on which the rest of the MNC depends, such that its growth of valuable and distinctive resources lessens its dependence on other subsidiaries and increases control of its own destiny and in which decline of such resources increases dependence and reduces self-control, during all of which times other entities in the MNC, including the MNC itself, attempt to enforce their will on the subsidiary.<sup>163</sup>

The degree of dependence of, or higher level of control by the subsidiary may vary from one to another. In some cases, Amit and Schoemaker say that a subsidiary may be able to collect a sustainable economic rent, which they denominate as “organizational rent” (which Birkinshaw and Hood follow), and which is “shown to stem from imperfect and discretionary decisions to develop and deploy selected resources and capabilities, made by bountifully rational managers facing high uncertainty, complexity and intrafirm conflict.”<sup>164</sup> The asymmetries upon which such organizational rent depends would include information available to headquarters as to the resources and capabilities of the relevant subsidiaries as compared with the information available to such subsidiaries, and other limitations on their rationality, again, as compared with the limitations affecting management of the relevant subsidiaries.

Birkinshaw and Hood define capabilities as “a subsidiary’s capacity to deploy resources, usually in combination, using organizational processes to effect the desired end.”<sup>165</sup> They indicate that “the subsidiary’s capabilities are, to some extent, distinct from the capabilities of the headquarters operation and its sister subsidiaries. In other words, the particular geographical setting and history of the subsidiary are responsible for defining a development path that is absolutely unique to that

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<sup>162</sup> *Ibid* at 776.

<sup>163</sup> *Ibid* at 777.

<sup>164</sup> Raphael Amit and Paul JH Schoemaker, "Strategic Assets and Organizational Rent" (1993) 14:1 Strategic Management Journal 33 at 33.

<sup>165</sup> *Supra* note 147 at 781.

subsidiary which, in turn, results in a profile of capabilities that are unique.” Such capabilities, which develop over time as a result of past experiences, they say, are “sticky” and “cannot be easily transferred from one subsidiary to the next, even when the transfer is undertaken willingly” but, instead, are subject to path-dependent trajectories.<sup>166</sup>

They note that the network perspective recognizes that each subsidiary is part of a network which involves the parent company and other subsidiaries, and is not engaged only in a dyadic relationship with the parent company.<sup>167</sup> The decision process perspective is based on the bounded rationality of individual managers and their ability to exert control over subsidiaries. It recognizes that subsidiaries operate independently and are capable of autonomous behaviour.<sup>168</sup>

Both perspectives on subsidiary choice assume that strategic behaviour often occurs beyond top management levels in an MNC or MNE, that sometimes the internal growth of an MNC subsidiary may only be controlled loosely by HQ, and that sometimes the development and strategic behaviour of a subsidiary may eventuate in ways not actively encouraged by top management.<sup>169</sup> These assumptions were demonstrated by Robert Burgelman in a series of studies published between 1983 and 1996.<sup>170</sup> The present work has repeatedly averted to business units independently pursuing their several and individual goals and objectives, as distinct from overall organizational goals and objectives. Burgelman and others have repeatedly demonstrated this.

Birkinshaw and Hood indicate that the charter of the subsidiary “defined as the business – or elements of the business – in which the subsidiary participates and for which it is recognized to have responsibility within the MNC”<sup>171</sup> is the subject of a shared understanding between the subsidiary and headquarters. Where such charter does not change over a long period of time, its

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<sup>166</sup> *Ibid* at 781.

<sup>167</sup> *Ibid* at 778.

<sup>168</sup> *Ibid* at 777.

<sup>169</sup> *Ibid* at 777 and 780.

<sup>170</sup> These include: RA Burgelman, "A Process Model of Internal Corporate Venturing in the Diversified Major Firm" (1983) 28:2 *Administrative Science Quarterly* 223; RA Burgelman, "A Model of the Interaction of Strategic Behavior, Corporate Context and the Concept of Strategy" (1983) 8:1 *Academy of Management Review* 61; RA Burgelman, "Intraorganizational Ecology of Strategy Making and Organizational Adaptation: Theory and Field Research" (1991) 2:3 *Organization Science* 239; and RA Burgelman, "A Process Model of Strategic Business Exit: Implications for an Evolutionary Perspective on Strategy" (1996) 17 *Strategic Management J* 193.

<sup>171</sup> *Ibid* at 782

charter and capabilities may mirror each other; however, changes in its resource base, charter, or market conditions may result in mismatches between the two.

They emphasize that “in *most* corporations there is *internal competition for charters*”,<sup>172</sup> both with respect to charters and responsibilities held by other subsidiaries and for new charters and responsibilities. That is to say, one subsidiary may endeavour to take over the charter or responsibility of another. This assumes that the competing subsidiaries have some similarities in terms of capabilities. Further, they indicate that “not all charters are “contestable” in this fashion. Some charters are country specific and so are inextricably to the local subsidiary operations; others are tied to large immobile assets (e. g., an auto plant) so they cannot easily be shifted to another location”. However, where the underlying resources are relatively mobile, the charter may be highly contestable. In fact, such contestation is regarded as “one of the fundamental drivers behind the subsidiary evolution process.”<sup>173</sup>

In effect, this charter competition is one aspect of internal competition over the allocation of corporate resources. It is apparent that the charter or responsibility of the subsidiary implicates certain allocations of resources. In this sense, we may consider the charter or responsibility of the subsidiary to constitute one such resource. More generally, the corporation may permit bids for new investments or may even create a system through which resources can be challenged as to their allocation by other business units.<sup>174</sup> Such a system of bids or challenges “increases awareness of the relative capabilities among subsidiaries and provides a motivation for them to continually upgrade their capabilities”, which distinguishes it from a central planning process, in which capabilities and knowledge of them by the parent may remain static over relatively long periods of time.<sup>175</sup>

With respect to the attributes of a particular subsidiary, Birkinshaw and Hood assert that “the most critical factor affected subsidiary evolution is its *track record* – that is, the extent to which it has delivered, over the years, results at or above the expectations of the parent company.”<sup>176</sup> This

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<sup>172</sup> *Ibid* [emphasis in the original].

<sup>173</sup> *Ibid*.

<sup>174</sup> *Ibid* at 787.

<sup>175</sup> *Ibid*.

<sup>176</sup> *Ibid* at 788 [emphasis in the original].

record of past success reduces the uncertainty concerning whether it will attain future success and also provides a legitimate justification for such decision if it should prove to be wrong. They also indicate that the quality of the parent-subsidiary relationship, namely, the informal ties between key decision-makers at the head office and senior management of the subsidiary is an important factor impacting the subsidiary evolution process,<sup>177</sup> for similar reasons. The importance of such personal ties, contributing, as they do, to a perception that they eliminate some uncertainty, have been discussed previously in this chapter.

Birkinshaw and Hood indicate, as well, that research has demonstrated that the assessment of initiatives is affected more by perceptions of the qualities of the individuals putting them forward than by the merits of the initiatives themselves. Thus, initiatives put forward by individuals well known to parent company decision makers will be far better received than those put forward by relatively unknown managers.<sup>178</sup>

### **Multinational Enterprise Organizational Structure**

In our discussion of strategy and structure, it is become apparent that even enterprises with single, or multiple but related product lines, or several unrelated product lines, as well as enterprises having several divisions (called here “multidivisional corporations” or “MDCs”) may take various strategic initiatives which have structural implications, such as operating a number of plants geographically dispersed within a single jurisdiction (a “uninational corporation”) or within more than one jurisdiction (a “multinational corporation” or “MNC”). Theodore Herbert considered the research and theoretical work concerning multinational corporations in an article which appeared in 1984,<sup>179</sup> but which is still useful, not only by way of a summary of both literatures for present purposes, but also as a source of description of such organizational forms as actually observed.

#### ***MDCs and MNEs***

Herbert noted that: “Strictly speaking, the differences between the multinational and uninational but geographically dispersed corporation are of degree rather than of kind. Both encounter

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<sup>177</sup> *Ibid* at 789.

<sup>178</sup> *Ibid*.

<sup>179</sup> Theodore T Herbert, "Strategy and Multinational Organization Structure: An Intraorganizational Relationships Perspective" (1984) 9:2 *Academy of Management Rev* 259.

management, technical, and operations difficulties, a direct and inevitable result of separation of operations in space. In this view, the MNC is simply the extreme case of the dispersed firm, the components of which happened to be located in a number of autonomous political units".<sup>180</sup> The MNC is not homogeneous, but heterogeneous, with respect to jurisdictional operations and, accordingly, the management of its business is affected by variations and differences in requirements of the macro-political/economic systems across which it does business. These may include monetary and exchange risk, expropriation and regulatory system hazards, divergence of host country and business interests, government-subsidized competitors, cultural differences, and restrictions based on social or economic impact; differences which require considerable advance consideration as part of the development of an international strategy.<sup>181</sup>

While Herbert's article is directed towards assessing the impact of such variations on the strategic and structural development of MNCs, it is important to note that his focus on intraorganizational development is not limited to those types of corporations, but also extends to MDCs. Many of his observations apply to both. Among other things, he demonstrates how the structure of the organization evolves and how that structure is, or should be, related to its evolving strategy. This is important for our purposes.

His review of the research confirms theoretical arguments that formal authority is subject to change over time, at least insofar as such formal authority is reflected in the formal intraorganizational structure. It is apparent that informal structure and informal authority may also adapt over time, for example, in order to "take into account" developments in formal structure and authority. Consequently, such developments would be expected to affect assignments of responsibility for organizational, as well as for legal, purposes.

### ***MNC Development***

Herbert discusses structural design criteria which relate to the strategy and structure of operations dispersed across jurisdictional boundaries as including: firstly, the technical nature of the operations; secondly, the extent of foreign product diversity and the relative size of foreign sales;

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<sup>180</sup> *Ibid* at 259-260.

<sup>181</sup> *Ibid* at 260.

and, thirdly, the percentage of foreign sales supported by foreign manufacturing.<sup>182</sup> He indicates that there are four principal generic strategies that lead to internationalization, namely: 1. volume expansion, which is likely handled initially by an export manager or international department at headquarters, who have neither line authority nor responsibility, which can create problems; 2. resource acquisition, in which necessary resources are obtained in a jurisdiction other than the home jurisdiction for use in the home jurisdiction and otherwise; 3. reciprocity, in which there is a two-way flow of benefits, such as the transfer of resources to the home jurisdiction and supply of finished products and financing to the foreign jurisdiction; and 4. integration, in which operations in each world or regional market are largely self-contained.<sup>183</sup>

Herbert indicates that resource acquisition and reciprocity strategies often lead to wholly-owned subsidiaries or joint ventures, and then later to international divisions organized by either: 1. geography, where there are few product lines in a given area or country, which facilitates adaptation to local conditions, enables decentralized decision-making, and often involves acting as a separate profit centre; or 2. product line, where the products are technologically complex, and the focus is on high-potential markets where an immediate effect can be achieved, albeit sometimes at the expense of long-term strategy; or 3. function, like the parent company's organization, which is often appropriate where functional superiority represents a significant competitive advantage, perhaps including high manufacturing efficiency, in-depth marketing services for clients, production innovation, and the ability to actualize short turnaround and delivery commitments.<sup>184</sup>

Herbert describes integration as the most internationally-oriented structure, which treats foreign and domestic markets more or less identically, as the market itself determines the manner of development and provision of goods and services, which may lead to some differences from the parent structure. "Each regional organization is more or less self-sufficient and independent. Loose coordination or broad strategic guidance is the function of an international headquarters. Worldwide staff activities may be located centrally, to avoid duplication of effort, achieve economies of scale, or ensure uniformity procedures."<sup>185</sup> Full responsibility for production and

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<sup>182</sup> *Ibid.*

<sup>183</sup> *Ibid* at 261-2.

<sup>184</sup> *Ibid* at 263.

<sup>185</sup> *Ibid* at 264.

marketing is assigned to regional managers, who normally report of the CEO of the overall organization. This structure “encourages decentralization of authority, the identification of responsibility for performance, and the development of managerial talent worldwide.”<sup>186</sup>

Herbert identifies a number of implications of the relationship between strategy and structure, as follows: firstly, each resource strategy is best carried out in a different structural configuration; secondly, mismatches of strategy and structure may be expected to create certain particular difficulties; thirdly, potential difficulties may be expected even where the strategy and structure are appropriately matched; and fourthly, the relationship of the subsidiary with the host country may be affected by the resource strategy, the structural framework, or both.<sup>187</sup>

Herbert indicates that each strategy tends to have implications or consequences, which can actually be observed, with respect to the type of structure, the degree of formalization, the locus of decision-making, the size and nature of local staff, the nature and direction of communications, the extent of control, the metrics used to measure performance, the size and nature of managerial personnel, the relationship with the home office the nature and quantity of the products produced, and the nature of the investment, profit, and capital policy and its division as between headquarters and the local operation. For example, considering just resource acquisition, reciprocity and integrated operations strategies, the degrees of control range from tight to looser to more general, the performance measures range from highly quantitative and cost-centred to less rigid and quantitative to profit and return on investment, and the characteristics of managerial personnel range from almost entirely expatriates, to an mix of expatriates and local personnel with a larger administrative component, to largely local personnel.<sup>188</sup>

As previously noted here, these implications are also relevant to MDCs and, except for the last item, even to MDCs which are uninational. That said, Herbert concludes that an extraorganizational dimension, namely, that of host-country relations may significantly affect the effectiveness of a particular strategy.<sup>189</sup>

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<sup>186</sup> *Ibid.*

<sup>187</sup> *Ibid.*

<sup>188</sup> *Ibid* at 266.

<sup>189</sup><sup>189</sup> *Ibid* at 268-9.



### ***Matrix Organizations***

Herbert argues that some of the disadvantages of operating as an international division, on the one hand, and of fully integrating international and domestic operations, on the other hand, can be reduced by adopting a matrix form of organization. For example, the foreign subsidiary may be required to account, simultaneously, to a geographic regional office and to a divisional office to which the foreign subsidiary is assigned by reason of its functional or product/service attributes.<sup>190</sup> In particular, he references research conducted by Stanley M. Davis in this regard.<sup>191</sup>

Davis's work (in this case conducted with Paul Lawrence) indicates that matrix organizations became popular in the 1970s, particularly in large diversified organizations in which many complex and conflicting interests must be balanced and to deal with high degrees of complexity and ambiguity.<sup>192</sup> These are very different organizations from the woollen mills and iron factories of Great Britain which employed and, according to some sources, even innovated, the hierarchical "command and control" industrial structure.<sup>193</sup>

In a 2005 study involving 294 top-level and mid-level managers from seven major MNCs in six different industries, Sy and D'Annunzio identified five major challenges of the matrix organizational form: 1. misaligned goals; 2. unclear roles and responsibilities; 3. ambiguity with respect to authority; 4. lack of a matrix guardian, namely, someone having sufficient authority and responsibility to resolve some of the preceding issues; and 5. employees focused on their own organizational silos.<sup>194</sup>

They compared respective strengths and weaknesses of the matrix form. The strengths include leveraging economies of scale, while remaining small and task focused; focusing employees on

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<sup>190</sup> *Ibid* at 263-4.

<sup>191</sup> Stanley M Davis, "Matrix Organization and Behaviour in Multinational Enterprise" (1973) 33 *Academy of Management Proceedings*. See also Stanley M Davis and Paul R Lawrence, "Problems of Matrix Organizations" *Harvard Business Rev* 131 (May-June 1978); Tom Peters, "Beyond the Matrix Organization" *McKinsey Q* 1 (September 1979); Thomas Sy and Stephane Cote, "Emotional Intelligence: A Key Ability to Succeed in the Matrix Organization" (2004) 23:5 *J Management Development* 437; Thomas Sy and Laura Sue D'Annunzio, "Challenges and Strategies of Matrix Organizations: Top-Level and Mid-Level Managers' Perspectives" (2005) 28:1 *Human Resource Planning* 39.

<sup>192</sup> Davis and Lawrence, *supra* note 191 at 131-2.

<sup>193</sup> Sy and Cote, *supra* note 191 at 439, citing, for this point: BA Pasternack, and AJ Viscio, *The Centerless Corporation*, (New York, NY: Simon and Schuster, 1998).

<sup>194</sup> Sy and D'Annunzio, *supra* note 191 at 39. The functions of the "matrix guardian" are discussed at 45-6.

multiple business goals; facilitating innovative solutions to complex technical problems; improving employees' companywide focus through increased responsibility and decision-making; allowing for quick and easy transfer of resources; increasing information flow through the creation of lateral communication channels; and enhancing personal communication skills. They identify the weaknesses as violating the principle that authority should be commensurate with responsibilities; violating the principle that each subordinate should have only a single boss; creating ambiguity and conflict; increasing costs due to increased need for additional management and administration; and increasing the likelihood of resistance to change, as employees may associate the matrix with loss of status, authority, and control over traditional domain.<sup>195</sup>

### **Headquarters Functions, Strategy, and Structure**

Alfred D. Chandler examined the functions of the headquarters of multidivisional corporations in a 1991 article entitled *The Functions of the HQ Unit in the Multibusiness Firm*,<sup>196</sup> in which he concluded, among other things, that in which he concluded, among other things, that "the decisions made by the senior executives at their headquarters have been absolutely critical to the performance of such multinational and multiproduct companies. For those corporate executives not only monitor the current performance of their several businesses but also determine and implement investment in facilities and personnel required for future production and distribution in the different product and geographical markets they serve. On such decisions depend the competitive success or failure of their enterprises and the national industries in which they operate."<sup>197</sup>

Chandler indicates that during the interwar years, American companies adopted some version of the M-Form with a corporate headquarters (also called a corporate office or HQ unit), and integrated product or geographical divisions, when senior managers in centralized, functionally departmentalized U-Form structures "realized that they had neither the time nor the necessary

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<sup>195</sup> *Ibid* at 40.

<sup>196</sup> Alfred D Chandler, Jr, "The Functions of the HQ Unit in the Multibusiness Firm" (1991) 12 Strategic Management J 31.

<sup>197</sup> *Ibid* at 31.

information to coordinate and monitor day-to-day operations, or to devise and implement long-term plans for the several product lines.”<sup>198</sup>

Accordingly, they created a headquarters which engaged in two related functions. One was entrepreneurial or value-creating, namely, “to determine strategies to maintain and then to utilize for the long-term the firm’s organizational skills, facilities and capital and to allocate resources – capital and product-specific technical and managerial skills – to pursue the strategies.” This work maintains that this task is absolutely critical: it aims at advancing the business and thereby creating value. Thus, structure, processes and personnel must be adopted and adapted to this end.

The objective of the second function involved administration and loss-prevention, namely, “to monitor the performance of the operating divisions; to check on the use of the resources allocated; and, when necessary, redefine the product lines of the division so as to continue to use effectively the firm's organizational capabilities.”<sup>199</sup> In Chandler’s view the monitoring role was intimately related to strategic planning and resource allocation, which he regarded as a classic entrepreneurial function. Monitoring provided essential information about changing technology and markets, the nature and pace of competition in the different businesses, the performance of divisional operating managers, and facilitated their continuing development of product-specific, firm-specific, and more general managerial capabilities.<sup>200</sup> It can readily be seen that Chandler’s “monitoring”, which operates in aid of the first, value-enhancing, function, is quite different from economic monitoring.

By the 1970s, in most large MBEs, planning and administrative offices existed at the business unit level which normally operated through a functional U-Form structure and at the divisional and corporate offices, which usually operated through a version of the M-Form structure with each level having its own staff and senior executives responsible for profit, market share, and other measures of performance.<sup>201</sup>

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<sup>198</sup> *Ibid* at 33.

<sup>199</sup> *Ibid*.

<sup>200</sup> *Ibid* at 34.

<sup>201</sup> *Ibid*.

### *Financial Control, Strategic Control, and Strategic Planning Models*

Chandler relied on Michael Goold and Andrew Campbell's 1987 study "Strategies and Styles: The Role of the Centre in Managing Diversified Corporations"<sup>202</sup> for information concerning 16 carefully selected British diversified and conglomerate firms, as well as his own information concerning American conglomerates and multibusiness firms.<sup>203</sup> Goold and Campbell identify three main management styles used at corporate headquarters, which they denominate as Strategic Planning, Strategic Control, and Financial Control, and which they describe as leading to different strategies and different results.<sup>204</sup> Chandler argues, instead, that "in these three styles, like the internal organization of the headquarters, result from different paths of growth, and therefore from different patterns of investment and from different sets of organizational capabilities... [which] capabilities, in turn, reflect the different characteristics of the businesses in which the firms operate" and says that successful adaptation of these styles to their industries' characteristics determine the effective size and boundaries of their enterprises.<sup>205</sup>

Applying this analysis, he found that the strategic planning companies "are by and large the least diversified, operate the smallest number of businesses, have the highest linkages between divisions and the highest overlap between business units within divisions"; that the strategic control companies "operate more businesses, have fewer overlaps between the divisions and have less synergy between business units"; while the financial control companies "are the most diversified... have the lowest linkages between divisions, and have the lowest overlap between units within divisions."<sup>206</sup>

Financial control companies generally grew almost entirely by acquisition rather than direct internal investment, often acquiring businesses and unrelated industries. A relatively small corporate office includes a few general line officers, almost no executives in functional areas, and divisional managers, who perform a linking and surveillance role between the units and the centre.

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<sup>202</sup> Michael Goold, and Andrew Campbell, *Strategies and Styles: The Role of the Centre in Managing Diversified Corporations* (Oxford: Basil Blackwell, 1987).

<sup>203</sup> Chandler, *supra* note 186 at 35.

<sup>204</sup> *Supra* note 188 at 87.

<sup>205</sup> Chandler, *supra* note 186 at 36.

<sup>206</sup> *Ibid* at 36-38.

Corporate executives may suggest, but the business units within the divisions define and implement, business unit strategy.<sup>207</sup>

The budget, the goal of which is normally short-term profit, “is considered a contract between the corporate office and the business unit” against which current financial performance, which is the critical measure of achievement, is assessed monthly and quarterly and failure to meet financial targets often results in a change in management of the business unit.<sup>208</sup> The corporate office adjusts the portfolio businesses accordingly, selling off weak performers and making new acquisitions, usually avoiding “technologically complex, capital-intensive industries where product and process innovations require long-term investment and associated risks.”

The development and implementation of strategic plans and controls were generally similar as between strategic planning companies and strategic control companies, with strategy initially determined by the business units subject to review by divisional headquarters, and then subsequently by corporate headquarters, involving annual planning cycles of preparation of annual business plans and operating plans involving extensive staffs at business unit, divisional, and headquarters levels, and producing budgets linked to long-term strategic plans and annual business plans.<sup>209</sup> In strategic planning companies, the head office played a more decisive role, but it was less decisive in the case of strategic control companies, where the divisional office was more involved in planning.

With respect to strategic control companies, the divisional headquarters had a much greater role, generally initiating capital projects and proposals for new businesses, while headquarters generally initiated closures and divestitures. Financial budgets and goals were regarded as targets to be met, not as subjects for discussions of the extent of, reasons for, and proposals to remedy, divergence. Instead, budgets and goals formed the basis of allocations of incentives and sanctions, much as with respect to financial control companies.<sup>210</sup> Although guided by the corporate office, the divisional headquarters in strategic control companies carried out most of the functions of carried out by headquarters in the case of strategic planning companies. This sometimes meant that long-

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<sup>207</sup> *Ibid* at 38.

<sup>208</sup> *Ibid*.

<sup>209</sup> *Ibid* at 40.

<sup>210</sup> *Ibid* at 41.

term gains were sacrificed for short-term gains or that some opportunities were lost which might have been better recognized as a result of greater attention by headquarters.<sup>211</sup>

Because strategic planning companies regarded their divisions and business units as portfolio investments, corporate executives reviewed strategic themes against their own portfolio mix and against the dynamics and suggestions of the individual business units. Proposals for large scale capital allocations and entries into new businesses could arise at business unit and corporate levels but required corporate sponsorship if they were major new initiatives. Agreed-upon plans were expressed in long-term and short-term goals against which actual results were monitored, not as contracts directly impacting incentives, such as bonuses, or sanctions, such as management removal, but as the basis for discussions concerning progress towards long-term strategic and financial goals.<sup>212</sup>

### ***Development of Corporate Level Functions***

Chandler's examination of IBM, GE and DuPont, particularly in the last half of the twentieth century, with even more focus on the 1970s and 1980s, led him to a number of conclusions concerning the capacity of the headquarters or corporate office. One such conclusion was that a multinational corporation could not enter new businesses based on existing capabilities alone; instead, such existing skills and facilities would have to be supplemented by developing other new complementary skills and facilities. Further, the sizes and boundaries of enterprises were not determined only by existing capabilities, and by success in developing additional supplementary capabilities, but were "also determined by the ability of the corporate headquarters to carry out both its basic functions – entrepreneurial and administrative."<sup>213</sup>

Moreover, the nature and performance of such entrepreneurial and administrative functions were affected by the characteristics of the industries concerned, including such matters as the types of products and services produced and distributed. For example, in "industries in which new product development is a critical component of intrafirm competition, where R&D expenditures are high, state-of-the-art facilities costly, and marketing records specialized skills, the corporate office needs

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<sup>211</sup> *Ibid.*

<sup>212</sup> *Ibid.*

<sup>213</sup> *Ibid* at 48.

to concentrate on the entrepreneurial (value-creating) function”, including playing a strong role in the strategic planning process in order to fully utilize competitive strengths, and to determine pathways for new product and process development.<sup>214</sup>

On the other hand, in mature industries, with a stable final product, where R&D is important to improve the product and to cut costs, and where both facilities, although costly, and marketing skills, although complex, are already highly developed, “the corporate office can more easily delegate strategic planning to the operating divisions, and maintain strategic control by setting targets and establishing long-term goals for the corporation as a whole.”<sup>215</sup> Where the products and services remain much the same, production technology is not complex and does not require expensive facilities, but where competition is more dependent upon advertising, marketing and distribution, then “financial controls alone have been usually enough to prevent losses and maintain profits in multibusiness enterprises.”<sup>216</sup>

## CONCLUSION

This work began by addressing, in Part 1, the question: What is? What corporate law and governance regimes exist in modern corporate law today? In keeping with the descriptivist methodology of this work, Part 1 identified what are generally considered to be the legally essentialist characteristics of the modern business corporation and examined how those characteristics are instantiated in statute law and other declarative law enacted or proposed as a model for enactment in several leading jurisdictions.

Part 2 of this work considered the question: Why this? It sought to examine assumptions about the corporation that have influenced, might have influenced, or might in the future influence theorization about the corporation and the legislation, regulation, jurisprudence and judicial treatment, and practice relating to the corporation and corporate law generally.

The assumptions examined related principally to those made by classical and neoclassical economic theory in general, and theory of the firm, in particular. Assumptions about the relationships among the economy, society, the polity, and the state, were reviewed and critiqued

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<sup>214</sup> *Ibid.*

<sup>215</sup> *Ibid.*

<sup>216</sup> *Ibid.*

from other economic perspectives and from the perspectives of disciplines and fields other than economics. Then, assumptions of classical and neoclassical economics related to economic action at the micro-economic level were examined and critiqued from similar perspectives.

The preceding chapter and the present chapter have considered assumptions relating to the corporation as an economic actor and, continuing the descriptivist methodology of this work, the instantiation of the corporation as observed in action in the “real world”. This involved, in the preceding chapter, an examination of the history of development of the modern business corporation, principally in the United States and Great Britain, over much of the past two centuries, as chronicled by Alfred Chandler, and variously critiqued and chronicled by others.

The present chapter identifies several barriers to unified action within the corporation, including limitations, and diffusion, of rationality, information and decision-making and the problem of resolving conflict within and without the corporation. Problems of dealing with complex and multiple goals, official and unofficial goals, and intraorganizational groups, coalitions, and organizations also arise. This chapter discusses the corporation, like other organizations and the polity and the state generally, as a political system. In particular, it is examined as a socio-political conflict system seeking to achieve some ordering of collective preferences in accordance with superordinate goals or superordinate processes.

The present chapter continues to investigate the principal modes of organization of the activity of large modern business corporations; namely, unitary or U-form corporations, and multi-divisional or M-Form corporations (“MDCs”); and briefly describes multinational enterprises (“MNEs”) and matrix organizations. In addition to addressing problems of bounded rationality and imperfect information, and multiple and complex goals, these organizational forms must also take into account the bases, and dispersion, of power and influence within the organization and its constituent components. In effect, this continues the descriptive methodology of the present work and, by examination of how the modern business corporation is instantiated in present day reality, leads to the investigation of organizations generally and the ways in which the organizational “lens” can contribute to knowledge and theorization of, and about, the modern business corporation. This is the focus of Part 3 of this work.



Ultimately, this leads to the consideration of the dual aspect of the corporation, combining legal entity attributes, particularly notable in its external or outward focus, and organizational attributes, particularly notable in its internal or inward focus. This work denominates this as the “corporative” perspective on, or the “corporative” theory of, the corporation. To this we now turn.

## **PART 3 – HOW, INSTEAD, TO ANALYZE THE CORPORATION: A CORPORATIVE THEORY OF CORPORATE LAW AND GOVERNANCE**

### **SECTION A – THE ORGANIZATION**

#### **PURPOSE AND SCOPE OF PARTS 2 AND 3 OF THIS BOOK**

##### **Purpose and Scope of Part 2**

The modern business corporation is in society, and society is in the modern business corporation. Expressed differently, the corporation is intra-social, and society is intra-corporate.

As demonstrated in Part 2 and Appendix B of this book, considered from an internal perspective, the corporation is social, in the sense that its function and operations are constituted, at least in part, by individual human beings interacting with other individual human beings, by individual human beings interacting with various groups of individual human beings, and by groups of individual human beings interacting with other groups of human beings.

Consequently, in its internal operation and functions, it may be said to be a situs of interpersonal, social, and political behaviour among individuals and groups, a situs of interpersonal, social, and political interaction, of group interaction, of social and personal identity, of search for meaning, of economic attainment, and of many other species of human behaviour. As also demonstrated in Part 2 and Appendix B of this book, considered from an external perspective, the corporation as a legal entity can act towards external actors only through and by means of individual human beings.

This work argues that corporate legal theory, corporate law, and corporate governance practices give insufficient recognition to these aspects of the corporation, concentrating, instead, on economic principles of venerable, if now doubtful, application. This work, instead, has, up to this point, attempted to address, and henceforth will attempt to address, those often-ignored issues.

The corporation may be analyzed as an organization. The immediately preceding part of this book, Part 2, which, together with Appendix B, discusses the discourse concerning, and the theorization of, the firm and the corporation, principally from perspectives other than law, has referred to various salient aspects of organizations, both internally and externally, including the firm and the corporation.

In the course of considering the firm as a single economic actor, the final chapter of Part 2, Chapter Three, examined various alternatives to the perspective of classical and neoclassical economics.

Among other things, it examined the firm as a political system, and as a socio-political conflict system, as a system of achieving joint preference ordering, and, in general, as an organization, and, in particular, as an organization with significant economic objectives.

### **Purpose and Scope of Part 3**

Among other things, Part 2, together with Appendix B, provides some background for this part of the book, Part 3, which more formally investigates research and theorization concerning organizations, including aspects of organizations relevant to business organizations, particularly the modern business corporation. In this respect, Part 3 outlines some of the theory and research upon which are based certain general statements and criticisms made previously in the text. As in other sections of the text, the scope of the present work renders it advisable to closely examine certain principal texts, while addressing comments and criticism from other texts somewhat less closely.

As noted earlier, in order to facilitate an orderly progression of exposition, it was necessary to defer investigation of research, theoretical and empirical review, and theorization underlying and supporting some of this work's statements and criticisms until a later point in the narrative. That point has now been reached.

Accordingly, this chapter and the following two chapters consider, in broad terms, the definition, and characteristics, of organizations generally, while also situating the corporation within the broader universe of organizations. The final chapters in this part, Part 3, integrate the analysis of the corporation as an organization with its status as a legal entity, and present the corporative theory of, or corporative perspective with respect to, the modern business corporation.

## **CHAPTER FOUR – THE ORGANIZATION - DEFINING AND OTHER ATTRIBUTES**

### **WORKING DEFINITIONS AND FORMAL DEFINITIONS**

#### **Working Definitions**

Up to this point in the present book, we have been content to employ a rough working definition of the term “organization”. In that regard, we may say that an organization is a social unit structured and managed in such a way as to meet one or more particular needs or to pursue or accomplish one or more collective goals or purposes. Another way of expressing this would be to

say that it is a group of people working together in an organized way to meet, pursue, or accomplish one or more collectively shared needs, goals or purposes.

Since satisfaction of a need may be considered to amount to a “goal or objective”, the present text will generally not mention need satisfaction or attainment of a need separately from “goals” or “objectives”. It will likewise be assumed that “goals” and “objectives” are more or less interchangeable terms, with the result that use of one or more of such terms generally means and includes the other. We will consider various authorities in support of these propositions.

It can immediately be seen that these working definitions involve three principal components: firstly, the notion of “social unit” or “group of people”; secondly, the notion of structuring, managing, or applying rationality to, the collective activities of such social unit or group of people; and thirdly, the notion of collective, or shared, needs, goals or purposes. These components will be analyzed in due course.

### **Formal Definitions**

For this purpose, three definitions advanced by social theorists will be considered here: those advanced by Philip Selznick, Egon Bittner, and Meyer Zald.

#### ***Philip Selznick Definition***

In a highly influential and oft-cited article published in 1948, “Foundations of the Theory of Organization”, Philip Selznick begins by observing: “Trades unions, governments, business corporations, political parties, and the like are formal structures in the sense that they represent rationally ordered instruments for the achievement of stated goals. “Organization,” we are told, “is the arrangement of personnel for facilitating the accomplishment of some agreed purpose through the allocation of functions and responsibilities.” Or, defined, more generally, formal organization is “a system of consciously coordinated activities or forces of two or more persons.”<sup>1</sup> It is clear from this that a single individual, such as a sole proprietor, cannot qualify as an “organization”; and that a firm as an organization must comprehend more than one individual. In effect, the economic model of the firm as single individual and sole proprietor itself excludes consideration of its “firm” as an organization. Thus, it invisibilizes what is inside the “black box” of its “firm”.

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<sup>1</sup> Philip Selznick, "Foundations of the Theory of Organization" (1948) 13:1 American Sociological Rev 25.

Selznick says that “formal organization is the structural expression of rational action. The mobilization of technical and managerial skills requires a pattern of coordination, a systematic ordering of positions and duties which defines a chain of command and makes possible the administrative integration of specialized functions.”<sup>2</sup> One might say that an organization is more than a social group, but, instead, is a social group having certain needs, goals or purposes, and having certain structure and processes developed in an intendedly rational manner in view of those needs, goals or purposes.

It is implicitly assumed that the satisfaction of such needs or the attainment of such goals or purposes requires the effort of a group of persons, rather than that of a single person. This may be because the group possesses resources not available to any one person or, at least, to any one person within the group under consideration.

Selznick’s examples of organizations include governments, trade unions, business corporations, and political parties. This indicates that the goals that are sought by organizations may be variously described as political, social, and economic in nature. Some organizations may pursue goals that are exclusively in one such area, while others may pursue various goals that are in more than one such area.

The allocation of functions and responsibilities within the organization involve both delegation, most notably at the outset, and coordination, on an ongoing basis, and without consideration of the identity of the persons involved. Selznick opines that: “In this context *delegation* is the primordial organizational act, a precarious venture which requires the continuous elaboration of formal mechanisms of coordination and control. The security of all participants, and of the system as a whole, generates a persistent pressure for the institutionalization of relationships, which are thus removed from the uncertainties of individual fealty or sentiment. Moreover, it is necessary for the relations within the structure to be determined in such a way that individuals will be interchangeable and the organization will be free of dependence upon personal qualities. In this

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<sup>2</sup> *Ibid* at 25 [footnotes omitted]. For the first quotation, he cites John M Gaus, “A Theory of Organization in Public Administration” in *The Frontiers of Public Administration* (Chicago: University of Chicago Press, 1936) at 66; and for the second, he cites Chester I Barnard, *The Functions of the Executive* (Cambridge: Harvard University Press, 1938), at 73. Here, as elsewhere in the present work, in an effort to improve readability, footnotes in quoted text are normally omitted without specifically mentioning their omission.

way, the formal structure becomes subject to calculable manipulation, an instrument of rational action.”<sup>3</sup>

Within the group, a structure is developed, involving positions that are largely, if not completely, independent of the identity of the incumbents, relationships among the positions and their incumbents that are likewise independent of the identity of the incumbents, but, rather, in both cases, express some rational determination as to the means of satisfying the relevant needs, goals or objectives. Similarly, the positions developed may relate to the various functions required to be performed that are independent of the membership of the organization or the incumbents of particular positions at any particular time.

In that sense, the organization is conceived as having some permanence and stability, as enduring beyond its present membership, and as being independent of that membership. In this way, the relationships, structure, and process instituted may be said to become institutionalized, and the organization may be said to become an “institution”. The organization is perceived to have a life separate and apart from, and beyond, that of its present members and, as a matter of fact, beyond its past, present and future members. This, of course, is a principal characteristic of a corporation as a matter of law.

It is important to note that the structuring of the organization, also involving delegation and concomitant coordination, may itself create groups or sub-groups within the organization. For example, the creation of a marketing function within the organization, the delegation of certain duties in that behalf, and the requirement for ongoing coordination of its activities within the marketing function itself, and within the organization as a whole may be considered to create a group within the organization. The question arises, for later discussion and investigation, whether that group (or subgroup) within the organization may itself satisfy the requirements to constitute it as an actual organization, albeit within or “nested” in the higher-order organization.

For example, while the focal group may have superordinate goals and objectives which are those of the organization at the highest level, it may also have discrete goals and objectives which may not be shared by the whole organization, or by all parts of the organization, or which may even be completely unique to that particular intraorganizational functional or other group. As has been

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<sup>3</sup> *Ibid* at 25 [emphasis in the original].

demonstrated in the present work, there is considerable evidence concerning the independent nature of certain goals and objectives of intraorganizational groups.

The processes and ways of proceeding within that group or function may, likewise, range along some continuum of identity and diversity as compared with those of the organization as a whole. Other considerations, of course, such as stability, may contraindicate the existence of such intraorganizational groups as organizations per se. While this argument need not detain the present work, it is worth keeping in view as the analysis here proceeds.

### ***Egon Bittner Definition***

The sociologist Egon Bittner opines that the term “organization” as used in relevant conventions, applies correctly to “stable associations of persons engaged in concerted activities directed to the attainment of specific objectives. It is thought to be a decisive characteristic of such organizations that they are deliberately instituted relative to these objectives.” He says that organizations which are, in this sense, “implementing and implemented programs of action that involve a substantial dose of comprehensive and rational planning...are identified as instances of formal or rational organization in order to differentiate them from other forms.”<sup>4</sup>

Bittner, like Selznick, focuses on stability and rationality in his explication of the use of the term “organization”. Consequently, a group which is relatively stable, or even completely static but which does not pursue its common objectives in a manner which is considered, even if only by the members of the group, to be deliberate and rational cannot be an organization, and cannot be said to have a formal or rational organization.

Similarly, a group whose membership is constantly changing does not constitute a stable association of persons, and, accordingly, cannot be an organization. Of course, the requisite “stability” required to constitute the group as an organization may not be limited only to membership, but may also relate to the qualifications for, and the nature and process of, such continuing association.

Even if deliberation is not required in the formation of the organization, which Bittner says is usually assumed to be decisive as to whether the group constitutes and is “instituted as” an

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<sup>4</sup> Egon Bittner, "The Concept of Organization" (1965) 32:3 Social Research 239 at 243.

organization, the pursuit of its objectives involves rationally planning, and implementing, programs of action. The latter seem to require a certain degree of stability.

At this juncture, it is important not to assume that the “formal” organization exhausts the content, either of the term “organization”, or of its structure and processes. Instead, many practitioners and theorists of organizations explicitly acknowledge either that an “informal” organization may exist alongside the “formal” organization, or that some “informal” structure or structures, and processes may exist within the “formal” organization and processes, but that such “informal structure and processes” subsist separately and apart from its “formal” structure and processes. Selznick explains that the informal structure that exists in every organization will modify its goals, in the sense of causing abandonment, deflection, or elaboration of, such goals.<sup>5</sup>

This is true whether the organization has political, social or economic goals, or, expressed differently, has goals that sound (primarily or exclusively) in the polity, society or economy. In the case of the corporation, Chapter Five of the present text considers a number of issues relating to the relationship between formal organization and processes, and the one hand, and informal organization processes, on the other.

### ***Meyer Zald Definition***

In a different setting, involving a study of community organization agencies, Meyer Zald, a sociology and organizational behaviour theorist and practitioner, described organizations as follows: “Organizations come into being to pursue collective ends. A central part of the constitution of any organization is the sets of agreements about goals that are understood by major constituents. Not only do goals represent a set of constituting agreements, they focus organizational resources on a problem field. That is, organizational goals along with beliefs about how to attain them set tasks and problems for agency personnel.”<sup>6</sup>

Selznick characterizes an organization as both an economy and an adaptive social structure, saying that: “Considered as an economy, organization is a system of relationships which define the availability of scarce resources and which may be manipulated in terms of efficiency and

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<sup>5</sup> Philip Selznick, "An Approach to A Theory of Bureaucracy" (1943) 8:1 American Sociological Rev 47 at 47.

<sup>6</sup> Meyer N Zald, "Organizations As Polities: An Analysis of Community Organization Agencies" (1966) 11:4 Social Work 56 at 58.



effectiveness.”<sup>7</sup> The employment of such resources is a key determinant of organizational effectiveness. That employment of scarce resources is affected by the structure of the organization, systems of coordination, including delegation and control, stability of authority, and the effectiveness of inducements to individual participants.<sup>8</sup> This comports with Zald’s comments above. Again, these issues are explored in Chapter Five of the present work.

Zald says: “Central to organizational analysis, but often only implicitly treated, is an analysis of the polity of organizations—the patterned distribution and utilization of authority and influence.”<sup>9</sup> In this sense, every organization may be said to have or to be a “polity”, or to have or to be a political system, and, therefore, to have, and to be susceptible to, its own internal politics. As Zald notes, certain classes of organizations open (such as community organization agencies) display goals that are often in flux, patterns of power and influence that ebb and flow, constant overt or implicit conflict, and, often, unstable relationships with their external environments.<sup>10</sup> The immediately preceding Chapter Three discussed the corporation as a polity.

Zald observes that “[i]n a sense, the constitution of an organization represents its social contract—the basic purposes and modes of procedure to which the major supporters and staff of the organization adhere. When attempts are made to change the constitution of an organization, the agency can expect conflict and disaffection, unless clear benefits adhere to the major supporters.”<sup>11</sup> This “social contract” with respect to community organization agencies that Zald mentions may be analogized to the socioeconomic and political contract within a state or polity, or within a society, or within a corporation or other organization having business or economic objectives.

For Zald, this “constitution” includes not only the organization’s goals but also commitments to certain means or methods of proceeding, as expressed formally or in writing, and otherwise.<sup>12</sup> Thus, the constitution, for him, includes not only aspects of the formal, but also of the informal, organization under consideration. Not part of this “constitution”, but important to the conduct of the operations of the organization, are “many patterned aspects of agency operations” that do not

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<sup>7</sup> *Supra* note 1 at 26.

<sup>8</sup> *Ibid.*

<sup>9</sup> *Supra* note 6 at 57.

<sup>10</sup> *Ibid.*

<sup>11</sup> *Ibid* at 57-58.

<sup>12</sup> *Ibid* at 58.

involve basic agreements about goals and means. They may, however, represent, or be derived from, higher order commitments as to process and procedure. This will be further discussed below.

It is apparent that all of these definitions of the term “organization” encompass the corporation. Of course, it is respected convention to refer prominently to the perspective of Max Weber in any discussion of the nature of an organization, and, in particular, of bureaucracy. This warrants an examination of some of his writing on the subject. Among other things, this examination will make it apparent that Weber considers business firms and corporations as organizations.

## **PART A – GROUPS OF PEOPLE OR SOCIAL UNITS**

### **Max Weber on Organizations and Related Matters**

#### ***Organization as Social Relationship***

Weber’s magisterial work *Economy and Society: An Outline of Interpretive Sociology*<sup>13</sup>, was first published (in German) in 1922, after his death, although it was not translated into English until 1968. However, Part I of the book, translated by Talcott Parsons, was made available to English readers in 1947, under the title *The Theory of Social and Economic Organization*.<sup>14</sup> In order to understand, and to be able to assess, his foundational contribution, it is necessary to review the “building blocks” in this foundation, which will require some extensive reference to his text. This close attention will be repaid, however, as this work proceeds to further explicate other organizational theory and research.

Weber states that: “A social relationship which is either closed or limits the admission of outsiders will be called an organization (*Verband*) when its regulations are enforced by specific individuals: a chief and, possibly, an administrative staff, which normally also has representative powers”, which may be understood to mean the power of representing the organization and acting on its

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<sup>13</sup> Max Weber, *Economy and Society: An Outline of Interpretive Sociology* (Berkeley, Los Angeles and London: University of California Press, 1978). This was the first English translation of the complete work, by a group of translators, including C. Wright Mills and Talcott Parsons and was originally published in 1968. This book was identified by The International Sociological Association in 1998 as the most important book in sociology of the twentieth century: see <http://www.isa-sociology.org/books/books10htm>.

<sup>14</sup> Max Weber, *The Theory of Social and Economic Organization* (Glencoe, Illinois: The Free Press, 1947). This was first English translation, by Talcott Parsons, of Part I of his complete work, *Economy and Society*. In the present work, references are made to both works depending, in part, upon the present author’s judgment concerning which one provides an explication of the relevant concepts which is more salient for the purposes of the present work.

behalf, apparently with respect to both internal matters, such as enforcing its regulations, and external matters, in relation to extraorganizational actors.<sup>15</sup>

Weber's organization, which he insists is a "social relationship", is evidently a species of relationship which is not exhausted only between or among its members, or by admission of new members. Such a social relationship may be considered to be qualitatively different from other social relationships or types of social relationships. In fact, it seems to consider the focal organization as a "type" of relationship, which is reiterable or may be instantiated, at least, among the organization and each of its members, and perhaps among the organization and the totality of its then-existing members. Such a "type" relationship may be considered as notionally distinct from an apparently individuated or "one-off" relationship. That distinction is further emphasized by Weber's observation that such social relationship can be represented both internally, vis-à-vis its own members (the composition which is subject to change), and externally, vis-à-vis extraorganizational parties, generally or subject to some specification.

Such characteristics are not normally considered to be attributable to purely "social relationships" (rather than primary, usually familial or intimate, relationships), except insofar as those social relationships are expressed in some collective undertaking having at least notional reality, whether as a formally constituted association or as a partnership, joint venture, or corporation. It would normally be expected that such matters as possession and enforcement of regulations, and representation and acting by means of representation through representatives would be attributes of some notional or other entity, rather than of some social relationship. That is to say, such characteristics might be connected, logically or otherwise, with the reification or entification of the social relationship concerned. For example, the discussion of the corporation in the present work has demonstrated that the corporation fulfills the necessary elements of Weber's "organization".

Weber says that, in addition to representative powers, the "incumbency of a policy-making position or participation in the functions of the staff, constitute "executive powers" (*Regierungsgewalten*). These may be appropriated, or they may be assigned, in accordance with the regulations of the organization, to specific persons or to individuals selected on the basis of specific characteristics or procedures. "Organized action" is (a) either the staff's action, which is

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<sup>15</sup> *Supra* note 13 at 48.

legitimated by its executive or representative powers and oriented to realizing the organization's order, or (b) the members' action as directed by the staff.”<sup>16</sup> Of course, what Weber means by “organized action” is, simply, action taken by or on behalf of the organization.

In this regard, it may be noted that Alfred Chandler and others have specifically identified “executive powers” or “executive functions” and have distinguished them from other types of administrative functions. Indeed, Chandler identifies an “entrepreneurial function”, which consists in the determination of the corporation’s strategy and in the allocation of resources in relation to the same. Weber’s “executive powers” extend beyond policymaking to participation in operations. The term “organization”, for Weber, does not primarily identify an entity or a “thing” apart from human individuals, but, instead, is a certain kind of social relationship, one aspect of which is that it is “ordered”. Weber says that the order governing the organization may be established by the members on their own authority (*viz.* autonomously) or imposed by an outside agency (heteronomously).<sup>17</sup>

Further, Weber asserts that an “association's enacted order may be established in one of two ways: by voluntary agreement, or by being imposed and acquiesced in. The leadership in an organization may claim a legitimate right to impose new rules. The "constitution" of an organization is the empirically existing probability, varying in extent, kind and conditions, that rules imposed by the leadership will be acceded to. The existing rules may specify that certain groups or sections of the members must consent, or at least have been heard. Besides this, there may be any number of other conditions.”<sup>18</sup> Of course, the language Weber employs here is, at least arguably, more syntactically consistent with an “association” or “organization” as an entity than as a relationship.

In effect, having defined the organization as a particular species of relationship, Weber, consistently therewith, defines the constitution of the organization in empirical or probabilistic terms with respect to certain expectations concerning the relationship. Such a constitution has in view whether the parameters of the relationship which constitutes the organization permit further subsequent accepted rulemaking, whether subsidiary or otherwise. Weber’s definition of “constitution” may, perhaps, be better understood as having in view goals and objectives, and

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<sup>16</sup> *Ibid* [emphasis in the original. The editors placed all definitions in italics. Accordingly, further references to such emphasis being in the original are omitted after this point).

<sup>17</sup> *Ibid* at 49-50.

<sup>18</sup> *Ibid* at 50.

rules, methods and procedures, and even values, consistency with which is likely to meet with the acceptance of the members of the organization. These rules of the organization may relate either to organized action (an administrative order) or other kinds of social action (a regulative order).<sup>19</sup>

### *Typology of Organizations*

Weber maintains that organizations may also be distinguished in that: “Continuous rational activity of a specified kind will be called an *enterprise*; an association with a continuously and rationally operating staff will be called a *formal organization*. An organization which claims authority only over voluntary members will be called a *voluntary association (Verein)*; an organization which imposes, within a specifiable sphere of operations, its order (with relative success) on all action conforming with certain criteria will be called a *compulsory organization or association (Anstalt)*.”<sup>20</sup>

It appears that the “activity in which an enterprise engages” is business, which appears to include “business conducted by political and ecclesiastic organizations as well as by voluntary associations insofar as it has rational continuity.”<sup>21</sup> Although Weber does not use or define the expression “informal organization” where used here, his use of the term “formal organization” would suggest that an informal organization is one which lacks a continuously and rationally operating staff. It would appear that both formal organizations and informal organizations can also be characterized as either voluntary associations or compulsory associations.

Weber’s definitions make clear that he considers state and religious bodies as “organizations”. A “ruling organization” is “political”, he says, “insofar as its existence and order is continuously safeguarded within a given *territorial* area by the threat and application of physical force on the part of the administrative staff.” Famously, he stipulates that a “compulsory political organization with continuous operations (*politischer Anstaltsbetrieb*) will be called a “state” insofar as its administrative staff successfully upholds the claim to the *monopoly* of the *legitimate* use of physical force in the enforcement of its order”; and he says that “social action, especially organized action, will be spoken of as “politically oriented” if it aims at exerting influence on the government of a political organization; especially at the appropriation, expropriation, redistribution or

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<sup>19</sup> *Ibid* at 51.

<sup>20</sup> *Ibid* at 52 [emphasis in the original].

<sup>21</sup> *Ibid*.

allocation of the powers of government.”<sup>22</sup> Weber identifies as a "hierocratic organization" one “which enforces its order through psychic coercion by distributing or denying religious benefits ("hierocratic coercion"). A compulsory hierocratic organization will be called a "church" insofar as its administrative staff claims a monopoly of the legitimate use of hierocratic coercion.”<sup>23</sup>

Weber, then, considers voluntary and compulsory associations, (capitalist and non-capitalist) enterprises (associations carrying out continuous rational business activity), states and their subdivisions, political parties, and churches, including the Roman Catholic Church, to be organizations. In other contexts, he also includes armies, clubs, and other private associations.<sup>24</sup>

Of course, as can be seen from his definition of the term “organization”, for Weber, an organization is, or implicates, a social relationship with certain attributes, and, in particular: “The term “social relationship” will be used to denote the behavior of a plurality of actors insofar as, in its meaningful content, the action of each takes account of that of the others and is oriented in these terms. The social relationship thus consists entirely and exclusively in the existence of a probability that there will be a meaningful course of social action – irrespective, for the time being, of the basis for this probability.”<sup>25</sup> This predictability, which is key to Weber’s concept of relationship, is not inconsistent with the formal definitions of the term “organization” considered above.

### ***Organizations and Expectations of Social Action***

Accordingly, Weber considers a social relationship to exist when the probability of certain social action exists. The existence of the social relationship is not determinative of the social action, but, instead, the social relationship may be inferred from the probability of certain social action. Weber explains that the orientation of each to the others, and hence their relationship, need not be cooperative, but may even be competitive or otherwise, in terms of social action. However, the relationship is defined in terms of this likelihood of behaviour, since: “Even in cases of such forms of social organization as a state, church, association, or marriage, the social relationship consists exclusively in the fact that there has existed, exists, or will exist a probability of action in some

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<sup>22</sup> *Ibid* at 54 [emphasis in the original].

<sup>23</sup> *Ibid*.

<sup>24</sup> *Ibid* at 318.

<sup>25</sup> *Ibid* at 26-7.

definite way appropriate to this meaning. It is vital to be continually clear about this in order to avoid the “reification” of those concepts.”<sup>26</sup>

As mentioned above, it is open to question whether even Weber has avoided such reification when he talks in this way about “forms of social organization”. Alternatively, it can be argued that what are conventionally described as “organizations” do, as Weber argues, implicate or describe forms or modes of social relationships. Perhaps it is in seeking to develop a typology or taxonomy of social relationships that they are concretized, reified, or entified.

It is clear, however, that describing organizations in terms of the relevant social relationships, implicit or explicit, does direct attention to the instantiation of “relationships” in terms of actual behaviour; or that, expressed otherwise, patterns of instantiation of behaviour may be described as social relationships which, in some cases, may involve a social “organization”. Similarly, the actual behaviour of the parties to the social relationship may change, implicitly indicating a change in the nature of relationship, and, correspondingly, in the nature of the organization.

As has been, and will be, demonstrated further in the present text, many social theorists follow Weber in seeking to characterize organizations in terms of relationships, while simultaneously characterizing organizations as what Weber calls “forms of social organization”; that is to say, as something that obtains or exists separately from the instantiation of actual relationships between and among parties to those relationships, which parties may be described as participants, constituents, members, or by like terms vis-à-vis the form or vis-à-vis the instant case of social relationship to which they are parties.

By way of example, Weber refers famously to the state, which “ceases to exist in a sociologically relevant sense whenever there is no longer a probability that certain kinds of meaningfully oriented social action will take place. This probability may be very high or it may be negligibly low. But in any case it is only in the senses and degree in which it does exist that the corresponding social relationship exists. It is impossible to find any other clear meaning for the statement, that, for instance, a given “state” exists or has ceased to exist.”<sup>27</sup>

Certainly, the modern expression “failed state” is understood to describe a state which no longer functions in that capacity, which may also be taken to indicate that the social relationships

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<sup>26</sup> *Ibid* at 27.

<sup>27</sup> *Ibid*.

appurtenant to a state no longer exist. For example, the relationship between the state and a citizen no longer obtains in a failed state, as indicated by a number of criteria, including whether the state can expect loyalty from a citizen, whether a citizen can expect protection from the state, and whether other normal incidents of citizenship continue to obtain.

As Weber explains, a social relationship need not be reciprocal or symmetrical, but must involve mutual orientation such that one party, correctly or incorrectly, presumes a particular attitude or expectation of behaviour from the other to which the presuming party orients his own behaviour. Without this perceived attitude on the part of the other, which gives rise to an expectation of the other's behaviour by the presuming party, there is no social relationship. Consequently, it is only where both parties are perceived by the other to have a particular attitude and where, as a result, both parties have an expectation as to the behaviour of the other that a social relationship exists in Weber's terminology.<sup>28</sup> It is not necessary for this purpose, on Weber's definition, that the relationship be "objectively symmetrical" in the sense that each party to it has the same expectation of the behaviour of the other as the other does of the other party's behaviour, that is to say, that the relationship "means" the same to both parties, but there must be some mutual orientation.

Weber asserts that the "meaningful content" that remains relatively constant in a social relationship may be capable of formulation in terms of maxims to which the partners to the social relationship are expected, on average and approximately, to adhere. The more rational an action is in relation to values or given ends, the more likely it is to be expressed in such maxims.<sup>29</sup>

As mentioned, an organization, for Weber, involves a social relationship of some stability, however, not all social relationships may be so characterized: "A social relationship can be of a very fleeting character or of varying degrees of permanence. In the latter case, there is a probability of the repeated recurrence of the behaviour which corresponds to its subjective meaning and hence is expected. In order to avoid fallacious impressions, let it be repeated that it is *only* the existence of the probability that, corresponding to a given subject meaning, a certain type of action will take place which constitutes the "existence" of the social relationship. Thus that a "friendship" or "state" existed or has existed means this and only this: that we, the observers, judge that there is

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<sup>28</sup> *Ibid.*

<sup>29</sup> *Ibid* at 28.



or has been a probability that on the basis of certain kinds of known subjective attitude of certain individuals that will result in the average sense of a certain specific type of action.”<sup>30</sup>

Of course, it is only logical to conclude that attitudes of a party or expectations of the behaviour of that party by the other, and *vice versa*, will alter over time, in part in relation to the extent to which such attitudes or expectations continue to obtain. In this way, the social relationship, and, by way of instantiation of a social relationship, an organization, may be characterized by regular, if not actually continuous, development and realignment. A social relationship may even transition into a political relationship, which may be considered to be a continuance of the same relationship or a “new” relationship.<sup>31</sup>

Weber asserts that in a social relationship involving promises of future behaviour towards each other or towards third parties, each party premises his or her actions on the meaning of the agreement as the person acting understands it, but may also be motivated by a sense of duty to observe the terms of the agreement.<sup>32</sup> This may be considered to introduce some degree of stasis into the relationship. Such stasis may be relative and partial, or may be more enduring.

### ***Organization as Relationship, as Scheme or Structure, and as Social Unit***

As will be shown, in employing the term “organization”, social and organizational theorists and practitioners, including Barnard, Chandler, Simon, and Selznick, often fail to distinguish, imprecisely distinguish, or are confusing in attempting to distinguish, between “organization” as a scheme or method, on the one hand; and “organization” as a social unit or group of persons separate from its membership at any particular time, which is frequently characterized as an entity or “thing”. This may be considered to evidence a certain duality in cognitive, phenomenological, actual, and other terms. As noted below, those who, like Weber, seek to characterize an organization in terms of social relationship, may also be employing the term “organization” from a third perspective or in a third respect.

As has been demonstrated, and will be further demonstrated, in the present work, this categorical and conceptual difficulty is both shared and attenuated in the case of organizations which are recognized as entities in law, including the modern business corporation. Organizations which are

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<sup>30</sup> *Ibid.*

<sup>31</sup> *Ibid.*

<sup>32</sup> *Ibid.*

recognized as legal entities are characterized, firstly, not only by a “scheme of organization” involving certain structures and processes thought to be rationally conducive to the attainment of the goals and objectives; but also, secondly, as a social unit or group existing separately and apart from its current membership, that is, as a kind of “entity” or “thing”; and also, thirdly, whatever the Weberian “order” pursuant to which it is established, is also “established” within the legal order, and recognized within the legal order, as having specific “legal” attributes. In effect, rather than a duality, legal entities may be said to exhibit a triality, at least, in cognitive, phenomenological, actual, and other terms.

While other social and organizational theorists and practitioners exhibit various means of dealing with such duality or triality, this work typically attempts to separate the scheme of organization or organizational structure, on the one hand, from the social unit or group characterized by such scheme of organization or organizational structure, and, on the other hand, to separate both from the “legal” scheme of organizational structure instantiated by law with respect to the relevant social unit or group.

While more expert social and organizational theorists and practitioners appear to have experienced substantial difficulties in accurately specifying the duality of the phenomenon which they characterize in terms of “organization”, the present author, less expert in such matters, must admit to perhaps even greater difficulties than they experienced in specifying the triality which is characteristic of the “legal entity” organization, which is often expressed here as the organization of, attaching to, or accompanying, the legal entity; or expressed otherwise, as the legal entity of, attaching to, or accompanying, the relevant social unit.

Of course, social and organizational theorists and practitioners, like Weber, who characterize the organization as expressing, exclusively or principally, a social relationship may already be thought to be employing a triality in the definition of organization: that is, as relationship, as “scheme” or structure, and as a social unit or group. In that case, the addition of the legal form of organization might be considered to generate a quadrality of organizational referents.

With this attempt at disambiguation or classification of the senses in which the term “organization” is used, the sense of organization as social relationship can now be further investigated.

### *Typology of Social Relationships*

Weber distinguishes between social relationships as either “communal” or “associative”, on the following basis: “A social relationship will be called “communal” (*Vergemeinschaftung*) if and so far as the orientation of the social action – whether in the individual case, on the average, or in the pure type – is based on the subjective feeling of the parties, whether affectual or traditional, that they belong together.” On the other hand, “A social relationship will be called “associative” (*Vergesellschaftung*) if and insofar as the orientation of the social action within it rests on a rationally motivated adjustment of interests or a similarly motivated agreement, whether the basis of rational judgment be absolute values or reasons of expediency.”<sup>33</sup> However, “[i]t is especially common, though by no means inevitable, for the associative type of relationship to rest on a rational agreement by mutual consent. In that case the corresponding action is, at the pole of rationality, oriented either to a value-rational belief in one’s own obligation, or to a rational (*zweckrationale*) expectation that the other party will live up to it.” Examples of communal relationships are, according to Weber, a family, an erotic or amatory relationship, a relation of personal loyalty, a religious brotherhood, a national community, or the *esprit de corps* of a military unit.<sup>34</sup>

Weber says that social relationships that have common ends which are not immediately achievable and hence involve relatively permanent social relationships between the same persons are at least partly communal in nature, but may also be characterized by considerations of expediency.<sup>35</sup> This may even be true within the family. He maintains that, while such relationships may be thought to be the radical antithesis of conflict, conflict and even coercion may be present even in such relationships.

Weber’s “associative relationships”, on the other hand, are considered to be exclusively based on rational grounds and, often, are based on mutual consent. The consent may express a congruity of values, in which case the associative relationship itself may be instrumental in pursuit of such values. Weber notes that “[a]ssociative relationships, on the other hand, very often consist only in compromises between rival interests, where only a part of the occasion or means of conflict has been eliminated, or even an attempt has been made to do so. Hence, outside the area of

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<sup>33</sup> *Ibid* at 40-41.

<sup>34</sup> *Ibid* at 41 [emphasis in the original].

<sup>35</sup> *Ibid* at 42.

compromise, the conflict of interests, with its attendant competition for supremacy, remains unchanged. Conflict and communal relationships are relative concepts. Conflict varies enormously according to the means employed, especially whether they are violent or peaceful and to the ruthlessness with which they are used.”<sup>36</sup>

Weber says: firstly, that communal relationships are based on a feeling of “belonging together”; secondly, that associative relationships are based on rationality and, often, on mutual agreement; and, thirdly, that conflict and communal relationships are “relative concepts”. These remarks are consistent with the suggestion that, just as there may be conflict in communal relationships, a feeling of “belonging together” to some extent, however limited or expansive, may sometimes come, over time, to characterize associative relationships.

That is to say, even though the origination of the associative relationship was determined rationally and often voluntarily, some affective relationship may develop thereafter; and that such affective relationship may mitigate conflict and promote the continuity of the relationship. While this is not exactly what Weber says in the passage just quoted, this interpretation is consistent with his remarks. It is also consistent with empirical findings concerning business enterprises and other types of organizations some of which will be described under the next major heading “A Social Unit or Group of People”.

The existence of common qualities, a common situation, common modes of behaviour, a common language, a common biological inheritance, a common “feeling” about a situation and its consequences do not, for Weber, indicate a communal relationship; which is exhibited, instead, only when this common factor leads to a mutual orientation of the behaviour of the parties to each other and involves “feelings of belonging together”.<sup>37</sup>

It can readily be seen that the existence of a social relationship, whether communal or associative in Weber’s terminology, does not predict a complete unity of interests or the absence of conflict or coercion. Thus, the organization associated with certain social relationships should not be expected to feature a complete unity of interests, or the absence of conflict or coercion.

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<sup>36</sup> *Ibid.* As discussed in Chapter Three, March describes the firm as a socio-political conflict system. See also the discussion following under the heading “A Social Unit or Group of People”.

<sup>37</sup> *Supra* note 13 at 42.

Instead, we might expect that a more complete unity of interests or absence of conflict or coercion might be characteristic of a more communal organization and less characteristic of a more associative organization. We might expect that organizations in reality might not conform to an ideal type of either, but might be arrayed on a continuum between more communal and more associative, with a similar dispersion with respect to the presence of unity of interest and conflict and coercion, and with respect to the presence of the subjective feeling of belonging (together). As just demonstrated, to some extent Weber may even have anticipated this characterization.

### ***Open Relationships and Closed Relationships***

It is also possible that the dispersion of characteristics along these continua may be affected by another important binary mentioned by Weber; namely, whether the relationship, whether communal or associative in character, is “open” or “closed”, in each case, to outsiders. For Weber, a social relationship is “open” to outsiders “if and insofar as its system of order does not deny participation to anyone who wishes to join and is actually in a position to do so”, but is “closed” against outsiders “so far as, according to its subjective meaning and its binding rules, participation of certain persons is excluded, limited, or subjected to conditions.”<sup>38</sup>

Weber indicates that: “Whether a relationship is open or closed may be determined traditionally, affectually, or rationally in terms of values or of expediency for example, where it provides “the parties to it with opportunities for the satisfaction of spiritual or material interests, whether absolutely or instrumentally, or whether it is achieved through co-operative action or by a compromise of interests.” The “open or closed” determination is based solely on interest: “If the participants expect that the admission of others will lead to an improvement of their situation, an improvement in degree, in kind, in the security or the value of the satisfaction, their interests will be in keeping the relationship open. If, on the other hand, their expectations are of improving their position by monopolistic tactics, their interest is in a closed relationship.”<sup>39</sup>

Weber says that a closed social relationship may generate advantages that are appropriated by individuals or sub-groups on a permanent basis, called “rights”, and that appropriated rights which are enjoyed by individuals through inheritance or by hereditary groups, whether communal

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<sup>38</sup> *Ibid* at 43.

<sup>39</sup> *Ibid*.

associative, are called the “property” of the individual or groups in question.<sup>40</sup> Again, we would suggest that the “open” and “closed” feature of an organization may also be arrayed along a continuum ranging from completely open to completely closed. It might also be inferred that the subjective feeling of belonging may be affected by the position of the relevant organization on the open/closed continuum and other relevant continua.

In terms of Weber’s analysis, business enterprises, when characterized as social relationships, and within that characterization as “associative relationships”, may demonstrate some variability as to whether, and to what extent, they are “open” or “closed”. In turn, this may be affected by the order pursuant to which they were instantiated. For example, a partnership, normally constituted voluntarily, would be “closed” according to Weber’s definition, as participation of certain persons is excluded, limited, or conditional. A limited partnership would be considered to be closed vis-à-vis general partner status, but might be considered to be more open vis-à-vis limited partner status. That limited partnership might be considered to be instituted by legal order, in addition to voluntary order. A modern business corporation would normally be instituted in like manner. It seems that it would be considered “closed” vis-à-vis directors, officers, managers, and other employees; but that it might be considered to be “open” vis-à-vis shareholders if its shares are freely transferable, especially if they are listed and posted for trading on a recognized stock exchange.

Consideration of these examples leads to the suggestion that at least some types of organizations may be “open” in certain respects, but “closed” in other respects. In that case, the relevant categorization may depend upon, or at least be affected by, the purpose for which categorization is undertaken. We would expect that such observation might also apply to many organizations which are not corporations or other forms of business enterprises.

### ***Mutual Responsibility and Representation***

Another characteristic of an organization, for Weber, is representation and mutual responsibility, for: “Within a social relationship, whether it is traditional or enacted, certain kinds of action of *each* participant may be imputed to *all* others, in which case we speak of “mutually responsible members” or the action of certain members (the “representatives”) may be attributed to the others (the “represented”). In both cases, the members will share the resulting advantage as well as the

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<sup>40</sup> *Ibid.*

disadvantages.”<sup>41</sup> Weber says that the power of representation may be completely appropriated by a particular, often self-appointed, authority; or it may be conferred, for a limited time, or permanently, in accordance with particular characteristics; or it may be conferred by specific acts of the members or outside persons, in which case such power is “derived” or “delegated”.<sup>42</sup>

Whether social relationships involve mutual responsibility or representation is not determined by whether the relationships are communal or associative. Such mutual responsibility or representation may be related to the degree of closure against outsiders, says Weber, but this is not always the case. Mutual responsibility is often associated with household or kinship units, and with business partnerships, while representation is most frequently found in associations devoted to specific purposes and in legally organized groups.<sup>43</sup>

Recalling Weber’s treatment of communal and associative relationships, and their relations to feelings of togetherness and rational agreement, respectively, and the interpretation here that such characterizations need not be exclusive but may be partial, it might have been expected that Weber would have argued that mutual responsibility and representation need not be exclusive, but may be partial. In effect, some relationships might involve a combination of the two: for example, mutual responsibility with respect to one particular set of activities, but representation with respect to another particular set of activities. For example, a partnership would involve mutual responsibility, but a limited partnership would involve mutual responsibility only with respect to each general partner and representation vis-à-vis the general partners and limited partners.

Of course, for Weber, the social relationship is characterized by an expectation of behaviour commensurate with the relationship. The representation of the organization by its “representatives” is one aspect of this predictable behaviour. Both the representative and the organization expect that the other party will behave in the future in a certain predictable manner in relation to the subject-matter of the representation: “The primary factor underlying representation is that the action of certain members of an organization, the “representatives,” is considered binding on the others or accepted by them as legitimate and obligatory”.<sup>44</sup>

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<sup>41</sup> *Ibid* at 46-47 [emphasis in the original].

<sup>42</sup> *Ibid* at 47.

<sup>43</sup> *Ibid* at 47-48.

<sup>44</sup> *Ibid* at 292.

As is implied by the “social” nature of such relationship, both the organization and the representative have certain expectations of the other party in regard to the relationship. Presumably, the acceptance by the members of the actions of the representative as binding, legitimate, and obligatory is predicated on the assumption that such representation will be exercised properly and responsibly; while the willingness of the representative to undertake such representation is, in turn, predicated upon the assumption that the proper exercise of such responsibility will be considered as binding, legitimate, and obligatory with respect to the members. In this regard, it may be suggested that these duties and responsibilities are founded upon a relationship which is both “social” and “associative” in nature; and, further, that perceptions of the representative, on the one hand, and of the organization, on the other, may or may not be symmetrical vis-à-vis the other. That is to say, the expectations of one party need not completely accord with those of the other.

While perhaps not intended by Weber as a complete explication of the nature of the rights and duties arising in consequence of a relationship in which one party represents another, Weber’s remarks do admit of interpretation as a “social relationship” theory of rights and duties in that behalf. For example, with respect to the corporation, the representation of the corporation by duly authorized parties may be said, following Weber, to rest upon the mutuality inherent in a social relationship, in this case between the corporation and the parties to whom it grants authorization. This may also be considered to be true with respect to the representation of the “corporation” in its decision-making by the board of directors and other authorized parties, considering, in this case, the relationship to be between the corporation, on the one hand, and the board of directors and other authorized parties, on the other hand.

Weber maintains that, within the structures of domination, representation takes a variety of typical forms. These forms, according to Weber, include appropriated representation, estate-type representation, “instructed” representation, and free representation. In the case of appropriated representation, the chief or a member the administrative staff holds appropriated rights of representation, which traditionally have limited scope. This is common in all kinds of patriarchal and charismatic groups, clans, tribes, castes, sects, hereditary monarchies and similar patriarchal



or patrimonial organizations.<sup>45</sup> Thus, he indicates that it would include many forms of religious organizations, such as the Roman Catholic Church.

Weber explains that estate-type representation (which is derived from and includes the estates of the late Middle Ages in Germany and the estates-general in early modern France) does not constitute a representation insofar as it is a matter of representing and enforcing appropriated rights or privileges but does constitute a representation insofar as the decisions of such bodies as estates extends beyond the personal holders of privileges to the unprivileged groups.<sup>46</sup>

“Instructed” representation involves the choice of representatives in some manner to exercise powers of representation which are strictly limited by an imperative mandate and the right of recall. His examples include the communes in France and the Soviet type of republican organization. Today it might include the governorships of certain states in the United States of America. Free representation applies where the representative is not bound by instruction but is in a position to make his own decisions. He is obligated only to express his own genuine conviction, and not to promote the interests of those who have elected him.<sup>47</sup> Modern parliamentary representation is an example.

Weber also identifies a fifth type of representation, which is “that by the agents of interest groups. This term will be applied to the type of representative body where the selection of members is not a matter of free choice, but where the body consists of persons who were chosen on the basis of their occupations or their social or class membership, each group being represented by persons of its own sort. At the present time the tendency of this type is to representation on an occupational basis.”<sup>48</sup> Weber specifically mentioned as an example of this type a state of Soviets.

As we have shown, organization theorists, including Weber, Parsons, Gaus, Blau, Selznick, Zald,, Bittner, and Etzioni, generally consider, in broad terms, an organization to be a social unit or group of individuals working together in an organized way to meet, pursue or accomplish one or more collectively shared needs, goals or purposes.

Each element of this characterization will now be discussed at a very general level.

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<sup>45</sup> *Ibid.*

<sup>46</sup> *Ibid* at 293.

<sup>47</sup> *Ibid.*

<sup>48</sup> *Ibid* at 297.

## A Social Unit or Group of People

The first aspect of the definition of organization to be considered is the nature of the “social unit”, “group of people” or “group of individuals”. It may be noted that each of those terms, “social unit”, or “group of people” or “group of individuals”, suggest some form of collective orientation and collective behaviour.<sup>49</sup> In this sense, the terms reference a social relationship among the members of the group, much as suggested by Weber with respect, at least, to the organization. Indeed, some modern social theorists, such as Schuetz, contend that it is the “cultural pattern of group life”, meaning “all the peculiar valuations, institutions, and systems of orientation and guidance (such as the folkways, mores, laws, habits, customs, etiquette, fashions) which...characterize – if not constitute – any social group at a given moment in its history.”<sup>50</sup>

Of course, this observation is consistent with Alfred Schuetz’s early advocacy of phenomenological sociology and his development of a philosophy of social science that supported Weberian sociological and economic analysis. Accordingly, Schuetz treats the underlying social relationship as characterizing, and arguably even constituting, the group in much the same way as Weber treats the underlying social relationship as characterizing, and arguably even constituting, the organization or association. In this sense, of course, a group could not be seen as in stasis, but, instead, as dynamic, subject to regular, if not unremitting, change in its membership and other aspects. As such, reification of the group as a fixed entity would be inappropriate. The boundaries of the group, as discussed below, may be considered to be constituted in part in relation to those of other groups; and may be considered to periodically adjust accordingly.

It is not intended to embark here on a discussion of the typologies of social units or social groups which include households, communities, peer groups, clubs, teams, in-groups and out-groups, small groups, and larger groups. Instead, for present purposes, it will be assumed that those terms refer to more than one individual having some type of association among themselves. Some groups are characterized by voluntary association and others by involuntary association. Examples of the former include clubs, churches, political parties, and labour unions. Examples of the latter include

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<sup>49</sup> See, for example, John C Turner, Michael A Hogg, Penelope J Oakes, Stephen D Reicher, Margaret S Wetherell, *Rediscovering the Social Group: A Self-Categorization Theory* (Cambridge, MA: Basil Blackwell, 1987); and, from a leading proponent of phenomenological sociology, Alfred Schuetz, "The Stranger: An Essay in Social Psychology" (1944) 49:6 *American J Sociology* 499.

<sup>50</sup> Schuetz, *supra* note 49 at 499.

families, nationality or citizenship determined by birth or by presence within a jurisdiction, and military organizations characterized by conscription.

It will be assumed here that the presence of an individual in a group somehow affects his or her behaviour or, expressed differently, that the behaviour of an individual, as such, is intermediated by the group. The behaviour of the other individuals in the group and, perhaps, the behaviour of the group, as such, may also be intermediated by the behaviour of the subject-individual. This may be as a result of interaction among individuals other than the subject-individual, and, as well, as a result of interaction between the other individuals and the subject-individual. It may even be that mere presence of an individual in a group affects the subject-individual's own attitudes and behaviour. These assumptions will be discussed in greater detail below.

### *Intraorganizational Organizations*

The discussion of the firm as an economic actor in Chapters Two and Three averted to the existence of various groups within the organization, and to the existence of various subgroups within those groups. Those chapters considered the ways in which the corporation might act as a single economic actor at the macro-level, the level of the corporation or organization as a whole, but might act otherwise, both internally and externally, at the level of groups or subgroups within the corporation as organization. That is to say, those chapters considered the ways in which groups might act, and subgroups within groups might act, as individual economic actors separately from the corporation at the macro-organizational level.

This phenomenon can be easily explained, logically and syntactically. As indicated, an organization is considered to be a social unit or group of people which act collectively and also satisfy certain other conditions with respect to such collective action, which relate to its structure and processes, and to its goals and objectives. It is logical and rational to consider that there may be within such a social unit or group of people intraorganizational social units or groups of people which act "collectively"; and that such intraorganizational social units or groups of people taking collective action may themselves satisfy the other conditions to be considered as organizations in their own right.

These social units or groups of people may take collective action in various respects, such as with respect to different goals and objectives. Likewise, two or more social units or groups of people within the organization may pursue the same goals and objectives but may have different

memberships, which may be somewhat coextensive with, or entirely separate from, each other. This work maintains that each of these can be regarded as separate “organizations” within the macro-organization, provided that they satisfy the requisite elements of the definition of the term “organization”.

Accordingly, there may be within the corporation, at the macro-organizational level, organizations established with respect to various goals and objectives taking collective action with respect to their attainment. For ease of reference, these have often been referred to in this work as “groups” or “subgroups” within the organization; and they have sometimes been denominated as divisions, departments, functions, and otherwise. Considering whether groups or subgroups within a macro-organization satisfy the elements necessary to constitute an organization may contribute significantly to understanding the macro-organization itself.

It is frequently the case that research and theoretical literature in various disciplines refer to “groups” and “subgroups” within an organization without expressly analyzing whether those groups or subgroups themselves constitute organizations. Indeed, this seems to be almost invariably, or, perhaps even invariably, the case. Instead, it may often be assumed, no doubt for valid reasons limiting such discussion, that this is the case, and that such groups and subgroups have their own goals and objectives.

If, of course, those groups and subgroups are themselves organizations, each of them would also have organizational structures, procedures, and processes that are considered to be conducive to attainment of its own organizational goals and objectives. As such, those structures, procedures, and processes may differ from those of the macro-organization, and, as well, from those of other intraorganizational groups and subgroups.

In the case of a corporation, these groups may be constituted by action taken at the macro-organizational level; that is, at the “corporate”, headquarters, or head office level. Many social theorists, including Weber, recognize that an organization need not be created autonomously. Weber indicates that an organization may be either autonomous, meaning “that the order governing the organization has been established by its own members on their own authority, regardless of

how this is taken place in other respects”; or heteronomous, meaning that such order “has been imposed by an outside agency.”<sup>51</sup>

The characterization of the modern business corporation in this respect is unclear and depends upon how the corporation is characterized with respect to its organizational status. Considering the corporation itself as a formal organization, it is established as an enterprise by action of the incorporators, but is established as a legal entity heteronomously by the state pursuant to general corporate legislation but only on application, autonomously, by the incorporators. In that case, the order governing the corporation as organization may be considered to be established heteronomously only with respect to certain elements of the organization which are prescribed by statute, and the remaining elements may be considered to be established autonomously. Of course, the foregoing assumes that the corporation is identical with its formal organization. As discussed here, it is also possible to consider the corporation, purely as a legal entity, as engaging with the formal organization involving individual persons by which and by whom it is enabled to take action and it is animated and vivified.

However the relationship between the corporation as a legal entity and as an organization is elided, as has been seen in the previous chapter, commentators on organizations and, in particular, on corporations, frequently avert to “groups” and “subgroups” within the organization, to their goals and objectives, and to their membership or composition. Often, the goals and objectives of the organization, whether a corporation or otherwise, are distinguished from those of groups within it, and from those of subgroups within such groups.

In this regard, Chapter Three discussed March’s analysis of “the business organization as a socio-political conflict system subject to economic constraints”.<sup>52</sup> In terms of that analysis, March argued that it is a postulate of conflict system analysis “that the basic units are not themselves conflict systems”, and that viewing a single system “as either an elementary unit or a conflict system depending on the level of aggregation involved” presented analytical problems. Despite this,

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<sup>51</sup> *Supra* note 13 at 49-50.

<sup>52</sup> James G March, “The Business Firm as a Political Coalition” (1962) 24:2 *J Politics* 662 at 666. This is discussed in the section entitled “Organizations as Political Systems”, particularly under the headings “Firms, The Polity, and Economic Theory”, and “The Firm as a Socio-Political Conflict System”, and “The Firm as a Conflict System for Internal and External Conflicts”, and “Joint Preference Ordering in Economic Theory”.

March concluded that “most systems studied in the social sciences are apparently conflict systems of conflict systems.”<sup>53</sup>

As noted previously, among March’s conclusions was that economic theory, by which he appeared to mean classical or neoclassical economic theory, treated “the firm” as the basic unit of a larger conflict system, whether that was the industry, market, or the economic system as a whole, rather than as a conflict system itself.<sup>54</sup> As maintained in those sections of the present text, as a result, economic theory tended to disregard preference ordering within the firm itself, considered as a subsystem, or basic unit, of the larger economic system. Consequently, it became necessary to resort to other modes of analysis to explain the interaction of an organization with the intraorganizational organizations or groups contained within it.

In the result, generally speaking, researchers, analysts, and theoreticians of organizations, including corporations, frequently discuss the goals and objectives of intraorganizational groups and subgroups without any explicit reference to the status of those groups and subgroups as organizations and themselves, and often without analyzing the structure, systems and processes which are constitutive of, and sometimes partially or wholly distinctive (within the macro-organization) to, that group or subgroup as an organization itself. Awareness of these aspects of intraorganizational groups and subgroups may be expected to influence the veracity and predictive capacity of organizational and intraorganizational models of behaviour. Consequently, we turn now to some of these influences.

### ***Social Comparison Theory***

Leon Festinger, one of the most frequently cited psychologists of the twentieth century, famous for his social comparison theory and his concept of “cognitive dissonance”, explains that knowledge of group opinions or group abilities have an effect on an individual’s perceptions which were initially formed privately, especially at the time at which such opinions are initially formed and thus are, at that time or otherwise, inherently unstable.<sup>55</sup> According to Festinger, the opinions of members of a particular group tend to be less divergent than opinions outside the group.<sup>56</sup> Similarly, the prevalence of wide divergences in opinion among a particular group may result in a

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<sup>53</sup> *Supra* note 52 at 664.

<sup>54</sup> *Ibid* at 668.

<sup>55</sup> Leon Festinger, “A Theory of Social Comparison Processes” (1954) 7 *Human Relations* 117 at 122.

<sup>56</sup> *Ibid* at 123.

change in group composition.<sup>57</sup> An individual's excessive diversion of opinion from that of the group as a whole may lead to his or her ejection or voluntary removal from the group.<sup>58</sup>

Festinger argues that the more attractive a group is to a member, the greater will be the pressure to uniformity, expressed as a tendency to change one's own position, to attempt to change the positions of others, and to restrict the range of comparison of opinions.<sup>59</sup> He argues that the greater is the importance of an opinion to the life of the group or to the attainment of the satisfactions that attract the members to the group, the greater will be the pressure towards uniformity of opinion.<sup>60</sup>

Festinger concludes that the drive to compare opinions with other group members will be greater where the subject-matter is more important, more related to behaviour, and especially to social behaviour, and where the behaviour concerned is more immediate.<sup>61</sup> Consequently, where the attractiveness of the group is not a significant determinant, people tend to move in and out of groups based on opinion and ability similarity.<sup>62</sup> Where the attractiveness of the group is significant, the pressure to "fit in" may result in an opinion self-adjustment.

### ***Social Identity Theory***

The influential social psychologist Henri Tajfel criticizes Festinger's social comparison theory as being "almost exclusively concerned with social comparisons made between individuals and with evaluations of oneself and others made by means of these inter-individual comparisons", thereby neglecting an "important contributing aspect of an individual's self-definition, namely, that he is a member of numerous social groups and that this membership contributes, positively or negatively, to the image that he has of himself".<sup>63</sup> This difference of opinion is, perhaps, understandable in view of Tajfel's more social orientation. We might note in passing, however, that social comparison and pressure to conform to the behaviour of others may, in themselves, represent some indication of group membership.

This contribution of group membership to an individual's self-definition has become known as "social identity theory" or "social identification theory". Like social comparison theory, it is

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<sup>57</sup> *Ibid* at 128.

<sup>58</sup> *Ibid* at 136.

<sup>59</sup> *Ibid* at 131.

<sup>60</sup> *Ibid* at 132.

<sup>61</sup> *Ibid* at 130.

<sup>62</sup> *Ibid* at 136.

<sup>63</sup> Henri Tajfel, "Social Identity and Intergroup Behaviour" (1974) 13:2 *Social Science Information* 65 at 68-69.

important in this work insofar as it contributes to understanding intragroup and intergroup interaction. The extent of its contribution in this regard merits extensive exposition here.

Tajfel employs four related concepts to explain how this self-definition proceeds: social identity, social categorization, social comparison, and psychological distinctiveness. Festinger's social comparison theory was discussed in the preceding section. However, as Tajfel notes, Festinger concentrated on inter-individual comparisons which "neglects an important contributing aspect of an individual's self-definition, namely that he is a member of numerous social groups and that this membership contributes, positively or negatively, to the image that he has of himself."<sup>64</sup> Indeed, Tajfel indicates that group membership is a factor in each of these four aspects of self of definition. He maintains that the assumed need for differentiation or the establishment of psychological distinctiveness between groups is, under some conditions, "the major outcome of the sequence social categorization-social identity-social comparison."<sup>65</sup>

The first two of these concepts are the related concepts of social categorization and social identity, both of which are related to the term "group", but express the significance of the group to the individual concerned, which includes perceptual, epistemological, or cognitive matters. Tajfel says that: "The process of categorization, as it is used by the human individual in order to systematise a whole and simplify his environment, presents certain theoretical continuities between the role played by categorizing in perceptual activities and its role in the ordering of one's social environment. For our purpose, social categorization can be understood as the ordering of social environment in terms of social categories, that is, of groupings of persons in a manner which is meaningful to the subject."<sup>66</sup>

Tajfel explains that, for this purpose, "the term "group" denotes a cognitive entity that is meaningful to the subject at a particular point in time and must be distinguished from the way in which the term "group" is used in much of the social psychological literature where it denotes an "objective" (most often face to face) relationship between a number of people. In other words, social categorization is a process of bringing together social objects or events in groups which are equivalent with regard to an individual's actions, intentions, attitudes and systems of beliefs."<sup>67</sup>

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<sup>64</sup> *Ibid* at 69.

<sup>65</sup> *Ibid* at 74.

<sup>66</sup> *Ibid* at 69.

<sup>67</sup> *Ibid*.



Tajfel asserts, in effect, that the group which is meaningful to an individual is not the group of social psychology, where it denotes an “objective” (most often face-to-face) relationship, but the group as experienced by the individual concerned. That individual engages with the group and its members as the group is seen by the individual in relation to the individual’s own actions, intentions, attitudes, and systems of beliefs.

Tajfel’s second threshold concept, “social identity”, is understood to mean “that part of an individual’s self-concept which derives from his knowledge of his membership of a social group (or groups) together with the emotional significance attached to that membership.”<sup>68</sup> Social identity, then reflects the individual’s self-assignment, notionally or otherwise, to the group and the emotional significance to that individual of such self-assignment.

Both social identity and social categorization are, for Tajfel, highly important to the individual, inasmuch as social categorization is “the orientation which creates and defines the individual’s own place in society.”<sup>69</sup> He supports this conclusion with conclusions reached by Peter L. Berger, namely, that “[e]very society contains a repertoire of identities that is part of the objective knowledge of its members”;<sup>70</sup> and that “[s]ociety not only defines but creates psychological reality. The individual *realises* himself in society – that is, he recognizes his identity in socially defined terms and these definitions become reality as he lives in society”.<sup>71</sup>

We might express all of these observations by saying that the individual negotiates a notional or an epistemic space or spaces in society as he or she assesses, selects, and adopts social identities which he or she considers comport with his or her actions, intentions, attitudes, and systems of belief, and that such individual does so in relation to his or her perception of groups and their accord with his or her actions, intentions, attitudes, and systems of belief. The self of the individual is instantiated, expressed, and developed in his or her life in society.

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<sup>68</sup> *Ibid.*

<sup>69</sup> *Ibid.*

<sup>70</sup> PL Berger, “Identity as a Problem in the Sociology of Knowledge”, (1966) 7 *European J Sociology* 105 at 106. Also published that year was the book jointly authored by Peter L Berger with Thomas Luckmann: PL Berger and Thomas Luckmann, *The Social Construction of Reality: A Treatise in the Sociology of Knowledge* (Garden City, NY: Anchor Books, 1966). This became a seminal text in the field of sociology of knowledge.

<sup>71</sup> *Ibid* at 69, citing Berger, *supra* note 70 at 107 [emphasis in the original].

### *Intragroup Aspects of Social Identity*

Tajfel unpacks this further, delineating four principal consequences of this “recognition of identity in socially defined terms”. The first of these is that “[i]t can be assumed that an individual will tend to remain a member of a group and seek membership of new groups if these groups have some contribution to make to the positive aspects of his social identity; *i.e.* to those aspects of it from which he derives from satisfaction.” Secondly, if it does not make this contribution, “the individual will tend to leave it *unless*: *a*) leaving the group is impossible for some “objective reasons or, *b*) it conflicts with important values which are themselves a part of his acceptable social identity.”<sup>72</sup>

Thirdly, if “leaving the group presents the difficulties just mentioned, then at least two solutions are possible: *a*) to change one’s interpretation of the attributes of the group so that its unwelcome features (*e.g.* low status) are either justified or made acceptable through a reinterpretation; *b*) to accept the situation for what it is and engage in social action which would lead to desirable changes in the situation (of course, there may be various combinations of *a*) and *b*), such as, for example, when the negative attributes are justified and social action to remove them is undertaken at the same time).”

Fourthly, Tajfel says that “[n]o group lives alone – all groups in society live in the midst of other groups. In other words, the “positive aspects of social identity” in [the first item] above, and the reinterpretation of attributes and the engagement in social action in [the third item] above, only acquire meaning in relation to, or in comparison with, other groups.”<sup>73</sup> Again, the participation of an individual in a group is affected by his or her self-perception and perception of the group. Perception of the group is affected, in turn, by another process of comparison, this time comparing or relating one group to others, and assessing how his or her perception of each group accords with the individual’s own actions, intentions, attitudes, and systems of belief.

When Tajfel says that no group lives alone and that all groups in society live in the midst of other groups, it need not be assumed that the presence of groups in society is, of necessity, ordered and exclusive. Instead, an individual may be a member of a great many groups, some of whom may have other members in common, while others may not. Likewise, groups may be situated within

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<sup>72</sup> *Ibid* at 69 [emphasis in the original].

<sup>73</sup> *Ibid* at 70.

other groups. But, Tajfel says, no one group is coeval and coterminous with the society itself. A group, in this sense, exists within the overall society.

Of course, it is not necessary that the range of opinion constituting phenomenological sociology or that constituting a social philosophical analysis of Weberian sociology be accepted in order to accept the analyses but forward by Schuetz, Tajfel, and Festinger, respectively, above. Instead, these analyses are offered here as prolegomena to the analysis of the organization itself.

### ***Individual and Intragroup Aspects of Social Identity***

In an influential and much-cited review article,<sup>74</sup> Blake Ashforth and Fred Mael apply the social identity theory (SIT) developed by Tajfel and others to groups and organizations. In addition to its influence and continuing use as a reference, the breadth and depth of its review of the subject makes it an appropriate primary source for the explication of social identity theory in a coherent and disciplined manner consistent with the arguments made in the present work. Consequently, it is cited extensively for this purpose below.

#### *Social Classification and Social Identification*

Ashforth and Mael say that social classification, firstly, enables an individual to classify others by means of prototypical characteristics abstracted from the members of the group or organization; and, secondly, “enables the individual to locate or define *him-or herself* in the social environment.” They explain that, according to SIT, “the self-concept is comprised of a *personal* identity encompassing idiosyncratic characteristics (e.g., bodily attributes, abilities, psychological traits, interests) and a *social* identity encompassing salient group classifications.”<sup>75</sup>

In this regard, “*Social identification*, therefore, is the perception of oneness with or belongingness to some human aggregate... As such, social identification provides a partial answer to the question, Who am I?”<sup>76</sup> The present work has repeatedly referred to individuals as constantly “negotiating” their identities; and also refers summarily to this process as variously involving acquiring “new”,

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<sup>74</sup> Blake E Ashforth and Fred Mael, "Social Identity Theory and the Organization" (1989) 14:1 Academy of Management Review 20. As March 2, 2018, it had reportedly been cited 9901 times. Available at: [https://www.google.ca/search?source=hp&ei=R7GZWuXPOsrktQWE7Y\\_QBg&q=Social+Identity+Theory+and+the+Organization&oq=Social+Identity+Theory+and+the+Organization&gs\\_l=psy-ab.13..0i2j0i22i30k114.2881.2881.0.4349.1.1.0.0.0.101.101.0j1.1.0....0...1c..64.psy-ab..0.1.100....0.BWxDKNaIhWs](https://www.google.ca/search?source=hp&ei=R7GZWuXPOsrktQWE7Y_QBg&q=Social+Identity+Theory+and+the+Organization&oq=Social+Identity+Theory+and+the+Organization&gs_l=psy-ab.13..0i2j0i22i30k114.2881.2881.0.4349.1.1.0.0.0.101.101.0j1.1.0....0...1c..64.psy-ab..0.1.100....0.BWxDKNaIhWs).

<sup>75</sup> *Supra* note 74 at 21 [emphasis in the original].

<sup>76</sup> *Ibid* [emphasis in the original].

and discarding “old”, identities. In effect, such short-form descriptions or assertions have been based on an understanding of social identity theory, and upon recognition that a new identification by the relevant individual of a group as salient to their own social identity may cause that individual to reassess the comparative saliences of other groups and, in effect, to reprioritize his or her social identity accordingly. Likewise, an adjustment to the salience of one group classification or “group identity” may also cause such readjustment across the board.

Ashforth and Mael hold that social identification is a perceptual cognitive construct that is not necessarily associated by the individual with any specific behaviours or affective states, or expenditure of effort, except that such individual is “psychologically intertwined with the fate of the group”.<sup>77</sup> That is, the individual personally experiences the successes and failures of the group. This need not, they say, entail internalization, or acceptance and incorporation within the self as guiding principles, of the values and attitudes of the group.<sup>78</sup>

Instead, this identification with a group has similarities with identification with a person or with a reciprocal role relationship (such as husband-wife or doctor-patient) inasmuch as one partly defines oneself in terms of a social referent.<sup>79</sup> We might say, in other words, that the subject-individual considers himself or herself to be one side of a relationship, in this case, with the group, which is, or is on, the other side of the relationship. This recalls Weber’s description of the organization as a social relationship.

Ashforth and Mael claim that the subject’s perception of a relevant group for such purposes may be relatively diffuse, inasmuch as the “individual’s social identity may be derived not only from the organization, but also from his or her work group, department, union, lunch group, age cohort, fast-track group, and so on.”<sup>80</sup> As often observed in the present work, this suggests that numerous group affiliations may contribute, simultaneously, to an individual’s social identity and, further, that their salience to the individual may be subject to periodic recalibration.

Ashforth and Mael explain that, with certain limited exceptions, such as missionary organizations (for reasons to which we will avert below), the existence of a single or blended organizational identification, characterizing holographic organizations, is problematic in most complex

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<sup>77</sup> *Ibid.*

<sup>78</sup> *Ibid* at 22.

<sup>79</sup> *Ibid.*

<sup>80</sup> *Ibid.*

organizations, and that, instead, individuals within subunits may share a common identity or identities which are subunit-specific, and are not shared across subunits, which is characteristic of ideographic organizations.<sup>81</sup> In this way, an organizationally situated social identity may be comprised of more or less disparate and loosely coupled separate group-related identities. The present work has previously maintained that these identities may operate at the level of the organization and at intraorganizational levels, including divisions, departments, functions, groups, subgroups, and subgroups of subgroups.

### *Social Identification and Organizational Commitment*

As previously noted, Ashforth and Mael maintain that social identification by an individual with a particular organization is distinct from commitment to that organization. They assert that organizational commitment is most commonly considered to involve, firstly, belief and acceptance of its goals and values; secondly, willingness to exert effort on its behalf; and, thirdly, a desire to maintain membership. They argue that an individual who believes that an organization is a convenient vehicle for his or her career or other goal may display organizational identification, but may not exhibit organizational commitment.<sup>82</sup>

The present author concludes that organizational commitment has an affective, rather than rational or exclusively rational, component, which may arise, at least in part, from “sharing” common purpose and effort. What Ashforth and Mael describe as organizational commitment or even organizational identification correlates well with certain definitions of the term “organization”. In particular, Chester Barnard, whose empirical and theoretical work will be discussed in the next chapter, defines the term “organization” in terms of identification or commitment, as well as cooperation. He asserts that that “an organization comes into being when (1) there are persons able to communicate with each other (2) who are willing to contribute action (3) to accomplish a common purpose”.<sup>83</sup>

According to SIT, membership in a group is consistent with in-group favouritism, cooperation and cohesion, and discrimination against an out-group and its members, even where there is no prior personal acquaintance, similarity or liking, and where there is no interaction within or between

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<sup>81</sup> *Ibid.*

<sup>82</sup> *Ibid* at 23.

<sup>83</sup> Chester I Barnard, *The Functions of the Executive*, (Cambridge: Harvard University Press, 1938) at 82.

groups.<sup>84</sup> Ashforth and Mael relate this to what Turner considered as a “psychological group”, which Turner defined as “a collection of people who share the same social identification or define themselves in terms of the same social category membership.” A member of a psychological group “does not need to interact with or like other members, or be liked and accepted by them. It is his or her perception of being, say, a loyal patriot or sports fan that is the basis for incorporation of that status into his or her social identity. The individual seems to reify or credit the group with a psychological reality apart from his or her relationships with its members.”<sup>85</sup>

The suggestion here may be that it is in crediting the group with a psychological reality apart from the individual’s relationship with the members of the group, perhaps both individually and collectively, that the individual reifies the group itself. This may be the case with respect to the organization which is implicated with a particular corporation: an employee, shareholder, or other individual who incorporates the corporation as organization into his or her social identity may be, in the first instance, reifying or entifying the organization as the group with which he or she identifies, and is thereby identifying with the corporation as such.

In the case of groups or organizations sufficiently large that the individual concerned may not be personally acquainted with all other members of the group or organization, the individual’s identification with the group or organization, and that individual’s reification of such group or organization may be based on typification of members, which would apparently involve creation of an “ideal type” of member.

We might speculate that this abstraction may be less immediate to the individual and, therefore, less attractive as a bonding or commitment mechanism than immediate personal acquaintance; with the result that the likelihood of bonding or commitment is likely normally somewhat greater in “face-to-face” relationships or situations, those involving groups or subgroups, rather than the organization as a whole, or some higher level groupings within the organization, such as divisions, departments, and the like. However, this is only an inference from other literature reviewed.

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<sup>84</sup> *Supra* note 74 at 24. They cite many articles by Tajfel, his sometime collaborator, John C Turner, and others, on this subject, as well as the extensively cited book chapter by H Tajfel and JC Turner, [1979] "An Integrative Theory of Intergroup Conflict" in WG Austin and S Worchel, eds, *The Social Psychology of Intergroup Relations* 33 (Pacific Grove, California: Brooks/Cole, 1979).

<sup>85</sup> *Supra* note 74 at 24. They cite Tajfel’s frequent collaborator, James C Turner, in his 1984 article "Social Identification and Psychological Group Formation" in H Tajfel ed, *The Social Dimension: European Developments in Social Psychology*, (Cambridge: Cambridge University Press, 1984) Vol 2 518, especially at 530.

Ashforth and Mael indicate that the distinctiveness of values and practices in relation to comparable groups tends to increase the tendency to identify with certain groups. Within the organization, such distinctiveness is qualified by the clarity and impermeability of group domains or boundaries.<sup>86</sup> Identification is also increased by the prestige of the group, the salience of out-groups (which reinforces awareness of one's in-group), and other factors traditionally associated with group formation, such as interpersonal interaction, similarity, liking, proximity, shared goals or threats, and common history.<sup>87</sup>

Within the corporation, these factors are likely to increase in salience with successively more granular groupings: for example, in the case of the group as compared with the organization or the subgroup compared with the group. Thus, the observations and generalizations to this effect in the present work finds support from the work of Ashforth and Mael.

#### *Implications of Social Identification*

Ashforth and Mael identify three general consequences of SIT that are relevant to organizations: firstly, individuals tend to choose activities congruent with salient aspects of their identities and to support institutions embodying those identities; secondly, social identification affects the outcomes conventionally associated with group formation, including intragroup cohesion, cooperation, and altruism, and positive evaluations of the group by its members, internalization of and adherence to group values and norms, and homogeneity of attitudes and behaviour; and, thirdly, SIT reinforces the factors that antecede such identification, including distinctive values and practices, group prestige, and salience of, and competition with, out-groups, and other traditional causes of group formation.<sup>88</sup> The present work has referred repeatedly to such consequences.

As the individual comes to identify with a group, its values and practices become more salient to that person, and are perceived as more unique and distinctive. Ashforth and Mael conclude that “perhaps the greatest contribution that SIT makes to the literature on organizational behavior is the recognition that a psychological group is far more than an extension of interpersonal relationships: Identification with a collectivity can arise even in the absence of interpersonal

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<sup>86</sup> *Supra* note 74 at 24.

<sup>87</sup> *Ibid* at 25.

<sup>88</sup> *Ibid* at 25-26.

cohesion, similarity, or interaction and yet have a powerful impact on affect and behavior.” Such social identification, they say, results “in crediting a collectivity with a psychological reality beyond its membership” and “enables the individual to conceive of, and feel loyal to, an organization or corporate culture”, even to such a point that Turner identified social identity as “the cognitive mechanism which makes group behavior possible.”<sup>89</sup>

As previously noted, the fact that an individual is able to identify with a collectivity even in the absence of some interpersonal interaction by the individual with it or its members vests the collectivity with what Ashforth & Mael call “psychological reality” apart from its membership, or, as they have said elsewhere, entifies it. They indicate that it is not clear whether this is because the collectivity is clothed by the individual with ideal characteristics generalized from the experience of the individual, such as with persons admired by or persons having a formative influence with respect to, the individual concerned. However, they indicate that the psychological reality of the collectivity is borne out in experience and research. The present work has relied on the same.

### ***Organizational Socialization***

In their extensive review of the research and literature, Ashforth and Mael explain that organizational newcomers are thought to be “highly concerned with building a *situational definition*”, namely, understanding the organization and learning how to act within it, which, in turn, requires learning “its policies and logistics, the general role expectations and behavioural norms, the power and status structures and so forth.” However, “organizational newcomers also are often concerned with building a *self-definition*”, which includes social identity.<sup>90</sup>

We may consider the situational definition to relate to general cognition and meaning with respect to the organization or group, and the self-definition to relate, in significant part, to situating oneself within the organization or group, but also more broadly, outside the focal organization or group. In effect, as the newcomer engages in the process of acquiring such situational definition and self-definition, that individual, as noted in the present work from time to time, negotiates his or her social identity: acquiring, developing, reprioritizing, reemphasizing, and discarding certain aspects

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<sup>89</sup> *Ibid* at 26. Their cite to Turner, who collaborated extensively with Tajfel in developing SIT, is: JC Turner, "Towards a Cognitive Redefinition of the Social Group" in H Tajfel, ed, *Social Identity and Intergroup Relations* (Cambridge, England: Cambridge University Press, 1982) 15.

<sup>90</sup> *Supra* note 74 at 26 [emphasis in the original].



or components of his or her social identity, which have sometimes been referred to in the present work, for convenience, and notionally, as different or separate “social identities”.

### *Developing a Social Identity*

Ashforth and Mael explain that the literature on organizational socialization indicates that definitions and self-definitions emerge through symbolic interactions, in which meaning evolves from verbal and nonverbal interactions of individuals. In part, individuals form self-conceptions by interpreting the responses of others in situated social interactions. In terms of organizations, this suggests that the internalization of organizational values and beliefs takes place as individuals are socialized into the organization and identify with it, which, in turn, effects internalization.<sup>91</sup>

They find that the shared values and beliefs, mission, structures and processes, organizational climate and other characteristics reflect, and even constitute, the identity of the organization, the “shared understanding of the central, distinctive and enduring character or essence of the organization among its members.” They note that Ashforth himself showed that “the more salient, stable, and internally consistent the character of an organization (or in organizational terms, the stronger the culture), the greater this internalization.”<sup>92</sup>

Ashforth and Mael indicate that socialization has a direct effect on internalization, and that internalization and identification occur separately from one another. For example, “total and quasi-total institutions such as prisons, military and religious organizations, professional schools, and organizational plans” apply not only investiture processes with respect to building incoming identity, but also apply divestiture processes to supplant existing identity with a new organizationally situated identity.

In connection with the latter, such institutions often “remove symbols of newcomer’s previous identities; restrict or isolate newcomers from external contacts; disparage newcomer’s status, knowledge and ability; impose new identification symbols; rigidly prescribe and proscribe behaviour and punish infractions; and reward assumptions of the new identity.” Evidently, “the more that the organization’s identity, goals, values and individual role requirements deviate from

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<sup>91</sup> *Ibid* at 27.

<sup>92</sup> *Ibid*. They cite: BE Ashforth, "Climate Formation: Issues and Extensions" (1985) 10 *Academy of Management Review* 837.

the societal mainstream, the greater the need for organizationally situated identification".<sup>93</sup> These findings are generally consistent with the experience of knowledgeable generalist observers.

Ashforth and Mael explain that social identity theory has important implications with respect to reification, "how an individual can identify with, or feel loyal and committed to, an organization per se. The implicit assumption is that regard for individuals simply generalizes to the group, that interpersonal relationships somehow are cognitively aggregated to create an individual-organizational relationship."<sup>94</sup>

The suggestion appears to be that, like aggregation of demand in economic theory, this represents some kind of methodologically individualistic fallacy, however, Ashforth and Mael purport to "reverse this logic and argue that identification with the group can arise quite separately from interpersonal interaction and cohesion. In perceiving the social category as psychologically real – as embodying characteristics thought prototypical of its members, – the individual can identify with the category per se (I am a Marine)."

Yet, as noted above, Ashforth and Mael claim that an individual is able to identify with a collectivity even in the absence of some interpersonal interaction by the individual with it or its members. This seems to contraindicate the generalization or aggregation explanation. Also of note is their observation that social identification thus permits the continuance of loyalty to one's own department despite a complete changeover of personnel and, likewise, permits a continued belief in the integrity of the organization despite wrongdoing by senior management.

Again, these findings seem to present difficulties with respect to the generalization or aggregation explanation of identification. For our purposes, however, it is important to note that such continued loyalty to the organization may involve some type of reification or entification which, according to Ashforth and Mael, is observed to be universally present with respect to all organizations, including corporations. Observations to this effect been cited throughout the present work.

Management of an organization, they say, has an interest in managing symbolic interactions, not only at the time of socialization into the new organization but also on a continuing basis. "Although

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<sup>93</sup> *Supra* note 74 at 28.

<sup>94</sup> *Ibid*, citing: JC Turner, "Social Identification and Psychological Group Formation" in H Tajfel, ed, *The Social Dimension: European Developments in Social Psychology* (Cambridge, England: Cambridge University Press, 1984) Vol 2 518.

the coherence of the group's or organization's identity is problematic, we believe that symbolic management is designed to impart this identity, or at least management's representation of it", which is effected "through the manipulation of symbols such as traditions, myths, metaphors, rituals, sagas, heroes, and physical setting".<sup>95</sup>

Ashforth and Mael "contend that precisely because identification is *group-specific*" organizations are able to claim "a positive and distinctive organizational entity [which] attracts the recognition, support and loyalty of not only organizational members but other key constituents (e. g., shareholders, customers, jobseekers)".<sup>96</sup> This has been the subject of frequent comment in the present work.

#### *Social Identity and Organizational Units*

Ashforth and Mael conclude that "the newcomer's emerging situational definitions and self-definitions are apt to be largely *subunit specific*" since, firstly, there is a greater need for, and ease of, interaction in the immediate work group which involves greater task interdependencies and interpersonal proximity; secondly, for those reasons, the immediate work-group, whose members are likely to have more homogeneous beliefs, is a more ready source of comparison for those emerging beliefs; thirdly, in view of such interdependence, proximity, and similarity, the newcomer may also regard the work-group as a psychological group, thereby facilitating social influence; and, fourthly, "given the importance of the situational definition to job performance and the centrality of the social identity to the self-concept, it is likely that a normative structure will emerge to regulate and maintain these conceptions."<sup>97</sup>

In other words, all other things being equal, the organizational level which is likely to be the most relevant to the social identity of individual members is generally that which is the most immediate to such individual member, namely, the smallest or most intimate grouping which satisfies the relevant requirements to be called a "group". Of course, while this identity may be most salient to the individual generally, that individual may also present other social identities of greater or lesser salience, either generally or in particular circumstances. As suggested previously, changes in

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<sup>95</sup> *Supra* note 74 at 28.

<sup>96</sup> *Ibid* [emphasis in the original].

<sup>97</sup> *Ibid* at 29 [emphasis in the original].

circumstances and affect and otherwise may cause the individual to reprioritize the salience of those social identities.

### ***Role Conflict***

Ashforth and Mael contend that an individual's social identity is likely to consist of "an amalgam of identities, identities that could impose inconsistent demands upon that person" in terms of the values, beliefs, norms, and demands inherent in such identities; and that an individual's social identity can also conflict with the demands of the individual's personal identity. In an organizational context, "conflicts between work-group, departmental, divisional, and organizational roles are somewhat constrained by the *nested* character of these roles; that is, each hierarchical level encompasses the former such that the roles are connected in a means-end chain".<sup>98</sup> Observations to this effect been made from time to time in the present work, but it can now be seen that Ashforth and Mael provide express support for such observations, including treatment of social identity as involving an amalgam of identities.

They find that "in the course of assuming a given identity (e.g., department), the group becomes more salient and both intragroup differences and intergroup polarities are cognitively minimized, thus rendering both lower order (e.g., work group) and higher order (e.g., organization) identifications less likely". They also note that "given the association between identification and internalization, a lack of congruence between the goals or expectations of nested groups may impede joint identification".<sup>99</sup> In effect, entry into a new group, although "nested", reduces identification with other groups of which the individual is a member, especially where such groups may have different goals or expectations.

It might be expected that "nested" groups within rationally ordered organizations would effect some congruence of higher-order goals and expectations as between higher levels and successively lower levels; that, at the same time, such higher order goals and expectations may command less salience with respect to individuals who are members of such nested groups; and that lower-order goals and expectations may command greater salience with respect to such individuals. Of course, where groups are not "nested", in the sense that the sub-group is a component of the relevant group, and so on, there would not necessarily be an expectation that goals or expectations of one group

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<sup>98</sup> *Ibid* [emphasis in the original].

<sup>99</sup> *Ibid* at 30.

may be congruent with that of another group, or that goals and expectations of any particular subgroup may be congruent with that of another subgroup. It must be emphasized, of course, that these characteristics may be expected to obtain only in the case of organizations which are rationally ordered.

Ashforth and Mael posit that, rather than integrating these several identities, the individual treats them cognitively “by ordering, separating, or buffering the identities.” That is, the individual may self-define in terms of the most salient social identity or personal attribute; or might defer to the identity under the greatest external pressure and minimize, deny or rationalize the conflict; or might “cognitively decouple the identity so that conflicts simply are not perceived”; or, finally, might “comply *sequentially* with conflicting identity so that the inconsistencies may not be resolved for any given action”.<sup>100</sup>

We have referred to this process in the present work from time to time as the individual “negotiating” his or her social identity; and as acquiring, developing, reprioritizing, reemphasizing, and discarding certain aspects or components of his or her social identity, which have sometimes been referred to in the present work, for convenience, and notionally, as different or separate “social identities”. Such references, it can now be seen, are consistent with social identity theory.

Ashforth and Mael indicate that this kind of identity segregation permits the individual to benefit from holding multiple roles “including resource accumulation, justification for failure to meet certain role expectations, and support against role failure or loss”.<sup>101</sup> Accordingly, they consider that “one’s identity is an amalgam of loosely coupled identities”, rather than a unified, consistent whole.”<sup>102</sup> Again, their analysis of the relevant research and literature thus supports observations made in this respect throughout the present work.

### ***Intergroup Relations***

Ashforth and Mael find that “much intergroup conflict stems from the very fact that groups exist”, since social identities are maintained primarily by intergroup comparison, in respect of which, in order to enhance self-esteem, groups seek to establish positive differences between themselves and

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<sup>100</sup> *Ibid* [emphasis in the original].

<sup>101</sup> *Ibid*, citing: PA Thoits, "Multiple Identities and Psychological Well-Being: Reformulation and Test of the Social Isolation Hypothesis" (1983) 48 *American Sociological Review* 174.

<sup>102</sup> *Supra* note 74, citing: KJ Gergen, "Personal Consistency and the Presentation of Self" in C Gordon & KJ Gergen, eds, *The Self in Social Interaction* (New York: Wiley, 1968) Vol 1 299 at 306.

reference groups. Consequently, in organizations “comprised of subunits members of which share a social identity specific to their subunit”, there is a tendency towards subunit identification such that “subunits tend to be the primary focus of intergroup conflict”, which tendency is “exacerbated by competition between subunits for scarce resources and by reward and communication systems that typically focus on subunit functioning and performance”.<sup>103</sup>

Ashforth and Mael say that just as “a strong group identity unifies group members, so too should a strong organizational identity unify organizational members”. However, where organizational identity is not strong, they say that firstly, the subject group as in-group “may develop negative stereotypes of the out-group and deindividuate and depersonalize its members”; secondly, may tend to maintain social distance from, and subordination of, the out-group; thirdly, that this may become a contagion, which may tend to polarize perceptions of the situation; and fourthly, that these tendencies may be exacerbated by competition, which may threaten the group and its identity. In fact, even absent objective sources of conflict, such as scarcity of resources, such groups may exhibit competition and hostility, which may be even greater than that which may obtain between individuals.<sup>104</sup> Apparently, in the case of groups which are more comparable and undifferentiated, the in-group bias may be greater than where there are differences.

Ashforth and Mael indicate that such comparisons are affected by the relative status of the groups concerned in that, firstly, groups often restrict their comparisons to similar, proximal, or salient out-groups; secondly, like individuals, who can make social comparisons on multiple dimensions, groups may exhibit in-group favouritism on dimensions regarded as important to them, but may have positive perceptions of the out-group on dimensions seen as important by the out-group and not by the in-group; and, thirdly, differing outcomes in allocations of resources or in social comparisons may not provoke bias where these differences are seen as legitimate or institutionalized.<sup>105</sup>

### **Conclusion – Organizations as Social Units or Groups of People**

Accordingly, investigation of the research and theorization of the first element of the definition of the term “organization”, namely, that it consists of a “social unit”, or a “group of people” or a

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<sup>103</sup> *Supra* note 74 at 31.

<sup>104</sup> *Ibid* at 32.

<sup>105</sup> *Ibid* at 33.

“group of individuals”, has indicated, firstly, the complexity and consequences of that element of the definition and, consequently, of the definition as a whole. That investigation has also indicated, secondly, that the organization itself may be analyzed in terms of the “groups” within it: the various groups and subgroups of which it may be composed.

Such investigation has also demonstrated, thirdly, that groups, and perhaps also individuals, engage in intergroup action; and, fourthly, that such intergroup action may take place on a number of levels, including between the organization itself and each group, between each group and each of its subgroups, between or among some or all of the groups and other groups, and between or among some or all of the groups and the subgroups of other groups within the organization, and, perhaps, between the organization and some or all of the subgroups of groups within the organization. Fifthly, subgroups within groups may engage in intragroup activity and that such intra-unit activity may also extend to activity within subgroups, whether by lower order subgroups or by individuals.

It is apparent from this investigation that: 1. The social identity of individuals is related, at least in part, to the organizations or groups of which they are members or in which they participate. 2. Individuals may also exhibit commitment to such organizations, the degree of which may be influenced by various factors. 3. The identification with, and commitment to, organizations by individuals may vary over time, a process described here as involving a “renegotiation” or reprioritization of such identities and commitments. 4. The incorporation of a new organization into an individual’s social identity is often sought to be fostered by socialization mechanisms undertaken by the organization, which may be described as “organizational socialization”. 5. An organization or group is seldom completely socially coherent, that is to say, most often various groups, or subgroups, or groups of groups or subgroups, can be identified within the focal supra-organization.

This investigation also indicates that: 6. Intraorganizational groups may constitute organizations, that is to say, they may collectively pursue common goals or objectives. 7. The goals pursued by intraorganizational groups may not be coextensive with those of the focal supra-organization. They may be the same as or similar to, partially complementary with, or conflict with her be inimical to, the goals of the focal supra-organization. 8. Thus, the focal supra-organization, in order to attain its own goals, must exercise some control or influence over the goals of its constituent

organizations and groups. 9. Failure or inability to exercise such control or influence may present a challenge to the operations and even existence of the focal supra-organizational group. 10. This may also create extraorganizational problems, potentially including liability in respect of the actions of intraorganizational organizations or intraorganizational groups which actions are not aligned with the goals, and even policies and processes, of the focal organization.

It is apparent from this review that managing an organization is a challenge of significant dimension. This challenge may be expected to be particularly acute where participants in the organization have no direct or automatic right to participate directly in such management, such as is the case with modern business corporations or with various types of political, social, non-governmental, or other organizations. The authority to select and monitor management, to approve or disapprove of, or to amend, certain management actions may assume considerable importance with respect to organizations of diverse objectives. This may be the case without respect to the entitlement of any such participants to terminate their participation in the organization, financial or otherwise, and whatever the legal status of the organization.

In the case of the modern business corporation, these organizational considerations impact the essentialist legal attributes of the corporation as a legal entity, but most especially, of course, the existence of central management and its separation, as a matter of law, from its equity participants.

The next chapter, Chapter Five, will consider the distinctive characteristics of organizations as compared with other groups: firstly, with respect to their structure, process, personnel, and operations generally which are developed rationally with a view to accomplishing its goals and objectives; and, secondly, with respect to jointly establishing, pursuing, and seeking to attain the collective goals and objectives of the group.



**PART 3 – HOW, INSTEAD, TO ANALYZE THE CORPORATION: A CORPORATIVE THEORY OF CORPORATE LAW AND GOVERNANCE****SECTION A – THE ORGANIZATION – PART B – STRUCTURE, PROCESS, AND MANAGEMENT****CHAPTER FIVE – THE ORGANIZATION - DEFINING AND OTHER ATTRIBUTES – STRUCTURE, PROCESS, AND MANAGEMENT****PROGRESSION OF THE PURPOSE AND SCOPE OF THE BOOK**

The earlier parts of this book, Parts 1 and 2, together with Appendices A and B, consider, respectively, the legal attributes of the corporation as instantiated in modern corporate legal statutes in an effort to describe what are generally considered to be the attributes of modern business corporations, in order to frame the discussion, to identify essential attributes requiring further investigation, and, in the course of such examinations, to endeavour to discern any assumptions or generalizations upon which those statutes might be grounded. Part 2 and Appendix B investigate assumptions or generalizations of classical and neoclassical economic theory reflected in discourse concerning the firm and the corporation which might be considered to have some relevance to corporate law and corporate legal statutes in terms of theorization of the corporation.

This part of the book, Part 3, sets forth an approach to, or perspective on, analyzing, or a theory of, the corporation which is an alternative to approaches, or perspectives, or theories which are historically related to classical and neoclassical economic theory. As shown in Part 2 of the book (concerning the corporation as an economic actor) and in Appendix B (concerning economic theory more generally), many of its generalizations and assumptions have been succeeded, since early theorization of the corporation in the common law, by recent refinements, recharacterizations, modifications, and even wholesale revisions, including behavioural economics, new institutional economics, agency theory, and joint production theory.

This part begins with an examination of the nature of organizations generally, not limited to, but, rather, including, organizations which purportedly have principally economic objectives, such as the modern business corporation. It will draw particular attention to literature reviews and theory relevant to the corporation and will review some of the principal perspectives in considerable detail. While this will require extensive references to the literature, it is considered that this

procedure will thereby provide a theoretical and empirical basis from which a theory of the corporation as legal entity and as an organization can be derived, supported, and analyzed.

Finally, this part of the book will then consider the implications of such organizational analysis to the corporation as a legal entity and otherwise. In that context, it will advance the present author's "corporative theory" of, or "corporative perspective" on, the modern business corporation.

### **PURPOSE AND SCOPE OF THIS CHAPTER**

Chapter Three, which was the last chapter in Part 2 of this work, examined the way in which the corporation functions as an economic actor and otherwise, internally and externally. Among other things, it showed that the modern business corporation sometimes functions as a single actor, and sometimes functions otherwise. In that regard, Chapter Three mentioned a number of considerations relevant to the organization which acts as, and on behalf of, the corporation or, expressed alternatively, instantiates the corporation in action in the real world.

As observed at the beginning of the immediately preceding Chapter Four, a rough working definition of the term "organization" is that it is a social unit structured and managed in such a way as to meet one or more particular needs or to pursue or accomplish one or more collective goals or purposes; or, alternatively, that it is a group of people working together in an organized way to meet, pursue, or accomplish one or more collectively shared needs, goals, or purposes. In this sense, an organization may be said to have a structure, processes, and to be managed in a manner which is rational vis-à-vis seeking to attain the relevant needs, goals, or purposes.

Chapter Four examined the aspect of the definition of "organization" which concerns itself with a "social unit" or "group of persons", and considered the nature and effects of the same. The present chapter directs attention to the means by which an organization is established and by which it conducts its business. This concerns the structure or method of its formal organization, as well as the processes and procedures by means of which it operates, and the features of the personnel who are engaged in such operations. In order to attain its goals and purposes, the structure, processes and personnel of the organization must be instantiated in an intendedly rational manner. As indicated earlier in the chapter, Weber himself emphasized the necessity of rationality in order that an organization may be said to exist. In that regard, Weber emphasized the importance of bureaucratic organization, the discussion of which in Chapter Four will be further advanced here.

Accordingly, Chapters Three and Four and Appendix B review literature from various fields which summarizes research and theory concerning, and itself theorizes, various aspects of the organization. Those chapters thus provide support for some of the generalizations and observations made earlier in this book in circumstances in which it was not possible to do this. They also provide support for the corporative theory or corporative perspective elucidated further later in this part of the book. It now remains to consider other aspects of the organization, as such, and then to relate these to the legal entity known as the corporation and, in particular, the modern business corporation.

As was noted in the immediately preceding chapter, commentators have observed that organizations of diverse natures share certain common characteristics. For example, Oliver Williamson observed that complex organizations, including, but not limited to economic enterprises, employ a knowledge of the attributes of human nature, a hierarchy, a separation of strategic and operating decisions, and the application of controls, in fashioning their decision making and implementation structure and processes<sup>1</sup> Again, many of these factors were explicated famously by Weber, to whose review of which subjects we now turn.

Following that review of the traditional Weberian analysis of formal organization or bureaucracy, we will turn to a review of other, generally more modern, relevant research, literature, and theory concerning the characteristics and behaviour of organizations, some of which relates more specifically to the modern business corporation. In that way, the present chapter will continue the effort to support some of the generalizations and observations made earlier in the work, but which were made subject to providing this kind of further support.

## **STRUCTURE, PROCESS, AND PERSONNEL**

### **Rational-Legal Authority, Administration, and Bureaucracy**

#### ***Legitimacy and Rational-Legal Authority***

Weber began his analysis by considering the grounds upon which authority could legitimately be claimed. As is well known, Weber considered that there were three grounds, each of which may be considered to be ideal types, on which authority could be claimed to be legitimate: rational,

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<sup>1</sup> Oliver E Williamson, "Organization Form, Residual Claimants, and Corporate Control" (1983) 26:2 JL Econ 351 at 365.

traditional, and charismatic. It will be assumed here that claims of authority relating to most organizations, including all economically-oriented organizations, such as modern business corporations, will be based on rational grounds.

Rational claims to legitimacy rest on “a belief in the ‘legality’ of patterns of normative rules and the right of those elevated to authority under such rules to issue commands (legal authority)”, in which case “obedience is owed to the legally established impersonal order [and] extends to the persons exercising the authority of office under it only by virtue of the formal legality of their commands and only within the scope of authority of the office.”<sup>2</sup> Such legal authority is made effective when certain other ideas of principles or accepted.

In this regard, Weber argued that legal authority relies on acceptance of a number of mutually interdependent ideas, which may be summarized as follows: 1. Any legal norms could be established by agreement or could be imposed on rational grounds or on grounds of expediency, where obedience by members of the group could be claimed.<sup>3</sup> 2. Bodies of law consist of a consistent system of abstract rules intentionally established, administration of which consists in applying them to particular cases, which administrative process involves “the rational pursuit of the interests which are specified in the order governing the corporate group within the limits laid down by legal precepts and following principles which are capable of generalized formulation and are approved in the order governing the group, or at least not disapproved in it.”<sup>4</sup> 3. The typical person in authority occupies an “office” acting pursuant to which, including when issuing commands to others, the officeholder is “subject to an impersonal order to which his actions are oriented”. 4. Someone obeying authority does so only in pursuance of his capacity as a member the corporate group and obeys only “the law”. 5. Obedience is owed by a member of the corporate group not to any individual person, “but to the impersonal order. Hence, it follows that there is an obligation to obedience only within the sphere of the rationally delimited authority which, in terms of the order, has been conferred upon [such person]”.<sup>5</sup>

It is significant that both Weber’s “law” and its administration involve devising general rules that are internally consistent, and applying them in a logically coherent manner to particular cases in a

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<sup>2</sup> Max Weber, *The Theory of Social and Economic Organization* (Glencoe, Illinois: The Free Press, 1947) at 328.

<sup>3</sup> *Ibid* at 329.

<sup>4</sup> *Ibid* at 330.

<sup>5</sup> *Ibid*.

manner which is non-subjective and impersonal. The order establishing and continuing to govern the group specifies its goals and objectives, and the rules and principles intended to apply to the group. Power and authority are considered to inhere in the group but to be exercised in concrete instances by duly appointed office holders whose authority emanates only from the office of which they are the incumbents. Such power and authority are established, and submission to them is accepted by members of the group, in each case, within stipulated boundaries, in connection with the institution and constitution of the group as an organization, the “order” governing the group.

Clearly, Weber’s characterization of organizational legitimacy is highly regarded and highly influential. It also accords with more modern usage. Of course, the fact that Weber’s description of this “rational-legal” paradigm of legitimacy meets with relatively ready acceptance by modern readers may result, in part, from its extensive influence and adoption, consciously or unconsciously, by other commentators and theorists. Indeed, in many significant respects, his description also accords with commonly held criteria concerning the “rule of law”. This observation is further discussed below.

### *The State, the Organization, and the Corporation*

It is immediately apparent that Weber’s characterization of legal authority posits that legal authority exists in relation to an “organization”; is instituted by the “order” establishing the organization; and that his “law”, or “rule”, is instituted by, and pursuant to, that founding order. Both the adoption and administration of those laws or rules are intended to be rationally coherent means of pursuing the agreed common interests for which the organization was established. The “organization” described by Weber satisfies the “common sense” and other definitions of that term generally in use at the present time as discussed in Chapter Four.

Weber’s characterization of the organization, of course, is intended to apply to the modern state, as well as many other forms of organization, including the corporation. His explication of formal organization or bureaucracy may be considered to be oriented, to a significant degree, to the state itself. However, it is also intended to be applicable to all other species of organizations.

Having regard to the purposes of the present work, it must be emphasized that Weber seeks to explain not only how the legitimacy of the state originates, but also how the legitimacy of all other organizations originate: namely, rationally, traditionally, or charismatically. In certain cases, the present work maintains, states may originate or, we may say, re-originate, as such, rationally; that

is to say, even if originally founded on traditional or charismatic principles, or based on states or statal authority which was so founded, they may be re-created or re-instantiated based on the adoption of new constitutional or other principles.

It is important to note that if it is assumed, for the purpose of argument, that Weber would agree that such constitutional re-origination or reformation of the state thus originates its legitimacy on a rational basis (regardless of how legitimated originally), then it can be seen that such a state would be fundamentally similar, in that regard, to any other type of organization. In other words, Weber would then argue that any organization whose authority is rationally established, including the constitutional state, in the circumstances posited, has certain fundamental characteristics. These fundamental characteristics include the “mutually interdependent ideas” upon which legal authority relies, as discussed in the previous section, and the “fundamental categories of rational legal authority”, many of which relate to bureaucratic authority, as discussed in the next section.

Restricting attention to the purpose of the present work, then, provided that the legitimacy and authority of the modern business corporation is founded on a rational basis, which seems to be a reasonable assumption and relatively free from doubt, it may be expected to be characterized by structures, processes, and personnel practices, characteristic of other forms of organization, including the state. This, of course, goes to the heart of the present work.

The modern business corporation must be considered, as a matter of corporate law and as a matter of legal theory, not only as an entity accorded certain attributes as a matter of law, or as an entity “for legal purposes”, which is to say as bearing rights and duties; but also as constituting, involving, or engaging, an organization whose characteristics are much like those of any other form of organization, as modified, of course, by its characterization as a matter of law.

### ***Hierarchy, Rules, and Formal Organization***

Weber identifies certain “fundamental categories of rational legal authority”, which we summarize here: 1. Official functions are continuously organized and bound by rules. 2. Spheres of competence are specified as part of systematic division of labour, which obliges and authorizes the incumbent to perform certain functions and to employ in that behalf clearly defined means of compulsion subject to definite conditions.<sup>6</sup> 3. Offices are organized in a hierarchy, in which each

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<sup>6</sup> *Ibid.*

lower office is under the control and supervision of a higher one. 4. The rules regulating conduct of office may be technical rules or norms, learning which may require specialized training upon receipt of which individuals become “officials”. 5. The means of production or administration are not owned by the officials, but are provided for their use in connection with such office, and are subject to an obligation to account for such use.<sup>7</sup> 6. The incumbent has no “right” to his official position, which does not belong to him. 7. “Administrative acts, decisions and rules are formulated and recorded in in writing” and “the combination of written documents and a continuous organization of official functions constitutes the ‘office’ which is the central focus of all types of modern corporate action.” 8. Legal authority can be exercised in a wide variety of different forms.<sup>8</sup> It is apparent that, while Weber may be more directly addressing the type of bureaucracy that exists within a governmental organization, he clearly intends that his observations have wider application.

It is highly significant that the exercise of rational legal authority requires that administrative acts, decisions, and rules be formulated and recorded in writing, and retained subsequently, apparently for future reference and employment in future cases. Of course, this permits reference to earlier formulations and interpretations of rules, as well as to administrative acts and decisions, to discern the principles upon which they were adopted, to apply such principles to present and future cases, and to further develop the body of rules, and administrative acts and decisions in a coherent and rational manner, as is the case with the common law practice of adherence to precedent.

It is clear that the “rational-legal” basis on which Weber says that legitimacy of authority may be founded, as one of the three alternatives, is closely related to his “fundamental categories of rational legal authority”, since the latter may be seen as giving expression to the ways in which the continuance of such rational legal authority may be justified on an ongoing basis. Administration, which, for Weber, involves the exercise of authority and imperative coordination,<sup>9</sup> must also be organized and conducted on similar rational-legal principles. Of course, it would be possible, at least theoretically, for authority to be legitimately conveyed or conferred on “rational-legal” grounds, but for the organization to function based upon principles which would be less “rational”

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<sup>7</sup> *Ibid* at 331.

<sup>8</sup> *Ibid* at 332.

<sup>9</sup> *Ibid* at 333.

in terms of its structure, processes, and operations than what Weber contemplates in connection with his “fundamental categories of rational legal authority”.

However, if, as a thought-experiment, one negates or reverses any of these fundamental categories, one finds that such a situation might provoke a challenge to the claimed legitimacy of such rational-legal authority. For example, in the absence of a systematic division of labour, the responsibility and authority of officials would not be clear, and could result in conflicting claims and exercises of such responsibility and authority. The latter might also result from the absence of hierarchical organization. In effect, the exercise of legitimate rational-legal authority in a manner which is neither sufficiently “rational” nor “legal”, that is, as regards its structure, processes and personnel, might be expected to lead to a challenge to the very legitimacy of such rational-legal authority.

As will be seen in the next section, Weber carries his conception of rational legal authority and his conception of its legitimacy into the structure and process of the organization established by its “order”.

### ***Organizational or Bureaucratic Officials***

Weber indicates that individual officials must be appointed and must function according to certain criteria, as follows: 1. They are personally free, and are subject to authority only with respect to their impersonal official obligations. 2. They are organized in a clearly defined hierarchy of offices. 3. Each office has a clearly defined sphere of legal competence, namely, authority. 4. The office is filled by a free contractual relationship with free selection. 5. Candidates are selected on the basis of technical qualifications. In the most rational case, this is tested by examination or guaranteed by diplomas certifying technical training, or both. They are *appointed*, not elected. 6. They are remunerated by fixed salaries in money. Only under certain circumstances does the employing authority, especially in private organizations, have a right to terminate the appointment, but the official is always free to resign. The salary scale is primarily graded according to rank in the hierarchy; but the responsibility of the position and the requirements of the incumbent’s social status may also be taken into account. 7. The office is treated as the sole, or at least the primary, occupation of the incumbent. 8. It constitutes a career. There is a system of “promotion” according to seniority or to achievement or both. Promotion is dependent on the judgment of superiors. 9. The official works entirely separated from ownership of the means of administration and without



appropriation of his position. He is subject to strict and systematic discipline and control in the conduct of the office.<sup>10</sup>

Of course, Weber is discussing the administration of the organization by its officials and, as a result, focuses on the claims made on them in that respect by the organization. As the first item emphasizes, the freedom of the officials of the organization is not restricted except in relation to authority. Although free in other respects, the official is said to be subject to strict and systematic discipline and control in his or her official capacity. Thus, the engagement of the official in the organization does not exhaust the activities, and hence, obligations, that may be undertaken by the official. Weber thus acknowledges that officials of the organization may be subject to claims that may be made upon them otherwise than by the organization.

One would expect that Weber would be able to make a similar observation with respect to members of the organization. Their freedom of agency, then, would be considered to be restricted by the organization only with respect to duties and other claims upon them made by the organization, its officials, other members, and other of its agencies or components.

Thus, with respect to both officials of the organization and members of the organization, involvement in the organization is regulated by rational legal authority in the order establishing the organization. In both cases, involvements of officials or of members which are outside the organization are expected to be significantly, if not entirely, free of organizational regulation or intrusion. In other words, the official, or member, of the organization submits to the intraorganizational authority of the organization, which, however, has no (or, at least, no express) extraorganizational authority over the official or member. However, as noted in the preceding chapter, that official or member may exhibit loyalty or commitment to the focal organization, which may tend to affect his or her external or extraorganizational behaviour, subject to mitigation by other external influences.

Of course, Weber indicated that this “type” of organization could be applied in business, charitable, political, and religious organizations and “in any number of other types of private enterprises serving ideal or material ends”.<sup>11</sup> In effect, it is an “ideal type”. Weber’s description of this formal or bureaucratic organization addresses the issues which have been specified here as the structure,

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<sup>10</sup> *Ibid* at 333-4 [emphasis in the original].

<sup>11</sup> *Ibid* at 334.

processes and procedures, and management and personnel aspects of the organization. Thus, he addresses concerns which may be expected to arise with respect any organization which satisfies the working definitions or more formal definitions of the term “organization” specified in the immediately preceding, and at the beginning of the present, chapter. In many respects, Weber’s descriptions of formal organization and bureaucracy are echoed by later commentators, including with respect to business enterprises and, in particular, the modern business corporation.

Importantly, Weber clearly includes “business organizations” within the scope of the term “organizations”. He also expressly indicates that formal organization and bureaucracy can be applied “in any number of other types of private enterprises serving ideal or material ends”. Accordingly, for Weber, business organizations not only qualify as a particular species of organizations, but they are also organizations to which a system of formal organization and bureaucracy may be applied.

### **Rationality, Organizations, and Efficiency**

As Weber indicated, the fundamental categories of rational legal authority include a systematic division of labour specifying spheres of competence and authority, and the existence of the hierarchy in which each lower office is controlled and supervised by a higher office.

Among the bases of selection for office are technical qualifications or technical competence, which are considered to be indicative of knowledge. Career advancement or promotion is dependent upon seniority or achievement, or both. In turn, seniority or achievement as criteria for advancement may also be considered to be indicative of knowledge. Further, requirements to justify decisions on rational criteria and to maintain records of decisions are considered to increase the rationality of decision-making by the organization at the time of the instant decision, as well as in the future.

These characteristics relate to what has been described here as the structure, process, and personnel aspects of the organization.

### ***Claims of Efficiency***

In fact, Weber claims: “Experience tends universally to show that the purely bureaucratic type of administrative organization – that is, the monocratic variety of bureaucracy – is, from a purely technical point of view, capable of attaining the highest degree of efficiency and is in this sense formally the most rational known means of carrying out imperative control over human beings.”

Further, he says that it is “superior to any other form in precision, in stability, in the stringency of its discipline, and in its reliability. It thus makes possible a particularly high degree of calculability of results for the heads of the organization and for those acting in relation to it.”<sup>12</sup>

These results follow, according to Weber, because bureaucratic administration is specifically rational in that control is exercised on the basis of knowledge. Bureaucratic officials acquire, by means of experience, a special knowledge of facts and documentary material which increases not only their effectiveness, but also their power.<sup>13</sup> In effect, Weber’s definition of bureaucratic administration virtually ensures that this is the case, at least in ideal terms.

Egon Bittner challenges Weber’s claim that bureaucratic organization is efficient, saying that “pure bureaucracy obtains when the principle of technical efficiency is given overriding priority above all other considerations”, which may be expected to be the case only with respect to bureaucracy as an ideal type, rather than as actually instantiated in reality.<sup>14</sup> He asserts that the “efficiency principle merely selects, identifies, and orders those existing elements of the scene of action that are perceived as related to it. The relevance of the known qualities of things becomes very apparent when one considers that it must be at least possible for them to be related in ways that the idealization stipulates.”<sup>15</sup>

In effect, Bittner argues that Weber’s theory rests on “a rich and ambiguous body of background information that normally competent members of society take for granted as commonly known” and which normally “furnishes the tacit foundation for all that is explicitly known, and provides the matrix for all deliberate considerations without itself being deliberately considered.” Because that information is regarded by members of society as “natural” and because such information “enters into that commonplace and practical orientation to reality which the members of society regard as ‘natural’ when attending to their daily affairs, Bittner maintains that the explicit terms of Weber’s theory is “embedded in this common-sense orientation” and cannot be understood without tacit reference to it.<sup>16</sup>

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<sup>12</sup> *Ibid* at 337.

<sup>13</sup> *Ibid* at 339.

<sup>14</sup> Egon Bittner, "The Concept of Organization" (1965) 32:3 *Social Research* 239 at 243.

<sup>15</sup> *Ibid* at 243-4.

<sup>16</sup> *Ibid* at 244.

Bittner's argument, then, is that Weber's claims for efficiency rest on assumptions which are considered "natural" or "normal" by members of society generally, and, accordingly, are not consciously and deliberately investigated. That is not, of course, to say either that they are not assumptions, or that they do not require investigation. Thus, while seeking to justify bureaucracy solely on the basis of efficiency, Weber "provides us with no clear-cut guide on how this standard of judgement is to be used. Indeed, the inventory of features of bureaucracy contains not one single item that is not arguable relative to its efficiency function."<sup>17</sup>

Consequently, says Bittner, "what Weber had in mind when speaking about efficiency was not a formally independent criterion of judgment but an ideal that is fully attuned to practical interests as these emerge and are pursued in the context of every-day life. The standard itself and the correct way to use it are, therefore, a part of the selfsame order of action that they purport to control."<sup>18</sup> It may be concluded, further, that Bittner's argument about Weber's efficiency standard asserts that efficiency is really an "ideal type" not seen, but only the subject of striving and approximation, in reality. Indeed, Bittner argues that Weber's efficiency is not a clear standard to be applied to judgments but, instead, some undefined ideal; or, perhaps, some rough and ready standard which is not independently justified but, instead, "satisfices" in all the circumstances.

It will be recalled that Weber claimed not only that bureaucratic organization is the most efficient, but also that it is "formally the most rational known means of carrying out imperative control over human beings." While Bittner's discussion relates to efficiency only, it is at least arguable that his criticisms of Weber's claims for efficiency may also be extended on essentially the same grounds to Weber's claims for rationality. Fortunately, it is sufficient for our purposes to recognize that Weber's claim of "efficiency" is intended to address the issue whether formal organization or bureaucratic organization is, in itself, intendedly rational. There is no doubt that Weber considers this to be the case.

Accordingly, an organization, including a business organization, applying a system of formal or bureaucratic organization may be considered to be acting rationally, or, at least, intendedly rationally, with a view to the attainment of its goals and objectives. Adoption of a scheme of formal

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<sup>17</sup> *Ibid* at 245.

<sup>18</sup> *Ibid* at 246.

organization or bureaucratic organization, then, may be considered to be consistent with the status of the adopting social unit or group of persons as an “organization”.

Of course, as discussed in Chapter Four under the subheading “Organization as Social Relationship”, Weber himself characterized an organization as a particular species of “social relationship”<sup>19</sup>, albeit one having attributes commonly included in other formal and informal definitions of the term “organization”.

### ***Organizational Rationality, and Individual Bounded Rationality***

Robert K. Merton, a leading social theorist prominent in the origination of theories of social groups and social roles, examined the relationship and bureaucratic structure and personality in a paper extensively cited despite its brevity. He describes bureaucracy as the “ideal type” of formal organization, and credits Weber with the “classical analysis of bureaucracy”<sup>20</sup> Of course, this judgment is widely accepted. Merton observes that a “formal, rationally organized social structure involves certain patterns of activity in which, ideally, every series of actions is functionally related to the purposes of the organization.”<sup>21</sup>

In Merton’s ideal type, both the structure and the patterns of activity are rationally and functionally related. He describes the structure of a formal organization, in terms of offices and hierarchy, competence, authority, and responsibility, in much the same way as does Weber. It is immediately apparent that the likelihood of such ideal types obtaining in the real world is far from certain. As noted repeatedly here, organizations, however defined, commonly pursue common purposes in a manner which is intendedly rationally conducive to those purposes. Of course, that is not to say that such manners of proceeding are actually and rationally conducive to such purposes.

March and Simon emphasize Weber’s objective of construing formal organization and, in particular, bureaucratic organization, as a means of avoiding, or at least minimizing, limits on the rational behaviour of individuals, which they refer to as “bounded rationality”. They suggest that “Weber wishes to show to what extent bureaucratic organization is a rational solution to the complexities of modern problems. More specifically, he wishes to show in what ways bureaucratic

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<sup>19</sup> *Supra* note 2 at 48.

<sup>20</sup> Robert K Merton, "Bureaucratic Structure and Personality" (1940) 18 *Social Forces* 560 at 560.

<sup>21</sup> *Ibid.*

organization overcomes the decision-making or ‘computational’ limits of individuals or alternative forms of organization (i.e., through specialization, division of labor, etc.).”<sup>22</sup>

In effect, the argument made by March and Simon is that in seeking, by means of rational structure and processes, to pursue certain goals or objectives, a formal or bureaucratic organization seeks to eliminate, or, at least, minimize, non-rational influences on that pursuit. Weber’s description of bureaucratic organization is certainly consistent with such objectives.

Simon’s concept of “bounded rationality” was developed and applied to organizations in 1947 in his magisterial work, *Administrative Behavior*.<sup>23</sup> Political scientist Terry Moe provides a succinct description of Simon’s model, in which he indicates that such concept “recognizes that people are limited both in the information and knowledge they possess and in the computational skills they bring to bear in making choices. Thus, they cannot engage in the kind of informed optimization attributed to economic man, nor can they engage in the kind of decision making under uncertainty that information economists and game theorists have so subsequently developed. Instead, boundedly rational individuals “satisfice.” This mode of choice, in turn, leads them to behave in a routine, myopic, but reasonably adaptive manner.”<sup>24</sup>

Applying the concept of bounded rationality in an organizational context, Simon’s key insight, Moe claims, is that “just as individuals will routinize behavior if left to their own devices, so routines can also be imposed by organizational superiors, who can take steps to shape the decisional premises (information, beliefs, aspiration levels) of subordinates and provide them with the programmed responses deemed suitable for efficient pursuit of the organization's objectives.”<sup>25</sup>

Organizational superiors, then, routinize the behaviour of subordinates in a way in which the subordinates might do themselves, if they possessed the appropriate perspective and, we would suggest, the appropriate incentives. The present work has maintained, of course, that the

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<sup>22</sup> JG March and HA Simon, "The Dysfunctions of Bureaucracy" [1958] in DS Pugh, ed, *Organization Theory: Selected Readings* (New York: Penguin Books, 1977) 30 at 30. This article, which is specifically focused on the subject discussed here, is excerpted from JG March and HA Simon, *Organizations* (New York: Wiley, 1958) 36. In a poll of the Fellows Group of the Academy of Management, it was identified as the seventh "most influential" management book of the twentieth century: Arthur G Bedeian and Daniel A Wren, "Most Influential Management Books of the 20th Century" (2001) 29:3 *Organizational Dynamics* 221 at 223.

<sup>23</sup> Herbert A Simon, *Administrative Behavior: A Study of Decision-Making Processes in Administrative Organization* (New York: Macmillan, 1947). In the poll referenced above in note 22 at 222, it was found to be the fifth most influential management book of the twentieth century.

<sup>24</sup> Terry M Moe, "The New Economics of Organization" (1984) 28:4 *American J Political Science* 739 at 744.

<sup>25</sup> *Ibid.*

“organizational perspective”, which is that of the relevant organizational superiors, is able to take into account not only information concerning the nature and effects of previous responses by the organization in similar cases, but also information concerning how such responses relate to other organizational actions and objectives.

For Simon, then: “It is this combination of bounded rationality and managerial efforts to program subordinate behavior that largely explains organizational structure. Individuals throughout the organization, precisely because they are boundedly rational, will behave in the routine, patterned ways characteristic of structured behavior; and (boundedly rational) managers, in seeking to shape and coordinate individual programs into an organized, efficient structure, impose behavioral routines via hierarchy, division of labor, communications flows, and training programs.”<sup>26</sup>

### **Individual Bounded Rationality, and Rulemaking**

Accordingly, as maintained by Weber and by Simon, in a rationally organized pursuit of the organization’s goals and objectives, officials within the hierarchy are governed by rules, which Merton describes as “general, abstract, clearly defined rules which preclude the necessity for the issuance of specific instructions in each specific case”, the generality of which “requires a constant use of *categorization*, whereby individual problems and cases are classified on the basis of designated criteria and are treated accordingly.”<sup>27</sup> As has been seen, the development of those rules in itself requires, or should require, categorization, including, of course, categorizing prior events and experiences.

A related perspective is that of Frederick Winslow Taylor, the founder of “scientific management”, often called “Taylorism”. Taylor explained that such scientific management involved “the deliberate gathering in on the part of those on the management’s side of all of the great mass of traditional knowledge, which in the past is been in the heads of the workmen, and in the physical skill and knack of the workmen, which he has acquired through years of experience”, as a first step, “and then recording it, tabulating it and, in many cases, finally reducing it to laws, rules and even to mathematical formulae.”<sup>28</sup> He considered that scientific management could thereby obtain

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<sup>26</sup> *Ibid.*

<sup>27</sup> *Supra* note 20 at 561 [emphasis in the original].

<sup>28</sup> Frederick Winslow Taylor, “Scientific Management” [1947] in DS Pugh, ed, *Organization Theory: Selected Readings* (New York: Penguin Books, 1977) 124 at 125. Excerpted from Frederick Winslow Taylor, *Scientific*

“the initiative of the workmen – that is, their hard work, their good will, their ingenuity... practically with absolute regularity, while under even the best of the older type of management this initiative is only obtained spasmodically and somewhat irregularly.”<sup>29</sup>

Taylor’s scientific management thus seeks to apply some kind of empirical methodology, by commencing with observation and investigation before applying techniques of analysis in seeking to develop a routine, the application of which, according to Simon, seeks to avoid the limitations of bounded rationality. Taylor was discussing the situation of workmen on the shop floor, but there was an obvious implication, which was developed elsewhere in his work, that the principles of “scientific management” could also be applied with respect to other employees and managers. As well as developing the knowledge or “science” with respect to the required tasks, scientific management also mandated the scientific selection and progressive development of the workmen. Taylor’s “scientific management” principles warrant further examination.

### ***Methodology of Rulemaking***

In the case of workmen, Taylor spoke of management’s duty “to deliberately study the character, the nature, and the performance of each workman with a view to finding out his limitations on the one hand, but even more important, his possibilities for development on the other hand” and then to provide the latter on an ongoing basis.<sup>30</sup> In the result, he said, the actual work would be divided almost equally between planning and other aspects of the work, to be performed by management, and the “actual work of the establishment”, to be performed by the workmen.<sup>31</sup>

While this classical model of management may be considered to involve a “machine” or at least “mechanistic” model of man, it is clear that Taylor, at least, did consider certain specifically human aspects of individuals in the workplace. His management provided its input not only in supervising and developing the individual employee but in assessing his or her capacity and limitations so as to provide “management” and direction beyond that point. Taylor’s laws or rules were to be developed against the background of knowledge and experience and so as to apply in most cases,

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*Management* (New York: Harper & Row, 1947) 39. In the poll referenced above in note 22, it was selected as the single most influential management book of the twentieth century and described as the “most influential management book ever published”.

<sup>29</sup> *Supra* note 28 at 124.

<sup>30</sup> *Ibid.*

<sup>31</sup> *Ibid* at 126.



arguably with some allowance for individual employee capacity as developed up to the relevant point in time. In effect, he attributed the subsequent improvement in performance to the application of a high level of relevant knowledge and experience, which, today, might be called “best practices”, in rule-relevant situations in the future.

It can be seen that, where rules have been developed to a high standard, the need to apply rational analysis may, ideally, involve a relatively small number of situations not contemplated by the rules, the number of which might be anticipated to be greatly reduced as a result of the breadth and depth of those rules. Further comment on this is made below.

The assumption is that rationally developed rules take into account prior events and experiences, and that against that experiential background, rules of general application can be devised that may be applied in many concrete cases. Ideally, such rules are developed, collectively, based on input from many sources, thereby combining many events and experiences and, further, considering such events and experiences from the perspectives of various participants in past cases, and in anticipated possible future cases. In that way, the development of the rules, the imposition of such rules, and the application of those rules in concrete instances would not be constrained by the bounded rationality of a single individual in a situation requiring immediate decision making, as sought by Weber and by Simon.

As Merton suggests, clearly defined rules “preclude the necessity for the issuance of specific instructions for each specific case”.<sup>32</sup> In connection with the use of rules as a corrective for bounded rationality, Simon says that, “decisions are programmed to the extent that they are repetitive and routine, to the extent that a definite procedure has been worked out for handling them so that they don’t have to be treated *de novo* each time they occur”. In effect, “if a particular problem occurs often enough a routine procedure will be worked out for solving it.”<sup>33</sup> On the other hand, “decisions are nonprogrammed to the extent that they are novel, unstructured and consequential”, perhaps “because [the problem] hasn’t arisen before, or because its precise nature

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<sup>32</sup> *Supra* note 20 at 561.

<sup>33</sup> HA Simon, "Decision Making and Organizational Design" [1960] in *Organization Theory: Selected Readings*, DS Pugh, ed, (New York: Penguin Books, 1977) 189 at 194. Excerpted from HA Simon, *The New Science of Management Decision* (New York: Harper & Row, 1960) c 1 at 1, and c 5 at 35 [emphasis in the original].

and structure are elusive and complex, or because it is so important that it deserves a custom-tailored treatment.”<sup>34</sup>

Programming is an important concept for Simon. By program, he means “a detailed description or strategy that governs the sequence of responses of a system to a complex task environment.” Similarly, a response is nonprogrammed “where the system has no specific procedures to deal with situations like the one at hand, but must fall back on whatever *general* capacity it has for intelligent, adaptive, problem-oriented action”. In that case, in the absence of specific skills and specific knowledge, “man has some general problem-solving capacities” which can be applied to reason about “almost any kind of situation, no matter how novel or perplexing” in terms of ends and means.<sup>35</sup> It is submitted, however, that nonprogrammed responses requiring the application of “general problem-solving capacities” invoke bounded rationality and, accordingly, are non-preferred, as compared with programmed responses, which seek to avoid the “bounds” or “boundedness” of rationality.

### ***Bounded Rationality, and Organizational and Personal Meaning***

Instead of considering all problems as problems of first impression, in programmed or rule-based responses, the bounded rationality of the individual is applied to considering into which category the instant situation falls, which determines the rule that applies, which can then be applied by the relevant official. This eliminates subsequent case-by-case determination on a “first impression” or “first-principles” basis for many routine situations which immediately present themselves; and, in turn, allows more detailed consideration for non-routine circumstances. It also requires fewer orders or commands to be issued, which is thought to reduce awareness of relative power and authority as between the command giver and the command receiver, and which may minimize conflict.

As we have indicated, rule-assignment or rule-categorization operates both retrospectively and prospectively, not only in an organizational context, but also in individual and personal contexts. Bittner observes that rules are not only used in “determining the *occurrence* of certain responses under suitable conditions, [but] are also invoked to clarify the *meaning* of actions retrospectively.”

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<sup>34</sup> *Ibid.*

<sup>35</sup> *Ibid* at 194-195 [emphasis in the original].

In this regard, he claims that “it is a readily demonstrable fact that a good deal of the sense we make of things happening in our presence depends on our ability to assign them to the phenomenal sphere of influence of some rule. Not only do we do this but we count on it happening.”<sup>36</sup>

Consequently, it is said that the ability to assign or categorize activity not only simplifies the exercise of bounded rationality, but also provides signification as to the relevance of the activity concerned. Thus, Bittner credits rulemaking with assisting in providing individuals with relevant cognitive frameworks, as well as with relevant frameworks of wider meaning or signification.

Further, Bittner maintains that “the formal organization meets exigencies arising out of the complexity and large scope of an enterprise”, ordering “affiliations between persons and performances that are too remote for contingent arrangement, by linking them into coherent maps or schedules.”<sup>37</sup> The formal organization thus provides its participants with a way of “making sense” of various aspects of the organization in ways not otherwise apparent to organizational participants. It may even be said that it is a “map of sense-making”.

Applying the argument made in the penultimate preceding paragraph, we may say that the formal organization also facilitates developing rules which can be applied at the relevant level of hierarchy, which will dovetail with superordinate rules existing at a superior level of the hierarchy, in order that a coherent system of rules be available which are rationally conducive to achieving those superordinate goals and objectives. This comports with Weber’s observations.

Bittner argues that the specifics of the superordinate rules, and their benefits and advantages, may not be known to the personnel at the subordinate level, who may know only that the rule applied to, or by, them at that subordinate level meets some overarching standard of organizational rationality. Because the rules are thought to be rational, the argument goes, they are perceived to be legitimate, and hence to require deference and observance. In turn, that knowledge at the subordinate level provides meaning in situations involving considerable complexity and in which meaning might be otherwise absent.

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<sup>36</sup> *Supra* note 14 at 250 [emphasis in the original].

<sup>37</sup> *Ibid* at 252. Indeed, Daft and Weick described organizations as “interpretation systems”. See: Karl E Weick and Robert L Daft, “The Effectiveness of Interpretation Systems” in KS Cameron & DA Whetten, eds, *Organizational Effectiveness: A Comparison of Multiple Models* (New York: Academic Press, 1983) 71; and Robert L Daft and Karl E Weick, “Toward a Model of Organizations as Interpretation Systems” (1984) 9:2 *Academy of Management Rev* 284.

Bittner says: “The integration transcends what might result from negotiated agreements between contiguous elements, and lends to elements that are not within the sphere of one another’s manipulative influence the character of concerted action. As a consequence of this, however, each link derives its meaning not so much from the specific rule that determines it, but from the entire order of which the rule itself is a part.”<sup>38</sup> Accordingly, he maintains that both immediate parties and non-immediate parties who could not themselves negotiate satisfactory agreements are encouraged to adhere to rules considered to have been rationally adopted and in the best interests of the organization as a whole.

In effect, for Bittner, at least implicitly, the rules “complete” contracts or arrangements that could never themselves be finalized by express agreement, for various reasons, including information asymmetries, lack of information, and lack of proximity. The rules themselves perform this function because intraorganizational actors assume that such rules are rational and legitimate, and consequently merit concurrence and obedience. These various assumptions and attitudes contribute to creating what Barnard and Simon call “zones of acceptance” or “zones of indifference” in relation to authority. This is discussed further in the next section under the heading “Formal Organizations and Informal Organizations”.

Indeed, Bittner goes so far as to suggest “the possibility of a principle of discipline that derives from the formal style of the rational scheme and which works against centrifugal tendencies and heterogeneity” in which the “resulting coherence will be in evidence as outwardly proper conduct and appearance.”<sup>39</sup> The propriety of conduct, then, will be immediately apparent to organizational participants. In the result, the formal scheme provides meaning and justification for, and thus a basis for acceptance of, organizational actions. It thereby contributes to creating commitment to, and identification with, the organization as a whole.

Accordingly: “When from the perspective of a fragmentary involvement the actual contingent outcome of one’s work cannot be appraised, or appears senseless, then it can be understood and judged in terms of its over-all functional significance by invoking the formal scheme”. Bittner claims, further, that the formal scheme can also be used as a basis for requiring corrections or enforcing prohibitions and, more generally, for applying to something that happens within the

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<sup>38</sup> *Supra* note 14 at 252.

<sup>39</sup> *Ibid.*

organization “the criterion of success or failure when real results are not visible, or must be discredited.”<sup>40</sup> Put plainly, a relevant actor at the subordinate level assumes that acting in accordance with the applicable rules is rational in terms of the organization, and, as such, this provides meaning to, and the basis for concurrence on the part of, such actor, quite independently of whether or not such actor can “make sense of” the situation.

The development and application of rules, then, is thought not only to contribute to rational decision-making, and to overcoming the limitations of bounded rationality, but is also thought to contribute to individual, group, and organizational, and even personal, sense-making. Such sense-making not only assists in providing cognitive and rational coherence to individuals, groups and to the organization as a whole, but also assists in providing a sense of coherence of effort, unity, and identity, and even commitment, for the organization and those individuals and groups within it. Bittner considers this paradigm to be operative irrespective of the type of organization concerned.

## **ORGANIZATIONAL STRUCTURE**

As has been demonstrated previously, an organization is considered to be characterized by a structure which is adopted in the exercise of rationality as a means of rationally pursuing the shared goals and objectives for which the group has been, and remains, constituted. Some more detailed examination of the specifically structural aspect of organizations now follows.

Weber famously claims that the “development of the modern form of the organization of corporate groups in all fields is nothing less than identical with the development and continual spread of bureaucratic administration”, and indicates that this is true “of church and state, of armies, political parties, economic enterprises, organizations to promote all kinds of causes, private associations, clubs, and many others.” Further, he indicates that its development is “the most critical phenomenon of the modern Western state.”<sup>41</sup>

Thus, Weber equates the “modern form” of organization with bureaucratic organization. He asserts that all modern forms of the organization adopt such bureaucratic organization or administration. Further, he includes within the scope of the term “organization” many groups which have significantly disparate objectives, including pursuit of religion, military power, political power,

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<sup>40</sup> *Ibid* at 253-254.

<sup>41</sup> *Supra* note 2 at 337.

economic power, social power, and state power. Of course, he considers economic enterprises, the business firm or corporation, as organizations and, as such, as appropriate for bureaucratic administration. In terms of both structure and process, such bureaucratic type of organization is characterized, as we have seen, by specialization and delegation.

March and Simon criticize this approach, saying that “Weber perceives bureaucracy as an adaptive device for using specialized skills, [but] he is not exceptionally attentive to the character of the human organism.”<sup>42</sup> They maintain, in effect, that Weber examines the adaptations by which bureaucracy uses specialized skills, as if they can be somehow divorced from their human possessors. They are not alone in this criticism. In Weber’s bureaucracy, Merton says, the “structure is one which approaches the complete elimination of personalized relationships and of nonrational considerations (hostility, anxiety, affectual involvements, etc.).”<sup>43</sup>

Of course, seeking to minimize the impact of personalized relationships and of nonrational considerations does not mean that such attempts will be successful. At the same time, failure to recognize, and to provide against, them may be deleterious to the attainment of organizational objectives. Other commentators have sought to consider these issues in more detail. An examination of their perspectives follows.

## **Fayol and Modern Business Management**

### ***Fayol on Structure***

A contemporary of Frederick Winslow Taylor, Henri Fayol, was considered as another founder of modern management principles. However, his approach, often called “Fayolism”, is more sensitive to the personnel aspects of the organization than are those of Weber and Taylor. His approach involves all aspects of the organization treated in the present work, namely, structure, process, and personnel. An examination of his approach will assist in explicating the interrelationships of those aspects. Fayol developed a number of major principles (fourteen) in this regard, which will be discussed here in terms of their relevance to what this work considers to be the structure, process, and personnel, of the organization.

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<sup>42</sup> *Supra* note 22 at 36.

<sup>43</sup> *Supra* note 20 at 561.

Even with respect to specialization and division of work, Fayol, like Weber and Simon, recognizes that division of work reduces the number of objects to which attention and effort must be directed, and facilitates acquisition by the employee of “an ability, sureness and accuracy which increase their output”.<sup>44</sup> He acknowledges that centralization, like specialization, is inevitable in any organization. Thus, the “question of centralization or decentralization, is a simple question of proportion, it is a matter of finding the optimum degree for the particular concern.”<sup>45</sup>

Moreover, the appropriate degree of centralization or decentralization “may itself vary constantly” so that it is “a problem to be solved according to circumstances, to the best satisfaction of the interests involved.”<sup>46</sup> As previously noted in this work, no single structure or scheme of organization is likely to be effective in all cases. As Fayol’s choice of title for his major work indicates, although many of his remarks are expressed to relate to organizations generally, his primary concern was industrial business enterprises.

Fayol describes the hierarchy of the organization as a “scalar chain [, which] is the chain of superiors ranging from the ultimate authority to the lowest ranks.” He says that this “line of authority is the route followed – via every link in the chain – by all communications which start from or go to the ultimate authority.”<sup>47</sup> He acknowledges, however, that in the great majority of businesses, where success turns on speedy execution, instead of insisting that a matter go up to the top of the chain of responsibility, and then down to the relevant position on other side, especially where a chain of different functions or departments are involved, the managers involved can authorize their respective subordinates to deal directly with each other and to inform their respective superiors what they have agreed upon. Fayol indicates that such a process can save time and inconvenience, improve results, and speed turnaround.<sup>48</sup>

One aspect of structure relates to maintaining order, both material and social. As to the first, Fayol indicates that there must be a place appointed for each thing and each thing must be in its appointed

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<sup>44</sup> Henri Fayol, "General Principles of Management" [1949] in *Organization Theory: Selected Readings*, DS Pugh, ed, (New York: Penguin Books, 1977) 101 at 102. This is excerpted from Henri Fayol, *General Industrial Management*, (New York: Pittman, 1949) c 4 at 19. In the poll referenced *supra* note 22 at 224, it was found to be the sixteenth most influential management book of the twentieth century.

<sup>45</sup> *Ibid* at 114.

<sup>46</sup> *Ibid* at 115.

<sup>47</sup> *Ibid* at 115-116.

<sup>48</sup> *Ibid* at 116-117.

place. Further, the appropriate place must be chosen in order to facilitate activities as much as possible, and to avoid loss of material.<sup>49</sup> As to the social order, this presupposes good organization and good selection, such that the place (or office) is suitable for the employee and the employee is suitable for the place (or office), which requires “precise knowledge of the human requirements and resources of the concern and a constant balance between these requirements and resources”.<sup>50</sup>

While the concern of the present section is structure, it will be convenient now to briefly examine some of Fayol’s related observations with respect to process and personnel. He indicates that “authority is the right to give orders and the power to exact obedience”, distinguishing between official authority, which is derived from office, and personal authority, involving intelligence, experience, moral worth, ability to lead, past services and other matters, and saying that the two are complementary. Similarly, he indicates that responsibility is a corollary of authority, its natural consequence, and essential counterpart, and arises wheresoever authority is exercised.<sup>51</sup>

In regards to exacting obedience and applying sanctions, whether rewards or penalties, Fayol notes that “it is relatively easy to establish a workman’s responsibility for his acts and a scale of corresponding sanctions; in the case of a foreman it is somewhat difficult, and proportionately as one goes up the scalar chain of businesses, as work grows more complex, as the number of workers involved increases, as the final result is more remote, it is increasingly difficult to isolate the share of the initial act of authority in the ultimate result and to establish the degree of responsibility of the manager. The measurement of this responsibility and its equivalent in material terms elude all calculation.”<sup>52</sup>

This accords with many of the present author’s statements and generalizations earlier in this work and provides some authority therefor. The indication, then, is that the higher the level in the organization at which the decision is taken, the more complex its nature, the more remote its ultimate result, and the greater the number of persons involved in it, the more unlikely it will be that responsibility with respect to such decision will be accurately apportioned among the participants or that such accurate apportionment is even possible. The present work maintains that these considerations support the initial assignment of collective, rather than individual,

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<sup>49</sup> *Ibid* at 118.

<sup>50</sup> *Ibid* at 119.

<sup>51</sup> *Ibid* at 103.

<sup>52</sup> *Ibid*.



responsibility in cases of nonfeasance, misfeasance, and other misdeeds, as a matter of law. This perspective will be further discussed later in Part 3.

Fayol relates authority, in terms of giving orders and exacting obedience against the threat of sanctions, to discipline. He says that discipline “is in essence obedience, application, energy, behaviour and outward marks of respect observed in accordance with the standing agreements between the firm and its employees, whether these agreements have been freely debated or accepted without prior discussion, whether they be written or implicit, whether they derive from the wish of the parties to them or from rules and customs, it is these agreements which determine the formalities of discipline.”<sup>53</sup>

Fayol’s position is consistent with Chester Barnard’s views on employee acceptance of authority, which are described in Chapter Four above and in this chapter under the heading “Common Purpose, Intraorganizational Cooperation, and the Zone of Acceptance”,<sup>54</sup> where Simon’s similar view is also described. It is also consistent, more generally, with Weber’s description of the institution of organizations, as described earlier in the present chapter under the heading “Rational-Legal Authority, Administration, and Bureaucracy”.

Just as the agreements creating obligations of obedience, application, energy, and behaviour are expected to vary in nature from one organization to another, so, too, is the nature of the discipline expected. Regardless of the source or form of discipline, however, Fayol concludes that “general opinion is deeply convinced that discipline is absolutely essential for the smooth running of business and that without discipline no enterprise could prosper.”<sup>55</sup> Where sanctions are required, the choice of the type and degree of sanction must involve the tact and experience of the manager, taking into account the individuals and attendant circumstances concerned.<sup>56</sup>

### *Fayol on Process*

It is, of course, difficult to disentangle issues of organizational structure from issues of process, and each of those from issues of personnel. However, it is hoped that effecting such a separation for the purpose of discussion, at least, imposes a greater degree of order on this discussion than

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<sup>53</sup> *Ibid* at 104.

<sup>54</sup> CI Barnard, "The Executive Functions" [1938] in *Organization Theory: Selected Readings*, DS Pugh, ed, (New York: Penguin Books, 1977) 166 at 170-171.

<sup>55</sup> *Supra* note 44 at 104.

<sup>56</sup> *Ibid* at 105.

might be possible otherwise. Issues of authority, responsibility, sanctions, and discipline relate to each of these areas, but have been discussed here in connection with organizational structure.

Fayol's fourteen principles of management included three which relate to organizational process and which are described here as Fayol's "three unities": unity of command, unity of direction, and unity of interest. Unity of command posits that for any action, an employee should receive orders from only one superior. Otherwise, according to Fayol, "authority is undermined, discipline is in jeopardy, order disturbed and stability threatened."<sup>57</sup> Unity of direction entails "one head and one plan for a group of activities having the same objective", which is considered by Fayol to be essential to unity of action, coordination and strength and focusing of effort.<sup>58</sup>

What the present author calls "unity of interest" is actually referred to by Fayol as "subordination of individual interest to general interest", the principle "that in a business the interest of one employee or group of employees should not prevail over that of the concern, that the interest of the home should come before that of its members and that the interest of the State should have pride of place over that of one citizen or group of citizens."<sup>59</sup> This diversity of interest as between the organization and individuals and groups within it has been the subject of frequent notice in the present work. Concerns arise as to how to ensure dominance of superordinate organizational goals over subordinate group and individual goals. Fayol recognizes the need to subordinate both the interests of individuals and the interests of groups of individuals to the interests of the organization.

Fayol attributes subordination of the general interest to individual interest to such causes as "ignorance, ambition, selfishness, laziness, weakness and all human passions", and claims that it can be reconciled and counteracted by means of superiors exercising firmness and providing a good example, by adopting agreements that are as fair as is possible, and by exercising constant supervision.<sup>60</sup> Fayol does not discuss how group loyalties and interests might affect adherence to organizational interests, and the one hand, and individual interests, on the other. However, discussion of these matters in the present work, both to date and to follow, provide alternative views. For the moment, however, it is sufficient to note that Fayol acknowledges the existence of

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<sup>57</sup> *Ibid* at 106.

<sup>58</sup> *Ibid* at 107. Emphasis in the original.

<sup>59</sup> *Ibid* at 108.

<sup>60</sup> *Ibid*.

individual interests and group interests as separate from, and requiring subordination to, the interests of the organization as a whole.

Another principle to which Fayol says that management should attempt to adhere is stability of tenure of personnel, since, in addition to the requisite abilities, time is required “to get used to new work and succeed in doing it well”, especially in the case of managers, who may require a lengthy and costly period of time in order to “settle in”.<sup>61</sup> He admits that some changes in personnel are inevitable due to age, illness, retirement, death, changes in capacity to perform duties, and achieving fitness for greater responsibilities.<sup>62</sup> Of course, as indicated in this work, attempts to define the term “organization” often emphasize stability of membership. Fayol’s attention is directed, as might be expected in a text on industrial management, to considerations of efficiency.

### *Fayol on Process and Personnel*

Fayol refers to initiative as involving the importance of the power, and the freedom, to think out and execute a plan and ensure its success. He states that such initiative requires tact and integrity, maintaining respect for authority and for discipline, and sacrificing some personal vanity, but says that initiative, on the part of the manager and everyone else, can represent a great source of strength for business, especially in difficult times. He indicates that unity and harmony, and *esprit de corps*, are sufficiently valuable that effort should be made to achieve them.<sup>63</sup>

In this regard, personnel should be compensated, he says, in a way that is as fair as possible both to such personnel and to the firm, so as to “encourage keenness by rewarding well-directed effort”.<sup>64</sup> This may involve providing bonuses or entering into profit-sharing arrangements at various levels of the hierarchy.<sup>65</sup> Such compensation may also include non-financial benefits and incentives.<sup>66</sup>

Another of Fayol’s principles of management is that management should also seek to achieve equity, which results from treating employees with kindness and with justice, and which produces

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<sup>61</sup> *Ibid* at 120.

<sup>62</sup> *Ibid* at 121.

<sup>63</sup> *Ibid* [emphasis in the original].

<sup>64</sup> *Ibid* at 109.

<sup>65</sup> *Ibid* at 110-113.

<sup>66</sup> *Ibid* at 113.

devotion and loyalty on the part of employees. This may require, variously, over time, forcefulness, sternness, good sense, experience, and good nature.<sup>67</sup>

As to his management principles, in general, Fayol claims that: “This code is indispensable. Be it a case of commerce, industry, politics, religion, war or philanthropy, in every concern there is a management function to be performed, and for its performance there must be principles, that is to say acknowledged truths regarded as proven on which to rely. And it is the code which represents the sum total of these truths at any given moment.”<sup>68</sup>

In summary, Fayol’s management principles provide useful insight into the interrelationship among organizational structure, process, and personnel considerations. They represent a significant advance on Weber’s more general observations. And they purport to relate to all types of organizations, including business corporations.

### **Determinants of Structure**

The present work has mentioned, from time to time, that the structure of organizations, including modern business corporations, is far from invariant, and, instead, exhibits considerable variety.

Chester Barnard referred to a “scheme of organization”, which he describes as “the definition of organizational positions”, the formal system of coordination of work to be done by the organization with “its purposes broken up in the subsidiary purposes, specializations, tasks, etc.”, as well as “the kind and quality of *services* of personnel that can be obtained; the kind and quantity of *persons* that must be included in the cooperative system for this purpose; the inducements that are required; and the places at which and the times when these factors can be combined”.<sup>69</sup>

In effect, Barnard recognizes the interrelationship among the structure, processes and personnel which instantiate the organization itself. He also observes that the scheme of organization assumes that other factors of organization remain fixed for the time being, with the result that “any scheme of organization at any given time represents necessarily a result of previous successive approximations through a period of time” and is, accordingly, subject to change, as changes in the other factors of organization transpire,<sup>70</sup> as has been mentioned frequently in the present work.

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<sup>67</sup> *Ibid* at 120.

<sup>68</sup> *Ibid* at 123.

<sup>69</sup> *Supra* note 54 at 169 [emphasis in the original].

<sup>70</sup> *Ibid* at 170.

Thus, Barnard recognizes that the scheme of organization must adapt to the environment, including the availability of external resources, as well as internal resources, such as personnel. In addition, of course, the structure, or scheme of organization, and the organization's processes and personnel must be adapted to changes in its strategy, as demonstrated by Chandler.

Indeed, Barnard also seems to admit that a scheme of organization is necessarily an ideal type, as suggested by Weber. Philip Selznick, a leading and highly influential organizational theorist, who set forth the principles of his approach in a widely cited paper published in 1948,<sup>71</sup> is also considered to regard organizational schemes or structures as ideal types. Bittner, for example, claims that each of Weber and Selznick "assumes that the formal structures represent an ideally possible, but practically unattainable state of affairs. While Weber outlined the contents of the normative idealization in general terms, Selznick pointed out that the normative idealization, to be an effective source of restraint, must be constantly adapted to the impact of functional imperatives of social systems."<sup>72</sup>

As indicated here, the organization is also required to adapt to external functional imperatives. As Bittner observes, an organization is seen as "having some determining power over action that takes place under the scope of its jurisdiction"; however, this "power to produce an intended result is uncertain and depends for its effectiveness on complex structural conditions."<sup>73</sup> The present work maintains, of course, that the organization must adapt to both internal and external influences and variances.

### **Specialization and Delegation, and Goals**

As noted previously, as expressed by Selznick, "formal organization is the structural expression of rational action", which is highly dependent upon delegation, "a precarious venture which requires the continuous elaboration of formal mechanisms of coordination and control". He says that as a result of the institutionalization of relationships, "the formal structure becomes subject to calculable manipulation, an instrument of rational action."<sup>74</sup> In effect, Selznick maintains that without institutional relationships, including formal delegation, the formal structure cannot be employed to take rational action having in view the attainment of the organization's objectives. As

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<sup>71</sup> Philip Selznick, "Foundations of the Theory of Organization" (1948) 13:1 American Sociological Rev 25.

<sup>72</sup> *Supra* note 14 at 242.

<sup>73</sup> *Ibid* at 250.

<sup>74</sup> *Supra* note 71 at 25.

will be discussed later, Selznick is doubtful that this objective is achievable, largely due to the nature of the human beings concerned.

As discussed frequently here, the employment of rational action in the achievement of an organization's goals and objectives is essential to it instantiating itself as an organization. Barnard, as previously noted, assigns the formulation and definition of the purposes and objectives of the organization to the organization's executive, noting, however, that such purpose must be "broken into fragments, specific objectives, not only ordered in time so that detailed purpose and detailed action follow in the series of progressive cooperation, but also ordered contemporaneously into the specializations – geographical, social and functional – that each unit organization implies."<sup>75</sup> He indicates that this is so complex that no single executive can effect this result, which, instead, requires the cooperation of the entire executive organization.

Hence "the critical aspect of this function is the assignment of responsibility – the delegation of objective authority."<sup>76</sup> One aspect of this assignment of responsibility, he asserts, is the scheme of positions and the system of communication adopted by the organization, which he says affects the organization's potential, while the other is "the actual decisions and conduct that make the scheme a working system", which has a rather more immediate effect.<sup>77</sup> These observations comport with those of Weber, Simon, and Merton, as discussed under the preceding heading "Structure, Process, and Personnel".

### *The Organizational Hierarchy*

Examining how Barnard explicates the organizational hierarchy provides some useful insights: "Accordingly, the general executive states that 'this is the purpose, this the objective, this the direction, in general terms, in which we wish to move, before next year'. His department heads, of the heads of his main territorial divisions, say to their departments or suborganizations: 'This means for us, these things now, then others next month, then others later, to be better defined after experience.' Their subdepartment or division chiefs say: 'This means for us such and such operations now at these places, such others at those places, something today here, others tomorrow there.' Then district or bureau chiefs in turn become more and more specific, their sub-chiefs still

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<sup>75</sup> *Supra* note 54 at 179.

<sup>76</sup> *Ibid* at 180.

<sup>77</sup> *Ibid*.

more as to place group, time, until finally purpose is merely jobs, specific groups, definite men, definite times, accomplished results.”<sup>78</sup>

In principle, each organizational level responds to the directives from its immediately superior level and translates the higher order goals and objectives expressed in such directives into actions which can be meaningfully effected at the subordinate level. Meanwhile, as Barnard says, communications pass up and down the hierarchy, chronicling problems and accomplishments, and redefining and modifying purposes, level after level.

Barnard observes that coordination of these activities is indispensable, saying that such coordination “requires a pyramiding of the formulation of purpose that becomes more general as the number of units of basic organization becomes larger, and more and more remote in future time. Responsibility for abstract, generalizing, prospective, long-run-decision is delegated *up* the line, responsibility for definition, action, remains always at the base where the authority for effort resides.”<sup>79</sup> Not only is the level of generality of decision making more abstract and generalized at higher organizational levels, but decision-making at successively higher levels involves a much longer term perspective. Accordingly, goals and decision-making at successively higher levels are more critical, although sometimes less immediate, to the success and continued existence of the organization as a whole.

It may be said that higher, more abstract goals and objectives are analyzed and particularized for action at the subordinate level, and the results of the actions are transmitted up the hierarchy. From this, it can be seen that the goals and objectives prevailing at that subordinate level must be effectively translated into, and be consistent with, and accepted by, those at subordinate levels. Similarly, the goals and objectives, and the implementational actions, which prevail and are acted upon at the subordinate level must be consistent with those of, and accepted by those at, the superordinate level. As observed previously in this work, lack of congruence of goals and objectives as between organizational levels may present significant difficulties.

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<sup>78</sup> *Ibid.* Although Barnard refers to "suborganizations", it seems, as supported by his manner of use of the word "subdepartments" here, that he does so without considering whether these "suborganizations" qualify formally and definitionally as "organizations". Consideration of that issue is arguably outside the boundaries of his research question. Accordingly, the definitional issue arguably arises implicitly, but not explicitly.

<sup>79</sup> *Ibid* at 180-181 [emphasis in the original].

*Communication of, and Commitment to, Organizational Goals*

Barnard averts to this problem of goal congruence as between organizational levels when he says that the “formulation and definition of purpose is then a widely distributed function, only the more general part of which is executive. In this fact lies the most important inherent difficulty in the operation of cooperative systems – the necessity for indoctrinating those at the lower levels with general purposes, the major decisions, so that they remain cohesive and able to make the ultimate detailed decisions coherent; and the necessity, for those at higher levels, of constantly understanding the concrete conditions and the specific decisions of the ‘ultimate’ contributors from which and from whom executives are often insulated.”<sup>80</sup>

Operating such a system obviously requires a high degree of coordination. Barnard’s “indoctrination” operates at least bi-directionally. While the organizational goals and objectives are communicated down to lower organizational levels, a properly functioning executive would seek, and would expect those levels to “communicate up the line”, the relevant circumstances impacting decision-making and actions at those levels. This can be regarded as involving “communicating up the line” not only lower level goals and objectives, but also how such lower levels effectuate and implement higher level goals and objectives and how effective they are.

The intended result, however, is that “indoctrinating” lower-level operating groups with higher level goals, such that lower level operating groups can appreciate the relevance of their goals to those higher goals, should assist in achieving both levels of goals, and in effecting upwards transmission of information relevant to their intended achievement. Consequently, Barnard can be understood to be saying that, in the absence of such coordination and indoctrination, lower level groups cannot fully appreciate the ways in which their own goals contribute to higher level goals, nor can higher-level groups fully appreciate the factors influencing achievement of lower level goals. Barnard’s observations thus accord with those of Bittner, as discussed above under the subheading “Bounded Rationality, and Organizational and Personal Meaning”, to the effect that, in some cases, at least, confidence in the efficacy of the system must be relied upon instead.

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<sup>80</sup> *Ibid* at 181. Bittner's observations concerning rules, legitimacy, and sense-making are relevant here. See the preceding section under the subheading "Bounded Rationality, and Organizational and Personal Meaning".



More generally, Barnard observes that “without that up-and-down-the-line coordination of purposeful decisions, general decisions and general purposes are mere intellectual processes in an organization vacuum, insulated from realities by layers of misunderstanding. The function of formulating grand purpose and providing for their redefinition is one which needs sensitive systems of communication, experience in interpretation, imagination and delegation of responsibility.”<sup>81</sup> The ability to achieve such coordination is powerfully influenced by the systems and processes of the organization, as well as the attributes of its participants. These subjects will be discussed further below.

### **Intraorganizational Organizations**

The present work has mentioned, from time to time, the importance of intraorganizational groups in, and to, the activities of the organization as a whole. It has also discussed the relationship between intraorganizational groups and their individual members. The present chapter permits some examination of the research and theory relating to these matters which, in turn, supports the arguments made in this behalf throughout the present work.

March and Simon are very clear on the importance of these issues, saying that “many of the central problems for the analysis of human behavior in large-scale organizations stem from the operation of subsystems within the total organizational structure”, noting the number of studies that have focused on “the ways in which the needs of individuals, the primary work group, and the large organization interact to affect each other.”<sup>82</sup>

As noted previously, March and Simon interact with, and devote particular attention to, the models of bureaucracy proffered by Merton, Selznick, and Gouldner. Their summary of Selznick’s explanation for the diversity of interest between subunits and the organization, as well as among subunits, in bureaucratic organizations is particularly succinct, and, in this writer’s judgment, even more apt than Selznick’s own; and, for that reason, will be referenced here.

March and Simon note that Selznick emphasizes the delegation of authority, which is motivated by demand for control at the top. Delegation increases the amount of training in specialized competences that is required. Restricting attention to smaller numbers of problems increases experience in, and improves ability to deal with, such problems. Delegation also decreases the

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<sup>81</sup> *Ibid.*

<sup>82</sup> *Supra* note 22 at 41.

difference between organizational goals and achievement, which stimulates more delegation, and thereby departmentalization, and thence a bifurcation of interests among subunits of the organizations.<sup>83</sup>

Importantly, the “maintenance needs of the subunits dictate a commitment to the organizational goals over and above their contributions to the total organizational program” as a result of which “the activities originally evaluated in terms of the organization goals are seen to have additional important ramifications for the subunits”. In turn, “many individual needs depend on the continued success and even expansion of the subunit.”<sup>84</sup> As indicated in the present work, the continued existence of an organization, which in this case is the subunit, is thought to be among any organization’s primary goals.

As we have previously observed and will have occasion again to observe variously throughout our discussion of organizational and intraorganizational goals, respectively, many organizational theorists, researchers, and practitioners treat intraorganizational groups, often without significant discussion or analysis, as if such intraorganizational groups themselves constitute organizations, “mini-organizations”, or intraorganizational organizations. Of course, it may also be that such characterization is simply not raised for explicit discussion.

In any event, many, if not most, of these commentators do not expressly address whether such a group or unit itself constitutes an organization which is nested within the macro-level organization. As a matter of fact, having conducted various research and Internet searches, the present writer has not found such an explicit examination within the context of the corporation. Accordingly, the outline of such an analysis appears below.

As maintained by Weber, the definition of the term “organization” does not require that it come into being either autonomously or endogenously. As can be seen from the discussion under the present heading, March and Simon, and Selznick, as well as many other commentators referenced otherwise in this work, consider that a unit or subunit of a “social unit”, or a group or subgroup of a “group of persons”, (one requirement) may have its own goals and objectives (a second

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<sup>83</sup> *Ibid* at 35. See discussion above under the subheading “The Organizational Hierarchy”, including at note 70.

<sup>84</sup> *Ibid* at 36.

requirement), thereby satisfying two definitional requirements in order to be considered as an organization.

The remaining requirement of the definition of “organization”, of course, is that the relevant social unit or group of persons adopt structures, processes and procedures in an effort to successfully attain their respective goals and objectives. Again, it is not necessary, for purposes of the definition of the term “organization”, that such structures and processes be adopted autonomously or endogenously. Instead, these structures and processes may be entirely imposed externally.

It is important that the superordinate organization may be expected to proceed rationally in order to attain its own goals and objectives and, therefore, to prescribe, or to allow the relevant group or subgroup or unit or subunit, to adopt, structures, processes, personnel, and other practices considered by the superordinate organization to be conducive to the objectives of the superordinate organization, and conducive to those objectives prescribed by the superordinate organization for the relevant subordinate group, subgroup, or unit or subunit.

The existence of intraorganizational organizations has a number of implications for organizational analysis, including the relationship between the goals of the superordinate organization and those of the subordinate organization, which will be discussed in the next section.

### **Goals of Intraorganizational Organizations**

#### ***Separation of Tasks and Goals***

A major assumption underlying the Selznick and the March and Simon arguments here is that the very specialist training and experience which improves the capacity of the relevant group members to deal with the problems assigned to the group creates an asymmetry of knowledge and experience as compared with superordinate and other groups. We would also argue that specialist training, knowledge, and experience also creates a sense of separateness or awareness of the distinctiveness of the focal group as compared with other groups, which may also increase the sense of identification with, and commitment to, the focal group. This is supported by observations of March and Simon which are noted below.

As observed by Fayol and others, the assignment of specialized tasks to the group also creates a separation of goals vis-à-vis the superordinate group, which has higher-order goals, some of which may be intended to be effected, in part, by the subordinate group attaining the goals of the

subordinate group. Similar divergences of goals are likely to exist among various groups at the same level, which have different but similar order goals, which are or may be, as a matter of fact, related in somewhat the same way to the goals of the superordinate group. Thus, it is likely that the instant subgroup has at least some goals which differ not only from those of the superordinate group, but also from those of other subgroups.

March and Simon explain that “the activities originally evaluated in terms of the organization goals are seen to have additional important ramifications for the subunits”, and that the continued success and even expansion of a subunit “dictate a commitment to the subunit goals over and above their contributions” to the goals of the macro-organization.<sup>85</sup> Consequently, the “bifurcation within the organization leads to increased *conflict among organizational subunits*” as a result of which “the content of decisions made within the organization depends increasingly upon considerations of internal strategy, particularly if there is little *internalization of organizational goals by participants*. As a result there is an increase in the difference between organizational goals and achievement and this results in an increase in delegation.”<sup>86</sup>

March and Simon are understood to maintain, then, that the goals of successful subunits must motivate members separately from goals of the organization; that macro-level goals may not be the subject of a lower level of awareness, internalization, and commitment by members of intraorganizational units or groups than lower level goals; and also that the “content of decisions made within the organization depends increasingly upon considerations of [organizational subunit] strategy”, which is to say, the strategy of intraorganizational units, groups, or organizations.

### ***Internalization of, and Commitment to, Intraorganizational Goals***

As explained in this work, organizational goals, including that of maintaining the organization, may find expression by individuals within the organization in terms of internalization and in terms of commitment. March and Simon described how Selznick relates intraorganizational conflict to internalization, saying: “The struggle for internal control not only affects directly the content of decisions, but also causes greater *elaboration of subunit ideologies*. Each subunit seeks success by

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<sup>85</sup> *Ibid.*

<sup>86</sup> *Ibid* [emphasis in the original].

fitting its policy into the official doctrine of the large organization to legitimize its demands. Such a tactic increases the *internalization of subgoals by participants* within subunits.”<sup>87</sup>

In effect, “subunit ideologies” are elaborated, at least, if not also formulated, so as to incorporate macro-organizational “ideologies”, and thereby to confer legitimacy on subunit ideologies, goals, and demands. For example, as discussed previously, Bouquet and Birkinshaw demonstrated the importance to subunit power and influence of subunits constantly reaffirming their commitments to macro-organizational objectives.<sup>88</sup> March and Simon’s suggestion seems to be that elaboration of organizational goals by subunits for the purpose of thereby acquiring purported legitimacy for subunit goals also has the effect of promoting intraorganizational conflict and power struggles.

Further, according to the Selznick model, decisions are made within the subunit based on operational criteria provided by the organization and by the subunit, with considerable importance being given to subunit goals. In the result, subunit members become habituated in their responses to situations which, in turn, reinforce the internalization of subunit goals.<sup>89</sup>

In their further appraisal of the Selznick model, March and Simon observe that internalization of subgoals is partially dependent on the “operationality” of operational goals, meaning by this the observation and testing of the achievement of organizational goals. Further, variations in operationality of organizational goals affect the content of daily decisions, and hence the extent to which subunit goals are internalized. Accordingly, they say that in the Selznick model “delegation has both functional and dysfunctional consequences for the achievement of organizational goals. It contributes both to their realization and to their deflection.”<sup>90</sup> In this regard, as discussed previously, Birkinshaw and Hood demonstrated that the track record of a subunit namely, “the extent to which it has delivered, over the years, results at or above the expectations of the parent

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<sup>87</sup> *Ibid* [emphasis in the original].

<sup>88</sup> Cyril Bouquet and Julian Birkinshaw, "Weight Versus Voice: How Foreign Subsidiaries Gain Attention from Corporate Headquarters" (2008) 51:3 *Academy of Management J* 577 at 594. See under the discussion in Chapter Three under the subheading “Power and SBUs”.

<sup>89</sup> *Supra* note 71 at 36-37.

<sup>90</sup> *Supra* note 22 at 37.

company” is the most critical factor affecting subsidiary evolution, which reflects subsidiary power and influence.<sup>91</sup>

March and Simon disagree with Selznick, however, when he maintains that all increases and decreases in goal achievement cause an increase in delegation; arguing, instead, that “by suitable changes in the extent to which organizational goals are operational or in the internalization of organizational goals by participants, some of the dysfunctional effects of delegation can be reduced.”<sup>92</sup> Thus, March and Simon claim that both of these mechanisms, operationalization and internalization, can be used as “dampers” to limit the operation of the dysfunctional mechanisms of delegation and intraorganizational internalization of, and commitment to, the goals of intraorganizational units or groups.

March and Simon thus contemplate that the prioritization of organizational and subunit goals can be influenced by intraorganizational action, including action by management of the organization. That point has been made at various points in the present work.

## **Formal Structure and Relationships**

### *Institutionalization of Relationships*

As discussed, such institutional analysts as Weber, Barnard, and Fayol have remarked on the institutionalization of relationships within bureaucratic or formal organizations. They treat such institutionalization of relationships as part of, or at least endemic in, structure.

Merton characterizes the interaction among parties in the hierarchy as involving “a considerable degree of formality and clearly defined social distance between the occupants of these positions” with a “more or less complicated social ritual”. He observes that such formality “serves to minimize friction by largely restricting (official) contact and modes which are previously defined by the rules of the organization”, which permits “ready calculability of others’ behaviour and a stable set of mutual expectations” and also “facilitates the interaction of the occupants of offices

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<sup>91</sup> Julian Birkinshaw and Neil Hood, "Multinational Subsidiary Evolution: Capability and Charter Change in Foreign-Owned Subsidiary Companies" (1998) 23:4 *Academy of Management Rev* 773 at 788. See the discussion in Chapter Three under the subheading “Power and SBU Evolution”.

<sup>92</sup> *Supra* note 22 at 37.

despite their (possibly hostile) private attitudes toward one another.”<sup>93</sup> He maintains, then, that such formality increases tendencies towards rationality. This is reminiscent of Weber and Barnard.

Selznick is emphatic on this point, saying that the “security of all participants, and of the system as a whole, generates a persistent pressure for the institutionalization of relationships, which are thus removed from the uncertainties of individual fealty or sentiment. Moreover, it is necessary for the relations within the structure to be determined in such a way that individuals will be interchangeable and the organization will be free of dependence upon personal qualities. In this way, the formal structure becomes subject to calculable manipulation, an instrument of rational action.”<sup>94</sup> In effect, the formalization of relationships is rationally coherent in terms of organizational teleology, although it may present substantial practical difficulties, as discussed next.

### ***Roles and Depersonalization of Relationships***

Selznick maintains that: “From the standpoint of organization as a formal system, persons are viewed functionally, in respect of their *roles*, as participants in assigned segments of the cooperative system. But in fact individuals have a propensity to resist depersonalization, to spill over the boundaries of their segmentary roles, to participate as *wholes*.”<sup>95</sup> In effect, the role identity of an individual as a participant in the organization does not exhaust either that individual’s social identity or their personal identity.

Selznick further acknowledges this when he says that “the whole individual raises new problems for the organization, partly because he brings with him a set of established habits as well, perhaps, as commitments to special groups outside of the organization.” Put another way, the “whole individual” may act in ways that are not determined by, and consistent with, that individual’s role. Consequently, “the needs of individuals do not permit a single-minded attention to the stated goals of the system within which they have been assigned”, which is the principal hazard inherent in the act of delegation.<sup>96</sup>

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<sup>93</sup> *Supra* note 20 at 560. Merton follows Weber in this regard, even using the term “calculability”. See discussion in the preceding section above under the subheading “Claims of Efficiency”.

<sup>94</sup> *Supra* note 71 at 25.

<sup>95</sup> *Ibid* at 26 [emphasis in the original].

<sup>96</sup> *Ibid*.

For example, in the case of delegation, functions and powers are assigned to roles or official positions, rather than to individuals as such, “however, delegation necessarily involves concrete individuals who have interests and goals which do not always coincide with the goals of the formal system. As a consequence, individual personalities may offer resistance to the demands made upon them by the official conditions of delegation”.<sup>97</sup> In other words, individuals may act in ways that are not role-determined.

As maintained by Weber, Barnard and Fayol, within the organization, contractual and other arrangements endeavour to ensure an appropriate relationship between the demands of the system, as expressed in instructions emanating from superordinate levels, and in the willingness of individuals, groups, and subgroups within the organization to accept and implement such instructions. Observing certain formalities as between the giver of instructions and the receiver facilitates greater recognition that the imperative emanates from the organization through a particular official or “office” as Weber would say, rather than from an individual person as such.

March and Simon relate this to Gouldner’s approach, which emphasizes the use of general and impersonal rules regulating work procedures. They indicate that “one consequence of such rules is to decrease the *visibility of power relations* within the group” which, in the American culture of egalitarian norms, increases the legitimacy of the supervisory position and therefore decreases tension within the group.<sup>98</sup>

We submit that this decrease in intragroup tension may also contribute to establishing a group-centric orientation, as indicated by measures of group identity and group commitment. We also note that unofficial contact within a group or between individuals in different groups, which may often be informal, typically characterizes relationships which are often personal, even face-to-face, and which involve factors which may mitigate against interpersonal friction.

### ***Repersonalization of Relationships***

An early exponent of modern management theory, Mary Parker Follett, commented on these matters in an article first presented in 1925, in which she claimed that scientific management tends to depersonalize orders, since “one might call the essence of scientific management the attempt to

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<sup>97</sup> *Ibid* at 27.

<sup>98</sup> *Supra* note 21 at 39 [emphasis in the original].



find the law of the situation. With scientific management the managers are as much under orders as the workers, for both obey the law of the situation.”<sup>99</sup> Her comments on depersonalization merit further examination.

Follett argued that the job of scientific management is not to devise methods to ensure obedience to orders, but is, instead, “how to devise methods by which we can best *discover* the order integral to a particular situation. When that is found, the employee can issue it to the employer, as well as employer to employee. This often happens easily and naturally.”<sup>100</sup> Like Taylor,<sup>101</sup> Follett assumes that the knowledge, experience and “know-how” of the worker makes a valuable, even essential, contribution to this process, which seeks to ameliorate the effects of bounded rationality.

Her perspective challenges Weber’s view that direct hierarchy is the best form of leadership for large organizations, while it also exhibits some similarities to Taylor’s earlier explication of scientific management. Many organization and management theorists would argue that there are but limited situations in which the exigencies of time and other matters permit a “quest” to discover the law of the situation; and that, consequently, Follett’s perspective is a form of idealization.

That said, her conceptualization of the “quest” may be a useful thought-guide. Organizational participants may be seen as being thereby directed to consider the relevant circumstances, and to make a determination as to the range of responses, group of responses, or individual response, which is most appropriate to the situation at hand. Follett’s perspective may be particularly relevant to organizations characterized by highly educated, highly intelligent, and highly motivated workforces; for example, in technology and other knowledge-based businesses, which often also adopt modern “flat hierarchy” schemes of organization considered to be appropriate for such businesses and workforces.

Follett’s concept of obeying the “law of the situation”, of course, invisibilizes, or, at least, attempts to invisibilize, the imbalance in power as between superior and inferior offices or their incumbents. In some ways, her approach amounts to a deinstitutionalization of intraorganizational relationships in which, she says, the “bossing pattern” of “bossing” on the one hand, and of being bossed and

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<sup>99</sup> MP Follett, “The Giving of Orders” [1941] in *Organization Theory: Selected Readings*, DS Pugh, ed, (New York: Penguin Books, 1977) at 155.

<sup>100</sup> *Ibid* [emphasis in the original].

<sup>101</sup> *Supra* note 28 at 42-46.

being in opposition to the bossing, on the other hand, are replaced by uniting “all concerned in a study of the situation, to discover the law of the situation and obey that.”<sup>102</sup>

In her scheme, to a large extent, the “role” assigned to the various parties to intraorganizational relationships (superior, inferior, or other) is de-emphasized to permit a shared role of inquiry, although, admittedly, one in which there is necessarily some inherent imbalance in the circumstances of participation. Of course, de-emphasizing roles may permit individuals to instantiate extraorganizational aspects of their social identity, behaving, perhaps, as more of a “whole person”, which may de-rationalize the process.

Follett refers to this process as depersonalizing orders and authority, but ultimately finds this expression inadequate, saying, instead, “I think it really is a matter of *repersonalizing*. We, persons, have relations with each other, but we should find them in and through the whole situation. We cannot have any sound relations with each other as long as we take them out of that setting which gives them their meaning and value. This divorcing of persons and the situation does a great deal of harm. I have just said that scientific management depersonalizes; the deeper philosophy of scientific management shows us personal relations within the whole setting of that thing of which they are a part.”<sup>103</sup>

Of course, the setting that gives intraorganizational relations “their meaning and value” relates to the organization itself, as well as its structure and processes, including the relationships among intraorganizational groups, and those among individual members of those groups, and those among individual members of those groups and such groups. It may be, however, that Follett is averting to “meaning and value” in the sense of how the activity in which the relationship is concerned “fits into” the overall organizational scheme, so as to give such activity “meaning and value” within the context.

It will be recalled that Bittner maintained that a formal and rational scheme of organization may link remote persons and performances into concerted action and that “each link derives its meaning not so much from the specific rule that determines it, but from the entire order of which the rule itself is a part”. He suggested that it may be possible to devise “a principle of discipline that derives

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<sup>102</sup> *Ibid* at 154.

<sup>103</sup> *Ibid* at 156 [emphasis in the original].

from the formal style of the rational scheme and which works against centrifugal tendencies and heterogeneity” and will appear coherent.<sup>104</sup> Follett may have anticipated Bittner’s analysis in this respect.

It is clear, then, that the “structuring” of relationships is generally considered by organizational theorists to represent one aspect of the structure of an organization. This is true of modern business corporations, as well as other organizations. It now remains to consider the “informal” structure and relationships within the organization, which is often discussed in terms of the organization’s “informal structure”.

### **Informal Structure and Relationships**

#### ***Prevalence***

The present work has averted, from time to time, to an informal organization, and its structure, processes, and personnel, which may operate either “outside”, or “alongside”, or, in some more or less integrated fashion, in connection with, the formal organization, structure, processes, and personnel.

While there may be some tendency to regard the existence of such an informal organization as counter-organizational or as counter-rational, Chester Barnard, at least, regarded the informal organization as “essential to formal organizations, particularly with reference to communication... not only [to] the organization as a whole, or [to] its ultimate subordinate units, but also [to] that special part which we call the executive organization”, describing “the maintenance of informal executive organization as an essential means of communication”.<sup>105</sup> He found that “in all the good organizations I observed the most careful attention is paid” to the informal executive organization, that informal organizations operate in all good organizations, and that “this is usually not apparent except to those directly concerned.”<sup>106</sup>

Barnard’s focus, as expected in a book so entitled, is on the functions of the executive in this respect. However, it is commonly thought that informal organizations exercise a role at non-executive levels of the hierarchy as well, and perhaps even throughout the hierarchy at every level. It is likely that the effects of the informal organization may differ at various levels of the hierarchy,

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<sup>104</sup> *Supra* note 14 at 252.

<sup>105</sup> *Supra* note 54 at 173.

<sup>106</sup> *Ibid.*

having regard to a number of factors. These may include the extent, and perhaps the type, of discretion conferred on officials at such hierarchical level. However, as discussed below, it is expected that the informal organization may have some impact throughout the organization.

### ***Roles and Relationships in Formal and Informal Structures***

As discussed earlier in the chapter, particularly in the previous section entitled “Formal Structure and Relationships”, the institutionalization of relationships within bureaucratic or formal organizations has been central to the work of many institutional analysts, including Weber, Barnard, Fayol, Merton, Selznick, March and Simon, and Follett. In effect, relationships among individuals within the formal organization are characterized in terms of the roles assigned to those individuals within it.

However, as discussed in that section, the role identity assigned to an individual as a participant in the organization does not exhaust either the social identity or the personal identity of the individual participant. As Selznick notes, individuals resist depersonalization and may express this by acting outside such roles and participating as whole individuals, rather than as “depersonalized” individuals who are wholly role-dependent. Commensurate with Follett’s observations, they may seek to repersonalize their intraorganizational relationships.

In our opinion, these observations are consistent with, and seem to explicate, the existence and operation of an informal organization, involving an informal structure and informal relationships. Individuals resisting deindividuation, intraorganizational definition solely by role assignment, and depersonalization of relationships may express these aspirations in the informal organization, informal structure, and informal relationships. Ambitious individuals may seek to expand their activities beyond their assigned roles, while less ambitious, or even timorous, individuals may seek to limit their role-assigned activities, perhaps as a result of fear of failure or other considerations.

Furthermore, of course, a particular intraorganizational role is not expected to be entirely unitary or even singular. That role may involve, instead, a role at the macro-organizational level, say at the level of the corporation, as well as other roles within various groups and subgroups. As discussed in Chapter Seven, the individual concerned may adopt various strategies in order to instantiate those various role-identities in particular circumstances. We submit that such strategies may include participation in role-identities outside the focal role by informal means, that is to say,

through the informal organization, informal structure, and informal relationships. We submit that such participation may involve some accommodation of the individual's various role-identities.

### *Invisibility of Informal Organizations and Relationships*

Barnard's observation that the operation of informal organizations within formal organizations is usually not apparent except to those directly concerned is not unimportant. It suggests, among other things, that someone who is an outsider with respect to the organization or relevant group or subgroup cannot, simply by examining the organizational chart with respect to the same, determine the actual, rather than ideal, assignments of authority and responsibility, and the sources and nature of power and influence in respect of the formal organization. Instead, such a determination would seem to require some empirical investigation concerning the instantiation of such matters, both in general, and in the case at hand.

Among other things, this has the consequence that the situs of actual decision-making, as well as authority and responsibility, may not always be apparent from the organizational chart. On the one hand, it may be more widely distributed than as indicated there; but, on the other hand, it may be more concentrated, instead.

This may become extremely important in connection with the application of sanctions internally, that is to say, within the organization or relevant group or subgroup, and externally, that is to say, from outside the organization taking it as the focal unit, or outside the relevant group or subgroup but within the organization more generally. Just as the existence and operation of the informal organization and the related issue of informal relations complicate the question concerning who may properly be considered blameworthy with respect to some misadventure of the relevant focal unit, so it is a complicated question concerning where and to whom credit may properly be assigned with respect to some achievement of the relevant focal unit.

It can readily be seen that both aspects of sanctioning, positive and negative, may be affected, including such matters as bonuses, negative readjustments of bonuses previously determined or paid, and imposition of legal liability by way of fines and penalties by individuals or groups of individuals or relevant subsidiary company actors within the corporation and at all organizational levels.

### *Informal Communication*

Focusing on “the executive”, of course, Barnard observes that the “functions of informal executive organization are the communication of intangible facts, opinions, suggestions, suspicions, that cannot pass through formal channels without raising issues calling for decisions, without dissipating dignity and objective authority, and without overloading executive positions; also to minimize excessive cliques resulting from too great divergence of interests and views; to promote self-discipline of the group; and to make possible the development of important personal influences in the organization.”<sup>107</sup> While Barnard focuses on the transmission of information, he also indicates that the informal executive organization may also perform other functions. Again, it may be expected that at least some of these functions, particularly the communication of information, may be exercised informally to some extent at other levels in the hierarchy.

Barnard explains that informal executive organization can accomplish a number of important results, one of which is “avoiding formal issues, that is, for avoiding the issuance of numerous formal orders except on routine matters and except in emergencies”, thereby avoiding disagreement which might challenge the exercise of authority, or of cooperation. Instead, he says that many major executives seldom issue explicit orders or judgments on important issues, preferring, instead to use them as means of expressing agreement with authority.<sup>108</sup> Such a procedure, of course, tends to reduce the visibility of the exercise, and imbalance, of power.

In effect, then, such executives, instead, “informally” communicate their views, judgments, and decisions, leaving it to affected subordinates to act accordingly. It can be readily seen that such informal communications may complicate identifying whether, when, and where, and by whom, the relevant judgments or decisions have been made.

In many cases, informal communication of the views of the superior will elucidate a response by the subordinate that the superior wants or expects the subordinate to take a certain action, but without issuing any order or instruction to that effect. Instead, it may be argued that the course of action appropriate in all the circumstances becomes apparent to the subordinate. It may even be said, cynically or otherwise, that the subordinate discovers “the law of the situation”. This is discussed further below.

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<sup>107</sup> *Ibid* at pp. 174-175.

<sup>108</sup> *Ibid* at 175.

### *Personal Influence*

Barnard avers that another merit of informal organization, at least at the executive level, is that it can enable positive exercises of personal influence. He notes that “many men not only exercise beneficent influence far beyond that implied by their formal status, but most of them, at the time, would lose their influence if they had corresponding formal status”. He speculates that this may be because “many men have personal qualifications of high order that will not operate under the stress of commensurate official responsibility”, like top golfers who cannot perform in tournaments.<sup>109</sup> This is broadly consistent with Taylor’s insistence that management incorporate into its rulemaking all of the experience and expertise available within the organization, at all levels, generally.

Barnard may also be claiming that the influence which some individuals attain with respect to their peers, in effect, as embodying the “best judgment” of that peer level would be dissipated, and, in fact, even lost completely, if the individual was promoted even to the next higher level of the hierarchy. In that case, that individual would no longer embody the “best judgment” of the individual’s preceding peer level, as they have ceased to be “peers” at that level. This may be particularly important where and to the extent that collective decision-making, involving unanimity, general concurrence, or otherwise, is practiced.

In a case in which the judgment of the “next best” individual at that peer level is considered to be substantially inferior to that of the focal individual, promoting the focal individual might result in a loss which might be greater than the benefits achieved by means of the promotion. The example can be further extended by positing that the judgments made at the preceding peer level are of great importance. Again, in that case, the loss of “leadership” by the relevant individual among those peers might be extremely detrimental to the organization generally.

It will be recalled that one advantage of formal organization as it pertains to the exercise of authority and responsibility is that incumbents of offices or positions are assumed to be fungible, easily replaceable, and devoid of personal characteristics, and, in particular, characteristics that might tend to personalize authority and responsibility, thereby inhibiting homogeneity. In effect, Barnard maintains that some of the disbeneficial aspects of formal or bureaucratic organization

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<sup>109</sup> *Ibid.*

can be mitigated, while the beneficial aspects may largely be maintained, by informal organizational activity.

Accordingly, Barnard recognizes that influence within the organization is not only a product of official status, but may also reflect the knowledge, experience, and judgment of the individual concerned, and the recognition and approbation of the same by others within the organization or within the relevant intraorganizational group. Clearly, personal influence can also be exercised with negative effects; however, in at least some cases, such results may be restrained by formal or informal mechanisms.

### *Generalizability among Types of Organizations*

Importantly, Barnard acknowledges the existence and significance of informal organizations which are related to formal organizations. This accords with the observations previously made in the present work. It is also important to note that, while Barnard tends to concentrate his discussion, and his examples, on business enterprises, particularly those engaged in manufacturing, his observations are usually more generalized and extend to all organizations.

For example, Chapter VII of his book, which chapter is entitled “The Theory of Formal Organization”, makes clear that the term “efficiency” as conceived in his book “is not used in the specialized and limited sense of ordinary industrial practice or any restricted sense applicable to technological processes”, since Barnard thinks that his usage has little meaning as applied to other kinds of organizations, such as churches, patriotic societies, scientific societies, and theatrical and musical organizations. Instead, efficiency, for Barnard, signifies “efficiency relative to the securing of necessary personal contributions to the cooperative system.”<sup>110</sup> This recalls March’s analysis of organizations, particularly the firm, as a political system as discussed under that heading in Chapter Six of the present work.

In the case of organizations that are not business enterprises, he says that “material inducements”, by which he primarily means money, are not particularly efficient. It is not clear, however, how Barnard ascertains this. It may relate to determining the quantum of personal contributions to the cooperative system that are necessary in order to induce their being made. If so, the question arises how to determine, and how to measure, it, and on what scale.

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<sup>110</sup> Chester Barnard, *The Functions of the Executive*, (Cambridge: Harvard University Press, 1938) at 92.



It seems that only a comparative, rather than absolute, determination, measure or scale would avail. For example, if funds are advanced to a particular corporation by way of loan, the absolute rate of interest “demanded for such contribution” in the relevant circumstances would lack relevance, absent a consideration of those circumstances and a comparison of those against other relevant circumstances. Accordingly, the application of such a measure of efficiency seems problematic.

Barnard’s use of the term “efficiency”, of course, differs from use of such term in classical and neoclassical economics, where it is usually applied to the production cost curve and in relation to diminishing marginal costs. The sense of the term in which Barnard uses it does not arise in that connection. Among other reasons, as we have indicated previously, this is, in part, because the “black box” of production, the process of generating products and services, does not arise in the context of securing contributions from participants which are necessary to effect the organization’s purpose.

By comparison, Barnard’s use of the term arises only in that context. It can be seen that informal structures, relationships, and communications are considered by Barnard to contribute to “efficiency” in industrial enterprises, other business enterprises, and other organizations having significantly different objectives. The “organization” element of the “business organization” is, for Barnard, fundamentally common to such organizations. Accordingly, the activities of business organizations, including the modern business corporation, may be expected to have certain fundamental commonalities within organizations of diverse goals.

## **Formal Organizations and Informal Organizations**

### ***Functions of Formal Organizations and Informal Organizations***

Herbert Simon maintains that the formal organization, which is “a set of abstract, more or less permanent relations that govern the behavior of each participant”, is created by “procedural coordination – the specification of the lines of authority, and the spheres of activity and authority of each organizational member”.<sup>111</sup> Formal authority is exercised to establish and enforce the scheme of formal organization, which then itself prescribes the lines of authority and division of

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<sup>111</sup> *Supra* note 23 at 147. Simon follows Weber not only in considering the organization as a relationship, but also in analyzing the “formal” organization. As described in Chapter Four, each of Weber, Selznick, and Bittner consider stability, at least somewhat analogous to Simon’s “permanence”, to be a necessary element of any organization.

work to be followed in carrying the work of the organization. It may also establish the scope of authority, procedures, and lines of communication.<sup>112</sup> We associate the latter two items not only with structure but also what we denominate here as “process”.

Accordingly, Simon, like Weber, characterizes an organization as a relationship, which he says is abstract but “more or less permanent” in terms of governing the behaviour of each participant. Unlike Weber, he expresses this not in terms of expectation, but in terms of authority. His description makes it clear that the “participants” in the formal organization are individuals and that they are “members” of the organization. It is assumed that the formal organization has some common purpose. It is also evident that the social unit or group of persons concerned in the organization is structured or “organized” with the objective of attaining such purpose.

Like Weber and other social theorists, Simon talks about the organization as a relationship. However, instead of referring to the “organization” as the relationship, Simon himself characterizes the “formal organization” as the operative relationship, as if the “formal organization” was somehow different from the “organization” as such. One might have expected that the “formal organization” would differ from the “organization” not only by reason of the formality of the relationships described, but also by reason of the “formal organization” being the reified or entified version of the “organization”. One might have expected, in that event, that the “formal organization” would be described as having a “scheme of organization” which could then be analyzed in terms of divisions, spheres, and lines, of authority.

In the result, of course, the conceptual and definitional problems previously discussed in this chapter and otherwise in this book continue to assert themselves even in Simon’s work. For example, Simon talks about the “formal scheme of organization”, not simply the “formal organization”, as an ideal type. He argues that the “formal scheme of organization will always differ from the “organization as it actually operates”; firstly, because the formal scheme is unlikely to be complete, in that it may omit many interpersonal relationships; and, secondly, because “the interpersonal relations in the organization as it operates may be in actual contradiction to the specifications”,<sup>113</sup> which is to say that the established rules and procedures are not always followed.

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<sup>112</sup> *Ibid* at 148.

<sup>113</sup> *Ibid*.

While this suggests the existence of an “informal organization”, Simon acknowledges this explicitly, referring to it as the “interpersonal relations in the organization that affect decisions within it but either are omitted from the formal scheme or are not consistent with that scheme”, and observing that probably “no formal organization will operate effectively without an accompanying informal organization.”<sup>114</sup> As noted in the preceding paragraph, Simon claims that this is partly because “the formal structure could not be specified in such detail as to obviate the need for an informal supplement”. But, while necessary, the informal relations that are permitted to develop within the formal structure must be limited and contained by the formal organization if the formal organization is to be effective.<sup>115</sup>

Simon also maintains that “it is an important function of the formal organization to prevent the development of organization politics – struggle for influence and authority – to a point that would be deleterious to the functioning of the organization”. Instead, the formal structure should encourage the development of the informal structure along constructive lines, including facilitating cross-fertilization and cooperation.<sup>116</sup> The implication, of course, is that the informal structure, either by providing a situs for organizational politics or by restraining its pursuit within the actual formal structure, may prevent seriously dysfunctional struggles for influence and authority within the formal structure.

### ***Common Purpose, Intraorganizational Cooperation, and the Zone of Acceptance***

Within the formal organization, authority significantly determines the actions of intraorganizational participants. Simon says that “the most striking characteristic of the “subordinate” role is that it establishes an area of acceptance in behavior within which the subordinate is willing to accept the decisions made for him by his superior” and that “his choice is then determined, always within the area of acceptance, by his superior, and the relation of superior-subordinate holds only within this area.”<sup>117</sup> Simon acknowledges Barnard’s origination of this concept, which Barnard calls the “zone of indifference”<sup>118</sup>, but which Simon calls the “zone of acceptance”.<sup>119</sup>

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<sup>114</sup> *Ibid.*

<sup>115</sup> *Ibid* at 149.

<sup>116</sup> *Ibid.*

<sup>117</sup> *Ibid* at 133.

<sup>118</sup> *Supra* note 54 at 169.

<sup>119</sup> *Supra* note 23 at 12.

For Barnard, this acceptance is implicit in his concept of an organization. He says that “an organization comes into being when (1) there are persons able to communicate with each other (2) who are willing to contribute action (3) to accomplish a common purpose”. Accordingly, the “vitality of an organization lies in the willingness of individuals to contribute forces to the cooperative system”, which willingness requires the belief that the purpose can be carried out and also requires that individual contributors secure satisfactions, which exceed the sacrifices required, in the process of carrying out the purpose.<sup>120</sup> Presumably, this demonstrates that the organization is “efficient” in the Barnardian sense discussed in the section on Informal Structure and Relationships under the heading “Generalizability Among Types of Organizations”.

Accordingly, Barnard asserts that “a purpose does not incite cooperative activity unless it is accepted by those whose efforts will constitute the organization” such that “there is initially something like simultaneity in the acceptance of the purpose and willingness to cooperate.”<sup>121</sup> In this context, willingness “means self-abnegation, the surrender of control of personal conduct, the depersonalization of personal action”, the effect of which is cohesion of effort or sticking together, and the cause of which is the disposition necessary to “sticking together”. The latter is required to maintain sustained personal effort as a contribution to cooperation.<sup>122</sup>

Barnard says that such willingness vis-à-vis the organization may be expressed as loyalty, solidarity, or *esprit de corps*, and relates to the intensity of attachment to the “cause”.<sup>123</sup> This use of the term “willingness” is distinctive, even unusual, inasmuch as it involves a substantial degree of commitment. Barnard maintains, however, that “the willingness of an individual cannot be constant in degree [but] is necessarily intermittent and fluctuating”, with the consequence that “the aggregate willingness of potential contributors to any formal cooperative system is unstable.”<sup>124</sup>

Barnard takes a utilitarian approach to motivation, saying that willingness to cooperate “is the expression of the net satisfactions or dissatisfactions experienced or anticipated by each individual in comparison with those experienced or anticipated through alternative opportunities... either personal and individualistic or those supported by other organizations”. Consequently, willingness

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<sup>120</sup> *Supra* note 110 at 82.

<sup>121</sup> *Ibid* at 86.

<sup>122</sup> *Ibid* at 84.

<sup>123</sup> *Ibid* [emphasis in the original].

<sup>124</sup> *Ibid* at 85.

to participate “is the net effect, first, of the inducements to do so in conjunction with the sacrifices involved, and then in comparison with the practically available net satisfactions afforded by alternatives.”<sup>125</sup> We may conclude that this likely involves Barnard’s concept, and measurement, of “efficiency”: Efficiency, he seems to argue, consists in, and may be measured by, this scale of net satisfactions or dissatisfactions in comparison with available alternatives. This accords with our previous comments.

In the case of the employer and employee relationship, the willingness of each of the parties to contribute to the formal cooperative system which constitutes their relationship is affected by Barnard’s “zone of indifference” or Simon’s “zone of acceptance”.

### *The Range of the Zone of Indifference or Acceptance*

For Simon, the factors affecting the zone of indifference include: for the employer, the fact that without it, the employer gains nothing from the employee; for the employee, the fact that he or she may genuinely be relatively indifferent, albeit within certain limits; the nature and magnitude of incentives; status and prestige; relations within the working group; possibility of promotion; possibility of other material and nonmaterial incentives; desire to maintain the organization; loyalty to the objectives of the organization; and loyalty to the organization itself.<sup>126</sup> Social attitudes, social and other sanctions, and the avoidance of social disapprobation and embarrassment may also be factors.<sup>127</sup>

Simon argues that organizational values are substituted for individual values within the zone of acceptance, and when the focal individual is behaving impersonally or “organizationally”, but that personal motives become apparent and hence restrict these organizational values when outside the zone of acceptance.<sup>128</sup>

It thus becomes apparent that the “zone of acceptance” or “zone of indifference” actually relates to the role conferred upon, and accepted by, the incumbent of the office; and, further, that the consent to enacting that role is exhausted when the limits of the role are reached. Accordingly, it

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<sup>125</sup> *Ibid.*

<sup>126</sup> *Supra* note 23 at 116-117. Loyalty to organizational objectives and to the organization itself are discussed at some length in Chapter Four under various subheadings under the heading “A Social Unit or Group of People”.

<sup>127</sup> *Ibid* at 131.

<sup>128</sup> *Ibid* at 204.

is somewhat misleading to say, as does Simon, that “if it is attempted to carry authority beyond” the subordinate’s “zone of acceptance” then “disobedience will follow.”<sup>129</sup> Instead, it is more accurate to say that the “zone of acceptance or “zone of obedience” has been exhausted, exceeded, or terminated at the point in question. Indeed, as noted above under the heading “Institutionalization of Relationships”, it may be more meaningful to conclude that the individual’s “organizational role” has been exhausted, exceeded, or terminated at that point, at which point the individual commences to reassert his or her social identity or personal identity without reference to organizational role or identity.

### *Cooperative Systems, Authority, and Acceptance*

Selznick also makes an important contribution to examining the relationship between the formal organization and the informal organization. As previously noted, he regards organization as an open economy and as an adaptive social structure. “Considered as an economy, organization is a system of relationships which define the availability of scarce resources and which may be manipulated in terms of efficiency and effectiveness.”<sup>130</sup>

He maintains that the ability to manipulate those relationships in terms of efficiency and effectiveness is affected by the structure of the organization, and not only by its processes of delegation and control. Manipulating the system of coordination “depends on the extent to which that system is operating within an environment of effective inducement to individual participants and of the conditions in which the stability of authority is assured.” Like Simon, he credits this conclusion to Barnard.<sup>131</sup>

Consequently, says Selznick, “The indivisibility of control and consent makes it necessary to view formal organizations as *cooperative* systems, widening the frame of reference of those concerned with the manipulation of organizational resources.”<sup>132</sup> As demonstrated earlier in the present discussion, Barnard also treated organizations as cooperative systems. That is to say, both experts hold, in effect, that the efficacy of formal organizations is dependent, at least in part, upon the establishment, and the continued existence and stability, of a range of cooperation between the organization and its participants, as well as among those participants, within which range

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<sup>129</sup> *Ibid* at 12.

<sup>130</sup> *Supra* note 71 at 26.

<sup>131</sup> *Ibid*.

<sup>132</sup> *Ibid* [emphasis in the original].

participants consent to be controlled by the organization and its authorized participants or within which range they agree to cooperate as members of such a cooperative system. Selznick thus agrees with Barnard and with Simon on this point.

Each of these authors maintains that a necessary component of such intraorganizational agreement on the part of members of the organization is that the organization and its authorized participants will not attempt to exercise control over participants except in specified and mutually agreed circumstances. As Weber maintains, such rules and procedures are established in the “order” bringing into being the organization itself, whether autonomously or heteronomously.

As demonstrated in Part 1 of this book, the legal authority of the corporation and its agents is similarly circumscribed, in this case, by law, which is the “order” by which it is brought into being as a legal entity. Consequently, it may be said that the authority, and the zone of acceptance, of the organization vis-à-vis its members is, in the case of the corporation, given effect by the law and other legally required procedures pursuant to which the corporation is established as a legal entity.

What is particularly characteristic of the corporation, then, is the legal status, as a legal entity, which accompanies its coming into being pursuant to the “order” which brings into being, which is the “legal order”. Other organizations which are constituted as “legal entities” by the legal order which brings them into being as such may also be expected to display similar attributes. The “difference” in this regard, then, between the corporation and many, if not most, other forms of organization is that because the order by which it is established is the “legal order”, it may possess attributes which relate directly to the “legal order”, and which, as a matter of law, and as a matter of fact, may be conferred only by the legal order.

### ***Intraorganizational Roles and Extraorganizational Roles***

For Selznick, formal structures can “never succeed in conquering the non-rational dimensions of organizational behaviour” which “remain at once indispensable to the continued existence of the system of coordination and at the same time the source of friction, dilemma, doubt, and ruin.” He explains that: “This fundamental paradox arises from the fact that rational action systems are inescapably imbedded in an institutional matrix in two significant senses; (1) the action system – or the formal structure of delegation and control which is its organizational expression – is itself only an aspect of a concrete social structure made up of individuals who may interact as *wholes*, not simply in terms of their formal roles within the system; and (2) the formal system, and the

social structure within which it finds concrete existence, are alike subject to the pressure of an institutional environment to which some over-all adjustment must be made.”<sup>133</sup>

As discussed in the present work, social identity theory, as expressed by Ashforth and Mael, considers an individual’s identity to be “an amalgam of loosely coupled identities”, rather than a unified, consistent whole.<sup>134</sup> As discussed in Chapter Four under the subheading “Role Conflict”, according to those authors, these “identities” relate to the various roles assumed by the individual. Individuals within the organization enact various aspects of their own social identity, as well as their own personal identity; and, further, may seek to accommodate differences in these identities, which, in effect, means differences in the behaviour normally attributable to such identities, in different ways, and at different times, depending on a number of factors, including perceived salience at the instant time.<sup>135</sup>

However, the primary interaction of such individuals within the organization concerned, and that which is usually of greatest concern to the organization, is intraorganizational interaction, which is rationally defined by the organization itself as the interaction most immediately relevant to the organization. Accordingly, the interactions within the organization which are not relevant to the organization in rational terms may tend to be disregarded. Of course, this does not eliminate interactions which are non-rationally based.

In Selznick’s analysis, “from the standpoint of individuals as a formal system, persons are viewed functionally, in respect of their *roles*, as participants in assigned segments of the cooperative system. But in fact individuals have a propensity to resist depersonalization, to spill over the boundaries of their segmentary roles, to participate as *wholes*” and the “whole individual raises new problems for the organization partly because of the needs of his own personality, partly because he brings with him a set of established habits as well, perhaps, as commitments to special groups outside of the organization.”<sup>136</sup> As we have previously noted, Selznick thus expresses, in terms of the enactment of “roles”, observations previously made by Barnard and by Simon, although

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<sup>133</sup> *Ibid* at 25 [emphasis in the original].

<sup>134</sup> Blake E Ashforth and Fred Mael, "Social Identity Theory and the Organization" (1989) 14:1 *Academy of Management Rev* 20 at 30.

<sup>135</sup> *Ibid*.

<sup>136</sup> *Ibid* at 26 [emphasis in the original].



in terms of position and authority vis-à-vis the organization, but also made by Ashforth and Mael, more generally, as noted above under the present heading.

Selznick's observation here is also consistent with modern social identity theory insofar as the individual is expected by the organization to instantiate in his or her behaviour within, and in relation to, the organization, and its intraorganizational groups and individual members, only the intraorganizational role to which he or she is assigned by the organization. Yet, as we have seen, that intraorganizational role and corresponding identity may not be single and completely homogeneous.

Put another way, such intraorganizational role and corresponding identity is only one aspect of the "whole person" of the individual, as Selznick describes it, and does not in any way exhaust all of the individual's other identities or roles. Instead, the extraorganizational roles and identities of such individuals may also continue to be operative even as the individual undertakes functions or roles within the organization. Selznick does not explicitly reference in this discussion the heterogeneity of the individual's intraorganizational roles and identities, but he does recognize the existence of the individual's extraorganizational roles and identities.

Selznick says that when individuals exercise non-assigned roles, the formal systems "cannot take account of the deviations thus introduced, and consequently break down as instruments of control when relied upon alone." At least in part, he attributes these deviations to the fact that "unfortunately for the adequacy of formal systems of coordination, the needs of individuals do not permit a single-minded attention to the stated goals of the system within which they have been assigned. The hazard inherent in the act of delegation derives essentially from this fact."<sup>137</sup> Of course, it is also possible to attribute such "breakdown in control" to the fact that the consent of the individual participant to organizational control, which Selznick posits, is necessarily limited to the organizational role or function assigned, as was noted, in varying language, by Weber, Chandler Barnard, and Simon. As such, it would appear that it ceases to operate beyond that limit.

While the organization delegates formal functions and powers to roles or official positions, "delegation necessarily involves concrete individuals who have goals and interests which do not always coincide with the goals of a formal system. As a consequence, individual personalities may

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<sup>137</sup> *Ibid.*

offer resistance to the demands made upon them by the official conditions of delegation.”<sup>138</sup> This kind of resistance by individuals may be expressed individually or, if related to more widely held goals and interests, even collectively.

In both cases, Selznick maintains that individual resistance may be acknowledged and recognized by action, or may be ignored and sublimated. If diversions of goals and interests from organizational goals and interests and their expression in individual resistance arise with some frequency, intraorganizational action, whether by the formal organization or by some informal organization, may eventuate, in an attempt to suppress such resistance. As we have noted frequently, these results may also attend delegation to intraorganizational groups.

### ***Informal Organizations and Institutionalized Deviance***

In Selznick’s terms, “in large organizations, deviations from the formal system tend to become institutionalized, such that “unwritten laws” and informal associations are established. Institutionalization removes such deviations from the realm of personality differences, transforming them into a persistent structural aspect of formal organizations. These institutionalized rules and modes of informal cooperation, he says, are normally attempts by participants in the formal organization to control the group relations which form the environment of organizational decisions.”<sup>139</sup> In effect, such informal associations and informal methods of organization permit certain limited variances or deviations from the rules of formal organization.

As suggested here, it is likely that only recurring deviations will become institutionalized in this manner. However, the recurrence of deviations of diverse manner may contribute to the rise of an informal organization, which may also be able to deal with previously unobserved, or novel, deviations. Importantly, though, unwritten rules, informal associations, and other aspects of informal organization are often said to arise largely in an effort to control the relations, not among individuals, but, instead, among groups within the organization.

Selznick agrees with Barnard, then, that informal organizations, structures, processes, and the like may have positive, negative, or relatively benign, effects. He also seems to agree with a proposition previously asserted in this work, namely, that goals and objectives of such informal organizations may exhibit different degrees of longevity, persistence, and recurrence. He states that the “informal

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<sup>138</sup> *Ibid* at 27.

<sup>139</sup> *Ibid*.

patterns (such as cliques) arise spontaneously, are based on personal relationships, and are usually directed to the control of some specific situation. They may be generated anywhere within a hierarchy, often with deleterious consequences for the formal goals of the organization, but they may also function to widen the available resources of executive control and thus contribute to rather than hinder the achievement of the stated objectives of the organization.”<sup>140</sup>

Selznick also suggests that the informal organization may also tend to introduce and act as a bridge towards potential modifications of the formal organization, saying: “The deviations tend to force a shift away from the purely formal system as the effective determinant of behavior to (1) a condition in which informal patterns buttress the formal, as through the manipulation of sentiment within the organization in favor of established authority; or (2) a condition wherein the informal controls effect a consistent modification of formal goals, as in the case of some bureaucratic patterns. This trend will eventually result in the formalization of erstwhile informal activities, with the cycle of deviation and transformation beginning again on a new level.”<sup>141</sup>

Of course, it may be that either of these effects enables some informal testing of possible innovations without the accoutrements and consequences of formal and official recognition. That is to say, informal reinforcement of formal patterns may test the extent to which such patterns continue to be accepted as valid and effective. Informal modification of goals by informal controls may permit an informal test of the validity, efficacy, and acceptance, of the original goals and, at the same time, of the extent to which such goals may come or should be, modified. This kind of informal testing, however, would not necessarily invoke the kinds of authorization, controls, and precedential concerns which might accompany more formal testing.

### **Organizational Continuity and Cooptation**

The tendency of an organization to seek to maintain its integrity and continuity has been discussed earlier in this work. Selznick deftly explains how informal organization and a process which he identifies as “cooptation” may be employed as relevant mechanisms for these purposes, for which reason some further extensive reference to his work follows.

Selznick expresses the need to maintain the organization in terms of five principal imperatives: Firstly, the security of the organization as a whole in relation to social forces in its environment.

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<sup>140</sup> *Ibid.*

<sup>141</sup> *Ibid.*

Secondly, the stability of the lines of authority and communication. Thirdly, the stability of informal relations within the organization, including the relationships of individuals and subgroups with the organization. Fourthly, the continuity of policy and of the sources of its determination, for each level within the organization, and for the organization as a whole. Fifthly, a homogeneity of outlook with respect to the meaning and role of the organization, in effect, “a unity derived from a common understanding of what the character of the organization is meant to be.”<sup>142</sup>

Challenges to the organization’s integrity and continuance may be expected to invoke various defensive mechanisms, one of which, according to Selznick, is a tendency to construct ideologies reflecting the need to come to terms with major social forces, and another which is cooptation. It is easy to appreciate what Selznick means by referring to the tendency to construct ideologies. On the other hand, he employs the term “cooptation” in a particular sense, by which he means “*the process of absorbing new elements into the leadership or policy-determining structure of an organization as a means of averting threats to its stability or existence.*”<sup>143</sup> He explains that formal authority may resort to cooptation where “there exists a hiatus between consent and control, so that the legitimacy of the formal authority is called into question.” Incorporating into the leadership organization new elements “which in some way reflect the sentiment, or possess the confidence of the relevant public or mass” may “lend respectability or legitimacy to the organs of control and thus reestablish the stability of formal authority.”<sup>144</sup>

We would note that there appears to be some relationship between informal organization and cooptation, both of which may sometimes operate to bolster legitimate formal authority. Formal authority may also employ cooptation as a response to organized forces applying or threatening to apply power against the formal authority, for example, where outside elements independently command funds or other resources which the organization requires. In this case, cooptation might involve sharing some power or influence in the determination of policy with the resource provider.<sup>145</sup>

Such informal cooptation recognizes the power which the resource provider may be able to exercise in the organization’s external environment, for example, where the organization requires

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<sup>142</sup> *Ibid* at 29-30.

<sup>143</sup> *Ibid* at 34 [emphasis in the original].

<sup>144</sup> *Ibid.*

<sup>145</sup> *Ibid.*

the loyalty and support of the external social community. Selznick indicates that such cooptation is an adaptive response of the cooperative system to a stable need which produces change which is consequential for the character and role of the organization in shaping its future fields of choice and modes of action.<sup>146</sup>

It is submitted that one response to such countervailing action by parties lacking formal authority may be for the parties having such formal authority to adopt some form of cooptation. Other responses and more broadly-based discussions of power and of responses to external and internal sources and applications of power were examined in our discussions of the organization as a polity, relying significantly upon the work of James March<sup>147</sup> and of Meyer Zald.<sup>148</sup>

It is notable, too, that this kind of cooptation is but one example of a variety of readjustments which an organization may be required to make to its strategy, and to its structure, processes, and related personnel matters, to take account of changes in the external environment, the internal environment, or other changes in and to its structure, processes, and related personnel matters.

Selznick's analysis of organizations also supports many of the generalizations and observations made up to this point in the present work. As will be recalled, Selznick sees organizations "as cooperative systems, adaptive social structures, made up of interacting individuals, sub-groups, and informal plus formal relationships".<sup>149</sup> This is consistent with the perspective advanced here.

As previously discussed, in spite of their interrelationship for purposes of analysis, it is convenient here to discuss the processes of the organization considered separately from its structure and from its personnel. In this respect, the work of March and Simon, as well as the work of Robert Merton, considering bureaucratic structure, personality, and its functions and dysfunctions provide a convenient guide to research and theory and, accordingly, will be usefully referenced below.

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<sup>146</sup> *Ibid* at 35.

<sup>147</sup> James G March, "The Business Firm as a Political Coalition" (1962) 24 *J Politics* 662.

<sup>148</sup> Mayer N Zald, "Organizations As Polities: An Analysis of Community Organization Agencies" (1966) 11 *Social Work* 56.

<sup>149</sup> *Supra* note 71 at 32.

## ORGANIZATIONAL PROCESS

### Reliability of Behaviour

March and Simon assess Weber's attempt to justify bureaucracy as a rational solution to the decision-making or computational limits of individuals, but, as seen above, they note that "he is not exceptionally attentive to the character of the human organism".<sup>150</sup> Of course, Weber maintained that the bureaucratic structure resulted in a precision, reliability, and efficiency of administration. March and Simon also say that, while Merton, Selznick, and Gouldner have suggested that bureaucratic organization has significant dysfunctions, and while Weber himself goes beyond the model of human individuals as a machine, those critics nonetheless perceive some continued utility for the "machine" model of human behaviour.<sup>151</sup>

As to efficiency, Merton notes that for the bureaucracy to operate successfully, "it must attain a high degree of reliability of behaviour, an unusual degree of conformity with prescribed patterns of action", which, in turn, "exerts constant pressure on bureaucratic officials" to be "methodical, prudent, and disciplined."<sup>152</sup> He says that discipline is fundamental in this regard, and that it "can be effective only if the ideal patterns are buttressed by strong sentiments which entail devotion to one's duties, a keen sense of the limitation of one's authority and competence, and methodical performance of routine activities." In this regard, "the efficacy of social structure depends ultimately upon infusing group participants with appropriate attitudes and sentiments", definite arrangements for which are made in bureaucratic organizations.<sup>153</sup> As will be shown below, Merton draws attention to the dysfunctions which derive from the exercise of control by rulemaking and otherwise in these manners.

March and Simon describe Merton's model of organization as embracing the "machine" model of human behaviour for securing reliability of behaviour within the organization as one in which "standard operating procedures are instituted, and control consists largely in checking to ensure that these procedures are, in fact, followed."<sup>154</sup> These standard operating procedures increase predictability of behaviour, while the verification of their proper application produces some degree

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<sup>150</sup> *Supra* note 22 at 30.

<sup>151</sup> *Ibid* at 31.

<sup>152</sup> *Supra* note 20 at 562.

<sup>153</sup> *Ibid* at 562-563.

<sup>154</sup> *Supra* note 22 at 32.

of accountability for conformity to those standard operating procedures. Both of these results are thought to contribute to overcoming bounded rationality.

### **Rigidity of Behaviour**

March and Simon explain that this emphasis on reliability of behaviour and the application of techniques used to install it has three principal consequences. They describe these consequences as the “reduction in personalized relationships, the increased internalization of rules, and the decreased search for alternatives [which] combine to make the behavior of members of the organization highly predictable; i.e., they result in an increase in the *rigidity of behavior* of participants.”<sup>155</sup>

These three principal consequences will be discussed separately below, however March and Simon maintain that rigidity of behaviour itself has these two major consequences: “First, it substantially satisfies the original demands for reliability. Thus, it meets an important maintenance need of the system. Further needs of this sort are met by strengthening in-group identification...Second, it increases the *defensibility of individual action*. Simple categories rigorously applied to individual cases without regard for personal features can only be challenged at a higher level of the hierarchy.”<sup>156</sup>

In this sense, then, organizational reliability is achieved in most cases, namely, those in which the applicability of the rule to the instant case is not challenged. Likewise, a tendency may arise to perceive individual cases as “fitting into” existing categories for a number of reasons, including, we would suggest, the desire: firstly, to be perceived to be competent in determining category-application; secondly, to be perceived to possess the competence to deal with most cases coming before the individual official; and, thirdly, to achieve positive performance assessments from the organization. This may sometimes result in “stretching” the category to fit the case at hand, which may sometimes produce unsatisfactory results.

Such behaviour by individual bureaucrats or officials is also seen to have one more consequence. “Third, the rigidity of behavior increases the *amount of difficulty with clients* of the organization and complicates the achievement of client satisfaction – a near-universal organizational goal.

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<sup>155</sup> *Ibid* at 33 [emphasis in the original].

<sup>156</sup> *Ibid* [emphasis in the original].

Difficulty with clients is further increased by an increase in the *extent of use of trappings of authority* by subordinates in the organization, a procedure that is encouraged by the in-group's defensiveness."<sup>157</sup> It can be seen that these difficulties with clients arise, at least in part, because of the lack of personal flexibility and because of personal resort to claims that such flexibility is not permitted by organizational guidelines.

Merton indicates that emphasis on categorization in decision-making and real or perceived organizational pressures to fit cases presented into existing categories may also decrease efforts to search for alternatives to prescribed actions.<sup>158</sup> For example, it may be the case that some alternative to the prescribed action may be preferable from a number of perspectives, including that of the organization, if the particular situation is not considered to fall within some existing category. In some cases, however, applying some rules from one category and some rules from another category may lead to superior results. In this regard, Merton notes that the lack of "ready adaptation under special conditions not clearly envisaged by those who drew up the general rules" can produce significant inefficiencies.<sup>159</sup>

### **Assessments of Behaviour**

Depending upon the assessments of their behaviour, ideally effected in the prescribed manner, of organizational officials by their superiors, officials may be subject to sanctions, or to discipline, including demotion and termination, or approbation, including increases in pay or responsibilities, bonuses, and promotions. As discussed above under the heading "Rationality, Organizations, and Efficiency", Weber considered the conduct of bureaucratic officials to be subject to discipline and control which is both strict and systematic,<sup>160</sup> making organizational results highly predictable and reliable.<sup>161</sup>

As discussed above, Fayol considered discipline to involve "in essence obedience, application, energy, behaviour and outward marks of respect observed in accordance with the standing agreements between the firm and its employees,"<sup>162</sup> both explicit and implicit, and including

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<sup>157</sup> *Ibid* at 33-34 [emphasis in the original].

<sup>158</sup> *Supra* note 20 at 563.

<sup>159</sup> *Ibid* at 564.

<sup>160</sup> *Supra* note 2 at 334. This is discussed under the heading "Rationality, Organizations, and Efficiency".

<sup>161</sup> *Ibid* at 337.

<sup>162</sup> *Supra* note 44 at 104. This is discussed under the heading "Fayol and Modern Business Management"



relevant rules and customs. In his sense, discipline is both positive, exhorting the employee to superior performance, and negative, penalizing inferior performance. As also mentioned there, Fayol considered unity of command to be essential to maintaining discipline.<sup>163</sup> Fayol also averts to the “standing agreements” between the firm and its employees, which may be considered to establish the “zone of acceptance” or “zone of obedience”, as discussed previously.

Of course, Fayol’s references to discipline are relatively conventional, and reflect the principles of the modern management, and the scientific management, perspectives. It can easily be seen, however, that Follett’s “law of the situation”,<sup>164</sup> which is discussed above, is also relevant to the positive and negative aspects of discipline. In such regard, assessments of performance and consequent imposition of positive and negative discipline can be seen as related to the extent to which the relevant official is able to devise, perhaps to persuade others regarding, and to implement, her “law of the situation”.

As remarked previously in this chapter, Follett’s law of the situation bears comparison with Bittner’s suggestion, as interpreted by the present author, that a coherent principle of discipline “that derives from the formal style of the rational scheme and which works against centrifugal tendencies and heterogeneity” can be developed as a kind of “higher order” discipline which gives meaning to all aspects of the organizational process.<sup>165</sup>

In accordance with Fayol’s principles of management, which are discussed above under the heading “Fayol on Structure” and under the present heading, agreements, whether formal or informal, explicit or implicit, and generally accepted rules and norms determine the scope of activity within which employees may be expected to accede to instructions of their employer.<sup>166</sup> It is apparent that such agreements, rules, norms could stipulate that employee should follow Follett’s “law of the situation” or Bittner’s supervening or superordinate coherent and rational principle and scheme of the organization. However, as noted in our discussions of those subjects, we would submit that, except in environments characterized by a relatively flat hierarchy, as well as highly motivated, and generally highly educated individual employees, this may present difficulties.

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<sup>163</sup> *Supra* note 44 at 106.

<sup>164</sup> *Supra* note 99 at 155. This is discussed under the heading “Formal Structure and Relationships”.

<sup>165</sup> *Supra* note 14 at 252. This is discussed under the heading “Bounded Rationality and Organizational and Personal Meaning”.

<sup>166</sup> *Supra* note 44 at 104

Among these are difficulties relating to approbation, sanction, and assessment, as well as ensuring conformity with what we describe as Fayol's three unities of command, direction, and interest.

### **Goal Displacement, Goals, and Instrumental Goals**

The present work has previously argued that goals which are essentially instrumental in nature may, in some cases, achieve their own validity, in effect, as actual separate goals which are not themselves actually perceived as instrumental in nature. This process is often denominated as "goal displacement".

#### ***Rule Orientation and Goals***

Merton argues that goal displacement results from the transference of organizational loyalty to loyalty to the rules of the organization. The section above headed "Reliability of Behaviour" averted to Merton's contention that discipline must be "buttressed by strong sentiments which entail devotion to one's duties, a keen sense of the limitation of one's authority and competence, and methodical performance of routine activities."<sup>167</sup> He asserts, however, that "this very emphasis leads to a transference of the sentiments from the aims of the organization onto the particular details of behavior required by the rules" such that "adherence to the rules, originally conceived as a means, becomes transformed into an end-in-itself; there occurs the familiar process of *displacement of goals* whereby 'an instrumental value becomes a terminal value' or, put another way, means are transformed into ends."<sup>168</sup>

Merton seeks to explain this transformation as resulting from "transference of sentiments" from organizational goals to rules instrumental to their achievement. When Merton averts to "sentiments", he does so in terms of organizational goals and organizational rules. He is not distinguishing between "sentiments" which support organizational goals and "sentiments" which support the goals of other intraorganizational units or groups. This argument, then, attempts to explain how rule orientation, conceived to be an instrumental value, becomes a separately recognized value in itself. It does not explain how other instrumental values, that is to say, instrumental values other than rule orientation, are transformed into independent values, although it still describes all of these transformations as "displacements of goals".

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<sup>167</sup> *Supra* note 20 at 562.

<sup>168</sup> *Ibid* at 563 [emphasis in the original].

Merton argues that as a result of the goal displacement which he describes, “conformance with regulations, whatever the situation, is seen not as a measure designed for specific purposes but becomes an immediate value in the life-organization of the bureaucrat” and “develops into rigidities and an inability to adjust readily.” In some cases, this may reach the point where “primary concern with conformity to the rules interferes with the achievement of the purposes of the organization.”<sup>169</sup>

This result flows from the transformation of rules, originally conceived of as instrumental, into non-instrumental or absolute goals or ends-in-themselves, which are “no longer conceived as relative to a given set of purposes”, but as goals-in-themselves.<sup>170</sup> Thus, says Merton, such rules become, for the official, symbolic, rather than strictly utilitarian, and so have “meanings” from which the official cannot be divorced.

### ***Role Orientation and Intraorganizational Rules***

The present text has previously averted to conflicts of goals as between the organization and a unit or subunit. If Merton’s argument is accepted, it can now be seen that one way in which this can arise is where each ultimate goal of the unit or subunit, is purely an instrumental goal of the organization, and rules conducive to the attainment of the goals of the unit or subunit cease to be seen by that unit or subunit as purely instrumental in nature.

In that case, not only may the unit or subunit pursue the subordinate goal at the expense of the organization’s superordinate goal, but the unit or subunit may even apply rules, which are themselves seen as non-instrumental goals, which are beneficial only to the attainment of the goals of the unit or subunit, and not to the superordinate goal of the organization. Of course, the purport of Merton’s argument is that the unit or subunit may also pursue rule conformity as a separate, non-instrumental, goal, sometimes at the expense of more fundamental goals. The pursuit of the goals of intraorganizational groups at the expense of the goals of the organization itself may be seen, in some ways, as, in itself, an example of goal displacement.

The Merton argument could be extended by indicating that “sentiments” which support the goals of groups or subgroups within the organization, in effect, as instrumental goals, may also be transformed into observance of the rules of such groups or subgroups as independent or non-

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<sup>169</sup> *Ibid.*

<sup>170</sup> *Ibid* at 564.

instrumental goals. The present work discusses in several places, including the present chapter, the ways in which identification with, and commitment to, groups and subgroups can arise; and also describes research supporting the relative strength of group and subgroup loyalties as compared with loyalties to the overall organization.

However, although Merton suggests that the goals of the organization at the top level attract strong positive sentiments on the part of participants, he does not explain how these goal-oriented positive sentiments become transferred, or even displaced, from those goals to the organization itself, or from group goals to the group itself. That is to say, he does not explain how identification with, and commitment to, the organization itself, or to its groups, or to their subgroups, arises, can be encouraged, and may be sustained. Investigation of relevant research is beyond our mandate.

### ***Rule Primacy***

As discussed above under the heading “Rigidity of Behaviour”, one aspect of goal displacement is that actions of officials become defensible in terms only of the rules themselves. To be clear, this means that official actions can be justified and defended on the sole basis that they conform to the rules. In this regard, March and Simon note that the application of simple categories “to individual cases without regard for personal features can only be challenged at a higher level of the hierarchy.”<sup>171</sup>

The primacy of rules at certain levels of the hierarchy may be such that officials may consider themselves under some pressure to find a rule which can be said to apply to the situation at hand and which, in itself, justifies a particular action on the part of the official. That action may be much easier to justify or defend than applying an amalgam or combination of one or more rules, or devising a new rule, or seeking to treat the situation as a case of first impression, either by applying other existing proximate rules, or by applying principles, by means of analogy, which are thought to underlie the rules.

It is acknowledged, of course, that not all instrumental goals are created processually in connection with developing and applying rules. Some subordinate or more proximate goals are deliberately adopted which are considered to be instrumental in the achievement of superordinate or less proximate, and perhaps even long range or long term, goals.

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<sup>171</sup> *Supra* note 22 at 33.

As has been seen from this discussion of rulemaking, it is difficult to separate issues of organizational process from issues relating to organizational personnel. The next section will attempt, however, to concentrate on the latter.

## **ORGANIZATIONAL PERSONNEL**

### **Controlling Organizational Behaviour**

As discussed above under the heading “Formal Structure and Relationships”, many institutional analysts, including Weber, Barnard and Fayol, consider the institutionalization of relationships and the concomitant removal of personal and affective relationships from the organization to be critical to the structure, process, and effectiveness of bureaucratic or formal organizations.

The bureaucratic or formal structure, says Selznick, assigns persons to positions or roles which are intended to be occupied by individuals each of whom is more or less interchangeable, in an effort to ensure that the organization will be dominated by rational, rather than by personal and affective, considerations.<sup>172</sup> This interchangeability also facilitates ready replacement of incumbents. Merton observes that individuals occupying positions or enacting roles in the organization are expected to observe a considerable degree of formality and to maintain a clearly defined social distance from other members of the organization.<sup>173</sup>

As we have previously suggested, relationships which are formal and impersonal, rather than affective and personal, emphasize the institutional order surrounding the giving and accepting of instructions and expectations relating to the same. The ideal here is that human actors instantiate roles assigned to them by the organization; and that neither authority nor susceptibility to authority arises from any purely personal element, such as personal power, influence, or prestige.

In that sense, as observed by March and Simon, following Gouldner, general and impersonal rules also contribute to decreasing the visibility of power relations, and hence to decreasing the level of interpersonal tension within the group.<sup>174</sup> The present author has argued, however, that these behaviours may also contribute to group-centric orientations among participants for a number of

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<sup>172</sup> *Supra* note 71 at 25.

<sup>173</sup> *Supra* note 20 at 560.

<sup>174</sup> *Supra* note 22 at 39.

reasons, including a perception that power relations exist primarily outside, and do not intrude into, the group, and a preference in that behalf.

Merton maintains that bureaucratic or formal organization is “a secondary group mechanism designed to carry on certain activities which cannot be satisfactorily performed on the basis of primary group criteria”.<sup>175</sup> Primary groups, such as families, are considered to be highly susceptible to affective motivations and satisfactions. This would not be expected to be the case with respect to secondary groups, which are, by nature, more formal.

As such, Merton indicates that the “normal responses involved in this organized network of social expectations are supported by affective attitudes of members of the group. Since the group is oriented toward secondary norms of impersonality, any failure to conform to those norms will arouse antagonism from those who have identified themselves with the legitimacy of these rules. Hence, the substitution of personal for impersonal treatment within the structures is met with widespread disapproval”, which is emotionalized as resentment.<sup>176</sup> These results are consistent with the claimed or, at least, intended subordination, by the group ethos, of non-rational considerations to boundedly rational considerations.

In the result, the behaviour of intraorganizational individuals is expected to be constrained by their respective roles. As mentioned earlier in this chapter, this is also assumed to be true, to at least some extent, with respect to intraorganizational organizations, such as groups and subgroups, themselves.

## **Organizational Changes in Behaviour and Relationships**

### ***Organizational Identity or Organizational Personality***

Merton<sup>177</sup> and March and Simon<sup>178</sup> say that when officials react to other officials as incumbents of positions with specified rights and duties, rather than as unique individuals, in effect, the “*amount of personal relationships*” is reduced.<sup>179</sup> As indicated, conflict within the bureaucratic structure may arise “when personalized relationships are substituted for the structurally required

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<sup>175</sup> *Supra* note 20 at 567.

<sup>176</sup> *Ibid.*

<sup>177</sup> *Supra* note 20 at pp. 565-566.

<sup>178</sup> *Supra* note 22 at p. 32.

<sup>179</sup> *Ibid* [emphasis in the original].

impersonal relationships”,<sup>180</sup> that is to say, when personal relationships intrude into the organizationally sanctioned impersonal environment within the organization.

Assuming and enacting these official impersonal roles and required impersonal relationships may result in a significant change in the recurrent and pervasive response pattern of individuals to certain stimuli, frequently known as “personality”.<sup>181</sup> Merton maintains that such changes in personality are institutionally demanded; and that the intrusion of personal, or primary group, attitudes into the institutional or secondary group, in which secondary group, or impersonal, attitudes are expected, threatens the bureaucratic environment, and could even result in its disintegration if they were fully supplanted by personalized relations.<sup>182</sup>

Barnard also treats of the adjustments which must be made to the personality of individuals to organizational environments. He uses the concept of the “organization personality”, to mean something like the personality that a member does, or must, employ as part of the organization. In fact, his concept is even more like the “personality of the organization”. He says: “The most important single contribution required of the executive, certainly the most universal qualification, is loyalty, domination by the organization personality. This is the first necessity because the lines of communication cannot function at all unless the personal contributions of executives will be present at the required positions, at the times necessary, without default for ordinary personal reasons.”<sup>183</sup>

He says that, when expressed as a personal qualification, this is the quality of “responsibility”. As will be seen shortly, Merton also directs attention to these matters. Barnard maintains that this contribution of personal loyalty, submission, or responsibility, does not arise solely or primarily from material inducements or other positive incentives. Instead, it may be seen as involving some type of sublimation of an individual’s non-organizational “personality” into that individual’s “newly constructed” or organizationally fashioned “organizational personality”.

Alternatively, as suggested in this work previously, the individual may be “negotiating” the demands of the various identities, or “personalities” if you will, comprising his or her social identity with the requirements of the organization. This may be analogized to the “zone of

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<sup>180</sup> *Supra* note 20 at 567.

<sup>181</sup> For discussion, see March and Simon, *supra* note 22 at 32, and the accompanying text there.

<sup>182</sup> *Supra* note 20 at 568.

<sup>183</sup> *Supra* note 54 at 170.

acceptance” or the “zone of indifference”, in which the individual assumes a disposition in relation to that individual’s participation in the organization to follow certain proper instructions given in the required manner by those having the requisite authority.

As in that case, it may be argued that the individual assumes a disposition to behave in certain organizationally acceptable manners, when enacting that individual’s role in the organization. It may even be said that he or she accepts modifications to his or her social identity, in effect, constructing a new “organizational identity”, which must be incorporated somehow into the individual’s pre-existing social identity and personal identity.

### ***Organizational Identity and Organizational Values***

Merton notes that “bureaucratic officials affectively identify themselves with their way of life” and its attendant attitudes and values, with the result that “through sentiment-formation, emotional dependence upon bureaucratic symbols and status, and affective involvement in spheres of competence and authority, there develop prerogatives involving attitudes of moral legitimacy which are established as values in their own right, and are no longer viewed as a purely technical means for expediting administration.”<sup>184</sup>

It is clear that this “moral legitimacy” either goes beyond, or is an extreme form of, goal displacement. Merton maintains, in effect, that the “ways of going about” administration in the relevant context are considered by organizational officials to be goals in themselves, and worthy of assertion and preservation. It is not clear whether such statement averts to “ways of going about” administration generally, in the particular organization concerned, or within intraorganizational groups of the particular organization concerned. Nonetheless, it is clear that he is arguing that process or processual goals may displace ultimate goals as the only end goals of the organization, becoming end goals themselves.

Merton is also describing, in general, the adoption of ultimate goals and other organizational goals by organizational participants. In this way, members of the organization often adopt many of its explicit or implicit values, even if this involves some accommodation of their own personal values. This is often discussed, as in the preceding chapters of the present work, as involving identification with, and commitment to, the organization. What Merton describes is a sense of bureaucratic

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<sup>184</sup> *Supra* note 20 at 565.



“professionalism”, only part of which appears to be related to the focal organization; the other part seems to relate to the role and function of bureaucrats, officials, or management personnel, as such. The latter may be seen as representing not only identification with, but also commitment to, such role or function. This concerns itself with maintaining performance, ethical, and other standards.

Apparently applying a model of government or of a highly bureaucratized business, Merton averts to the way in which a bureaucrat’s “official life is planned for him in terms of a graded career, through the organizational devices of promotion by seniority, pensions, incremental salaries, *etc.*, all of which are designed to provide incentives for disciplined action and conformity to the official regulations”.<sup>185</sup> Merton cites these as examples of features of the bureaucratic structure which are conducive to the formation of the bureaucrat’s sentiments promoting rigorous discipline.

As previously noted, Merton claims that these positive sentiments promote further changes in affect. He indicates that: “The official is tacitly expected to and largely does adapt his thoughts, feelings, and actions to the prospect of this career. But *these very devices* which increase the probability of conformance also lead to an over-concern with strict adherence to regulations which induces timidity, conservatism, and technicism.”<sup>186</sup>

### ***Organizational Cognition and Organizational Performance***

It can be readily appreciated that certain behaviour is expected from organizational officials, but, as just noted, Merton argues that officials also adapt their thoughts and feelings, not just their actions, to organizational expectations. In addition, his argument is that such adaptation may go beyond what is situationally required by organizational expectations. Thus, excessive attention to rules may result in underperformance of the organizationally required tasks.

For Merton, these results arise from structural sources, in a process in which: “(1) An effective bureaucracy demands reliability of response and strict devotion to regulations. (2) Such devotion to the rules leads to their transformation into absolutes; they are no longer conceived as relative to a given set of purposes. (3) This interferes with ready adaptation under special conditions not

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<sup>185</sup> *Ibid* at 564 [emphasis in the original]. Such “planned official life” apparently obtained at Merton’s time of writing at the start of the nineteen forties and for a number of decades thereafter, but its pervasiveness, both in bureaucracies generally, and in the extent of its scope even in bureaucracies in which it obtains, has apparently been reduced considerably since then.

<sup>186</sup> *Ibid* [Emphasis in the original].

clearly envisaged by those who drew up the general rules. (4) Thus, the very elements which conduce toward efficiency in general produce inefficiency in specific instances.”<sup>187</sup>

Gouldner acknowledges, similarly, that rulemaking produces inefficiencies.<sup>188</sup> March and Simon explain that “work rules provide cues for organizational members beyond those intended by the authority figures in the organization”. They say that “by defining unacceptable behaviour, they increase *knowledge about minimum acceptable behavior*. In conjunction with a low level of internalization of organizational goals, specifying a minimum level of permissible behaviour increases the disparity between organizational goals and achievement by depressing behaviour to the minimum level.”<sup>189</sup> It may be said, then, that rulemaking produces certain unanticipated adverse consequences.

On Gouldner’s model, this reduction to minimum acceptable performance is perceived by superiors as a failure, the usual response to which is to increase the closeness of supervision of the relevant work group. In turn, this increases the visibility of power relations within the organization and increases the tension level in the work group.<sup>190</sup> In effect, these related effects undercut some of the benefits sought to be derived from general and impersonal rules and from delegation generally. March and Simon explain that Gouldner thus “attempts to show how a control technique designed to maintain the equilibrium of a subsystem disturbs the equilibrium of the larger system, with a subsequent feedback on the subsystem.”<sup>191</sup> Gouldner’s argument also appears to envision subsequent feedback to the larger system in response to the feedback on the subsystem. His model thus supports the analysis of intraorganizational organizations and their interaction with the large organization which has been presented in the present work.

The present work has consistently maintained that intragroup relations, for example, at the group level, can significantly affect intraorganizational relations, whether between the focal group and the organization at large, or among the focal group and other similarly situated groups. In this case, adoption of, and adherence to, general and impersonal rules decreases awareness of power imbalances within the group, but, in the situations posited by Gouldner, may not decrease, may

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<sup>187</sup> *Ibid.*

<sup>188</sup> AW Gouldner, *Patterns of Industrial Bureaucracy*, (New York: Free Press, 1954).

<sup>189</sup> *Supra* note 22 at 39 [emphasis in the original].

<sup>190</sup> *Ibid.*

<sup>191</sup> *Ibid.*

create, or may even increase, awareness of power imbalances between the group and groups at hierarchical levels superior to that of the focal group.

This may stimulate resistance to the exercise of power by sources within the organization which are outside the immediate focal group. This may, in turn, cause the members of the immediate focal group to display some disaffection or resentment towards perceived interference by persons outside the focal group. As indicated in Chapter Four under the heading “A Social Unit or Group of People”, Ashforth and Mael indicate that perceived group membership is not only consistent with in-group favouritism, cooperation and cohesion, but is also consistent with discrimination against perceived out-groups and their members.<sup>192</sup>

In other words, the positive sentiments of individuals towards the organization, which are discussed by Merton, may collide with similar positive sentiments of individuals within the relevant focal group towards the focal group itself. As indicated above, individuals may tend to exhibit identification and commitment to various focal groups<sup>193</sup>, but tend to exhibit a higher level of identification and commitment to the most immediate focal group, rather than to less proximate groups, or to the organization as a whole,<sup>194</sup> although this is not always the case.<sup>195</sup>

### **Intraorganizational Organizations and Goal Displacement**

As discussed under the heading “Organizational Process - Goal Displacement, Goals, and Instrumental Goals” and under the immediately preceding heading “Organizational Changes in Behaviour and Relationships”, the organization, as a secondary group, is “designed to carry on certain activities which cannot be satisfactorily performed on the basis of primary group criteria”, according to Merton.<sup>196</sup> In lieu of the personalized relationships which obtain in primary groups, such as families, organizations are dependent upon various mechanisms to inculcate the positive sentiments required to engender identification and commitment on the part of individual members.

### ***Intraorganizational Identity, and Goals***

Yet, as seen from the review of research and theory set forth in the present work, particularly in Chapter Four under the heading “A Social Unit or Group of People” and in the immediately

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<sup>192</sup> *Supra* note 134 at 24.

<sup>193</sup> *Ibid* at 24.

<sup>194</sup> *Ibid* at 22.

<sup>195</sup> *Ibid* at 30.

<sup>196</sup> *Supra* note 20 at 567.

preceding subsection of the present chapter, social groupings more immediate than the organization at large, such as groups and subgroups, may evoke greater identification and commitment, as well as action corresponding with the same, on the part of individual members of the organization.<sup>197</sup> As discussed above, these identifications and commitments are considered to be aligned with organizational roles and to be related to the individual's social identity. Thus, an individual's social identity may reflect that individual's participation in the organization as a whole, and in one or more relevant groups, or subgroups, within the organization itself.<sup>198</sup>

This is sometimes expressed in abbreviated and informal fashion by saying that the individual has separate social identities in this regard: for example, considering an organization with three levels, an identity as a member of the organization; as a member of a particular intraorganizational group; and as a member of a particular subgroup within any relevant intraorganizational group. The relevant group or subgroup may be determined by reference to functional, geographic, professional, or other determinants or characteristics.

As discussed, of course, these identities may have different salience to the individual over time and from time to time; that is, such salience may change or be reprioritized at various points in time, depending on circumstances perceived by the individual to be then relevant to that particular individual. Ashforth and Mael posit that, in some cases, the several identities assumed by an individual may be incapable of integration, in which event the individual may treat them cognitively "by ordering, separating, or buffering the identities". This may involve: prioritizing the most salient social identity or personal attribute; developing a scale or hierarchy of salience and resolving conflict by deferring to most salient social identity; prioritizing the identity under the greatest external pressure and minimizing it; denying, or rationalizing conflict; decoupling the identity or identities giving rise to the conflict, such that the conflict is not perceived; or, finally, complying sequentially with the conflicting identities, thereby eliminating the appearance of conflict at any particular time.<sup>199</sup>

An individual may be subject to varying degrees of influence and to both internal and external pressures to conform to the attitudes and behaviour of the relevant organization, group, and

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<sup>197</sup> *Supra* note 134 at 22.

<sup>198</sup> *Ibid* at 30.

<sup>199</sup> *Ibid*.

subgroup. Both research and theory, as considered above, and as reviewed by Ashforth and Mael,<sup>200</sup> support the proposition that such influence and pressure is more attenuated in more immediate groupings.

### ***Reinforcement of Intraorganizational Goals***

Further, as noted above under the heading “Goals of Intraorganizational Organizations”, March and Simon apparently approve Selznick’s conclusion that because decisions are made within the subunit based on operational criteria provided by the organization and by the subunit, with considerable importance being given to subunit goals, the internalization of subunit goals is reinforced by repeated, and eventually habituated, responses to situations which arise within the subunit.<sup>201</sup>

In addition, Merton suggests that those who work together “have a sense of a common destiny” and share the same interests, to the point where “the esprit de corps and informal social organization which typically develops in such situations often leads the personnel to defend their entrenched interests rather than to assist their clientele and higher elected officials.”<sup>202</sup> He cites as examples withholding detailed information from an incoming official who does not properly recognize the status of the information providers, leading to errors for which the incoming official may be held responsible; and overloading a superior official with information or requests for approvals, in cases where there is some threat to the integrity of the group.<sup>203</sup>

It is noteworthy, however, that Merton claims not only that the relevant focal group may prefer its own interests as against other organizational interests, including superordinate goals, but also that such focal group may also prefer its own interests as against extraorganizational interests, such as the interests of customers and of members of the public, and that the immediate preference over extraorganizational interests may produce conflict with the organization’s clientele or the public. Such extrinsic conflict may be expected to be detrimental, to a greater or lesser degree, to the organization’s overall interests.

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<sup>200</sup> *Ibid* at 29.

<sup>201</sup> *Supra* note 22 at 36-37.

<sup>202</sup> *Supra* note 20 at 564.

<sup>203</sup> *Ibid* at 564-565.

Indeed, such extrinsic conflict may also be detrimental to the interests of the relevant focal group vis-à-vis those external parties with whom it is interacting. This detrimental effect may arise even independently of the intraorganizational detriment to the focal group. That is to say, the intraorganizational detriment of such conflict may not be the only cost of such behaviour to the focal group.

Defending intragroup interests may also encompass defending intragroup goals and objectives and, in particular, intragroup goals and objectives which are exclusive to, or are not widely shared outside, or which are more significant within, the instant group. We may consider such intragroup goals and objectives, when comparatively differentiated from extragroup goals and objectives, as more or less “group-centric”. The significance of non-group-centric goals and objectives may be subordinated, at least within the group, to that of group-centric goals and objectives. This may lead to some distortion of the relevance of the non-group-centric goals and objectives.

For example, a particular non-group-centric goal, say, achieving a certain level of profitability for the organization as a whole, may be perceived by group members to be less significant to the group and to such members than a particular group-centric goal, for example, the group achieving a certain level of profitability, or the group preserving its current personnel.

As has been shown, emphasizing performance at successively lower organizational levels as a determinant of individual performance bonuses may be considered to be perfectly rational, at least from an organizational perspective. However, because it focuses attention, apparently for quite appropriate reasons, on the level at which an individual’s own performance can have the greatest overall impact, it may tend to encourage that individual to privilege group performance, as a goal, over organizational performance.<sup>204</sup>

## CONCLUSION

As indicated at the beginning of this chapter, the present chapter continues to examine the essential attributes of the organization, defined, in effect, as a social unit or group of people working together in such a way as to meet one or more collectively shared needs or to accomplish one or

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<sup>204</sup> See, for example, Jeffrey M Martin and Kathleen M Eisenhardt, *Rewiring: Cross-Business-Unit Collaborations in Multibusiness Organizations* (2010) 53:2 *Academy of Management J* 265 at 293; and discussion in Chapter Three under the heading “Relationships among SBU’s”.

more collectively shared goals or purposes. The present chapter considers the ways in which the organization goes about seeking to achieve these objectives: in effect, the way in which it is “organized” to do this; or the structure, processes, and personnel and management adopted by the social unit or group of persons with the objective of so doing.

This chapter considered Weber’s concept of the legitimacy of rational-legal authority as a basis for the formation of organizations, statal and otherwise; the “order” pursuant to which organizations are established; and the consequences of that authority and order for the formal structure, processes, and personnel aspects of the organization.

Among other things, the chapter considered the relationship among various concepts, including: the organization as a relationship, as posited by Weber; the nature of the relationships within the organization, as delineated by Weber; the relationship between organizational participants and the organization; the relationship between the “scheme of organization” and the organization; the relationship between the organization as a reified and entified group, and the organization as social group or social relationship; and the putative rationality of the structure, processes and personnel practices of the formal organization in terms of rationally seeking attainment of the organization’s objectives; and other indicia of “efficiency”. The discussion demonstrated that these concepts and the relationships among them obtain in corporations, just as in other organizations.

This chapter also examined formal organization as a corrective mechanism to deal with the negative consequences of the “bounded rationality” of individuals and, perhaps, of groups of individuals, which would obtain otherwise. This included some consideration of the means, and advantages and disadvantages of: delegation and specialization of tasks; the adoption of a hierarchical form of organization; formalization of the relationships of individuals when acting within the organization; intraorganizational acceptance of authority; the establishment of intraorganizational groups; rulemaking; and organizational cognition and sense-making.

The chapter continues this book’s review of major historical perspectives of organizational theorists and practitioners concerning business and other organizations, including those of: Weber; Taylor and Fayol with respect to “scientific management”; Chester Barnard and Mary Parker Follett with respect to “modern management theory”; Philip Selznick with respect to neoclassical organizational theory (which combines formal and informal aspects); Herbert Simon, and James March and Herbert Simon with respect to what might be called “behavioural organization theory”;

Egon Bittner, taking a cognitive or phenomenological approach, with respect to the experience of individuals of organizationally derived meaning; Robert Merton, with respect to social groups and social roles; and others.

While certain analysts, notably Barnard, Taylor, Fayol, and Follett, concentrate attention on business enterprises, their observations were seen to be generalizable to other types of organizations; and the other analysts generalize their observations as such. Consequently, the present chapter demonstrated how various perspectives on organizations applied equally to corporations, as organizations.

The review in this chapter was partially enabled by empirical research and analysis concerning the modern business corporation presented in Part 2 of the book (Chapters Two and Three), concerning the corporation in action, and, concerning the corporation more generally, in Appendix B. That examination facilitates the examination of the corporation as an organization, in the previous chapter as a social unit or group of persons, and in the present chapter as characterized by structural, processual, and personnel and management elements.

The examination in Chapters Two and Three and, in greater detail, in Appendix B, when combined with the analysis of individuals, groups of individuals, and organizations which appeared in Chapter Four, also facilitates consideration in the present chapter of the relationships among individuals, intraorganizational groups, and organizations. In consequence, the necessary background was provided for the present chapter to discuss the relevant issues, both with respect to organizations generally, and with respect to corporations, in particular.

The present chapter, accordingly, discussed the importance of the organization and of its groups and subgroups to individual members of the organization, in terms of effects on the social identities of such individuals and their identification with the organization and with intraorganizational groups and subgroups, and the relevance to those individuals of the goals of the organization and of the goals of intraorganizational groups and subgroups. The chapter also discussed the “moderating effect” of informal structure, process, and relationships on formal structure, process, and relationships, both within the organization itself and within intraorganizational groups and subgroups.

Importantly, the present chapter has established that organizations engage with, respond to, and seek to provide partial fulfillment of, affective needs of the individuals, groups, and subgroups



within the organization. The chapter demonstrates that an intraorganizational individual “negotiates” his or her social identity and personal identity as that individual acquires identification with, and commitment to, the organization, and its intraorganizational groups and subgroups. In the course of such negotiation, the individual, whether implicitly or explicitly, assesses the costs and benefits of involvement in the organization, as compared with other alternatives, in terms of securing satisfaction of the individual’s needs, goals and objectives.

In the result, this chapter has established that the corporation, as an organization, has the same essential attributes, in general, as those of other organizations. It is admitted, of course, that the corporation is a business enterprise, that is, an organization a principal objective of which is to secure some economic gain. As noted in the immediately preceding paragraph, this entails that individuals contemplating initiating, continuing, or terminating, association with a corporation will undertake, explicitly or implicitly, something in the nature of a cost-benefit analysis, on a comparative basis.

In the case of a corporation, such cost-benefit analysis may involve consideration of different costs and benefits depending upon the nature of the relationship of the corporation, ranging from purely financial (as in the case of lenders) to highly affective as well as economic (as in the case of directors, officers, and employees). The cost and benefit factors may be considered to be arrayed in a complex multi-dimensional spectrum, each factor in which may be considered to involve a continuum. Since some species of relationships with the corporation may be expected to have significant affective components, affective costs and benefits will factor in such cost-benefit analysis.

The immediately following chapter will consider the final essential element of the definition of an organization: namely, the collective or shared needs, or goals or objectives for the satisfaction or attainment of which it has been brought into being. Like other organizations, the modern business corporation presents itself as having certain shared goals and objectives. In particular, the next chapter will present argument that economic gain alone, or profit maximization, as maintained by classical and neoclassical economic theory, is not the single overarching goal or objective of the modern business corporation or, indeed, of many, or all, of its constituents.

That chapter will demonstrate that many of the incidents of the organization are largely independent of those collective or shared needs, or goals or objectives; with the result that the

corporation, as an organization, does not differ intrinsically from other organizations, except at the margin, namely, in certain respects with respect to which the need, goal or objective of the focal organization, paradigmatically sustaining itself economically, is particularly important.

Importantly, by the conclusion of the next following chapter, the propriety of analyzing the corporation as an organization will have been established. What will then remain is to demonstrate how this organizational analysis impacts the essential attributes of the corporation as a matter of law, which will be the task of the final chapters of the present work.

## **SECTION A – THE ORGANIZATION – PART C – ORGANIZATIONAL GOALS AND OBJECTIVES**

### **CHAPTER SIX – THE ORGANIZATION - DEFINING AND OTHER ATTRIBUTES – GOALS AND OBJECTIVES**

#### **PURPOSE AND SCOPE OF PART 3 AND OF THIS CHAPTER**

The final chapter of Part 2 of this book, Chapter Three, presented alternatives to classical and neoclassical economic assumptions concerning the firm acting as a single economic actor. In particular, that chapter reviewed various barriers to unified action. It also examined the firm as a political system and, in particular, as a socio-political conflict system in which internal and external conflicts required to be resolved; contrasted the theory and research on those subjects with the approach to joint preference ordering taken by classical and neoclassical economics; and examined theory and research concerning organizations, particularly firms, as polities, and concerning firms as coalitions, contrasting all of this with the classical and neoclassical economic theory of the firm. Finally, it examined theory and research concerning significant legal and organizational variants of the firm in terms of their development historically, and their configurations at the present time.

The present section of Part 3 of the book, Section A, continues consideration of the nature of the organization. As such, it provides support, both in theoretical and in empirical terms, for many of the generalizations and assumptions about corporations and other organizations which the present author, in this book, and other authors have employed in making observations about corporations, and about organizations more generally.

The preceding two parts of Section A dealt with the organization as a social unit or a group of people, in Part A, and, in Part B, with the structure, processes, personnel, and other ways in which that social unit or group of people works together, or is “organized”, to meet, pursue, or accomplish one or more collectively shared needs, goals or purposes. Accordingly, the discussion there of “working together” or “organizing” a social unit or group of individuals to meet collective needs or to attain shared goals and objectives necessarily involved some discussion of those collectively shared needs, goals or purposes, at least in respect of the ends towards which such organization aims.

The present section focuses on the existence and typology of organizational goals and objectives. However, in view of the extensive prior discussion of organizational goals and objectives in the context referenced in the preceding paragraph, much of the present section will avert to matters more substantively discussed previously, in Chapter Three in Part 2, and in Chapters Four and Five in Part 3, of the book.

In particular, the present chapter will draw upon the examination of the corporation as an economic actor in Chapters Two; and the discussion of the defining attributes of organizations in the earlier chapters of this Part 3, beginning in Chapter Four, which considered the organization as a social unit or group of people, and continuing in Chapter Five, which considered the organization as involving structure, process, and management.

Upon conclusion of the present chapter, the essential attributes of the organization, the possession of those attributes by the corporation, and its qualification as an organization will have been established. It will then be in order to examine the dual aspect of the corporation as a legal entity and as an organization.

## **EXISTENCE AND TYPOLOGY OF ORGANIZATIONAL GOALS AND OBJECTIVES**

### **Existential Goals and Objectives**

As noted in Chapter Three, Charles Perrow, a leading organization theorist, identified four tasks which every organization must accomplish: firstly, securing adequate capital and other inputs for inception, operations, and expansion; secondly, securing legitimation, acceptance as carrying on a legitimate activity; thirdly, marshaling the necessary skills; and fourthly, coordinating its activities internally, and its relations with other organizations, clients, and consumers, externally.<sup>1</sup> Of course, failure in any of these tasks may entail that the organization will not be established initially or that it will fail over the course of time. Accordingly, these tasks may be considered to be “existential” goals, goals related to establishing and maintaining the organization’s existence.

Unless, of course, the purpose, goal or objective of the organization has some finitude, the continued existence of the organization is generally one of its purposes, goals or objectives,<sup>2</sup>

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<sup>1</sup> Charles Perrow, "The Analysis of Goals in Complex Organizations" (1961) 26:6 American Sociological Rev 854 at 856. See the discussion under the headings "Complex and Multiple Goals" and "Official Goals and Unofficial Goals".

<sup>2</sup> Meyer N Zald, "Organizations as Polities: An Analysis of Community Organization Agencies" (1966) 11:4 Social Work 56 at 64.

inasmuch as it was for those purposes, goals or objectives that it was brought into being. Of course, if the purpose, goal or objective is finite, then it need not, and may not be expected, to continue to exist beyond the satisfaction of that need or the accomplishment of that purpose, goal or objective.

As discussed in Chapter Three, Zald maintains that these collective ends and the beliefs about how to attain them form part of the constitution, or constitutive agreement, or “social contract”, of the organization.<sup>3</sup> Zald’s constitution is more than the oral statement of goals and procedures, which “may have little to do with the organization’s actual constitution”. Attempts to change that constitution may be expected to create conflict and disaffection within the organization, and may threaten the organization’s stability, and even its existence, unless such change produces clear benefits to important participants.<sup>4</sup> Zald’s focus on the organization’s constitution or constituting agreement as instantiated in action, which might be called the “operative constitution”, bears some conceptual affinity with Perrow’s concept of “operative goals”, which is discussed in the next section. Both take pains to distinguish the actual or “operative” phenomenon from the “ideal type”, or theoretical or ostensible nature, of the observed phenomenon.

As has been seen, these observations apply to corporations, as well as other forms of organizations. Discussion of matters particularly, or peculiarly, relevant to corporations appear below under the heading “Goals of Corporations”.

### **Official or Explicit Goals and Operative or Implicit Goals**

This subject has been discussed in Chapter Three under a similar heading, making extensive use of an important, much-cited, and succinct theory and research review by Charles Perrow, *The Analysis of Goals in Complex Organizations*.<sup>5</sup> Use of that review will be continued in this section. This source is particularly apt for our purposes, as Perrow “was perhaps the person most responsible for transferring knowledge of organizational sociology into the fields of organization theory and organization studies starting with [that article].”<sup>6</sup> His seminal observations in that article are still accorded great respect in such fields, and, consequently, will be a useful guide here.

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<sup>3</sup> *Ibid* at 58. See the discussion under the heading “Organizations as Politics”.

<sup>4</sup> *Supra* note 2 at 57-58.

<sup>5</sup> *Supra* note 1.

<sup>6</sup> Stewart R Clegg and James R Bailey, eds, *International Encyclopedia of Organization Studies*, Volume 1, (Thousand Oaks, California: 2008), at 234-235, under the entry entitled “Complex Organizations”.

The focus in Chapter Three was on the organization as a collectivity, embracing a plurality of individuals and, arguably, a plurality of groups and subgroups, sometimes acting in the economy as a single economic actor, and sometimes as separate economic actors. Here, the focus is more specifically on the difference between official or explicit goals, on the one hand, and unofficial, implicit, or operative goals, on the other hand, and on the impact of the same on the organization.

### ***Official Goals – Organizational and Intraorganizational***

In that regard, Perrow says that the official goals are “the general purposes of the organization” as set forth in authoritative pronouncements made on behalf of the organization, such as its charter, or annual reports, or public statements by key executives.<sup>7</sup> Official goals are, by their nature, expressly declared as such. Such official goals are usually purposely vague and general, and do not indicate either “the host of decisions that must be made among alternative ways of achieving official goals”, “the priority of multiple goals”, or “the many unofficial goals pursued by groups within the organization.”<sup>8</sup> Perrow refers to all of these as “operative goals”.

As we have suggested above, components and subcomponents of the organization may also have expressly declared official goals. In this case, they are generally assigned to the component or subcomponent by superior authority with the objective of facilitating the achievement of official higher-level organizational goals. As has been seen, the success of the component or subcomponent within the organization is generally perceived as determined, at least in part, by its success in pursuing and achieving assigned official goals. It may also be expected that the component or subcomponent of the organization will also have operative goals, as described by Perrow.

As discussed in the present chapter, both at the level of the organization and at the level of the organizational component or subcomponent, the declared or assigned goals often need to be ranked as to their priority, as Perrow suggests. However, the ranking or the means of assigning such ranking may or may not be clearly and explicitly determined. This will be discussed further below.

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<sup>7</sup> *Supra* note 1 at 855.

<sup>8</sup> *Ibid.*

### *Operative Goals*

As indicated earlier, Perrow claims that operative goals include official goals insofar as they are actually pursued; and, secondly, the means of prioritizing among the official goals actually pursued. Identifying the operative goals of the organization is, in effect, an empirical task which requires consideration of not only the official goals of the organization, but also of its actual operating policies and, in particular, of the ends to which they are actually conducive.

Perrow asserts that operative goals either “designate the ends sought through the actual operating policies of the organization; they tell us what the organization actually is trying to do, regardless of what the official goals say are the aims”; or they “provide the specific content of official goals”, thereby reflecting choices made among competing values.<sup>9</sup> Zald apparently draws attention to something similar to Perrow’s “operative goals” when he says that the “constitution of any organization” includes not only agreements about goals, but also agreements or beliefs about how to attain them, the means or modes of proceeding.<sup>10</sup>

As discussed in Chapters Three and Four and earlier in this chapter, operative goals may include, may reflect, and may also, to some degree, determine, the processes by which the organization goes about pursuing its goals. Those processes may themselves be, or may become, goals, often in the nature of instrumental goals, although Perrow concedes that these means or processes of achieving official goals may, in some cases, also become end goals in themselves.<sup>11</sup>

The extent to which procedural or processual goals not initially considered to be non-instrumental achieve non-instrumental or end goal status is likely to be highly contextually dependent. It is well to recall, however, March’s observations concerning organizations as involving conflict resolving mechanisms and mechanisms for determining the ordering of joint preferences. In some cases, it is a superordinate process, rather than a superordinate goal, which has this effect.

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<sup>9</sup> *Ibid.*

<sup>10</sup> *Supra* note 2 at 57-59.

<sup>11</sup> *Supra* note 1 at 855.

### ***Profit as Superordinate Goal – Official or Operative Goal***

As explicated in Chapter Three, March specifically considered “the business organization as a socio-political conflict system subject to economic constraints”.<sup>12</sup> As our discussion there indicated, March describes a conflict system as a system which lacks a preference ordering and in which preferences conflict; a resolution to which conflict is sought either by means of adherence to a superordinate goal, such as “profit”, as in the case of theories of business firms, he says; or by means of adherence to a superordinate process of conflict resolution not involving an explicit comparison of utilities, as in the case of theories of political coalitions.

As discussed in Chapter Three, March claims that the “implicit assumption that the firm represents a conflict system susceptible to useful description in terms of a superordinate goal (whether profit maximization or some other) is shared by most economists” and that “most economic theories build upon it (although not all necessarily depend upon it).”<sup>13</sup>

March found, however, that the assumption that profit is the superordinate goal of a business firm “is almost certainly wrong as a micro-description of a business firm”, in that it failed to meet technical requirements of stability, and meaningfulness, as well as the empirical requirement of validity.<sup>14</sup> Consequently, he maintains that profit is not the single overarching objective of a business enterprise, whatever the legal form of that business enterprise.

### ***Alternatives to Profit as Superordinate Goal***

If, as March claims, the superordinate goal of profit generation must be rejected as the sole determinant of conflict resolution in business firms, then theories of joint preference ordering and conflict resolution, such as that posited by March, would suggest that conflict must be resolved by means of a superordinate process not involving an explicit comparison of utilities.

Of course, there are several other possibilities, including, at least, the following: firstly, that there can be more than one superordinate goal, each of which may be applicable in different circumstances, or the conflict between each of which may be resolved by some other mechanism, such as an assignment of priorities, perhaps including application of a superordinate process rule;

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<sup>12</sup> James G March, "The Business Firm as a Political Coalition" (1962) 24:4 J Politics 662 at 666. See the discussion in Chapter Three under the headings “The Firm as a Socio-Political Conflict System” and “Joint Preference Ordering in Economic Theory”

<sup>13</sup> *Supra* note 12 at 669.

<sup>14</sup> *Ibid* at 669-670.



secondly, that resort may be had to a superordinate process of conflict resolution; and, thirdly, that in some cases, some combination of superordinate goals and superordinate processes may be employed. Finally, conflict resolution may reflect some combination of the foregoing, as well as, perhaps, other mechanisms and relevant factors.

By way of example, a particular business enterprise may adopt a goal of attaining a level of profitability, however measured, within a certain range, which may be affected by achievement of other goals. More specific targets within that range may depend upon the pursuit, and the attainment, of other goals; for example, achieving a level of retained earnings within a certain range, generating a level of returns to shareholders within a certain range, achieving a level of profitability per employee within a certain range or achieving other financial goals.

The target range for profitability and other financial goals may, in turn, be affected by the pursuit and attainment of other non-financial goals, including, for example, customer satisfaction, employee satisfaction, supplier satisfaction, community reputation, providing stability of employment, providing opportunities for education and advancement for management and employees, providing stability of the supply chain, ensuring the continued viability of employee compensation, retirement, and benefit plans, supplying certain community benefits, bearing a “fair” level of tax incidence, etc. Again, it might be expected that each of these goals would be established within a stipulated continuum or range, and that such continuum or range could be adjusted in relation to other objectives of the corporation.

While beyond the scope of the present discussion, a cogent argument exists that some significant, successful, and reputable corporations may be applying some of these considerations in their day-to-day judgments, implicitly or explicitly, and in their derivation and application of operative goals. In other words, the kind of conflict resolution and joint preference ordering posited by March may actually be operative in many decisions by corporations having intraorganizational and extraorganizational application and effects.

In fact, such conflict resolution would be consistent with the roles of the corporation and its participants, both within and without the corporation. The corporation is not only a means whereby shareholders can passively generate profits, but provides a vehicle for the satisfaction of many other financial and nonfinancial objectives of the various parties, as indicated in the example discussed here. The extent to which this is the case is demonstrated in situations in which the

existence of the corporation is terminated, such as Enron Corporation, WorldCom Inc., or Arthur Andersen LLP, or is significantly restructured and reorganized.

### ***Reconciling Official Goals and Operative Goals***

Applying March's conflict resolution argument to Perrow's typology of goals, it can be suggested that operative goals may be much more frequent determinants of decisions made at various levels in the organization than official or express goals. These operative goals are "shaped by the particular problems or tasks an organization must emphasize"<sup>15</sup>, which may vary, in at least some cases, from time to time. Given the importance of operative goals, it is important to ascertain how, and by whom, and even when, such operative goals are adopted; and by what problems, tasks, or other circumstances they are shaped.

In this regard, Perrow claims that the "operative goals will be shaped by the dominant group, reflecting the imperatives of the particular task area that is most critical, their own background characteristics (distinctive perspectives based upon their training, career lines, and areas of competence) and the unofficial uses to which they put the organization for their own ends."<sup>16</sup> While the first of these items, the criticality of the task area, relates to the objectives of the organization as a whole, the remaining two items, which are discussed under the next heading, relate to the interests of the dominant group.

### ***Changes in Operative Goals***

Assuming the accuracy of Perrow's claim concerning how operative goals are shaped, it might be expected that changes in the dominant group might affect the operative goals of the organization and, similarly, that changes in the operative goals of the organization might effect changes in which particular group or group of groups (previously existing, or newly established for the purpose) assumes dominance within the organization. Salancik and Pfeffer support this observation, on both theoretical and empirical grounds, saying, in effect, that "power shifts with changes in organizational environments"; and that the "dominant coalition" within, and leaders of, the organization "will tend to be that group that is most appropriate for the organization's

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<sup>15</sup> *Supra* note 1 at 854.

<sup>16</sup> *Ibid* at 856-857.

environment”.<sup>17</sup> The latter observation seems to be problematic, however, insofar as it is conclusory and lacking in immediate verification.

The final item which Perrow enumerates as affecting operative goals, “the unofficial uses to which they put the organization for their own ends”, assumes that the dominant group causes the organization to pursue ends which are of benefit to the dominant group, as such; which ends may be equally or incidentally beneficial to, neutral in respect of, or disbeneficial to, the interests of the organization as a whole. This is consistent with the ability of the dominant coalition to influence, prioritize, and “frame” the organization’s operative goals.

Perrow’s argument would entail that a shift in the dominant group might effect a shift in the “unofficial uses to which [the (new) dominant group puts] the organization for [its] own ends.” It might be expected, logically, that shifts in such “unofficial uses” may, to at least some extent, “accompany” shifts in the dominant coalition, perhaps subject to some lead time or lag time, as the case may be. Consequently, the operative goals of the organization may be in flux frequently, if not normally, or, perhaps, even constantly. As discussed below, intraorganizational organizations, however denominated, whether as divisions, departments, groups or subgroups, may themselves have their own dominant coalitions, and their own official goals and operative goals. Consequently, “shifts” in their dominant coalitions and operative goals may also be expected to take place over time.

Accordingly, shifts in the dominant coalition and operative goals of the organization as a whole and those of any particular intraorganizational group may not be congruent. This may cause a misalignment of goals as between the organization and the focal group at any particular point in time. The frequency and duration of these shifts will be expected to affect the temporal congruency, and the alignment or misalignment, of organizational goals vis-à-vis the goals of the intraorganizational focal group.

The same analysis might be expected to apply to any particular intraorganizational focal group vis-à-vis any other intraorganizational group. That is to say, shifts in the dominant coalition, and operative goals, of the organization and of its various intraorganizational groups may all eventuate

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<sup>17</sup> Gerald R Salancik and Jeffrey Pfeffer, "Who Gets Power – And How They Hold on to It – A Strategic-Contingency Model of Power" (1977) *Organizational Dynamics* 3 at 16.

from time to time and may result in conflict among those coalitions at different levels and among the operative goals pursued at such levels.

March concludes, to similar effect, that the “goals and commitments of business firms shift slowly over time in response to shifts in the coalition represented in the firm.”<sup>18</sup> As will be discussed further below, shifts in the organizational environment, as well as the perception of such shifts by its dominant coalition and leadership, shifts in the coalition and leadership, and consequent shifts in goals and commitments, both operative and otherwise, may be expected to be gradual in most cases but may, occasionally, be more abrupt.

Accordingly, empirically determining the state of each of the same may present substantial difficulties, and may have significant consequences. For example, attributing authority and responsibility, both generally and with respect to particular matters, and for a variety of purposes, including legal liability, may be difficult; and, as such, may entail detailed examination of relevant intraorganizational factors.

Further discussion of these matters specifically in relation to the corporation appears below under the heading “Organizational Goals and Intraorganizational Goals”, most particularly under the subheadings “Intraorganizational Goals, Power, and Loyalty”, and “Goals of Corporations”.

### **Teleological Goals and Instrumental Goals**

A useful typology of organizational goals would, among other things, distinguish between ultimate goals, and, on the other hand, goals which are purely instrumental in connection with the process of seeking to achieve goals which are not themselves purely instrumental, including, but perhaps not limited to, ultimate goals. The “purely instrumental” goals might be denominated as “instrumental goals”, while the goals that are non-instrumental (that is to say, not purely instrumental) might be denominated as “teleological goals”, “ultimate goals”, or “end goals”. These teleological goals, then, are goals which are “goals in themselves”, are generally accepted as such, and do not require independent validation or verification within the organization. They are “real goals”, “ultimate goals”, or “end goals”.

Perrow’s distinction between “official” and “operative” goals is different, of course. Among other things, his term “operative goals” is used to indicate the goals that are actually, not presumptively,

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<sup>18</sup> *Supra* note 12 at 675.

or theoretically, or “ideally” (as an “ideal” type of goal), pursued by the organization. They may or may not be entirely non-instrumental. While he apparently means to exclude “end goals” or ultimate goals, it is possible, logically, at least, that operative goals may actually include end goals or ultimate goals. Indeed, constituents and supporters of such organizations would be expected to maintain, with some justification, that “something is wrong” if the goals actually pursued by the organization do not include at least some of its stated goals. Perrow may, however, be drawing attention to the difficulties which may attend determining whether or not end goals or ultimate goals are actually “operative” in all the circumstances.

Perrow cites the example of a hospital whose official goal “may be to promote the health of the community through curing the ill, and sometimes through preventing illness, teaching, and conducting research.” It can be persuasively argued that the first item, promoting the health of the community, is an end goal or non-instrumental goal, while the others are instrumental in nature. Another example he gives is a business corporation which states “that its goal is to make a profit or adequate return on investment, or provide a customer service, or provide goods.”<sup>19</sup> Profit or return may be considered to be the ultimate goal or end goal, while providing customer service or goods may be seen as instrumental to that end.

Both of these examples demonstrate, at least if goals are considered not to be essentially problematic, that management of the organization can be seen “as using rational and logical means to pursue clear and discrete ends set forth in official statements of goals.”<sup>20</sup> A more granular examination of organizational goals should facilitate closer consideration of the merits of various strategies and tactics and a more accurate assessment of management performance. Perrow’s concept of “operative goals” would seem to contribute to facilitating such granular examination and assessment.

In this regard, Perrow observes that “if making a profit or serving customers is to be taken as a sufficient statement of goals, then all means to this end might appear to be based on rational decisions because the analyst is not alerted to the countless policy decisions involved.”<sup>21</sup> These

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<sup>19</sup> *Ibid* at 855.

<sup>20</sup> *Ibid* at 854.

<sup>21</sup> *Ibid* at 855.

decisions include identifying, evaluating, and successfully pursuing goals which vary in proximity, but which are purely instrumental vis-à-vis the ultimate goal.

Pursuit of these instrumental goals, as has been seen, may involve assignment of goals at various levels of the hierarchy of the organization to organizational components, such as groups and subgroups, however determined. Further, without an accurate assessment of goals which are apparently being pursued by the organization, their categorization as end goals, or instrumental goals, or, perhaps, as both end goals and instrumental goals, respectively, may not be possible.

### **Superordinate Goals and Subordinate Goals**

As discussed above under the subheading “Reconciling Official Goals and Operative Goals”, March maintains that preference ordering in conflict systems can proceed either by applying superordinate goals in order to assign priorities to various subordinate goals, and ranking procedural or instrumental goals accordingly; or by applying a superordinate process, such as effecting determinations by means of a political coalition, which may or may not itself be stable over time. It is, of course, arguable that the superordinate process or, perhaps, more accurately syntactically, the maintenance of the superordinate process, is itself a species of, or even manifestation of a, superordinate goal.

As we have stated elsewhere, the ordering of goals may differ as between different levels of the organization, in part because of their granularity, and in part because of their instrumentality. In the hospital example which Perrow cites, for example, a superordinate goal for the organization as a whole may be promoting the health of the community; for the inpatient department, curing illness; for the outpatient department, preventing illness; and so on; yet curing illness and preventing illness may both be subordinate objectives of the hospital as a whole.

Again, we might posit that preventing illness might be a subordinate objective of the inpatient department and that a more subordinate objective might be teaching, or conducting research on illness prevention. Thus, the respective priorities accorded to various objectives may vary as among the organization as a whole, groups within the organization, and subgroups within the organization.

As just demonstrated, even a rough typology or taxonomy of goals and objectives assists in “unpacking” the nature and effects of the same, which task we will now proceed to advance further.

## ORGANIZATIONAL GOALS AND INTRAORGANIZATIONAL GOALS

### The Modern Business Corporation in Action

#### *Strategy, Structure, and the Great Transformation*

Chapter Five of the present book examined assumptions of classical and neoclassical economics concerning the “firm” as a single economic actor, and challenged those assumptions on analytical and logical grounds, referencing economic and other perspectives. It also compared those classical and neoclassical assumptions to the “firm” or the corporation as found, by empirical research, to be instantiated in the “real world” or, in other words, to be the “firm in action”.

For such purpose, that chapter extensively reviewed the history of the development of the modern business corporation, primarily as chronicled and explained by the eminent business historian, Alfred D. Chandler, Jr., most particularly in his works *Strategy and Structure*,<sup>22</sup> and *The Visible Hand: The Managerial Revolution in American Business*.<sup>23</sup> Chandler is generally considered to have had a transformational effect on business history and, as such, to be the founder of modern business history. He is also considered to have made significant contributions to organizational theory and to business strategy.

Chandler’s *Strategy and Structure* described the means by which modern business corporations, pursuing their goals, came to be organized, in terms of their structure, processes, and personnel, while also relating those matters to the strategy they pursued, and to the pattern and trajectory of their development. In particular, it described the hierarchical structure as involving head offices (which we might also describe as “headquarters” or “corporate” offices), divisions, departments, and field offices; the functions or work undertaken by managers at each level; the nature and division of decision-making as between strategic and tactical matters, as well as operating matters, undertaken at each level; and the nature and flows of information required in such decision-making and operations.<sup>24</sup>

The *Visible Hand* described the “great transformation” of the economy and of business enterprise as new technologies and markets permitted the production and distribution of goods on a much

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<sup>22</sup> Alfred D Chandler, Jr, *Strategy and Structure: Chapters in the History of the Industrial Enterprise* (Boston: MIT Press, 1962).

<sup>23</sup> Alfred D Chandler, Jr, *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, Mass.: The Belknap Press of Harvard University Press, 1977).

<sup>24</sup> *Supra* note 22 at 11.

greater scale than ever before; and, according to Chandler, in which, as a result, the “visible hand of management” replaced Adam Smith’s “invisible hand of market forces”, as modern business enterprises took over certain “market” functions, including coordinating production and distribution, and allocating funds and personnel for future production and distribution.<sup>25</sup>

### ***The New Function of Management and the Manager***

Chandler indicates that this change originated a new economic function, namely, administrative coordination and allocation, as well as “a new subspecies of economic man – the salaried manager – to carry out this function.”<sup>26</sup> This new economic function and the new economic man engaged in that function responded to the complexity involved in the “great transformation”. That complexity involved great modifications of the strategy, structure and processes, and management and personnel practices, as well as size, of these new mega-organizations. It also forced changes in their goals and objectives.

Chandler explains how the “great transformation” resulted in administration of the organization and its managerial hierarchy becoming a source of permanence, power and continued growth; separating an increasingly professionalized management from ownership of the enterprise; and establishing decision-making practices which favoured long-term stability and growth, rather than the maximization of current profits.<sup>27</sup> It was this separation of professional management from ownership, according to Chandler, which, in turn, ultimately separated their respective interests. His attempt to explain the development of a lack of congruence as between the interests of management and the interests of owners may be considered to be somewhat more nuanced than that of a pure “agency” explanation.

### ***Operational Complexity and Organizational Complexity, and This Work***

Chandler chronicles how the size and scope of the enterprise and the attendant complexities of managing the enterprise increased, necessitating the increasing professionalization of management, and the development of new management structures involving large numbers of business units pursuing various growth strategies, in an effort to secure the stability, growth, and

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<sup>25</sup> *Supra* note 23 at 1.

<sup>26</sup> *Ibid* at 484.

<sup>27</sup> *Ibid* at 8-10.



continued existence of the enterprise as a whole.<sup>28</sup> The present author argues that these factors may tend to inhibit the scope and immediacy of the corporation's ability to respond in the short-term to changes in the external environment, thereby increasing the importance of long-term planning and strategy, and, accordingly, tending to promote the prioritization of longer-term, over shorter-term, objectives. It can be seen that this argument and Chandler's are well aligned.

Carrying on different businesses through separate business units also facilitated corporate pursuit of some degree of diversification, as the portfolio businesses might be expected to have somewhat different characteristics, embedding different types and degrees of risk and reward. Diversification might thereby be expected to reduce the incurrence and amplitude of risk and reward effects, both anticipated and unanticipated, on overall organizational performance over time.

As explained in Chapter Five, Chandler's description and explication of what is described here as the "modern business corporation in action" provides an empirical foundation for the discussion of the modern business corporation, in various contexts, in the present book. As such, it provides a description and an analysis of the modern business corporation from an organizational perspective. When combined with our consideration of research and theory concerning organizations generally, it also facilitates a comparison of organizational aspects of the modern business corporation with other types of organizations. Finally, when combined with our consideration of the essential characteristics of the modern business corporation as a matter of law, we can begin to see how this combinatorial approach may be persuasive theoretically, and possessed of significant explanatory, and possibly predictive, power empirically.

As will be recalled, Chapter Three examined various literature reviews, research, and theory relating to the structure, processes, and personnel aspects of modern business corporations, including considerations relevant to the importance and functions of business units; and the relationship of business units to other business units, and to the corporate and other levels of the organizational hierarchy. The materials reviewed in Chapter Three included materials relating to the goals and objectives of the corporation as a whole, those of its groups, and those of its subgroups.

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<sup>28</sup> *Ibid* at 486-487.

The purpose of the present section is to consider the goals and objectives of corporations and, most especially, the question whether such goals and objectives satisfy the formal and informal definitional requirements for organizations generally. We consider that question to have been largely settled, in the affirmative, of course, in the course of discussion earlier in this work, especially in Chapters Two and Three. Consequently, the present section will briefly reference those discussions and will indicate how they demonstrate that corporations may be said to have goals and objectives, thereby satisfying that definitional requirement in order to be considered as “organizations”.

### **Goals of the Corporation In Action**

As discussed in various places in this work, goals, whether teleological goals or end goals, on the one hand, or purely instrumental goals, on the other, or goals which might fall between those two if arrayed on some notional continuum, may be considered, on the one hand, to be goals of, and attributed to, the organization as a whole, which are shared among many or all its participants, which we may denominate as “organizational goals”; and, on the other hand, to be goals of, and attributed to, components of the organization, which are shared only among participants in the relevant organizational component. We may denominate these as “intraorganizational goals” or, variously, as “group goals”, “subgroup goals”, “divisional goals”, “departmental goals”, and the like, as appropriate.

As noted in Chapter Three under the heading “M-Form Corporations”, Fligstein established that the multidivisional form, or “M-form”, or “MDF” corporation, sometimes also called a multidivisional corporation (“MDC”), had become, by the last decades of the twentieth century, the “preferred organizational form for the large firms that dominate the American economy”.<sup>29</sup> Consequently, the relationship between the corporation as a whole, as represented by its headquarters or head office, and individual business units (“BUs”), sometimes called “strategic business units” (“SBUs”), within the corporation, has been the focus of some attention in relevant literature, both practical and theoretical.

Much of this literature is canvassed in Chapter Three. However, it becomes useful to refer to some of this research and theory in the present discussion, which focuses on the needs sought to be met,

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<sup>29</sup> Neil Fligstein, “The Spread of the Multidivisional Form Among Large Firms, 1919-1979” (1985) 50:3 *American Sociological Rev* 377 at 377.

or the goals sought to be attained, by organizations, including corporations, as an essential element of the claim that corporations may be considered to be organizations.

### **Goals of the Corporation as Organization**

As noted at the beginning of this chapter and in Chapter Three, Charles Perrow, the prominent organizational theorist, established that corporations, like other complex organizations, have certain official goals, unofficial goals, and operative goals, the analysis of which presents difficulties arising from organizational complexity.

Some of the difficulties arising from organizational and intraorganizational goal conflicts were reviewed in Chapter Five under the headings “Intraorganizational Organizations” and “Goals of Intraorganizational Organizations”, referring there to observations by Selznick and by March and Simon, and “Intraorganizational Organizations and Goal Displacement”, referring there to observations by Selznick and by Merton.

One of the studies discussed in Chapter Three under the heading “Power and SBUs” was Bouquet and Birkinshaw’s study of the relationship between multinational enterprises (“MNEs”), also called multinational corporations (“MNCs”), and their national or “in-country” subsidiary operations, without regard to their particular legal form, in their capacity as BUs or SBUs. MNEs almost invariably are constituted with multiple divisions, however structured legally, and thus can be regarded for many organizational purposes as functionally similar to M-form or MDF corporations or MDCs, but with the additional attribute that they conduct foreign operations. Consequently, for many organizational purposes, they can be regarded as M-form corporations with foreign operations.

While acknowledging that an MNE operates as an “economically integrated economic institution that encourages members to continuously justify their existence within an emerging global hierarchy”, Bouquet and Birkinshaw maintain that the MNE is also, at the same time, “a socially constructed community of subsidiary members that can only advance their cause with corporate headquarters if they are believed to adhere to a common set of strategic goals, norms, and values.”<sup>30</sup>

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<sup>30</sup> Cyril Bouquet and Julian Birkinshaw, “Weight Versus Voice: How Foreign Subsidiaries Gain Attention from Corporate Headquarters” (2008) 51:3 *Academy of Management J* 577 at 581.

This kind of requirement for existential justification would seem to apply equally, and based on the same reasoning, to MDCs which operate within a single national boundary (and, accordingly, are considered to be “uninational”). It is also noteworthy that Bouquet and Birkinshaw anthropomorphize the separate business units as “members” of “a socially constructed community”, that being the economic enterprise considered as a whole, regardless of the legal entity status of its “members”. Certainly, their study confirms the prevalence of “political” activities as discussed by March and others.

As discussed in Chapter Three, using data for 283 subsidiaries of MNEs, Bouquet and Birkinshaw investigated how BUs weight, and change the weighting of, goals; change goals and their weighting; pursue relationships; and seek and exercise attention, power and influence, and resource allocations from the ultimate parent. In order to be perceived as a “reliable, credible, and trustworthy actor” (a description which may be considered as additional evidence of anthropomorphization), it was found that one of the tasks which the national subsidiary or BU had to undertake was to continually “reaffirm its commitments to the parent’s objectives”.<sup>31</sup>

In the absence of that research finding, it might have been thought that the commitments of business units, whether operating domestically or in foreign countries, to overall parent company goals would be assumed as a matter of course. That such continuous reaffirmation of organizational goals is, as a matter of fact, required from groups and subgroups within the organization is, in itself, an indication of the extent to which group and subgroup goals may be considered, at least at, or by, the head office or headquarters level, to be more dispositive of the actions of the group or subgroup, as the case may be, than goals of the organization itself.

As a minimum, such finding certainly attests to a perception of the importance, and perhaps independence or partial independence, of group goals and subgroup goals at those levels, respectively.

### **Organizational Control of Intraorganizational Groups by Corporations**

As referenced in Chapter Three under the heading “Headquarters Functions, Strategy, and Structure”, Chandler finds that MDCs adopt three principal frameworks or styles by which the ultimate parent corporation, that is to say, the organization at the macro-level, exercises control

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<sup>31</sup> *Ibid* at 594.

over divisions, departments and other organizational components of the corporation acting as groups and subgroups within the corporate organization. Following Goold and Campbell,<sup>32</sup> Chandler identified these as the Strategic Planning, Strategic Control, and the Financial Control models, which are claimed to result from different patterns of growth, patterns of investment, and sets of organizational capabilities reflecting, in part, the industries in which such corporations operate.<sup>33</sup>

As explained in the earlier discussion in this work, the principal variable among these three models is the extent of headquarters control over the strategy, financial budgets, goals and targets, and financial performance of a division or business unit. Strategic planning companies are subject to the least stringent, and financial control companies to the most stringent, controls.

The relative importance of organizational goals as compared with business unit goals varies accordingly. It is likely that this is also the case with respect to subunits within the business unit. For example, the goals pursued by particular subunit or subgroup may range from direct goals that are assigned to it by higher authority; goals of the business unit or group, which are assigned to all subunits or subgroups within it; and goals of the organization itself, which are assigned to all business units and groups within the organization.

As shown in the section entitled “Relationships Among SBUs” in Chapter Three, often the most immediate and hence most powerful incentives to performance are those determined at the lowest relevant level, which is often the one whose performance a given individual has more power to affect.

As reported there, Martin and Eisenhardt found that business unit general managers were more motivated by formal incentives that rewarded BU performance, which were considered to be “high-powered”, than by incentives that rewarded performance at the corporate level, which were considered to be “low-powered” incentives.<sup>34</sup> That result may be considered to reflect rational

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<sup>32</sup> Michael Goold and Andrew Campbell, *Strategies and Styles: The Role of the Centre in Managing Diversified Corporations* (Oxford: Basil Blackwell, 1987).

<sup>33</sup> Alfred D Chandler, "The Functions of the HQ Unit in the Multibusiness Firm" (1991) 12 *Strategic Management J* 31 at 36.

<sup>34</sup> Jeffrey A Martin and Kathleen M Eisenhardt, "Rewiring: Cross-Business-Unit Collaborations in Multibusiness Organizations" (2010) 53:2 *Academy of Management J* 265 at 278, 277, and 293.

design and efficacy of an incentive structure which is more heavily weighted to achieving goals with respect to which the business unit general manager has more control or capacity to influence.

### **Intraorganizational Goals, Power, and Loyalty**

#### ***Intraorganizational Goals***

Intraorganizational goals have been discussed extensively in this work already, especially in Chapter Five in relation to “Organizational Structure”, “Organizational Personnel”, and, of course, in the present chapter above in relation to “Organizational Goals and Intraorganizational Goals”. Particular emphasis has been placed on the relationship between organizational goals and the goals of intraorganizational components, such as functions, divisions, departments, and other groups and subgroups within the organization. Here, the focus is on the relationship between group goals, group power, and group-focused loyalties.

#### ***Power and Organizations***

Each Part of the present work has involved some discussion of power, whether social, political, or economic. A brief discussion of some aspects of the subject, in the broadest possible terms, as relevant to organizations and corporations, is now in order. It will be possible only to avert to a few relevant matters with great brevity in order to situate this work’s discussion of organizations and, in particular, the corporation, with respect to this subject. For this purpose, reference will be made to Robert Bierstedt’s influential article, *An Analysis of Social Power*,<sup>35</sup> which canvasses the subject, research, and relevant literature in some detail.

In that article, Robert Bierstedt explained that social power encompasses political, economic, financial, industrial, and military power, that “society itself is shot through with power relations”, and that power “is a universal phenomenon in human societies and in all social relationships”, perhaps excepting the primary or family group.<sup>36</sup> Considering “force” as the application of sanctions, “power itself is the predisposition or prior capacity which makes the application of force possible... the ability to employ force, not its actual employment, the ability to apply sanctions, not their application.”<sup>37</sup> Within an organization, this application of sanctions is generally subject

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<sup>35</sup> Robert Bierstedt, "An Analysis of Social Power" (1950) 15:6 American Sociological Rev 730.

<sup>36</sup> *Ibid* at 730.

<sup>37</sup> *Ibid* at 733.

to previous assent, at least with respect to something approaching a particular “zone of acceptance” or “scope of agreement”.

Bierstedt argues that “the locus of power is in groups and it expresses itself in inter-group relations”; that it “appears in the statuses which people occupy in formal organization”; and that it is “a function of the organization of associations, of the arrangement and juxtaposition of groups, and of the structure of society itself.”<sup>38</sup>

Concerning formal organizations, Bierstedt maintains: “It is in the formal organization of associations that social power is transformed into authority. When social action and interaction proceed wholly in conformity to the norms of the formal organization, power is dissolved without residue into authority. The right to use force is then attached to certain statuses within the association, and this right is what we ordinarily mean by authority. It is thus authority in virtue of which persons in an association exercise command or control over other persons in the same association... Power in these cases is attached to statuses, not to persons, and is wholly institutionalized as authority. In rigidly organized groups this authority is clearly specified and formally articulated by the norms (rules, statutes, laws) of the association.”<sup>39</sup>

As noted in the present work, such organizational theorists and commentators as Weber, Barnard, Chandler, Fayol, Selznick, Merton, and Zald, among others, adopt similar perspectives. In formal organizations, authority, the ability to exercise command or control over certain other persons, and to impose sanctions for failure to adhere to the same, arises from the institutionalization of power as attaching to organizational status, or office, rather than to personal attributes. At this level of theorization, the distribution and possible diffusion of such authority is often not considered.

### ***Power, Organizational Stability, and Change***

According to Bierstedt, power “is required to inaugurate an association in the first place, to guarantee its continuance, and to enforce its norms. Power supports the fundamental order of society and the social organization within it, wherever there is order. Power stands behind every association and sustains its structure. Without power there is no organization and without power there is no order.”<sup>40</sup> This is not, of course, to suggest that an organization arising as a result of

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<sup>38</sup> *Ibid* at 732.

<sup>39</sup> *Ibid* at 734.

<sup>40</sup> *Ibid* at 735.

voluntary commitment on the part of its participants is without power or the ability to enforce sanctions in respect of its members.

As discussed early in Chapter Four, Weber distinguishes between organizations established by the members on their own authority, which he considered to be established autonomously, from organizations imposed by an outside agency, which he considered to be established heteronomously.<sup>41</sup> For Weber, all organizations are “ordered” relationships, and are characterized by certain expectations. In the case of organizations established autonomously, he says that its “enacted order may be established in one of two ways: by voluntary agreement, or by being imposed and acquiesced in.”<sup>42</sup> Thus, the analyses of Weber and Bierstedt agree in this regard.

Bierstedt explains that while social organization “makes possible the orderly social intercourse of people do not know each other... [t]he members do become acquainted with each other and begin to interact not only “extrinsically” and “categorically,” in terms of the statuses they occupy, but also “intrinsically” and “personally,” in terms of the roles they play and the personalities they exhibit.”<sup>43</sup> In effect, as Selznick notes, and as discussed previously here, “individuals have a propensity to resist depersonalization, to spill over the boundaries of their segmentary roles, to participate as *wholes*.”<sup>44</sup> That is to say, they cannot be confined to their purely institutional roles and, as a result, interact with each other in their plenary human capacity, including in respect of their extraorganizational roles, as human wholes or as a whole human beings.

As discussed in the present work, the extent to which individuals consistently maintain and instantiate their organizational roles, and do so exclusively, is in itself problematic and is subject to variation over time. This may have intraorganizational effects.

Even in non-hierarchical organizations, subgroups may “arise and begin to exert subtle pressures upon the organization itself, upon the norms which may be breached in the observance thereof, and upon the authority which however firmly institutionalized is yet subject to change”<sup>45</sup> In formal

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<sup>41</sup> Max Weber, *Economy and Society: An Outline of Interpretive Sociology* (Berkeley, Los Angeles and London: University of California Press, 1978) at 49-50.

<sup>42</sup> *Ibid* at 50.

<sup>43</sup> *Supra* note 35 at 735.

<sup>44</sup> Philip Selznick, "Foundations of the Theory of Organization" (1948) 13:1 *American Sociological Rev* 25 at 26. See the discussion in Chapter Five under the heading “Formal Structure and Relationships”.

<sup>45</sup> *Supra* note 44 at 26.



hierarchical organizations, subgroups constituted by the organizational hierarchy may also take such actions in such a way as to threaten the stability of the organization.

Informal relationships and the “informal organization” may facilitate these developments, not only positively, but also negatively. Chester Barnard emphasizes the positive influences which informal relationships and the informal organization can exert at the executive level.<sup>46</sup> Bierstedt explains that “no formal organization can remain wholly formal under the exigencies of time and circumstance. Power is seldom completely institutionalized as authority, and then no more than momentarily.”<sup>47</sup> In short, the formality of the formal organization, including role assignments, inevitably is mitigated by informal relationships and the “informal organization” in which power is not institutionalized as authority, as is the case in the formal organization, but remains as uninstitutionalized power.

As seen here, pressures on, and challenges to, the stability of the organization arise both internally and externally. In many cases, developments in the external environment of the organization require adjustments to how it functions, including adjustments to its structure, processes and procedures, and personnel. Bierstedt explains that “the intrusion of the time dimension and the exigencies of circumstance require continual re-adjustments of the structure of every association not excepting the most inelastically organized, and it is power which sustains it through these transitions” and “supplies the stability which it maintains throughout its history”.<sup>48</sup>

Consequently, it can be seen that certain structural readjustments to institutionalized power, which, according to Bierstedt, is institutionalized as formal authority, cannot themselves be implemented by action taken by organizational leaders solely under the formal authority which is vested in them by the formal organization. Implementation of at least some of those structural adjustments may go beyond the authority vested in the repository of formal authority. Such formal authority may require to be supplemented either by other lawful means of conveying formal authority, or by informal organization and informal authority providing support for the formal authority acting beyond the bounds of its actual formal authority.

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<sup>46</sup> CI Barnard, "The Executive Functions" [1938] in *Organization Theory: Selected Readings*, DS Pugh, ed, (New York: Penguin Books, 1977) 166 at 173-174.

<sup>47</sup> *Supra* note 35 at 735.

<sup>48</sup> *Ibid* at 735-736.

Bierstedt's argument, then, maintains that structural readjustments of formal authority, or institutionalized power, require support from the uninstitutionalized power which resides in informal relationships and in the informal organization.

### ***Internal and External Threats to Organizational Stability***

By way of example, we refer to the earlier discussion in the present chapter under the heading "Organizational Control of Intraorganizational Groups by Corporations". There, we referenced the text in Chapter Three under the heading "Headquarters Functions, Strategy, and Structure", which related to Chandler's conclusion that MDCs adopt three principal frameworks or styles by which the ultimate parent corporation, that is to say, the organization at the macro-level, exercises control over divisions, departments and other organizational components of the corporation acting as groups and subgroups within the corporate organization.

Chandler identified these as the "Strategic Planning", "Strategic Control", and the "Financial Control" models, which are claimed to result from different patterns of growth, patterns of investment, and sets of organizational capabilities reflecting, in part, the industries in which such corporations operate.<sup>49</sup> We suggest that, in addition, these models also reflect differences in the strategy of the parent company and in the goals assigned by it to the relevant business units.

Among other things, this suggests that, as the corporation changes its strategy to take account of changes in its environment, it may seek to change its structure, as Chandler proposed more than fifty years ago, which may, in turn, make it appropriate to change the means by which it exercises control over its business units. For example, strategic planning companies, which regard their divisions and business units as portfolio investments, review divisional and business unit proposals in terms of the parent company's portfolio mix and related matters. Such a company might sell off its investments in particular businesses, which, in turn, might make it possible and even efficacious for the parent company to exercise a higher level of control over certain remaining divisions and business units. Similarly, effecting many acquisitions in unrelated business areas might lead to a reduction in such control.

Often, changes in the external environment provoke similar reactions from different companies with similar strategic and control orientations, such as conglomerates. DiMaggio and Powell

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<sup>49</sup> *Supra* note 33 at 38 – 41.

described this as a type of “institutional isomorphism”.<sup>50</sup> Chandler remarks on the experience of U. S. conglomerates, which engaged in “expansive growth through unrelated acquisitions in the 1960s and into the 1970s, then drastic pullbacks in the 1980s.”<sup>51</sup>

Both increases and decreases in control may result in changes in headquarters functions and staffing. Chandler provides many examples of these strategy-control realignments, both in *Strategy and Structure*<sup>52</sup> and in his later article, “The Functions of the HQ Unit in the Multibusiness Firm”.<sup>53</sup> We submit that headquarters staffing and processes may also have an effect on the degree of control which it may exercise, which might lead to an increase or decrease in the quantum of control, or to some change in the means by which control is exercised. For example, in connection with Chandler’s references to responding to changes in the corporation environment by effecting changes in its strategy a few paragraphs ago, we indicated that the resultant changes in strategy might make it appropriate to change the methods by which control is exercised at the organizational or headquarters level over strategic business units.

Among other things, it might be suggested that the means of exercise of control by headquarters might also differ from one business unit to another, depending on the position or importance of that business unit in the corporation’s overall strategy, and depending on the strategy pursued by the relevant business unit, among other things. An example of another influencing factor is the interrelationship between the operations and strategies of the focal business unit with some other business units or business units.

An extraorganizational party, whether a strategic or financial investor seeking to acquire the corporation and to subsequently implement changes in its strategy, structure and operations, for example, by divesting certain divisions, combining certain divisions, or integrating certain divisions with divisions of the acquiror would not have, *ex hypothesi*, as complete and understanding of these interactions as would be expected to be the case at the highest levels of the corporation itself. Consequently, proposals of this nature, such as are often made by hedge funds,

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<sup>50</sup> Paul J DiMaggio and Walter W Powell, "The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields" (1983) 48:2 *American Sociological Rev* 147.

<sup>51</sup> *Supra* note 33 at 39.

<sup>52</sup> *Supra* note 22.

<sup>53</sup> *Supra* note 33.

and by private equity and specialist investors, may be extremely difficult, not only for target shareholders, but also for the proponents, to evaluate with any real precision.

### ***Theories of Intraorganizational Power***

#### *Coping with Uncertainty – A Strategic Contingencies’ Theory*

Prominent among theories of intraorganizational power is one which considers intraorganizational power to arise, at least in part, from the capacity of the relevant business unit to take account of changes in the external environment by providing for contingencies, in effect, in such a way as to “buffer” the exposure of the organization and of other business units.

A prominent and influential theory in this behalf was elaborated in 1971 in a much-cited paper by David Hickson and Bob Hinings and their collaborators, “A Strategic Contingencies’ Theory of Intraorganizational Power.”<sup>54</sup> The theory presented in that article is based upon research reported in their 1968 study, “Dimensions of Organization Structure.”<sup>55</sup> Their theory was further advanced in their 1974 article, “Structural Conditions of Intraorganizational Power.”<sup>56</sup>

A similar theoretical approach was developed by Jerry Salancik and Jeffrey Pfeffer in a 1974 research study entitled “The Bases and Uses of Power in Organizational Decision-Making: The Case of a University”<sup>57</sup> and in a 1977 analytical article entitled “Who Gets Power – And How They Hold on to It – A Strategic-Contingency Model of Power.”<sup>58</sup>

Hickson and Hinings et al. (1971) adopt<sup>59</sup> Lawrence and Lorsch’s definition of an organization as “a system of interrelated behaviors of people who are performing a task that has been differentiated into several distinct subsystems.”<sup>60</sup> This is generally similar to the working definitions and formal definitions considered earlier in the text of Chapter Four. Averting to previous studies of power in work organizations whose focus was generally on the individual, Hickson and Hinings et al. follow

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<sup>54</sup> DJ Hickson, CR Hinings, CA Lee, RE Schneck, and JM Pennings, "A Strategic Contingencies’ Theory of Intraorganizational Power" (1971) 16:2 Administrative Science Q 216.

<sup>55</sup> DS Pugh, DJ Hickson, CR Hinings, and C Turner, "Dimensions of Organizational Structure" (1968) 13:1 Administrative Science Q 65.

<sup>56</sup> CR Hinings, DJ Hickson, JM Pennings, and RE Schneck, "Structural Conditions of Intraorganizational Power" (1974) 19:1 Administrative Science Q 22.

<sup>57</sup> Gerald R Salancik and Jeffrey Pfeffer, "The Bases and Uses of Power in Organizational Decision-Making: The Case of a University" (1974) 19:4 Administrative Science Q 453.

<sup>58</sup> *Supra* note 17.

<sup>59</sup> *Supra* note 57 at 216.

<sup>60</sup> Paul R Lawrence and Jay W Lorsch, "Differentiation and Integration in Complex Organizations" (1967) 12:1 Administrative Science Q 1 at 3.

Perrow in focusing on the power of functional groups, even considering that “power” as a term “takes on different meanings when the unit, or power-holder, is a formal group in an open system with multiple goals, and the system is assumed to reflect a political-domination model of organization, rather than only a cooperative model”, as Perrow maintains.<sup>61</sup>

Accordingly, instead of focusing on the vertical superior-subordinate relationship, “when organizations are conceived as interdepartmental systems, the division of labor becomes the ultimate source of intraorganizational power, and power is explained by variables that are elements of each subunit’s task, its functioning, and its links with the activities of other subunits.”<sup>62</sup> Those tasks and links, then, are variables affecting differentials in power as among subunits.

Hickson and Hinings et al. maintain that a major task of organizations is coping with the uncertainty which confronts them. Organizations may create certain subsystems specifically to deal with uncertainty; and they may also eliminate uncertainty, in whole or in part, by reference to other subsystems. Dividing and allocating to subsystems the task of coping with uncertainty creates a reciprocal interdependency, imbalance in which gives rise to power relations: “The essence of an organization is limitation of the autonomy of all its members or parts, since all are subject to power from the others; for units, unlike individuals, are not free to make a decision to participate, as March and Simon (1958) put it, nor to decide whether or not to come together in political relationships. They must. They exist to do so... The groups use differential power to function within the system rather than to destroy it.”<sup>63</sup>

As mentioned previously, some care must be taken to recognize anthropomorphizations of organizations and intraorganizational units. As Hickson and Hinings say here, unlike individuals participating in organizations, intraorganizational units are likely to have only very limited freedom to decide “whether to stay or whether to go” from the organization, that is to say, whether to exercise “voice or exit”. There are some cases, such as where management effects a management buyout (“MBO”), either as a leveraged buyout (“LBO”) or otherwise, in which management of the intraorganizational unit may have some ability in this regard, but this must be considered to be relatively exceptional, at least in so far as it affects day-to-day decision-making. Staying or

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<sup>61</sup> Charles Perrow, 1970. "Departmental Power and Perspectives in Industrial Firms" [1970] in Mayer N Zald ed, *Power in Organizations* (Nashville: Vanderbilt University Press, 1970) 59 at 84.

<sup>62</sup> *Supra* note 54 at 217. They cite: James G March and Herbert A. Simon, *Organizations*. (New York: Wiley, 1958).

<sup>63</sup> *Ibid.*

remaining within an organization in the case of an individual, would normally be considered to be relatively less constrained than a similar decision for a business unit of a business unit of a corporation, and, accordingly, to be less remote from everyday decision-making.

Considering dependency as the reverse of power, Hickson et al. find that intraorganizational dependency can be associated, firstly, with “the degree to which a subunit copes with uncertainty for other subunits”; secondly, “the extent to which a subunit’s coping activities are substitutable; and, thirdly, the focal unit’s centrality, meaning “the varying degree above [a minimum of task interconnection among subunits] with which the activities of a subunit are linked with those of other subunits.”<sup>64</sup>

They define “uncertainty” as “a lack of information about future events, which results in the unpredictability of alternatives and outcomes “; and “coping” as having the means to deal with uncertainties in such a way as to generate adequate task performance.<sup>65</sup> This finding is not at all surprising. It might be expected that a subunit a high proportion of whose function consists of coping with uncertainty for a large number of subunits and whose performance of that function is highly nonsubstitutable, perhaps even approaching uniqueness, would have considerable power.

But it is not only the task of coping with uncertainty which is divided and allocated within the system: more basic functional differentiations and allocations are effected; some subunits may have a high degree of uncertainty, while others may have almost none. Hickson et al. say that “if organizations allocate to their various units task areas that vary in uncertainty, then those subunits that cope most effectively with the most uncertainty should have most power within the organization, since coping by a subunit reduces the impact of uncertainty on other activities in the organization, a shock absorber function”. They indicate that, by coping, “the subunit provides pseudo certainty for the other subunits by controlling what are otherwise contingencies for other activities. This coping confers power through the dependencies created.”<sup>66</sup>

We would argue, however, that, logically, more successful performance of tasks of higher uncertainty would be expected to increase the power of the focal subunit as compared with another subunit only where the tasks or subunits are of similar orders of magnitude, and of similar orders

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<sup>64</sup> *Supra* note 54 at 218.

<sup>65</sup> *Ibid* at 219.

<sup>66</sup> *Ibid* at 219-220.

of criticality to the organization as a whole, and, of course, where the substitutability such tasks is comparable as between subunits; in other words, *ceteris paribus*. Otherwise, variances in power among subunits might be expected.

It is apparent that coping capacity is a capacity of both subunits and of the organization as a whole. At the organizational level, “organizations do not necessarily aim to avoid uncertainty nor to reduce its absolute level, as Cyert and March (1963) appear to have assumed, but to cope with it. If a subunit can cope, the level of uncertainty encountered can be increased by moving into fresh sectors of the environment, attempting fresh outputs, or utilizing fresh technologies.”<sup>67</sup> Coping by one subunit, then, may permit the assumption of higher levels of uncertainty by other subunits within the organization, and hence by the organization as a whole. This makes sense logically, and also accords with diversification theory.

This is not, of course, to suggest that coping capacity is the only determinant of intraorganizational power; however, it seems to be an important one. Hinings and Hickson et al. indicate that, according to strategic-contingencies theory, “different subunits will travel different routes to power at different times, as the circumstances in and around organizations change”, inasmuch as “changing fields of operation (markets), changing technologies, changing outputs, will all affect power”, which is continuously shifting.<sup>68</sup> As shown previously, Barnard advances a somewhat similar argument.

#### *Resource Dependence – Strategic-Contingency Theory*

Salancik and Pfeffer aim to elaborate upon strategic-contingency theory, “a view that sees power as something that accrues to organizational subunits (individuals, departments) that cope with critical organizational problems”. Subunits and others use power “to enhance their own survival through control of scarce critical resources, through the placement of allies in key positions, and through the definition of organizational problems and policies”, in the course of which processes, organizations can become “both more aligned and more misaligned with their environments.”<sup>69</sup>

They say that “to the extent that power is determined by the critical uncertainties and problems facing the organization and, in turn, influences decisions in the organization, the organization is

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<sup>67</sup> *Ibid.*

<sup>68</sup> *Supra* note 54 at 42.

<sup>69</sup> *Supra* note 17 at 4.

aligned with the reality it faces”. Such alignment facilitates the organization’s adaptation to its environment, whereas a misalignment creates significant problems, by reason of maladaptation.<sup>70</sup>

Hickson and Hinings and their collaborators focus attention on coping with uncertainty. In their model of strategic-contingency theory, Salancik and Pfeffer focus, instead, more directly on their own version of resource dependence theory, asserting that that “to understand power in an organization one must begin by looking outside it – into the environment – for those groups that mediate the organization’s outcomes but are not themselves within its control.”<sup>71</sup>

These groups include groups which provide critical resources and, we would maintain, groups to which the focal organization may be able to provide critical resources. They argue that “the environment sets most of the structure influencing organizational outcomes and problems” with the result that “management would do well to devote more attention to determining the critical contingencies of their environments”,<sup>72</sup> in effect, maintaining awareness of those environments, and changes in those environments, and implementing appropriate, timely measures accordingly. Their theorization treats uncertainty as only one species of environmental influence and relates it, in part at least, to resource dependence.

However, in this regard, the environment in which organizations operate “includes both the internal environment, the shifting situational contexts in which particular decisions get made, and the external environment that it can hope to influence but is unlikely to control.” This environmental context determines the problems to be dealt with, the criticality of those respective problems, and the availability of needed resources.<sup>73</sup>

Salancik and Pfeffer maintain that subunits that contribute to the critical resources of the organization will gain influence within the organization, and will use that influence to “bend the organization’s activities to the contingencies that determine its resources”. As they say, this entails that, contrary to the assumption of many organizational analysts and managers, units or subunits of the organization on the same tier in the organizational pyramid may not enjoy equal power and

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<sup>70</sup> *Ibid* at 5.

<sup>71</sup> *Ibid* at 20.

<sup>72</sup> *Ibid*.

<sup>73</sup> *Ibid* at 10.



status.<sup>74</sup> In fact, it is possible, logically, that a subunit which is centrally located and controls critical resources that are widely required may possess more power than a unit at a higher level.

Organizational power, as discussed below, may result in organizational change, but it may also result, to some degree, in stasis, as result of which “the organization will never be completely in phase with its environment or its needs.”<sup>75</sup> We consider that this lack of phasing may also result, quite simply, from the fact that responses to changes generally require acknowledgement of their recurrence, analysis of the reasons and effects, and analyzing and adopting some one or more of various alternative courses of action, each element of which reactive process take some time. One might expect that the reactive capacity of the focal organization would be a significant determinant of the extent to which its intended realignment “lagged” developments in the environment or was more “in phase” with such developments.

These observations support the arguments made in the present text that the success of the organization requires that it be able to develop an adequate understanding of its environment, both external and internal; the contingencies existing in such environment, both external and internal, the means of mitigating the same; the resources which it requires to succeed, both external and internal, and the criticality of each of the same; and the most effective means by which to access, and then to employ, such resources.

#### *Scarcity, and Criticality, of Resources, and Uncertainty*

Salancik and Pfeffer maintain that three conditions affect the use of power in organizations: scarcity, criticality, and uncertainty. “The first suggests that subunits will try to exert influence when the resources of the organization are scarce. If there is an abundance of resources, then a particular department or a particular individual has little need to attempt influence. With little effort, he can get all he wants anyway.”<sup>76</sup> We would suggest that extraorganizational or external scarcity of resources may often be a key determinant of intraorganizational or internal scarcity of resources, but what is more particularly relevant to intraorganizational power is the latter.

The second condition, criticality, “suggests that a subunit will attempt to influence decisions to obtain resources that are critical to its own survival and activities”; however, what is critical, they

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<sup>74</sup> *Ibid.*

<sup>75</sup> *Ibid* at 17.

<sup>76</sup> *Ibid* at 13.

say, depends on “people’s beliefs about what is critical [which] may or may not be based on experience and knowledge and may or may not be agreed upon by all.”<sup>77</sup> An accurate assessment of criticality can avoid wasted effort.

Salancik and Pfeffer suggest that increasing scarcity of a resource tends to decrease the use of objective criteria in its allocation, and to increase the tendency to use power, and to increase the quantum of power which is employed, in an effort to obtain it. “Every subunit will vie for resources according to its needs and demands, but not all will be able to completely satisfy their demands. If a subunit is to obtain resources, it must overcome the pressures of other subunits for the same contested resource.”<sup>78</sup> However, “power is exercised only when there is discretion in the allocation of resources.”<sup>79</sup>

As to the third condition which affects the use of power, uncertainty: “When individuals do not agree about what the organization should do or how to do it, power and other social processes will affect decisions. The reason for this is simply that, if there are no clear-cut criteria available for resolving conflicts of interest, then the only means for resolution is some form of social process, including power, status, social ties, or some arbitrary process like flipping a coin or drawing straws.”<sup>80</sup> As a result, contestants with more power are more likely to succeed. This recalls our discussion of March’s analysis of a business organization as a political coalition.

#### *Resources, Influence, Leadership, and Survival*

Salancik and Pfeffer draw the conclusion that “those units most likely to survive in times of strife are those that are more critical to the organization” which “gives them power to influence resource allocations that enhance their own survival.”<sup>81</sup> This is not at all surprising. We would expect that the power to allocate resources is important not only to the sustenance, growth, and survival, but also to the decline, atrophy, and even extinction, of a focal subunit.

They say: “The strategic-contingencies model implies that subunits that contribute to the critical resources of the organization will gain influence in the organization. Their influence presumably is then used to bend the organization’s activities to the contingencies that determine its

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<sup>77</sup> *Ibid.*

<sup>78</sup> *Supra* note 57 at 463.

<sup>79</sup> *Ibid* at 464.

<sup>80</sup> *Supra* note 17 at 13.

<sup>81</sup> *Ibid* at 14.

resources.”<sup>82</sup> Among other things, these observations suggest that the subunits that contribute greater amounts to the organization’s critical resources and thereby acquire greater influence or power may not be denominated as such on the organizational charts, may not necessarily be situated at the top of the organizational hierarchy, and may not have leaders whose titles necessarily indicate their importance within the organization.

Instead, what might be called “organizational criticality power” or “criticality power”, a power which arises from contribution of critical resources to the organization, may not be readily apparent, and may, instead, require some knowledgeable investigation to discern. Of course, not all intraorganizational power is criticality power. Instead, other dimensions or aspects of power are at work within the organization.

While such alignment between criticality and criticality power might be desirable, it is not clear, as a matter of logic, that such a realignment always eventuates. Salancik and Pfeffer’s observation, though, is bolstered by their argument that “The power to define what is critical in an organization is no small power... If an organization defines certain activities as critical when in fact they are not critical, given the flow of resources coming into the organization, it is not likely to survive, at least in its present form.”<sup>83</sup>

Thus, misunderstanding the criticality of activities may be expected to lead to engagements in activities which are less productive than other activities might be, to omit or to reduce engagement in activities which may be more highly productive than others, and to misallocate resources accordingly. This may impact organizational growth, maintenance, and even survival. Thus, the use of power to acquire criticality power in circumstances in which such criticality power is unwarranted may be disbeneficial, not only to the organization, but also to the relevant subunit.

#### *Power and Leadership, Alignment, and Realignment*

Moreover, “power not only influences the survival of key groups in an organization, it also influences the selection of individuals to key leadership positions and by such a process further aligns the organization with its environmental context.”<sup>84</sup> The exercise of power in leadership selection may also tend to reflect the criticality, and hence power, of certain key groups, and

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<sup>82</sup> *Ibid* at 10.

<sup>83</sup> *Ibid* at 10.

<sup>84</sup> *Ibid* at 14.

changes in each of these factors: “The critical contingencies facing the organization may change. When they do, it is reasonable to expect that the power of individuals and subgroups will change in turn.”<sup>85</sup> The present work has made arguments to this effect previously.

Salancik and Pfeffer go on to suggest: “One implication of the idea that power shifts with changes in organizational environments is that the dominant coalition will tend to be that group that is most appropriate for the organization’s environment, as also will the leaders of an organization.”<sup>86</sup> They chronicle the dominance of engineers in American industrial firms up until the 1950s, as they were able to deal with production problems; followed by that of marketing executives in the 1950s, as production became routinized and mechanized, and as the principal problem became selling all the goods so produced; followed by financial executives in the 1960s, as the need to maintain the stability of markets and production led to greater need for funds to finance acquisitions of competitors, and to undertake costly research and development of new and improved products.<sup>87</sup>

Perrow finds, likewise, that the leadership of hospitals varied over the late nineteenth and early twentieth century, especially as medical technology advanced and major decisions were increasingly based on technical competence.<sup>88</sup> It is clear, however, that the dominance of the “most appropriate” group is contingent, rather than inevitable. What Salancik and Pfeffer appear to be able to maintain, instead, is that the organization and its leaders, and the subunits and their leaders, as the case may be, may suffer as a result of non-performance by reason of such misalignment, which, in turn, may be expected to invoke remedial action to force realignment.

As the present work has indicated previously, changes in power, and, more particularly, in the leadership of the organization and changes in the dominant coalition are not likely to be contemporaneous with changes in the critical contingencies facing the organization. Instead, it may be expected that leadership and dominant coalition changes are likely to lag critical contingency changes to some degree, although it may be the case that some forward-looking organizations might make anticipatory leadership and coalition changes in the expectation of critical contingency developments.

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<sup>85</sup> *Ibid* at 16.

<sup>86</sup> *Ibid*.

<sup>87</sup> See also Perrow’s comments on leadership by successive skill groups related to strategy, *supra* note 1 at 865.

<sup>88</sup> *Supra* note 1 at 858.

In any event, in all probability, changes in power may precede leadership and coalition changes, whether anticipatory or otherwise. Indeed, changes in power may themselves be anticipatory. That is, the anticipation of changes in the ambient environment, whether internal or external, and the resultant changes in critical contingencies facing the organization may result in power shifts within the organization even before those environmental or critical contingency changes eventuate.

While it might be expected that the identity of the leadership of the organization would be immediately apparent to outside observers, this may not be the case, particularly if the leadership of the formal organization and that of the informal organization are not congruent. Similarly, the members of the “dominant coalition” may not be obvious, or even easily determined.

Instead, determining the parameters of the organizational leadership, or that of the relevant group, or subgroup, as the case may be, or the members of the dominant coalition of the organization, group, or subgroup, may require detailed and appropriate investigation. The lack of synchronicity of changes in environment, critical contingencies, leadership, and coalitions (particularly in their relative salience or dominance) complicates such investigation further.

In this regard, examination of organizational decisions alone, for example, to determine the sources and use of power in that regard, will not necessarily reflect the distribution of power within the organization. “Using power for influence requires a certain expenditure of effort, time, and resources. Prudent and judicious persons are not likely to use their power needlessly or wastefully. And it is likely that power will be used to influence organizational decisions primarily under circumstances that both require and favor its use.”<sup>89</sup> Furthermore, there may be many organizational decisions with respect to which the bearers of power are more or less indifferent and, in consequence, with respect to which the exercise of power may be unnecessary at all, or to any significant degree.

Nonetheless, the maintenance by subunits of their existing power is, according to Salancik and Pfeffer, facilitated by: firstly, the ability to name their functions as critical to the organization when they may not be; secondly, the tendency to categorize problems in familiar ways and to accord weight to the perceptions of those with prior credibility or existing power; and thirdly, the ability

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<sup>89</sup> *Supra* note 17 at 12.

to institutionalize power by establishing structures and policies that favour their influence and become accepted as more or less permanent.<sup>90</sup>

It must be noted again, however, that maintenance of existing subunit power on such bases may be antithetical to organizational performance, which may be revealed by appropriate attention by organizational management to environmental conditions, and which may precipitate a realignment of subunit power, often including the acquisition of substantial subunit power and even dominance by a new subunit whose function is more aligned with the bases on which the former dominant subunit claimed, but did not actually successfully meet, those conditions of power.

For example, naming the function of the focal unit as critical when it is not may result in that function receiving excessive attention and in more critical functions receiving inadequate attention, thereby decreasing organizational performance. Characterization of “new” problems in familiar ways and assigning dealing with them to subunits whose power and credibility is based on factors that are not relevant to the “new” problems may be detrimental to organizational performance.

This may also be the case if structure and policies favour subunits with existing power, but whose functions and capacity do not extend sufficiently to dealing meaningfully with the “new” problems. In each of these cases, accurate assessment of the factors contributing to the “resulting” shortfall in organizational performance may lead to a readjustment of subunit power.

### ***Information and Sanctions as Sources of Intraorganizational Power***

Salancik and Pfeffer also identify two other important sources of institutionalized power. One of these is the ability to structure and control information systems, since “those who have information are in a better position to interpret the problems of an organization, regardless of how realistically they may, in fact, do so.” The other is the ability to distribute rewards and resources, which may be used to pacify competing interest groups.<sup>91</sup>

#### ***Information***

An example of the use of the power to structure information systems provided by Salancik and Pfeffer is “setting up committees to investigate particular organizational issues and having them

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<sup>90</sup> *Ibid* at 18-19.

<sup>91</sup> *Ibid* at 19.

report only to particular individuals or groups". This facilitates "awareness of problems by members of those groups while limiting the awareness of problems by the members of other groups."<sup>92</sup> Such an imbalance in information with respect to the identification, analysis, and scope of, determination of factors relevant to, and potential solutions with respect to, such issues is considered to create or to exacerbate an imbalance in power.

An interesting example of the ways in which intraorganizational power in general and intraorganizational power derived from control over intraorganizational information can operate is provided by a study of the crisis at General Motors Corporation ("GM") relating to defects in its engine ignition switches and the related cover-up of the same. These events were investigated by special counsel to GM's board of directors, Anton R. Valukas, the chairman of Chicago law firm Jenner & Block, who had also acted as Examiner in the bankruptcy of Lehman Brothers Holdings. The study, "Ethical Culture and Legal Liability: The GM Switch Crisis and Lessons in Governance", by Marianne Jennings and Lawrence J. Trautman, provides some interesting information in this regard, citing the report by Mr. Valukas (the "Valukas Report") extensively.<sup>93</sup>

The authors find that "organizational dysfunction may have caused or may have been the result of organizational communication failures and insufficient knowledge at the levels of the organization where change could have been implemented", referring, in particular, to observations in the Valukas Report that, in addition to individual mistakes and organizational dysfunction, including the fact that some GM systems were "inaccessible to some and impenetrable to many."<sup>94</sup> Relevant information often resided in isolated subunits which had minimal intraorganizational incentive to collaborate proactively with other subunits.<sup>95</sup>

In addition to information silos, however, some of the problems of GM apparently arose from integration failures, namely, failures to understand how seemingly disparate pieces of information fit together, as well as from incentive failures, namely, failures to provide adequate rewards or reinforcement, and, to the contrary, even punishing employees, for surfacing potential problems.<sup>96</sup>

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<sup>92</sup> *Ibid.*

<sup>93</sup> Marianne Jennings and Lawrence J Trautman, "Ethical Culture and Legal Liability: The GM Switch Crisis and Lessons in Governance" (2016) 22 BU Journal of Sci & Tech L 187.

<sup>94</sup> *Ibid* at 222-223.

<sup>95</sup> *Ibid* at 224.

<sup>96</sup> *Ibid* at 232.

As noted previously in the present work, employees at lower levels make determinations as to the information to be transmitted to superiors. These determinations may have significant effects, as “organizational members rely on accurate and timely information not only to make effective decisions but to effectively coordinate and implement those decisions”.<sup>97</sup>

In particular, Jennings and Trautman note that: “Both those with practical experience (including CEOs and consultants) and academics agree on this proposition: Negative information struggles to find its way to the top of a large organization.”<sup>98</sup> A study by Detert and Trevino indicates that employees often express concern about the treatment of information they provide, albeit often indirectly, to leaders even two to five levels above them, who often have the power to handle strategic contingencies and resolve key uncertainties within particular work environments.<sup>99</sup>

Further, as Jennings and Trautman observe: “Those at the top of the organization often fail to recognize the messages they send by indirect communication”, which “can result from emphasis”<sup>100</sup>, for example, on schedules, results, and performance, rather than, for example, on safety or reputational issues. Often, the dispersal of such indirect communication throughout the organization cannot be controlled by the formal organization or otherwise. Such indirect communication may often arise from informal relationships and from the informal organization more generally, which may be even more difficult to control than those of a more formal nature.

### *Sanctions*

As noted in the immediately preceding subsection, the ability to distribute rewards, to provide incentives, and to dispense punishments also significantly affect intraorganizational power. The GM example and its discussion by Jennings and Trautman is instructive in this regard. Evidently, at the time when the ignition switch issues were evolving, there was a “culture of cost-cutting”, which impacted all aspects of its business and its culture, particularly as it was necessitated by a massive restructuring of GM’s North American operations which had been underway for several years.<sup>101</sup> This affected the ignition switch problems because those responsible for a vehicle were

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<sup>97</sup> Keith Leavitt and David M Sluss, "Lying for Whom We Are: An Identity-Based Model of Workplace Dishonesty" (2015) 40:4 *Academy of Management Review* 587 at 587. They cite: O Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985).

<sup>98</sup> *Supra* note 93 at 231, citing: James R Detert and Linda K Trevino, "Speaking to Higher-Ups: How Supervisors and Skip-Level Leaders Influence Employee Voice" (2010) 21:1 *Organization Science* 249.

<sup>99</sup> Detert and Trevino, *supra*, note 98 at 249.

<sup>100</sup> *Supra* note 93 at 233.

<sup>101</sup> *Ibid* at p. 191.



also responsible for its costs, including any changes required, and the effects of this cost-cutting also extended to suppliers, with orders being sourced from those with the lowest price bids, rather than the bids providing the highest quality.<sup>102</sup>

Accordingly, those responsible for the “cost” of GM vehicles acquired great intraorganizational power due to the centrality and criticality of that function. We would submit that the internal legal function apparently also acquired considerable internal power, again, as a result of the centrality and criticality of the legal function, both during and after the restructuring. The centrality and the criticality of the legal function were further enhanced as internal and external legal investigations and proceedings were undertaken with respect to the “ignition switch” problem.

It was said that employees of GM never wanted to be “the bearers of bad news”.<sup>103</sup> Employees apparently feared “pushback” and retaliation for raising safety issues. This extended to reporting safety problems, apparently over a very long period, leading to the conclusion that since as long ago as 1958, GM had “allowed cost pressures to prevent fixes and avoid public disclosure”<sup>104</sup> of safety issues, leading to failures of accountability.<sup>105</sup> Presumably, such internal retaliation could extend to denials of salutary performance reviews, bonuses, raises, promotions, and other financial and nonfinancial benefits. In general, of course, as we have noted previously, such sanctions, both positive and negative, tend to be concentrated in their effectiveness at lower organizational levels, where they provide more powerful incentives.

Accordingly, it would be reasonable to expect that organization-level incentives, such as participation in the profit or bonus incentive plans at the GM corporate level, which might be more immediately impacted by reputational and other considerations, would be less significant, both immediately and quantitatively, to unit and subunit employees. In this way, internal sanctions could very well have independently reinforced the efforts of units engaged in cost-cutting and legal functions to minimize problems arising from, or relating to, cost-cutting, as well as safety, issues.

The Valukas Report found that these failures of accountability involved “not only a culture of silence, but also a culture of concealment” in which employees “did not take notes at all at critical safety meetings because they believed GM lawyers did not want such notes taken”, despite the fact

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<sup>102</sup> *Ibid* at p. 205.

<sup>103</sup> *Ibid* at p. 209.

<sup>104</sup> *Ibid* at p. 215.

<sup>105</sup> *Ibid* at p. 218.

that no evidence could be found reflecting any such instruction.<sup>106</sup> This attests to the power of the legal function in relation to the dominant “culture of cost-cutting”. It also attests to the power of informal communications and relationships, and of the informal structure generally, with respect to intraorganizational behaviour.

It was also found that the very nature of group decision-making at GM also promoted a lack of accountability, including with respect to the ignition switch problems, which were considered by “an astonishing number of committees” at those meetings, at which some of these issues were flagged, solutions were proposed, and then were referred to another committee or ad hoc group. At that point, the proposed solution often died, but without any single person “owning” the decision, and without clarity as to the membership of, and issues considered by, the relevant committees, which usually did not maintain minutes. Responsibility was regularly deflected onto others, and often meetings ended with agreement to a plan of action which none of the parties in attendance actually intended to pursue.<sup>107</sup>

Accordingly, the GM “ignition switch debacle” chronicled by Jennings and Trautman aptly illustrates the control of information and the control of sanctions as tools in pursuing and exercising intraorganizational power.

### ***Exercise of Intraorganizational Power***

In their 1974 study of the distribution of power within a university, Salancik and Pfeffer acknowledge their reliance on the perspectives of Herbert Simon,<sup>108</sup> of Cyert and March,<sup>109</sup> and of March alone,<sup>110</sup> treating the organization as a coalition. They assert that this coalitional view rejects the notion that organizations function as do individuals, resolving conflicts by means of the use of economic incentives to arrive at a preference ordering shared by all organizational participants. Instead it “emphasizes the differences in objectives and preferences of subunits and participants and seeks to describe the process by which conflicting preferences and beliefs are resolved”.<sup>111</sup>

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<sup>106</sup> *Ibid* at p. 220.

<sup>107</sup> *Ibid* at p. 222.

<sup>108</sup> Herbert A. Simon, "Theories of Decision-Making in Economics and Behavioral Science" (1959) 49:3 *American Economic Review* 253.

<sup>109</sup> Richard M. Cyert and James G. March, *A Behavioral Theory of the Firm*. (Englewood Cliffs, N.J.: Prentice-Hall, 1963).

<sup>110</sup> *Supra* note 12.

<sup>111</sup> *Supra* note 57 at 453-454.

This recalls our discussion of March's analysis of joint preference ordering by means of superordinate goals, such as in highly rational organizations, on the one hand, and superordinate procedures, such as in political coalitions, on the other hand. It also recalls our objections made in earlier chapters and in Appendix B with respect to the assumption of methodological individualism in the social sciences, in theory and in practice.

In this connection, Zald, following Selznick, explains how the "organizational analysis" approach studies the organization as a whole and focuses on "the allocation of power to different groups and the manner in which subgroup loyalties and power affect the operation of organizations." He also indicates that, while central to this approach, an analysis of the polity of organizations, namely, "the patterned distribution and utilization of authority and influence" is often only implicitly treated in research and theoretical discussions.<sup>112</sup> His analysis, as well as that of Hickson and Hinings and their colleagues, significantly influenced Salancik and Pfeffer.

### ***Distribution of Intraorganizational Power – Formal and Informal***

As referenced in the immediately preceding paragraph, in the forty years since Zald made this observation, there have been many studies of the distribution of power, influence, and loyalty within organizations and, in particular, within corporations. A number of these studies are referenced in Chapters Three and Four.

By way of example, Bouquet and Birkinshaw study how power and influence may be variously distributed among groups and subgroups within the corporation.<sup>113</sup> As discussed previously, in another study Birkinshaw and Hood demonstrated how one single country business unit within a MNE could exercise its power and influence in order to expand its scope of operations.<sup>114</sup> At a more general level, Amit and Schoemaker showed that some business units determined by country of operation within an MNE may enjoy greater independence and be able to exercise greater power than others. Factors relevant in this respect were found to include BU track record and informal ties between BU and corporate level managers.<sup>115</sup>

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<sup>112</sup> *Supra* note 2 at 57. Of course, Zald also applied significant elements of Perrow's analysis.

<sup>113</sup> *Supra* note 30 at 578.

<sup>114</sup> Julian Birkinshaw and Neil Hood, "Multinational Subsidiary Evolution: Capability and Charter Change in Foreign-Owned Subsidiary Companies" (1998) 23:4 *Academy of Management Rev* 773. See the discussion in Chapter Three in the section entitled "Power and SBU Evolution".

<sup>115</sup> Raphael Amit and Paul JH Schoemaker, "Strategic Assets and Organizational Rent" (1993) 14:1 *Strategic Management J* 33 at 33.

As referenced in Chapter Six under the heading “Relationships Among SBUs”, Wenpin Tsai’s 2002 study of 24 BUs, in a variety of businesses, within a single large MDC, examined situations in which individual business units not only competed with each other for resources, but in certain cases actually competed with each other for business externally. Contrary to expectations, he found that intrafirm coordination and knowledge sharing was not significantly affected by internal competition for resources, but, again, contrary to expectations, was actually enhanced by external competition for business. This was only the case, however, in decentralized environments.<sup>116</sup>

The latter finding may suggest that high-powered incentives at the business unit level to succeed against external competitors, and even internal competitors, in externally-oriented competition, when combined with lower-powered organization-wide incentives, may facilitate BU general managers cooperating across business units, in order for both business units to succeed against external competition. The study also found that informal relationships and social interaction among business unit general managers promoted trust and increased cooperation.<sup>117</sup>

This finding can be taken as an indication of the importance of informal networks and of the “informal organization” within the formal organization, including the capacity to exercise power or influence within the organization. Those subjects are canvassed, in particular, in the section on Organizational Structure, especially in the sections on “Intraorganizational Organizations”, “Informal Structure and Relationships”, and “Formal Organizations and Informal Organizations”.

### ***Intraorganizational Politics***

A particular unit within the organization may pursue activities designed to advance its own particular interests within the organization as a whole, such as expanding its operations, as discussed in the immediately preceding paragraphs. Such activities are frequently characterized, usually critically, as undertaking “political” activity or “playing politics”, as if to minimize their legitimacy, and as involving “games”, or “political games”. These subjects are considered by Henry Mintzberg, the eminent social theorist, and management and strategy expert, in an important article, “The Organization as Political Arena”, published in 1985.<sup>118</sup>

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<sup>116</sup> Wenpin Tsai, "Social Structure of "Coopetition" Within a Multiunit Organization: Coordination, Competition, and Intraorganizational Knowledge" (2002) 13:2 Organization Science 179 at 187.

<sup>117</sup> *Ibid.*

<sup>118</sup> Henry Mintzberg, The Organization as Political Arena (1985) 22:2 J Management 133.

Mintzberg describes politics as one of the systems of influence in an organization, the others being: the system of authority, which defines “formal power”, the power allocated on an explicit and legally sanctioned basis; the system of ideology, which “although implicit, typically represents norms and beliefs that are widely accepted in the organization”; and the system of expertise, which “represents power that is usually certified on an official basis and typically sanctioned by formal authority”.<sup>119</sup> The system of politics, he says, “may be described as reflecting power that is technically illegitimate (or, perhaps more accurately, ‘alegitimate’) in its means (and sometimes in its ends as well” such that “behavior termed political is neither formally authorized, widely accepted, nor officially certified”.<sup>120</sup>

Political behaviour, according to Mintzberg, “is typically divisive and conflictive, often pitting individuals or groups against formal authority, accepted ideology, and/or certified expertise, or else against each other” and arising when the other systems of influence are absent or weak. However, he indicates that the political system “can also be evoked” by those other systems, “as when departmentalization, created through formal authority, encourages group processes that benefit parochial interests at the expense of the needs of the organization at large.”<sup>121</sup> It may be assumed, then, that the other systems, namely, those of ideology and expertise, may also evoke the political system in their service, in certain situations.

In some organizations at some times, he says, “politics may be the dominant system of influence, and conflict strong”, either because politics and conflict “weakened the other systems of influence”, or arose by reason of their weakness.<sup>122</sup> He describes an organization “which is captured in a whole, or in significant part, by politics and conflict” as involving a “Political Arena” of which he identifies and describes four basic types and the interrelationships among them. However interesting, they cannot be examined here.

Mintzberg finds that political activity in organizations is often described in terms of games. He identified thirteen types of political games described in the literature, “although no comprehensive description of the organization as a system of various political games could be found”. Each of these games has some relationship with the other systems of influence.<sup>123</sup> He finds that some of

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<sup>119</sup> *Ibid* at 134.

<sup>120</sup> *Ibid* [emphasis in the original].

<sup>121</sup> *Ibid*.

<sup>122</sup> *Ibid* at 139.

<sup>123</sup> *Ibid* at 134. Examining these here would be interesting but would take us too far afield.

these games can coexist with, and often could not exist without, strong legitimate systems of influence; other highly divisive games “arise in the presence of legitimate power but are *antagonistic* to it, designed to destroy or at least weaken it”; and others “arise when legitimate power is weak, and *substitute for it*”.<sup>124</sup>

It is important, however, to recognize the existence of political behaviour among intraorganizational organizations or units, behaviour which is analogized to that within the polity, the external political environment, or the environment of the state.

### ***Intraorganizational Loyalty***

#### *Relation to “Organization Personality”*

The section of Chapter Five entitled “Organizational Changes in Behaviour and Relationships” discussed Barnard’s perspective on loyalty as the most important single contribution required of the executive. In particular, he expressed the view that loyalty involved domination by the “organization personality”, which he defined to mean something like the personality that a member does, or must, employ as part of the organization.<sup>125</sup> We explicated this concept as meaning that an individual’s non-organizational “personality” is sublimated into his or her “organizational personality” in respect of the individual’s role within the organization.

As argued previously in this work, the individual may assume multiple intraorganizational roles and identities which often require to be “managed” or, as this book has often said, “negotiated” in some fashion. In Barnard’s terms, this could be expressed by saying that the individual had a separate organization personality in respect of the organization as a whole and in respect of each component of the organization of which that individual is a member. Alternatively, it might be posited that Barnard’s “organization personality” synthesizes those separate aspects of organizational identification.

While the former assumption clearly contemplates that the individual is required to “negotiate” or “manage” those identities, the latter assumption may simply ignore or assume this. However, neither construction explicitly acknowledges that intraorganizational groups may satisfy all of the requirements to be considered as “intraorganizational organizations”, as does the present work.

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<sup>124</sup> *Ibid* at 139 [emphasis in the original].

<sup>125</sup> *Supra* note 46 at 170.

However, it is clear that discussions of loyalty engage notions of identification, at least, and perhaps of commitment.

Barnard himself claims that loyalty and similar expressions, such as “solidarity”, and “*esprit de corps*” relate to intensity of commitment, which is “vaguely recognized as an essential condition of organization”. According to him, loyalty “is required is not necessarily related either to position, rank, fame, remuneration, or ability.”<sup>126</sup> It can be readily seen that loyalty and other expressions relating to commitment may characterize intraorganizational groups as well as the macro-organization itself. In this regard, then, the organizational character of intraorganizational groups may be said to be assumed by Barnard himself. In effect, Barnard may assume that intraorganizational groups or components themselves constitute organizations and may be analyzed accordingly.

#### *Relation to Organizational Identification*

Herbert Simon claims that one component of organizational loyalty on the part of participants is the perception that the organization’s objective is important and has value not only independently, but also for the participant concerned.<sup>127</sup> He says: “The individual who is loyal to the *objectives* of the organization will resist modification of those objectives, and may even refuse to continue his participation if they are changed too radically.”<sup>128</sup> Another component of organizational loyalty relates to the participant’s interest in the continuance of the organization or in the organization itself: “The individual who is loyal to the organization will support opportunistic changes in its objectives that are calculated to promote its survival and growth.”<sup>129</sup>

For present purposes, it is important to note that these components of organizational loyalty may also characterize loyalty to the intraorganizational components of the organization itself: its internal organizations, divisions, departments, functions, units, subunits, groups, subgroups, and so on. It may be assumed, following Simon, that the loyalty of individuals to the objective of the focal group may be distinguished from their loyalty to the focal group itself.

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<sup>126</sup> Chester Barnard, *The Functions of the Executive*, (Cambridge: Harvard University Press, 1938) at 84 [emphasis in the original].

<sup>127</sup> Herbert A Simon, *Administrative Behavior: A Study of Decision-Making Processes in Administrative Organization* (New York: Free Press, 1945), 3d ed 1976 at 115.

<sup>128</sup> *Ibid* at 118 [emphasis in the original].

<sup>129</sup> *Ibid*.

As observed previously in this work, it is important to distinguish between the individual's identification with the organization or relevant focal group, on the one hand, and his or her commitment to it, on the other hand. Simon's use of the term "loyalty" seems to more closely approximate the former, as does his title for Chapter X in which these remarks appear, which is "Loyalties and Organizational Identification".

Simon's comment that "the identification of the individual may be either with the organization objective or with the conservation of the organization"<sup>130</sup> makes this quite clear, since the sense of this quotation is identical in its effect with his comments on loyalty quoted in the first paragraph of the present section. On the other hand, because Simon does not contrast such identification with "commitment", it is possible to be only almost, but not quite, definitive on the issue. As will be seen below, the extent of identification with conservation of the organization as an objective may vary among organizational participants and, in particular, may be higher among the professional managerial group whose members are typically interested not only in material benefits and values, but also in non-material benefits and values, such as prestige and power.<sup>131</sup>

Simon's explication of the concept of identification is that "*a person identifies himself with a group when, in making a decision, he evaluates the several alternatives of choice in terms of their consequences for the specified group.*"<sup>132</sup> Of course, as previously noted, Simon relates identification to acceptance of intraorganizational authority and roles. Within the area of acceptance, the individual will behave "organizationally" or impersonally, substituting the organizational value scale for the individual's personal value scale as the criterion of "correctness" in his or her decisions. But, "when the organizational demands fall outside this area, personal motives restrict themselves, and the organization, to that extent, ceases to exist."<sup>133</sup>

Simon acknowledges that "it might be hoped, then that it would be feasible to broaden, to some degree, the area of identification which governs the administrator's decisions", in effect, by taking steps "to transfer allegiance from the smaller to the larger organizational units, and from the narrower to the broader objectives". Simon seems to assume, then, that loyalty or allegiance is more immediately felt at lower component levels of the organization, but that steps can be taken

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<sup>130</sup> *Ibid* at 206.

<sup>131</sup> *Ibid* at 117.

<sup>132</sup> *Ibid* at 205 [emphasis in the original].

<sup>133</sup> *Ibid* at 204.



to change this. He also notes that “to the extent that this is achieved, the precise location of decision-making functions is of less importance”.<sup>134</sup> In other words, to the extent that component-level loyalty and identification does not exceed that exhibited at the organizational level, decisions may be expected to be less reflective of, or less biased in respect of, the interests of the component.

*Changes in the Dominant Coalition or Top Management Team*

The expectation is that at the highest organizational level, as Chandler advocated, the senior officers would adopt an “impartial over-all view” which would be “unencumbered by any particular division loyalty or bias”.<sup>135</sup> It will be recalled, however, that Salancik and Pfeffer, as referenced above in the subsection entitled “Power and Leadership, Alignment, and Realignment” chronicle the dominance of executives from certain functional groups, such as engineering, marketing, and finance in various periods during the twentieth century.<sup>136</sup> As also noted there, Perrow likewise found that certain functional groups dominated the leadership of hospitals during different periods of the late nineteenth and early twentieth century.<sup>137</sup>

In this regard, Perrow indicates that domination by functional or “skill” groups may occur in two ways. The first of these eventuates where a department “because of the technology and stage of growth, effectively exercise a veto on the executive’s decisions and substantially shape decisions in other departments.” This recalls the GM example discussed previously. The other, he says, contradicting Chandler, or, at least, Chandler’s aspirations, arises where “lines of promotion may be such that top executives are drawn from one powerful department, and retain their identification with the parochial goals of that department.”<sup>138</sup> In addition, there is evidence that certain other types of loyalties, some related to function, such as professional and task loyalties, still continue to obtain.

Simon maintains that “the organization objective itself changes in response to the influence of those for whom the accomplishment of that objective secures personal values.”<sup>139</sup> This is particularly the case with the dominant coalition. As already noted, the group which consists of the most senior officers of the corporation, the “top management team” or “TMT”, enjoy

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<sup>134</sup> *Ibid* at 216.

<sup>135</sup> *Supra* note 22 at 275.

<sup>136</sup> *Supra* note 17 at 16.

<sup>137</sup> *Supra* note 1 at 858.

<sup>138</sup> *Supra* note 1 at 865.

<sup>139</sup> *Supra* note 127 at 114.

significant non-material benefits in terms of prestige and power which continue to accrue as a result of the organization continuing its existence.<sup>140</sup> Accordingly, it may be expected that these continuance, maintenance, or “conservation” values, that is to say, the objectives of continuing, maintaining, or conserving the corporation, will be among the values sought by that group.

Of course, as noted previously, it cannot be assumed that changes in the dominant coalition will be effected at all at once. This may be the case whether the dominant coalition is considered to be the TMT, the board of directors, or both. Certainly, changes in the TMT are likely to be effected more gradually, even though, over time, there may be a change in orientation of the TMT itself. For example, it would be unlikely that changes in the functional training and experience from, say, engineers, to marketing executives, would take place en bloc. Instead, it would be more likely that such a change would involve the gradual introduction of additional members with the soon-to-be dominant functional background.

This may also take place as a result of what Selznick describes, and we outlined in Chapter Five under the heading “Organizational Continuity and Co-optation”, as “cooptation”. As noted there, this means “the process of absorbing new elements into the leadership or policy-determining structure of an organization as a means of averting threats to its stability or existence”<sup>141</sup> It may be that, in some cases, the increasing power of a particular function or of persons having a common functional background may precipitate a gradual turnover of functional dominance.

## **The Dominant Coalition as Intraorganizational Group**

### ***The Top Management Team as a Group of Individuals***

As noted previously, Cyert and March consider that the “dominant coalition” of individuals responsible for setting firm direction is the top management team (“TMT”) of the corporation,<sup>142</sup> which also, according to Mintzberg, identifies environmental opportunities and problems, interprets relevant information, considers organizational capabilities and strengths, and formulates and implements strategic change.<sup>143</sup> The position of the board of directors (“BOD”) vis-à-vis the dominant coalition, the CEO, and the TMT generally is considered at the end of this section.

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<sup>140</sup> *Ibid* at 117.

<sup>141</sup> *Supra* note 1 at 34 [emphasis omitted].

<sup>142</sup> *Supra* note 109.

<sup>143</sup> Henry Mintzberg, *The Structuring of Organizations: A Synthesis of the Research*. (Lebanon, Indiana, U.S.A.: Prentice Hall, 1979).

The foundation has now been laid for the assertion that the dominant coalition or top management team may be examined as a social unit or group of persons and, moreover, can be evaluated as to whether it constitutes an intraorganizational organization, that is to say, an organization within the larger umbrella organization. To some extent, we have accepted and articulated the first proposition up to this point. As we indicated with respect to intraorganizational organizations generally, the determination of whether the TMT constitutes an organization in itself requires consideration of whether it is “organized”, that is to say, set up with a structure, processes, and composed of personnel conducive to the attainment of some common goal or objective and also “operated” in this way. The question whether the TMT constitutes an organization seems to present some difficulties that do not arise specifically with respect to a division or function within the umbrella organization. One of these potential difficulties is discussed next.

### ***Top Management Team Goals and Objectives***

As to the existence of some common goal or objective, it may be assumed, with some justification, that the TMT, like the board of directors itself, shares the official or explicit, and probably even all or most of the operative or implicit goals or objectives of the corporation, in large part because the TMT and BOD participate in crafting those goals and objectives. It is of course possible, perhaps even likely, that, firstly, the TMT as a group may have other more proximate goals and objectives; secondly, this may be true for BOD; and, thirdly, some members of the TMT or BOD, as the case may be, may have other, more personal, goals and objectives. Each of these sets of goals and objectives may be supported by internal sanctions operating at the TMT, BOD, or organizational levels.

For example, the Chief Financial Officer (“CFO”) may have goals and objectives that relate to the finances of the organization as a whole and, perhaps, with respect to organizational components as well. The CFO may also have functional, professional, and educational characteristics and loyalties. The CFO’s performance evaluations, compensation, and bonuses, and future prospects may depend in part upon organizational performance, but is also likely to depend in part upon the CFO’s performance in respect of the finance function. The weighting of these factors may have a significant impact on the attention paid to such factors by the CFO. Other TMT members are likely to be in somewhat similar positions, *mutatis mutandis*, having both organizational level, as well as

functional, goals and objectives that weigh variously on their performance assessments, compensation, bonuses, and future prospects, among other things.

The negotiation or assimilation of an individual's identity as a member of the TMT, for example, will have certain characteristics in common with negotiation of membership in groups at other organizational levels. Similarly, each member of the TMT may be expected to exhibit certain role behaviour consistent with such position, function, and professional and other attributes. Reference is made to the discussion of these matters in Chapter Five, particularly under the headings "Organizational Process" and "Organizational Personnel".

It is, of course, necessary to recognize that the term "top management team" or "TMT" may not be formally defined within any particular organization. In any particular corporation, it may be considered to include the chief executive officer, as well as the heads of various functions ("C-suite" executives) or divisions, but it may also be considered on the one hand, to exclude some of the incumbents of those positions and, on the other hand, to include others. It may simply be considered to be the incumbents of the positions at the hierarchical level immediately below the CEO, or it may be considered to be those reporting directly to the CEO.

In this regard, the informal structure and relationships within the formal organization must also be considered. It may be that the TMT in a particular corporation includes positions or individuals who would not be considered as members in other corporations. Simon may be taken to recognize this in his specification of the "controlling group" as "the group that has the power to set the terms of membership for all the participants" in the organization. While the "legal" power to do this inheres in the board of directors, the "de facto" power may inhere in the TMT. Simon certainly recognizes that "if the group that holds a legal control fails to exercise this power, then of course, it will devolve on individuals further down the administrative hierarchy."<sup>144</sup> To be sure, the respective positions of the BOD and the TMT were not the focus of Simon's attention in this regard. Indeed, at Simon's time of writing, the TMT, not the BOD, was considered to be the dominant coalition or controlling group.

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<sup>144</sup> *Supra* note 108 at 118-119.

### *Top Management Teams and Collective Action*

Questions arise concerning how the top management team, as a group, takes decisions and implements actions. In this regard, Anneloes Raes and her colleagues developed a process model of interaction between the TMT and middle managers ("MMs"), considering the TMT as "the inner circle of executives who collectively formulate, articulate, and execute the strategic and tactical moves of the organization."<sup>145</sup> Accordingly: "In describing TMT role behavior, we have assumed that the TMT exists and operates as a social entity and that TMT members are, at least to some extent, consistent in their behaviour toward MMs." As a result, they considered it appropriate to focus on the TMT, rather than on individual members, as interfacing with MMs.<sup>146</sup>

Thus arises "the issue of the teamness of TMTs", which is debated among scholars.<sup>147</sup> It is said: "On the one hand, it seems that many organizations currently do have teams at the top whose members function on the basis of shared goals and responsibilities. On the other hand, even when formal and legal structures for being a team are in place, there may still be differences in the extent to which TMTs are cohesive, interdependent, and behaviourally integrated."<sup>148</sup>

While it is clear that a BOD has collective legal responsibility and that its individual members also have individual legal responsibility, only the latter is the case with respect to the TMT: TMT members have no collective, but only individual, legal responsibility. As a result, the extent to which the TMT may be expected to function collectively, as a matter of fact, presents different issues. While members might consider that they share common goals, it is not as clear that they consider that they have, or share, any collective responsibility for actions of the TMT as a whole, apart, perhaps, from some moral feeling of collective responsibility which may, however be very

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<sup>145</sup> Annaloes ML Raes, Mariëlle G Heijltjes, Ursula Glunk, and Robert A Roe, "The Interface of the Top Management Team and Middle Managers: A Process Model" (2011) 36:1 *Academy of Management Rev* 102 at 102.

<sup>146</sup> *Ibid* at 119.

<sup>147</sup> *Ibid*, citing: MR Barrick, BH Bradley, AL Kristof-Brown, & AE Colbert, "The Moderating Role of Top Management Team Interdependence: Implications for Real Teams and Working Groups" (2007) 50:3 *Academy of Management J* 544; and DC Hambrick, "Top Management Groups: A Conceptual Integration and Reconsideration of the "Team" Label" (1994) 16 *Research in Organizational Behavior* 171.

<sup>148</sup> *Supra* note 144 at 119; citing, for the first remark: J O'Toole, J Galbraith, & EE Lawler, III, "When Two (Or More) Heads Are Better Than One: The Promises and Pitfalls of Shared Leadership" (2002) 44:4 *California Management Rev* 65; and R Wageman, DA Nunes, JA Burruss, & JR Hackman, *Senior Leadership Teams: What It Takes To Make Them Great* (Boston: Harvard Business School Press, 2008); and for the second remark: MR Barrick, BH Bradley, AL Kristof-Brown, & AE Colbert, "The Moderating Role of Top Management Team Interdependence: Implications for Real Teams and Working Groups" (2007) 50:3 *Academy of Management J* 544; and Z Simsek, JF Veiga, MH Lubatkin, & RN Dino, "Modelling the Multilevel Determinants of Top Management Team Behavioral Integration" (2005) 48:1 *Academy of Management J* 69.

genuine and serious. However, some part of the sanctions possibly applicable to members of the TMT, both individually and collectively, such as bonuses, may be based on assessments of their collective performance. This may encourage awareness of collective responsibility.

Raes et al. indicate that managing the TMT-MM interface is likely to be more important in larger organizations with more diversified functions because asymmetries of information, and interest, and constraints against TMT-MM contact are likely to be greater in such organizations.<sup>149</sup> “In large, multibusiness organizations, MMs are often general managers of separate business units who are particularly likely to have information that is different from that of the TMT” and to have interests which pertain primarily to their own business unit.<sup>150</sup>

These subjects have been discussed in Chapter Five and earlier in the present chapter, especially under the heading “Information and Sanctions as Sources of Intraorganizational Goals, Power, and Loyalty”. As noted there, subordinates very frequently have the opportunity to determine the information which is transmitted to their superiors as part of the reporting or decision-making processes. While the information available to the subordinates may be quite granular, various degrees of selectivity may be involved in “packaging” the information which is to go to superiors. As also discussed there, most particularly under the heading “Theories of Intraorganizational Power”, Raes and her co-authors note that the influence of a particular business unit may depend on its network centrality and resources, on its geographic location and confidence, and on its attempts to exercise upward influence<sup>151</sup> These findings comport with the findings of Hickson and Hinings et al.,<sup>152</sup> Pugh, Hickson, Hinings, and Turner,<sup>153</sup> and Hinings and Hickson et al.;<sup>154</sup> and with those of Salancik and Pfeffer.<sup>155</sup>

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<sup>149</sup> *Supra* note 144 at 118, citing: DC Hambrick, S Finkelstein, & AC Mooney "Executive Job Demands: New Insights for Explaining Strategic Decisions and Leader Behaviors" (2005) 30:2 *Academy of Management Rev* 472; and S Tengblad, "Time and Space in Managerial Work" (2002) 18 *Scandinavian J Management* 543.

<sup>150</sup> *Supra* note 144 at 118, citing: M Ketokivi, & X Castaner, "Strategic Planning as an Integrative Device" (2004) 49:3 *Administrative Science Q* 337; and Martin & Eisenhardt, 2010, *supra* note 34.

<sup>151</sup> *Ibid* at 119; citing: for the first item, JM Pappas & B Wooldridge, "Middle Managers' Divergent Strategic Activity: An Investigation of Multiple Measures of Network Centrality" (2007) 44:3 *J Management Studies* 323; for the second item, Bouquet and Birkinshaw, *supra*, note 30; and, for the third item, WK Schilit & FT Paine, "An Examination of the Underlying Dynamics of Strategic Decisions Subject to Upward Influence Activity" (1987) 24:2 *J Management Studies* 161.

<sup>152</sup> *Supra* note 54, 55, and 56.

<sup>153</sup> *Supra* note 55.

<sup>154</sup> *Supra* note 55 and 56.

<sup>155</sup> *Supra* notes 17 and 57.

Raes et al. also note that the TMT and MMs have to process unstructured streams of complex information, make sense of them, and find solutions under conditions of unclear cause-and-effect relationships.”<sup>156</sup> They say that the tasks of MMs in this regard are complicated by their dual roles as links between the TMT and lower organizational levels, entailing that in their actions with the TMT, they are both the “accomplice of the TMT” and the “representative” of their BU. Raes et al. conclude that “this dual role leads to a potential conflict of interest, both inside the MMs and between the TMT and MMs.”<sup>157</sup>

It is also important to note that the TMT and MMs “have fewer opportunities to interact than do those in other leader-follower relationships, making their episodes of interaction important “windows of opportunity” for achieving alignment in their activities.”<sup>158</sup> Among other things, this limits the opportunities for trust to be generated between or among the parties, such that longer tenure might be beneficial. Various TMT members having different perspectives may interact with the same middle manager over time, making assessments of the confidence and trustworthiness of such middle manager more difficult, inasmuch as these activities may require organized communication among the relevant TMT members.

Finally, Raes and her colleagues say that while “scholars are debating the teamness of TMTs in terms of their internal functioning, we know of no research that does address the question of how TMT members coordinate and execute their collective leadership actions toward followers.”<sup>159</sup> In effect, then, research was lacking only a few years ago, at their time of writing, concerning the interaction between the TMT and middle management, or between the TMT and some focal group of middle management, in terms of intergroup interaction, at least. The review in the present work suggests that this is not atypical of interaction among intraorganizational groups more generally.

### ***Board of Directors, Top Management Team, and the Dominant Coalition***

As discussed in Chapter One and in Chapter A1 of Appendix A, modern corporate law statutes assign to the board of directors the responsibility for managing or supervising the management of

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<sup>156</sup> *Ibid* 103; citing: J Child, "Organizational Structure, Environment, and Performance: The Role of Strategic Choice" (1972) 6:1 Sociology 1; AC Edmondson, MA Roberto, & MD Watkins, 2003. "Dynamic Model of Top Management Team Effectiveness: Managing Unstructured Task Streams" (2003) 14:3 Leadership Q 297; and MA Geletkanycz & DC Hambrick, "The External Ties of Top Executives: Implications for Strategic Choice and Performance" (1997) 42:4 Administrative Science Q 654.

<sup>157</sup> *Ibid* at 103.

<sup>158</sup> *Ibid*.

<sup>159</sup> *Ibid* at 119.

the business and affairs of the corporation.<sup>160</sup> Accordingly, it is clear that the board of directors possesses the legal authority to determine how the business and affairs of the corporation will be managed.

However, the board is also empowered to designate offices, appoint officers, specify their duties, and delegate to them powers to manage or to supervise the management of the business and the business and affairs of the corporation, subject to certain statutory limitations.<sup>161</sup> As discussed there, officers may have certain powers and responsibilities pursuant to the relevant statute and corporate charter documents, the relevant common law, and relevant contracts and agreements.<sup>162</sup>

It is commonly acknowledged that a corporation of any significant size is normally managed from day to day by its officers and employees, rather than by its board of directors. The related question is who exercises de facto or actual authority over how the corporation will be managed from one day to another: the board, on the one hand, or the CEO and the TMT, on the other. The logical possibility exists, of course, that such day today responsibility and authority could be shared in some fashion; however, this possibility does not figure significantly in the relevant literature. The prevailing view concerning the composition of the dominant coalition or controlling group vis-à-vis the board, the CEO, and the TMT more generally has varied over time.

#### *Berle and Means on the Dominant Coalition*

As is well known, Berle and Means analyzed the impact of the separation of ownership and control of the corporation in terms of the separation of equity ownership by shareholders and the exercise of control by management of the corporation, resulting in a divergence in their interests.<sup>163</sup> For them, the term “management” included both the board and what would now call the top management team or TMT: “managers consist of a board of directors and the senior officers of the

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<sup>160</sup> See Chapter A1 in the section entitled "Management Role of the Board of Directors". In particular, reference is made to the material under the heading "Statutory Role", which also cites the relevant statutory provisions of the four modern corporate law statutes selected for examination in this work. Of course, as discussed in Chapter A2, the shareholders retain certain powers relating to the exercise of management rights by the board in exceptional circumstances and relating to the election and monitoring of directors.

<sup>161</sup> See Chapter A1 in the section entitled "Management Role of the Board of Directors", and, in particular, the discussion under the heading "Board Appointment of Chief Executive Officer, Other Officers, and Other Management", which also makes reference to the relevant statutory provisions.

<sup>162</sup> See Chapter A1 in the section entitled "Duties of Officers and Employees" and the relevant statutory provisions cited there.

<sup>163</sup> Adolf A Berle, Jr, and Gardiner C Means, *The Modern Corporation and Private Property* (New York: McMillan, 1932) at 6.



Corporation".<sup>164</sup> Mark Mizruchi argues that "because their key point about the separation of ownership from control is that managers become a self-perpetuating oligarchy", this indicates that Berle and Means regard the board, rather than the officers, as in control of the firm.<sup>165</sup> He also notes that at their time of writing boards of directors were largely composed of the CEO and other senior officers of the firm.

Berle's 1954 book, *The 20th Century Capitalist Revolution*, frequently elides the board and its management, treating them collectively as "management". He points out that change of management by shareholder votes is "extremely rare, and increasingly difficult and expensive to the point of impossibility". When combined with the business judgment rule, he says that this "leaves management with substantially absolute power" except for the power of their own consciences.<sup>166</sup> Yet later in Chapter V, "Corporate Capitalism and "The City of God", he refers only to the consciences of the directors as distinct from the officers of the corporation,<sup>167</sup> as holding out hope that corporations will make contributions to the improvement of society and the self-realization of individuals.<sup>168</sup>

Berle's 1958 article "'Control' in Corporate Law"<sup>169</sup> focuses on "control" in the sense of the power or a legal authority to elect a majority of the board of directors, who have the legal authority to manage, and thus concentrates attention on legal, rather than de facto or actual, authority. This accords with his earlier view that "all powers granted to the corporation or to the management of the corporation...are necessarily... exercisable only for the ratable benefit of all the shareholders as their interest appears".<sup>170</sup>

Stephen Bainbridge argues, as does the present work, that it is the board of directors which has primacy over the power and right to exercise decision-making, rather than the shareholders as in a shareholder primacy model, or the managers, as maintained by managerialism.<sup>171</sup>

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<sup>164</sup> *Ibid* at 96.

<sup>165</sup> Mark Mizruchi, "Berle and Means Revisited: The Governance and Power of Large U.S. Corporations" (2004) 33:5 *Theory and Society* 579 at 591.

<sup>166</sup> Adolf A Berle, Jr, *The 20th Century Capitalist Revolution*, (New York, Harcourt, Brace & World, Inc. 1954) at 180.

<sup>167</sup> *Ibid* at 184-186.

<sup>168</sup> *Ibid*.

<sup>169</sup> Adolf A Berle, Jr, "'Control' in Corporate Law" (1958) 58:8 *Colum L Rev* 1212.

<sup>170</sup> Adolf A Berle, Jr, "Corporate Powers as Powers in Trust" (1931) 44 *Harv L Rev* 1049 at 1049.

<sup>171</sup> Stephen M. Bainbridge, "Director Primacy: The Means and Ends of Corporate Governance" (2002) 97 *Nw U L Rev* 547 at 605.

*The Dominant Coalition in Historical Perspective*

Chandler's historical analysis indicates that before 1850, industrial enterprises were very small and usually family affairs, such that the "two or three men responsible for the destiny of a single enterprise handled all its basic activities – economic and administrative, operational and entrepreneurial" with the result that "business administration as a distinct activity did not yet exist."<sup>172</sup> While "a very few of the very largest American economic enterprises to develop embryonic administrative structures",<sup>173</sup> it was the operation of the great railways across America that gave rise to a full-time administrative structure in American business.

Chandler chronicled the ascendancy of management control as a result of the increasing complexity of business operations and the need for specialized and highly developed skills and their management, concentrating on four of the largest industrial corporations.<sup>174</sup> For example, the increased diversification of the business of the DuPont Company after the First World War greatly increased its administrative needs, including the application of broad goals and policies, resource allocations, and performance appraisals.<sup>175</sup>

The board of directors of the Standard Oil Company (New Jersey) in 1912 consisted largely of full-time executives, mostly generalists, and a very few heads of specific functional activities.<sup>176</sup> By 1919, the board of directors consisted of executives responsible for particular functional activities, such as marketing production, manufacturing, finance, treasury, and control.<sup>177</sup> As specialists, they "had little time for, information about, or interest in the administration of the company as a whole", with the exception of the individuals who acted, separately, as Chairman of the Board and as President, and, thus, the directors could not "fully appreciate the needs and problems of their colleagues on the Board."<sup>178</sup> Although the directors managed various functions,

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<sup>172</sup> *Supra* note 22 at 19.

<sup>173</sup> *Ibid* at 20.

<sup>174</sup> This is discussed in Chapter Two in the section entitled "History of the Development of the Modern Business Corporation" and in Chapter Three in the section entitled "Forms of Corporations – Legal and Organizational Variants".

<sup>175</sup> *Supra* note 22 at 91.

<sup>176</sup> *Ibid* at 169.

<sup>177</sup> *Ibid* at 181.

<sup>178</sup> *Ibid*.

in general, the asymmetry of information between the board and the management of individual departments, subsidiaries, divisions and functions, was even then quite apparent.<sup>179</sup>

With the adoption of a multidivisional structure and the creation of the head office of general executives and staff specialists in 1927, the general officers on the board were relieved of operating responsibilities. By 1933, its board consisted of “full-time executives who devoted their time wholly to over-all coordination, appraisal, and policy planning.”<sup>180</sup> Similar developments took place at the remaining companies closely studied by Chandler: at Sears, Roebuck and Company in that same year,<sup>181</sup> at The du Pont Company in September 1921,<sup>182</sup> and at General Motors in December 1920.<sup>183</sup>

Adopting a multidivisional structure “clearly removed the executives responsible for the destiny of the entire enterprise from the more routine operational activities and so gave them the time, information and even psychological commitment for long-term planning and appraisal”, in effect, attending to the policy function, while giving the general managers of the multifunction divisions “the responsibility and the necessary authority for the operational administration”, the operations or administration function.<sup>184</sup>

Chandler concluded that in the large corporation, the task of allocating resources and determining the basic goals and policies had long ago been abdicated by shareholders, who had “neither the time, information nor (as long as the enterprise is paying dividends) the interest to make basic policy decisions”<sup>185</sup> The members of the Board of Directors, unless “they were also full-time, career executives of the concern... had only a little more knowledge and understanding of the workings of their company than the stockholders”, “had neither the time nor sources of information independent of the full-time executives” to study its workings, and “were occupied with their own business activities”.<sup>186</sup> In this sense, “the members of board unless they were full-time executives of the concern, were as much captives of the professional entrepreneurs as were the stockholders.” Thus, the task of management was left to professional managers.

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<sup>179</sup> *Ibid* at 193.

<sup>180</sup> *Ibid* at 218.

<sup>181</sup> *Ibid* at 307-8.

<sup>182</sup> *Ibid* at 111.

<sup>183</sup> *Ibid* at 130.

<sup>184</sup> *Ibid* at 309-310.

<sup>185</sup> *Ibid* at 312.

<sup>186</sup> *Ibid* at 313.

Both the board and shareholders “had only a negative or veto power on the government of their enterprise and on the allocation of its resources” since they lack both the information and “the awareness of the company situation to propose realistic alternative courses of action.”<sup>187</sup> However, according to Chandler, both the board and the shareholders came alive “whenever company’s dividend stopped and receivership loomed.”

On the other hand, those professional entrepreneurs, the “general executives”, once freed from non-entrepreneurial responsibilities, can spend their full-time on the entrepreneurial tasks of planning and appraisal, relying on head office staff for independent verification of divisional information and for alternative policy proposals and recommendations; and their actions are subject only to negative control by their “legal superiors”, the board of directors.<sup>188</sup> Thus, it was the professional managers at head office, the “general executives”, who were the “key decision-makers” and had the “actual or real, rather than merely to legal, power to allocate resources available to them and... in fact, determine the basic goals and policies for their enterprise.”<sup>189</sup>

Chandler’s historical perspective enables a number of observations to be advanced. Firstly, the roles of the shareholders, directors, and top management team vis-à-vis actual performance of the management function has changed substantially over time. Secondly, a significant influence in this regard was the increase in scale and scope of operations conducted by the focal corporation. The small group of individuals, family or otherwise, who originated its operations became insufficient to manage those operations. Thirdly, specialty skills were required. This, in turn, increased the importance of coordination as a critical function, also involving specialized skills.

As we have seen, these developments created various intraorganizational groups or intraorganizational organizations, surfacing the issue of possible identification with, and possible commitment, by participants to the organization, and its groups and subgroups. Fourthly, such scale and scope attenuated the need for, and volume of, strategic and policy determinations required. Fifthly, ideally, these should be made by headquarters personnel without operating attachments to groups or subgroups within the organization other than to the headquarters group itself. This is important not only to ensure concentration on the relevant strategic matters, as

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<sup>187</sup> *Ibid.*

<sup>188</sup> *Ibid* at 313-314.

<sup>189</sup> *Ibid* at 312.

Chandler says, but also to reduce identification with and commitment to operational groups and subgroups, as distinct from identification with and commitment to the organization itself.

### ***The Board of Directors as a Group of Individuals***

The first sections under the present heading, “The Dominant Coalition as Intraorganizational Group”, considered whether the top management team could be examined as a social unit or group of persons, and evaluated as to whether it constituted an organization itself within the large organization, which might be described as an intraorganizational organization. Similar questions arise with respect to the board of directors. Thus, much of the discussion under those headings concerning the TMT is also relevant to the BOD. There are, however, some salient differences.

Firstly, with respect to a large corporation, it can normally be assumed that members of the TMT are full-time officers and employees of the corporation. Currently, other than the CEO, most, if not all, members of the BOD are not so engaged. Secondly, as officers and employees, TMT members acquire certain rights and obligations, under statutory corporate law, agency law and other common law, and relevant contracts. Other than the CEO, their intraorganizational duties and responsibilities do not span the entire organization, but are more limited. This is not the case with respect to directors. Moreover, the BOD exercises responsibility directly on behalf of the corporation, while the CEO and other TMT members exercise only delegated authority, as agents.

Thirdly, while TMT members may be expected to have certain intraorganizational identities and commitments at the group or subgroup level, in addition to their organizational identities and commitments, directors are expected to have only the latter. They must, nonetheless, “negotiate” their identity as a director of the focal corporation vis-à-vis the board as a group, and vis-à-vis their other social identities.<sup>190</sup> Fourthly, in general, the board interacts only as a group with the CEO and other TMT members. Actions by the chair of the board or its committees or other actions by individual directors or committees of directors which are authorized by the board itself are exceptions to this general rule. Fifthly, because most directors are not engaged in that capacity on a full-time basis, their own individual opportunities for interaction within the board, on the one hand, and with the CEO and TMT members, on the other hand, are quite limited. As noted above

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<sup>190</sup> *Supra* note 14.

under the heading “Top Management Teams and Collective Action”,<sup>191</sup> this presents difficulties in terms of taking decisions and actions, creating role behaviour, and developing trust and confidence, within the group, in this case, the BOD, and with the TMT.

### ***Board of Directors Goals and Objectives***

As discussed under the heading “The Dominant Coalition as Intraorganizational Group” with respect to the TMT, the Board’s goals and objectives may be expected to relate almost exclusively to goals and objectives of the corporation itself, to a much higher degree than would be the case with respect to the TMT. Of course, the board may set certain goals and objectives for itself, as a group within the organization or as an intraorganizational group. The TMT may do likewise. However, as discussed under that same heading, unlike the TMT, the BOD has a collective legal responsibility, in addition to individual responsibility.

### ***Board of Directors and Collective Action***

As discussed in relation to the TMT, and as discussed under the heading “The Board of Directors as a Group of Individuals”, the board makes decisions and takes action as a group. The factors referenced in the discussion indicate some of the distinctive aspects of decision-making by a board of directors, acting as a group, as compared with other groups.

## **Organizational Goals and Corporate Operations**

### ***Historical Development of Operations***

As discussed extensively in Chapter Two, Chandler described the evolution of the corporation in the United States during the nineteenth and twentieth centuries as technology and modern management techniques evolved, enabling corporations to pursue various strategies, and enabling and, some extent, requiring them to adapt their organizational schemes accordingly, including effecting changes in the structures, processes, and management and personnel practices, of such corporations. Chandler, Fligstein, and others described the evolution of corporations operating exclusively or primarily in the United States into multinational enterprises conducting operations around the world.

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<sup>191</sup> See also the study by Raes et al., *supra* note 145, and literature cited in that footnote and others in that section. See also: Amy J Hillman, Gavin Nicholson, and Christine Shropshire, "Directors' Multiple Identities, Identification, and Board Monitoring and Resource Provision" (2008) 19:3 Organization Science 441.

### *MDCs and MNEs*

As discussed in Chapter Three under the heading “Headquarters Functions, Strategy, and Structure”, Chandler examined the relationship among the strategy, structure, and headquarters and business unit functions in the case of various multidivisional corporations.<sup>192</sup> Chandler stressed the importance of the monitoring function as being intimately related to strategic planning and resource allocation, a classic, if not the defining or ultimate, entrepreneurial function.<sup>193</sup>

As also seen in Chapter Three, this time under the heading “Multinational Enterprise Organizational Structure”, Theodore Herbert discussed various generic strategies, largely based on resource flows, that would lead to internationalization and other structural design criteria that have been found to impact the strategy and structure adopted with respect to multinational operations and to affect their evolution and development.<sup>194</sup>

The relationships between headquarters and business units on the one hand, and among business units, on the other hand, are referenced in Chapter Three under the headings “The Headquarters-Strategic Business Unit Relationship” and “Relationships Among SBUs”, respectively. Research by Bouquet and Birkinshaw<sup>195</sup> and by Birkinshaw and Hood<sup>196</sup> reviewed under those headings explored various models of the structure and process considerations in the relationships between the headquarters and business units of MNEs. In particular, the relationships between meta-level organizational goals, on the one hand, and goals of MDCs and MNEs are discussed earlier in the present chapter under the headings “Goals of the Corporation as Organization” and “Organizational Control of Intraorganizational Groups by Corporations”. Hence, only a few supplementary remarks concerning change are offered here.

With respect to both MNEs and MNCs, of course, the evolution of the ultimate parent corporation’s strategy, at both the organizational and business unit levels, and the development of the related structure, processes, and management and personnel practices often lead to significant change and even to significant periods of change within the organization at various levels. For

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<sup>192</sup> *Supra* note 33. See also J Child, "Organizational Structure, Environment, and Performance: The Role of Strategic Choice" (1972) 6:1 *Sociology* 1.

<sup>193</sup> *Supra* note 33 at 34.

<sup>194</sup> Theodore T Herbert, "Strategy and Multinational Organization Structure: An Intraorganizational Relationships Perspective" (1984) 9:2 *Academy of Management Rev* 259.

<sup>195</sup> *Supra* note 30.

<sup>196</sup> *Supra* note 114.

example, the structure of authority, and the relationships between formal and informal structure and formal and informal authority frequently evolve<sup>197</sup>, as does the relationship with the host countries of the relevant foreign subsidiaries or other operations.<sup>198</sup>

For example, as noted earlier in the present chapter under the heading “Internal and External Threats to Organizational Stability”, as the corporation adapts its strategy to environmental changes, it may seek to change its structure, as posited by Chandler.<sup>199</sup> Such change in structure may make it appropriate to change the means by which the corporation exercises control over its business units generally or in particular cases.

As noted earlier in this chapter under the heading “Power, Organizational Stability, and Change”, according to the present author’s interpretation of Bierstedt, the formality of the organization and its formal authority, and their development, are mitigated by informal relationships and the informal organization. This is particularly important at times when structural readjustments become necessary or are otherwise being made to the formal structure and formal authority: in such cases, formal authority or institutionalized power require support from the uninstitutionalized power which resides in the informal relationships and the informal organization relating to the same.<sup>200</sup>

It may, perhaps, go without saying that during significant periods of change authority relationships may come under some pressure and the relationship between formal and informal authority and between the operations of the formal and the informal organization may also change. These circumstances may exacerbate the normally considerable difficulties of assigning business or legal responsibility to particular groups or to particular individuals.

### ***Inceptions and Terminations of Operations***

As discussed in Chapter Three under the heading “Organizations as Polities”, as corporations seek to enter into new areas of operation or to withdraw from existing areas of operation, various groups or subgroups within the organization may be differentially affected. These different effects may

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<sup>197</sup> *Supra* note 157 at 261-266 ff.

<sup>198</sup> *Ibid* at 268-269.

<sup>199</sup> *Supra* note 33 at 38-41.

<sup>200</sup> *Supra* note 35 at 735.



include differences in the affect of individual members of the organization, group, or subgroup, such as identification with, and commitment, or loyalty, to, affected groups or subgroups.

Entries into or exits from the corporation's areas of operation may also differentially affect various levels within the hierarchy of the corporation, group, or subgroup, as the case may be. As previously seen, Simon suggests that prestige and power may be considered to have a greater value and hence to be more important as independent goals or objectives as one ascends the organizational hierarchy.<sup>201</sup>

For example, an acquisition may enhance the prestige or power of an officer of the corporation to a greater degree if the officer is a member of the top management team, as compared with officers at lower levels of the hierarchy. Similarly, the disposition by the corporation of the unit or subunit to which an individual belongs may be regarded by that individual as positive, at least in personal terms, if the individual secures continued employment of the corporation at a higher level in the hierarchy, or at a higher level of compensation, or if the function in which the individual is to be engaged is or becomes more central to, or a "core function of, the corporation as a whole.

Of course, commencement of new, or termination of existing, areas of operations may be consequential upon other changes in goals and objectives. As Meyer Zald observes, changes in goals tend to produce conflict and disaffection, and, if such changes in goals are significant, may threaten the existence and viability of the organization.<sup>202</sup> Such effects may be particularly attenuated in cases of inceptions and terminations of operations.

### ***Changes in Coalitions and in the Environment***

As noted in Chapter Three under the headings "Competing Preferences Within the Firm, and Formation of Coalitions" and "Continuing the Coalition", one may treat the formation of a business firm or corporation as involving a political coalition responsive to the demands of its constituents. In that event, it is clear, according to March, that the demands of organizational constituents are not constant but, instead, shift "in response to experience (both actual and vicarious), and the attention which may be brought to bear upon such demands, namely, "the extent to which they are seen as relevant to action – shifts in response to the perception of problems".<sup>203</sup>

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<sup>201</sup> *Supra* note 127 at 117.

<sup>202</sup> *Supra* note 2 at 362-363.

<sup>203</sup> *Supra* note 1 at 673.

Consequently, as the coalition represented in the firm changes, the goals and commitments of the corporation also shift, even if slowly, over time.<sup>204</sup> Of course, the corporation must also continue to monitor and respond to conditions in its environment, both internal and external. These changes in conditions might result in changes in strategy, structure, and process, becoming appropriate.<sup>205</sup>

### ***Changes in Goals and in Monitoring***

As discussed in Chapter Three, Chandler shows that the upper levels of the hierarchy of the corporation, including at headquarters and divisional levels, vary the nature and extent of their involvement in planning, monitoring, and control, depending on the nature of the goals and objectives pursued by the corporation at the relevant time.<sup>206</sup> Accordingly, changes in goals and objectives would be expected to result in changes in these functions.

Changes in goals and objectives may often be considered to be salutary, at least to the extent that such changes aim to maintain and continue the existence of the organization. They may be considered, variously, as evidence of its continuing “relevance” to its environment; as evidencing a capacity to attain a certain range of goals and objectives; as evidence of the organization’s effectiveness in terms of its ability to attain certain goals and objectives to date; as a means of fine-tuning existing goals and objectives; as a means of adding new and more relevant goals and objectives and eliminating older and less salient goals and objectives; and as claiming new goals and objectives for the organization which may be instrumental to, or congruent with, existing goals and objectives of groups, subgroups, and individuals within the organization.

### **Goals of Corporations**

#### ***Profit Maximization as Superordinate Goal***

As shown in Chapter Three, commentators have established that the claim that all corporations have only a single goal, that of making a profit, is highly problematic at the very least, and, more likely, highly inaccurate. James March’s attack on this assumption from a theoretical perspective, which is summarized in a number of the initial subheadings in that chapter under the heading “Organizations as Political Systems”, is well considered and highly persuasive.

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<sup>204</sup> *Ibid* at 675.

<sup>205</sup> See Chandler, *supra* note 33 at 48.

<sup>206</sup> *Ibid*.

Even more persuasive, however, is his report that the studies of behaviour of firms is not consistent with the single superordinate goal of profit maximization.<sup>207</sup> He asserts that studies of polities have likewise been unable to derive a single superordinate goal, such as the “public interest”, which is simultaneously meaningful, stable, and valid.<sup>208</sup> Accordingly, studies of conflict resolution in both firms and in polities became focused on theorizing conflict resolution by means of a superordinate process, rather than by means of a superordinate goal.<sup>209</sup>

That is not to say, course, that corporations do not have end goals. Instead, the author’s assertion is that they likely have a number of ultimate goals, the prioritization of which at any particular time is dependent upon the exercise of power and influence within the corporation; and they may also have a multiplicity of instrumental goals ranked by similar means.

It has likewise been established, elsewhere and in the present work, that each component (unit or subunit) of the corporation has a number of goals and objectives, some of which may align to varying degrees, and others of which may not align at all, with those of the corporation as a whole. While some of these may be assigned by superior elements and levels of the hierarchy of the corporation, others may not be so assigned. It has also been established that some of the goals of a particular component may align, and others may not align, with the goals of other components, whether in related or unrelated areas of the corporation, at similar or different levels within the corporate hierarchy, or otherwise.

It has also been demonstrated that each component of the corporation may compete with some one or more components of the corporation for resources and otherwise; that the power and influence of each component may vary from one to another; and that each component may engage in activities aimed at increasing its power and influence vis-à-vis the headquarters of the corporation and vis-à-vis other components.

It is now in order to discuss the taxonomy of goals of the corporation and its components.

### ***Typology of Goals in Corporations***

The review in the early sections of this chapter of Charles Perrow’s important work on organizational goals discussed his important distinctions among official goals, and unofficial

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<sup>207</sup> *Supra* note 12 at 670.

<sup>208</sup> *Ibid* at 671.

<sup>209</sup> *Ibid*.

goals, and operative goals. “Where operative goals provide the specific content of official goals they reflect choices among competing values.” They may also reflect the ends sought through the actual operating policies or “what the organization actually is trying to do, regardless of what the official goals say are the aims.”<sup>210</sup>

These may be distinguished from instrumental goals in aid of official goals, which would be expected to consider the ways in which the organization actually goes about achieving its official goals. As is often the case, stated purpose and reality may differ: the goals actually pursued may not be the official goals claimed by the corporation or other organization.

Perrow says that: “A business corporation, for example, may state that its goal is to make a profit or adequate return on investment, or provide a customer service, or produce goods.”<sup>211</sup> As demonstrated previously, its actual goals may be expected to be somewhat more complex and diverse: “If profit-making is an overriding goal of an organization, many operative decisions must still be made which will shape its character.”<sup>212</sup> While the official goals can be determined from official documents and sources, the operative goals pursued by the corporation can be determined only by empirical investigation. Some consequences of these observations are discussed next.

### ***Managerial Capitalism and Goals***

Perrow, refers to the frequent assertion “that the importance of profits, *per se*, has declined with the increased power of professional management, especially in large organizations” on the grounds that “since management does not have a personal stake in profits, they consider them less important than stability, growth, solvency, and liquidity.”<sup>213</sup> Perrow cites a study conducted by James Dent which surveyed executives of one hundred and forty-five business firms of varying sizes concerning the aims of top management of their organizations, finding that making a profit was reported most often, and that employee welfare and “good products or public service” tied for second place.<sup>214</sup> This suggests that generating, but not necessarily maximizing, profit is important.

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<sup>210</sup> *Supra* note 1 at 855.

<sup>211</sup> *Ibid.*

<sup>212</sup> *Ibid* at 863.

<sup>213</sup> *Ibid* [emphasis in the original]. The congruence with Chandler’s observations may be noted.

<sup>214</sup> *Ibid* at 864, citing: James K Dent, "Organizational Correlates of the Goals of Business Managements" (1959) 12 J Personnel Psychology 375 at 375-376.

Perrow repeats Robert A. Gordon's assertion "that the common pattern of evolution is for active leadership by owners in the early years of the firm, then it is passed on to new generations of the families concerned, and gradually responsibility for decision-making passes to professional executives who frequently have been trained by the original leaders. Goals likewise shift from rapid development and a concern with profits to more conservative policies emphasizing coordination, stability and security of employment."<sup>215</sup>

As noted in Chapter Two and in the present chapter, Chandler chronicles similar developments in Great Britain and in the United States, but relates changes in responsibility for decision-making to the impact of technology on the scale of operations of corporations, leading, among other things, to the advent of the professional manager and to "managerial capitalism".<sup>216</sup> He concludes, with Dent and Gordon, that the "decision-making of such career managers was observed to favour long-term stability and growth, rather than maximizing current profits."<sup>217</sup>

As indicated previously, Herbert Simon averts to the "conservation" values of an organization, which are those derived from the size and growth of the organization which are relevant, in personal terms, to the professional managerial group who exercise actual control or, in effect, act as the dominant coalition.<sup>218</sup> As already mentioned, these may be expected to include prestige, reputation, extraorganizational power and influence, compensation, and many other attributes of, or related to, the organization.

Simon explains that the group "which exercises the power of determining the basic value criteria" of the organization "will attempt to secure through the organization its own personal values – whether these be identified with the organization objective, with the conservation objectives, with profits or what not." But, according to him, that group is not able to exercise "an unlimited option to direct the organization in any path it desires, for the power will continue to exist only so long as the controlling group is able to offer sufficient incentives to retain the contributions of the other participants to the organization."<sup>219</sup>

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<sup>215</sup> *Supra* note 1 at 864, citing: Robert A Gordon, *Business Leadership in the Large Corporation*, (Washington, D. C.: Brookings Institution, 1945) at 308-312, 322, 327-329, 336, 340.

<sup>216</sup> *Supra* note 22, and note 23, and note 33.

<sup>217</sup> *Supra* note 23 at 10.

<sup>218</sup> *Supra* note 127 at 117.

<sup>219</sup> *Ibid* at 119. This seems to adopt the political coalition theory credited to his collaborator, James March.

Thus, he indicates that “in business organizations, the control groups can ordinarily be expected to be oriented primarily toward profits and conservation.”<sup>220</sup> Clearly, the profit generation objective must be balanced against the organization objective and conservation objectives. In effect, this means that profits need not be maximized but, instead, should be optimized. That is to say, the profit objective should be expressed in terms of satisficing, rather than in terms of absolute quanta, and in terms of balancing it as against other organization and conservation objectives.

Such control group orientations indicate that the control group should employ all of the corporation’s resources, including financial and personnel resources, “in such a manner as to attain a maximum of inducement to employees, and a maximum of attainment of organization objectives with these resources.”<sup>221</sup> Simon considers this to be a criterion of efficiency. We would note, however, that such inducements must be provided to all providers of resources, not just to employees.

Simon explains that, despite the apparently opportunistic pursuit of efficiency, “most commercial organizations...do tend usually to maintain fairly stable objectives”. He expresses this stability of objectives in terms of the business actually pursued by the corporation. According to him, such stability arises because: firstly, “sunk costs” incurred by the organization “make immediate and rapid adjustment unprofitable even from the standpoint of conservation”; secondly, the organization normally acquires know-how in a particular field, which he describes as an intangible sunk cost or, more properly, a “sunk asset”; and, thirdly, it also requires goodwill “which is also a sunk asset that may not be readily transferable to another area of activity.”<sup>222</sup>

Simon says that “stated differently, a change in organization objectives ordinarily entails decreased efficiency and use of resources (sunk costs and know-how) and a loss of incentives otherwise available to maintain a favorable balance (goodwill).”<sup>223</sup> Consequently, changes in organization objectives may be expected to be effective, in most cases, gradually, partly in order to continue to benefit from accrued sunk costs and know-how, least until such time as the benefits of the new area of activity may be realized, in whole or in part. This kind of organizational objective “arbitrage” may be expected to be especially characteristic of industries or markets characterized

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<sup>220</sup> *Ibid.*

<sup>221</sup> *Ibid.*

<sup>222</sup> *Ibid* at 120.

<sup>223</sup> *Ibid.*

by administered competition and whose participants have enormous organizational scope, for example, in the petroleum industry, in which the market capitalization of ExxonMobil Corporation over the past 20 years has consistently placed it in the top ten publicly traded corporations.

The present work has frequently observed that the assumption that the dominant or superordinate goal of all corporations is maximizing current profits must be considered to be counterfactual and erroneous. As a result, such assumption should not be operationalized in examinations of the goals and objectives pursued by boards of directors, top management teams, senior and other executives, middle managers, and others, vis-à-vis the assignment of responsibility as a matter of law or otherwise. This will be discussed further in the next following chapter.

It goes without saying that shifts in goals, such as those chronicled by Perrow, Gordon, and Chandler, may or may not be articulated as changes to formal goals but may be reflected, instead, in operative goals only. Consequently, as advised by Perrow, determining operative goals and shifts in formal, as well as operative, goals will require an empirical investigation, involving what goals are currently pursued by a corporation as a matter of fact and are, accordingly, its real “goals in action”.

### ***Changes in Power and Goals***

Perrow describes how skill groups can come to dominate boards of directors and other management levels, saying that, firstly, because of technology and stage of growth, a particular department may “effectively exercise a veto on the executive’s decisions and subsequently shape decisions in other departments”; while, secondly, top executives may be recruited from one powerful department and “retain their identification with the parochial goals of that department.”<sup>224</sup>

He says that where one task area dominates a firm, there may be no shifts in power, with the result that operative goals will remain fairly stable. However, where basic tasks shift, either because of growth or changing technology, operative goals may change, with concomitant shifts in power. Despite such changes, however, “the formal authority structure may not vary during this sequence,

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<sup>224</sup> *Supra* note 1 at 865.

but recruitment into managerial positions and the actual power of management, trustees or skill groups would shift with each new problem focus. Multiple leadership is also possible”.<sup>225</sup>

As discussed earlier in this chapter under the heading “Theories of Intraorganizational Power”, strategic contingencies theories, as articulated by Hickson and Hinings and their collaborators,<sup>226</sup> or by Salancik and Pfeffer,<sup>227</sup> attribute the intraorganizational power of components of the corporation in large part to the ability of such component to contribute to the reduction of uncertainty, and the garnering of resources critical to, the corporation as a whole.

As demonstrated in the discussion there, this may also result in changes in the relative power of components of the corporation as a whole, both vis-à-vis the corporation itself, and vis-à-vis other components of the corporation. Determining where intraorganizational power resides and whether there is any change in the locus of such power is a matter for empirical investigation. The existence of informal relationships and of the informal organization, and the extent of their power and influence, as described in Chapter Five, notably under the heading “Formal Organizations and Informal Organizations”, is such that the relevance of the formal “organizational chart” to such matters must be considered to be problematic.

### ***Pursuit of Multiple Goals in Corporations***

The present discussion of the goals of the corporation has found grounding in the empirical and theoretical work of Chandler, March, and Perrow. Among other things, it has been found that while one of the goals of the typical corporation is normally to generate profit, neither generating profit nor maximizing profit is the single superordinate goal of the corporation; and that, instead, in most cases, a corporation has a number of ultimate goals or end goals, as well as certain operative goals and instrumental goals. It is also been shown that goals operate not only at the organizational level, that of the parent corporation, but also at intraorganizational levels, in functions, divisions, groups, subgroups, and other components of the corporation.

James March maintains that his theory of the business firm as a political coalition “has both face validity and a certain amount of empirical support”, especially as it “seems more consistent than

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<sup>225</sup> *Ibid.*

<sup>226</sup> *Supra* note 54.

<sup>227</sup> *Supra* note 17.



other available theories with [certain] widely observed attributes of business decision making.”<sup>228</sup> The attributes to which he appeals in this regard are as follows: “1. Organization goals seem to be a series of more or less independent constraints. 2. Business firms seem to tolerate a rather large amount of apparent inconsistency in goals and decisions, both over time and from one part of the organization to another. 3. Goals and decisions tend to be paired and decentralized with loose cross connections. 4. The extent to which decisions within the firm involve extensive conflict and "marginal" decisions varies with the munificence of the environment. 5. The goals and commitments of business firms shift slowly over time in response to shifts in the coalition represented in the firm.”<sup>229</sup>

A proper response to March’s points is as follows: 1. We agree that both theory and empirical research support a multiplicity of goals, rather than a superordinate goal of profit-making. 2. Our review of theoretical and research literature suggests that goals of the organization at one time may not persist to another; may not be pursued in all cases, or in, or by, all components of the organization; and, in some cases, may be differentially applied, minimally applied, or ignored. Thus, March’s second point seems to be well supported. 3. Components of the corporation, including divisions, departments, groups, and subgroups will rationally pursue component-relevant goals set by the organization in anticipation of, and thereby intended to facilitate the attainment of, organization-relevant goals. 4. The availability of resources, whether scarce or munificent, affects the choice of goals, both at the corporate or organizational level and at the component level, and, in both cases, although normally to a greater extent with respect to scarce resources, may promote intraorganizational conflict. 5. Goals of corporations and their respective components may be expected to shift in response to changes in their internal and external environments, which may include the constellation of power within the corporation, or within the focal component.

March maintains that models of firm decision-making “have not gone beyond the static implications of the fact that firms are political coalitions. Essentially they assert that certain phenomena occur in the firm because of its character as a coalition. They do not attempt to reflect

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<sup>228</sup> *Supra* note 12 at 675.

<sup>229</sup> *Ibid.*

shifts in coalitions per se.” Instead, he argues that describing shifts in coalitions, leading to a more general theory of coalition development, “has hardly been touched except conceptually”.<sup>230</sup>

Of course, the present work does not seek to develop a theory of decision-making in terms of coalitions but, instead, has sought to establish that such a “political” approach can contribute much to understanding the theory and operations of corporations. In that sense, it is but one aspect of conceptualizing the corporation as involving an organization, and not only as a rights-and-duty-bearing entity in law. We consider that up to this point we have established the capacity of such a conceptualization to the legal understanding of the corporation. This work now proceeds to consider this dual conception.

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<sup>230</sup> *Ibid* at 678.

## **SECTION B – THE CORPORATION AS LEGAL ENTITY AND AS ORGANIZATION**

### **CHAPTER SEVEN – A CORPORATIVE THEORY OF CORPORATE LAW AND GOVERNANCE**

#### **PURPOSE AND SCOPE OF THIS CHAPTER AND THE FOLLOWING CHAPTERS**

Part 1 of this book examined what are normally considered to be the essential legal attributes of the corporation as instantiated in modern corporate statutes, how they engage with the common law and, in particular, agency law, and how those attributes are interrelated as a matter of law and otherwise. Part 2, together with Appendix A, investigates assumptions or generalizations of classical and neoclassical economic theory, and of other academic disciplines and fields, which are reflected in discourse concerning the firm and the corporation, in part, least, in an effort to determine whether, and if so, to what extent such assumptions or generalizations are instantiated in the declarative law applicable to the modern business corporation.

The present part, Part 3, investigates the modern business corporation as a species of organization, that is, from the perspective of organizational theory and practice. That investigation, as conducted in Chapters Four to Six inclusive, also brought to bear theory and research from a number of academic disciplines and fields, including not only economics, but also, principally, social psychology, sociology, political science, social theory, and various management and business disciplines and fields.

The present chapter investigates how the essential characteristics of the modern business corporation as a matter of law, as described and considered in Part 1, may be impacted by the essential characteristics of the modern business corporation as an organization, as described and considered in Parts 2 and 3 and Appendices A and B. Accordingly, the present investigation will involve considering how the attributes of the corporation, as an organization, relate to each of its essential legal attributes, as a corporation as a matter of law.

#### **WHAT NEW METHOD OF ANALYSIS? AND WHY?**

In analyzing the corporation, including analyzing the corporation from a legal perspective, it is common to characterize the corporation, very often implicitly, from an organizational perspective, that is to say, treating the corporation as an organization, like other organizations, but without expressly acknowledging this.

It is as if concentrating attention on those legal aspects of the corporation which are distinctively “legal” invisibilizes, or, at least, occludes, other aspects of the corporation. In this case, such other aspects include the ways in which the corporation acts, as a legal actor, an economic actor, a social actor, a political actor, and, generally, in any capacity whatever with respect to human individuals or entities other than the focal corporation itself.

Legal writers, including law professors, legal practitioners, and theorists, when engaging with the corporation, assume, almost always without explicit acknowledgement, that the corporation or, at least, the “more-than-one-individual corporation”, possesses organizational attributes and, in fact, either is, or engages with, something that can be characterized as an organization.

Volumes, too numerous to count, have been written concerning the corporation as an economic actor, that is, acting in “the economy”; as a social actor, that is, acting in a “society”; and as a political actor, that is, acting in the “polity” or in relation to the “state”. These have included works of theory, including works concentrating on economic theory, social theory, political theory, and, of course, legal theory.

Those works concentrating on legal theory have frequently involved extensive consideration of economic theory, social theory, political theory, and other subject-matters. It is not the purpose of the present work to demean or diminish the importance of analyzing the corporation from the perspective of economics or the economy, society, or the polity or state. On the contrary, it is acknowledged that these perspectives are extremely useful and important to the theory and practice of corporate law, including its statutory and other regulation.

It is, instead, the contention of the present work that all too few works of legal theory have concentrated on aspects of the corporation from a legal perspective, and most notably, with respect to its essential legal attributes, which are consequences of, or may be affected by, or related to, its organizational status; and, consequently, all too few such works have considered, extensively or otherwise, the organizational research and theory applicable to the same. The focus of the present work is to investigate whether, and if so, how, and to what extent, consideration of the corporation from an organizational perspective, including theory and research, may inform legal theory and practice in relation to the corporation.

The earlier chapters in the present Part 3 of this work, together with the earlier Parts of this work, have explicated certain aspects of organizational analysis, including research and theory, most

especially those which may be considered as more immediately applicable to the corporation, and have frequently identified their implications with respect to the corporation. The remaining chapters in Part 3 investigate the questions: What difference does this make? How does our investigation of the corporation as organization and of organizational theory and practice inform, affect, modify, or even transform, our understanding of the corporation as a matter of law, both in theory and practice?

In keeping with the descriptive methodology of the present work, the present chapter will proceed by considering: firstly, the extent to which the essential legal elements of the corporation, as discussed in Part 1 of this work and as they are instantiated in declarative law (as further described in this paragraph), are or may be affected by the essential organizational attributes of the corporation; secondly, the extent to which corporate discourse and corporate essentialist legal discourse engages with or may be affected by essential organizational attributes and otherwise by organizational theory and practice; thirdly, how such organizational analysis may be brought to bear on the legal analysis of the corporation, in theory and practice; and, fourthly, a few summary examples of how this approach may be instantiated. These issues will be discussed under headings related to each of the essential legal elements of the corporation. The instantiation of each of these legal essentialist characteristics in declarative law will, for the sake of simplicity, mainly focus on the Canadian business corporation statutes discussed in Part 1 and Appendix A of this work. While there are some differences between incentives and the American statutes discussed there, discussion of those differences would entail diversions from present objectives which are too great to countenance.

In conclusion, the findings of this work will be summarized as the “corporative theory of the corporation” or, expressed alternatively, the “corporative perspective on the corporation”. In this regard, it is intended that this corporative theory or corporative perspective be applicable not only with respect to legal theory and practice relating to the corporation, but also to organizational theory and practice more broadly, including in such disciplines as economics, sociology, political science, social theory, organizational theory, and in such business disciplines as organizational behaviour, general management, strategy, information management, and finance.

## WHY NOW?

In the course of investigating assumptions and generalizations commonly made about the firm and, more particularly, the corporation, as an economic actor, Part 2 and Appendix B compared the assumptions of classical and neoclassical economics in that behalf with research-based evidence and theory with respect to the “corporation in action”, in effect, as an organizational actor, by which is meant an organization which acts, as such, “in the real world”.

In that connection, Part 2 reviewed the exposition by the pre-eminent business historian, Alfred D. Chandler, Jr., of the development of the modern business corporation in the United States during the latter part of the nineteenth and much of the twentieth century. As part of the book’s descriptive or descriptivist methodology, this review revealed the “corporation in action” or the corporation in the “real world” during that period and, when combined with other materials surveyed, up to the present time.

Chandler emphasized, firstly, the massive impact of technological developments, such as advances in communications and transportation, on the design, production, sales, and distribution of products during that period; secondly, the impact of all of the foregoing developments on industries and markets; and, thirdly, on the corporations involved in such concerns. In respect of the latter, Chandler described the characteristics, evolution, and development of “managerial capitalism”, which was enabled and facilitated, and arguably even necessitated, by the technological developments which eventuated and the attendant consequences. The impact which Chandler ascribed to managerial capitalism, it will be recalled, was extremely significant, not only for the corporations concerned, but also for the relevant industries and markets, and for the economy, society, and polity, more generally.<sup>1</sup>

Chandler demonstrated the importance of the telegraph and extensive railway systems to mass production and distribution, which, in turn, had extremely important economic, social, and political consequences. These included reducing imbalances of standards of living as between rural and urban areas, promoting consumption, arguably leading to the “consumer society” of the latter half

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<sup>1</sup> See, especially, Chapter Two in the section entitled "History of the Development of the Modern Business Corporation" and therein under the heading "Administrative or Organizational Development and Economic Theory".

of the twentieth century, increasing awareness of distant states, regions and cities, and facilitating greater economic, social and political unification, and nationalism.<sup>2</sup>

Chandler implicitly compared this to the “great transformation” described by Polanyi as involving the “dual movement” embracing the increasing dominance of the market as economic, societal, and political institution, and the “commoditization” of non-commodities; combined with the development of social protection mechanisms, legislatively and otherwise, to ameliorate the most pernicious effects of such marketization and commoditization.<sup>3</sup>

The developments which were related to Chandler’s “great transformation” or, even if not so related, eventuated in the period under review, included the development of the automobile and the American national highway system, the development of the assembly line system or “Fordism” and improvements in it, including by way of “time and motion study” and other elements of scientific management or “Taylorism”, and the development of business machines, including, eventually, the computer.<sup>4</sup> Nevertheless, the nature and scale of the technological or technologically enabled developments which have eventuated since Chandler wrote about this in 1977 have been both massive and massively impactful. These more recent technological or technologically enabled developments are, to some extent, described in previous chapters of the present work, and others are sufficiently familiar to readers not to require their exposition here. The pace of such developments may be expected to continue and even to accelerate in subsequent periods of like duration.

If Chandler is right, then the massive scope and scale of the developments in the economy, society, the polity, including developments in industries, markets, and in the methods by which economic, social, and political actors organized themselves to respond to these developments, as corporations and other organizations, which transpired over the past one hundred and fifty years may be

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<sup>2</sup> See, especially, Chapter Two in the section entitled "History of the Development of the Modern Business Corporation" in therein under the heading "Strategy and Structure".

<sup>3</sup> See, especially, Chapter Two in the section entitled "History of the Development of the Modern Business Corporation" and therein under the heading "Strategy and Structure"; and Appendix A, Chapter A2 – under the headings "Karl Polanyi's Embeddedness" and "Polanyi and Granovetter Compared".

<sup>4</sup> See, especially, Chapter Two in the section entitled "History of the Development of the Modern Business Corporation" and therein under the heading "Administrative or Organizational Development and Economic Theory".

expected to be exceeded, perhaps even greatly exceeded, by developments over the next one hundred and fifty years.

Just as “managerial capitalism” evolved as an organizational adaptation by the economy, society, and the polity generally, but, more particularly, by corporations, to technological or technologically enabled developments in that century and a half, organizational adaptations, perhaps even more considerable in scale and scope, may be expected to eventuate in the future. If that is the case, it becomes extremely important for corporate and organizational law to carefully consider the nature of the corporation and other business organizations, as a matter of law, both in theory and in practice.

In fact, it may be that evolution of the corporation, at least as a matter of legal theory, has not yet fully “caught up to” the development of managerial capitalism. While the practice of corporate law is arguably somewhat more advanced in that regard than corporate legal theory, for example, with respect to corporate and organizational criminal liability, much remains to be done.

It may be contended that, in many ways, the advancement of corporate legal theory, which, by now, has proceeded beyond classical and neoclassical economic analysis of the firm, is still inhibited by the singularity of its attention to economic analysis alone, without consideration of, or benefit from, other academic disciplines, including business strategy, general management, organizational behaviour, organizational theory, psychology, sociology, and political science.

As corporations struggle to embrace, or otherwise adopted, the technological and technologically enabled developments and related organizational developments, such as by means of virtual organizations or organizations which are “hollowed out” as compared with the corporations of past eras, and to respond to other changes in their ambient physical and other environments, many of which raise concerns about the sustainability of corporate activities, concerns about the physical environment (such as global warming), and social responsibilities of corporations and other business entities, questions arise anew concerning the corporation, in particular, what it is, and what purpose or purposes does it or should it serve.

Corporative analysis can be helpful in this regard: firstly, proceeding by descriptivist analysis to determine what it is that is identified as a corporation and what functions it carries out; and secondly, by focusing on its legal essentialist characteristics and investigating their relationships



with changing (and some unchanging) internal and external phenomena which engage with these contemporary issues.

## LEGAL ESSENTIALIST ATTRIBUTES AND ORGANIZATIONAL ANALYSIS

In Chapter One, under the heading “The Corporation and Corporate Essentialism in Law”, the essential attributes of the corporation in law were identified as: 1. separate legal entity (“SLE”) status; 2. limited liability or asset partitioning; 3. transferable equity interests and capital lock-in; 4. central management independent of “owners” of the equity interests or equity capital; and 5. indefinite duration. Each of these attributes is described under separate eponymous headings in that section of Chapter One.

While alternative formulations of these attributes are in common use, most of these direct attention to similar features.<sup>5</sup> For example, Armour, Hansmann and Kraakman refer to the “five core structural characteristics of the business corporation” as being “(1) legal personality, (2) limited liability, (3) transferable shares, (4) centralized management under a board structure, and (5) shared ownership by contributors of capital.” They indicate that “in virtually all economically important jurisdictions, there is a basic statute that provides for the formation of firms with all of these characteristics, which they describe as “having strongly complementary qualities”.<sup>6</sup>

The present part of this chapter will discuss each of these attributes, principally with respect to the contribution which is, or might be, made by organizational analysis with respect to each attribute and how such contribution may inform legal theory and practice. Of course, these attributes are interrelated. Accordingly, discussion of one attribute often necessarily requires some reference to one or more other attributes, which entails that discussion of a particular attribute may sometimes appear under headings related to one attribute and sometimes under headings related to one or more of the correlated attributes. Appropriate cross-

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<sup>5</sup> Jason Neyers lists “limited liability, effective legal personality, perpetual existence, free transferability of shares, and separation of ownership and control”, which he describes as “an amalgam of the traditional attributes listed in P.L. Davies (with contribution from D.D. Prentice), *Gower’s Principles Of Modern Company Law*, 6th ed. (London: Sweet & Maxwell, 1997) at c. 5.; R.C. Clark, *Corporate Law* (Boston: Little Brown, 1986) at s.1.1 (2); H.A.J. Ford & R.P. Austin, *Principles of Corporations Law* (Sydney: Butterworths, 1995) 86-7; L.E. Ribstein, ‘Limited Liability and Theories of the Corporation’ 50 Mar. L. Rev. 80 at 89.” Thus, his list, which is very similar to the one used in the present text, reflects English, Canadian, and American usage. See Jason Neyers, “Canadian Corporate Law, Veil-Piercing, and the Private Law Model Corporation” (2000) 50:2 UTLJ 173 at 176.

<sup>6</sup> John Armour, Henry Hansmann, and Reiner Kraakman. “The Essential Elements of Corporate Law” (2009). University of Oxford Legal Studies Research Paper No. 20/2009; Yale Law, Economics & Public Policy Research Paper No. 387; Harvard Law School Law and Economics Research Paper No. 643; Harvard Law School Public Law & Legal Theory Research Paper No. 09-39; European Corporate Governance Institute Law Working Paper No. 134/2009. Available: <https://papers.ssrn.com/abstract=1436551>.

references, the detailed headings and subheadings in the chapter, and the Table of Contents are employed in an effort to make sense of such correlations. In some cases, detailed discussion of the correlation appears in relation to the first attribute discussed, while in other cases, such detailed discussion is deferred and appears in relation to the subsequent correlated attribute discussed. Often, determination of the order of this discussion depends upon its salience to other topics referenced in the focal discussions.

### **FACT PATTERN FOR DISCUSSION – GREAT MOTORING CORPORATION**

For the purpose of discussing how the essential attributes of the corporation as a matter of law may be affected by essential attributes of the organization of the corporation, it will be convenient to use the following example or fact pattern as a basis for discussion:

1. The business enterprise which is the focus of our discussion and which is intended to, and actually does, bear no resemblance to any real corporation has, as its ultimate parent corporation, a public corporation listed on the New York Stock Exchange known as Great Motoring Corporation (“GMC” or the “Corporation”) which has several million shareholders resident in various jurisdictions all over the world. It is incorporated in one of the jurisdictions whose declarative corporate law was surveyed in Part 1 of this book. This is also the case with respect to each of its subsidiaries all of whom are wholly-owned in the sense that 100% of their equity shares are owned by GMC or other of its subsidiaries or both. The headquarters of GMC coordinates the activities of its divisions and departments which operate across its relevant operations, however such operations are legally organized. This is the first level of the organization’s hierarchy.
2. GMC manufactures vehicles and has four divisions, each of which bears the brand name of vehicles manufactured and sold by the division: Challenger, Champion, and Ultimate for automobiles and Great Motor Trucks, or “GMT”, for trucks. This is the second hierarchical level. Challenger and Champion operate as divisions of GMC, without being separately incorporated, while Ultimate and GMT are separately incorporated.
3. Each division has five departments: Design; Manufacturing; Marketing, Sales and Distribution (usually called “Sales”); Finance and Treasury (usually called “Finance”).
4. Accounting, Control and Operations (usually called “Operations”). This is the third hierarchical level.

5. Each department is subdivided into units or groups which involve separate functions within the division, for example, the separate Accounting group, the Control group, and the Operations group within the Operations division. This is the fourth hierarchical level.
6. Each unit or group is, in turn, subdivided into subunits or subgroups which involve separate subfunctions within each unit or subunit. For example, the Accounting group has a number of subunits or subgroups which include Accounting Principles, Depreciation and Amortization, and Consolidation. This is the fifth level of the organizational hierarchy.
7. Thus, the “organizational chart” for GMC has five hierarchical levels on the vertical axis and four levels on the horizontal axis, basically, then, filling twenty spaces on the chart.
8. The Corporation as a whole, and each division, department, unit or group, and subunit or subgroup, has numerous subsidiaries, joint ventures, partnerships, and other legal forms by which it carries on business.
9. Likewise, the corporation as a whole, and each division, department, unit or group, and subunit or subgroup operates in a variety of jurisdictions.

With that, the review of the essential legal attributes of the modern business corporation thus commences.

#### **ATTRIBUTE ONE – SEPARATE LEGAL ENTITY**

A statement that a corporation is a legal entity is easily intelligible. As previously mentioned,<sup>7</sup> among other things, a legal entity can acquire, hold, dispose of, and otherwise deal with property on its own behalf, that is to say, that it can exercise rights of ownership vis-à-vis property. It can also enter into contracts thereby acquiring rights and becoming subject to liability, in both cases, on its own behalf, in that regard. Further, it can sue and be sued and otherwise be a party to various types of legal proceedings, also on its own behalf.

A statement that an entity, such as a corporation, is a separate legal entity may be considered as a statement that its status as a legal entity is appurtenant to the entity entirely on its own behalf, and not as dependent upon, or derivative from, the status of some other legal entity. In the case of a corporation, which has shareholders, as well as management, separate legal entity status indicates that the corporation’s legal entity status is not dependent upon, nor derivative from, the status of its shareholders or of its management. This is the sense in

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<sup>7</sup> See Chapter One in the section entitled "The Corporation and Corporate Essentialism in Law" and therein under the heading "Essential Attributes of the Corporation in Law" and the subheading "Separate Legal Entity".

which such statement will be understood and explicated in the present section. Considerations of limited liability and of asset partitioning will be discussed mainly in the eponymous section below.

## **Declarative Law**

### ***A Rights-and-Duty-Bearing Entity***

As described in Chapter One,<sup>8</sup> a corporation may be considered to be a separate legal entity (“SLE”), that is to say, a rights-and-duty-bearing entity, a party or entity which may possess legal rights and which may be subject to legal duties.<sup>9</sup> These are normally considered to include the capacities to own property, to enter into contracts, and to maintain and to defend legal actions.<sup>10</sup> Its property is free of any claims of creditors of the shareholders of the corporation; and those shareholders, as such, and their assets may not be called on in respect of obligations of the corporation.

This work has maintained that the meaning of the term “legal person” is substantially identical to that of “rights-and-duty-bearing party or entity”.<sup>11</sup> Our examination of four important North American business law statutes examined this issue, finding two styles of statutory conveyance of authority. The first style, such as that adopted in the CBCA and OBCA, conveys legal authority equivalent to that enjoyed by a natural person, but may also enumerate other specific authorities which are included in the more general authority. The second style, which is adopted in the DGCA and, in part, in the MBCA, simply enumerates the specific authorities enjoyed by corporations subject to the statute.

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<sup>8</sup> *Ibid.*

<sup>9</sup> See, for example, Simon Deakin, "Capacitas: Contract Law and the Institutional Foundations of a Market Economy" (2006) 2:3 *European Rev Contract Law* 3; and Simon Deakin, "The Juridical Nature of the Firm" in: T Clarke & D Branson, eds, *The Sage Handbook of Corporate Governance* (London: Sage, London, 2012). See also Edward M Iacobucci, and George G Triantis, "Economic and Legal Boundaries of Firms" (2007) 93:3 *Va L Rev* 515, at 518 and 524; and Simon Deakin, David Gindis, Geoffrey M Hodgson, Kainan Huang, and Katharina Pistor. "Legal Institutionalism: Capitalism and the Constitutive Role of Law" (2017) 45 *J Comparative Economics* 197.

<sup>10</sup> *Ibid.*

<sup>11</sup> For example, see Chapter One in the section entitled "The Corporation and Corporate Essentialism in Law" and therein in under the heading "Essential Attributes of the Corporation in Law" and the subheading "Separate Legal Entity".

### *Relationship to Natural Persons*

CBCA and OBCA corporations have the rights, powers, and privileges of a natural person.<sup>12</sup> This is intended to mean that such a corporation has the legal capacity to engage in any activities which may be undertaken by a natural person. Naturally, a corporation cannot engage in any activities which require actual corporeal existence; but this is a factual, rather than a legal, consequence. As discussed previously,<sup>13</sup> a corporation, according to Lord Haldane, has neither mind nor body,<sup>14</sup> and, according to Blackstone, is not liable to corporal penalties, imprisonment, apprehension, arrest, or excommunication.<sup>15</sup>

The legal capacity of a natural person and, by extension, of a corporation includes owning property, entering into contracts, and initiating, maintaining, and defending legal proceedings of various kinds. As previously noted, this does not entail that the corporation is a “natural person” in view of the law, or that the corporation has “legal personality” (except in the sense stipulated) or that the corporation is possessed of “legal personhood” (except in the sense stipulated), or is, except for such purposes, otherwise to be considered a “person” as a matter of law.<sup>16</sup>

Similarly, having powers equivalent to those of a natural person does not entail, of course, that the word “person”, where used in law, whether in statutes or otherwise, always and everywhere includes a corporation, or that where the word “person” is so used, it can be replaced in relevant particular circumstances by the word “corporation”. Instead, it signifies that the corporation is recognized, as a matter of law, as an actor within the realm of “legal action”, the realm to which

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<sup>12</sup> *Ibid*, especially see Chapter One in the section entitled "The Corporation and Corporate Essentialism in Law" and therein under the heading "Essential Attributes of the Corporation in Law and therein under the subheading "Separate Legal Entity – Rights, Powers, and Privileges in Modern Corporate Statutes – CBCA and OBCA". As noted at the inception of this chapter, the modern corporation law statutes discussed in this Part are principally the Canada Business Corporations Act, RSC 1985, c C-44 [CBCA] and the Ontario Business Corporations Act, RSO 1990, c B.16 [OBCA]. However, some references are made, especially in the present chapter, to the Delaware General Corporation Law, 8 Del Code, c 1, § 101 [DGCL]; and to the Model Business Corporation Act, American Bar Association, *Model Business Corporation Act Annotated*, 4th ed, (Chicago: American Bar Association, 2008) [MBCA].

<sup>13</sup> *Ibid*.

<sup>14</sup> *Lennard's Carrying Co v Asiatic Petroleum Co*, [1915] AC 705 at 713 (UKHL).

<sup>15</sup> William Blackstone, *Commentaries on the Laws of England in Four Books. Notes selected from the editions of Archibold, Christian, Coleridge, Chitty, Stewart, Kerr, and others, Barron Field's Analysis, and Additional Notes, and a Life of the Author by George Sharswood. In Two Volumes.* (Philadelphia: J.B. Lippincott Co., 1893). Vol. 1 – Books I & II at 476-477. Available at <http://oll.libertyfund.org/title/2140>.

<sup>16</sup> *Ibid*. However, as Pickering notes, references to "legal" personality and to "legal" persons are greatly preferable to references to personality and persons without the "legal" modifier. See Murray A Pickering, “The Company as a Separate Legal Entity” (1968) 51:5 Mod L Rev 481 at 489.

law addresses itself. As previously noted, the purposes of this work neither require nor permit a more complete discussion of these “legal personality” issues.

Consideration of the statutes examined here confirm this. As noted, while “the nature of the business or purposes to be conducted or promoted” by DGCL corporations must be set forth in its certificate of incorporation, it is not necessary to go beyond the statement that such business or purposes are “to engage in any lawful act or activity for which corporations may be organized” under the DGCL. Such a statement thereby includes within the purposes of the corporation all such lawful acts and activities, unless otherwise expressly limited.<sup>17</sup>

An MBCA corporation may engage “in any lawful business unless a more limited purpose is set forth in the articles of incorporation”. It also “has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs”.<sup>18</sup>

### ***Rights, Powers, and Privileges Expressly Stated***

As noted in Chapter One, each of the statutes examined also enumerate specific powers expressly, but not exhaustively, possessed by the corporations under its jurisdiction. These powers include the right to own property, to contract in its own name, and to initiate, maintain and defend legal proceedings in its own name. One difference among the statutes reviewed concerns the effect of incorporation: under the DGCL the incorporators signing the certificate of incorporation and their successors and assigns “shall, from the date of such filing, be and constitute a body corporate”.<sup>19</sup>

In effect, the DGCL expressly states that those who take the initiative in establishing the corporation in the prescribed way themselves, with their successors and assigns, constitute the corporation. Ignoring any theories of legal personality which might be presented by or associated with such a statement, this kind of statement recognizes that the actors initiating the formation of the corporation likewise constitute and continue to animate it.

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<sup>17</sup> See Chapter One in the section entitled "The Corporation and Corporate Essentialism in Law" and therein under the heading "Essential Attributes of the Corporation in Law" and the subheading "Separate Legal Entity – Rights, Powers, and Privileges in Modern Corporation Statutes – MBCA".

<sup>18</sup> See "Chapter One in the section entitled "The Corporation and Corporate Essentialism in Law" and therein under the heading "Essential Attributes of the Corporation in Law", especially under the headings "Separate Legal Entity" and "Limited Liability and Asset Partitioning".

<sup>19</sup> *Ibid.*

Even if those incorporators are themselves bodies corporate (as is possible under the DGCL), at some point there is an individual human actor who acts for it and on its behalf. However, the express characterization to this effect in the DGCL, which assists in enunciating the relationship of corporation and organization, does not limit its applicability in other situations. Such relationship will be explored further below.

## **The Corporation, the Legal Entity, the Organization, and the Participants**

### ***Organization, Legal Status, and Organizational Action***

As noted earlier, that the corporation is a particular kind of organization has been widely conceded by commentators from various fields.<sup>20</sup> For example, the acclaimed institutional economist Geoffrey Hodgson notes that economists use the terms “firm”, “corporation”, and “company” as virtual synonyms.<sup>21</sup> He indicates that a firm is a “special type of organization that is legally recognizable and devoted to production”. In particular, it is defined as “*an integrated and durable organization involving two or more people, acting openly or tacitly as a ‘legal person’, capable of owning assets, set up for the purpose of producing goods or services, with the capacity to sell or hire these goods or services to customers.*”<sup>22</sup>

Such an entity is integrated in that “it is regarded as a ‘legal person’ owning its products and entering into contracts” and durable “in that it constitutes more than a transient contract or agreement between its core members and it incorporates structures and routines of some expected longevity.” Hodgson’s firm is a distinct legal entity or legal person which “may carry legal entitlements and liabilities in its own right”, which “manages the resources in its possession, essentially by administrative control rather than by internal contract” as “an organized enclave, apart from markets and exchange”, although the latter dominate its external relations.<sup>23</sup>

Hodgson avers to the derivation of the term “firm” from the Latin adjective *firmus*, meaning strong, powerful, durable and lasting” and the use it acquired as a noun to mean “(legally binding) ‘signature’”; and he describes the firm as “an organizational and legally circumscribed entity”.<sup>24</sup>

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<sup>20</sup> *Ibid.*

<sup>21</sup> Geoffrey M Hodgson, “The Legal Nature of the Firm and the Myth of the Firm-Market Hybrid” (2002) 1:1 Int’l J Economics of Business 37 at 39.

<sup>22</sup> *Ibid* at 56 [emphasis in the original].

<sup>23</sup> *Ibid.*

<sup>24</sup> *Ibid* at 40.

“Firms”, he says, may take the form of partnerships, cooperatives, companies, or corporations, although these “different types of firms all have important differences of structure, rationale and possible behaviour.”<sup>25</sup>

Organizational theorists Christopher Bartlett and Sumantra Ghoshal also approached firms as organizations, saying that an organization “is fundamentally a social structure”, and that even when actions of and within organizations are “motivated by a variety of economic and other objectives, they emerge through processes of social interactions that are shaped by the social structure”.<sup>26</sup> Hodgson maintains that “the law does not ignore the organizational character of the firm”, and that “even in legal terms, the firm is a structured set of relations between persons”, including relationships within the firm that are governed by legislation, such as the employment relationship.<sup>27</sup> It has been argued in the present work that the “structured set of relations between persons” which Hodgson acknowledges obtains in connection with the corporation “even in legal terms” is recognized by corporate law, both as a matter of declarative or statutory law, and as a matter of common law.

In particular, Chapter A1, which is entitled “Corporate Essentialism and Corporate Organization in Law”, notes that statutory corporate law vis-à-vis the relationships between the corporation, on the one hand, and the board of directors, the officers, and other employees, on the other hand, principally deals, firstly, with the relationships between the corporation, the board and individual directors; and, secondly, with the relationships between the corporation and officers; in effect, with the highest levels in the hierarchy of the organization. Most other matters concerning the relationship between the corporation and employees and between the employees inter se are dealt with by the common law or by specific statutes concerning employment relationships.

It is noteworthy, however, that Hodgson acknowledges that firms, including corporations, are organizations. It will be recalled that Chapter Three of the present work discussed James March’s approach to the firm as a political coalition, recognizing that the modern business firm as a “large

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<sup>25</sup> *Ibid.*

<sup>26</sup> Christopher A Bartlett, and Sumantra Ghoshal, "Beyond the M-Form: Toward a Managerial Theory of the Firm" (1993) 14 *Strategic Management J* 43.

<sup>27</sup> *Ibid* at p. 44, citing: SE Masten, “A Legal Basis for the Firm”, in Oliver E Williamson, and Sidney G Winter, eds, *The Nature of the Firm: Origins, Evolution, and Development*. (Oxford and New York: Oxford University Press, 1991).



complex organization” for “making and implementing decisions within a market economy”,<sup>28</sup> and considering “the business organization as a socio-political conflict system subject to economic constraints”.<sup>29</sup> As discussed there, March argues that the economic theory of the firm “suppresses as outside its domain” process by which the firm, as “an organization composed of a rather complex mixture of people with considerable heterogeneity of goals generates a single preference ordering.”<sup>30</sup> Likewise, March, writing in 1962, asserts that while economists “for many years” have considered firms are organizations rather than entrepreneurs, “only in the last few years have such strictures had any impact on the theory of the firm.”<sup>31</sup>

Of course, the present work has taken the position that the organizational character of the corporation is important, both as a matter of theory and practice. As a separate legal entity, of course, legal authors have recognized that the corporation is separate from its members,<sup>32</sup> both individually and collectively. As Murray Pickering has commented, “essentially, therefore, the company is simply a means [provided by law] by which the property and associated rights of numerous individuals may be amalgamated and reconstituted for their more efficient and effective utilisation.”<sup>33</sup> This “reconstitution” involves an exchange of property by the holder with the corporation in exchange for certain rights vis-à-vis the corporation. As a legal entity, it is separate and independent from its members (property contributors) in every respect.<sup>34</sup>

Pickering explains that the first principal effect of formation of a company is that “its shareholders, and their transferees, become members of an association and are granted rights as such” and that “pre-eminent among these” are, normally, “powers of control in the widest sense of an entitlement to participate, by voting, in the management of the company through the appointment and removal of its directors, the distribution of profits and other decisions of the company in general meeting,

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<sup>28</sup> See the section entitled “Organizations as Political Systems – Firms, The Polity, and Economic Theory” and see James G March, “The Business Firm as a Political Coalition” (1962) 24 (2) J Politics 662.

<sup>29</sup> See the section entitled “Organizations as Political Systems” and therein under the heading “The Firm as a Socio-Political Conflict System”; and *supra* note 28 at 666.

<sup>30</sup> See the section entitled “Organizations as Political Systems” under the heading “Joint Preference Ordering in Economic Theory”; and *supra* note 28 at 669; and the section entitled “Organizations as Political Systems” under the heading “The Firm as a Conflict System for Internal and External Conflicts”; and *supra* note 28 at 664 and 668-669.

<sup>31</sup> See the section entitled “Organizations as Political Systems” and therein under the heading “Business Coalitions and the Economic Theory of the Firm”; and *supra* note 28 at 675.

<sup>32</sup> For example, see Pickering, *supra* note 16 at 481.

<sup>33</sup> *Ibid* at 509.

<sup>34</sup> *Ibid*.

and also by the power to enforce the company's regulations."<sup>35</sup> These shareholder rights are discussed extensively in the present work in Chapter A2 entitled "Corporate Essentialism and Equity Owners". The second principal effect which Pickering describes is that "the members relinquish all proprietary and other interests in the monetary or other consideration which they have given for their shares and which becomes wholly vested in the company".<sup>36</sup> The corporation is then able to deal with such property as its own.

After the corporation comes into existence, then, there is "an association of members, which may themselves be corporate bodies; and... an entity possessing independently of its membership the legal capacity to exercise proprietary, contractual and other powers."<sup>37</sup> In effect, this "association of members" is limited to, or exhausted by, the exercise of individual and collective rights of participation in the corporation as shareholders. Generally, a particular shareholder may also participate in the organization in some other capacity, for example, as a director, officer, employee, creditor, supplier, or customer. However, there is no doubt that the shareholders participate with others in the organization which constitutes the corporation and which is a separate legal entity from the shareholders and other organizational participants.

While the language of the modern North American corporate statutes does not emphasize this as much as British and other similar statutes, which expressly use language relating to "association", there is no doubt that the result is the same: the corporation is both a separate legal entity and an organization. Of course, under the British statute, the Companies Act 2006<sup>38</sup>, a company is incorporated by the issuance of a certificate of incorporation pursuant to the filing of articles of association, together with its memorandum of association, which identifies its subscribers and is its main constitutional document but is treated as part of its articles.

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<sup>35</sup> *Ibid* at 501.

<sup>36</sup> *Ibid* at 501-502.

<sup>37</sup> *Ibid* at 489.

<sup>38</sup> (*UK*) *Companies Act 2006*, 2006 c. 46. The principal provisions relating to the incorporation of companies appear in sections 7 through 16 inclusive. The statute came fully into force with defect from October 2009. Available at: <http://www.legislation.gov.uk/ukpga/2006/46/contents>.

### *The Organization and Organizational Participants*

As indicated in the immediately preceding section, Geoffrey Hodgson treats the firm as an organization which is devoted to production and has certain legal characteristics. He defines it as “*an integrated and durable organization involving two or more people, acting openly or tacitly as a ‘legal person’, capable of owning assets, set for the purpose of producing goods or services, with the capacity to sell or hire these goods or services to customers.*”<sup>39</sup> He expressly recognizes the firm and, in particular, the corporation, as organizations. As explained previously, Hodgson’s definition accords with the formal and informal definitions of the term “organization” discussed in Chapter Four.<sup>40</sup>

As such, the organization involves a social unit or a group of people<sup>41</sup> who collaborate or work together, which involves certain structures, processes, and personnel attributes,<sup>42</sup> in pursuit of shared ends, goals, or objectives.<sup>43</sup> The participants in the organization, its “organizational participants”, may be said to be the persons who are members of the focal social unit or the focal group of people. As Weber indicates, the organization is a social relationship<sup>44</sup> which involves certain expectations of social action, as well as mutual responsibility to act towards each other in accordance with the agreement regarding mutual behaviour and representation of the organization,<sup>45</sup> such that action taken by authorized members of the group may be imputed to all other members of the group.<sup>46</sup>

The preceding paragraph merely averts to, but does not describe, the organizationally essentialist characteristics of an organization, those characteristics which organizational theorists consider as essential to an organization, which, it has been established in this work, includes a corporation. It is important, however, for present purposes, to emphasize that those individuals or entities who are identified as “organizational participants” are members of a social unit or group of people who collaborate or work together, involving certain structures and processes and personnel considered

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<sup>39</sup> *Supra* note 19 at 56 [emphasis in the original].

<sup>40</sup> See the section entitled “Working Definitions and Formal Definitions”.

<sup>41</sup> See the section entitled “Part A – Groups of People or Social Units”.

<sup>42</sup> See Chapter Five.

<sup>43</sup> This is discussed in Chapter Six.

<sup>44</sup> *Supra* note 41, especially under the heading “Max Weber on Organizations and Related Matters”, in particular under the subheading “Organization as Social Relationship”

<sup>45</sup> *Ibid.* See, in particular, the discussion under the subheading “Organizations and Expectations of Social Action”.

<sup>46</sup> *Ibid.* See especially, the text under the subheading “Mutual Responsibility and Representation”.

appropriate, in order to achieve certain ends or goals or objectives. These attributes constitute its organizationally essentialist characteristics.

Accordingly, in order to be considered as organizational participants, unsurprisingly, such persons must participate in the social relationship thereby obtaining. That is to say, the primary determinant of organizational participation, as that term is used here, is participation in the activities of the organization in some capacity. Chapter Four demonstrated, somewhat unsurprisingly, that an individual person may be a member of more than one social unit or group of persons. These social units or groups of persons may, but also may not, have any relationship between or among them, whether in terms of membership or various other relevant matters.

For example, one or more of them may be “nested” within another or within others, their memberships may overlap to some extent, or their memberships may be entirely discrete and separate from one another. The existence of any relationship among such social units or groups of persons, or among their respective members, is likely to be affected by the nature of such unit or group. If more than one of the social units or groups of persons to which an individual belongs meets the formal requirements to be considered an organization, it is clear that an individual may belong to or participate in more than one organization.<sup>47</sup>

As explained in Chapter Four, membership in a number of such groups, units, or organizations requires that the focal individual determine the extent of their interest in, or commitment to, each of the same.<sup>48</sup> As demonstrated in that chapter, this requires determination of the extent to which the focal individual adopts an intragroup or intraorganizational identity, and, correspondingly, the extent to which that individual will preserve some extraorganizational identity, whether or not affected by participation in other groups, units, or organizations, or otherwise.<sup>49</sup>

Consequently, a focal individual’s social identity may relate partly to participation in a particular group, unit, or organization, and partly may be quite independent of such participation.<sup>50</sup> A focal individual may be said to be “within” or “inside” the group with respect to that participation and

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<sup>47</sup> See, in particular, discussion in the section entitled "Groups of People or Social Units" under the heading "A Social Unit or Group of People" and therein under the subheading "Intraorganizational Organizations".

<sup>48</sup> Note, especially, the discussion in the section entitled "Groups of People or Social Units" under the heading "A Social Unit or Group People" and therein under the subheadings "Intragroup Aspects of Social Identity" and "Individual and Intragroup Aspects of Social Identity".

<sup>49</sup> Particularly relevant is the discussion under the subheading "Organizational Socialization".

<sup>50</sup> See, particularly, discussion under the subheading "Role Conflict".

“outside” the group otherwise. Such individual may be said to be “inside” the group insofar as and to the extent that such relationship obtains and has salience in the particular circumstances, and “outside” the group insofar as and to the extent that it does not (which may or may not entail that some other relationship is more salient). This characterization of “inside” and “outside” may be considered to relate to the proximity, and to the salience, of the particular relationship to the corporation or to the individual, as the case may be. The relationship may occupy a place somewhere on a continuum between relationships which are “as intimate as possible” and those which are “as distant as possible”.

Geoffrey Hodgson expresses this in terms of the “boundaries of the firm”, a subject which is discussed further below. He says that “the boundary of the firm is made up of points in time at which the ‘legal person’ of the firm concludes legal (written or unwritten) contracts with individuals or other legal persons” such that upon hiring a person “cross[es] the boundary [from the outside] to the inside of the firm”. However, an employee “is only ‘inside’ the firm during the periods, and under the circumstances specified in the employment contract.”<sup>51</sup> When Hodgson observes that such contract by an employee with the legal person of the firm (or corporation) crosses the legal boundary of the firm (corporation) and places the employee “inside the firm”, it is the “firm as organization” that the employee has joined, although it may be said as a kind of shorthand description that the employee is now “inside the corporation (as legal entity)” in that certain aspects of the employer-employee relationship are internalized within the corporation and its hard outer legal shell.

This language recalls the description of the employment relationship and acceptance of authority by Barnard (referring to the “zone of indifference” of the employee with respect to instructions from superiors) and by Herbert Simon (referring to the “zone of acceptance”).<sup>52</sup> With respect to the employment relationship, certainly, it can be described as one of authority: authority by the employer over the employee and acceptance of such authority by the employee, which is conveyed by, and within, the terms of the employment contract. Such authority, according to Fayol, involves

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<sup>51</sup> *Supra* note 19 at 44.

<sup>52</sup> See the discussion in Chapter Four; and the discussion in Chapter Five, most particularly in the section entitled “Organizational Structure”, and therein under the heading “Formal Organizations and Informal Organizations” and therein under the subheadings “Common Purpose, Intraorganizational Cooperation, and the Zone of Acceptance” and “The Range of the Zone of Indifference or Acceptance”; and in the section entitled “Organizational Personnel”.

the right to give orders and the power to exact obedience.<sup>53</sup> As Robé says, it allows the employer to make decisions about the activities of the employee during the time of employment.<sup>54</sup>

Importantly, because the employment contract is expressed in general terms, the power or authority conveyed by the employment contract is broadly understood between employer and the employee; as a result of which the employer may, as a practical matter, assume authority within the “zone of acceptance” or “zone of indifference”.<sup>55</sup> However, there are limits to such authority and to the legitimacy of the instructions which may be issued pursuant to the same.

### ***Organizational Participants, Stakeholders, and Corporate Social Responsibility***

Considering that the corporation has objectives which may be described, at least in part, as economic in nature, it might be expected that participants in the corporation qua organization might also have objectives which might be described, at least in part, as themselves economic in nature. However, for the purposes of the analysis conducted in the present work, which involves considering organizational aspects of the corporation, our primary focus is on participation in the relevant organization, rather than participation in the economic aspects of the corporation.

Among other things, this entails that the organizational participants referred to in this work cannot, without further consideration, be identified with “stakeholders” as that term is employed in relevant literature.<sup>56</sup> This is certainly the case to the extent that the term “stakeholder” is considered

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<sup>53</sup> See the discussion in Chapter Five in the section entitled "Organizational Structure" under the heading "Fayol and Modern Business Management" and therein under the subheading "Fayol on Structure".

<sup>54</sup> Jean-Philippe Robé, "The Legal Structure of the Firm" (2011) 1:1 Accounting, Economics, and Law Article 5 at 37.

<sup>55</sup> Reference is made to the discussion of master and servant law, agency law, and employment law in Chapter A3.

<sup>56</sup> There is a considerable literature with respect to the stakeholder theory of the corporation. Two of the most cited articles are Thomas Donaldson and Lee E Preston, "The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications" (1995) 20:1 Academy of Management Rev 65 (more than 12,000 citations); and Ronald K Mitchell, Bradley R Agle and Donna J Wood, "Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts" (1997) 22:4 Academy of Management Rev 853 (more than 8,000 citations). Other articles which are very frequently cited include: Robin W Roberts, "Determinants of Corporate Social Responsibility Disclosure: An Application of Stakeholder Theory" (1992) 17:6 Accounting, Organizations and Society 595; RE Freeman, "The Politics of Stakeholder Theory: Some Future Directions" (1994) 4:4 Business Ethics Q 409; TM Jones, "Instrumental Stakeholder Theory: A Synthesis of Ethics and Economics" (1995) 20:2 Academy of Management Rev 404; TM Jones and Andrew C Wicks, "Convergent Stakeholder Theory" (1999) 24:2 Academy of Management Rev 206; RE Freeman, "Divergent Stakeholder Theory", (1999) 24:2 Academy of Management Rev 233; RE Freeman, AC Wicks and B Parmar, "Stakeholder Theory and "The Corporate Objective Revisited"" (2004) 15:3 Organization Science 364; IM Jawahar and GL McLaughlin, "Toward a Descriptive Stakeholder Theory: An Organizational Life Cycle Approach" (2001) 26:3 Academy of Management Rev 397; MC Jensen, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function" (2002) 12:2 Business Ethics Q 235; Robert Phillips, R Edward Freeman, and Andrew C Wicks, "What Stakeholder Theory Is Not" (2003) 13:4 Business Ethics Q 479.

to connote some economic interest which is affected by the operations of the focal corporation. More importantly, however, even when the term “stakeholder” is used to reference a party whose interest, whether economic or otherwise, might in some way be affected by the operations of the focal corporation, this does not in any way indicate that such party in interest is internal to the organization.<sup>57</sup> As indicated in the discussion under the preceding heading, while organizational participants may have economic interests that relate to the organization, such economic interests do not exhaust the interests of organizational participants, who are, first and foremost, participants in the social relationships which are constitutive of the organization.

Although the scope of the present work does not permit consideration of stakeholder theory of the corporation to any significant extent, it is important to note that the terms “organizational participant” and “stakeholder” are not synonymous and, indeed, reflect different perspectives on the corporation. For example, where a party “outside the corporation” interacts with the corporation as a legal entity on a single liquidated transaction on a purely external basis, such a party can be described as an organizational participant only in a somewhat superficial respect.

In addition, stakeholder theory of the corporation is often considered to have significant normative implications and to recognize the corporation as having moral obligations to such stakeholders. The concepts of organizational participation and of organizational participants employed in the present work are used without assigning to them any normative significance. Similarly, such concepts do not directly address issues of corporate social responsibility, which subject is not directly considered by the present work. It is simply not possible to address issues of stakeholder theory and corporate social responsibility in any meaningful fashion in a work of this nature.

### ***The Borders of the Corporation and the Borders of the Organization***

It is clear that the determination of whether a person is or is not a participant in the corporation is an empirical one involving certain indicia of organizational participation, as noted above. However, certain categories of persons identified by their relationship with the corporation, as a matter of law and otherwise, may be considered presumptively to be organizational participants. These include directors, officers, managers, and employees. The question of how organizational

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<sup>57</sup> Donaldson and Preston, *supra* note 56.

participation affects persons with such relationships is discussed further below, in relation to those and other categories.

There are at least two problems having great significance with respect to the issue of organizational participation which concern the issue of the “borders” of the corporation. The first, which is already been discussed in this work, concerns aspects of the organization which traverse the strict legal boundaries of the focal corporation. The organization of the business enterprise as a whole may involve a vast array of corporations and other forms of business entities (which are, generally speaking, excluded from our discussions) arranged in a vast hierarchy of corporations (each of which, for purposes of simplicity, is generally assumed here to be wholly owned). Reference is made to the example provided under the heading “Fact Pattern for Discussion”. Issues relating to the structure of business enterprise are considered extensively in Chapters Two,<sup>58</sup> Three,<sup>59</sup> Five,<sup>60</sup> and Six.<sup>61</sup>

Geoffrey Hodgson distinguishes between “modern conglomerates made up of legally separate units” and “multinational conglomerates” which are “multinational enterprises [which] exist as separate legal bodies in different countries, all owned by the headquarters corporation.”<sup>62</sup> Accordingly, as his discussion of the subject makes clear, he treats the operations of an MNE in a particular country as the “local” or “national” operation of the MNE as a whole, regardless of the legal form employed. In fact, in so doing, he even assumes that the local operation will normally involve several separate legal entities.

Addressing the issue of legal form more broadly, Hodgson acknowledges that “the formal legal status of any organization tells us no more than a small part of the whole story” and that legal formalities have the effect of “masking a different reality.”<sup>63</sup> Thus, “a conglomerate of different firms may in practice act like a single firm, because control of the conglomerate is concentrated in a single group”. However, different structures may have different legal and economic

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<sup>58</sup> Note, especially, comments under the heading “History of the Development of the Modern Business Corporation”.

<sup>59</sup> See, in particular, discussion under the heading “Forms of Corporations – Legal and Organizational Variants”.

<sup>60</sup> Much of Chapter Five is relevant, notably the text commencing under the heading “Organizational Structure” and continuing thereafter.

<sup>61</sup> Relevant issues are discussed throughout the chapter but, most notably, in the text under the heading “Organizational Goals and Intraorganizational Goals”.

<sup>62</sup> *Supra* note 21 at 47. A similar definition of the term “conglomerate” appears at 53.

<sup>63</sup> *Ibid.*



consequences. He gives the example of dissolution of a conglomerate which, he says, involves different processes than the disintegration of a single firm or economic entity into separate legal units.<sup>64</sup>

By way of another example, executive authority with respect to a particular function in a subsidiary of the fourth level of the corporate hierarchy may reside in an executive on the corporation which is at the second level of the corporate hierarchy. Such person might be providing instructions to individuals engaged in a corporation which a subsidiary of a subsidiary of the corporation in which the instructing executive is situate. Thus, the instructing individual might not be an official of the focal corporation at all.

The second issue with respect to the borders of the corporation concerns whether the organization extends beyond the “borders” of the corporations, taken as a whole, through and by means of which the business enterprise operates as a collectivity of legal entities. As discussed with respect to the preceding issue, whether an individual or group is a participant in a particular organization is determined by the nature of the relationship between the focal individual or group, on the one hand, and the relevant organization, on the other.

As noted previously, the nature of such relationship is not determined solely by economic relations, economic dependency, or other economic factors; nor is it determined solely by legal relationships. Of course, this makes it important to assess the extent to which legal relationships and organizational relationships affect each other. This may go beyond determining the extent to which legal essentialist attributes and organizational essentialist attributes affect each other.

As noted previously, a relevant discrimination concerns whether the organizational relationship is exclusively, primarily, or significantly, “internal” to the organization as compared with the ways in which the organization customarily deals with “external” or extraorganizational parties. As suggested in discussion elsewhere in this work, it is expected that this determination would be made empirically, based on the relevant facts and circumstances, both generally and, more particularly, on a case-by-case basis. General categories of possible participants are discussed further below.

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<sup>64</sup> *Ibid.*

*The Corporation, Organizational Participants, and Intraorganizational Relations*

The amalgamation and reconstitution of property and associated rights by the contributors in connection with the formation of the corporation, as described by Pickering in the section above entitled “Organization, Legal Status, and Organizational Action”, separates the corporation, as a separate legal entity, from its participants, including the “entrepreneur” of economic orthodoxy. As expressed in a recent article by Simon Deakin, David Gindis, Geoffrey Hodgson, Kainan Huang, and Katharina Pistor,<sup>65</sup> “legal incorporation means that the state recognizes the firm as a singular legal person with rights and duties” which is “itself an owning agent; that is to say, ownership of the assets of the firm are vested in the legal person the corporation”.<sup>66</sup>

It thus has the capacity to own property. It also “hires the workers, buys machines and raw materials and sells the output”, thereby entering into contracts of various natures; and “is sued if it sells defective products and sues if it suffered damages from breach of contract and the like”,<sup>67</sup> a capacity to initiate, maintain, and defend legal proceedings to which we previously averted. Deakin et al indicate that “the ‘economic’ activities of the firm become possible because the firm has a legal status, and has powers enshrined in law”, including asset ownership, contractual capacity, and capacity to maintain legal actions.<sup>68</sup> Consequently, the “corporation hires the workers, buys machines and raw materials and sells the output. The corporation is sued if it sells defective products and sues if it suffered damages from breach of contract and the like.”<sup>69</sup>

Of course, the capacity to own property, enter into contracts, and be involved in legal proceedings, in each case, in its own name, are distinguishing attributes of a legal, or rights-and-duty-bearing, entity. As Jean-Philippe Robé says, “the corporation is recognized by the legal system as being a juridical person having rights and liabilities”.<sup>70</sup> Deakin et al maintain that the “glue binding the corporation together is the power of corporate law, the adoption of its principles by the shareholders, and the agreement between them” and it is the “establishment of the singular legal person under which the entrepreneurs (shareholders) operate” which constitutes the corporation and not, as Coase argues, the entrepreneurial administration of a production process.<sup>71</sup>

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<sup>65</sup> Simon Deakin, David Gindis, Geoffrey M Hodgson, Kainan Huang, and Katharina Pistor, "Legal Institutionalism: Capitalism and the Constitutive Role of Law" (2017) 45 J Comparative Economics 188. [Deakin et al].

<sup>66</sup> *Ibid* at 194-5.

<sup>67</sup> *Ibid* at 195, and at 197-8.

<sup>68</sup> *Ibid* at. 197.

<sup>69</sup> *Ibid* at 195.

<sup>70</sup> *Supra* note 54 at 5.

<sup>71</sup> *Supra* note 65 at 195.

Deakin et al maintain that the corporate form is economically effective because of what Hansmann, Kraakman, and Squire refer to as its “entity shielding” function, protecting corporate assets from the personal creditors of the shareholders and the shareholders from creditors of the corporation;<sup>72</sup> and its function of protecting corporate assets by “locking-in capital”;<sup>73</sup> because of the extensive powers of directors and officers to manage the corporation which “could easily give rise to abuse were it not for the broadly defined fiduciary duties the law imposes upon them”;<sup>74</sup> and because of the ability of the corporation to outlast its original individual members and, as we note here, their successors.<sup>75</sup> These enablers of economic effectiveness were identified previously in this work as the legal essentialist attributes of the corporation.<sup>76</sup> This work maintains that these legal essentialist attributes are key components of “the glue binding the firm together”.

Thus, Deakin et al observe that the “glue that holds the firm together consists of the legal provisions that bind the parties into one entity, and in turn draw on appropriate legislation.” Indeed, “in the case of the corporation, the glue can outlast the lifetimes of the individual members involved. Their individuals and assets may change many times over.” This is a consequence of duration of the corporation’s existence. However, they maintain that the corporation as a legal entity is “distinct from its human constituents. A coalition of owners may create a firm. And firms typically own non-human assets. But the firm is not the same thing as a coalition [of owners] or a collection of assets.”<sup>77</sup>

As the present work has indicated, organizational objectives, including continuity, may not infrequently require making significant changes to the corporation’s strategy and structure and these may, in turn, require a readjustment of the rights of corporate participants. As indicated in Part 1 of the present work, such readjustment is provided for in the declarative corporate law applicable to the corporation. It enables the property and associated rights of contributors which are “amalgamated and recombined” in Pickering’s

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<sup>72</sup> *Ibid* at 197, citing: H Hansmann, R Kraakman, and R Squire "Law and the Rise of the Firm"(2006) 119:5 Harv L Rev 1333. Those authors have become well known for their exposition of asset partitioning, limited liability (negative asset partitioning), and entity shielding (affirmative asset partitioning).

<sup>73</sup> *Supra* note 65 at p. 197. The subject of locking-in capital has been explored extensively by Margaret Blair. Leading contributions are: MM Blair, "Firm-Specific Human Capital and Theories of the Firm" in: MM Blair and Mark J Roe, eds, *Employees and Corporate Governance*. (Washington, DC: Brookings, 1999) at 58–89; and MM Blair, "Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century" (2003) 51:2 UCLA L Rev 387. As noted previously in this work, and by Margaret Blair, the concomitant right involves the ability to transfer equity interests.

<sup>74</sup> *Supra* note 65 at p. 197. As argued previously in this work, others protective mechanisms, including the election of directors and the right to approve extraordinary transactions, also safeguard the rights of shareholders.

<sup>75</sup> *Ibid*.

<sup>76</sup> See the discussion in Part 1 and Appendix A of this work, especially Chapters One, and A1 through A3, inclusive.

<sup>77</sup> *Supra* note 32 at 197.

terminology in exchange for the acquisition of rights vis-à-vis the corporation by those contributors and their successors in interest to be varied. Consequently, say Deakin et al, “legal personality has clear advantages in regard to uncertainties and complexities surrounding any long-standing contract, and the required flexibilities that are needed to face an unpredictable future. Rather than contracting for everything in advance, entrepreneurs rely on evolved commercial law and the choices of legal template on offer.”<sup>78</sup>

Robé argues that it is not only the creation of the separate juridical entity which reduces uncertainties and complexities and provides flexibilities, but it is also the specification of “the *procedures* which will be followed to operate the venture”, either in the articles, bylaws, or shareholders’ agreement, in corporate law, or in general contract law.”<sup>79</sup> Those procedures involve the assignment of decision-making, such that “after contribution of the assets to the corporation, decisions about their use will *not* be made by contracting parties negotiating to revise their contract with some parties having residual control rights over the real assets while others have none” but, instead, such decisions “will be made by the officers or directors or shareholders, in accordance with the company’s articles of corporation and the applicable corporate law, which provide for procedural rules governing how decisions will be made through time in connection with the venture.”<sup>80</sup>

As demonstrated in Part 1 of this work, as a result of its endowment with what has been described here as its essentialist legal attributes, the corporation can subsist for an indefinite length of time as a legal entity separate from its participants, who are accorded certain rights in respect of their participation. As further demonstrated in Parts 2 and 3 of this work, as an organization, groups, and subgroups, and even individuals within the corporation may come into conflict with respect to intraorganizational goals and objectives which are not identical either with those of other groups, subgroups, and individuals, or with the organization as a whole. Ghoshal and Bartlett argue that much recent organizational analysis considers “conflict among disparate subunit goals ...as pervasive”.<sup>81</sup> The formal legal procedures of corporate law and of other applicable law provide methods for resolving such conflicts, and thereby, considered together, constitute a superordinate procedure of joint preference ordering, or for resolving conflicts within the organization, considering it as a socio-political conflict system.

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<sup>78</sup> *Ibid* citing Robé, *supra* note 54 at 17.

<sup>79</sup> *Ibid* [emphasis in the original].

<sup>80</sup> *Ibid* [emphasis in the original].

<sup>81</sup> Sumantra Ghoshal and Christopher A Bartlett, "Linking Organizational Context and Managerial Action: The Dimensions of Quality of Management" (1994) 15 Strategic Management J 91 at 109.

Robé concludes that “it is precisely because we do *not* live in a comprehensive contracting world that there is room for creating corporations, as separate legal persons, to own businesses and as a consequence deal with future issues as they arise in accordance with the by-laws and corporate law.” He draws the further conclusion that: “*The incompleteness of contracts indeed leads to an understanding of ownership: to an understanding of ownership by separate juridical persons. The so-called “legal fiction” of the corporation, far from being negligible in economic analysis, is actually central to it.*”<sup>82</sup>

If joint preference ordering is not achieved, this may result in dissatisfaction on the part of various participants. For example, dissatisfied shareholders, who are unable to seek a return of capital by reason of capital lock-in, may seek to exercise a right of voice or exit. Certain rights of voice are specifically provided as a matter of law, in the statutes and otherwise. Shareholders subject to transformational changes proposed by management may take actions, individually and collectively, to oppose these initiatives, by means of shareholder proposals, proxy solicitations, changes in board membership by exercising the voting rights of shareholders, or by seeking to initiate alternative transformational changes, whether by way of merger proposal, takeover bid, or otherwise.

Thus, the law (both declarative law – statutes – and common law) regulates certain aspects of the organization which animates and vivifies the corporation. It is not, of course, only the formal legal procedures applicable to a particular corporation which permit it to resolve intraorganizational conflicts; instead, informal procedures also contribute. Informal influences contributing to conflict resolution may be provided by the informal structure or “informal organization” and by informal processes, procedures, and other intraorganizationally embedded understandings, and values, and “rules of the game”.

As discussed, particularly in Chapter Three, joint preference ordering takes place within the corporation itself at various hierarchical (both vertical and horizontal) levels with respect to conflicts within the focal unit level, among the focal unit and other organizational units and subunits, and between the focal unit and the highest level of the organization. In some cases, such conflict resolution or joint preference ordering may result from the application of standardized rules and procedures. This is consistent with concept of bounded rationality, rulemaking and bureaucratic procedure generally in which it is sought to minimize the exceptional cases that

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<sup>82</sup> *Supra* note 54 at 17 [emphasis in the original]. Robé distinguishes between the corporation as a legal entity, on the one hand, and the “firm”, on the other hand, which he equates to the “enterprise” or the economic activity carried on by the corporation. *Supra* note 54 at 6 and 9.

may require individual consideration and determination in order to preserve resources to that end, rather than dissipating such resources with respect to more ordinary or non-exceptional situations.

### *Categories of Organizational Participants*

As discussed above, the assignment to the board of directors of plenary decisionmaking authority with respect to most matters requiring decisions to be made by the corporation facilitates central day-to-day decisionmaking which, in turn, is normally final except in exceptional circumstances. This permits the readjustment and reallocation of the rights of corporate participants vis-à-vis the corporation, and each other, over time and from time to time.

For the purposes of the present work, it is clear that a threshold question is whether a particular person or group is a member of, part of, or a participant in, the focal organization and, more particularly, what is the nature of such relationship. From an organizational perspective, as has been seen, this involves determining the expectations of the parties to such relationship. From a legal perspective, a threshold question is what legal rights are enjoyed by the person or group who participates in the organization as a result of declarative and common law, charter documents, relevant agreements, and other relevant determinants.

#### Shareholders

As discussed in the preceding section, shareholders contribute property, property rights, and other things to the corporation in exchange for receiving certain rights evidenced by way of shares in the corporation. As Deakin et al note, the corporation is not “a *res* or thing which the shareholders can be said to own”;<sup>83</sup> instead, they own shares in the corporation rather than owning the corporation itself;<sup>84</sup> and, accordingly, even in a single shareholder corporation, the corporation is distinct in this respect.<sup>85</sup> The ownership of shares entitles the holder to certain rights vis-à-vis the corporation as determined by its charter documents, declarative corporate law, and other applicable common and other law. As previously discussed, certain of these rights, while attached to a share of the corporation and exercised on that basis, such as the right to vote, affect its decisionmaking processes when exercised collectively, that is, in common with other such shareholders.

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<sup>83</sup> *Supra* note 65 at 195.

<sup>84</sup> *Ibid*, citing: Margaret M Blair and Lynn A Stout, "A Team Production Theory of Corporate Law" (1999) 24:4 J Corp L 751; PW Ireland, "Company Law and the Myth of Shareholder Ownership" (1999) 62:1 Mod L Rev 32; and JP Robé, "The Legal Structure of the Firm" (2011) 1:1 Accounting, Economics, and Law Article 5.

<sup>85</sup> *Supra* note 65 at 195.

Pickering emphasizes that “the company is more than an entity capable of the ownership of property. It is also an association of persons, all of whom individually possess their standing at law.”<sup>86</sup> As the persons so associated are themselves capable of legal action it became necessary to determine whether or not the corporation would be affected by acts of members.

As discussed in Chapter One, it was determined in the case of *Foss v. Harbottle*<sup>87</sup> that “the company’s members have no capacity to act in else, or in the company’s name, on its behalf or for its benefit.”<sup>88</sup> Consequently, the liability of the corporation and of its shareholders can be separated at common law. As determined in *Salomon v. Salomon & Co. Ltd.*,<sup>89</sup> such separation of liability persists even of the corporation has but a single shareholder. This separation is effected by means of the essentialist legal attributes of limited liability and asset partitioning, discussed further below.

As noted in Chapter One, the separation of legal liability facilitates the transfer of shares to successors in interest. Neither the vendor nor the purchasers are, in general, affected after the completion of the transaction by the creditworthiness either of the other party or of the corporation itself. Ordinarily, unless the corporation is a private company or its shares are subject to a shareholders’ agreement or other applicable legal restrictions, this permits the relatively free alienation of the shares. As previously discussed, this opportunity to “exit” from such share ownership facilitates joint preference ordering within the corporation as a legal entity and as an organization.<sup>90</sup>

Equally well, the separation of the corporation from acts of its members or shareholders entails determining who may act on behalf of the corporation. This is discussed in the following section. However, in terms of taking legal action on behalf of the corporation, as Pickering notes, “the company and the company alone must act, and be acted against, to enter into and enforce its rights and obligations.”<sup>91</sup> This entails, procedurally, that “the proper plaintiff in respect of a wrong

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<sup>86</sup> *Supra* note 16 at 498.

<sup>87</sup> (1843), 67 ER 189, 2 Hare 461 (Ch).

<sup>88</sup> *Supra* note 14 at 500.

<sup>89</sup> [1897] AC 22 (UKHL) [*Salomon*].

<sup>90</sup>As discussed in Chapter A2 and otherwise, the opportunity to exercise “voice” also facilitates joint preference ordering and conflict resolution. These and other applicable legal mechanisms provide opportunities to align the reasonable expectations of participants in the corporation, whether participating by equity ownership or otherwise.

<sup>91</sup> *Supra* note 16 at 501. He cites the well-known cases of *Foss v. Harbottle*, *supra* note 58, and *Mozley v. Alston* (1847), 41 ER 833, 1 Ph 790 (Ch).

alleged to be done to a company or association *prima facie* the company or association... itself.”<sup>92</sup> Pickering notes that “the rule applies to actions by and against the company and *vis-à-vis* both outsiders and its own shareholders.”<sup>93</sup> Thus, the separation of the corporation and shareholders is given effect procedurally, as well as substantively, as a matter of law.

In certain cases, a holder of a sufficient number of shares of a public company sufficient, when combined with control of the proxy apparatus or otherwise, to elect a majority of the board of directors (commonly referred to as a “controlling shareholder” may purport to issue instructions or directions to the board of directors, the CEO, or other officers. The exposition here indicates that such instructions or directions are not legally effective.<sup>94</sup> Even a shareholder of all the shares of the corporation and even shareholders who together hold all the shares of the corporation are not empowered to take such action. The board of directors is not, and the directors individually or not, agents of the shareholders.<sup>95</sup>

Instead, the suggestions of controlling shareholders may be regarded, as a matter of law, as suggestions the persuasive effect of which, however, may be supported by an implicit or explicit threat of removal of voting support (or even removal from office) if disregarded, if not in the immediate case, then over a longer term. Often, particularly in the case of founding entrepreneurs, these interventions by controlling shareholders may be made with reasonable regularity. In that event, depending on the nature and degree of interaction, the controlling shareholder may be considered to be a participant in the organization. In any event, although not legally binding, such interventions must be recognized and given appropriate weight in the organizational analysis of the corporation.

The duties of the board of directors and individual directors are, of course, owed to the corporation and not, under Canadian law, to the shareholders generally or to any shareholders in particular. Accordingly, the directors must consider such interventions in the light of all relevant circumstances.<sup>96</sup> In some cases, those circumstances may include the prospect of disruption of the

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<sup>92</sup> *Edwards v. Halliwell* [1950] 2 All ER 1064 at p. 1066, *per* Jenkins LJ [emphasis in the original].

<sup>93</sup> *Supra* note 16 at 501.

<sup>94</sup> See the discussion in Chapter Four in the section entitled “The Corporation as Principal”, particularly under the headings “Authority of Principal Divided Between Board and Shareholders” and “Respective Capacities of the Board and of Shareholders to Initiate Action”.

<sup>95</sup> See the remarks by Robé, *supra* note 54 at 31.

<sup>96</sup> *Ibid* at 32.



business and affairs of the corporation if the controlling shareholder seeks to remove the board. Needless to say, the merits of the suggestions offered should be given appropriate consideration.

## **Directors**

This work argues, notably in Chapters One and A1 through A3 inclusive, as well as in Chapters Two through Six inclusive, that the board of directors of the corporation is the primary, primordial, or first-level, actor for and on behalf of the corporation. In consequence, it has also maintained that the board of directors is not, and that an individual director is not, in any sense, an agent of the corporation.<sup>97</sup> Instead, as we argue in Chapters One, A1, and A2, the authority of the corporation as principal with respect to all matters, including appointment of agents, is shared to some extent, albeit unequally, as between the board of directors (collectively) and the shareholders (collectively). For practical purposes, however, it is the board of directors which has ultimate management authority, including appointing agents.

As detailed in Chapter A1,<sup>98</sup> day-to-day responsibility for managing the business and affairs of the corporation is assigned, without exception, to the board of directors, but subject to the rights of shareholders, as detailed in Chapter A2, to elect the directors,<sup>99</sup> to receive information with respect to the business and affairs of the corporation,<sup>100</sup> and to exercise supervisory authority with respect to exceptional circumstances or transactions.<sup>101</sup> The board is the body empowered to make decisions on behalf of the corporation and, in effect, is its highest decision making authority for most purposes.

Directors are themselves rights-and-duty-bearing parties, in which regard they are separate from the corporation itself. In the ordinary case, members of the board are not liable for obligations incurred by, nor are they entitled to benefits belonging to, the corporation. This is commensurate with the corporation's status as a separate legal entity and, in this case, as separate from its board

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<sup>97</sup> See Chapter A3 in the section entitled "The Corporation as Principal" and, in particular, under the headings "Respective Capacities of the Board and of Shareholders to Initiate Action", "Nature of the Duties and Responsibilities of Directors", and "The Representative Role of the Board". See also the literature cited in that part of the chapter and, especially, under those headings.

<sup>98</sup> See, in particular, "Management Role of the Board of Directors" and "Management Responsibility for Running the Business".

<sup>99</sup> See, especially, "Legal and Management-Related Rights of Shareholders".

<sup>100</sup> See, in particular, "Informed Voting by Shareholders".

<sup>101</sup> See, especially, "Shareholder Rights Beyond Voting".

of directors, both collectively and individually. Of course, as noted in Chapters A1,<sup>102</sup> and A3,<sup>103</sup> directors may incur liability for breaches of their “broadly defined fiduciary duties” imposed on them by law to the corporation, which include duties of care, good faith, and compliance. This is generally conceded to be appropriate in view of their “extensive powers to manage the corporation”.<sup>104</sup>

The authority of the directors to manage the corporation is direct and is a consequence of corporate law, as discussed in those chapters. They are not agents of the corporation or of its shareholders and, accordingly, they have no duties as “agents” towards the corporation or anyone else, including the shareholders. Further, not being agents, they are not subject to direct control or supervision by anyone who is their principal, as is normally the case with respect to agents.<sup>105</sup> However, as discussed in Chapters A1 and A3, the directors are bound to comply with legal formalities, including the relevant corporate statute and regulations, and the corporation’s charter documents, relevant to the corporation’s status as a legal entity.

Chapters Five and Six discussed various matters relating to the corporation as an organization. In particular, they considered matters relating to the relationship between the corporation at its highest organizational level and groups and subgroups within it, both individually and collectively, and relationships among those various groups and subgroups, as well as the positions of individuals within the organization and those various groups and subgroups. Those considerations raised further issues concerning the goals and objectives of the organization and its intraorganizational groups and subgroups and the effect of such goals and objectives on organizational, group, subgroup, and individual performance and attainment.

In turn, other subjects of discussion included matters relating to the informal structure and relationships of and within the organization, and the relationship between informal structure and relationships, on the one hand, and the formal structure and relationships, on the other hand. Chapters Five and Six raised the question of the extent to which the board of directors operates as

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<sup>102</sup> See, in particular, discussion under the heading “Management Role of the Board of Directors”.

<sup>103</sup> Note, especially, the discussion under the heading “The Corporation as Principal”.

<sup>104</sup> Deakin et al, *supra* note 65 at 197. These observations are reiterated by numerous authors, including, for example, Robé, *supra* note 54 at 4.

<sup>105</sup> *Supra* note 65. See also Robé, *supra* note 54 at 4 and at 33-4. See also Margaret M Blair, “Firm-Specific Human Capital and Theories of the Firm” in Margaret M Blair and Mark J Roe, eds., *Employees and Corporate Governance* (Washington, DC: Brookings, 1999) at 290.

an intraorganizational group and, even, as an intraorganizational organization. It is argued that such matters are, or may be, significant with respect to the role, duties, and operations of the board of directors.

Among other things, the board of directors of the ultimate parent corporation (“parent board”) must concern itself, on behalf of such corporation, with the election of boards of directors of subsidiary corporations (“subsidiary boards”). The directors on those subsidiary boards are, of course, required to comply with their statutory, law, and other legal duties, which will have to be reconciled with instructions or directions from the parent board, unless, of course, the ultimate parent corporation is party to a unanimous shareholder agreement under which it assumes the duties and obligations of the directors of the subsidiary.<sup>106</sup>

As a practical matter, however, such conflicts of duty are not particularly acute as long as the subsidiary is wholly-owned by the parent corporation. Although the focal director would owe separate duties to each corporation, the fact that the equity ownership and voting power is held only by the ultimate parent corporation would normally limit the freedom of action of the subsidiary board, which may be subject to replacement at any time, by written resolution or otherwise, at the instance of the sole shareholder. Thus, in many cases, the subsidiary boards do not act independently. Often, instructions and directions are transmitted directly from officers of the ultimate parent corporation (or some intermediary corporation) to officers of the focal subsidiary.

In many cases, that is, instructions or directions from the ultimate parent corporation to direct or indirect subsidiaries may be transmitted not from the parent board to the subsidiary board, but from an officer of the parent corporation to an officer of the focal subsidiary, or by an officer of a corporation subordinate to the parent corporation which is a direct or indirect parent of the focal subsidiary to an officer of such focal subsidiary. That is to say, the strict legal proprieties concerning the separate legal entity status of each corporation within the corporate group

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<sup>106</sup> Such reconciliation of the subject of considerable discussion in the relevant literature, which is, however, beyond the scope of this work. Although the focus of this work is on public corporations, subsidiaries of the ultimate parent corporation may or may not be public. Parents of subsidiaries which are not public corporations may take advantage of the unanimous shareholder provisions of s 146 the CBCA or s 108 of the OBCA. To the extent that such an agreement restricts the powers of the directors to manage or supervise the management of the business and affairs of the corporation, the shareholder has all of the rights, powers, duties and liabilities of a director in that behalf.

controlled by the parent corporation may not be observed. Indeed, such observance may not be organizationally effective in certain circumstances.

The effect of this state of affairs on the legal liability of the parent board and its directors, of the board and directors of the relevant subordinate corporations, and of the board of directors of the focal corporation are beyond the present scope of discussion. However, even the formal organizational structure and the formal processes and procedures may not accord entirely with the legal requirements attendant upon each corporation's status as a separate legal entity. Moreover, the informal organization and informal processes and procedures may be even less respectful of those legal requirements.

As noted in Chapter Five, even within a single (and even if unitary) corporation, compliance with the requirements of its organizational hierarchy are often short-circuited in order to improve performance. For example, rather than transmitting requests for information on the corporation up the hierarchical chain of a particular department or division to the level which it interfaces with another department or division, subordinate employees may be authorized, either explicitly or implicitly, to communicate directly with their counterparts in the other focal department or division.<sup>107</sup>

A frequent observation in this work, according with its overall objective, is that improving understanding of how corporations operating in the "real world" on the part of those concerned with law as it relates to corporations may be expected to improve legal compliance and legal efficacy while minimizing undue interference with factors conducive to corporate success.

## Officers

Although responsibility for the management of the business and affairs of the corporation is assigned by modern corporate statutes to the board of directors, such statutes also normally empower the board, subject to the provisions of the corporation's articles and bylaws, to appoint officers.<sup>108</sup> In some cases, as detailed in Chapter A1, the right to appoint officers other than the

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<sup>107</sup> See, especially, discussion under the heading "Fayol and Modern Business Management" and therein under the subheading "Fayol on Structure".

<sup>108</sup> See the discussion in Chapter A1, most notably in the section entitled "Management Role of the Board of Directors" under the heading "Board Appointment of Chief Executive Officer, Other Officers, and Other Management". As indicated there, Delaware corporate law permits the bylaws or the board of directors to empower the selection of officers otherwise.

Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”) may be delegated to the CEO, the CFO (with respect to officers reporting to the CFO), or other officers. Whatever the formal mechanics of appointment, the officers to whom subordinate officers report are generally considered to bear some (or, in some cases, complete) responsibility for the engagement, continuance, and termination of such subordinate officers.

In addition to the corporate statute, articles, bylaws, and relevant resolutions, the authority and responsibilities of officers may also be determined by a relevant contract, generally an employment contract of the officer is a full-time employee, by the provisions of other declarative law, and, importantly, by agency and other relevant common law. As discussed in Chapter A1,<sup>109</sup> actual authority may be conveyed to such an officer thereby. In addition, “a person held out by a corporation as a director, officer, or agent” may be clothed with apparent or extensible authority, namely, authority “to exercise the powers and perform the duties that are customary in the business of the corporation or usual” for such an officer, unless such authority is expressly vitiated by actual knowledge on the part of the person “dealing with the corporation” or “who acquired rights from the corporation”. Provisions to this effect are implemented by most modern corporate statutes, failing which, as noted in Chapter A2, they are imposed by agency law.<sup>110</sup>

Chapter A1 also discusses the duties imposed on officers by statute, by contract, and by common law.<sup>111</sup> Consideration of the essential organizational attributes of the corporation as organization as presented elsewhere in Parts 2 and 3 of this work complexify these matters considerably. Firstly, a question arises whether the references to persons “dealing with the corporation” or “acquir[ing] rights from the corporation” are limited to persons who are not themselves directors, officers, or agents of the corporation (which expression would include all management and many, if not all, other employees).<sup>112</sup>

This question addresses a situation in which a person whose superior “holds out” that person, perhaps expressly or perhaps implicitly, by acquiescence or otherwise) as having certain authority.

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<sup>109</sup> *Supra* note 102. Particular reference is made to the discussion under the heading “Apparent or Ostensible Authority of Directors, Officers, and Others”.

<sup>110</sup> See the discussion in Chapter A3, especially under the headings “Organizational Liability for Acts of Corporate Actors”; and “The Corporation as Principal”, and therein particularly in the discussion under the subheadings “The Role of Chief Executive Officer, Other Officers, and Other Management” and following.

<sup>111</sup> See, in particular, “Duties of Officers and Employees”. The quotations reflect Canadian federal and Ontario statutes.

<sup>112</sup> See, especially, “Duties of Officers and Employees”, particularly under the subheading “Duties at Common Law”.

It asked whether such person can be treated by a person within the corporation or within the enterprise and organization of which the corporation is a part and who does not have knowledge otherwise, explicitly or by virtue of the person's position with or relationship to the corporation (and, similarly, is such position or relationship limited to the focal corporation only?), as having such authority by reason of the applicable statute and common law.

The answer to this question has implications not only within the focal corporation but also within other corporations which are within the enterprise and organization controlled by the ultimate parent. It is clear from the description provided in this book that instructions or directions which are expected to be heeded frequently pass between persons who are officers in different corporations within the same overall enterprise. A related question concerns the effect of such instructions or directions on the liability on the person issuing, and on the person receiving, them, including the impact of the same as a matter of declarative and other corporate law, contract law (particularly concerning the relevant employment contracts), and agency and other common law more generally.

Secondly, as is apparent from the foregoing discussion, a question arises concerning the extent to which a person outside the corporation and the overall enterprise (that is, a "real outsider"), or a person outside the corporation but within the umbrella of the overall corporate enterprise (and hence, arguably, a third party to the focal corporation) may be said to be "dealing with" or to "acquire rights" from the focal corporation, in circumstances in which the person purporting to deal with the third party or to convey rights to that third party is not expressly "held out" by the focal corporation as having such authority. For example, the holding out may be effected by a person lacking actual authority to represent the focal corporation, such as a director, officer, employee, or other agent of a parent, subsidiary, or other affiliate of the focal corporation.

These questions acquire significance in relation to consumer transactions, such as what bank-related entity or entities have various types of responsibilities when a consumer goes into a bank branch and contributes funds to some government-sponsored plan (perhaps a registered retirement savings plan or RRSP in Canada, or an individual retirement account or IRA in the United States) which purports to be sold and administered by a bank-related entity other than the bank itself. However, these questions also acquire significance in relation to business-to-business transactions, for example, where parent corporation logos and names appear on business cards and other

stationery but orders are issued by or to, or formal contracts are executed by, a subsidiary of that ultimate parent corporation.

The point of the present discussion is not to resolve the specific questions posed or to result in the context of the examples provided, some of which may already have been addressed by declarative law or by common law in certain jurisdictions. Instead, it is to illustrate the types of issues which arise, as legal matters, where greater familiarity with organizational matters is acquired. Such issues are not limited to matters of corporate law alone. Of course, those types of issues go beyond the primary concern addressed here, which, as stated, is the interrelationship among legal essentialist characteristics of the corporation and organizational essentialist characteristics of the corporation.

### Managers and Other Employees

As described in Chapter A3, the CEO and any other officers appointed by or on behalf of the board of directors constitute the “first” or “top” level, or superior, agents of the corporation,<sup>113</sup> below which are various levels of inferior agents of the corporation.<sup>114</sup> All agents of the corporation may incur liability on its behalf and are entitled to indemnification with respect to the same.<sup>115</sup> Moreover, agents of the corporation may also incur liability to the corporation on account of any breach of duty to the corporation as principal.<sup>116</sup>

As discussed previously in this chapter, and in Chapter A3, all employees of the corporation, whether or not they are agents of the corporation, because they are in a relationship of employment with the corporation, may be considered to be participants in the corporation as organization.

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<sup>113</sup> See the discussion in Part 1 and Appendix A of this work, especially Chapters One, and A1 through A3, inclusive..

<sup>114</sup> Note, in particular, the discussion in Chapter A3 in the section entitled “The Corporation as Principal” under the subheading “Intracorporate Agency”.

<sup>115</sup> See, especially, the discussion in the section entitled “Organizational Liability for Acts of Corporate Actors” generally, especially under the heading “Master and Servant Law”, and under the headings following; and the discussion in the section entitled “The Corporation as Principal” under the heading “The Role of the Chief Executive Officer and Other Top Management Team Members” and under the headings following.

<sup>116</sup> This is referenced in a number of places in Chapter A3, including in the section entitled “Organizational Liability for Acts of Corporate Actors” under the headings “The Agency Relationship in Law” and “The Principal-Agent Relationship Inter Se” and in the section entitled “The Corporation as Principal” under the headings “Agency Law Duties”, “Intracorporate Agency”, and “Liability and Indemnification of Directors, Officers, and Others”.

## Lenders

Whether parties who provide debt financing to the corporation are participants in the corporation as organization depends upon the particular circumstances. It will be recalled that organizational participants are engaged in a relationship not only with the corporation, but also with other organizational participants.

Debt financiers who are not trade creditors are generally parties to the agreements with the corporation which deal with the conditions for the avilment, drawdown, and maintenance of funding, including both positive and negative covenants, and including events of default whereupon repayment is accelerated or becomes due. Certain legal essentialist characteristics, which may also be the subject of loan covenants or conditions are important in this regard. Capital lock-in prevents reduction of the capital available to the business, while limited liability protects the shareholders' assets from claims of the corporation's creditors, and asset partitioning protects the assets of the corporation from claims of creditors of the shareholders.

Debt providers whose arrangements of the corporation are restricted to simply lending funds, without further involvement in the corporation as organization, may not be considered to be organizational participants. Their relationship may be said to be external to the corporation as organization. However, where a lender appoints, is entitled to appoint a certain number of directors, or certain officers (perhaps the Chief Financial Officer, Treasurer, or Comptroller, a Monitor, and even a Receiver or Receiver-Manager), as a condition of the loan or upon the occurrence of certain other conditions, that lender, by means of its duly appointed agent, may be considered to be an organizational participant.

In that event, consideration must be given to how such organizational participation affects, or may affect, the legal relationship between the lender, corporation, and other relevant parties, including, but not limited to, matters relating to the legal essentialist characteristics of the corporation. For example, as in cases of instructions passing between officers of corporations that directly or indirectly control the focal corporation and officers of the focal corporation, questions (which, however worthy, cannot detain us here) may arise concerning the duties of the lender-appointed directors or officers to the focal corporation.

Other questions, which may have legal implications, may arise concerning the knowledge which may accrue to such lender as a result of this organizational participation, including, in particular,



the duties of such lender-appointed director or officer to the focal corporation with respect to the same, and the uses to which such knowledge may be put on behalf the lender and otherwise. Similar questions may arise where, for example, the lender has regular, perhaps monthly or even more frequent, meetings with the CFO and other senior financial officers, and perhaps with the Audit Committee of the board of directors. Where lenders can be said to assume a role as a participant in the organization, organizational analysis informs us that the communications between lenders and other intraorganizational participants may assume a character which is quite different from situations in which the lender is treated as a purely extraorganizational or external party. For example, there may be some expectation by corporate officers of some degree of cooptation of the lender's representative.

Whatever legal answers may be given to such questions in the absence of such organizational analysis, it is clear that the organizational analysis may be meaningful to both these questions and their answers and may affect the result reached based on this new understanding of the facts and circumstances relevant as a matter of law. Consequently, corporative theory or the corporative perspective may have, or may come to have, significantly legal consequences.

#### Distributors and Customers

As discussed, whether a distributor of the corporation's product or services is a participant in the organization will depend on the nature of their participation in the corporation not just on an economic basis, but in the ongoing enterprise. Robé, who considers the firm as an economic entity, finds that whether a distributor which is a party to a long-term contract requiring the distributor to distribute the focal corporation's goods or services only and exclusively can be regarded as an economic member of the firm will depend upon the degree of integration of the distributor's activities with those of the focal corporation, including the extent to which the distributor is required to make or has made investments which are specific to the focal corporation.<sup>117</sup>

As shown in the present book, social theorists from Weber's time to the present have articulated the relationship between organizations, authority, and power.<sup>118</sup> One of the indicia of whether a

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<sup>117</sup> *Supra* note 54 at 43-44.

<sup>118</sup> See, for example, Chapter Four, especially in the section entitled "Groups of People or Social Units" under the heading "Max Weber on Organizations and Related Matters"; and Chapter Five in the section entitled "Structure, Process, and Personnel" especially under the heading "Rational-Legal Authority, Administration, and Bureaucracy".

particular party participates in the focal organization is whether the focal party is subject to authority and power of, and within, the organization. Of course, other indicia include whether the focal party displays identification with, and even commitment to, the organization, and whether the focal party is identified as a participant by other parties who claim, or are seen by others, to be themselves participants. The behaviour of the focal party may be affected by these factors to various degrees, which may sometimes approach, approximate, or even exceeding, the requirements of legal contracts and other applicable law.

Adopting a corporative theory of the corporation, and thereby applying both legal and institutional analysis to it and to its activities facilitates considering how institutional factors may influence the behaviour and activities of the corporation, whether positively, negatively or benignly, as a legal entity subject to law; and, similarly, how knowledge of such institutional factors can be enlisted in aid of the law and legal compliance.

#### Suppliers and Others

In the case of all parties contracting with the focal corporation, Hodgson argues that whether that party is a member of the firm (as an economic entity) depends on the focal corporation's "effective power over them and on its ability to abuse it because of their lack of autonomy". He maintains that the firm as an economic entity has no "neat boundaries" but, instead, "just grey margins surrounding the firm" which depend, instead, on the issue at stake. Further, those boundaries "are linked to the fact that the firm is an organization exercising power (authority) and within which power is being exercised" and whose "limits could be said to exist where the effects of the power fade away."<sup>119</sup> Accordingly, he would employ these criteria in determining whether suppliers are members of his (economic) firm. For Robé, as well, the question whether suppliers bound by long-term contracts are part of the (economic) firm depends on the extent of control which the focal corporation exercises over them. This control, he says, reflects supplier-specific investments made by the focal corporation.<sup>120</sup>

In addition, Hodgson notes that mutual understanding and trust may characterize long-term "relational" contracting, including supply agreements, and the development of long-term

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<sup>119</sup> *Supra* note 21 at 44.

<sup>120</sup> *Supra* note 54 at 47.

relationships, especially when such relationships involve shared knowledge and mutual, interactive learning.<sup>121</sup> As explained previously, although the present book considers participation as relating to the organization through and by means of which the corporation operates and carries on business, the criteria employed by Hodgson and by Robé are relevant to determining what parties are to be considered as participants in the organization.

### **The Separate Legal Entity, the Organization, and the Individual Human Actor**

#### ***Acting on Behalf of the Corporation***

It is clear that the incorporators who become and constitute the relevant body corporate as a separate legal entity must either be individual human actors, or, if the incorporators are other than individual human actors, must be taking action through the instrumentality of individual human actors; and that such human actors, on their own behalf or on behalf of other bodies corporate or entities, actually personate, animate, and vivify the corporation, both at incorporation and subsequently.

It might be considered that those same human actors could be regarded as an organization, in the sense of a social group or unit of persons acting in concert in order to attain some common need or to achieve some common goal or objective. As a minimum, the incorporators or the individual human beings through whom they act are taking action, collectively or in concert, in order to establish the corporation, which is the common goal or objective. Accordingly, as established earlier in this work, those individuals acting to establish a corporation may be said to constitute an organization; and the individuals who thereafter carry on the “business” of such corporation may be said to act in that capacity as members of such organization.

Clearly, it is not possible to explicate all of the consequences of this duality; however, a number of the principal consequences have been chosen for examination here, including: firstly, the means by which the legal entity takes action through individual human beings, which engages issues relating to authority and its limitations; secondly, the related issue of the means by which individual human actions taken on behalf of the legal entity may be distinguished from individual human actions taken otherwise, including actions taken on one’s own behalf and actions taken on behalf of others; thirdly, the means by which actions taken on behalf of the legal entity may be

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<sup>121</sup> *Supra* note 21 at 45.

structured, whether simply or unitarily, through various divisions or groups within the single legal entity, or whether through various subsidiary corporations, each of which is a separate legal entity; fourthly, the considerations which are often applicable in respect of the foregoing determination; and, fifthly, how the application of those considerations at various points in time may implicate and result in adaptational changes in structure by the legal entity and, correspondingly, the implications of such changes in structure over time. As many of these issues have already been canvassed in the present chapter, those issues can be dealt with summarily here.

### ***Authority and Limitations on Authority***

As discussed above in relation to “Officers” and “Managers and Other Employees”,<sup>122</sup> the scope of the duty and actual authority of an officer, manager, or other employee may be determined by the bylaws or board resolutions, employment agreements, employee and other policy manuals, and otherwise. Frequently, the title of the officer or employee is some indication of duty and authority. However, it is possible that an officer or employee may receive instructions or directions that enlarge the express duty and authority previously relevant. As discussed, the officer or employee may explicitly or implicitly accept such variation, at least if it is within that person’s zone of acceptance or zone of indifference.

In certain cases, an officer or employee may seek to expand such duty and authority, whether as a result of exercising initiative or otherwise. If that expansion is within what might be called the employer’s “zone of acceptance” or “zone of indifference” with respect to such matters, the employer may, explicitly or implicitly, permit such extension of duty and authority. Ghoshal and Bartlett explain that “organizational effectiveness depends on the willingness and ability of visual to take personal initiatives, and on the structure, processes and norms organizations need to facilitate such initiatives”.<sup>123</sup>

However, whenever an employee exceeds his or her actual authority, this may come into conflict with formal authority, either because someone else has actual authority in the instant case or because the employee expansion of authority conflicts with rules regarding authority. Similarly, such employee action may conflict with the informal organization, rules, procedures which are

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<sup>122</sup> See also the references in notes 108 and 109 to certain discussions in Chapters A1 and A3 of this work.

<sup>123</sup> *Supra* note 81 at 109.

operative. Thus, according to Ghoshal and Bartlett, “individuals are also subject to certain failures and limitations, so the same structure, processes and norms [which facilitate personal initiatives] must also protect the organization from those pathologies of individual behaviors and actions.”<sup>124</sup> In some cases, the employer may tolerate such employee action as a sort of “test” of whether actual authority should be expanded.<sup>125</sup>

As previously discussed, where an employer permits an employee to exceed his or her actual authority, such employee would acquire ostensible authority, which would normally permit third parties outside the corporation to rely on actions of that employee, both at common law and by statute.<sup>126</sup>

At common law, the scope of authority of agents to interact with outsiders was originally related to the function performed. For example, employees within the sales function sold products and services to outsiders; employees within the operations or financial function collected receivables from outsiders; employees within the purchasing function purchased from outsiders the necessary products and services to be used as inputs; and employees of the operations or financial function attended on the payment of accounts payable to outsiders. Consequently, the scope of the delegation and specialization, by means of function, in turn, determined the scope of authority of individual persons to act as agents of the corporation. The inclusion of any individual person in a particular department or function, and the title bestowed on such person, was intended to convey to outsiders the nature and extent of the authority of such person to act with respect to relevant outsiders.

The ascension of M-form corporations or MDCs, and multinational enterprises or MNEs, as chronicled in Chapter Three<sup>127</sup> complicated these issues. The span of activity of particular functions, divisions, departments, or corporations within the overall organization could be

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<sup>124</sup> *Ibid.*

<sup>125</sup> As indicated previously, this is sometimes the case with respect to deviance from otherwise applicable organizational rules. See, in particular, Chapter Five under the heading “Organizational Structure” especially under the headings “Informal Structure and Relationships” and “Formal Organizations and Informal Organizations” and, under the latter heading, in the section entitled “Informal Organizations and Institutionalized Deviance”.

<sup>126</sup> *Supra* note 122.

<sup>127</sup> See, particularly, discussion in the section entitled “Forms of Corporations – Legal and Organizational Variants”. See also discussion in Chapter Two in the section entitled “History of the Development of the Modern Business Corporation”, and in Chapter Six in the section entitled “Organizational Goals and Intraorganizational Goals” and therein, especially, under the heading “Organizational Goals and Corporate Operations” and therein under the subheading “MDCs and MNEs”.

extremely difficult for outsiders to determine. This might affect not only the actual authority, but also the ostensible authority, of officers or managers within those groups. Such perceptions by outsiders may relate to legal matters, including some relating to the legal essentialist characteristics of the corporation, such as separate legal entity status and asset partitioning. Legal boundaries may not always be clear: outside parties may not know the legal nature of the group with whom they are interacting. Accordingly, they may not know whether they are engaging with the legal capacity of the ultimate parent corporation, a subsidiary, an affiliate, or otherwise. Yet it is clear that such legal boundaries make a difference both to the external parties and to the enterprise itself.

Depending on the degree of integration within the organization, the names by which intraorganizational groups are identified to outsiders may or may not reflect their legal status; but they may not even adequately reflect their function. Consequently, the titles of officers and managers within those intraorganizational groups may not be an adequate indicator of their actual authority. For example, when Enron Corporation filed a bankruptcy petition with the bankruptcy court in the Southern District of New York on December 2, 2001, it also filed on behalf of 13 of its critical subsidiaries. However, the time, it had more than 3,500 subsidiaries in the United States and abroad, many, if not all, of which were expected to commence bankruptcy proceedings.<sup>128</sup> That all of these were clearly identified to trade creditors and others as entities that were legally separate from Enron may be considered to be extremely doubtful.

A related concern is whether shareholders of, and lenders to, Enron or any of the subsidiary or affiliated corporations were aware of the legal status of the subsidiaries and other entities and the legal effects of such status. For example, Simon Deakin and Suzanne Konzelmann report that “Enron took advantage of US accounting rules, which enable companies to set up corporate vehicles, so-called special purpose entities or SPEs, to manage assets off balance sheet” by transferring an asset to an SPE in exchange for issuing debt to the vendor company. Such debt, together with equity investment from an outside investor would enable the vendor company to earn a higher rate of return as a result of the SPE investment.<sup>129</sup>

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<sup>128</sup> Orrick, Herrington & Sutcliffe LLP, "Enron Corp. And Related Entities: Legal And Strategic Issues Affecting Creditors of Enron" (December 4, 2001) 2 Thinking About Enron 1 at 3.

<sup>129</sup> Simon Deakin and Suzanne J Konzelmann, "Learning from Enron" (2004) 12:2 Corporate Governance Intl Rev 134 at 136.

Then, “in the course of the nineteen nineties, Enron set up several thousand companies which, thanks to the rules of US GAAP on SPEs and so-called “equity accounting”, did not count as its subsidiaries and whose accounts therefor did not need to be consolidated with its own and enabled it to “replace potential liabilities (risky or heavy investments with the potential to be a drain on the oh company)” with assets in the form of debt obligations owed by the SPE to Enron and earnings from such repayments of debt.<sup>130</sup> This did not infringe any accounting principles or rules of corporate law until, in the absence of real outside investors, Enron started creating “sham” outside investors and outside investments. The eventual restatement of Enron’s earnings statement and balance sheet which became necessary on discovery of the shams reduced Enron’s net worth by several billion dollars and contribute to its eventual bankruptcy.<sup>131</sup>

These transactions also involve borrowings from third parties were not aware of the non-independent nature of the SPEs and who dealt with persons who were not independent of Enron but, instead, were Enron employees who reported to the CFO of Enron.<sup>132</sup> It might be conjectured that the persons dealing with those third-party lenders likely represented themselves as employees are agents of the relevant SPEs, rather than as Enron employees. In this sense, the complexity of the Enron ownership structure may have obfuscated the nature and identity of the party, and its representative, securing the loan.

### ***Acting on One’s Own Behalf and Acting on Behalf of Another***

As noted above,<sup>133</sup> the activities of typical organizational participants, particularly employees, are not exhausted by intraorganizational action. Instead, organizational participants commonly engage in extraorganizational activities, which may or may not involve participation in other organizations. Accordingly, Hodgson describes employees as "crossing the boundaries of the

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<sup>130</sup> *Ibid* at 137.

<sup>131</sup> *Ibid* at 138.

<sup>132</sup> Stuart L Gillan and Jon D Martin, "Corporate Governance Post-Enron: Effective Reforms, or Closing the Stable Door?" (2007) 13 J Corporate Finance 929 at 943.

<sup>133</sup> Reference is made to the text in this chapter under the heading "The Corporation, the Legal Entity, the Organization, and the Participants" and therein under the subheadings "The Organization and Organizational Participants" and "The Borders of the Corporation and the Borders of the Organization", and "Categories of Organizational Participants"; and under the heading "The Separate Legal Entity, the Organization, and the Individual Human Actor" and therein under the subheading "Acting on Behalf of the Corporation".

firm", and as being "inside" the firm "during the periods, and under the circumstances specified in the employment contract."<sup>134</sup>

In the case of officers, managers, and employees, the employment contract and attendant declarative and common law is an appropriate point of commencement for an inquiry into when the employee is acting on behalf of the corporation. As discussed in Chapter A3,<sup>135</sup> an officer, manager or other employee who pursues other activities, at least during normal working hours, may be considered to be in breach of the focal employment agreement which may result in liability to the corporation. This is also true of actions in excess of the individual's actual authority.

However, acts done by the individual on behalf of the corporation which are within the individual's actual authority do not incur any personal liability. It is the scope of the individual's responsibility within the corporation which is a primary determinant of when acts of the individual is acting on behalf of the corporation and thus binds the corporation, and also when the individual is acting on his or her own behalf, or on behalf of another (which may be a group, corporation or other organization, or otherwise).

Such a person may, however, undertake activities on behalf of the corporation during other periods and away from the corporation's offices. Such person may also be undertaking activities on the person's own behalf simultaneously or intermittently during those periods, which activities may not be subject to the employment arrangements. Further, that person may take actions on behalf of other groups or organizations. As is well known, some acts undertaken by officers, managers, or other employees outside of their exercise of authority may be considered to breach the express and implied terms of the employment arrangements and, as such, to provide grounds for the employer taking action against the employee by way of sanctions, sometimes including termination of employment.<sup>136</sup>

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<sup>134</sup> *Supra* note 21 and accompanying text.

<sup>135</sup> See "Organizational Liability for Acts of Corporate Actors"; and "The Corporation as Principal" under the subheadings "Intracorporate Agency" and "Liability and Indemnification of Directors, Officers, and Others".

<sup>136</sup> One example which often comes to public notice involves celebrities who enter into agreements to represent, endorse, or otherwise promote a particular brand of consumer product. Such agreements commonly contain "morals clauses" which allow the brand owner contracting for such services to terminate the contract, generally without penalty, in the event that the subject celebrity engages in action which somehow brings them into public disrepute.



### *Effects of Separate Legal Entity Status on Organizational Structure*

As discussed earlier in this chapter, especially under the heading “The Corporation, the Legal Entity, the Organization, and the Participants”, in many cases, the organization and the corporation will correspond and yet their boundaries will not be coterminous. As indicated, the relevant business activity, which we have denominated as “the enterprise” may involve a business entity or business entities characterized by various legal forms, including, perhaps, corporations, limited liability corporations (LLCs), limited partnerships, partnerships, business trusts and others.

#### MDCs and MNEs

Chapter Three distinguishes between a unitary or U-Form corporation and a multidivisional corporation (“MDC”) or M-Form corporation.<sup>137</sup> Alfred Chandler and Oliver Williamson identify a unitary or U-Form corporation as operating in a single product line or in multiple but related product lines, and as vertically integrated with central or ministration through various functional departments. Fligstein describes the multidivisional form as decentralized, being organized into product divisions and each of which contains a unitary structure with separate functional departments. Such a division is not normally a separate corporation but, instead, operates as a matter of law, as the focal corporation directly.

As described in Chapters Two and Three, Chandler chronicles the historical development of M-form corporations or MDCs largely by reference to the expansion of, and advances in, technology.<sup>138</sup> Chapter Three details the different relationships which can obtain between the focal corporation’s headquarters, on the one hand, and its strategic business units (“SBUs”) or business units (“BUs”), on the other.<sup>139</sup> The exposition in these two chapters relates to the organization by which the ultimate parent corporation operates its business or enterprise; from which it may be

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<sup>137</sup> The corporation described as “U-Form” or “M-Form” is the ultimate parent corporation, sometimes called the “holding corporation” at the top of the ownership and organizational hierarchy and “org chart”. See, especially, the text under the heading “Forms of Corporations – Legal and Organizational Variants” and therein under the subheadings “Unitary or U-Form Corporations” and its subheading “Characteristics of the Unitary or U-Form Corporation; and “M-Form Corporations” and its subheading “Characteristics of M-Form Corporations”.

<sup>138</sup> *Ibid.* For the detail of such historical development, see Chapter Two, in particular, under the heading “History of the Development of the Modern Business Corporation”.

<sup>139</sup> See the discussion under the heading “Forms of Corporations – Legal and Organizational Variants” at, and following the text, under the subheading “The Headquarters-Strategic Business Unit Relationship”.

concluded that the “big picture issues” relating to such organization are largely independent of the legal form of those business units. Exceptions to this state of affairs are discussed below.

In this regard, Chapters Four, Five, and Six compared the organizational essentialist attributes of an organization with the features of corporations as organized and operated “in the real world”. These concerned the presence of the following elements: firstly, a social unit or group of persons (Chapter Four); secondly, the structure, processes, and management and organizational personnel by means of which it functions or operates (Chapter Five); and the goals and objectives shared, and pursued, by members of the organization (Chapter Six). These “organizationally essentialist” attributes could be ascribed to the ultimate parent corporation of a corporate group or enterprise and to such corporate group or enterprise without, for the most part, referencing the legal structure of the groups or business units encompassed within it.

Concerning the organization of the business or enterprise, reference is made to the heading “Fact Pattern for Discussion” in this chapter. There, an example was provided involving a public listed corporation known as “Great Motoring Corporation” (“GMC” or the “Corporation”), having four divisions, two of which, Ultimate and GMT, each have a separate subsidiary of GMC at the top of their divisional “organization chart”, and two of which, Challenger and Champion, do not have direct subsidiaries of GMC at the apex of their divisional hierarchy. GMC can be described as a multidivisional corporation, or M-Form corporation, or MDC, as described in Chapters Two,<sup>140</sup> and Three.<sup>141</sup>

Chapter Two discusses Chandler’s chronology of the development of MDCs, denominated by him as multidivisional enterprises (“MDE’s”), which he related to advances in transportation and communications, as well as increases in the concentration of population, in wealth and in demand, among other things. This permitted advances in what he called “administrative coordination”, saying that the modern business enterprise appeared when the volume of economic activities made administrative coordination more efficient and more profitable than market coordination.<sup>142</sup> This

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<sup>140</sup>*Ibid.*

<sup>141</sup> *Supra* note 138.

<sup>142</sup> See, especially, the section entitled “History of the Development of the Modern Business Corporation”, especially under the heading “The Visible Hand: The Managerial Revolution in American Business” and therein under the subheadings “Chronicling the Development of the Multiunit Managerial Corporation”; and under the heading “Administrative Development and Business Expansion – Fundamental Observations”.

permitted the development and continued growth of multiunit business enterprises. Chandler criticized economists for their failure to analyze the function of administrative coordination such that their theory of the firm remained essentially a theory of production.<sup>143</sup>

Much of the discussion in Chapter Three concerning M-form corporations relates to the relationships between the headquarters and the strategic business unit and to the relationships among SBUs. Much of such discussion also relates to the organizational structure of multinational enterprises (MNEs) and to MDCs more generally. In particular, the relationship between headquarters functions and organizational strategy and structure is discussed, including examination of financial control, strategic control, and strategic planning models of interaction between headquarters and business units.<sup>144</sup>

In effect, the description of MDCs and MNEs (and, for that matter, unitary corporations) by specialists and other commentators is generally agnostic on the subject of legal form: that is to say, the discussion of the overall organizational structure and processes generally does not treat the legal form of a particular business units, or even divisions, as being of cardinal importance. As noted previously, and reported in Chapter Three,<sup>145</sup> an extensive review by Birkinshaw and Hood of literature and theory development in connection with the evolution of multinational subsidiaries<sup>146</sup> even defines the term "subsidiary" in non-legal terms, considered it as a "value-adding entity in its country" regardless of the legal structure of that economic subsidiary, that is, whether as one or more separate legal entities or divisions or branches or branch of the MNC.<sup>147</sup>

An earlier review of research and theoretical work concerning MNCs by Theodore Herbert examined the principal strategies leading to internationalization and the relevant structural design criteria relating to such strategies and structures of operations, but generally without specifically

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<sup>143</sup> *Supra* note 138. See the discussion under the heading "Administrative or Organizational Development and Economic Theory".

<sup>144</sup> Reference is made to the discussion in the section entitled "Forms of Corporations – Legal and Organizational Variants", commencing with the heading "M-Form Corporations" and continuing to the end of the chapter.

<sup>145</sup> In particular, note the discussion under the heading "Power and SBU Evolution".

<sup>146</sup> Julian Birkinshaw and Neil Hood, "Multinational Subsidiary Evolution: Capability and Charter Change in Foreign-Owned Subsidiary Companies" (1998) 23:4 *Acad Mgem Rev* 773 at 773 and 774. See the discussion in Chapter Three under the headings referenced in note 139.

<sup>147</sup> Note, especially, discussion in the section entitled "Forms of Corporations – Legal and Organizational Variants" under the headings "Power and SBU Evolution", "Multinational Enterprise Organizational Structure", and "Headquarters Functions, Strategy, and Structure".

referencing the legal structure attendant upon such international operations.<sup>148</sup> For example, it reviews the potential establishment of an international division and considers the possibility that it can be structured according to geography, product lines, function or some combination of these criteria and considers them most likely to be headed by a Vice President reporting directly to the CEO.<sup>149</sup> It also considers a structure in which foreign and domestic markets are treated identically by means of fully integrated regional operations, the officers heading which would report directly to the CEO.<sup>150</sup> It also considers the use of a matrix structure,<sup>151</sup> as discussed in Chapter Six.<sup>152</sup> Thus, these reviews of research and theory concerning MNEs are generally ambivalent concerning the legal structure of the foreign operation.

In many cases, administrative or organizational considerations operate across the organization irrespective of legal boundaries; and the division and allocation of authority and responsibility within the organization is often based on organizational, rather than legal, parameters. However, legal considerations may become more dominant in certain fact situations, such as where a particular division is experiencing organization decline: it may be advisable to structure that possibly failing division as a separate corporation, in order to immunize other divisions from the adverse consequences of its possible failure. Where the focal corporation is actively and regularly engaged in acquisitions or divestitures, whether in a particular division or otherwise, it may be advantageous to employ separate corporate entities, at the divisional level or otherwise.

### Deconglomeration

Davis, Diekmann & Tinsley's 1994 review of the deinstitutionalization of conglomerates during the nineteen eighties relates this development to the external environment and other considerations.<sup>153</sup> It indicates that the model of growth through acquisition centred on diversification into other industries arose partly as a result of the regulation of horizontal and

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<sup>148</sup> Theodore T Herbert, "Strategy and Multinational Organization Structure: An Intraorganizational Relationships Perspective" (1984) 9: 2 *Academy of Management Rev* 259.

<sup>149</sup> *Ibid* at 263.

<sup>150</sup> *Ibid* at 264.

<sup>151</sup> See the discussion in Chapter Three under the headings referenced in note 139 and, in particular, under the heading "Matrix Organizations" and the literature referenced in the footnotes under that heading.

<sup>152</sup> See the discussion in the section entitled "Forms of Corporations – Legal and Organizational Variants" and therein under the heading "Multinational Enterprise Organizational Structure".

<sup>153</sup> Gerald F Davis, Kristina A Diekmann, and Catherine H Tinsley, "The Decline and Fall of the Conglomerate Firm in the 1980s: The Deinstitutionalization of an Organizational Form" (1994) 59:4 *American Sociological Rev* 547.

vertical integration by statute starting in 1950 and that this gave rise to the “firm-as-portfolio” model described by Michael Porter as being dominant in the late 1980s.<sup>154</sup>

Those authors indicate that doubt concerning the merit of bringing weakly related businesses together under a single management and the rise of a takeover market in the nineteen eighties provided motive and mechanism to deinstitutionalize these conglomerates,<sup>155</sup> by means of “bust up” takeovers “where raiders bought conglomerates and financed the deal from the post-acquisition sale of their separated parts” by means of divestitures, and by divestiture of unrelated businesses to focus on “core businesses” when not threatened by hostile takeovers.<sup>156</sup>

The conglomerate form and the “firm-as-portfolio” model of the corporation, they argue, deinstitutionalized “the very idea of the corporation as a bounded social entity analogous to a sovereign body”, effectively as a separate legal entity.<sup>157</sup> Whereas the growth of a corporation could be seen as somehow natural or organic like a body, “conglomerates strained the body analogy, because they offered no credible basis for a myth of identity” in the sense that the parts were not contiguous and “did not *belong* together by any “natural” link.”<sup>158</sup>

Thus, the authors argue, although the rise of conglomerates may have resulted from growth strategies, the very existence of conglomerates themselves “inherently undermined the notion of the firm as a bounded actor, capable of growth, and distinct from its environment; and poor financial performance of invited challenges in the form bust-up takeovers moreover, once bust up to possible, the sovereignty of any organization boundary was rendered problematic” and, accordingly, “any aspect of what an organization did was a potential candidate for externalization if it failed to meet a market test” as adjudged by actors inside and outside of the organization.<sup>159</sup>

Chapter Six demonstrated that organizations, including corporations, experience internal and external threats to their organizational stability and that the ability to secure scarce and critical

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<sup>154</sup> *Ibid* at 547. See Michael E Porter, "From Competitive Advantage to Corporate Strategy" (1987) 65:3 Harvard Business Rev 43. See also Neil Fligstein, "The Spread of the Multidivisional Form Among Large Firms, 1919-1979" (1985) 50 American Sociological Rev 377; and Neil Fligstein, "The Structural Transformation of American Industry: An Institutional Account of the Causes of Diversification in the Largest Firms, 1919-1979" in WW Powell and PJ DiMaggio, eds, *The New Institutionalism in Organizational Analysis*, (Chicago, Ill: University of Chicago: 1991).

<sup>155</sup> *Supra* note 153 at 548.

<sup>156</sup> *Ibid*.

<sup>157</sup> *Ibid* at 551.

<sup>158</sup> *Ibid* at 565-566.[emphasis in the original.]

<sup>159</sup> *Ibid* at 566.

resources needed by the organization, to “cope” with uncertainty to which the organization is subject, to obtain and distribute critical information, and to allocate resources and sanctions are important determinants of intraorganizational power, including the capacity to influence organizational goals.<sup>160</sup>

As argued there, these critical abilities and their significance are not likely to be immediately apparent from a glance at the corporation’s organizational chart. Depending upon the historical background to the corporation’s current configuration, its duration, and many other factors, even “loosely coupled” enterprises may become significantly integrated in ways not obvious to outsiders. Consequently, external proposals assessing certain corporate operations as performing inadequately, may not reflect the totality of the contribution of such operations to the organization as a whole. Similarly, proposals for their divestiture may not take into account all of the concomitant costs and disbenefits. That is not, of course, to argue that such proposals are intrinsically unmeritorious and unworthy of implementation; but, instead, suggests that a painstaking organizational investigation and assessment should attend such proposals.

#### Multilayered Subsidiary Forms (MLSFs)

As just discussed, developments, both internal and external, to a particular corporation at the level of the ultimate parent corporation may result in changes to its internal legal structure. Some of these developments may be shared more widely among companies in certain industries or pursuing certain strategies, while others may be shared among public companies generally. An important 2002 study by Boies and Prechel examined changes in the structure of the largest US industrial corporations in the late 20th century, from MDCs to multilayered subsidiary forms (MLSFs), during a period of economic uncertainty. They attributed this change to capital dependence, arguing that “capital accumulation opportunities and constraints are historically contingent, and corporate transformation occurs in response to those historical and social forces” and that the MLS of increases financial flexibility<sup>161</sup>

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<sup>160</sup> See the discussion in the section entitled "Organizational Goals and Intraorganizational Goals", especially under the heading "Intraorganizational Goals, Power, and Loyalty" and therein under the subheading "Information and Sanctions as Sources of Intraorganizational Power".

<sup>161</sup> John Boies and Harland Prechel, "Capital Dependence, Business Political Behavior, and Change to the Multilayered Subsidiary Form" (2002) 49:3 Social Problems 301 at 321.

They defined a MLSF as a hierarchy of two or more levels of subsidiary with a parent company acting as a management company, at the top.<sup>162</sup> This took place in connection with a reconfiguring of product lines, such that after reconfiguring a large division into subsidiaries, top management would acquire other corporations to gain greater market concentration and control in a particular product line, while divesting from other product lines by spinning off subsidiary corporations. This resulted in the elimination of non-core businesses and the reduction of diversification.<sup>163</sup>

The study reports that during the nineteen eighties, the size of the largest corporations and the concentration of asset ownership in them increased substantially but that subsidiaries became increasingly widespread by the early nineteen nineties. The largest 100 industrial corporations had 703 subsidiaries in 1981, but 2,724 subsidiaries in 1987, with another 1796 subsidiaries added in the next six years, by 1993. The mean number of divisions in the largest 100 industrial corporations dropped from 8.8 in 1981 to 4.3 in 1993, while the mean number of subsidiary corporations increased from 21 to 48.<sup>164</sup> Ten of the largest had more than 100 domestic subsidiaries, one of which had 156 and another of which had more than 200.<sup>165</sup> There were no fourth level or fifth level domestic subsidiaries in 1981, but 34% of that group had fourth level and 15% had fifth level domestic subsidiaries in 1993. A number of corporations had fifth, sixth, and even seventh level subsidiaries by 1996.<sup>166</sup>

As compared with a MDC structure, Boies and Prechel say that a MLSF structure: may create an improved incentive structure for employees, because of separate financial reporting, such as by use of “tracking stock” which acts as a proxy for how well the subsidiary would perform if it was an independent company; may improve the operation of internal capital markets (capital availment by the parent); may reduce the cost of acquiring and maintaining investment in the focal entity; may permit public ownership of the minority interest, which may increase visibility although at the expense of the compliance and financial costs of maintaining public company; may facilitate increasing the capital base by public equity offerings which may be dilutive unless the parent invests proportionately (which, however, may be done at a later time when it has funds available

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<sup>162</sup> *Ibid* at 301.

<sup>163</sup> *Ibid* at 302.

<sup>164</sup> *Ibid*.

<sup>165</sup> *Ibid* at 321.

<sup>166</sup> *Ibid* at 302.

or when the stock price is cheaper); and may facilitate any necessary restructuring and employee layoffs.<sup>167</sup> It also increases financial flexibility; allows changes from debt to equity financing; may expedite forming joint ventures or other business combinations with third parties; insulates the parent and other subsidiaries from liability for the focal corporation; and may result in a higher price/earnings multiple or higher stock value.<sup>168</sup>

Boies and Prechel purport to follow Chandler and Williamson in maintaining that “conglomerates are a category within a corporate form; business units within conglomerates can be organized as divisions or subsidiaries”.<sup>169</sup> However, they maintain that “change in the dominant business unit (e.g., department, division, subsidiary)” can be seen as “the criterion to signify corporate form change”.<sup>170</sup> They say that: “Just as the shift from departments to divisions changed the basis of top management control, the change from divisions to subsidiaries changed the way in which top management controls their business units”, which becomes expressed in terms of property relations since, unlike divisions which “are part of the same corporation see central office, subsidiaries are legally separate corporations that are wholly or partly owned by the parent company.”<sup>171</sup>

Their principal argument in this regard is that where the subsidiary corporations are public corporations, top management of the parent company can employ stock values, profits and other related information concerning the subsidiaries to monitor their performance. Of course, not all conglomerates involve hierarchies of public corporations, but those that do are affected by the separate legal status of the subsidiaries. As well as requiring relevant information to be provided to outside shareholders, of course, other matters involving duties and responsibilities to shareholders become relevant not only at the parent corporation level, but at the level of the subsidiary public company. In those events, the scope of the legal consequences of separate legal entity status result more from public company status than from SLE status.

### **Extraorganizational Action and the Corporation**

It has become apparent that shifts in organizational structure, whether from the U-form to the M-form, or from the M-form to the MLSF reflect adjustments in corporate strategy. Those

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<sup>167</sup> *Ibid* at 308-309.

<sup>168</sup> *Ibid* at 321.

<sup>169</sup> *Ibid* at 304.

<sup>170</sup> *Ibid*.

<sup>171</sup> *Ibid*.



adjustments in corporate strategy may also be reflected in changes in organizational processes and in changes in organizational personnel. As suggested here, the sudden “curtaining off” or internalizing of certain functions within a particular subsidiary, as compared with previous operation of those functions across the organization as a whole, may be undertaken in response to its perceived decline and possible restructuring or divestiture, and in order to preserve the benefits of asset partitioning. This is an example of the kind of organizational change which engages legal essentialist attributes to which legal experts and others must be attentive.

In view of the way in which many MDCs, MNEs, and even MLSFs integrate certain operations and functions across the whole enterprise, observers must consider whether or not changes in such practices are motivated by legal matters, including paying attention to and relying upon legal essentialist attributes of the corporation. Such changes may also require the attention to the question how organizational participants are differentially affected by such changes; and, in effect, how such changes affect the expectations of organizational participants with respect to the corporate relationship, whether at the level of the ultimate parent and organization as a whole or at the level of the focal corporation concerned.

For example, in the GMC fact pattern, the incorporation of a new corporation to carry on the activities previously carried on by the Champion Division may suggest that its performance is otherwise than its name might indicate; namely, that it is experiencing some organizational decline such that it would benefit the parent corporation and other divisions if it was subject to asset partitioning. Alternatively, it may suggest that its performance has been sufficiently positive that its divestiture and the resulting reemployment of funds arising from such divestiture might be appropriate and might actually be under consideration. These observations lead to consideration of limited liability and asset partitioning.

### **Legal Structure, Organizational Structure, and Value of a Diversified Enterprise**

As reviewed in Chapter Two, Chandler chronicled the relationship between strategy and structure in the context of the challenges of diversification and against the background of the historical development of major industrial corporations.<sup>172</sup> A 1998 review of research and theoretical

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<sup>172</sup> See, in particular, discussion in the section entitled "History of the Development of the Modern Business Corporation" and therein under the headings "Strategy and Structure" and "The Visible Hand: The Managerial Revolution in American Business".

literature by Bethel and Liebeskind<sup>173</sup> argues that, while a firm's organizational structure has been shown to be related to diversification and performance,<sup>174</sup> "to date the legal organization of firms has been largely neglected by organization scholars."<sup>175</sup> Of course, the present work has maintained that the corporation is characterized by both legal and organizational aspects or characteristics and that these interact with one another, particular importance being assigned to the interaction of legal essentialist characteristics and organizationally essentialist characteristics.

Bethel and Liebeskind devote attention to the diversified firm, in particular, and find that the "existing literature on the relationship between strategy and structure tends to ignore the legal dimension of the organization of diversified firms".<sup>176</sup> The authors argue that "*the value of a diversified firm is related to its legal organization*".<sup>177</sup> In particular, they examine what they call "corporate groups", in which "a 'parent corporation' owns or partially owns a series of subsidiary corporations and/or partnerships", which subsidiary firm's operate domestically.<sup>178</sup>

They claim that the prevalence of corporate groups is sought to be explained by the desire to limit product and other tort liability, to reduce taxes, and to allow large shareholders to increase their voting control relative to a simple, that is to say unitary, corporation. They purport to show that "under some circumstances the value of a diversified firm will be higher if it is organized in the corporate group than if it is organized as a simple corporation" because costs that might otherwise be borne by some current stakeholders of the simple corporation (but not by others who may benefit, instead) as a result of diversification and which may result in the corporation incurring "protection costs" (such as lawsuits, proxy battles, imposing protective covenants and charter documents, debt instruments or labour agreements) can be reduced or eliminated within the corporate group structure.<sup>179</sup>

Their discussion is framed in terms of "stakeholder" analysis, distinguishing primarily between parties having fixed claims against the corporation, such as holders of debt instruments or

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<sup>173</sup> Jennifer E Bethel and Julia Porter Liebeskind, "Diversification and the Legal Organization of the Firm" (1998) 9:1 *Organization Science* 49 at 51.

<sup>174</sup> *Ibid* at 49.

<sup>175</sup> *Ibid* at 63.

<sup>176</sup> *Ibid* at 49.

<sup>177</sup> *Ibid* at 51 [emphasis in the original].

<sup>178</sup> *Ibid* at 51-2. They acknowledge that foreign operations may involve additional risks.

<sup>179</sup> *Ibid* at 50-51.

creditors, as against those having residual claims, such as holders of equity or common shareholders. Our analysis focuses, instead, on organizational participants. However, their focus on fixed and residual claimants against the corporation can be accommodated within our corporative perspective. Their investigation yields a number of conclusions about the relationship between legal and organizational characteristics.

Firstly, the performance, and hence value, of a diversified firm is related to its legal organization, and not only to its internal organization. That is to say, the value of the diversified firm is affected not only by its organizational characteristics, but by its legal characteristics.<sup>180</sup> As explained in our corporative theory, particular legal and organizational characteristics, including those which we describe as “essentialist”, affect or “map onto” each other in various ways. For example, Bethel and Liebeskind say that the economies of scope (reduction of average cost per unit produced) are lower in a corporate group because of separate accounting and more independent management.

Secondly, “the value of any specific diversification event should depend, inter alia, on the legal organization with which it takes place”.<sup>181</sup> This would apply to acquisitions and divestitures. They posit that differences in stock market valuations of such trigger events may be affected by the legal form obtaining pre-event and post-event, inasmuch as stock market values would be discounted if the legal organization considered by the market to be preferred is not adopted at the relevant time. For example, completely selling off, as a subsidiary, a business operation which has high potential tort liability is more advantageous than selling it off as a division by way of asset sale.

Thirdly, “the “relatedness” of a given diversification strategy may be a choice variable for managers, because it is more difficult and costly to exploit economies of scope in corporate groups.”<sup>182</sup> In other words, there may be barriers to achieving such savings, which may be in the form of high associated protection costs.

Fourthly, “corporate restructurings, especially spinoffs and divestitures, may result from changes in the cost of diversification or changes in the distribution of its costs and benefits between fixed and residual claimants.”<sup>183</sup> They argue that this is because “the optimal legal organization of a firm

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<sup>180</sup> *Ibid* at 60-61.

<sup>181</sup> *Ibid* at 61.

<sup>182</sup> *Ibid*.

<sup>183</sup> *Ibid*.

depends on economies of scope, cash flow variance, and the priority claims, changes in any of can be expected to change the optimal legal organization of a firm and even, its overall scope.”<sup>184</sup> For example, they suggest that firm should spin off or divest lines of business affected by “strict liability” product regimes. They also argue that, for this reason, firms are less vertically integrated in industries where product liability exposure is high.

Fifthly, they argue that residual claimants (common shareholders) “are more likely to undertake variance-increasing diversification than fixed claimants, and to maximize economies of scope by organizing the firm as a simple corporation”, which explains why block share purchases were followed by corporate restructurings of American large corporations during the nineteen eighties. In effect, “the legal organization of a diversified firm can be expected to be related to that firm’s ownership structure, and to be responsive to changes in ownership structure”.<sup>185</sup>

Finally, they say that “changes in the cost of protective activities and/or in claimants’ ability to impose protection costs on other claimants” should result in “changes in legal organization and changes in firm scope”.<sup>186</sup> This and other such claims will be evaluated, further, in the next chapter with respect to the second essentialist legal attribute, namely, limited liability and asset partitioning.

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<sup>184</sup> *Ibid* at 62.

<sup>185</sup> *Ibid*.

<sup>186</sup> *Ibid*.

## PART 3

### CHAPTER EIGHT – A CORPORATIVE THEORY OF CORPORATE LAW AND GOVERNANCE – PART B

#### ATTRIBUTE TWO – LIMITED LIABILITY AND ASSET PARTITIONING

##### Declarative Law

##### *Limited Liability*

As described in Chapter One, shareholders of modern business corporations do not enjoy any rights nor are they subject to any liabilities, as such shareholders, vis-à-vis the corporation and its property, contracts, actions or inactions.<sup>1</sup> Shareholders of the corporation are not, as such, liable in respect of acts of the corporation alone nor are the assets of such shareholders subject to claims of creditors of the corporation.

The CBCA and OBCA specifically enumerate liabilities, acts, or defaults which constitute extremely limited exceptions to the rule. The DGCA and MBCA permit the constating documents of a corporation to impose personal liability on shareholders for specified acts or debts (DGCA) or for debts only (MBCA). Both of these statutes expressly indicate that a shareholder may become personally liable by reason of such shareholder's own acts or conduct. Conventionally referred to as "limited liability", when relating it to the shielding of the personal assets of the shareholders from claims of creditors of the corporation, Hansmann and Kraakman refer to this as "defensive asset partitioning"<sup>2</sup>, while Hansmann, Kraakman and Squire refer to it as "owner shielding".<sup>3 4</sup>

##### *Entity Shielding*

The obverse of such limited liability involves protecting the corporation against claims by creditors of its shareholders and against seizure of the corporation's assets to satisfy claims by creditors of shareholders. Hansmann and Kraakman refer to this as "affirmative asset partitioning",<sup>5</sup> while

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<sup>1</sup> See, especially, "The Corporation and Corporate Essentialism in Law" and therein, most notably, discussion under the heading "Limited Liability and Asset Partitioning".

<sup>2</sup> Henry Hansmann, and Reinier Kraakman, "The Essential Role of Organizational Law" (2000) 110:3 Yale LJ 387 at 387 and 393-395.

<sup>3</sup> Henry Hansmann, Reinier Kraakman, and Richard Squire, (2006) "Law and the Rise of the Firm" 119:5 Harv L Rev at 1337.

<sup>4</sup> Henry Hansmann, Reinier Kraakman, and Richard Squire, "The New Business Entities in Evolutionary Perspective" (2005) U Ill L Rev 5 at 11-13.

<sup>5</sup> *Supra* note 2 at 393 and 394.

Hansmann, Kraakman and Squire refer to this as “entity shielding”.<sup>6</sup> The corporation is protected against claims by creditors of the shareholders of the corporation and against seizure of its assets to satisfy such claims.

As indicated in our discussion in Chapter One, exposing the corporation’s assets only to liabilities of the corporation and, the same time, proscribing access to assets of the corporation’s shareholders to satisfy liabilities of the corporation, is both consistent with, and important to, establishing the status of the corporation as a separate legal entity.

### **Separate Legal Entity Status and Asset Partitioning**

The preceding chapter, in the section entitled “Attribute One – Separate Legal Entity”, discusses the corporation as a separate legal entity or SLE, which is described as a “rights-and-duty-bearing entity”, and describes the implications of such status as a matter of declarative law and otherwise. It also demonstrates how the corporation, as a separate legal entity, is enabled to take action by means of individual human actors acting collectively in order to achieve common goals and objectives. This type of collective action denominates the corporation as, or as involving, an organization. Accordingly, that section indicated how the organizational analysis of the corporation explicated in previous chapters may be expected to affect the first legal essentialist attribute of the corporation, namely, separate legal entity status, and how such effects might have other legal and organizational implications, with respect to organizational characteristics, organizational participants, and otherwise.

The present chapter and section proceed similarly with respect to what has been identified as the corporation’s second legal essentialist attribute, namely, asset partitioning, both with respect to the assets of the corporation and with respect to the assets of those involved in the corporation as shareholders and otherwise. The concept of a separate legal entity as a rights-and-duty bearing entity is consistent with its ownership of its property in the sense of it having certain legal rights with respect to the same, and non-ownership of other property, including the property of its shareholders and others, in the sense of not having legal rights with respect to the property of such others.

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<sup>6</sup> *Supra* note 3 at 1337; and *supra* note 4 at 11-13.

Thus, the concepts, firstly, that the corporation's property could be affected by ownership rights held by someone who has rights vis-à-vis the corporation but not against such property (i.e., a shareholder); and, secondly, that the property of someone having such rights, as a shareholder or otherwise, vis-à-vis the corporation could be affected by their ownership of its shares; appear to be consistent, or, at least, do not appear to be inconsistent with such asset partitioning. Consequently, the present chapter averts to a number of issues which also relate to separate legal entity status, and hence could have been discussed in the preceding chapter, but have been left for discussion here so as not to unduly burden the text of the previous chapter.

However, as is well known, while the law in Great Britain, Canada, and United States had long acknowledged not only the concept of the corporation as a separate legal entity, but also recognized the concept of asset partitioning, in both cases, with respect to certain categories of corporations, at least, asset partitioning in the form of limited liability did not characterize corporations generally, as distinct from particular corporations or particular types of corporations,<sup>7</sup> until the 19th century, England in 1855,<sup>8</sup> in Canada in 1850,<sup>9</sup> and in United States around 1825 according to Phillip Blumberg.<sup>10</sup> Some of the consequences of this chronology are discussed below.

## **Asset Partitioning and Policy Considerations**

### ***Capital Requirements, Characteristics of Investors, and Capital Markets***

Henry Manne indicated that the development of large corporations in the 19th century began essentially in the eighteen thirties with the first wide public promotions of railroads as an investment, in order to address the need to raise capital from a relatively large number of investors.<sup>11</sup> In England, it was thought by some that schemes requiring large investment, such as roads, ships and commerce, by availing themselves of limited liability, would enable members of

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<sup>7</sup> Phillip Blumberg, "Limited Liability and Corporate Groups" (1986) 11 J Corp L 573 at 580. He indicates that some Royal charters provided expressly for limited liability, while others did the reverse, but that it was generally accepted by the late 18th century that in the absence of charter provision, shareholders were not directly liable; and, in any event, that shareholder liability was coming to an end as a practical matter.

<sup>8</sup> *The Limited Liability Act*, 1855, 18 & 19. Vict. Ch. 133 (1855). See also discussion in Blumberg, note 1.

<sup>9</sup> *Joint Stock Companies Act*, 1850, 13 & 14 Vict. Ch. 28 (Can. (1850)). See also discussion in Blumberg, note 1. See also AW Currie, "The First Dominion Companies" (1962) 28:3 Canadian J Economics and Political Science 387.

<sup>10</sup> Blumberg indicates that corporate charters issued in New York for banks and insurance companies and for companies with public functions, such as canal, bridge, and turnpike companies commonly provided for limited liability, *supra* note 7 at 589.

<sup>11</sup> Henry G Manne, "Our Two Corporation Systems: Law and Economics" (1967) 53:2 Va L Rev 259 at 260. These somewhat more expansive description by Chandler is referenced in Chapter Ten above.

the aristocracy, the trading class, and the working class, to participate in such investments and to associate with one another in that respect.<sup>12</sup>

Manne argued that when large corporations raise capital, limited liability “allows individuals to use small fractions of their savings for various purposes, without risking a disastrous loss if any corporation in which they have invested becomes insolvent.”<sup>13</sup> It also permits investors to invest different amounts of funds without becoming liable equally, proportionately or otherwise, for debts in excess of the corporation’s capital, which is considered to unfairly disadvantage investors, wealthy or not, whose small investment of capital might put their entire wealth at risk.

At the same time, it facilitates investment by those wealthy investors who possess large amounts of capital, perhaps greatly disproportionate to the assets of other investors. Instead of being liable to the fullest extent of their wealth, by limiting their potential loss to the amounts contributed as capital, investors absorb losses in proportion to their investments. Otherwise, with a rule of equal liability for debts, Manne says that “small investments and corporations would tend to come only from the individuals who were nearly insolvent already. Wealthy individuals would never make small investments in a corporation.”<sup>14</sup>

As previously noted,<sup>15</sup> a rule of limited liability eliminates the necessity for someone considering an investment in a corporation to make inquiries concerning the wealth of existing investors; and also facilitates the need for a corporate or vendor to make inquiries concerning the wealth or creditworthiness of prospective new investors, including those who require shares of existing investors. This facilitates the transferability of shares, as discussed in Chapter One.<sup>16</sup>

Halpern, Trebilcock, and Turnbull maintain that imperfect capital markets may impose a cost on prospective investors ascertaining the identity and wealth levels of investors, with the result that wealthy shareholders may refuse to purchase even a small number of shares and, in extreme

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<sup>12</sup>See, for example, the discussion in Donna Loftus, "Capital and Community: Limited Liability and Attempts to Democratize the Market in Mid-Nineteenth-Century England" (2002) 45:1 *Victorian Studies* 93 at 102, 104, and 107, etc.

<sup>13</sup> *Supra* note 11 at 262.

<sup>14</sup> *Ibid.*

<sup>15</sup> See the discussion in Chapter One in the section entitled “The Corporation and Corporate Essentialism in Law”, and, in particular, under the heading “Essential Attributes of the Corporation in Law” and the subheading “Transferable Equity Interests and Capital Lock-In”.

<sup>16</sup> *Ibid.*



conditions, securities markets will not exist.<sup>17</sup> In the absence of limited liability, since the maximum potential loss of a wealthy investor is independent of the number of shares but, instead, depends on the wealth of the other shareholders, a wealthy investor may determine to become a shareholder only by acquiring a sufficient number of shares that, firstly, it is worth closely monitoring the operations of the corporation; or, secondly, the investee company agrees to restrictions on the investment, operating, and financing decisions of management; or both. This would make it likely that ownership of equity shares would be concentrated in the hands of the few wealthy shareholders, which would make it unlikely that an active market in the corporation's shares would develop.<sup>18</sup>

Accordingly, asset partitioning, together with the separation of management rights from equity ownership, facilitates what might be called the "financialization" of corporate shares: that is to say, the treatment of shares of corporations, particular public corporations, as an investment, and the accompanying commodification of such shares as investment instruments or investment securities. Easterbrook and Fischel maintain that with unlimited liability, "shares would not be homogeneous commodities, so there would no longer have one market price."<sup>19</sup> Instead, with limited liability, "the identity and wealth of other investors is irrelevant. Shares are fungible; they trade at one price in liquid markets".<sup>20</sup>

In the absence of a rule of limited liability, Halpern et al. argue that it would be appropriate to adopt a pro rata liability rule whereby each equity investor is liable for the amount invested plus a proportion of the excess claims arising from default. This would have the effect of prorating liability for unsatisfied liabilities to the amount invested. Accordingly, these authors maintain that such pro rata rule would increase the risk of investment, and hence the expected rates of return required in order to motivate such investment. This would require monitoring the activities of the company but not the wealth composition of its shareholders.<sup>21</sup> Halpern, Trebilcock, and Turnbull

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<sup>17</sup> Paul Halpern, Michael Trebilcock, and Stuart Turnbull, "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30:2 UTLJ 117 at 136.

<sup>18</sup> *Ibid* at 136-7.

<sup>19</sup> Frank H Easterbrook and Daniel R Fischel, "Limited Liability and the Corporation" (1985) 52:1 U Chicago L Rev 89 at 96.

<sup>20</sup> *Ibid* at 95-6.

<sup>21</sup> *Supra* note 17 at 137.

conclude that “in the case of large, widely held companies, a limited liability regime, as a general rule, is the most efficient regime.”<sup>22</sup>

The effects of organizational analysis concerning the implications of limited liability and asset partitioning with respect to investors, investment characteristics of corporate shares, and capital markets are discussed below in relation to the effect of the foregoing on shareholders as organizational participants and otherwise.

### ***Separation of Management from Equity Ownership***

As indicated in the preceding section, asset partitioning assists in facilitating the separation of management of the corporation from its equity ownership. Manne emphasizes the importance of raising capital from a relatively large number of investors to the development of large corporations in the United States during the 19th century. Consequently, he maintains that the concept of the corporation “as a capital-raising device” and the concept of centralized management are directly related.<sup>23</sup>

He argues that “if the principal economic function of the corporate form was to amass the funds of investors, qua investors, we should not anticipate their demanding or wanting a direct role in the management of the company” or even in selecting particular managers, which he did not consider, at least in theory, to be a function of capital investors. Instead, he maintained that “management is a discrete economic service or function”, from acting as, or even selecting, individual managers.<sup>24</sup> Easterbrook and Fischel agree that “the publicly held corporation facilitates the division of labor” whereby “the distinct functions of managerial skills and the provision of capital (and the bearing of risk) may be separated and assigned to different people.”<sup>25</sup>

Manne considers the task of selecting such managers to be part of the entrepreneurial function, by which he means “not only conceiving an idea, but also engaging in those steps necessary to bring the idea to successful fruition”, which includes acting as promoters “in forming a corporation and marketing its shares”.<sup>26</sup> Similarly, Chandler, of course, considered the separation of ownership of

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<sup>22</sup> *Ibid* at 147. Discussion of the exceptions to which they draw attention appears in the text below.

<sup>23</sup> *Supra* note 11 at 260. See also the discussion of Chandler's treatment of the subject in Chapter Two in the section entitled “History of the Development of the Modern Business Corporation.”

<sup>24</sup> *Ibid* at 261.

<sup>25</sup> *Supra* note 19 at 94.

<sup>26</sup> *Supra* note 11 at 260.

shares of the corporation from its management to be a function of the increased complexity of what he called “the administrative function” in and after the second half of the nineteenth century,<sup>27</sup> which effectively created a need for specialized management, and thereby created what Chandler called “managerial capitalism”.<sup>28</sup>

Limited liability facilitates both the centralization of management separately from equity ownership, and the lock-in and transferability of equity capital. As noted above, the absence of limited liability would require continuous monitoring of corporate operations, by both shareholders and prospective shareholders. Even then, because they are not guaranteed any direct participation in management, investors are not going to be able to forecast, on a reliable and consistent basis, when liability might be incurred. In particular, Manne notes that “the possibility of liability arising at an unforeseen time and in an unpredictable amount would probably be too great a risk for large numbers of small investors to shoulder” with the result that “limited liability is probably an essential aspect of a large corporate system with widespread public participation.”<sup>29</sup>

The combination of separate legal entity status, and limited liability and asset partitioning, on the one hand, and the separation of management from equity ownership, on the other hand, have an interrelationship which is not always recognized. The directors, officers, and other managers who act as human individuals for and on behalf of the corporation as an inanimate legal entity are not ordinarily liable to third parties for their actions in that regard nor are their assets subject to the claims of the corporation’s creditors. Jean-Philippe Robé suggests that asset partitioning, not only with respect to the assets of equity owners who are shareholders in the case of a corporation, but also with respect to the assets of those charged with management of the corporation “is a truly essential aspect in the development of corporate law; some claim more important than limited liability”.<sup>30</sup>

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<sup>27</sup> See, especially, Chapter Two under the heading “The Visible Hand: The Managerial Revolution in American Business” and therein under the subheadings “Post-Civil War Developments in Business Organization” and “Administrative Responses to Technological Developments” and under the following subheadings and headings.

<sup>28</sup> In particular, this is discussed in Chapter Two under the headings “The Visible Hand: The Managerial Revolution in American Business” and “Administrative or Organizational Development and Economic Theory”.

<sup>29</sup> *Supra* note 11 at 262.

<sup>30</sup> Jean-Philippe Robé, “The Legal Structure of the Firm” (2011) 1:1 Accounting, Economics, and Law, Article 5 at 35.

### *Investment in Shares, Diversification, Lock-In, and Transferability*

As noted above, the combination of limited liability, capital lock-in and transferability, and centralization of management separately from equity ownership permits the equity shares of public corporations to be the subject of investment by investors with a variety of investment objectives. This will be discussed further below.

As Henry Manne says, it also permits investment by many individuals in many enterprises “without risking a disastrous loss if any corporation in which they have invested becomes insolvent.”<sup>31</sup> In effect, this directs attention to the diversification of investment permitted by these interrelated factors. Some commentators have credited Manne with originating this observation.<sup>32</sup>

Consequently, say Easterbrook and Fischel, “many investors will have diversified holdings. Only a small portion of their wealth will be invested in any one firm.” They credit limited liability, when combined with separation of investment from management, with making “diversification and passivity a more rational strategy”, and one which “potentially reduces the cost of operating the corporation”, in effect, by reducing its cost of capital, as the perceived risk of investment is reflected in the price investors are willing to pay for shares.<sup>33</sup> They note that such diversification permits investors to bear additional risk beyond that which they would otherwise consider acceptable.<sup>34</sup> Consequently, corporations can enter into high-risk ventures “(such as the development of new products) without exposing the investors to ruin” because the investors “can hedge against the failure of one project by holding stock in other firms.” Hence, limited liability increases the availability of funds that would otherwise subject investors to incremental risk.<sup>35</sup> This is considered to benefit the ambient economy and society.

As discussed previously, because the investor’s capital is generally “locked-in”, transferability is important. Manne argues that an individual may decide at a particular time that “his needs are best served by a high-risk investment” but would not want to make this decision “on a near-permanent basis”. It is apparent that an individual’s investment needs and interests may be expected to change

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<sup>31</sup> *Ibid.*

<sup>32</sup> Roger E Meiners, James S Mofsky, and Robert D Tollison, "Piercing the Veil of Limited Liability" (1979, 4 Del J Corp L 351 at 358.

<sup>33</sup> *Supra* note 19 at 94. They also credit Henry Manne with emphasizing that limited liability allows more efficient diversification: at 96-7. Meiners et al. do the same: *supra* note 32 at 358.

<sup>34</sup> *Supra* note 19 at 96-7.

<sup>35</sup> *Ibid* at 97.

with a number of factors, including, Manne says, age, family circumstances, wealth and size and quality of investment portfolio, and even death, introducing “a new owner with different needs and circumstances.”<sup>36</sup>

In addition, three factors extraneous to the individual are normally relevant to transfer decisions: firstly, alternative opportunities for utilization of funds; secondly, changes in circumstances within the corporation such that “the investment no longer serves its initial function;” and, thirdly, the investor may want “to disassociate himself from a particular corporation if for any reason he becomes dissatisfied with its management.”<sup>37</sup> Limited liability and separation of ownership from management mitigate the disadvantages of capital lock-in by facilitating transfer of an equity investment.

### ***Asset Partitioning, MDFs, and MLSFs***

#### History

Phillip Blumberg explains that in the United States, while limited liability was generally firmly established in most states by 1825, “corporations generally were not permitted to own shares of other corporations until late in the nineteenth century”,<sup>38</sup> a development whose importance was noted by Chandler.<sup>39</sup> At that time, a number of states adopted statutory provisions permitting the general incorporation of a single parent or holding company to hold the majority of the stock of locally chartered subsidiaries.<sup>40</sup> English law allowed a corporation to purchase shares of another company if permitted by its memorandum of association.<sup>41</sup> Consequently, “limited liability in Anglo-American law was established firmly in a time when corporations generally lacked the power to acquire and own shares of another corporation. Such power came much later.”<sup>42</sup>

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<sup>36</sup> *Supra* note 11 at 264.

<sup>37</sup> *Ibid.*

<sup>38</sup> *Supra* note 7 at 576. He notes that the first state specifically permitting this was New Jersey, in 1889, which was also the first to adopt general incorporation of companies holding a majority of the stock of locally chartered subsidiaries.

<sup>39</sup> Alfred D Chandler, Jr., *Strategy and Structure: Chapters in the History of the American Corporate Enterprise* (Boston: MIT Press, 1962).

<sup>40</sup> *Supra* note 7 at 605 and 607.

<sup>41</sup> *Ibid* at 608.

<sup>42</sup> *Ibid* at 610.

### Limited Liability of Parent and Holding Corporations

This change in the law permitting corporate ownership of shares of another corporation, according to Blumberg, “opened the way to a profound change in corporate structure. Corporations began to organize other corporations to conduct parts of their business and to acquire other corporations as an alternative method of expansion.” He indicates that “with this development, a corporation no longer represented the entire enterprise. The enterprise became increasingly fragmented among parent and subsidiary corporations.”<sup>43</sup> Because “the parent (as the shareholder) and the subsidiary collectively made up the enterprise... the parent’s shareholders already benefitted from limited liability, and insulation of the parent created a second layer of protection.”<sup>44</sup>

Blumberg argues that when corporations were given the power to acquire and own shares of other corporations, “the extension of limited liability from protection of ultimate investors to protection of parent corporations followed almost automatically, without any apparent consideration of the soundness or the desirability of the extension of the principle to create successive layers of protection against liability within the corporate group.” Further, any increase in the efficiency of the economic system which might arise from limited liability is “largely irrelevant when the special case of intragroup liability is considered.”<sup>45</sup>

The argument, then, is that “both as an academic and a political matter, the application of limited liability to corporate groups has never undergone the scrutiny and debate that such a fundamental extension of the doctrine deserves” and that restriction of limited liability with respect to intracorporate liability may be appropriate in some situations.<sup>46</sup> We will discuss this in connection with the effect of limited liability on organizational participants, particularly employees, in the next section, to which we turn our attention shortly.

### Choosing MDFs and MLSFs as Legal Business Forms

In much the same way as individuals, by means of incorporation, can participate in ventures having a higher degree of risk than they would undertake on a personal basis (that is to say, without limited liability), corporations may establish direct or indirect subsidiaries to undertake ventures having a higher degree of risk, as Easterbrook and Fischel note above. For example, Barney, Edwards, and

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<sup>43</sup> *Ibid* at 607.

<sup>44</sup> *Ibid*.

<sup>45</sup> *Ibid* at 630. See also 607.

<sup>46</sup> *Ibid* at 630-631.

Ringleb conducted an empirical investigation of the strategies which corporations use with respect to their legal liability to employees exposed to hazardous materials while on the job.<sup>47</sup>

They found, firstly, that firms facing the threat of legal liability as a result of employee on-the-job exposure to hazardous materials were less vertically integrated than other firms; and secondly, that the level of threat of such liability was associated with a higher percentage of small firms in an industry.<sup>48</sup> This suggests that such corporations are willing to shift these burdens of production onto their forces of production, namely, the employees actually performing the work.

The willingness of corporations to mitigate risk by using direct and indirect subsidiaries so as to obtain the protection of limited liability is considered to be affected by external environmental conditions, including the nature of the business (as the example concerns non-the-job risk indicates) and financial and other conditions prevailing generally at the relevant time. For example, a 1986 study shows that the business forms that are adopted for international transactions is related to perceived political risk.<sup>49</sup>

The earlier discussion of MDCs, MDFs and MNEs is relevant in this regard.<sup>50</sup> Among other things, that discussion describes the rise of conglomerates, partly in an effort to mitigate regulatory risks, and later their demise and deconglomeration in connection with leveraged buyouts effected by “corporate raiders”, who were financing their acquisitions in part from the proceeds of post-acquisition sale of components of the conglomerate.<sup>51</sup> In both situations, other environmental conditions also appear to have been relevant.

The discussion of MLSFs presents a 2002 study by Boies and Prechel which examined changes in the structure of the largest US corporations the late 20th century from MDCs to MLSFs during a

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<sup>47</sup> Jay B Barney, Frances L Edwards and Al H Ringleb, “Organizational Responses to Legal Liability: Employee Exposure to Hazardous Materials, Vertical Integration, and Small Firm Production” (1992) 35:2 *Academy of Management J* 328 at 328.

<sup>48</sup> *Ibid* at 346.

<sup>49</sup> Frederick J Phillips-Patrick, “Political Risk and Organizational Form” (1992) 34:2 *JL & Econ* 675 at 687.

<sup>50</sup> See, particularly, discussion in Chapter Seven under the heading “The Separate Legal Entity, the Organization, and the Individual Human Actor”, especially under the subheading “Effective Separate Legal Entity Status on Organizational Structure”; discussion in Chapter Three under the heading “Forms of Corporations – Legal and Organizational Variants”; discussion in Chapter Two in the section entitled “History of the Development of the Modern Business Corporation”; and discussion in Chapter Six in the section entitled “Organizational Goals and Intraorganizational Goals” and especially, under the heading “Organizational Goals and Corporate Operations” and therein under the subheading “MDCs and MNEs”.

<sup>51</sup> Gerald F Davis, Kristina A Diekmann, and Catherine H Tinsley, “The Decline and Fall of the Conglomerate Firm in the 1980s: The Deinstitutionalization of an Organizational Form” (1994) 59:4 *American Sociological Rev* 547.

period of economic uncertainty prevailing from 1981 to 1996.<sup>52</sup> As indicated there, the increase in the use of direct and indirect subsidiary corporations by the largest 100 industrial corporations was dramatic, both in terms of the numbers of such subsidiaries (ten of the largest had more than 100 domestic subsidiaries) and the number of levels of such subsidiaries (a number of which had seven levels of subsidiaries).<sup>53</sup> As established earlier in this work, these changes may not be attributable entirely to risk-related considerations. Other considerations may be operative. For example, potential dispositions of non-core businesses may also have been relevant in some situations.

A 2018 study by Belenzon, Lee and Patacconi, using data from 16 countries in Europe, the Americas and Asia, examined the propensity of courts in a particular country to impose liability on all members of a corporate group with respect to obligations of any single member, which they considered to be a measure of enterprise liability. They found that in countries with weaker enterprise liability (or stronger limited liability of individual corporations within the group), corporate groups tended to partition their assets and operations more finely into legally independent subsidiaries; to grant more autonomy to their subsidiary managers; and to grow faster. They found that these effects were stronger in industries in which the downside risk was greater.<sup>54</sup>

These authors argue that “stronger limited liability protections for headquarters increase the benefits of asset partitioning and decreases the agency costs of delegation by externalizing risk.” In turn, this decreases the risk associated with investment, lessens the degree of control exercised by headquarters, and thereby permits corporate groups to invest more and grow faster.<sup>55</sup>

In the result, then, the decision by a parent corporation to carry on a particular business through a separate legal entity, such as a corporation, or otherwise will be affected by a number of factors, many of which relate to downside risk.

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<sup>52</sup> See the discussion in Chapter Seven in the section entitled "The Separate Legal Entity, the Organization and the Individual and Human Actor" and therein under the heading "Effects of Separate Legal Entity Status on Organizational Structure" and under the subheading "Multilayered Subsidiary Forms (MLSFs)". See also the references there to the study: John Boies and Harland Prechel, "Capital Dependence, Business Political Behavior, and Change to the Multilayered Subsidiary Form" (2002) 49:3 Social Problems 301.

<sup>53</sup> *Ibid.*

<sup>54</sup> Sharon Belenzon, Honggi Lee, and Andrea Patacconi, "Towards A Legal Theory of the Firm: The Effects of Enterprise Liability on Asset Partitioning, Decentralization and Corporate Growth" (2018) NBER Working Paper No. 24720, National Bureau of Economic Research at 33. Available at: <http://www.nber.org/papers/w24720>.

<sup>55</sup> *Ibid.*



### **Implications of Organizational Analysis for Limited Liability and Asset Partitioning**

The preceding section, in the subsection entitled “The Corporation, the Legal Entity, The Organization, and the Participants – Categories of Organizational Participants”, discussed the relationship of various parties to the corporation and whether such relationship might implicate those parties as participants in the organization. That section considered the implications of organizational essentialist characteristics for separate legal entity status, which is a legal essentialist characteristic, and vice versa; and the implications of each of the same for organizational participants. This section will engage similarly with limited liability and asset partitioning, another legal essentialist characteristic. Again, the focus of the discussion will be on particular categories of organizational participants.

#### ***Shareholders***

##### **Separation of Shareholders and the Corporation as Rights-and-Duty-Bearing Parties**

As discussed in reference to this topic under the heading “Separate Legal Entity Status and Asset Partitioning”, these two corporate essentialist characteristics have the effect of firmly separating shareholders, even those who take the initiative (as entrepreneurs, according to Manne)<sup>56</sup> in forming the corporation or “promoting” it as a public corporation by a public offering of its securities, from the corporation, by establishing a relationship of rights and duties between them.

Those respective rights and duties include capital lock-in and share transferability, as well as rights and duties relating to central management intrinsically separate from equity ownership. This is particularly true with respect to public corporations. The assets of shareholders are isolated from the corporation’s operations by limited liability or negative asset partitioning, while the corporation’s assets are isolated from claims against the shareholders by means of affirmative asset partitioning, the net result of which is to ensure the complete separation of the assets and liabilities of shareholders from those of the corporation, thereby giving effect to the corporation’s “autonomous existence” as a separate legal entity.<sup>57</sup>

Further, in respect of the cash or other property contributed by shareholders as the cost of acquiring their shares, like the rest of the business of the corporation, those assets are in the care of the board

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<sup>56</sup> *Supra* note 20 and accompanying text.

<sup>57</sup> See the discussion of the subject by Robé, *supra* note 30 at 3.

of directors, which has a duty of loyalty, a duty of care, and a duty of compliance.<sup>58</sup> These duties are not only significant to shareholders contributing capital or to their subsequent transferees, but are also significant to creditors and others.<sup>59</sup>

While directors, officers, and employees may own equity shares of the corporation, it is not the ownership of shares which entitles the person to participate in management of the corporation but, instead, the status as a director, as an officer, or as an employee. The legal relationship between shareholders and the corporation is described in Part 1, especially in Chapters One and Three, and in the present chapter and section. It is clear that shareholders enjoy certain rights and that the corporation owes them certain duties with respect to the selection of directors, expressing opinions (a right of “voice”), receiving certain information, approving or disapproving of certain fundamental or exceptional transactions, and transfer or liquidation of their investment (a right of “exit”).

#### Organizational Expectations

One question which is relevant to any relationship is the extent to which each party maintains expectations concerning the behaviour of the other.<sup>60</sup> In the case of a large public corporation, its expectations concerning shareholder behaviour are usually concentrated at some level of aggregation; that is to say, while the board of directors and management of the corporation may have expectations concerning the behaviour of a particular shareholder, in most cases (that is to say, unless the shareholder has a large share position or is especially vocal) those expectations relate to the corporation’s shareholders in the aggregate or to particular groups of shareholders. In many cases, those expectations may be that the particular shareholder or the shareholders generally will vote to elect the directors proposed and to support the matters put forward for consideration by shareholders. However, in at least some situations, the case may be otherwise.<sup>61</sup> This is also true with respect to the expectations of shareholders.

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<sup>58</sup> See discussion in Chapter A1 in the section entitled “Management Role of the Board of Directors”.

<sup>59</sup> *Ibid* at 35.

<sup>60</sup> See Chapter Four in the section entitled “Groups of People or Social Units”, particularly under the heading “Max Weber on Organizations and Related Matters”.

<sup>61</sup> The assumption that shareholders, in particular, institutional shareholders, support management obtained into the 1950s and 1960s but was put in question thereafter, particularly with the increase in merger and acquisition activity and, in particular, the rise of contested takeover bids or merger proposals thereafter.

The expectations of the corporation with respect to individual shareholders, groups of shareholders, and its shareholders as a whole, and vice versa, may vary in accordance with the degree of interaction between the parties. For example, where the board or management of a corporation and a certain group of shareholders enjoy a high level of interaction, the expectations of each party may be more fulsome than otherwise. In effect, the higher level of participation of the shareholder in the corporation as an organization may implicate that particular shareholder group as a participant in such organization, and may do so to a degree much greater than would be the case with a lower level of interaction.

This organizational participation may give rise to greater predictability concerning the exercise by the shareholder group of legal rights, including those relating to the legal essentialist characteristics of the corporation. For example, regular interaction with a large shareholder or a shareholder group may create expectations by the corporation concerning under what circumstances such shareholder or group might terminate its organizational relationship with the corporation by exercising its legal essentialist right of transfer. This may become important in the case of proxy battles or contested takeover bids.<sup>62</sup>

#### Investment and Diversification

The present chapter has already established that the combination of legal essentialist characteristics of the corporation: as a separate legal entity with both affirmative and defensive asset partitioning; with capital lock-in and transferability; and with centralized management; facilitates the use of shares of a corporation as an investment. As discussed, shareholders may be able to diversify risk by diversifying their investments, such as by holding shares in different corporations. The shareholders of a corporation may also have different investment objectives as among themselves.

This may result in certain shareholders having affinities with other shareholders with similar investment objectives, having previously established affinities with other shareholders, or having affinities with other shareholders whose operations and investments may be subject to similar regulation. In all of these cases, such shareholders, as organizational participants, may act as a

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<sup>62</sup> It is generally considered that boards of directors and managements that consult regularly with significant shareholders are better able to satisfy the expectations of such shareholders, to partially meet those expectations, and, in any event, to better "manage" shareholder relations, with a greater likelihood of positive effect.

group. As such, they may act individually, vis-à-vis the corporation, differently than they might have acted otherwise.

For purposes of both organizational and legal analysis, as well as corporative analysis, shareholders as organizational participants cannot be considered to be entirely fungible. These observations may also obtain with respect to the investment horizon or expected duration of investment by a shareholder.<sup>63</sup> For example, a group of shareholders, each of whose members as the objective of achieving significant capital appreciation over the long-term, say, five years, may have, and may express, different interests in the corporation as compared with a group the members of which have an objective of achieving a very high rate of return over a very short period of time, say, three months.

A heightened degree of interaction between the corporation, on the one hand, and shareholders, on the other, whether individually, in groups, or as a whole, may be expected to result in an increased knowledge by both parties of the objectives sought, and the attendant means of achieving them. As demonstrated in earlier chapters,<sup>64</sup> alignment between the strategy pursued by the corporation and the structure, processes, and human management resources by which such strategy is sought to be implemented within its organization may be expected to have a significant effect on the corporation's achievement of that strategy and performance, as measured by various financial and other indicators.

In the result, the corporation's mode of organization may be the single most important ingredient in its success. At the same time, as previously demonstrated, the specifics of such organization may not be readily amenable to determination by shareholders and other organizational participants other than directors, TMT members, and perhaps by other officers, managers, and employees the performance of whose functions give rise to some more detailed awareness of its organizational structure, processes and personnel, the relation of the same to relevant strategic issues, and the respective advantages of the same. As noted below, considerations related to the

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<sup>63</sup> For example, Lisa Fairfax argues that this enables shareholders to influence corporate policy in order to promote the long-term health of the corporation and a variety of social and public objectives. Lisa M Fairfax, "Making the Corporation Safe for Shareholder Democracy" (2008) 69 Ohio St LJ 53 at 83-85.

<sup>64</sup> See the discussion in Chapter Two under the heading "History of the Development of the Modern Business Corporation".

separate legal entity status of business units and other components of the enterprise may amplify the difficulty of making such assessments.

### Organization and Intracorporate Boundaries

As discussed in previous chapters,<sup>65</sup> a single parent or holding corporation may have many levels of hierarchical and legal organization. A multidivisional corporation, such as Great Motoring Corporation in our example, may employ subordinate holding corporations to organize certain divisions, but may operate directly, that is to say, without subordinate holding corporations in the case of other divisions. It may have a number of levels in its organizational hierarchy and may employ various levels of subordinate holding and operating corporations or other legal entities at various organizational levels.

Depending on applicable accounting rules, the financial statements of some or all of these corporations and other legal entities may be consolidated with those of the parent corporation, in effect, presented in such a way as to reflect the real ownership of the parent corporation of the enterprise as a whole.<sup>66</sup> Among the significant considerations this raises, only three are considered here: firstly, issues relating to investment and diversification; secondly, issues relating to risk; and, thirdly, issues concerning the value of the corporation and organization concerned.

### *Unboundedness and Financial Analysis*

Normally, the financial information required to be made available to shareholders, regulators and others<sup>67</sup> is insufficiently granular, even when segmented,<sup>68</sup> to permit a detailed analysis of the operations, investment and other cross, and relative contributions to revenue and profits attributable to the businesses carried out by separate organizational and legal components of the corporation or shown on the parent corporation's organizational chart.

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<sup>65</sup> *Ibid.* See also the discussion in Chapter Five, especially under the headings "'Organizational Structure" and "Organizational Personnel".

<sup>66</sup> Specifying the relevant details would exceed the information necessary for comprehension of the essential elements of the issues considered.

<sup>67</sup> See discussion in Chapter A2 under the heading "Part B – Informed Voting by Shareholders – Financial Disclosure".

<sup>68</sup> A brief explanation of segmented presentation follows immediately below.

Generally speaking, segmented presentations are required under International Financial Reporting Standards (“IFRS”)<sup>69</sup> in relation to each “operating segment” of a corporation, which term is defined to mean a component of an entity that engages in revenue earning business activities; whose operating results are regularly reviewed by the chief operating decision maker; and for which discrete financial information is available; but only if the operating segment is a “reportable segment”. A reportable segment, broadly speaking, is one the reported revenue, reported profit or loss, or reported assets of which are more than 10% of the total from all operating segments<sup>70</sup>

A post-implementation review of the relevant standard, International Financial Reporting Standard 8 (“IFRS 8”), finds that auditors, accounting firms, standard-setters, regulators, and investors agreed that audited segmented information was useful, although investors sometimes thought that “segments are supported in such a way as to obscure the entity’s true management structure (often as a result of concerns about commercial sensitivity) or to mask loss-making activities within individual segments.”<sup>71</sup> While these comments support the importance of management structure as an element of business success, they also suggest some of the problems which understanding such structure prevents to investors and other organizational participants.

In the result, while the corporation may achieve certain benefits by way of diversification, shareholders are likely to be unable to appreciate the nature and extent of such diversification within the corporation itself, and hence are likely to be unable to assess how this intracorporate diversification affects the desired level of diversification of the individual shareholder’s own investment portfolio. Simply put, intracorporate diversification may complicate shareholder portfolio diversification. This may result in the shareholder not attaining the level of portfolio diversification sought, which may, in turn, be reflected in some underpricing of the focal corporation shares.

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<sup>69</sup> The accounting standards widely applicable in developed countries generally are the International Financial Reporting Standards (“IFRS”) promulgated by the International Accounting Standards Board (“IASB”). International Financial Reporting Standards, IFRS Foundation. Available at: <https://www.ifrs.org/issued-standards/list-of-standards/ifrs-8-operating-segments/>.

<sup>70</sup> *Ibid.*

<sup>71</sup> IFRS Foundation. July 2013. International Financial Reporting Standards “Post-Implementation Review: IFRS 8 Operating Segments”. Available at: <https://www.ifrs.org/-/media/project/pir-ifrs-8/educational-material/pir-ifrs-8-operating-segments-feedback-statement.pdf>.

### *Unboundedness and Financial Risk*

The second issue arises from the same factual background and relates to misspecification of risk. In the context just discussed, the extent of the risk to which certain business operations: firstly, are subject; and, secondly, are able to mitigate with respect to other business operations within the focal corporation; may be extremely difficult or even impossible to determine. For example, as discussed in the previous chapter,<sup>72</sup> Enron's use of special purpose entities and other legal entities which were not required to be consolidated with the financial statements of the parent corporation enabled it to avoid disclosure of relevant financial information. When Enron commenced using such entities illegally, without conforming to relevant accounting requirements, its overstatement of earnings and understatement of liabilities reduced its net worth by several billion dollars and contributed to its eventual bankruptcy.<sup>73</sup>

Jill Fisch chronicles how JP Morgan spun off its Chief Investment Office ("CIO") as a separate unit of the bank to invest the bank's excess deposits using, among other things, the acquisition, holding, and trading of synthetic credit derivatives in its Synthetic Credit Portfolio ("SCP").<sup>74</sup> However, while the CIO portfolio generated massive profits initially, it generated losses, instead, in later years. The unit increased the size of trades and began to manipulate the method of, and credit derivatives in, the portfolio and failed to report these.<sup>75</sup>

Management and the board ignored the risks associated with CIO derivatives trading, especially when the unit was generating large profits, and breaches of CIO risk limits and internal advisory policies were repeatedly reported to Morgan management but were routinely ignored. Subsequent congressional investigation revealed "a bank culture in which risk limit breaches were routinely disregarded, risk metrics were frequently criticized or downplayed, and risk evaluation models were targeted by bank personnel seeking to produce artificially lower capital requirements."<sup>76</sup>

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<sup>72</sup> See discussion in Chapter Seven in the section entitled "Separate Legal Entity" under the heading "The Separate Legal Entity, the Organization, and the Individual Human Actor" and in the references at notes 127 and 128.

<sup>73</sup> Simon Deakin and Suzanne J Konzelmann, "Learning from Enron", (2004) 12 (2) *Corporate Governance: An International Rev* 134 at 136-138.

<sup>74</sup> Jill E Fisch, "The Mess Morgan: Risk, Incentives and Shareholder Empowerment" (2015) 83 *U Cin L Rev* 651 at 655.

<sup>75</sup> *Ibid* at 656-7.

<sup>76</sup> *Ibid* at. 658-9, citing *JP Morgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses, Staff Report, Permanent Subcommittee on Investigations, U.S. SENATE, Apr. 11, 2013* at 10. Available at:

In the result, consulting a publicly available description of JP Morgan's risk management practices, even if relatively fulsome, would not have assisted shareholders, actual or prospective, other securities market participants, or regulators in assessing the real risk assumed by the bank, because those practices were not followed.

*Organizational Contribution to Corporate Value and Share Price*

Finally, as suggested previously, the difficulty of assessing the contribution of the organization to the market price and value of the parent corporation is considerable.

Chandler indicates that the firm is both a legal entity and an administrative entity involving teams of managers who coordinate and monitor its different activities, noting that "once established, a firm becomes a pool of physical facilities, learned skills and liquid capital."<sup>77</sup> The organizational or administrative aspect of the corporation is essential. As Margaret Blair says: "finance capital and physical capital do not operate themselves. They must be coordinated, managed, maintained, and operated daily by people, who must then develop systems, routines, and reputational and information networks to carry out their tasks", which tasks must often be worked out over a long period of time.<sup>78</sup>

In the past, these organizational capabilities", says Chandler, acted as a barrier to new market entrants, accounted for the "long-term persistence of profits by the same players over decades", and, together with such retained earnings, "became the basis for their continued growth."<sup>79</sup> Continued industry and global leadership is a function of "how the enterprises evolve their organizational capabilities and how their long-term competitive strength and weakness reflect these learned capabilities as well as those of their competitors from abroad and related industries."<sup>80</sup>

These organizational capabilities "permit the enterprise to be more than the sum of its parts" and "give it a life of its own above and beyond the individuals involved. The individuals come and go,

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[https://www.hsgac.senate.gov/imo/media/doc/REPORT%20-%20JPMorgan%20Chase%20Whale%20Trades%20\(4-12-13\).pdf](https://www.hsgac.senate.gov/imo/media/doc/REPORT%20-%20JPMorgan%20Chase%20Whale%20Trades%20(4-12-13).pdf).M.

<sup>77</sup> Alfred D Chandler, Jr., "Organizational Capabilities and the Economic History of the Industrial Enterprise" (1992) 6 J Economic Perspectives 79 at 79.

<sup>78</sup> Margaret M Blair, "Locking In Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century" (2003-2004) 51 UCLA L Rev 387 at 398.

<sup>79</sup> *Supra* note 77 at 83.

<sup>80</sup> *Ibid* at 99.



the organization remains.”<sup>81</sup> In effect, Chandler maintains that the organization persists despite wholesale change in its membership, an attribute which, as established here, characterizes organizations generally, and not just business corporations.<sup>82</sup> Philip Selznick notes that relations within, and the structure of, the organization are such that individuals are interchangeable and the organization free of dependence upon personal qualities.<sup>83</sup> Such organization may endure indefinitely and, in the case of the corporation, it may endure indefinitely as a separate legal entity.

The structure, processes, and personnel of the human organization which acts in the “real world” in the place and stead of the inanimate corporation as legal entity is often difficult for even “insiders” to comprehend. Its description is not exhausted by a single organization chart. As mentioned here frequently, informal structures and processes which may be described as an informal organization are frequently, even almost invariably, operative. Again, these do not lend themselves to summary description in corporate disclosure documents and, consequently, to their easy assimilation by shareholders and investors.

Yet the intrinsic and market values of the corporation and its shares are normally highly dependent upon these factors. Disclosure of the investee corporation’s strategy or business model, by itself, does not adequately explain the relevant relationships. As demonstrated in the present work, the corporation’s strategy and business model must be aligned with its organization. The methodology of such alignment is likely to elude investigation even by knowledgeable and resourceful investors.

### *Organizational Learning*

As discussed previously, the value of knowledge and experience to any kind of large organization has been acknowledged by organization theorists and practitioners including Chandler, Weber, Barnard, Fayol, Taylor, March and Simon, and others.<sup>84</sup> It is well-established that specialization of responsibility and consequent knowledge accrual overcome some of the limits of the bounded rationality of individuals.

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<sup>81</sup> *Ibid* at 86.

<sup>82</sup> See the discussion in Chapter Four, especially under the heading “Working Definitions and Formal Definitions”. Egon Bittner requires a stability in membership over time.

<sup>83</sup> *Ibid* and therein under the heading “Formal Definitions”, notably under the subheading “Philip Selznick Definition”.

<sup>84</sup> See the discussion in Chapters Two under the heading “History of the Development of the Modern Business Corporation”, Three under the heading “Forms of Corporations – Legal and Organizational Variants”, and, variously, Four, Five, and Six.

For example, acquisition of knowledge concerning changes in the organization's internal or external environment requires a strategic response which depends in part on the organization's ability to act cohesively, which, say Marsick and Watkins, "requires alignment of vision of about what to do, shared meaning about intentions, and the capacity to work together across many different kinds of boundaries. This collaborative capacity leads to collective action."<sup>85</sup>

Marsick and Watkins assert that a learning organization "is one that has embedded the capacity to adapt or to respond quickly and in novel ways while working to remove barriers to learning" by making changes in the systems that affect learning, namely, strategy, structure, slack, and technology,<sup>86</sup> as well as "systems thinking, here defined as making systemic connections and creating embedded systems to capture and share knowledge", which is, they say, the "glue that makes the other disciplines work".<sup>87</sup> They cite a number of studies which "provide growing evidence of a relationship between performance and the dimensions of the learning organization."<sup>88</sup>

However, as noted in connection with many of the matters previously discussed here, organizational aspects of the corporation are not expected to be easily susceptible to investigation. The interrelationship between such organizational aspects and related legal issues, such as separate legal entity status, limited liability, and asset partitioning may be even more difficult to investigate.

### *Communities of Practice*

Another example of a valuable but usually non-apparent organizational element is what Wenger and Snyder call "communities of practice", which are "groups of people informally bound together by shared expertise and passion for a joint enterprise" within a corporation, such as engineers engaged in deepwater drilling, consultants specializing in strategic marketing, or front-line managers overseeing check processing at a commercial bank.<sup>89</sup> The authors maintain that these can "drive strategy, general new lines of business, solve problems, promote the spread of best

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<sup>85</sup> Victoria J Marsick and Karen E Watkins, "Demonstrating the Value of an Organization's Learning Culture: The Dimensions of the Learning Organization Questionnaire" (2003) 5:2 *Advances in Developing Human Resources* 132 at 135.

<sup>86</sup> *Ibid* at 136.

<sup>87</sup> *Ibid* at 140.

<sup>88</sup> *Ibid*.

<sup>89</sup> Etienne C Wenger and William M Snyder, "Communities of Practice: The Organizational Frontier" (Jan.-Feb. 2000) *Harvard Business Rev* 139 at 139.

practices, develop people's professional skills, and help companies recruit and retain talent", and thereby improve organizational performance.<sup>90</sup>

Such communities of practice are informal (establishing themselves, their agendas, and their leadership on their own) and self-selected (by ability and interest) such that members "tend to know when and if they should join", whether "you have something to give and ...are likely to take away something", and whether prospective members may be appropriate for the group.<sup>91</sup> They may be recognized by, but are generally independent from, the formal management structure, for example, at American Management Systems and the World Bank.<sup>92</sup> How such communities of practice might be affected by the nature of the relationship between organizational and legal matters such as SLE status and asset partitioning would not likely be clear to investors and prospective investors, and other organizational participants.

### *Enterprise Integration*

Another example of organizational elements which are not immediately apparent but which may contribute significantly to corporate value and share price, which is provided by Brandenburger and Stuart, is the relationship, outside the boundaries of the corporate legal entity, between the corporation and the customers it serves and the suppliers upon which it relies.<sup>93</sup> For example, a corporation may find ways to meet the needs of buyers better than other firms,<sup>94</sup> it might reduce a supplier's costs of doing business with it,<sup>95</sup> it might reduce a customer's willingness to purchase from other corporations by reducing the cost of purchasing from it (perhaps by entering into a long-term supply agreement which saves switching costs as compared with other potential suppliers),<sup>96</sup> or it might increase the opportunity costs to its suppliers of providing products or services to other corporations.<sup>97</sup> Such practices have been shown to add value to the corporation and the market price of its shares.

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<sup>90</sup> *Ibid* at 140. See also examples of these results, provided at 140-141.

<sup>91</sup> *Ibid* at 142.

<sup>92</sup> *Ibid* at 144-5.

<sup>93</sup> Adam M Brandenburger and Harbone W Stuart, Jr., "Value-Based Business Strategy" (1996) 5:1 *Journal of Economics & Management Strategy* 5 at 6.

<sup>94</sup> *Ibid* at 16.

<sup>95</sup> *Ibid* at 17.

<sup>96</sup> *Ibid*

<sup>97</sup> *Ibid* at 17-8.

As is well known, in such cases, the focal corporation and its suppliers are each making firm-specific investments or, as Blair would say in terms of team production, in team-specific investments in the relationship between them, because once such investments “have been sunk into the enterprise, [their value] is tied to the overall success of the enterprise.”<sup>98</sup> As in the case of other organizational matters, it might be expected that shareholders would find it difficult to evaluate their effects on the focal corporation as a result of the legal structure of entities below the focal corporation the hierarchy of organization and the hierarchy of legal ownership.

#### Organizational Advantages and Organizational Change

As the foregoing examples indicate, the organizational advantages of a particular corporation may be unknown, or misperceived, or undervalued, both by shareholders and by outsiders, such as activist investors seeking board or management changes, sales of component parts of the corporation, or seeking to acquire control of the focal corporation. Shareholders should be attentive, however, to well-informed investors who have expended the time and effort to develop an “organizational map” of the corporation as a whole, and who have investment objectives similar to the shareholder concerned.

Such organizational map may be helpful in identifying how the corporation may respond to changes in its external or internal environment and the risks and opportunities that they present. As maintained previously, a sale of a particular business, whether it is a separate corporation or simply a division, may have implications which extend far beyond financial considerations, including containment of risk or provision of “sleeping opportunities” as yet unpursued. An accurate assessment of a corporation’s organizational advantages or disadvantages at the level of the parent corporation may be complicated by the below-parent-level legal structure of the enterprise. Such below-parent-level legal structure of the enterprise may not be completely apparent from public disclosure documents. Nevertheless, such legal structure may be important to shareholders and other organizational participants, notably employees.

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<sup>98</sup> *Supra* note 66 at 395 and see also 399.

## ***Board of Directors***

### Role and Function

As discussed at various places in the present work,<sup>99</sup> the board of directors is the primary, primordial or first-level actor for and on behalf of the corporation. It has the responsibility and authority for managing or supervising the management of the business and affairs of the corporation, including appointing officers to exercise delegated authority with respect to the same. This work has maintained that, lacking corporeal capacity, the corporation as a separate legal entity can only act in the real world through human actors. As a rights-and-duty bearing entity, certain human actors must be assigned responsibility and authority to act for and on behalf of the corporation, and this role is assigned to the board of directors.

Margaret Blair is among the commentators<sup>100</sup> who note that centralization of such authority in a relatively small group is especially important in larger organizations with many investors and participants.<sup>101</sup> An additional benefit, she says, is that “assigning decision-making to a board *restricts the control that various individual participants, such as the president, or a major financial investor, might otherwise have*”, which “thereby helps assure all participants” that management will not be able to use corporate assets for their own personal benefit” and that “financial participants will not be able to easily pull assets out of the firm once other participants have made investments” which are, to some degree or other, firm specific.”<sup>102</sup>

Blair argues that such allocation of decision-making entails that “individual team members relinquish some of the ability they might otherwise have had to hold up other members”, which “makes their commitments to engage with the others in a cooperative way more credible.”<sup>103</sup> Robé indicates that even majority shareholders who are the principal officers of the corporation and hold

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<sup>99</sup> See, in Chapter Seven, the discussion in the section entitled “Separate Legal Entity”, especially under the heading “The Corporation, the Legal Entity, the Organization, and the Participants”, most notably under the subheading “Categories of Organizational Participants – Directors”; and the heading “The Separate Legal Entity, the Organization, and the Individual Human Actor”; and also the earlier sections of this work referenced in those places.

<sup>100</sup> Another is Stephen M Bainbridge, “Participatory Management Within a Theory of the Firm” (1996) 21:4 J Corp L 658 at 662 and 665. See also Kenneth J Arrow, *The Limits of Organization* (New York: Norton 1974).

<sup>101</sup> *Supra* note 66 at 434.

<sup>102</sup> *Ibid* [emphasis in the original].

<sup>103</sup> *Ibid*.

a majority position of the board may be restrained by the remaining directors, the directors' duties of fidelity and care, and applicable corporate law.<sup>104</sup>

Margaret Blair and Lynn Stout's explication of their version of team production theory describes the board of directors as a "mediating hierarchy", which possesses authority to mediate the claims of participants in the corporation as separate legal entity, at least those which cannot be resolved at lower levels, which can "limit shirking and deter rent-seeking behavior among team members. In other words, team members submit to a hierarchy not for the hierarch's benefit but for their own",<sup>105</sup> at least if that hierarch is informed, faithful, and disinterested.<sup>106</sup> They say that participants who do not like the decision of the board or subordinate authority concerning the division of duties and rewards can either stay in and abide by those decisions, or leave, in which case they lose the value of their firm-specific investments and do not share in the residual value generated by the enterprise.<sup>107</sup>

In effect, "a public corporation is a team of people who enter into a complex agreement to work together for their mutual gain", with the participants "including shareholders, employees, and perhaps other stakeholders such as creditors or the local community" agreeing to subject themselves to the mediating hierarchy, thereby yielding "control over outputs and key inputs (time, intellectual skills, or financial capital) to the hierarchy" in exchange, not for specified items, terms or outcomes, but for "participation in a process of internal goal setting and dispute resolution". Blair and Stout refer to this as a "*pactum subjectionis*",<sup>108</sup> invoking the "pact of subjection" of political theory<sup>109</sup>, a pact "in which individuals so associated alienate their political agency to a ruler, within certain stated provisions and limits"<sup>110</sup> as described by Schmidt.<sup>111</sup>

As Chapter A3 of this work demonstrates, the employment relationship is just such a pact of subjection: the employee agrees to be subject to the instructions of the employer (which may be a corporation) subject to agreed terms and conditions which are accepted by the employer as the

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<sup>104</sup> Robé, *supra* note 30 at 26, and see also discussion at 34.

<sup>105</sup> Margaret M Blair and Lynn A Stout, "A Team Production Theory of Corporate Law" 1999 85:2 Va L Rev 247 at 278. Emphasis in the original. See also further discussion at 320.

<sup>106</sup> *Ibid* at 282, 284, and 284, respectively.

<sup>107</sup> *Ibid* at 279.

<sup>108</sup> This is normally distinguished from the *pactum societas* or pact of association, by means of which individuals form a political association.

<sup>109</sup> This is generally considered to involve reciprocal rights and duties, namely, of protection on the part of the sovereign, and of obedience on the part of the subject.

<sup>110</sup> James Schmidt, "Civil Society and Social Things: Setting the Boundaries of the Social Sciences" (1995) 62: 4 Social Research 899 at 905.

<sup>111</sup> *Ibid*. Schmidt places these terms in the context of social contract theory generally, with particular reference to Locke, Hobbes, Rousseau, Kant, and Fichte, invoking Otto Gierke in aid.

basis upon which the employer agrees to employ and compensate the employee. The reciprocity of the fundamental nature of that relationship is palpable. Capital providers to public corporations who cede their property to the corporation in exchange for shares of the corporation recognize that the shares represent a package of reciprocal rights as between the corporation and shareholder. These reciprocal rights are described in Chapters A1 and A2, and the impact of organizational analysis upon such relationship and rights is discussed next, and also later in this chapter under the heading “Centralized Management Independent of Equity Ownership”.

### Board as Mediating Hierarch

Leaving aside (for discussion in the next section concerning central management) the way in which the board of directors functions as a social unit or group of individuals, our review of the organizational aspect of corporations has identified at least two significant ways in which that review is relevant to directors. As the primary actor having the ultimate authority and responsibility for the corporation, in order to discharge its functions and its legal duties, the board receives information from, and transmits instructions or directions to, subordinate levels of hierarchy.

The discussion in Chapters Four, Five, and Six explicated the informal structures, processes, and relationships, as well as goals, which often characterize various levels of hierarchy within the corporate organization in addition to the formal structure, processes, relationships, and goals. The Nobel laureates Holmstrom and Tirole identify the organizational problem of “coordinating the actions of a differentially informed set of experts”, which “takes time and effort even when parties share organizational goals” but “more typically, individuals have differing objectives and informational expertise [which] may permit them to pursue their own objectives to the detriment of the organization as a whole.”<sup>112</sup> Discussion elsewhere in this work averts to these issues, which go to the very core of organizational operations, and are present at each level of its hierarchy. As they say, “the organization must succeed in capturing the returns from informational expertise by alleviating the exchange hazards that inevitably accompany asymmetric information.”<sup>113</sup>

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<sup>112</sup> Bengt Holmstrom and Jean Tirole, “The Theory of the Firm” in R Schmalensee and RD Willig, eds, *Handbook of Industrial Organization*, Volume I (North Holland: Elsevier, 1989) 61 at 62.

<sup>113</sup> *Ibid* at 64.

### Transmission of Information and Instructions

In order to satisfy the board's positive mandate of advancing the business of the corporation, involving identifying suitable opportunities, as well as its defensive mandate of mitigating risks attendant to the business and the opportunities presented, the board must endeavour to ensure the accuracy and completeness of the information which it receives from others within the corporation and otherwise. As was explained in those earlier chapters, the board must also endeavour to ensure that its instructions and directions are suitably transmitted to, and implemented by, organizational participants at inferior hierarchical levels and, on some occasions, by suppliers, distributors, and customers. Efforts to ensure compliance with these communication issues may involve employing sampling, multiple sourcing, and crosschecking of information and receipt of instructions, and other techniques.

Employees are obligated to communicate to the employer all facts to the employer ought to know, in effect, to reveal all relevant information,<sup>114</sup> a duty which when combined with "the fact that an employee is less likely to profit successfully from nondisclosure should reduce his incentive to distort or conceal information from his employer", according to Masten.<sup>115</sup> Masten argues that it may also decrease the employee's incentive to accumulate information in the first place, increasing the need for employee oversight.<sup>116</sup>

With respect, this seems to oversimplify the information disclosure problem. In fact, problems may arise in particular fact situations. For example, in many cases it will be difficult to establish that information not communicated by the employee was both possessed by the employee and considered by the employee to be something that the employer should know. It is also likely to be exacerbated by competing loyalties, as noted below. Further, a problem may arise concerning who represents the employer. For example, it may be argued that, in certain circumstances, it may not be sufficient to communicate information only to one's immediate superior, depending upon its salience and other relevant matters.

To the extent, however, that communication only to one's immediate superior discharges this obligation, the superior, who is vested with a like obligation, becomes the decisionmaker as to

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<sup>114</sup> Scott E Masten, "A Legal Basis for the Firm" (1988) 4:1 *JL Econ & Org* 181 at 186.

<sup>115</sup> *Ibid* at 190.

<sup>116</sup> *Ibid* at 196.



whether or not the information is communicated to persons at higher levels of the hierarchy. Of course, at each successive level the recipient of the communication, by reason of additional responsibilities or otherwise, may have information not available to the communicating inferior party, which may affect the superior party's decision as to further communication. Such additional information may enter into the determination of whether or not to communicate the focal information further.

#### Content of Information and Instructions

An additional issue for consideration by the superior party is the specific content of the information required to be communicated. Abbreviation, summarization, changes in format, and selection criteria (such as a more detailed or a more general level of data presentation) may significantly affect the interpretation of the focal information by the recipient. Even knowledge of the background, experience and interests of the recipient may factor into how the focal information is communicated. Communication of directions or instructions to subordinates may be subject to similar considerations.

As noted in previous chapters,<sup>117</sup> however, communication of information (up), or of instructions (down), may be further complicated by the individual employee's identification with, and commitment to, the focal group and their perception of the objectives of the focal group, of higher level components of the organization, and of the organization as a whole. These affective considerations may impact whether and how further information or instructions are transmitted. As is well known, the purport of information or instructions can be significantly affected by its format, the accompanying information or instructions, identification with respect to urgency or priority, and other circumstances. Of course, all of the foregoing may affect the information received, and instructions or directions issued, by the board of directors.

Divisions, departments, or other functional groups or business units may or may not constitute separate legal entities which are subject to limited liability and asset partitioning. As previously indicated, it may be advantageous in some circumstances for the parent corporation or a lower tier organizational entity to be able to assert SLE status and claim the benefit of limited liability and

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<sup>117</sup> See the discussion in Chapter Five, especially in the section entitled "Organizational Structure", and therein under the heading "Goals of Intraorganizational Organizations" and following headings; and in the section entitled "Organizational Process".

asset partitioning, in which case barriers to transmission of information and instructions which were not previous present may be implemented.

In any event, to the extent that SLE status, limited liability, and asset partitioning may possibly be asserted at some future point in time, their consequences can only be taken into account by the board if and to the extent these matters are known to the board vis-à-vis each corporation or other entity at each hierarchical level. It is clear that the relevant information would have to be supplied to the board by the CEO or other TMT members and that such information would be subject to the problems of information asymmetries previously noted.

## *Officers*

### Status and Duties

As established elsewhere in this book,<sup>118</sup> unlike directors,<sup>119</sup> officers are agents of the corporation, subject to the direction of the board of directors, in the case of the CEO, or superior officers, in the case of other officers, and are subject to certain statutory duties<sup>120</sup> and other duties by virtue of their employment relationships with the corporation.<sup>121</sup> They are not, in any sense, agents of the shareholders who not own the corporation or its assets.<sup>122</sup>

### Organizational Capabilities

As noted earlier, Chandler attributed the continuing growth and profitability of the leading corporations which he surveyed largely to what he called “organizational capabilities”.<sup>123</sup> He claimed that that these learned capabilities “resulted from solving problems of scaling up the processes of production, from acquiring knowledge of customers' needs and altering product and process to service such needs, coming to know the availabilities of supplies and the reliability of

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<sup>118</sup> In particular, see the discussion in Chapter A1; and in Chapter A3 under the heading “The Corporation as Principal”.

<sup>119</sup> See, especially, the discussion in Chapter A1 under the heading “Management Role of the Board of Directors”

<sup>120</sup> In particular, see the discussion in Chapter A1 under the headings “Management Role of the Board of Directors” and “Duties of Officers and Employees”.

<sup>121</sup> See, especially, the discussion in Chapter A3 under the heading “Organizational Liability for Acts of Corporate Actors” and under the heading “The Corporation as Principal”, particularly from and after the heading “The Role of Chief Executive Officer and Other Top Management Team Members”.

<sup>122</sup> This is recognized by many authors, including Robé, *supra* note 30 at 3-4.

<sup>123</sup> See the discussion in this chapter concerning “Implications of Organizational Analysis for Limited Liability and Asset Partitioning”, particularly under the heading “Shareholders” and therein under the subheading “Organization and Intracorporate Boundaries”, especially under the titles “Organizational Contribution to Corporate Value and Share Price” and “Organizational Learning”.

suppliers, and in becoming knowledgeable in the ways of recruiting and training workers and managers.”<sup>124</sup> This learned knowledge was “evident in the firms’ product-and process-specific human skills”, the most critical of which were those of the senior executives, “the top managers who recruited and motivated the middle and lower-level managers, defined and allocated their responsibilities, monitored and coordinated their performance, and who, in addition, planned and allocated resources for these enterprises as a whole.”<sup>125</sup>

#### Firm-Specific Investments by Officers

Of course, the human skills and experience acquired by the corporation reflects skills and experience acquired by individual human participants within the organization, particularly, according to Chandler, its senior executives and top managers. This process results in such individuals acquiring knowledge which is “firm-specific”, either having unique or simply greater value to the focal corporation as compared with the external labour market generally, and which constitutes a “firm-specific” investment by the officer concerned in the relationship with the focal corporation.

Gilson exemplifies this by referring to the skills demanded of employees in a manufacturing system which is a firm-specific investment which, once made, is “essentially sunk”. This gives the corporation “an incentive to renege on the return promised to employees for their firm-investment”,<sup>126</sup> requiring control of such incentive by means of appropriate corporate governance mechanisms. Increased age, length of service, and hierarchical position may be expected to affect the transferability of the employee’s knowledge to alternative corporate employers. The availability of alternative comparable employment may be expected to diminish at successively higher levels of the organizational hierarchy. This suggests that the CEO, followed by TMT members, followed by other officers, may have reduced comparable relocation opportunities as compared with those of other managers and employees.

#### Career Development

Officers, particularly those who are considered to have “high potential” for successively higher positions may be groomed for these by appropriate human-resources initiatives. For example, in

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<sup>124</sup> *Supra* note 77 at 84.

<sup>125</sup> *Ibid.*

<sup>126</sup> Ronald J Gilson, "Corporate Governance and Economic Efficiency: When do Institutions Matter?" (1996) 74:2 Wash U LQ 327 at 335.

order to break down the educational, professional, and functional loyalties which often affect organizational commitment,<sup>127</sup> high potential officers may be transferred to other divisions or departments, to different countries, or to head office. This may reduce the knowledge and experience which might otherwise have been acquired in a particular product market or industry segment characterized by comparable competitors who might have been sources of potential job opportunities with more specialized (i.e. less diversified) knowledge and experience.

Devising such career paths is intended to produce CEOs, TMT members, and other officers who will enable the focal corporation to achieve greater success in the future. This kind of career development is also considered to contribute to such officers' ability to satisfy their duty of care.<sup>128</sup> However, it also increases their specific human investment in the focal corporation. As noted previously, the contribution of such practices to organizational effectiveness may not be readily discernible by insiders.<sup>129</sup>

Organizational analysis suggests that the employment of CEOs, TMT members, and other officers, like that of other managers and employees, may be affected by SLE status, limited liability and asset partitioning. For example, as they ascend the organizational hierarchy, officers may move from one business which is a division of the ultimate parent corporation to another which is a subsidiary, whether direct or indirect. These changes may affect the officer's entitlement to pension and other entitlements, and to payments on termination of employment.

Especially later in the overall employment relationship between the officer and the enterprise, these entitlements may become of such importance to the officer that they are reflected, perhaps at the request of the officer (at least if emboldened to do so), in revisions to the relevant contract of employment. Otherwise, such entitlements may be unconsolidated at the level of the enterprise as a whole, which may be detrimental to the officer concerned. This may particularly be the case

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<sup>127</sup> See the discussion in Chapter Five, particularly in the section entitled "Organizational Structure" and therein under the headings "Intraorganizational Organizations", "Goals of Intraorganizational Organizations", and "Formal Organizations and Informal Organizations"; and in the sections entitled "Organizational Process" and "Organizational Personnel"; and Chapter Six, especially in the section entitled "Organizational Goals and Intraorganizational Goals" and therein under the heading "Intraorganizational Goals, Power, and Loyalty".

<sup>128</sup> See the discussion in the present chapter in the section entitled "Officers" and therein under the heading "Firm-Specific Investments by Officers" *et seq.*

<sup>129</sup> See discussion in the present chapter in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning", notably under the heading "Shareholders" and therein under the subheadings "Organization and Intracorporate Boundaries", especially under the title "Organizational Contribution to Corporate Value and Share Price", and under the heading "Shareholders" and therein under the subheading "Organizational Advantages and Organizational Change".

if the legal entity by whom the officer is employed at a particular time becomes bankrupt or insolvent, and the SLE-asset partitioning legal attributes are asserted against such officer.

#### Information Asymmetry, Monitoring, and Default

Halpern, Trebilcock and Turnbull assert that employees “may obtain an intimate knowledge of the financial position of the company and can use this information and setting the terms and conditions of employment”,<sup>130</sup> depending upon their level and function. However, such information is likely to be quite asymmetrical as between the parent corporation or focal corporation, on the one hand, and the officer or employee, on the other. As noted here, the financial position of the parent corporation, when consolidated with its subsidiaries and other affiliates and related entities (for which consolidation is required or permissible) is separate from the financial position of a particular subsidiary or other entity by whom the officer (or employee) may be employed at the particular time. Accordingly, it may not be possible for the officer to monitor the financial condition of the relevant entity.

For example, in the example provided earlier,<sup>131</sup> Great Motoring Corporation may determine that its direct subsidiary, Ultimate, is experiencing continuing losses at a level which threatens the operations of the parent corporation, and its divisions, Challenger and Champion, and its subsidiary, Greater Motor Trucks, such that it determines that Ultimate is presently insolvent and should be shuttered. In the absence of contractual and statutory provisions the contrary, it might be possible in the circumstances for Great Motoring Corporation to avoid any liability to the officers, managers, and other employees of Ultimate. This sometimes eventuates, in part, due to moral hazard, whereby the corporation obtains benefits by assuming increased risk but the downside burden is transferred to other parties, which Halpern, Trebilcock and Turnbull note,<sup>132</sup> includes employees.

Except for very highly placed officers, such as the CEO and some or all of the TMT members, and perhaps certain other officers having relevant functional responsibilities, such information may not be available widely and, in any event, may not be available to some or all of the officers of Ultimate. As a result, such persons would be unable to take appropriate steps to protect themselves.

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<sup>130</sup> *Supra* note 17 at 139.

<sup>131</sup> See Chapter Seven under the heading “Fact Pattern for Discussion – Great Motoring Corporation”.

<sup>132</sup> *Supra* note 17 at 140. Unfortunately, they do not consider the complex types of organizations discussed here.

Moreover, as a result of the distribution of organizational identification, commitment and loyalties at different organizational levels and functions, others within the organization may be able to assist some officers of Ultimate in avoiding disastrous results.

#### Lack of Diversification

Importantly, unlike financial investors, whether shareholders or lenders, employees are unable to diversify their firm-specific investments in the focal corporation both as employees and as creditors, say Halpern, Trebilcock and Turnbull.<sup>133</sup> Easterbrook and Fischel argue that, unlike shareholders or other creditors who can minimize risk by diversification, “human capital... is notoriously difficult to diversify” and “managers who have firm-specific investments in human capital cannot diversify the risk of business failure.”<sup>134</sup> Instead, because “investors want managers’ fortunes tied to the fate of the firm’s other control”, they “induce managers to bear extra costs of these firms fail” and “offer disproportionate rewards for success.”<sup>135</sup> For example, base salaries may be relatively low, but potential bonuses may equal or exceed base salaries, in some cases amounting to several times the base salary. This limits the downside for the corporate employer, while incenting performance.

Halpern, Trebilcock and Turnbull note that “diversification of risk must also consider the alternative market opportunities available to the employee of the company goes bankrupt”, which opportunities and hence which costs of default may be greater for some employees (such as accountants and technicians) than for others.<sup>136</sup> Of course, the extent to which the investment of the officer or employee in employment with the focal corporation is firm-specific affects the availability of such alternative market opportunities.

#### Consolidation of Liabilities to Officers

The question arises whether a parent corporation or other focal corporation should be able to benefit from SLE status, limited liability, and asset partitioning with respect to officers, managers, and employees of the overall corporate enterprise in all circumstances. The organizational analysis

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<sup>133</sup> *Ibid* at 143.

<sup>134</sup> *Supra* note 19 at 107.

<sup>135</sup> *Ibid*.

<sup>136</sup> *Supra* note 17 at 143.

conducted in the present work indicates that in many cases the internal organization by which the ultimate parent corporation takes action may operate across legal boundaries.

In our example, the officers of Great Motoring Corporation with responsibility for financial matters may give directions or instructions directly to their counterparts at Ultimate, at subsidiaries, direct and indirect, and at other affiliates, of Ultimate on a regular basis, in effect, ignoring the corporate legal proprieties as a matter of course. Let it be assumed that in the months immediately preceding the bankruptcy or insolvency of Ultimate, this changes and all instructions concerning financial matters are transmitted by the board of Great Motoring Corporation to the board of Ultimate. It is acknowledged, of course, that the board of Great Motoring Corporation is not entitled, in its embodiment as a shareholder of Ultimate, to give instructions to the board of Ultimate. However, this change in procedure might signal to the board and informed officers of Ultimate that significant financial dangers were in view.

Accordingly, Halpern, Trebilcock and Turnbull argue for an exception to limited liability in the case of employees, on the grounds that “amongst corporate creditors, employees, as a class, probably face the most severe informational disabilities, have the least ability to diversify risk of business failure, and may have the strongest equity argument (in terms of relative capacity to absorb losses).”<sup>137</sup> They acknowledge that “some employees will possess both superior information on corporate finances and high job mobility (e.g., corporate executives and professional employees”.<sup>138</sup> However, they claim that all officers, managers and other employees should be potentially eligible for such treatment. This will be discussed further below.

The corporative analysis of the organization’s essentialist attributes and the corporation’s legal essentialist attributes demonstrates that, analyses such as those of Gilson, Easterbrook and Fischel and Halpern, Trebilcock and Turnbull, which are clearly highly sophisticated according to certain legal and economic perspectives, are lacking by way of comparison to corporative analysis.

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<sup>137</sup> *Ibid* at 149.

<sup>138</sup> *Ibid* at 149-150.

## *Managers and Other Employees*

### Status and Duties

As established elsewhere in this book,<sup>139</sup> non-officer managers and other employees having supervisory responsibilities and some freedom of action with respect to their assigned tasks are agents of the corporation, subject to the direction of the board of directors, the CEO, or appropriate officers. They possess certain rights and are subject to certain duties by virtue of their employment relationships with the corporation, under declaratory law, common law, including agency law, and otherwise.<sup>140</sup>

These “legal” relationships between the employee and the corporation must be considered in relation to, and in relation to our knowledge of, the formal and informal relationships not only between the employee and the corporation but among those two and various other participants in any corporation as legal entity and as organization. While it is not possible to specifically enumerate all of these intersections of corporate and organizational participation, the identification of a few of them should provide some indication of the scope of application of the corporative perspective.

### Organizational and Intraorganizational Commitment

As noted elsewhere with respect to officers,<sup>141</sup> the performance of duties by other employees, managerial or otherwise, may be affected by the nature and levels of identification with, and loyalty and commitment to, the organization and various intraorganizational groups. As a result, employees may consider that they have “duties” not only to the corporation but to the specific intraorganizational groups with which they are affiliated, which may include informal, as well as formal, groups.<sup>142</sup>

It is intended by the focal corporation that such intraorganizational groups pursue goals and objectives which are both congruent with those of the focal corporation and congruent with the intraorganizational goals and objectives assigned to such groups by the focal corporation.<sup>143</sup> In

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<sup>139</sup> In particular, see the discussion in Chapters A1 and A3.

<sup>140</sup> See, especially, the discussion in Chapter A1 under the heading “Duties of Officers and Employees” and in Chapter A3 under the heading “Organizational Liability for Acts of Corporate Actors” and under the heading “The Corporation as Principal”, particularly from and after the heading “Intracorporate Agency”.

<sup>141</sup> *Supra* note 127, and the earlier sections of the present work referenced there.

<sup>142</sup> *Ibid.*

<sup>143</sup> *Ibid.*



fact, some goals and objectives of the focal group may be wholly or partially and congruent with those of the organization as a whole or those of groups that superior hierarchical levels<sup>144</sup>. It can readily be seen that this may produce a conflict of identification, loyalty and commitment for the focal employee.

Officers and managers who are superiors to the focal employee may take these matters into account from an operational, as well as a legal, perspective. In cases in which such superiors anticipate that an employee may have conflicts in this regard, they may wish to take prophylactic measures to avoid non-compliance with instructions and directions. For example, the superior may issue instructions and directions which are highly specific and extremely clear in an effort to avoid claims by the focal employee that noncompliance resulted from the ambiguity of the relevant instructions or directions.

#### Employee Participation and Intraorganizational Relationships

##### *The Employment Contract, Subordination, and the Duty of Fairness*

As established in Chapters Five and Six, Weber, Simon, and others characterize an organization as a relationship in which the behaviour of each participant is governed primarily by expectations in the case of Weber and by authority in the case of Simon, who focuses more closely on corporations.<sup>145</sup> The relationship is one of inferior and superior. Within certain parameters, which Barnard calls the “zone of indifference” and Simon calls the “zone of acceptance”, the subordinate is willing to accept decisions made by the superior.<sup>146</sup>

Robé explains that the employment contract “allows the employer to be the decision-maker in connection with the employee’s activity during his employment” by giving authority “to the employer (and, in fact, to the member of the firm’s management team, as agents of the employer) to direct the employee because the employee *accepted* entering into a legal relationship of this kind” by which the employee agreed “within certain limits, to do her job as directed by his

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<sup>144</sup> *Ibid.*

<sup>145</sup> In particular, see the discussion in Chapter Five under the heading "Formal Organizations and Informal Organizations" especially under the heading "Functions of Formal Organizations and Informal Organizations".

<sup>146</sup> In particular, see the discussion in Chapter Five in the section entitled “Organizational Structure” and therein under the heading "Formal Organizations and Informal Organizations", especially under the headings "Common Purpose, Intraorganizational Cooperation, and the Zone of Acceptance" and "The Range of the Zone of Indifference or Acceptance" and under the headings following.

employer in the sphere in which he expects to be subordinated".<sup>147</sup> Masten notes that an employer also has "the right to expect loyalty, respect, and faithfulness from his employees", as well as decent and proper deportment so as not to injure the employer's business.<sup>148</sup>

The duties of the employer and employee, respectively, are discussed elsewhere in this book.<sup>149</sup> The employee's duties are enumerated much more extensively than are those of the employer.<sup>150</sup> One of the employer's affirmative duties is to deal with the employee fairly and in good faith, including a duty to provide the employee with information about risks of physical harm or pecuniary loss that the employer knows, has reason to know, or should know are present in the employee's work, but which are unknown to the agent.

#### *Intraorganizational Transfers of Employment and Appropriateness*

Questions arise concerning how this duty applies to intraorganizational transfers of employees even assuming that the transfer is effected so as to preserve all of the employee status and rights, including length of service and other matters affecting pension rights. For example, when a solvent and high performing subsidiary transfers an employee, at the direction of its parent or other affiliate corporation which normally gives direction to the focal corporation, does the focal corporation, as immediate employer, have a duty to advise the employee to this effect? Similarly, does the directing corporation have such a duty? Or does the corporation accepting the transferred employee have such a duty? Or, as a normative matter, or as a legal matter, should one or more such corporations have such duty?

Intraorganizational transfers may be considered within the overall organization to be normal and even a tacit part of the bargain between the employer and employee and as an expected aspect of the role of employee within the umbrella organization. Not only does the employer possess authority over the employee within the context of the employment relationship but management

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<sup>147</sup> *Supra* note 30 at 37 [emphasis in the original].

<sup>148</sup> *Supra* note 114 at 187.

<sup>149</sup> See, especially, the discussion in Chapter A3 in the section entitled "Organizational Liability for Acts of Corporate Actors"; and in the section entitled "The Corporation as Principal", particularly under the headings "Agency Law Duties", "Intracorporate Agency", and "Liability and Indemnification of Directors, Officers and Others".

<sup>150</sup> *Supra* note 140. In particular, see the material in Chapter A3 under the heading "The Principal-Agent Relationship Inter Se".

also has the “ability to shape the definition of the situation”, thereby “tacitly channeling activity toward some possibilities and away from others”, according to Freeland.<sup>151</sup>

For example, it is often asserted that a person felt compelled to accept a promotion to a new position in a different city, where not otherwise required by the relevant terms of employment, to avoid suffering the negative consequences of ending one’s ability to secure promotions. This is particularly the case in certain kinds of businesses, such as retail banking. “The rules of appropriateness associated with roles and identities are the primary tools that the firm uses to motivate actors to transcend their own self-interest and their own individual preferences”, in effect, to use the employee’s “desire to manifest appropriate role behavior” in order to supplant or diminish individual self-interest. These rules of appropriateness are “rules of the game – shared common knowledge concerning how the firm functions and is supposed to function.”<sup>152</sup>

Freeland indicates that determining what behaviour is appropriate “is neither given nor simply imported from the outside world. Rather, it is given substance within the firm by the organizational definition of the situation, which emphasizes some rules of appropriate behaviour (or aspects of such rules) and deemphasizes others.” Moreover, the “standards of appropriate behaviour, in turn, are determined largely by top managers through the power of close control conferred by the law.”<sup>153</sup> In effect, close control allows management “to shape not only what actors in the organization see and think”, in terms of rational decision-making, “but also what they value and feel”, in terms of normative decision making.<sup>154</sup>

Of course, as a matter of law, intraorganizational transfers of employment may often result in the substitution of one employer for another, that is, in the creation of a new employment relationship between the employer and the employee, as a matter of law. However important this may be to the employee in the event of the subsequent insolvency of the new employer, it may not be considered particularly important to the employee at the time. This perceived unimportance and consequent inattention is not likely to be the sole result of the employee’s self-perceived lack of bargaining power, requiring a legal remedy such as group or enterprise liability to employees generally in

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<sup>151</sup> Robert F Freeland, "The Social and Legal Bases of Managerial Authority" (2009) 57:4 *Entreprises et histoire* 194 at 211.

<sup>152</sup> *Ibid* at 212.

<sup>153</sup> *Ibid*.

<sup>154</sup> *Ibid*.

cases of bankruptcy or insolvency, as maintained by Halperin, Trebilcock and Turnbull, Blumberg, and others.<sup>155</sup>

An employee's reaction to the proposed transfer may also be affected by the prevailing standard of "appropriateness" of employee behaviour generally in respect to such matters and the employer control which is exerted with respect to the same. This may warrant investigation of the question whether such a transfer is in the best interests of the employee, whether the employer should be advising the employee of all material information relating to the employee's decision whether or not to accept the transfer, and whether failure to do so might not violate the employer's duty to treat the employee fairly and in good faith.<sup>156</sup>

Unlike a purely economic analysis, corporative analysis permits us to approach this problem from a much broader perspective. The reason that this kind of situation might call for a remedy at law is not simply because of an inequality of bargaining positions, but because, in addition to that, expectations of the parties vis-à-vis the organization or the enterprise as a whole makes consideration of a remedy appropriate.

#### Firm-Specific Investments by Employees

As noted above, Chandler directed attention to the importance of organizational capabilities, identifying those the top managers as particularly critical to the corporation's success.<sup>157</sup> He noted that these organizational capabilities embodied "knowledge and skills... developed by learning from trial and error, feedback, and evaluation". Thus, "the skills of individuals depended on the organizational setting which they were developed and used", which "skills and knowledge were company-specific and industry-specific" and were "difficult to transfer from one industry to another, or even from one company to another, precisely because they had been learned within a very specific organizational context".<sup>158</sup> As noted above, Gilson considers that these investments by employees are essentially "sunk costs" and the employer has an incentive to renege on return from employs an action for such investment.<sup>159</sup>

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<sup>155</sup> As discussed in the preceding section "Officers", and, most particularly, under the heading "Consolidation of Liabilities to Officers".

<sup>156</sup> *Supra* notes 149, 150 and 151-155, and accompanying text.

<sup>157</sup> *Supra* note 77 at 84.

<sup>158</sup> *Ibid.*

<sup>159</sup> As discussed in the preceding section "Officers" under the heading "Firm-Specific Investments by Officers", *supra* note 126 at 335.

The learned knowledge of top executives includes various human and organizational skills relating to “managing” middle and lower level managers and planning and allocating resources for the focal corporation’s organizational components.<sup>160</sup> The learned knowledge of the middle or lower level managers “managed” by the top executives may be expected to become increasingly company-specific and industry-specific at successively lower levels of the hierarchy. Consequently, managers at such levels would be expected to be increasingly dependent upon the fortunes of the focal corporation at successively lower levels of the hierarchy. This may be the case even more with respect to non-managerial employees whose skills and experience may not reflect their duration of employment to the same degree, suggesting that a greater variety of alternative potential opportunities may be available to them.

Needless to say, the extent of the “sunkness” of firm-specific investment by managers and employees (including officers) at different levels is an empirical matter which cannot easily be determined. The extent to which risk of insolvency is transferred to managers and employees (including officers) at different levels is also an empirical matter which cannot easily be determined. However, these considerations are obviously relevant to discussions concerning the assumption and transfer of risk of insolvency and related issues of expectations and fairness. They will be further discussed below under the heading “Central Management Independent of Equity Ownership”.

#### Consolidation of Liabilities to Employees

As previously discussed,<sup>161</sup> the way in which corporate activities are conducted from an organizational perspective may not be completely respectful to, and may even sometimes disregard, to some extent, the legal essentialist characteristics of SLE status, limited liability, and asset partitioning. That is to say, a parent corporation or a holding corporation or other entity subordinate to such parent corporation may administer particular business operations in the same way, whether or not conducted by a corporation, which has SLE status, or by the superior corporation directly, in effect, as a division or department.<sup>162</sup>

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<sup>160</sup> This is discussed with respect to officers under the title "Organizational Capabilities".

<sup>161</sup> See the discussion in Chapter Seven concerning "Separate Legal Entity", especially under the headings "The Corporation, the Legal Entity, the Organization, and the Participants" and "The Separate Legal Entity, the Organization, and the Individual Human Actor – Effects of Separate Legal Entity Status on Organizational Structure".

<sup>162</sup> See the example provided in Chapter Seven under the heading "Fact Pattern for Discussion – Great Motoring Corporation".

The question arises whether the ultimate parent corporation, in addition to the focal corporation, should bear responsibility for obligations of the focal corporation to employees, particularly in the event of insolvency or other restructuring, voluntary or otherwise. A related question is whether all of the intervening corporations in the ownership chain between the ultimate parent corporation and the focal corporation should share in such liability.

These questions bear on the issue of how any protection of employees should be fashioned, whether by the courts or by the legislature. Many of those who argue that employees as a class “may have the strongest equity argument (in terms of relative capacity to absorb losses)” for an exception from limited liability, also seem to suggest that a legislative solution may be more appropriate.<sup>163</sup> It certainly would provide greater clarity as to its purpose, certainty as to its application (including definitions of “control” and provision for exceptions), and historical perspective concerning the bases of employee protection generally.

The analysis conducted here indicates that drafting such legislation would be complicated and would likely involve a number of rebuttable presumptions concerning “control” and other related matters. Further, such organizational analysis illustrates the importance of such legislation recognizing organizational aspects of control and influence over legal components of the overall business group, and not just legal conceptions of control. Any such legislation should recognize what the law considers as “de facto” control and not just “de jure” control. To the extent that limiting limited liability arises as a result of judicial, not legislative, action, similar considerations apply. Among the many advantages of legislative action is the increase in advance knowledge of the effects of such changes.

### ***Lenders***

Lenders or external financiers who provide funds to the corporation largely independent of any of other relationship must be distinguished from those who provide credit in connection with the provision of goods and services, such as suppliers and employees. The term will be used here in the first-mentioned sense.

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<sup>163</sup> *Supra* note 17 at 149-150. They mention as “defensible approximations of optimal rules” the rules concerning director liability for a limited amount of the wages of employees under the Canada Business Corporations Act.

### Organizational and Intraorganizational Commitment

As indicated in Chapter Seven, lenders who are otherwise independent of the corporation and simply lend funds without involvement in the corporation as organization may not be considered as organizational participants.<sup>164</sup> As previously noted, a lender which is entitled to representation on the board or among the top management team or other corporate officers,<sup>165</sup> may be considered to be an organizational participant. This may also be the case where the lender is related to other organizational or legal participants, such as the majority or major shareholder. In such cases, the legal relationship between the lender and the corporation as a legal entity, on the one hand, and the organizational relationships between the lender as organizational participant and the organization by which the corporation takes action, on the other hand, may affect each other.

A lender which is an organizational participant may be more affected by organizational essentialist attributes than other lenders. For example, its nominee directors may be subject to intraorganizational considerations with respect to the function of the board of directors; or its nominee as Chief Financial Officer may be subject to intraorganizational considerations with respect to the function of the top management team. These may include identification with and commitment to the corporation and, as well, to the board or to the TMT, the case may be; and to the issues of goal congruence and incongruence as between the corporation as a whole and the group in which the lender's nominee participates.

### Transferring Risk to Lenders and Other Creditors

An argument which is often made is that limited liability transfers the risks of business failure from shareholders to creditors without compensation. Landers argues, in effect, that the concern of the ultimate parent corporation (holding 100% of the shares of its subsidiaries) in MDCs and MLSFs is with overall profitability and not with the profitability of individual BUs or protection to creditors, which may lead to intermingling and transfers of assets in non-market price transactions, complicating a lender's task in obtaining and monitoring information and operations. He argues that this may justify subordination of debts owed to the parent company by its bankrupt

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<sup>164</sup> See the section entitled "The Corporation, the Legal Entity, the Organization, and the Participants" under the heading Categories of Organizational Participants" under the subheading "Lenders".

<sup>165</sup> For example, the loan agreement and other related documents may provide that the lender will be entitled to nominate a particular number of directors, that the other members of the board of directors agree to include them in the management slate of proposed directors, and that majority or major shareholder will vote in favour of such nominees. This may involve a considerable number of signatories and possibly a significant number of documents.

subsidiary, allowing creditors of that subsidiary to hold the parent company level, and allowing consolidation of affiliated corporations in bankruptcy to permit creditors of any such affiliate corporation to share equally in the pool of assets.<sup>166</sup>

Halpern, Trebilcock and Turnbull<sup>167</sup> contrast this with Posner's arguments, in effect, arguing that the lender should be in a position to accurately assess the risk involved in making the loan, to reflect that risk in the interest rate, and, in most (but not all) cases, should be able to impose conditions restricting the corporation's freedom of action in sufficient detail to maintain the original risk assessment.<sup>168</sup> These conditions may include restrictions on declaring dividends, making investment decisions and issuing new debt, and may also require the corporation to provide specified financial information regularly, sometimes monthly.<sup>169</sup> Belenzon, Lee & Pataconi note that "sophisticated contractual creditors such as banks and other financial institutions can charge higher interest rates compensate for the risks associated with weaker enterprise liability" and prevent their absorption of risk sought to be externalized by the focal corporation.<sup>170</sup>

David Millon concludes that efficiency rationales for limited liability are unpersuasive and proposes, instead, that the purpose of limited liability is to act as a subsidy to encourage business investment at the expense of corporate creditors. He suggests that while tort creditors, victims of corporate torts, are forced to bear any losses that exceed corporate assets, contract creditors can usually insist on compensation *ex ante* for such quantum of losses.<sup>171</sup>

In cases in which there is no minority interest in any of the direct and indirect subsidiaries of the ultimate parent corporation, there are, by definition, no outside shareholders to monitor compliance with corporate boundaries. However, as noted already, employees and others, such as trade creditors, may be affected by any unboundedness as among the separate legal entities within the overall corporate group. As noted with respect to employees, parties other than lenders typically have less bargaining power to agree on operating restrictions and monitoring mechanisms.

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<sup>166</sup> Jonathan M Landers, "A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy" (1976) 43:3 U Chi LR 589.

<sup>167</sup> *Supra* note 17 at 124-125.

<sup>168</sup> Richard A Posner, "The Rights of Creditors of Affiliated Corporations" 1976 43:3 U Chi LR 499.

<sup>169</sup> *Supra* note 17 at 133-134.

<sup>170</sup> *Supra* note 54 at 33.

<sup>171</sup> David Millon, "Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability" (2007) 56 Emory LJ 1305 at 1307.



## Consolidation of Liabilities to Lenders and Other Creditors

Lenders may become aware that the ultimate parent corporation “manages across legal boundaries”, that is to say, treats business units in the same manner, whether they are divisions or departments of the ultimate parent corporation or separate legal entities, such as direct or indirect subsidiary corporations. Such lenders may negotiate for guarantees of loans to the focal corporation from other corporations within the group. These may be limited to corporations or other legal entities within the same or related lines of business, or may not be so limited. Lenders may impose restrictions on those related corporations and may monitor their compliance, as well as that of the focal corporation. Alternatively, the lender may make the funds available to the group of related corporations specifying that they are secured by assets of such group and may monitor compliance by such group. Unlike tort creditors, contract creditors such as lenders have some ability to investigate the affairs of the borrower corporation, to attempt to negotiate appropriate protections, and to monitor compliance with the same, and the operations and performance of the borrower corporation in other regards.

Proposals to consolidate the liabilities of corporations below the ultimate parent corporation tier of the corporate group structure and organizational chart will be discussed below.

### *Piercing the Corporate Veil*

It is common to assert that the strictness of legal liability is often sought to be ameliorated by “piercing the corporate veil” to allow plaintiffs in tort and contract access not only to the assets of the focal corporation defendant but also to the assets of its shareholder, its immediate parent corporation. Although a comprehensive review of the subject is beyond the present purposes, some aspects of veil piercing relate to our organizational analysis and corporative perspective and so will be reviewed briefly.

Strasser and Blumberg argue that the traditional “veil piercing” rules are both uncertain and emphasize corporate formalities.<sup>172</sup> Langlois indicates that the corporate veil is often used if the subsidiary as acted as “agent” for the parent firm such that “the two are essentially inseparable from a managerial point of view”; the parent firm has perpetuated a concealment or

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<sup>172</sup> Kurt A Strasser and Phillip I Blumberg, "Legal Form and Economic Substance of Enterprise Groups: Implications for Legal Policy" (2011) 1:4 Accounting, Economics, & Law viii at 9.

misrepresentation which gave rise to estoppel; or if the parent firm has fraudulently conveyed the assets of the subsidiary firm to avoid meeting the legal obligations of the subsidiary.<sup>173</sup>

Robert Thompson's important 1991 empirical study of "piercing the corporate veil" American cases surveyed 1583 such cases,<sup>174</sup> finding that the law respects limited liability "unless compelling reasons are shown to vary from it" thereby providing a degree of certainty and planning "while it shifts risks to those who did not explicitly contemplate those risks."<sup>175</sup> He found that these compelling reasons often involve the activities of insiders.

In particular, he found that "Mere ownership of stock (or overlap of ownership in corporate groups) is not sufficient, nor is overlap of shareholders and directors (or common directors within a corporate group). More pejorative conduct is required. Undercapitalization, if found by the court, usually leads to loss of limited liability. Failure to follow corporate formalities also leads to piercing, but more powerful factors are demonstrations of lack of substantive separation of the corporation and its shareholders, and intertwining in the activities of the corporation and its shareholders."<sup>176</sup>

Lack of substantive separation and intertwining of activities as between the focal corporation and its parent corporation speak to the organizational aspects by means of which the business of the focal corporation and its parent corporation is conducted. Thompson finds that statutory provisions relating to product liability employ "the more common bargain reasons for piercing – misrepresentation, undercapitalization, and absence of corporate formalities" less frequently than in bargain cases; and statutory provisions of other natures, such as securities laws, tax laws or labour laws, adopt "control" provisions which are affected by the specific purpose of the statute.<sup>177</sup>

Other useful reviews of veil piercing cite many of the same factors as relevant. Jason Neyers' lawful and comprehensive article from 2000 reviews cases in Canada and the United Kingdom.<sup>178</sup> Blumberg's 2005 paper<sup>179</sup> and Meiners, Mofsky and Tollison's 1979 paper argue that the

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<sup>173</sup> Richard N Langlois "Business Groups in the Natural State" (2013) 88 J Economic Behavior & Organization 14 at 23.

<sup>174</sup> Robert B Thompson, "Piercing the Corporate Veil: An Empirical Study" (1991) 76 Cornell L Rev 1036 at 1048.

<sup>175</sup> *Ibid* at 1071.

<sup>176</sup> *Ibid*.

<sup>177</sup> *Ibid* at 1072-1073.

<sup>178</sup> Jason W Neyers, "Canadian Corporate Law, Veil-Piercing, and the Private Law Model Corporation" (2000) 50:2 UTLJ 173.

<sup>179</sup> *Supra* note 7 at 630. He emphasizes this point, in particular, with respect to intragroup liability.

importance of limited liability is overemphasized, both with respect to contract and tort claims.<sup>180</sup> Meiners et al. note that factors important in insulating the parent corporation from liability for subsidiaries include adequate capitalization to meet normally foreseeable obligations, not intermingling business records, accounts, property, transactions and employees; observing certain corporate formalities such as board meetings; and not representing to and possibly misleading the public concerning the extent to which the related enterprises are unified.

They characterize these factors as indicating whether or not “the corporate privilege has been used in good faith for legitimate business purposes”. Where a parent corporation sufficiently dominates another corporation, they may be treated as if they were one corporation as a matter of law, in which case the parent corporation will not be insulated from the liabilities of the subsidiary.<sup>181</sup>

In view of the uncertainty and excessive attention to legal formality which Strasser and Blumberg, among others, identify, there have been frequent proposals for comprehensive judicial or legislative attention to veil piercing and other mechanisms to ameliorate possibly adverse consequences from strict application of statutory limited liability and asset partitioning rules. These are discussed under the heading “Proposals for Limiting Limited Liability and Asset Partitioning” at the end of this chapter.

### ***Distributors and Customers***

#### **Organizational Participation and Intraorganizational Commitment**

In considering the path to market of the focal corporation, it is apparent that some corporations may appoint “distributors” on an exclusive or non-exclusive basis, who may also be denominated as “dealers” in order to offer the products and services of the focal corporation to customers or end-users. Whether or not such distributors or dealers participate in the focal corporation’s organization may depend on a number of factors, including the presence or absence of exclusivity, the duration of the relationship, the term of the relationship, whether aspects of the legal relationship are embodied in extensive distributorship or dealership agreements, the nature of the obligations, events of default, and remedies on default, any asymmetries in bargaining power, the

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<sup>180</sup> *Supra* note 32 at 356.

<sup>181</sup> *Supra* note 32 at 356.

implicit or explicit control exercised by the focal corporation over the distributor or dealer, and, finally, the degree of dependence of the distributor on the focal corporation.

Luigi Zingales states that the “defining characteristic of a firm is that it substitutes authority for the price mechanism in determining how decisions are made” and identifies the boundaries of the firm with the limit of the firm’s authority over decision-making.<sup>194</sup> Robé suggests that the “limits could be said to exist where the effects of the power fade away”. He indicates that the firm has no “neat boundaries” or “bright line” distinguishing “inside” and “outside” in all circumstances but instead, “just grey margins surrounding the firm within which different answers may be given to the question, depending on the issue at stake.”<sup>195</sup>

Robé argues that in circumstances in which firms are able to “operate via legal instruments allowing them to issue *orders* and exercise *authority*” at one end of the spectrum, this indicates that the parties receiving such orders are part of the firm, and not merely equals bargaining with respect to “horizontal” market transactions, as at the other end of the spectrum. Many cases, of course, would be in between these opposites. He would apply this test to suppliers of inputs and distributors of outputs.<sup>196</sup>

### Control and Information Asymmetry

Franchise agreements, for many of the reasons noted above, have, in particular, been found to subject franchisees to significant control by franchisors. To that end, franchise legislation been adopted in many jurisdictions, often imposing prospectus standards of disclosure of information to potential franchisees and prospectus-like remedies for non-disclosure.<sup>197</sup> In the United States, the Federal Trade Commission promulgated a rule<sup>198</sup> and published proposed interpretive guides,<sup>199</sup> which became effective October 21, 1979 and were the subject of an extensive review

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<sup>194</sup> Luigi Zingales, "In Search of New Foundations" (2000) 55:4 J Finance 1623 at 1644.

<sup>195</sup> *Supra* note 30 at 44.

<sup>196</sup> *Ibid* at 45 [emphasis in the original].

<sup>197</sup> The provinces of Alberta and Ontario were leaders in adopting such legislation. The Ontario legislation is the *Arthur Wishart Act (Financial Disclosure)*, 2000 SO 2000, c 3, <<http://canlii.ca/t/kq2q>> retrieved on 2018-09-18. The legislation is the *Franchises Act*, RSA 2000, c F-23, <<http://canlii.ca/t/j8qr>> retrieved on 2018-09-18.

<sup>198</sup> *Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures*. 16 C.F.R. § 436 et seq. (1979).

<sup>199</sup> *Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule*, 44 Fed. Reg. 49966 (1979).

article shortly after that time.<sup>200</sup> That article suggests methods which may be employed to distributorship agreements in an attempt to avoid the application of the statute, saying that “in general, the seller should expressly reserve control only over those items which it considers essential to the operation of the subject distributorship. The seller should remain mindful of the general policy of the rule to require disclosure if the subject arrangement renders the distributor dependent upon the seller for the daily operation of its business.”<sup>201</sup>

It is apparent from the organizational analysis conducted here that distributors and dealers which do not receive the benefit of franchisee disclosure under applicable legislation may be relatively unaware of the intraorganizational structure of the focal corporation with which they are contracting and with which they may be establishing a long-term and close relationship. For example, the production and sales of the product or service concerned may be housed in separate legal entities with various tiers of subsidiaries involved, including. This is common in the oil and gas business (separating “upstream” or production operations from “downstream” or product distribution operations, very often separating regional and country operations with separate subsidiaries or groups of subsidiaries for each function) and in certain other types of businesses.

Robé comments that adopting such a “corporate structure” or configuration of separate legal entities may not result in any change in how the corporate group (which he denominates as the “firm” in an economic sense and the present text denominates as the “organization”, the “corporate group” or the “enterprise”) operates under normal conditions since “it is still the same people are making the key decisions and giving the orders, irrespective in the main of the formal corporate governance of the subsidiaries”.<sup>202</sup> He argues that, even though local CEOs may have some status within the firm and some say over the firm’s local organization, “they are part of the governance structure of the firm as an organization, not autonomous skippers of the local subsidiaries and, for all practical purposes, are subordinates within the hierarchy set in place at the mother company’s headquarters level.”<sup>203</sup> This means that the consequences of the actions of the organization legally attach to individual subsidiaries, rather than to the corporate group as a whole.

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<sup>200</sup> David L Black, “New Federal Trade Commission Franchise Disclosure Rule: Application to Distributorship Arrangements” (1980) 35:2 Bus Law 409.

<sup>201</sup> *Ibid* at 425.

<sup>202</sup> *Supra* note 30 at 49.

<sup>203</sup> *Ibid* at 49-50 [emphasis in the original].

Distributors and dealers may be incented to sell the products and services of the focal corporation without investigation of the relevant legal framework for a number of reasons, including fear of such arrangements not being established or being disrupted at a later point in time. Thus, it may be difficult, as a practical matter and taking into consideration relevant power and influence considerations, for the distributor or dealer to monitor arrangements “in the background” of the focal corporation, such as whether it is solvent and whether its parent corporation is solvent. As an example, they might not be aware of the institution of separate upstream and downstream operations posited in this discussion.

Yet such matters may be important to the dealer or distributor who may be the subject of warranty or product liability claims by its purchasers at some later date. Equally well, the closer the relationship between the focal corporation and the focal distributor or dealer, the more difficult it may be for the latter to raise these “legal” issues. In this sense, the extent to which the distributor or dealer act as a participant in the focal organization may inhibit its attempt to investigate, monitor, and access its “legal” or “contract” rights. The range of situations which may be envisioned is considerable and, unfortunately, cannot be further explored here. However, some further comments on relevant policy changes appear in the last section of this chapter.

### ***Suppliers and Others***

In principle, the issues of the relationship between the focal corporation and its suppliers are similar to its relationship with its distributors, dealers, and customers. However, the consequences of the interposition of separate legal entities may be much more immediately relevant. For instance, separating the production and distribution operations of the focal corporation into separate tiers of subsidiaries may result in drastic changes in the creditworthiness of the corporate entity to which a supplier ships product and thereby becomes a trade creditor. As noted previously, similar results may attend acquisitions and dispositions of subsidiaries or groups of subsidiaries within the overall corporate group.

### **Proposals for Limiting Limited Liability and Asset Partitioning**

As previously noted, there are a number of proposals to limit limited liability and asset partitioning, whether traditionally or legislatively. Time and space limitations allow only a brief review of these. David Millon asserts that “veil piercing is the most heavily litigated issue corporate law, yet legal doctrine in this area is notoriously incoherent”, requiring an examination of underlying policy. He

maintains that limited liability, as a matter of policy, should not “protect illegitimate behaviour”, by which he means opportunistic behaviour by shareholders towards third parties, in effect, by using “limited liability as a device deliberately or recklessly to extract value from third parties without their consent and without compensation.”<sup>204</sup> He argues that limited liability should protect controlling shareholders who have managed the business in a financially responsible manner from losses that could not reasonably have been anticipated or prevented and which precipitate insolvency.

The only shareholders who should be liable for focal corporation debts, says Millon, are those who actually exercise their control over the corporation to cause it to act in a financially irresponsible manner and to shift costs of insolvency to its creditors in an unreasonable manner. He maintains that shareholders who do not act in this way should not lose the protection of limited liability.<sup>205</sup> Millon’s proposals relate primarily to judicial veil-piercing, which may be somewhat more problematic than statutory veil-piercing, which might, however, be based on similar principles.

For example, he would presume that majority shareholders exercise control over corporations, on the assumption that “a substantial investment creates an incentive to exercise control over business decisions”, but he admits that the majority shareholder might sometimes be unable to, or might choose not to, exercise such power and might play no role in the selection of management. He also considers the possibility that “the majority shareholder, even though not actively involved in management or the selection of management, may know or have reason to know that those who are in control or running the business in a financially irresponsible manner”, which might justify veil piercing in some circumstances.<sup>206</sup> He notes that minority shareholders acting in concert should also be subject to veil-piercing for these reasons.<sup>207</sup>

With respect to contracts, Millon focuses on two points in time. At the time the corporation assumes an obligation, for example, to a lender, the court should determine, firstly, “whether the shareholders believed in good faith that the corporation would be able to discharge this obligation in a timely manner”; and, secondly, whether this belief was reasonable under the circumstances.<sup>208</sup> At this first point in time, “reasonable shareholder expectations about future revenues, expenses

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<sup>204</sup> *Supra* note 171 at 1307.

<sup>205</sup> *Ibid* at 1360-1361.

<sup>206</sup> *Ibid* at 1361.

<sup>207</sup> *Ibid* at 1362.

<sup>208</sup> *Ibid* at 1364.

and cash flows” are relevant to such determination. Then, between the incurrence of the debt and its maturity, managers should act responsibly towards creditors by not engaging in conduct “that significantly increases the risk of default that each creditor has agreed to assume”, primarily by maintaining sufficient liquid working capital.<sup>209</sup>

With respect to tort claims, Millon would discontinue limited liability for shareholders “who caused their corporations to engage in activities that are likely to harm others but decide as a matter of policy to make no provision for compensation, knowing that the corporation will be unable to satisfy a claim brought by an injured party and intending to hide behind the limited liability shield” and for shareholders who fail to pay any attention at all to the need to provide compensation for injured third parties.<sup>210</sup>

Stephen Bainbridge distinguishes between veil piercing, which he says should be limited to natural persons liable for debts and obligations of the corporation of which they are shareholders, from enterprise liability, which he says should be invoked when someone is attempting to hold an entire corporate group liable, whether one is dealing immediately with affiliated corporations or with a parent and subsidiary.<sup>211</sup> He concedes that there are many legitimate reasons for enterprises to split assets among multiple corporate entities, including regulatory requirements applicable to the focal corporation as a result of the nature of its business, with the result that “sorting out legitimate use of multiple entities from those serving solely as a vehicle for judgment proofing is a nontrivial task.”<sup>212</sup> In some cases, where an operating entity is run by different managers than the owning entity, the managers of the operating entity have an incentive, in protecting their firm-specific investment in human capital, to insure against liabilities that threaten their employer’s solvency.<sup>213</sup>

Strasser and Blumberg, leading theorists of enterprise liability, start from a different perspective, considering the whole corporate group as “in reality one business enterprise, operating under the unitary control of the parent and possessing a high degree of economic integration” such that its functions (including administration, finance, employee selection, and management, and use of the corporate persona) are carried on interdependently.<sup>214</sup> They argue that in such cases the

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<sup>209</sup> *Ibid* at 1366.

<sup>210</sup> *Ibid* at 1374.

<sup>211</sup> Stephen M Bainbridge, "Abolishing Veil Piercing" (2001) 26 J Corp L 479 at 528.

<sup>212</sup> *Ibid* at 532.

<sup>213</sup> *Ibid* at 533-4.

<sup>214</sup> *Supra* note 172 at 6.



justifications for limited liability for individual investor shareholder do not apply to the parent company shareholder. Indeed, whether to function interdependently or to allow substantial business units “substantial independence of initiative or action”, in the case of the controlling parent company shareholder, “is a strategic management decision made by those in charge of the whole enterprise and one that can of course be changed as senior management of the parent chooses” and regardless of the “legal form or internal designation of that business unit, whether it is a separate corporate subsidiary, an operating division or some other internally defined unit.”<sup>215</sup>

Strasser and Blumberg argue that the “transaction cost justifications for limited liability are not applicable to a parent company shareholder” since it frequently owns 100% of subsidiary and so need not monitor the assets of its fellow shareholders to determine its contingent liability, since it provides management itself, so that there is no need to monitor third-party management, this matter and reducing costs of diversifying portfolio investments is not relevant. They maintain that diversifying businesses carried on within the corporate group is a different kind of decision that it is with respect to investors seeking to diversify investments to reduce the risk of any single investment. Instead, they assert that the internal management decision of the ultimate parent corporation to diversify the businesses which it carries on has operating costs and benefits quite different from those attached to investment diversification; for example, whether and how closely to integrate the operations of such businesses and a variety of other factors which relate to the operations of the businesses and not simply to spreading financial risk.<sup>216</sup>

Accordingly, Strasser and Blumberg argue that the legal rights and responsibilities of parent corporations as shareholders should reflect the distinctive economic roles which they play, as compared with the roles of parties who are only investor shareholders. They contend that legal decision making by courts, legislatures or administrative agencies, should start with the fundamental reality that “the legally separate subsidiaries are in fact part of a larger economic enterprise controlled by a parent company”, rather than focusing only on legal form and possibly ignoring economic substance and other relevant regulatory considerations.<sup>217</sup>

The present book has maintained that a corporation, which is unable to act otherwise, is animated or vivified only by individual human actors who, together, constitute an organization at least some

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<sup>215</sup> *Ibid.*

<sup>216</sup> *Ibid* at 7.

<sup>217</sup> *Ibid* at 10.

of whose objectives are economic in nature. Accordingly, the questions to which the present book devotes attention are somewhat different from the more limited questions that are posed by Strasser and Blumberg. They contend that control and economic integration, administrative and financial integration, employee selection, and management are important determinants of whether a group of corporations is one enterprise; and that another important indicator is whether “the enterprise chooses to present itself as one business, using a consistent corporate persona.”<sup>218</sup>

As a result of the starting point of the present book, we have proceeded by examining the legal essentialist characteristics of the corporation as a legal entity and the organizational essentialist characteristics of the corporation as an operating organization in order to endeavour to assess the impact of these various characteristics upon and interrelationship with the other such characteristics. Accordingly, while the inquiry conducted by the present book has some similarities with the “enterprise quest” proposed by Strasser and Blumberg, the present inquiry “goes behind” their indicators of collective enterprise to the ultimate essentialist attributes of each of the corporation as a legal entity and the organization as its human actor or instantiator. Nonetheless, the Strasser and Blumberg analysis has some similarities with the corporative approach of the present book.

### **A Corporative Approach to Limited Liability and Asset Partitioning**

The focus of this chapter is on how analysis and, in particular, organizationally essentialist characteristics, affect certain legally essentialist characteristics, in this case, limited liability and asset partitioning. The book has demonstrated that the corporation, as organization, may operate across internal legal boundaries, to a large extent, without taking them into account except where it is not possible to do otherwise, as a matter of law.

For example, implying the “Fact Pattern for Discussion” from Chapter Ten, the CEO of GMC at the parent corporation level may give instructions or directions to the executive responsible for each division, without taking into account whether the division is a separate legal entity. The CEO of GMC would not normally request, or request that GMC’s board of directors pass a resolution (which, coming from a shareholder, would not be binding in any event) requesting, that the board of Ultimate, one of its divisions the top company in the hierarchy of which is separately

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<sup>218</sup> *Ibid* at 11.

incorporated, to authorize Ultimate to take a certain action or to instruct Ultimate's CEO directly to take such action. Instead, GMC's CEO would more likely provide instructions directly to the CEO of Ultimate, just as would be done with the CEO of the Challenger division, which is a division of GMC, but is not a separately incorporated subsidiary.

In effect, boards of directors, officers, managers and other employees frequently "ignore" the separate legal entity status of corporations within the parent corporation's overall organizational hierarchy, particularly with respect to matters whose primary immediate effect is within the organization itself. That is to say, the strict "legal boundaries", such as separate legal entity status, of intraorganizational organizations, which may not be at the forefront of organizational operations, are very often subordinated to organizational requirements, at least intraorganizationally and immediately. As noted in this chapter, these legal boundaries may assume greater intraorganizational significance, in terms of managing the organization as a whole, "at the margins" or in exceptional (or, at least, non-ordinary) circumstances, in circumstances in which it may be legally advantageous for the organization as a whole to be able to assert its compliance with, and entitlement to benefit from, legal boundaries, for example, where a particular corporate entity is failing and the organization may seek to take advantage of its SLE status by insulating claims to the focal corporation, in this case Ultimate, only. This would not be possible with Challenger, which is a division only, and not a separately incorporated subsidiary.

Limited liability and asset partitioning may be disadvantageous to organizational participants, as legal counterparties, such as employees. In many cases, employees, especially if they are not represented by a union, may not know the current legal status of the intracorporate organization which is their direct employer, or of another intracorporate organization with which they may deal. Such legal status may have changed since the inception of their employment. Their original employer may have ceased to exist or may have ceased to have assets to support employee claims against it. Employees may think that still they are employees of GMC or Ultimate or a direct subsidiary of Ultimate but may find that they have become, instead, employees of a corporation, limited partnership, or special purpose vehicle at the fourth-tier of the hierarchy. The effect of insolvency of the immediate employer on its employees may differ, at least in some jurisdictions, according to its legal status.

Likewise, the chief marketing officer (“CMO”) of one of Ultimate’s direct subsidiaries (third tier of the hierarchy) may sell or transfer goods or services to another intraorganizational organization in the belief that it is a separate legal entity whose income and assets are adequate for such purpose, only to discover that its income and assets have been encumbered for some purpose, that its business is failing, and that GMC and Ultimate will ultimately allow the CMO’s corporation to become bankrupt. The focal CMO may thus be taking actions disadvantageous to his or her position as an employee and which, if they were known to be so disadvantageous, might have been avoided. Further, the CMO’s action may impair the position of suppliers and customers of the focal corporation, the latter of which would likely be particularly important to the CMO.

Lack of knowledge of the legal status of intraorganizational organizations and the lack of knowledge of whether and how such legal status may be asserted by relevant levels of the organization may be detrimental to various organizational participants, including employees, suppliers, and customers. An argument that employees, suppliers, and customers are able to protect themselves contractually may not completely recognize “the realities of the market”. Furthermore, while these organizational participants may, in some cases, get notice of changes in legal status which may affect them in these respects, this may not always be the case.

In the result, organizational analysis may suggest that it may be appropriate to consider affording some legal protections to certain categories of organizational participants in various circumstances, whether by statute or otherwise. What is important from the present, corporative, perspective is that decision making of this nature considered, firstly, the “facts on the ground” or facts “in the real world”, from an organizational perspective, and, secondly, how those facts may affect the impact on such “facts” of applicable law. In short, actual “real world” behaviour, rather than stylized perceptions of human and organizational behaviour, must be considered in framing applicable legal standards. Among other things, this signifies that appeals to the expectations of organizational participants should be based on actual relationships, rather than invocations of stylized or abstract perceptions of “legal rights and duties”.

## **CHAPTER NINE – A CORPORATIVE THEORY OF CORPORATE LAW AND GOVERNANCE –PART C**

### **PURPOSE AND SCOPE OF THIS CHAPTER**

This chapter continues to investigate how the legal essentialist characteristics of the modern business corporation, as described in Part 1 and Appendix A of this book, may be impacted by the essential characteristics of the modern business corporation as an organization, as described and considered in Parts 2 and 3, and vice versa.

In this regard, Chapter Seven considered the first legal essentialist attribute, that of constituting a separate legal entity, while Chapter Eight considered the second, limited liability and asset partitioning. Those two legal essentialist attributes are closely interrelated with the remaining ones: thirdly, capital lock-in with transferable equity interests; fourthly, centralized management independent of equity owners; and, fifthly, its indefinite duration of existence. In consequence, many of the comments which might be made in that regard in relation to these three remaining attributes have already been anticipated in the previous discussion of the first two attributes. This is particularly true with respect to the interrelationship among the five legal essentialist attributes. Accordingly, this chapter will endeavour to raise some observations particular to the third and fourth attributes which were not specifically referenced in those earlier discussions.

### **ATTRIBUTE THREE – CAPITAL LOCK-IN WITH TRANSFERABLE EQUITY INTERESTS**

#### **Declarative Law**

#### ***Capital Lock-In***

As discussed in Part 1 and Chapter A1 of this work, unless shares are redeemable at the option of the holder (“retractable”), the capital contribution which they represent (by way of consideration for the original issuance of the shares) cannot be withdrawn at the option of the holder as a matter of right.<sup>1</sup> Shares that are made redeemable by the corporation’s articles may be purchased or

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<sup>1</sup> See Chapter One in the section entitled “The Corporation and Corporate Essentialism in Law” under the heading “Transferable Equity Interests and Capital Lock-In”. The consideration to be paid for shares is determined by the directors and, when issued, is added to the stated capital account of the relevant class and series of shares. See ss 25-26 of the Canada Business Corporations Act, RSC 1985, c C-44 [CBCA] and ss 23-24 of the Ontario Business Corporations, RSO 1990, c B.16 [OBCA]. Amounts credited to a retained earnings or other surplus account in respect of a relevant stated capital account may be added to such stated capital account in certain circumstances of approved by special resolution. Reductions to a stated capital account must be approved by special resolution and are subject to

redeemed from the holder at prices not exceeding the redemption price stated, or calculated according to a formula contained, in the articles, and subject to a solvency test.<sup>2</sup>

### ***Transferability of Equity Interests***

As Chapters One and A1 indicate, absent permitted restrictions in the charter documents of the corporation, the shares of a modern business corporation, unless it is a “private” or “close” corporation, are generally freely transferable, as a matter of corporate law.<sup>3</sup> Some statutes contain extensive provisions concerning transfers of shares, including provisions relating to the issuance, purchase and sale, and registration of shares.<sup>4</sup>

### ***Voluntary and Involuntary Transfer of Equity Interests to the Corporation***

As discussed in Chapter A2, shareholders who dissent in the prescribed manner from special resolutions approving certain fundamental transactions are entitled to be paid by the corporation the value of their shares as determined in the prescribed manner.<sup>5</sup> On the other hand, shareholders who fail to accept a public takeover bid for all the shares of a certain class of shares may be required, in certain circumstances as described in Chapter A2, to transfer their shares to the successful bidder.<sup>6</sup> As likewise discussed in that chapter, under the oppression remedy, the purchase or exchange of securities, inter alia, may be ordered by a court.<sup>7</sup>

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solvency tests: s 38 *CBCA* and ss 24 (9) and 34 *OBCA*. See also Chapter A1 in the section entitled "Management Responsibility for Running the Business", particularly under the heading "Share Capital".

<sup>2</sup> S 36 *CBCA* and s. 32 *OBCA*.

<sup>3</sup> See the discussion in Chapter One in the section entitled "The Corporation and Corporate Essentialism in Law" under the heading "Transferable Equity Interests and Capital Lock-In". As noted there, corporations which are not "public", which involves whether they are listed or publicly traded or satisfy certain other conditions, may also be subject to a unanimous shareholder agreement. As noted there, the focus of the present work is public" corporations and, accordingly, that subject is not discussed here. Likewise, as noted there, the statutory permissibility of provisions relating to qualifications for special or advantageous treatment under tax or regulatory statutes is not discussed here. See also, in particular, the discussion in Chapter A2 in the section entitled "Shareholder Rights Beyond Voting", especially under the heading "Right to Sell or Transfer Shares".

<sup>4</sup> For example, see the discussion in the section entitled "Shareholder Rights Beyond Voting", especially under the heading "Right to Sell or Transfer Shares"; and see Part VII, ss 48-81, of the *CBCA*, and Part XI, ss 139-147 of the *OBCA*.

<sup>5</sup> See, in particular, the discussion in the section entitled "Legal and Management-Related Rights of Shareholders"; and in the section entitled "Shareholder Rights Beyond Voting", especially under the headings "Right to Sell or Transfer Shares", "Dissent and Appraisal Rights", and "Compulsory and Compelled Acquisitions".

<sup>6</sup> See, in particular, the discussion in the section entitled "Legal and Management-Related Rights of Shareholders"; and in the section entitled "Shareholder Rights Beyond Voting", especially under the headings "Right to Sell or Transfer Shares", and "Compulsory and Compelled Acquisitions".

<sup>7</sup> See, in particular, the discussion in the section entitled "Legal and Management-Related Rights of Shareholders"; and in the section entitled "Shareholder Rights Beyond Voting", especially under the heading "Remedies of Shareholders and Others" and therein under the subheading "Oppression Remedy".

## **Organizational Analysis, Capital Lock-In, and Transferable Equity Interests**

The questions examined here concern what effect the organizational analysis conducted earlier in this book and in more detail in Appendix A of this book has on the legal essentialist attributes of capital lock-in and transferability of equity interests, and vice versa. Many of the points that arise for discussion in this connection have already been mentioned in other contexts in Chapters Seven and Eight. Accordingly, this chapter will frequently avert to those discussions, sometimes focusing more directly on capital lock-in and transferability of equity interests than on the legal essentialist attributes which were the focus of discussion in those earlier chapters.

As in the previous chapters, the discussion will relate to the various categories of organizational participants. It is acknowledged, however, that while the legal essentialist attributes of capital lock-in and transferability of equity interests are most immediately relevant to shareholders, they do have significant impacts upon other organizational participants. Among organizational participants, the board of directors has the most immediate impact upon capital lock-in and transferability of equity interests. Finally, because of the close interrelationship between capital lock-in and transferability, the subjects will largely be discussed in tandem, as if they were concomitant legal attributes.

### ***Shareholders***

#### **Capital Lock-In**

As discussed in Chapter Seven, in exchange for their contribution of money, property, property rights or other things to the corporation, the original shareholders of the corporation receive certain rights evidenced by way of shares in the corporation, as determined by the corporation's charter documents and applicable law.<sup>8</sup> As described in the present chapter under the heading "Declarative Law", generally speaking, these rights do not include the right to require repayment of amounts contributed to the equity capital of the corporation by the original shareholders or their successors in interest.

The board of directors, as the ultimate decision-maker with respect to the corporation, is empowered to determine whether to return any capital to shareholders by way of dividend or

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<sup>8</sup> See the section entitled "The Corporation, the Legal Entity, the Organization, and the Participants", particularly under the heading "Categories of Organizational Participants" and under the subheading "Shareholders".

repurchase of shares from the shareholders individually or collectively, as permitted by law, and whether to distribute any earnings to shareholders by way of dividends.<sup>9</sup> As indicated in Chapter Eleven,<sup>10</sup> in respect of their management or supervision of the management of the business and affairs of the corporation, including the determinations with respect to the corporation's capital just mentioned, the directors are subject to certain duties which, to some extent, ameliorate capital lock-in by attempting to ensure that capital is employed in order to advance the business of the corporation, subject to some standard of reasonableness.<sup>11</sup>

As discussed in Chapter Seven,<sup>12</sup> the effects of capital lock-in ("LIC") on shareholders is also ameliorated by the power of the shareholders to elect directors,<sup>13</sup> to remove directors,<sup>14</sup> to make proposals with respect to the business and affairs of the corporation,<sup>15</sup> to requisition meetings of shareholders for the purpose of discussing certain permitted issues,<sup>16</sup> and to conduct proxy contests with respect to the election of directors.<sup>17</sup> Shareholders also have the power to approve or disapprove contracts in which directors are interested,<sup>18</sup> matters submitted to them by the directors,<sup>19</sup> and certain fundamental transactions.<sup>20</sup> They also have the rights to receive certain information intended to facilitate the exercise of such rights.<sup>21</sup>

The locking-in of capital affects decision-making by the board and by management with respect to the corporation as a separate legal entity. As Margaret Blair indicates, these factors "made it possible to build lasting institutions", empowering the board to make investments "in long-lived

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<sup>9</sup> See Chapter A1 in the section entitled "Management Responsibility for Running the Business".

<sup>10</sup> See the discussion in the section entitled "Shareholders".

<sup>11</sup> See Chapter A1 in the section entitled "Management Role of the Board of Directors"; and Chapter Four in the section entitled "The Corporation as Principal".

<sup>12</sup> See Chapter Seven in the section entitled "The Corporation, the Legal Entity, the Organization, and the Participants", particularly under the heading "Categories of Organizational Participants" and under the subheading "Shareholders".

<sup>13</sup> See Chapter A2 in the section entitled "Legal and Management-Related Rights of Shareholders", particularly under the heading "Voting in Relation to Directors".

<sup>14</sup> *Ibid.*

<sup>15</sup> See Chapter A2 in the section entitled "Legal and Management-Related Rights of Shareholders", particularly under the heading "Shareholder Rights to Initiate Consideration of Certain Matters".

<sup>16</sup> *Ibid.*

<sup>17</sup> See Chapter A2 in the section entitled "Informed Voting by Shareholders".

<sup>18</sup> See Chapter A2 in the section entitled "Legal and Management-Related Rights of Shareholders", particularly under the heading "Approval of Director-Interested Contracts or Transactions".

<sup>19</sup> See Chapter A2 in the section entitled "Legal and Management-Related Rights of Shareholders", particularly under the heading "Approval of Matters Submitted to Shareholders by Directors".

<sup>20</sup> See Chapter A2 in the section entitled "Legal and Management-Related Rights of Shareholders", particularly under the heading "Voting to Approve or Disapprove Fundamental Actions or Transactions".

<sup>21</sup> See Chapter A2 in the sections entitled "Informed Voting by Shareholders" and "Shareholder Rights Beyond Voting".



and specialized physical assets, in information and control systems, in specialized knowledge and routines, and in reputation and relationships, all of which could be sustained even as individual participants in the enterprise came and went.”<sup>22</sup>

Moreover, LIC permits the full amount of a corporation’s capital to be invested in the business and reduces uncertainty as to the amount of capital available at any particular time. Otherwise, restrictions might have been required concerning the amount or percentage of capital which could be withdrawn within a particular time period or more generally, in order that the corporation could maintain a reserve sufficient to effect such return of capital. The practical (and perhaps a charter or other legal) requirement of maintaining such a reserve would reduce the corporate return on investment, possibly increasing the return required by shareholders, make it more expensive to carry on the business.

Blair notes that charters and statutes in the United States in the nineteenth century typically prevented capital withdrawals unless the corporation was formally dissolved;<sup>23</sup> allowed directors to pay dividends only out of “clear profits and income”, but not capital;<sup>24</sup> and, later on, emphasized that the directors were not required to pay out all of the profits as dividends, but only as much as they deemed prudent;<sup>25</sup> and that shareholders have no legal right to dividends except as and when declared by the directors.<sup>26</sup>

Consequently, once a shareholder determines to become a shareholder, whether by original subscription or as a subsequent transferee of a share, that shareholder becomes a participant in the organization, even if it is only in the capacity of exercising, actually or potentially, the right to determine or to influence the determination of those who lead the organization, the board of directors; to approve or disapprove related party transactions; or to approve or disapprove of fundamental agreements and transactions. Together with the transferability of equity capital, the foregoing rights are discussed in Chapter A2 in relation to what Albert Hirschman called exit, voice, and loyalty.<sup>27</sup> Transferability, or exit, is discussed under the next heading. Capital lock-in

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<sup>22</sup> Margaret M Blair, "Locking In Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century" (2003-2004) 51 UCLA L Rev 387 at 430.

<sup>23</sup> *Ibid* at 429.

<sup>24</sup> *Ibid* at 431.

<sup>25</sup> *Ibid*.

<sup>26</sup> *Ibid*.

<sup>27</sup> See Chapter A2 in the section entitled "Legal and Management-Related Rights of Shareholders".

also has important effects on non-shareholder participants, which are discussed under the appropriate sections below.

### Transferability

Transferability, the ability for a shareholder to exit an investment in the corporation by transferring the “share” embodying the rights and liabilities of that shareholder, is the concomitant of capital lock-in. As discussed in Chapter Eight, because the share represents capital which is locked in to the corporation, the principal means of “freeing up” such capital is to transfer the share.<sup>28</sup> Transferability also facilitates the treatment of shares as a means of investment.

As noted in Chapter Eight, limited liability and asset partitioning, despite capital lock-in, permit individuals to purchase shares of various corporations without the necessity of monitoring such investments in an effort to avoid catastrophic risk of loss; and, together with the separation of management rights from equity ownership, permits treatment of shares of corporations as instruments for the investment of funds separately from any investment of labour and effort; together with transferability, permit the commodification of corporate shares as tradable instruments the value which depend on prospective and actual rates of return; and permit diversification of such investments.<sup>29</sup>

As explained in Chapter Eight, shareholders may have different investment objectives, investment horizons, and investment strategies, which may be affected by the legal structure of the corporation in whose shares they invest, including the extent to which the investee corporation operates its businesses by means of a unitary form, by means of a multidivisional form (using divisions, with or without subordinate separate subsidiaries), or by means of a multilevel subsidiary form (structuring subordinate operations as separately incorporated subsidiaries).<sup>30</sup> As discussed in Chapter Two, Chandler demonstrated that organizational form and legal form may be

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<sup>28</sup> See Chapter Eight in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning – Shareholders". See also Chapter Three in the section entitled "Part A – Legal and Management-Related Rights of Shareholders".

<sup>29</sup> See Chapter Eight in the section entitled "Asset Partitioning and Policy Considerations".

<sup>30</sup> See Chapter Eight in the sections entitled "Asset Partitioning and Policy Considerations"; and "Implications of Organizational Analysis for Limited Liability and Asset Partitioning", particularly under the heading "Shareholders".

independent,<sup>31</sup> however, the organizational attributes of a business enterprise are extremely important in understanding its operations and prospects for success.<sup>32</sup>

As discussed elsewhere, the objectives of shareholders may change as a result of factors pertaining, as well as those extraneous, to the individual's personal circumstances. These changes in objectives may make it appropriate in some cases to vary a particular investment in shares and to acquire an investment, in shares or otherwise, more suitable to the shareholder's revised objectives. The ability to transfer shares makes possible the termination of the original investment and the reinvestment of the proceeds. Thus, as Henry Manne notes, the original investment decision need not be near-permanent.<sup>33</sup>

As explicated in Chapter Eight, the legal structure of the corporate group or enterprise below the ultimate holding corporation at the top of the ownership and organizational hierarchy may significantly impede rigorous financial and risk analysis, which may, in turn, adversely affect accurate market assessment of the "intrinsic value" of the shares of the ultimate corporation.<sup>34</sup> A significant barrier to rigorous financial and risk analysis is the frequent inadequacy of disclosure of the organizational advantages of the corporate group, including its organizational structure, processes, and personnel and personnel and management practices. These include the means of integration of the organizational components, however structured legally, into the functioning enterprise or corporate group.

Overall, the disclosure of its organizational advantages, including strategic alignment and functional and tactical implementation of strategy is unlikely to be reflected in public disclosure documents affecting market evaluation and pricing. As noted previously, the full impact of its organizational advantages, as well as of any organizational disadvantages, may not even be fully known to the board of directors and senior management.<sup>35</sup> In fact, organizational considerations

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<sup>31</sup> See Chapter Two in the section entitled "Strategy and Structure", especially under the headings "Structure", "The Relationship between Strategy and Structure" and following.

<sup>32</sup> See Chapter Two in the sections entitled "The Visible Hand: The Managerial Revolution in American Business", and, especially, under the heading "Administrative or Organizational Development and Economic Theory".

<sup>33</sup> See Chapter Eight in the section entitled "Asset Partitioning and Policy Considerations", particularly under the heading "Investment in Shares, Diversification, Lock-In, and Transferability".

<sup>34</sup> See Chapter Eight in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning", particularly under the heading "Shareholders" under the subheadings "Investment and Diversification" and "Organization and Intracorporate Boundaries".

<sup>35</sup> *Ibid.* See also the discussion under the heading "Shareholders" under the subheading "Organizational Advantages and Organizational Change".

may be those which are most important to the value of the overall business.<sup>36</sup> As noted in Chapter Two, Oliver Williamson credits Alfred Chandler with having established for the first time that organization form had important business performance consequences, such a revolutionary and important observation that “the mistaken notion that economic efficiency was substantially independent of internal organization was no longer tenable after [Strategy and Structure] appeared.”<sup>37</sup>

Unless the shareholder concerned is the controlling shareholder, or a member of a control group of shareholders, or is otherwise engaged, alone or with other shareholders, in dialogue with the board of directors or management of the corporation, it is unlikely that the role of the shareholder as a participant in the organization would overcome these difficulties.

### *Directors*

#### Role of the Board of Directors

As often stated in this work, the board of directors, collectively, is the primary actor and decision maker for and on behalf of the corporation as a legal entity and the human organization which empowers its subordinate action and decision making. As Chandler says, it is administrative coordination which made possible the integration of specialized operations into a single enterprise and the development of managerial capitalism.<sup>38</sup> Of course, this involved the development of the legal and organizational variants described in Chapter Three.<sup>39</sup> Importantly, also, organizational complexity exacerbated the necessity of prioritizing the claims of organizational participants and others. Among other things, this has led to consideration of organizations, including corporations, as political systems and, in particular, as a socio-political conflict system involving a system of joint preference ordering, which operates at various hierarchical levels, as explained in Chapter Three.<sup>40</sup>

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<sup>36</sup> See the discussion in Chapters Five and Six.

<sup>37</sup> See Chapter Two, and, in particular, notes 98 and 99.

<sup>38</sup> See the discussion in Chapter Two in the section entitled "History of the Development of the Modern Business Corporation" under the heading "Administrative or Organizational Development and Economic Theory".

<sup>39</sup> See the discussion in Chapter Three in the section entitled "Forms of Corporations – Legal and Organizational Variants".

<sup>40</sup> See the discussion in Chapter Three in the section entitled "Organizations as Political Systems", which makes particular reference to the analysis of James March.

At the pinnacle of the organizational hierarchy, the board of directors makes the ultimate determinations as to how the preferences of individual organizational participants will be jointly ordered and implemented. This necessarily involves the joint preference ordering of preferences themselves reached as a result of joint preference ordering within various organizational components and at different organizational levels, as explained in Chapter Nine, and often irrespective of the boundaries of legal entities. As explained in Chapter Three, the allocation and division of authority and responsibility may not be bounded by legal structures or requirements but, instead, may be bounded by organizational considerations,<sup>41</sup> some of which are explicated in Chapter Five.

#### Locking-In Capital and Duties of Directors

In making such determinations, the board of directors of the ultimate parent corporation, both as a matter of law and as a matter of organization, must be concerned with the best interests of the corporation as a whole,<sup>42</sup> and not with those of individual components. However, determining what is in the best interests of the corporation as a whole must take into account the several contributions of organizational components, including the absorption of risk across the enterprise, as well as at lower hierarchical levels.<sup>43</sup>

These considerations are important with respect to the lock-in of capital contributions, as well as with respect to the non-shareholders who make firm-specific investments in the corporation. Both categories of investors are reliant upon directors to suitably perform their duties. For example, as described in Chapter Eight, assumption of inappropriate levels of risk, which were not generally discerned even by sophisticated investors, at a single organizational component led to the bankruptcy of Enron (and, incidentally, of the accounting firm Arthur Andersen) and, separately, the near-insolvency of JP Morgan.<sup>44</sup> Apocryphal situations such as these may have important effects on the rates of return on equity demanded by prospective investors.

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<sup>41</sup> *Ibid.*

<sup>42</sup> These duties are discussed in Chapter A1 in the section entitled "Part B – Management Role of the Board of Directors" and in Chapter A3 in the section entitled "Part B – The Corporation as Principal".

<sup>43</sup> See the discussion in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals" and in Chapter Seven in the sections entitled "The Corporation, the Legal Entity, the Organization and the Participants" and "The Separate Legal Entity, the Organization, and the Individual Human Actor".

<sup>44</sup> See the discussion in Chapter Eight in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning".

Particularly in situations in which information which is or may become critical to locked-in equity investment and which may not be available, publicly or otherwise, except to the board of directors, the CEO and top management team and other senior officers, shareholders are highly reliant upon the directors to fully discharge their duties in making decisions. Admittedly, the legal and organizational complexities of a large corporation may make it difficult even for directors to secure the detailed information and analysis which may be necessary in this regard. The present work directs attention to many of the topics worthy of investigation by directors from an organizational perspective and the ways in which they relate to legal characteristics of the corporation and vice versa, which is to say, topics which are important in connection with the focal corporation from a corporative perspective.

Margaret Blair argues that board decision-making “helps assure all participants that financial investors will not be able to easily pull assets out of the firm once other participants have made investments that are committed to the enterprise, and that active managers will not be allowed to use the assets of the firm for their own personal benefit”, and that it deprives other participants of “some of the ability they might otherwise have had to hold up other members” which “makes their commitments to engage with the others in a cooperative way more credible.”<sup>45</sup> Accordingly, the board “can help to mediate among competing interests in a corporation.”<sup>46</sup> Capital lock-in is reinforced by the duties of the directors with respect to their decisions to repay capital and by the necessity to consider the interests of other organizational participants in that regard.

#### Transferability and the Role and Duties of Directors

In a public corporation, the transferability of equity shares as a legal attribute of the corporation may be affected, as a practical matter, by the board of directors in a number of ways, including: entering into a merger agreement or an agreement to recommend acceptance of a takeover bid to shareholders; repurchasing shares by private agreement or the public markets with the intention of improving share price; “splitting” equity shares into a greater number of shares with the intention of improving overall equity market capitalization; and engaging in outreach and persuasion activities with respect to equity shareholders, especially those having practical or legal control of the corporation, individually or collectively.

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<sup>45</sup> *Supra* note 22 at 434.

<sup>46</sup> *Ibid* at 436.

Explaining matters such as how the corporation's strategy is being implemented, has been amended, the effects of any such amendments on corporate performance, any shortfalls from targets and any proposals for recoupment may have greater effect on shareholder confidence in the board and management team. As discussed in Chapter A2, the board of directors can thereby endeavour to encourage shareholder voice and to develop shareholder loyalty, in the hope of moderating shareholder impetus towards exit.<sup>47</sup> These matters will be discussed further in connection with Attribute Four – Central Management Independent of Equity Ownership.

### *Officers*

The roles, responsibilities, and duties of officers in relation to the corporation's status as a separate legal entity and in relation to the organizational analysis conducted in this work are discussed in Chapter Seven, which, in turn, further references discussion in Chapter A1.<sup>48</sup> Similar discussions in relation to limited liability and asset partitioning appear in Chapter Eight.<sup>49</sup>

### Capital Lock-In

Capital lock-in provides assurance to officers and others who make firm-specific investments in the corporation that those firm-specific investments will be protected, Margaret Blair comments, which helps to induce "individuals with sufficient talents and experience to run a business operation" that they should "give up their own entrepreneurial aspirations in order to work in a business in which they would not be independent and might not share directly in the potential business profits."<sup>50</sup>

Combined with SLE status, limited liability, and asset partitioning, LIC helps to assure the CEO, TMT, and other officers that the corporation possesses the financial resources, and possesses or can acquire the other resources requisite in order to advance its business, sustain its existence, acquire and maintain a positive reputation, and achieve growth, all of which are normally sought by such officers.<sup>51</sup> As established by Chandler and others, career management tends to favour long-

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<sup>47</sup> See discussion under the heading "Legal and Management-Related Rights of Shareholders".

<sup>48</sup> See the discussion in Chapter Seven in the section entitled "The Corporation, the Legal Entity, the Organization, and the Participants" and therein under the heading "Categories of Organizational Participants" and the subheading "Officers".

<sup>49</sup> See the discussion in Chapter Eight in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning" under the heading "Officers".

<sup>50</sup> *Supra* note 22 at 427.

<sup>51</sup> In this regard, see the discussion in Chapter Six in the section entitled "Existence and Typology of Organizational Goals and Objectives".

term stability and growth, rather than maximizing current profits.<sup>52</sup> Chapter Six demonstrated how components of the organization, whether or not considered as intraorganizational organizations, may pursue intraorganizational goals, and that such intraorganizational goals may be affected by changes in the corporation's internal or organizational environment, as well as by changes in its external environment.

### Transferability

Combined with SLE status, limited liability, and asset partitioning, transferability helps to assure the CEO, TMT and, and other officers that the corporation will not be subject to unreasonable demands from shareholders, whose capital is locked in the corporation, since shareholders are able to monetize their investment by transferring their shares to others.

Thus, transferability may be considered to mitigate or ameliorate opportunities for excessive conflict between shareholders, on the one hand, and other organizational participants, on the other hand. Henry Manne argues for the importance of transferability by observing that "in most instances, a functioning stock market will be of more interest to a potential corporate investor than will the limitation of his liability in the event that the corporation is not successful"; and that market liquidity facilitates transfer by a shareholder as a result of changes in investment needs, and in the event of shareholder dissatisfaction with management of the corporation.<sup>53</sup>

### *Managers and Other Employees*

The roles, responsibilities, and duties of managers and other employees in relation to the corporation's status as a separate legal entity and in relation to the organizational analysis conducted in this work are discussed in Chapter Seven which, in turn, further references discussion in Chapter A1.<sup>54</sup> Similar discussions in relation to limited liability and asset partitioning appear in Chapter Seven.<sup>55</sup>

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<sup>52</sup> See the discussion in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals", particularly under the headings "Organizational Goals and Corporate Operations" and "Goals of Corporations".

<sup>53</sup> Henry G Manne, "Our Two Corporation Systems: Law and Economics" (1967) 53:2 Va L Rev 259 at 264. See also the discussion in the present chapter under the heading "Shareholders" under the subheading "Transferability".

<sup>54</sup> See the discussion in Chapter Seven in the section entitled "The Corporation, the Legal Entity, the Organization, and the Participants" and therein under the heading "Categories of Organizational Participants" and the subheading "Managers and Other Employees".

<sup>55</sup> See the discussion in Chapter Eight in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning" under the heading "Managers and Other Employees".



Although managers normally operate at hierarchical levels which are inferior to those of officers, as a result of their firm-specific investment in the corporation as a legal entity and as an organization, they likewise benefit from capital lock-in and the transferability of equity interests. This is also largely true of non-managerial employees. As previously indicated, managerial and other employees may be affected by identification with, and loyalty and commitment to intraorganizational groups, as well as to the organization as a whole.

These affective phenomena may be expected to influence the employee concerned to make firm-specific investments in the corporation, even to the extent that the quantum of such investment is it unlikely to approximate any return to the employee from such investment. In that sense, such firm-specific investment may be considered to be non-rational, at least in the sense of economic rationality. However, as demonstrated in the present work, organizational participants may be expected to derive non-economic benefits from their association with the corporation, and these may make such participation worthwhile.

As previously discussed, managerial and other employees may be shifted among various divisions and subsidiaries of the ultimate parent corporation. They may not have the flexibility to accept the review such transfers and may be unable to investigate the financial and other circumstances of their “new” and “direct” employer within the corporate group.<sup>56</sup> Consequently, while capital lock-in might protect their corporate-specific or corporate group-specific investments, this may not necessarily be the case in any particular circumstances.

In addition, of course, the ability of the ultimate parent corporation or other subordinate level legal entities, including corporations, to transfer the shares of the particular corporation by which an employee is directly engaged may make capital lock-in and transferability of equity interest a two-edged sword: advantageous on the one hand but disadvantageous on the other.

### ***Lenders***

Both the locking in of capital and transferability are advantageous to lenders: the former to prevent dissemination of assets providing security for the lenders; and the latter to permit transfer of shares to parties who may be more capable of creating value for the business or more willing to devote resources to doing this.

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<sup>56</sup> *Ibid.* The discussion throughout the section is relevant to the matters discussed here.

### *Distributors and Customers*

Blair argues that separate legal entity status assures sales agents and customers that an ongoing relationship with the corporation, such as continued provision of warranty service, may be continued and will be backed by the assets sets of the whole business, regardless of changes in personnel.<sup>57</sup>

### *Suppliers and Others*

Just as on the output side, Blair argues that suppliers of inputs can rely on the separate legal entity status of the corporation to continue its relationship with suppliers over time. For example, when a corporation manufactured products requiring iron or steel seeks to enter into a long-term supply agreement with the owner of an iron and steel mill, the latter “can be reassured that the assets of the whole business are backing the commitments made under the contract”<sup>58</sup> and regardless of changes in personnel.

## **ATTRIBUTE FOUR – CENTRAL MANAGEMENT INDEPENDENT OF EQUITY OWNERSHIP**

### **Declarative Law**

Chapter A1 discusses the statutory role of the board of directors under modern corporate statutes, which is to manage or supervise the management of the business and affairs of the corporation; the related duties of directors; the power of the board of directors to appoint officers,<sup>59</sup> which officers are subject to certain statutory duties;<sup>60</sup> and the extensive nature of such general management powers.<sup>61</sup> As Chapter A2 explains, normally the directors are selected by the shareholders.<sup>62</sup> Although participation in the selection of directors is normally a right of holders of equity shares, no shareholder of a public company has a right, as such, to be a director.

Accordingly, a shareholder is not generally entitled by reason of equity ownership to participate in management of a public corporation. In this sense, the right to manage or exercise management of such a corporation is “independent” of equity ownership. As discussed previously, this does not

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<sup>57</sup> *Supra* note 22 at 448.

<sup>58</sup> *Ibid.*

<sup>59</sup> See the discussion in the section entitled "Management Role of the Board of Directors".

<sup>60</sup> See the discussion in the section entitled "Duties of Officers and Employees".

<sup>61</sup> See the discussion in the section entitled "Management Responsibility for Running the Business".

<sup>62</sup> See the discussion in Chapter A2 in the section entitled "Legal and Management-Related Rights of Shareholders".

entail that directors or officers may not participate in such equity ownership; but, instead, that equity ownership is not a necessity of, nor does it entitle anyone to participation, in the corporation as a director or as an officer.

### **Effects of Legal Separation on Organizational Participation**

As discussed, the separation of centralized management from equity ownership (“management ownership separation”) is an essentialist legal attribute of the corporation. Our corporative analysis leads to the question of how such separation, as a matter of law, affects the organization and its participants, more particularly in terms of its organizational essentialist attributes. The related question, of course is how the organization and its participants, particularly in terms of organizational essentialist attributes, affect management ownership separation and its consequences. These two questions are, of course, interrelated and, accordingly, discussing each distinctively from the other presents substantial difficulties. However, this will be attempted to at least some extent.

### **No Prioritization of Management-Equity Ownership Relationship**

Unlike a partnership or other business forms, a corporation, as a separate legal entity, is a distinct rights-and-duty-bearing entity which is, among other things, legally separate and distinct from its equity contributors, equity owners, or, in the case of the corporation, its shareholders. The incorporators of the corporation name the first directors, who then issue shares, which enables the newly incorporated corporation to take any action requiring shareholder approval.<sup>63</sup> It is not necessary that the incorporators become directors or shareholders of the corporation, which comes into being upon issuance of a certificate of incorporation.

Management ownership separation, accordingly, does not develop subsequent to, but is coeval with incorporation. Consequently, as part of their overall management powers, the board of directors is free to develop organizational structures and processes which are independent of the owners of equity capital in terms of normal course activities, but subject to certain shareholder powers as previously described. Similarly, shareholders may, but are not required to, take part in managing the corporation’s business, either as directors or as officers or other employees. Instead,

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<sup>63</sup> *Canada Business Corporations Act*, RSC 1985, c C-44, ss 5 to 9 inclusive [*CBCA*]; *Business Corporations Act*, RSO 1990, c B.16, ss 4 to 7 inclusive [*OBCA*].

the equity contributors cede control over the corporation's assets and activities to a board that is legally independent of shareholders<sup>64</sup> and has broad powers.<sup>65</sup>

### **Independence of Organization from Equity Ownership of Legal Entity**

Management ownership separation facilitates the development of organizational structures and processes which are independent of relationships between shareholders as contributors and owners of equity, and the one hand, and the corporation, on the other. For example, as discussed previously, large enterprises which are constituted as corporate groups can be managed from an organizational perspective in many, if not all, aspects without regard to the existence of separate legal entities within the corporate group.<sup>66</sup>

In the result, changes in ownership at the ultimate parent corporation level need not necessarily affect the organization and its operations below that level. At the same time, changes in ownership below the ultimate parent corporation level may take some corporations out of the group or may add corporations to the group, which changes may affect the organization of the overall enterprise.

This work has largely set aside discussions of possible problems with minority interests in corporations below the ultimate parent corporation level: that is to say, corporations which are subsidiaries, but not wholly-owned subsidiaries, of the ultimate parent corporation. In those cases, as previously noted, the duties of directors, and the residual powers of, and remedies available to, shareholders provide some mitigating influence and protection to minority shareholders.

### **Commoditization of Equity Interests**

As discussed in Chapter Eight, the legal essentialist attributes of SLE status combined with limited liability and asset partitioning entail that parties having legal and other relations with the corporation, such as shareholders, directors, and officers and other employees are protected with respect to such dealings with the corporation, provided that such dealings are regular and lawful.<sup>67</sup>

Among other things, persons who are prepared to act as directors or officers (or other managers or employees) are not generally exposed to liability except with respect to the value of any shares

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<sup>64</sup> See Blair, *supra* note 22 at 393.

<sup>65</sup> See Jean-Philippe Rob , "The Legal Structure of the Firm" (2011) 1:1 Accounting, Economics, and Law Article 5, at 31.

<sup>66</sup> See the discussion in Chapter Seven in the section entitled "The Separate Legal Entity, the Organization, and the Individual Human Actor". See also the discussion in Chapter Eight in the section entitled "Asset Partitioning and Policy Considerations" and therein especially under the heading "Asset Partitioning, MDF's, and MLSFs".

<sup>67</sup> See the discussion in Chapter Eight in the section entitled "Separate Legal Entity Status and Asset Partitioning".

that they might hold in the corporation irrespective of such office.<sup>68</sup> Because the other assets of shareholders were not exposed to loss on this account, individuals could invest in small amounts of money without placing their entire wealth at risk, as argued by Henry Manne, Halpern, Trebilcock, and Turnbull, and others.<sup>69</sup> As previously noted, limited liability makes the wealth of past or future shareholders irrelevant to acquisitions or dispositions of shares by other shareholders, which enhances transferability, and contributes to the creation of a viable market for such shares.<sup>70</sup>

As previously argued, the absence of any requirement to participate in management, together with limited liability and transferability, facilitates the “financialization” of corporate shares: not only in treating their purchase as an investment but also in their commodification as investment instruments or investment securities.<sup>71</sup> However, as noted in Chapters Seven<sup>72</sup> and Eight,<sup>73</sup> management ownership separation, together with separate legal entity status, facilitates intraorganizational management across, and often largely ignoring, SLE boundaries. Such intraorganizational organizational unboundedness greatly complicates analysis of a particular ultimate parent corporation and enterprise from financial performance, financial risk, and intraorganizational diversification perspectives.<sup>74</sup>

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<sup>68</sup> References to this effect appear throughout the present text. See the discussion in Chapter A1 in the section entitled “Management Role of the Board of Directors” and therein under the headings “Duties of Directors” and “Indemnification of Directors”; and in the section entitled “Duties of Officers and Employees” and, in particular, therein under the heading “Indemnification of Officers”.

<sup>69</sup> See the discussion in the section entitled “Asset Partitioning and Policy Considerations” under the heading “Capital Requirements, Characteristics of Investors, and Capital Markets”.

<sup>70</sup> *Ibid.* See also the discussion of remarks by Henry Manne, Halpern, Trebilcock, and Turnbull, and Easterbrook and Fischel.

<sup>71</sup> *Ibid.* See also the discussion in the section entitled “Asset Partitioning and Policy Considerations” under the headings “Separation of Management from Equity Ownership” and “Investment in Shares, Diversification, Lock-In, and Transferability”.

<sup>72</sup> See the discussion in the sections entitled “The Corporation, the Legal Entity, the Organization, and the Participants” and “The Separate Legal Entity, the Organization, and the Individual Human Actor”, especially under the heading “Effects of Separate Legal Entity Status on Organizational Structure” and “Legal Structure, Organizational Structure, and Value of a Diversified Enterprise”.

<sup>73</sup> See the discussion in the section entitled “Implications of Organizational Analysis for Limited Liability and Asset Partitioning” under the heading “Shareholders”, most notably under the headings “Investment and Diversification”, “Organization and Intracorporate Boundaries”, and “Organizational Advantages and Organizational Change”.

<sup>74</sup> *Supra*, notes 72 and 73.

### **Certainty as to Authority – Identity and Capacity**

As discussed in detail in Chapter Seven, in order to take action, the corporation, as a separate legal entity, must act by and through individual human actors.<sup>75</sup> As noted there, among the issues which arise in that connection are issues concerning authority, as to both the identity of the person or persons having authority, and the limitations of such authority.<sup>76</sup> In the case of a general partnership, subject to the partnership agreement, each general partner has a right to take part in any aspect of the partnership business. In the result, specialization or delegation of authority by the partnership to individual partners can only result from the partnership agreement or other internal arrangements among the partners, which arrangements are normally unknown to outsiders.<sup>77</sup>

In the case of the corporation, however, only the board of directors is the primary actor for and on behalf of the corporation, and it has the authority to make effectively all decisions required to be made in the normal course of business.<sup>78</sup> It appoints immediate subordinate agents to act on behalf of the corporation, who appoint lower level subordinate agents, and so on, creating a hierarchy of agents arranged in superior-inferior relationships the result of which is to regularize the corporation's dealings and ensure that they are binding upon the corporation.

This would not necessarily be the case in the event that any shareholder, or any shareholder having a certain percentage of the outstanding shares of the corporation, was entitled to act on its behalf, in the same way in which general partners are entitled to act on behalf of the partnership concerning any aspect of its business. Authority and responsibility are delegated and specialized within the

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<sup>75</sup> See, in particular, the discussion in Chapter Seven in the sections entitled "The Corporation, the Legal Entity, the Organization, and the Participants" and "The Separate Legal Entity, the Organization, and the Individual Human Actor".

<sup>76</sup> See the discussion in Chapter Seven in the section entitled "The Separate Legal Entity, the Organization, and the Individual Human Actor". See, in particular, the discussion under the headings "Acting on Behalf of the Corporation" and "Authority and Limitations on Authority".

<sup>77</sup> This is frequently remarked by legal commentators seeking to distinguish between the legal management rights in respect of general partnerships and those in respect of corporations. See, for example, Robert W Hillman, "Power Shared and Power Denied: A Look at Participatory Rights in the Management of General Partnerships" (1984) U Ill L Rev 865.

<sup>78</sup> See the discussions in Chapter A3 in the section entitled "The Corporation as Principal" in the sections entitled "Authority of Principal Divided Between Board and Shareholders" to and including "the Representative Role of the Board"; and in the section entitled "Conclusion – The Intracorporate Organization of the Corporation in Law"; and in Chapter Seven in the section entitled "The Separate Legal Entity, the Organization, and the Individual Human Actor".

corporation; however, the doctrines of ostensible and apparent authority protect parties dealing in good faith with the corporation.<sup>79</sup>

### **Stability of the Board of Directors**

As previously noted, management ownership separation facilitates the transferability of equity interests: “management”, both at the board of directors level and at the officer level, need not change automatically as a result of the transfer of any equity shares. This makes the continuity of such management, and hence the business strategy and business plan pursued by such management, likely to survive for a longer period than might otherwise be the case.

For example, if a shareholder was to be entitled to a board seat for every ten per cent shareholding, then a sale of shares by a shareholder so as to fall below the threshold would have the effect of displacing such shareholder’s nominee from the board. In certain cases, such as sales by other shareholders having nominees on the board of directors which took them below that threshold level, their nominees might be required to resign or otherwise be replaced, which might result in the board being unable to conduct meetings due to a lack of quorum.

Similarly, an acquisition of shares which took a shareholder from slightly above ten per cent to slightly above twenty per cent would entitle the shareholder to an additional “board seat”. In the event that the charter documents provided for a fixed number of directors all of whom are in place or a maximum number of directors which equaled the number of directors then on the board, this might require a resignation in order to create room for the new twenty per cent shareholder to nominate an additional director.<sup>80</sup>

It can be seen that private share transactions which might be advantageous to particular shareholders might be complicated by such linkage between share ownership and rights to participate in management. Furthermore, as previously noted,<sup>81</sup> automatic changes in board

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<sup>79</sup> See the discussions in Chapter A3 in the sections entitled "Organizational Liability for Acts of Corporate Actors", and "The Corporation as Principal" in the sections entitled "Intracorporate Agency", and "Conclusion – The Intracorporate Organization of the Corporation in Law"; and in Chapter Seven in the section entitled ""The Separate Legal Entity, the Organization, and the Individual Human Actor".

<sup>80</sup> The Canadian federal and the Ontario provincial statutes provide that the articles of incorporation of a corporation may provide for a minimum number and a maximum number of directors: *Canada Business Corporations Act*, RSC 1985, c C-44, ss 6 (1) (e) and 107 (a) [CBCA]; *Business Corporations Act*, RSO 1990, c B.16, ss 120, 125 and 168 (1) (m) [OBCA].

<sup>81</sup> See the discussion in Chapter Eight in the section entitled "Asset Partitioning and Policy Considerations" under the headings "Separation of Management from Equity Ownership" and "Investment in Shares, Diversification, Lock-In, and Transferability".

membership as a result of changes in ownership status would present significant difficulties, including difficulties of continuity of strategy and policy.

### **Management Stability and Organizational Stability**

As established in our discussion of resource dependence, strategic contingencies' theory, and strategic-contingency theory in Chapter Six, the corporation and other organizations must identify critical resources upon which it depends for its continuance and must respond to changes relevant to such dependence, whether in the external or internal environment.<sup>82</sup> Such adaptive responses must, to the greatest extent possible, be consistent with ongoing corporate strategy, structure, and processes in order to minimize costly disruptions.<sup>83</sup> This is facilitated by management ownership separation, as a result of which board membership does not change automatically upon certain changes in equity ownership, and by the consequent stabilization of operational management at the CEO, TMT, and officer levels.

Relative stability of board membership contributes to director tenure for a period which is, ideally, sufficient to develop the requisite expertise and trust and confidence among board members,<sup>84</sup> but not so long as to inhibit, by reason of friendship, free discussion among the directors.<sup>85</sup> A high level of trust and confidence is particularly valuable with respect to major or "bet the farm" decisions.<sup>86</sup> This is also important with respect to committee assignments, which typically involve

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<sup>82</sup> See the discussion in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals", most particularly under the heading "Intraorganizational Goals, Power, and Loyalty" and therein under the subheadings "Power, Organizational Stability, and Change", "Internal and External Threats to Organizational Stability" and "Theories of Intraorganizational Power".

<sup>83</sup> *Ibid.*

<sup>84</sup> A useful review of research streams relevant to a behavioural theory of board behaviour is: Hans van Ees, Jonas Gabrielsson and Morten Huse, "Toward a Behavioral Theory of Boards and Corporate Governance" (2009) 17:3 *Corporate Governance International Rev* 307. They identify one stream which concentrates on the complexities of board decision-making and other behavioural processes, involving "" theories and concepts from the fields of cognition and small group decision-making", citing as examples: DP Forbes and FJ Milliken, "Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups" (1999) 24 *Academy Management Rev* 489; J Gabrielsson. and H Winlund, "Boards of Directors in Small and Medium Size Industrial Firms: Examining the Effects of the Boards Working Style on Board Task Performance" (2000) 12 *Entrepreneurship and Regional Development* 311; V Rindova, "What Corporate Boards Have to Do With Strategy: A Cognitive Perspective" (1999) 36 *J Management Studies* 953; M Huse, A Minichilli and M Schoning, "Corporate Boards as Assets for Operating in the New Europe: The Value of Process-Oriented Boardroom Dynamics" (2005) 34 *Organizational Dynamics* 285; and H van Ees, G van der Laan, and TJB Postma, (2008) "Effective Board Behavior in the Netherlands" (2008) 26:2 *European Management J* 84.

<sup>85</sup> These points are supported and relevant literature is examined in Yaron Nili, "The 'New Insiders': Rethinking Independent Directors' Tenure" (2016) 68 *Hastings LJ* 97, especially 116-123. One concern is that long-tenured independent directors may so identify with the CEO and other inside directors that they become "co-opted".

<sup>86</sup> Jeffrey Sonnenfeld suggests UPS as an example: Jeffrey A Sonnenfeld, "What Makes Great Boards Great" (2002) *Harv Bus Rev*.



a high level of delegation to a relatively small number of directors, thus requiring a high level of confidence in them on the part of the other directors.<sup>87</sup> Often such committee assignments involve responses to crisis situations and other circumstances requiring immediate responses by the board of directors, such as approaches with respect to “friendly” takeover bids (or tender offers, in the American parlance) or mergers.<sup>88</sup> While such committee assignments avail the opportunity to get to know other committee members more closely, external time and other pressures mitigate against this to some extent, and also create a certain intensity which may be inimical to developing such awareness.<sup>89</sup>

Perhaps for the first time explicitly in academic literature, this book has suggested that the board of directors can be analyzed as, and may actually constitute, an intraorganizational organization. This applies the corporative perspective, combining a legal analysis of the corporation as a legal entity and an organizational analysis of the corporation as an organization. It is argued that the board of directors, alone or together with the TMT, constitutes an intraorganizational organization: an organization within an organization involving, as such organization, a social unit or group of people collaborating on an intendedly rational basis to seek to accomplish a common goal or objective or, perhaps, more than one such common goals or objectives.

### **Top Management Team Stability and Organizational Stability**

The perspective that the Top Management Team, alone or together with the board of directors, constitutes the “dominant coalition” of individuals responsible for setting firm direction, as

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<sup>87</sup> Often cited as contributing to such confidence is the expertise or the experience of the committee members, for example, with respect to the audit committee. Trust and confidence are also important in committees that are struck to respond to shareholder litigation: See Jerold S Solovy, Barry Levenstam and Daniel S Goldman, "The Role of Special Litigation Committees in Shareholder Derivative Litigation" (1990) 25:4 Tort & Ins LJ 864; special committees of independent directors in transactions involving conflicts of interest: see Scott V Simpson, "The Emerging Role of the Special Committee—Ensuring Business Judgment Rule Protection in the Context of Management Leverage to Buyouts and Other Corporate Transactions Involving Conflicts of Interest" (1988) 43:2 Bus Law 665; and in tender offer and other M&A transactions: see Scott V Simpson and Katherine Brody, "The Evolving Role of Special Committees in M&A Transactions: Seeking Business Judgment Rule Protection in the Context of Controlling Shareholder Transactions and Other Corporate Transactions Involving Conflicts of Interest" (2014) 69 Bus Law 1117.

<sup>88</sup> Often a "high wire" act is required in which complex issues involving high potential financial exposure must be considered and decisions reached within a very short timeframe. See Martin Lipton, "Takeover Bids in the Target's Boardroom: An Update After One Year" (1981) 36:3 Bus Law 1017.

<sup>89</sup> *Ibid.* See also the sources mentioned *supra* notes 84 to 88.

maintained by Cyert and March and by Mintzberg,<sup>90</sup> is discussed in Chapter Six.<sup>91</sup> Chandler asserted that management control eventually replaced board of directors control, although, to be sure, even when board of directors control prevailed its members were largely full-time executives.<sup>92</sup> Berle and Means, of course, maintained that the separation of equity ownership from “management” referred to both the board of directors and the TMT, although, because directors were the relevant time mostly senior officers, Mizruchi interpreted this to mean that the board was in control.<sup>93</sup>

### *TMT Collaboration and Stability*

As previously noted, that chapter also considers whether the TMT, alone or together with the board of directors, constitutes an intraorganizational organization, by reason of possessing the attributes discussed in the immediately preceding paragraph. Although a thoroughgoing analysis of that characterization goes beyond the scope of the present work, Chapter Six considers each of the attributes of the organization in connection with the board of directors and in connection with the TMT.<sup>94</sup>

A prominent issue in that regard is the “teamness” of the TMT. While not addressing the question raised here whether the TMT can be considered and evaluated as an intraorganizational organization, a study referenced in Chapter Six by Annaloes Raes et al.<sup>95</sup> considers the ways in which the TMT takes collective action vis-à-vis the middle managers who are subordinate to the TMT and how identification with, and loyalty and commitment to intraorganizational components (which may actually be intraorganizational organizations, as may be indicated by the criteria

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<sup>90</sup> See the discussion under the heading “The Dominant Coalition as Intraorganizational Group”.

<sup>91</sup> See the discussion in the section entitled “Organizational Goals and Intraorganizational Goals”, particularly under the heading “Intraorganizational Goals, Power, and Loyalty”, and “The Dominant Coalition as Intraorganizational Group”.

<sup>92</sup> See the discussion in the section entitled “Organizational Goals and Intraorganizational Goals” particularly under the heading “Intraorganizational Goals, Power, and Loyalty”.

<sup>93</sup> See the discussion in the section entitled “Organizational Goals and Intraorganizational Goals” particularly under the heading “The Dominant Coalition as Intraorganizational Group” and therein under “Board of Directors, Top Management Team, and the Dominant Coalition” under the title “Berle and Means on the Dominant Coalition”.

<sup>94</sup> See the discussion in the section entitled “The Dominant Coalition as Intraorganizational Group”, especially under the headings “The Top Management Team as a Group of Individuals”, “Top Management Team Goals and Objectives”, and “Top Management Teams and Collective Action”. See also the sections of Chapter Five referenced there.

<sup>95</sup> Annaloes ML Raes, Mariëlle G Heiljtes, Ursula Glunk, and Robert A Roe, “The Interface of the Top Management Team and Middle Managers: A Process Model” (2011) 36:1 Academy Management Rev 102.

referenced in the present work) affects such interactions, which they claim may be fewer in number than in other superior-inferior relationships.

As noted in the first paragraph of this chapter under the heading "Management Stability and Organizational Stability", the board of directors, CEO and TMT are expected to scan the internal and external environments, and identify, and react appropriately to, such changes. An intended result of specialization and delegation is to ensure that members of the TMT perform this task with respect to their areas of authority and responsibility, in effect, separately, but collaboratively.

Consequently, as some minimum period of tenure of the TMT as a group may be expected to promote greater trust in areas in which not only separate performance of individual TMT members is operative, but also in which collaborative performance is operative, the board, the CEO, and the other non-focal members of the TMT may express greater trust and confidence in the focal TMT member both in terms of individual tasks, including scanning and action, and collaborative tasks, including collaborative scanning and action. Rapid changes in board membership, such as might be effected as a result of automatic changes in shareholding might be expected to increase CEO and TMT changeover, thereby affecting trust and confidence at these various levels.

Cyert and March, and Mintzberg, identify the dominant coalition with the TMT.<sup>96</sup> In some cases, the dominance of certain functional groups changes over time in response to environmental and other changes as noted by Chandler, Salancik and Pfeffer, and Perrow.<sup>97</sup> In the normal course, absent some critical event such as a proxy battle or takeover bid, such changes may be expected to be more gradual rather than dramatic single events.<sup>98</sup> Again, automatic changes in board membership as a result of the absence of management ownership separation might have a negative effect in this regard.

A related consideration, as noted in Chapter Six, is that individual members of the TMT have no collective, but only individual, legal responsibilities to the corporation.<sup>99</sup> Accordingly, the extent

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<sup>96</sup> See the discussion in the section entitled "Organizational Goals and Intraorganizational Goals" under the heading "The Dominant Coalition as Intraorganizational Group".

<sup>97</sup> See the discussion in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals" under the heading "Intraorganizational Goals, Power, and Loyalty", particularly under the subheading "Changes in the Dominant Coalition or Top Management Team".

<sup>98</sup> *Ibid.*

<sup>99</sup> See the discussion in the section entitled "Organizational Goals and Intraorganizational Goals" under the heading "The Dominant Coalition is Intraorganizational Group" and therein under the subheading "Top Management Teams and Collective Action".

of collaboration among TMT members is a factor, as a matter of law, principally (if exclusively) by considerations of individual legal duty. Failure to “collaborate effectively” with other TMT members may be a factor in performance assessment of the focal individual, but cannot necessarily be assumed to be a separate head of legal duty. In any event, any legal duty of effective collaboration would likely assume reciprocity, limitations on which might affect the duty of the focal officer. The complexities which attend such effective collaboration are discussed throughout the present work. At the same time, however, sanctions, both positive and negative, are often based partly on individual performance and partly on a collective performance.<sup>100</sup> Thus, collaboration can be congruent with the personal goals of TMT members.

As noted in Chapters Five<sup>101</sup> and Six,<sup>102</sup> because the requisite transmission of information and instructions involves a significant element of subjectivity, such transmission may be impaired by frequent changes in board, TMT, and lower level officer personnel. Raes and her co-authors have concluded that such transmission between the TMT and officers reporting to individual TMT members is further complicated by the dual role of such officers as TMT subordinates and as representatives of their focal business unit.<sup>103</sup> They say that the limited extent of interaction between TMT members and their direct reports limits the opportunities for generating trust.<sup>104</sup> As previously noted, this may be expected to be the case with board-TMT member interaction as well.

### ***TMT and Goal Stability***

As established in Chapter Three, the corporation may be considered as a conflict system for internal and external conflicts, for resolving these by ordering joint preferences,<sup>105</sup> and for implementing and effecting the same.<sup>106</sup> As demonstrated in Chapter Six, the organization as a whole may have separate official or explicit goals, as well as operative or implicit goals.<sup>107</sup> In the

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<sup>100</sup> *Ibid.*

<sup>101</sup> See the discussion in the section entitled "Organizational Structure", particularly under the headings "Formal Structure and Relationships", "Informal Structure and Relationships", and "Formal Organizations and Informal Organizations".

<sup>102</sup> See the discussion in the section entitled "The Dominant Coalition as Intraorganizational Group", particularly therein under the heading "Top Management Teams and Collective Action", and "The Board of Directors as a Group of Individuals".

<sup>103</sup> *Ibid.*

<sup>104</sup> *Ibid.*

<sup>105</sup> See the discussion in the sections entitled "Barriers to Unified Action" and "Organizations as Political Systems"

<sup>106</sup> See the discussion in the section entitled "Forms of Corporations – Legal and Organizational Variants" and the examples mentioned there.

<sup>107</sup> See the discussion in the section entitled "Existence and Typology of Organizational Goals and Objectives" and "Organizational Goals and Intraorganizational Goals".

case of the corporation, unless otherwise determined by the charter documents (which would be rare in the case of modern business corporations unless established for some highly particular purpose), such goals are generally promulgated by the board of directors. However, each intraorganizational component may establish its own goals.<sup>108</sup>

Ideally, of course, the goals of the organization as a whole and of its individual components should be completely aligned; however, the extent of such alignment is affected by the power and influence of any particular individual component.<sup>109</sup> Changes in such power and influence may result from changes in the board, the TMT, other officers, and component-level management. Such changes, in turn, may produce a realignment of organizational and intraorganizational goals. It is apparent that the automaticity of board changes as a result of equity ownership changes would exacerbate the need for, and the difficulties of effecting, such realignment on a timely basis.

#### *Adaptational Costs of TMT Instability*

Accordingly, management ownership separation may be expected to reduce the frequency of such changes and thereby improve the extent of alignment as between organizational and intraorganizational goals. This, in turn, may be expected to reduce the expenditure of time, financial, and other resources in trying to adapt to frequent goal changes, at least some of which may be relatively, even highly, unproductive. For example, variations of slightly different hierarchies of goals at the level of the ultimate parent corporation may be expected, in many, if not all, cases, to require component level hierarchical variations. Returning, say, to the original hierarchy at the level of the ultimate parent at some later time might result, in significant ways, in the expenditures of resources at many, or even all, of the various organizational levels.

Further lack of synchronicity of the organization with its internal and external environments as a result of TMT changes may require further readjustment, sometimes by means of experimentation, which can be extremely costly.<sup>110</sup> The cost of readjustments includes the time necessary to absorb changes. Investment of time and financial and other investments in retooling the organization may,

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<sup>108</sup> See, in particular, the discussion in the section entitled "Organizational Goals and Intraorganizational Goals".

<sup>109</sup> See the discussion in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals", especially under the headings "Intraorganizational Goals, Power, and Loyalty", "Organizational Goals and Corporate Operations", and "Goals of Corporations".

<sup>110</sup> See the discussion in Chapter Two in the section entitled "History of the Development of the Modern Business Corporation" and in Chapter Six, particularly in the sections entitled "Existence and Typology of Organizational Goals and Objectives" and "Organizational Goals and Intraorganizational Goals".

in at least some cases, be expected to diminish profitability, return on equity, and share price, which may result in the corporation become more vulnerable to takeovers driven by price rather than as a means of disciplining non-performing management. As established by Hirschman and other chroniclers of organizational failure, quite apart from takeover exposure, the results may be expressed in a “cascade to the bottom”.<sup>111</sup>

Effecting changes in the organizational structure, processes, and personnel requires the exercise of power, which, as noted by Bierstedt and Weber, is required to guarantee the continuance of the organization, but which is not unlimited.<sup>112</sup> Intraorganizational components of the organization may employ power and influence in an effort to preserve or secure intraorganizational advantage in such circumstances. As Barnard and Bierstedt indicate, the exercise of formal organizational authority may be mitigated by informal relationships and authority.<sup>113</sup> The expenditure of authority as a resource frequently is, or should be, a considered decision, and, accordingly, must be weighed in the light of alternative such expenditures. Unnecessary or inappropriate exercises of authority may mitigate its employment in other circumstances.

### **Management as a Separate Organizational Component and Constituency**

Divorcing management from equity ownership permits the development of the organization of the corporation independently, to a greater or lesser extent, and thereby increases the professionalization of management, both at the board level, and at the level of the TMT, subordinate officers and other managers. As Chandler indicated, management or administration, as he calls it, is perceived to be a separate function within the corporation.<sup>114</sup> The adoption of

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<sup>111</sup> See the discussions in Chapter A2 in the section entitled "Legal and Management-Related Rights of Shareholders".

<sup>112</sup> See the discussion in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals", especially under the heading "Intraorganizational Goals, Power, and Loyalty".

<sup>113</sup> *Ibid.*

<sup>114</sup> See the discussion in Chapter Two in the section entitled "History of the Development of the Modern Business Corporation" and therein under the heading "Strategy and Structure"; and therein under the subheadings "Functions and Activities of Management", "Executive Management and Senior Management Roles", and "Conclusion"; and also in the section entitled "The Visible Hand: The Managerial Revolution in American Business" under the heading "Recapitulation of Historical Analysis of Administrative or Organizational Development" and "Administrative or Organizational Development and Economic Theory"

specialization and delegation in pursuit of rationality and efficiency was observed by Weber in connection with formal organizations generally,<sup>115</sup> including the corporation.<sup>116</sup>

In turn, management or administration becomes professionalized,<sup>117</sup> and its practitioners adopt an attitude of professionalization as part of their own self-image.<sup>118</sup> Lipartito and Morii emphasize that Berle and Means focused not on the separation of management and control leading to a principal-agent conflict, as maintained by some later writers, but, instead, on the separation of ownership and control, namely, management exercising control over a corporation “owned” by others: the managerial corporation.<sup>119</sup>

As discussed previously, management ownership separation contributes to professional management seeking satisfaction which is not entirely monetary, as noted by William Baumol and by Robin Marris, providing perquisites, say Lipartito and Morii, such as salary, staff, and discretionary investments,<sup>120</sup> as well as prestige, power, and job satisfaction.<sup>121</sup> Instead, professional management may focus on sustaining satisfactory profits and performance over a relatively long term horizon, and on growth, as noted by Buchanan (“growth not profits”),<sup>122</sup> rather than maximizing profits in the short-term.<sup>123</sup> Instead, professional managers might be even “more

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<sup>115</sup> See the discussion in Chapter Seven in the section entitled “Groups of People or Social Units”; and in Chapter Five in the section entitled “Structure, Process, and Personnel” under the heading “Rational-Legal Authority, Administration, and Bureaucracy” and therein under the headings “Hierarchy, Rules, and Formal Organization”.

<sup>116</sup> See the discussion in Chapter Five in the section entitled “Structure, Process, and Personnel” and therein under the heading “Rational-Legal Authority, Administration, and Bureaucracy” and under the subheadings “Legitimacy and Rational-Legal Authority” and “The State, the Organization, and the Corporation” and “Organizational or Bureaucratic Officials”; and in the section entitled “Organizational Structure”.

<sup>117</sup> With respect to Weber’s discussion of the subject, see the discussion *supra* note 116. With respect to discussion by Chandler, see the discussion in Chapter Two in the section entitled “The Visible Hand: The Managerial Revolution in American Business” under the headings “Administrative Development and Business Expansion – Fundamental Observations”; and in the section entitled “Administrative or Organizational Development and Organizational Theory” and, in particular, therein under the subheadings “Ascension of Managerial Capitalism, “Mid-Managerial Capitalism”, and “Managerial Capitalism Matures”.

<sup>118</sup> See the discussion in Chapter Two in the section entitled “The Visible Hand: The Managerial Revolution in American Business” under the heading “Administrative or Organizational Development and Organizational Theory” and, in particular, therein under the subheadings “Ascension of Managerial Capitalism, “Mid-Managerial Capitalism”, and “Managerial Capitalism Matures”.

<sup>119</sup> Kenneth Lipartito and Yumiko Morii, “Rethinking the Separation of Ownership from Management in American History” (2010) 33:4 Seattle U L Rev 1025 at 1027.

<sup>120</sup> *Ibid*, citing: William J Baumol, *Business Behaviour, Value and Growth* (New York: Macmillan, 1959) and Robin Marris, *The Economic Theory of Managerial Capitalism* (New York: The Free Press, 1964).

<sup>121</sup> Robert A Gordon, “Ownership and Compensation as Incentives to Corporation Executives” (1940) Quarterly J Economics 455 at 473.

<sup>122</sup> Norman S Buchanan, *The Economics of Corporate Enterprise* (New York: Henry Holt, 1940). Cited by Lipartito and Morii, *supra* note 119 at 1028.

<sup>123</sup> *Supra* note 119 at 1031.

focused on profit and performance than the classic owner-manager, with his or her diverse menu of subjective motivations” and a greater motivation, by virtue of fiduciary duty, to suppress their own self-interest.<sup>124</sup>

Members of management, considering management as full-time employees of the corporation (“Management”), which thereby excludes members of the board of directors in their capacity as directors but includes the CEO, TMT and other officers, are agents of the corporation and are subject to employment relationships,<sup>125</sup> the consequences of which have been discussed previously.<sup>126</sup> Relationships and behaviour in such a professionalized environment become formalized and standardized in certain respects, as delineated by Weber;<sup>127</sup> however, informal relationships and organizational structures continue to be operative.<sup>128</sup>

As explicated extensively in Chapter Four of this book, directors and members of Management adapt their social identities to incorporate their roles and functions within the organization.<sup>129</sup> Some commentators even consider this to involve their adoption of a “corporate personality”.<sup>130</sup> These factors, including more specific characteristics of the situation and other personal characteristics, affect the actual behaviour of directors and members of Management.<sup>131</sup>

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<sup>124</sup> *Ibid* at 1032.

<sup>125</sup> See the discussion in Chapter A3 in the sections entitled "Organizational Liability for Acts of Corporate Actors"; and "The Corporation as Principal", and therein under the headings "Officer Status", and "Intracorporate Agency" and the headings thereafter.

<sup>126</sup> *Ibid*. See also the discussion in Chapter Five in the section entitled "Organizational Structure", particularly under the headings "Formal Structure and Relationships" and "Formal Organizations and Informal Organizations", Chapter Seven in the sections entitled "The Corporation, the Legal Entity, the Organization, and the Participants" and "The Separate Legal Entity, the Organization, and the Individual Human Actor"; and Chapter Eight in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning", particularly under the heading "Board of Directors", "Officers", and "Managers and Other Employees".

<sup>127</sup> see the discussion in Chapter Four in the section entitled "Groups of People or Social Units", particularly under the heading "Max Weber on Organizations and Related Matters"; and in Chapter Five in the section entitled "Structure, Process, and Personnel" and therein under the headings "Formal Structure and Relationships", "Informal Structure and Relationships", and "Formal Organizations and Informal Organizations"; and in the section entitled "Organizational Personnel".

<sup>128</sup> See the discussion in Chapter Five in the section entitled "Organizational Structure" and therein under the headings "Informal Structure and Relationships" and "Formal Organizations and Informal Organizations".

<sup>129</sup> See the discussion in Chapter Four in the section entitled "Groups of People or Social Units", particularly under the heading "Max Weber on Organizations and Related Matters" and "A Social Unit or Group of People".

<sup>130</sup> See the discussion in Chapter Five in the section entitled "Organizational Personnel", particularly under the heading "Organizational Changes in Behaviour and Relationships", notably, under the subheading "Organizational Identity or Organizational Personality"; and in Chapter Nine in the section entitled "Organizational Goals and Intraorganizational Goals", particularly under the headings "Intraorganizational Politics" and "Intraorganizational Loyalty".

<sup>131</sup> Christopher A Bartlett and Sumantra Ghoshal, "Beyond the M-Form: Toward a Managerial Theory of the Firm" (1993) 14 Strategic Management Journal 23 at 45.



### **Administrative Coordination and Professionalization**

In addition to collaboration, delegation and specialization of intraorganizational functions require coordination, both at similar, and at different, hierarchical levels. As described in Chapter Two, Chandler separates activities which he identifies as administrative (rather than functional) into coordination, appraisal, and planning.<sup>132</sup> As demonstrated there, these administrative, as well as functional, activities take place at various levels of management, which are differentiated by task, authority, and means of control.<sup>133</sup>

Cheffins, following Chandler, Berle and Means, and others, comments on the “basic business logic assumed to underpin the divorce between ownership and control”, namely, that as business enterprises became more complex and physically decentralized their continued success “was contingent upon developing robust managerial capabilities buttressed by the hiring of career-oriented, professionally trained executives”, the talent pool for which was greatly expanded by eliminating stock ownership as a necessary qualification for top executive posts.<sup>134</sup>

As explained in Chapter Eight, and as noted by Holmstrom and Tirole, the organizational problem of coordinating actions, which is time-consuming and laborious even when organizational participants share common organizational goals is further complicated when this is not the case and where they have different information and different informational expertise.<sup>135</sup> For example, Bartlett and Ghoshal explain that the corporation’s objectives and standards must be communicated from the highest levels (the Board, CEO, and TMT) down to the front-line managers, while business needs and opportunities must be communicated in the reverse direction,

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<sup>132</sup> See the discussion in Chapter Two in the section entitled "History of the Development of the Modern Business Corporation" and therein especially under the heading "Strategy and Structure" under the subheading "Functions and Activities of Management".

<sup>133</sup> See the discussion in Chapter Two in the section entitled "History of the Development of the Modern Business Corporation" and therein especially under the heading "Strategy and Structure" under the following subheadings: "Functions and Activities of Management", "Executive Management and Senior Management Roles", and "Administrative Levels and Activities", and "Distribution of Decision-Making Authority".

<sup>134</sup> Brian Cheffins, "The Rise and Fall (?) of the Berle-Means Corporation" (2018) 9:11 Cambridge Legal Studies Research Paper Series 50/2018, at 15.

<sup>135</sup> See the discussion in Chapter Eight in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning", particularly under the headings "Board of Directors" and "Officers".

from front-line managers to corporate level managers.<sup>136</sup> According to the eminent managerial theorist, Joseph Bower, the level of detail required to make informed decisions is too great for it to be evaluated by top management.<sup>137</sup>

Accordingly, like Chandler, Bower considered the key role of middle management to be the selection, screening and interpretation of information.<sup>138</sup> Chandler considered the role of staff at department, division, and corporate levels to be acting as a check on information provided upwards, but Bower considered their role as more political, in effect, in terms of assessing the upward flow of requests, proposals, estimates and other information against, at least in part, the past evaluations of the managers providing it.<sup>139</sup> This required middle management to focus not only on content of projects proposed, “but also on the process by which they were developed and the credibility and commitment of those proposing them.”<sup>140</sup> Ideally, the communication by top management of its corporate objectives and priorities to middle management should facilitate the middle management process of selecting, screening, and interpreting information for upward transmission.<sup>141</sup>

In addition, delegation and specialization, which contributes to the creation of such information asymmetry, also contributes to the creation of intraorganizational groups, intraorganizational goals, and intraorganizational identification, loyalty and commitment, as delineated in Chapters Five<sup>142</sup> and Six.<sup>143</sup> These of course, further exacerbate problems of coordination.

The development and modification of organizational relations, as explicated by Weber,<sup>144</sup> has been shown by Chandler to be influenced by historical factors, to demonstrate significant path

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<sup>136</sup> *Supra* note 131 at 32.

<sup>137</sup> Joseph L Bower, *Managing the Resource Allocation Process* (1970) (Boston, MA: Harvard Business School, Division of Research, 1970).

<sup>138</sup> *Supra* note 131 at 32.

<sup>139</sup> *Ibid.*

<sup>140</sup> *Ibid.*

<sup>141</sup> *Ibid* at 33.

<sup>142</sup> See the discussion in the sections entitled "Organizational Structure", "Organizational Process" and "Organizational Personnel".

<sup>143</sup> See the discussion in the sections entitled "Existence and Typology of Organizational Goals and Objectives" and "Organizational Goals and Intraorganizational Goals".

<sup>144</sup> See the discussion in Chapter Four in the section entitled "Groups of People or Social Units" and in Chapter Five in the section entitled "Structure, Process and Personnel"

dependence, and to create a relationship between strategy and structure,<sup>145</sup> and, ultimately, to result in what Chandler denominates as the “managerial corporation”, as discussed previously.<sup>146</sup> As noted here, this organizational development is facilitated by the legal essentialist characteristic of what has been denominated here as management ownership separation.

As will be further discussed below, because the equity owners are neither those who supervise Management (or operating management), which is the role of the board of directors, or who undertake management of the corporation, namely, Management (or operating management), even if this may not be the case otherwise (which is not assumed here), the interests of the equity contributors of the corporation (shareholders) are, in consequence, not necessarily the only interests considered by the board or by other management, whether in seeking to resolve joint preference conflicts or otherwise.

Management ownership separation, by reducing or eliminating the correspondence between management and equity ownership, significantly enlarges the opportunity for management to consider the whole range of organizational participants in making decisions. The lack of dependence of the management prerogative on ownership of equity shares entails that management may own a significant block of shares on the one hand, or, on the other, may own none.

### **Management Ownership Separation and Organizational Participants**

As already discussed in this work, the legal essentialist attribute of management ownership separation has various implications not only for the organization in terms of structure, processes, and personnel but also for organizational participants. It may be convenient, however, to recall some of these briefly, at this point.

#### ***Shareholders***

As shown in Chapter Seven, the corporation’s legal status as a separate legal entity in respect of which equity contributors acquire rights against the corporation evidenced by means of shares separates equity contribution from the legal entity, and the legal entity from the legal holders of

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<sup>145</sup> See the discussion in Chapter Two in the section entitled "History of the Development of the Modern Business Corporation" under the heading "Strategy and Structure".

<sup>146</sup> See the discussion in Chapter Two in the section entitled "History of the Development of the Modern Business Corporation" under the heading "The Visible Hand: The Managerial Revolution in American Business". As a result of information asymmetries and other factors, the present work modifies Chandler's descriptor from "managerial corporation" to "mid-managerial corporation".

rights with respect to the corporation itself, unlike the case of a partnership, and requires establishment of a primordial human actor or actors to take action for and on its behalf: namely, the board of directors.<sup>147</sup> The choice of the board of directors as the corporation's primary human actor, rather than, say, a shareholder holding a majority or plurality of the shares, in itself effects the separation of equity ownership from management.

As demonstrated in Chapter Eight, limited liability and asset partitioning permit commodification of corporate shares and their treatment as investments, although management of the organization across intracorporate legal boundaries, which is often the practice, complicates investment and risk analysis. Organizational advantages are very often not required to be disclosed, often partly as a result of the interaction of intracorporate legal boundaries and disclosure requirements, and may be thought to be proprietary and confidential information to be protected from securities markets, as well as from competitors. Thus, proposals for divestitures or restructurings may ignore existing organizational practices and advantages which are not of such a nature as to be immediately apparent to outsiders.<sup>148</sup>

Capital lock-in and transferability permits management to be treated as a career, since the absence of the ability to withdraw capital contributes to the stability of ongoing operations, while the ability to transfer shares provides a safety valve in respect of changes in personal circumstances, outlook for the corporation, and shareholder satisfaction with management, as noted earlier in the present chapter.<sup>149</sup>

As noted in the present chapter, also, the indefinite duration of corporate existence, when combined with the normal objective of management of an organization to ensure its continuance, facilitates the adoption of a long-term perspective on its operations, as well as short-term and medium-term perspectives. In turn, this permits the board and other management to consider the interests of organizational participants over such various time horizons, which necessarily includes parties

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<sup>147</sup> See the discussion in the section entitled "The Corporation, the Legal Entity, the Organization, and the Participants" and more particularly under the heading "Categories of Organizational Participants" and under the subheading "Shareholders"; and in the section entitled "The Separate Legal Entity, the Organization, and the Individual Human Actor".

<sup>148</sup> See the discussion in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning", particularly under the heading "Shareholders".

<sup>149</sup> See the discussion earlier in this chapter in the section entitled "Capital Lock-In with Transferable Equity Interests" particularly under the heading "Declarative Law"; and under the heading "Organizational Analysis, Capital Lock-In, and Transferable Equity Interests" under the subheading "Shareholders".

who may participate in the organization and engage in legal relations with the corporation in the future.

### ***Directors***

It is apparent, from the foregoing and otherwise, that management ownership separation has significant effects on the board of directors and on its members who are not automatically required as a matter of corporate law to be shareholders,<sup>150</sup> but have complete authority in respect of its day-to-day management, as discussed in Chapters Seven<sup>151</sup> and Eight<sup>152</sup> and in the earlier chapters referenced therein.<sup>153</sup> As the primary human actor on behalf of the corporation, the board of directors, when acting in accordance with its duties, has no legal liability either to the corporation or as a result of such membership, as a result of its SLE status, limited liability and asset partitioning. Accordingly, the board is free to consider how to best advance the interests of the corporation.

### ***The Board as Intraorganizational Organization or Component***

As previously noted in this chapter, the board of directors does not automatically change as a result of changes in shareholdings and, in consequence, can develop over time as a social group or as an intraorganizational organization, as explicated in Chapters Four,<sup>154</sup> Five,<sup>155</sup> and Six.<sup>156</sup>

Chapter Six maintained that individuals may develop loyalty not only to the organization but also to intraorganizational components within the organization, which may be considered in appropriate cases, to constitute intraorganizational organizations, organizations in their own right

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<sup>150</sup> Corporations may enact bylaws or pass board resolutions requiring that certain percentages of fees payable to directors be paid by way of shares or that directors maintain certain minimum shareholdings, however, such provisions are *not* required, although they are often permitted, by applicable corporate law.

<sup>151</sup> See the discussion in the section entitled "The Corporation, the Legal Entity, the Organization, and the Participants" and more particularly under the headings "Categories of Organizational Participants – Directors"; and in the section entitled "The Separate Legal Entity, the Organization, and the Individual Human Actor".

<sup>152</sup> See the discussion in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning", particularly under the heading "Board of Directors".

<sup>153</sup> See, in particular, the discussion in Chapter Two in the sections entitled "Duties of Directors", "Management Role of the Board of Directors", and "Management Responsibility for Running the Business"; and in Chapter Four in the sections entitled "The Corporation as Principal", notably under the headings "Nature of the Duties and Responsibilities of Directors", "The Representative Role of the Board", "The Role of Chief Executive Officer and Other Top Management Team Members" and "Comparison of Duty of Directors with Duty of Officers".

<sup>154</sup> See the discussion in the section entitled "Groups of People or Social Units".

<sup>155</sup> See the discussion in the sections entitled "Organizational Structure" and "Organizational Personnel".

<sup>156</sup> See the discussion in the sections entitled "Existence and Typology of Organizational Goals and Objectives" and "Organizational Goals and Intraorganizational Goals".

which subsist within the umbrella organization.<sup>157</sup> As explicated there,<sup>158</sup> the board is a group of individuals who collaborate towards the achievement of a common goal and, accordingly, may be denominated as an intraorganizational organization. In the case of the board of directors, whether or not this is the case, individual directors may acquire and exhibit identification with, and commitment to, and loyalty towards, the board of directors as an intraorganizational component.<sup>159</sup> Commitment, at least partly because of its relationship to effort and thence to task effectiveness,<sup>160</sup> has been shown to have a strong influence on group performance,<sup>161</sup> apparently including that of boards of directors.<sup>162</sup>

### ***Organizational Knowledge as a Firm-Specific Investment***

As previously established, individual directors, assuming that they are not “inside” directors who have such investments otherwise, also make firm-specific investments in the corporation on whose board of directors they serve in connection with that service.<sup>163</sup> These include becoming acquainted and developing relationships of trust with the other directors (which has been shown to increase commitment),<sup>164</sup> learning about the corporation and the industry or industries in which it operates, and learning about the organizational aspects of the corporation, including its

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<sup>157</sup> See the discussion in the sections entitled “Organizational Goals and Intraorganizational Goals”, especially under the heading “Intraorganizational Goals, Power, and Loyalty”; and under the heading “The Dominant Coalition as Intraorganizational Group”.

<sup>158</sup> *Supra* note 154, notably in the section entitled “Organizational Structure” under the heading “A Social Unit or Group of People”, and note 155, especially in the section entitled “Organizational Personnel”; and note 140.

<sup>159</sup> See J Gabriellsson and H Winlund, “Boards of Directors in Small and Medium Size Industrial Firms: Examining the Effects of the Boards Working Style on Board Task Performance” (2000) 12 *Entrepreneurship and Regional Development* 311 at 315. With respect to commitment generally, see Robert D Stephens, David D Dawley, and David B Stephens, “Commitment on the Board: A Model of Volunteer Directors’ Level of Organizational Commitment and Self-reported Performance” (2004) 16:4 *J Managerial Issues* 483 at 484, citing a meta-review of the subject: JP Meyer, DJ Stanley, L Herscovitch and L Topolnytsky, “Effective, Continuance, and Normative Commitment to the Organization: A Meta-analysis of Antecedents, Correlates, and Consequences” (2002) 61 *J Vocational Behaviour* 20; as well as meta-analyses of the concept, showing a relationship between commitment and performance.

<sup>160</sup> *Ibid* at 326, citing PW Mulvey and HJ Klein, “The Impact of Perceived Loafing and Collective Efficacy on Group Goal Processes and Group Performance” (1998) 74 *Organizational Behavior and Human Decision Processes* 62.

<sup>161</sup> Gabriellsson and Winlund, *supra* note 159 at 316, citing MA Korsgaard, DM Schweiger, and HJ Sapienza, 1995 “Building Commitment, Attachment, and Trust in Strategic Decision-Making Teams: The Role of Procedural Justice” (1995) 38 *Academy Management J* 60; and RS Dooley and GE Frysell, “Attaining Decision Quality and Commitment from Dissent: The Moderating Effects of Loyalty and Confidence in Strategic Decision-Making Teams” (1999) 42 *Academy Management J* 389.

<sup>162</sup> *Ibid* at 327.

<sup>163</sup> The personal costs of outside directors acquiring information about the firm are greater than for inside directors: Kevin D Chen and Andy Wu. “The Structure of Board Committees” (2014) Harvard Business School Working Paper 17-032, available at: [https://www.hbs.edu/faculty/Publication%20Files/17-032\\_22ea9e7a-4f26-4645-af3d-042f2b4e058c.pdf](https://www.hbs.edu/faculty/Publication%20Files/17-032_22ea9e7a-4f26-4645-af3d-042f2b4e058c.pdf).

<sup>164</sup> See Stephens, Dawley and Stephens, *supra*, note 159 at 496.

organizational structures, processes, and personnel, all of which may affect the individual director's knowledge and decision-making capacity.<sup>165</sup>

Effectiveness in such tasks<sup>166</sup> may be expected to be reflected in enhancements in the director's personal reputation as a director<sup>167</sup> among other members of the board, who may transmit such information to individuals who are directors of other corporations,<sup>168</sup> thereby enhancing the director's reputation externally,<sup>169</sup> which may, in turn, secure additional board appointments.<sup>170</sup> Similarly, outside directors, may be disciplined for poor performance.<sup>171</sup> However, directors are also considered to constitute decision-making experts, a description which suggests the transferability of the related skills and experience. Although the skills and experience may be transferable, to the benefit of the director and the corporation to whose board corporation he or she is appointed, specific knowledge and information about the focal corporation may not be.

As Chapter A1 demonstrates,<sup>172</sup> specific knowledge concerning the organization by which the corporation's business is conducted is essential to the discharge of the board's management

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<sup>165</sup> Outside directors with longer tenure have more firm-specific knowledge than those with shorter tenure, thereby reducing the information asymmetry vis-à-vis management: see Chen and Wu, *supra*, note 163 at 8.

<sup>166</sup> See Laura Lin, "The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence" (1996) 90 Nw U L Rev 904. For example, one study showed that directors demand better quality audits in order to protect their reputations: Antti Fredriksson, Anila Kiran, and Lasse Niemi "Reputation Capital of Directorships and Audit Quality" (May 15, 2018). Available at SSRN: <https://ssrn.com/abstract=3178727> or <http://dx.doi.org/10.2139/ssrn.3178727>.

<sup>167</sup> Gilson and Kraakman opine that such reputational concerns must be supplemented by incentives: Ronald J Gilson and Reinier Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors" (1991) 43:4 Stan L Rev 863 at 875. For this and other reasons, they propose, at 884, that boards include "professional outside directors", who would have enhanced reputational incentives to perform, at 891.

<sup>168</sup> See Renee B Adams, Benjamin E Hermalin, and Michael S Weisbach, "The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey" (2010) 48:1 J Economic Literature 58 at 63, citing: Sydney Finkelstein, Donald C Hambrick, and Albert A Cannella Jr. *Strategic Leadership: Theory and Research on Executives, Top Management Teams, and Boards*. (Oxford and New York: Oxford University Press, 2009).

<sup>169</sup> See Adams, Hermalin, and Weisbach, *supra* note 167 at 94-95, citing: Stuart C Gilson, "Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default" (1990) 27:2 J Financial Economics 355; Steven N Kaplan and David Reishus, "Outside Directorships and Corporate Performance" (1990) 27:2 J Financial Economics 389; (1990; Eliezer M Fich, "Are Outside Directors Better than Others? Evidence from Director Appointments by Fortune 1000 Firms" (2005) 78:5 J Business 1943; and Eliezer M Fich and Anil Shivdasani, "Financial Fraud, Director Reputation, and Shareholder Wealth" (2007) 86:2 J Financial Economics 306.

<sup>170</sup> Better corporate performance has been found to generate additional board appointments and financial returns: David Yermack, "Remuneration, Retention, and Reputation Incentives for Outside Directors" (2004) 59:5 J Finance 2281.

<sup>171</sup> See Eugene F Fama, "Agency Problems and the Theory of the Firm" (1980) 88 J Pol Econ 288 at 294. Famously, he says that "the market for their services...prices them according to their performance as referees."

<sup>172</sup> See the discussion in the section entitled "Management Role of the Board of Directors", particularly under the headings "Statutory Role" (which specifically discusses the term "affairs") and "Duties of Directors".

function and duties. This is particularly the case, in certain statutes, which expressly assign to the board responsibility not only for management or supervision of the corporation's business but also for its "affairs", which is defined to mean "the relationships among the corporation, its affiliates, and the shareholders, directors and officers of such bodies corporate but does not include the business carried on by such bodies corporate".<sup>173</sup> The responsibility for "affairs" has received scant attention in legal literature, concerning such duties or otherwise.<sup>174</sup>

The logical construction of this express assignment of responsibility, together with the definition of the term "affairs", is that the responsibility of the board of directors in such cases (leaving aside, for further discussion, whether it obtains without any express assignment), includes responsibility for managing or supervising legal relationships in which affiliates of the focal corporation, and the shareholders, directors and officers of the focal corporation act as legal counterparties of the corporation or act as intraorganizational participants. This is potentially important in connection with the oppression remedy, discussed in Chapter A2.<sup>175</sup> For example, in an appropriate case, the oppression remedy might be applied with respect to the corporate essentialist attribute of limited liability and asset partitioning in such a way as to impose liability on other corporations other than the focal corporation which are owned by the same ultimate parent corporation (that is, within the same corporate group, enterprise, or group of companies comprising a particular enterprise) with respect to obligations of the focal corporation.

Suppliers, employees, and customers in a legal relationship (and hence being legal counterparties) with, and hence organizational participants in, a corporate group) might be able to assert rights against other corporations in the corporate group other than the focal corporation with which they have a legal relationship. Employees of long standing who are "transferred" to another corporation within the group might employ the oppression remedy to claim benefits, such as pensions, based on their employment by corporations within the overall corporate group, rather than just with the particular focal corporation. Suppliers with long-term contracts might endeavour to assert rights against other corporations within the group after the bankruptcy or insolvency of the focal

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<sup>173</sup> See the discussion in the section entitled "Management Role of the Board of Directors", particularly under the heading "Statutory Role".

<sup>174</sup> While there may be some such discussions, a review by the author has not disclosed even one.

<sup>175</sup> See the discussion in the section entitled "Shareholder Rights Beyond Voting" and therein under the headings "Remedies of Shareholders and Others", "Oppression as a Legal, Organizational, and Corporative Remedy", and "Aligning Participants' Reasonable Expectations and Legal and Organizational Form".



corporation who was their legal counterparty. In effect, the liabilities of corporations within the same group could be consolidated, as a matter of law, just as they would be for accounting purposes. As argued in Chapter A2, by means of the oppression remedy, the legal rights of such parties as legal counterparties of the corporation could be aligned with the expectations of such parties as organizational participants, which otherwise might have been frustrated.

It must be noted that most, if not all, of the organizational information and background required to manage or supervise the management of such relationships, as well as the business of the corporation, is firm-specific and thus is not transferable to a directorial role with another corporation. Instead, it is a “sunk cost” to be employed while a director of the focal corporation, which then becomes a “stranded asset” subsequently. Of course, to the extent that it results in enhancements in the focal director’s reputation as a director, it may also improve the director’s status and value in the “market for directors” and result in additional board appointments.

### **Officers, Managers, and Other Employees**

Chapter A3 explicates the roles of officers, managers, and other employees (collectively, “Managers”) as agents of the corporation appointed by the human actor authorized to act on behalf of the corporation and, in that capacity, to appoint agents, and to authorize such agents to appoint sub-agents, with various capacities and responsibilities and at various levels.<sup>176</sup> Chapter A1 examines issues relating to the appointment and duties of Managers.<sup>177</sup>

Chapter Seven discussed the interrelationship of the corporation as a separate legal entity and the organization which enables it to act and, in particular, discussed the roles of Managers as organizational participants and as persons having legal relations with the corporation as a legal entity.<sup>178</sup> It noted that the scope of authority of individuals when acting externally, or vis-à-vis outsiders to the corporation, may be affected by ostensible or apparent authority, which, however, is complicated by Managers who act across intraorganizational legal boundaries or who exercise

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<sup>176</sup> See the discussion in the section entitled “Organizational Liability for Acts of Corporate Actors” and in the section entitled “The Corporation as Principal” under the headings “The Role of Chief Executive Officer and Other Top Management Team Members” *et seq.*

<sup>177</sup> See, in particular, the discussions in the sections entitled “Management Role of the Board of Directors” and “Duties of Officers and Employees”. The latter also discussed the statutory duties of officers as a matter of corporate law, which have no statutory equivalent with respect to other managers and employees.

<sup>178</sup> See the discussion in the section entitled “The Corporation, the Legal Entity, the Organization, and the Participants”, notably under the heading “Categories of Organizational Participants” and therein under the subheadings “Officers” and “Managers and Other Employees”.

informal authority or responsibility which is recognized within the organization but not necessarily recognized without the organization.

Chapter Eight examined the interrelationship between limited liability and asset partitioning, as essentialist legal attributes of the corporation and the organization, including the legal and organizational positions of Managers.<sup>179</sup> Although Managers ordinarily have no external liability to outsiders for breach of duty, as a result of limited liability and asset partitioning, as well as rights of indemnification, they may incur liability to the corporation in certain circumstances. Importantly, however, they may not be able to protect themselves adequately in respect of intraorganizational boundaries, including those which limit the liability of components of the organization which are legally constituted as corporations or other separate legal entities and are characterized by limited liability and asset partitioning. Consequently, an argument arises in favour of consolidation of liabilities to Managers across the entire organization and enterprise.

The previous sections of the present chapter considered the legal essentialist attribute of capital lock-in with transferable equity interests in respect of the same issues and organizational participants.<sup>180</sup> A pre-eminent consideration is the extent to which Managers make investments in the enterprise which are not transferable outside the corporate group.<sup>181</sup> The considerations specified under this heading of the chapter are also relevant to management ownership separation.

### **Lenders**

As is the case with respect to the other categories of organizational participants discussed previously under the present heading, the interrelationship between the legal essentialist attributes discussed previously and organizational essentialist and other attributes also obtain with respect to management ownership separation and are discussed in this and the two immediately preceding chapters of this work: Chapter Seven with respect to separate legal entity status;<sup>182</sup> Chapter Eight

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<sup>179</sup> See discussion in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning" under the headings "Officers" and "Managers and Other Employees".

<sup>180</sup> See discussion in the section entitled "Organizational Analysis, Capital Lock-In, and Transferable Equity Interests", particularly under the headings "Officers" and "Managers and Other Employees".

<sup>181</sup> This is widely accepted in the literature. For example, see Margaret M Blair, "Firm-Specific Human Capital and Theories of the Firm" (1999) in Margaret M Blair and Mark J Roe, eds, *Employees and Corporate Governance* (Washington DC: Brookings Institution Press, 1999).

<sup>182</sup> See discussion in the section entitled "The Corporation, the Legal Entity, the Organization, and the Participants", particularly under the heading "Categories of Organizational Participants" and the subheading "Lenders".

with respect to limited liability and asset partitioning;<sup>183</sup> and the earlier part of the present chapter with respect to capital lock-in and transferability.<sup>184</sup>

Of course, importantly, management ownership separation presents a challenging binary for lenders, the discussion of which here excludes trade creditors. On the one hand, it facilitates evaluating the creditworthiness of the focal corporation independently of organizational advantages and management continuity, which often entails focusing excessively on asset values, rather than the capacity of the enterprise to generate sustainable earnings and growth. On the other hand, focus on asset values concentrates on realizable values of assets as recognized by third parties who may seek to acquire such assets in the event of realization by lenders in a distress situation. Again, this approach often undervalues organizational advantages and management continuity and as such, may be overly conservative.

In point of fact, lenders are normally highly dependent upon the capabilities of the CEO, and the TMT, and other Management. Lenders are also subject to legal boundaries within the overall enterprise a corporate group, in consequence of which they may seek guarantees or other forms of cross-collateralization or covenants prescribing certain intraorganizational practices, such as transfer pricing below market prices, such as to limit or proscribe it by positive or negative covenants, whether general or specific. As explicated here, management of the organization or enterprise across legal boundaries may operate both formally and informally, and the means by which this is effected may be difficult for outsiders to discern; as a result of which outsiders may not be aware of the extent to which it is operative and of the effects which it has from a corporative perspective, including both legal and organizational effects. It is submitted that a partial response to such complications may be afforded by developing increasing sophistication in these legal and organizational; that is to say, corporative, aspects.

Such a credit underwriting process is likely to involve significant costs, some of which the lenders may seek to pass on the borrowers by way of interest rates or credit investigation or underwriting fees, and some of which, likely to be a smaller portion, they may, instead, absorb themselves. This

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<sup>183</sup> See discussion in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning" under the heading "Lenders".

<sup>184</sup> See the discussion in the section entitled "Capital Lock-In with Transferable Equity Interests" particularly under the heading "Organizational Analysis, Capital Lock-In, and Transferable Equity Interests" under the subheading "Lenders".

credit investigation or underwriting process may require skills and experience which bankers focused on asset-based lending may not necessarily possess. Thus, it may be necessary to acquire new, or to train existing, bankers in respect of these skills. Importantly, however, such credit assessment processes focus on relationships between strategy and structure and other matters thought to be highly determinative of business success. The corporative perspective both permits and encourages focus on these elements of business activities.

### **Distributors and Customers, Suppliers, and Others**

As discussed in Chapter Seven,<sup>185</sup> depending on the degree of control which the focal corporation has over its distributors and its suppliers and the nature of its relationship with customers and others, such parties may be considered to be organizational participants, as well as parties having legal relations with the corporation as a legal entity. As in the case of lenders, a closer relationship with the corporation, as an organizational participant, that is to say, a higher degree of integration between the two parties, may affect the legal rights of such parties, who may be considered to possess certain knowledge of its internal organization which may, in some cases, prevent their insistence, or in other cases, the corporation's insistence, upon strict legal rights.

Chapter Eight indicates that distributors, customers, suppliers, and others may identify with, exhibit commitment to, and exhibit loyalty towards, the focal corporation or enterprise in a manner and to an extent commensurate with their participation in the organization.<sup>186</sup> Such attitudes may, as explained in Chapter A2 (with respect to shareholders), reduce the tendency of such parties to exit from the relevant relationship in the event of negative developments and increase their tendency to exercise their right of voice in such circumstances: protesting changes to, rather than leaving, the relationship.<sup>187</sup>

As explained earlier in this chapter, capital lock-in and transferability contribute to a higher comfort level on the part of participants,<sup>188</sup> in this case distributors, customers, suppliers, and

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<sup>185</sup> See the discussion in the section entitled ""The Corporation, the Legal Entity, the Organization, and the Participants", particularly under the heading "Categories of Organizational Participants" and under the subheadings "Distributors and Customers" and "Suppliers and Others".

<sup>186</sup> See discussion in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning" under the headings "Distributors and Customers" and "Suppliers and Others".

<sup>187</sup> See discussion in the section entitled "Legal and Management-Related Rights of Shareholders".

<sup>188</sup> See discussion in the section entitled "Capital Lock-In with Transferable Equity Interests" particularly under the heading "Organizational Analysis, Capital Lock-In, and Transferable Equity Interests" under the subheadings "Distributors and Customers" and "Suppliers and Others".

others, in their dealings with the corporation, particularly in the case of long-term arrangements. As explained above, greater continuity of the board of directors, the CEO, TMT and other officers and managers as a result of management ownership separation also contributes in this regard.

## **CHAPTER TEN – A CORPORATIVE THEORY OF CORPORATE LAW AND GOVERNANCE –PART D**

### **PURPOSE AND SCOPE OF THIS CHAPTER**

This chapter completes our investigation of the relationship and interaction between and among the legal essentialist characteristics of the modern business corporation as a legal entity, as described in Part 1 and, in more detail, in Appendix A, of this book, and its organizational essentialist characteristics, as an organization, as described in Parts 2 and 3 of the book.

This chapter considers the fifth legal essentialist attribute namely, its indefinite duration and theoretically possible perpetual existence. As in the case of the preceding two chapters, the three chapters need to be considered together. Many of the relevant matters that are discussed in portions of the text in relation to one legal essentialist attribute also bear on other legal essentialist attributes. In the result, each of the chapters supplements and amplifies discussion of those legal essentialist attributes and the organizational essentialist attributes in one place or the other. The next chapter endeavours to summarize the argument of the book, to delineate some of the current challenges to contemporary capitalism and to the modern business corporation, and to indicate how corporative theory can facilitate responses to those challenges.

### **ATTRIBUTE FIVE – INDEFINITE DURATION OF CORPORATE EXISTENCE**

#### **LEGAL AND ORGANIZATIONAL CONTEXT**

##### **Declarative Law**

Chapter One<sup>1</sup> explains that, rather than expressly providing that a corporation has perpetual existence, modern corporate law statutes are often silent on the subject, but provide for termination of the corporation's existence in certain stipulated manners, voluntarily or involuntarily.<sup>2</sup> Some statutes permit the articles to limit the duration of the corporation, which, apparently, is rarely effected.<sup>3</sup> For example, Delaware permits the articles to contain a provision limiting the duration

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<sup>1</sup> See the discussion in the section entitled "The Corporation and Corporate Essentialism in Law" under the heading "Essential Attributes of the Corporation in Law" and therein under the subheading "Indefinite Duration".

<sup>2</sup> See e.g. the Canada Business Corporations Act, RSC 1985, c C-44 [CBCA], s 207ff; and the Ontario Business Corporations Act, RSO 1990, c B.16 [OBCA], s 191ff.

<sup>3</sup> See e.g. the Delaware General Corporation Law, also known as the "Delaware Code", 8 Del Code, c 1, § 101 [DGCL], § 102(b)(5). The Model Business Corporations Act, American Bar Association, *Model Business Corporation Act Annotated*, 4th ed, (Chicago: American Bar Association, 2008) [MBCA]. § 2.02 (a) of the MBCA does not require to be contained in the articles any provision setting the duration of the corporation's existence, which is considered, accordingly, to be perpetual. § 2.02 (b) (2) (iii), which permits the articles to set forth provisions not inconsistent with

of the corporation's existence provides that "otherwise the corporation shall have perpetual existence".<sup>4</sup> The Model Business Corporations Act is similar.<sup>5</sup>

Consequently, in the case of a public corporation, it can be assumed that it has indefinite and possibly perpetual existence ("IE"). Attention now turns to examining the interaction of IE with respect to the corporation's other legal essentialist attributes. Generally speaking, it may be said that IE amplifies the importance of the others.

### **Relation to Other Legal Essentialist Attributes**

It is, of course, the SLE attribute which enables the corporation to have a lifespan beyond those of its legal counterparties (who are individuals) and its organizational participants (who are individuals). As explicated in Chapter Seven, as a legal entity, the corporation lacks the capacity to take action except through individual human actors: firstly, the board of directors; and, secondly, those to whom the board of directors delegates authority to act on behalf of the corporation.<sup>6</sup> The IE attribute makes it apparent that there may be a succession of such boards of directors, individual directors, and board delegates over the corporation's lifespan.

Likewise, there may be a succession of legal counterparties and organizational participants, including shareholders, officers, managers and employees, suppliers and customers, as well as the board of directors and individual directors in relation to the corporation as such. As discussed in Chapter Four, while the identity of the participants in the organization may change over time, this does not affect the continuance of the organization as such, which is a separate social entity.<sup>7</sup> The tendency towards organizational preservation as an objective of any organization may be complicated by reason of the IE of the corporation as a SLE, thus entailing many successions in organizational membership or participation.<sup>8</sup> In fact, IE may highlight the importance, as well as

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law, inter alia, "defining, limiting, and regulating the powers of the corporation", allows a shorter duration to be inserted in the articles, according to the Official Comment.

<sup>4</sup> DGCL, § 102(b)(5).

<sup>5</sup> *Supra* note 158. § 3.02 of the MBCA specifically states that, unless its articles of incorporation provide otherwise, every corporation has perpetual duration.

<sup>6</sup> See the discussion in the sections entitled "The Corporation, the Legal Entity, the Organization, and the Participants" and "The Separate Legal Entity, the Organization, and the Individual Human Actor"; and discussion in Appendix A, particularly in Chapter A3 in the section entitled "The Corporation as Principal".

<sup>7</sup> See the discussion in Chapter Four in the section entitled "Working Definitions and Formal Definitions."

<sup>8</sup> See the discussions in Chapter Six in the section entitled "Existence and Typology of Organizational Goals and Objectives", particularly under the headings "Existential Goals and Objectives", and "Official or Explicit Goals and Operative or Implicit Goals"; and in the section entitled "Organizational Goals and Intraorganizational Goals", especially under the headings "Organizational Goals and Corporate Operations" and "Goals of Corporations".

the difficulties, of acculturating and integrating new members into the group, of them acquiring a new social identity, and of the symbols and rituals attached to the same.<sup>9</sup>

As will be further discussed below, the corporation and those who are its legal counterparties and organizational participants, both at the focal time and other salient times, will have interests across a temporal spectrum ranging from immediate or short term interests to long term interests, and some of those will have interests across, or at various points of, that temporal spectrum. The sheer numbers of legal counterparties and organizational participants over a long period of time, never mind a theoretically indefinite one, could be mind-numbing.

Except in the case of legal counterparties and organizational participants which are also corporations or otherwise possess IE, the interests of longest duration will be those of the focal corporation itself. Accordingly, as noted below, in fulfilling their duties to act “honestly and in good faith with a view to the best interests of the corporation”, and to “exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances”,<sup>10</sup> the board of directors must consider what the best interest of the corporation might be across the broad time spectrum of the corporation’s likely and possible existence or duration.

The IE attribute highlights the importance of the rights of shareholders with respect to selecting management, approving director interested contracts and fundamental or other actions or transactions, and exercising voice by way of shareholder proposals and requisitions for meetings,<sup>11</sup> as well as exercising a right of exit by way of transfer of shares without which a shareholder could never dispose of such investment.<sup>12</sup>

It goes without saying that, at least in the case of ownership of shares by individuals, partnerships, or other entities not possessing the attribute of IE, the importance of management ownership separation is further attenuated by IE. Because of IE, the consequences of management actions may extend for long period into the future. Excessively “long-tailed” (long-duration) liabilities

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<sup>9</sup> *Supra* note 6. See also the discussion in Chapter Four in the section entitled "Groups of People or Social Units".

<sup>10</sup> *Supra* note 6. See also the discussion in Chapter A1 in the section entitled "Management Role of the Board of Directors".

<sup>11</sup> *Supra* note 6. See also the discussion in Chapter A2 in the section entitled "Legal and Management-Related Rights of Shareholders".

<sup>12</sup> *Supra* note 6. See also the discussions in Chapter A2 in the section entitled "Shareholder Rights Beyond Voting"; in Chapter Eight in the sections entitled "Asset Partitioning and Policy Considerations" and "Implications of Organizational Analysis for Limited Liability and Asset Partitioning"; and in the present chapter in the sections entitled "Capital Lock-In with Transferable Equity Interests" and "Central Management Independent of Equity Ownership".



may arise which may not “fall in” or become concretized for a long time, for example, a breach of environmental or other laws in the present the damage from which eventuates at a point in time well into the future but while the corporation itself still subsists. IE thus heightens concerns about responsibility, authority, and control mechanisms to ensure that members of management do not create excessively long-tailed liabilities which may affect the corporation and its legal counterparties and organizational participants, including the society and polity concerned.

### **Problems of Intertemporal Choice**

Considered purely as a matter of logic, the problems of intertemporal choice, considered simply as choices made at one point in time which affect choices to be made at a point in the future, must increase to a considerable degree when the length of time over which such choices must be made is indefinite and may theoretically approach perpetuity. The construction of means-ends relationships and the expectation of satisfaction from the attainment of specified goals and objectives must be considered to be extremely problematic over extremely long time-frames.<sup>13</sup>

The difficulties of procuring collaboration and cooperation in an intendedly rational manner among organizational participants<sup>14</sup> over an indefinite time frame and, at least theoretically, possibly in perpetuity, in order to accomplish common goals and objectives,<sup>15</sup> which may themselves change over time, can seem formidable. These issues are presented dramatically in the contemporary debate concerning “short-termism” and “long-termism” to which we now turn.

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<sup>13</sup> In this regard, see the discussions in Chapter Three in the sections entitled "Barriers to Unified Action" and "Organizations as Political Systems"; in Chapter Five in the section entitled "Structure, Process, and Personnel" and therein under the headings "Rationality, Organizations, and Efficiency" and "Individual Bounded Rationality, and Rulemaking"; and in Chapter Six, especially in the section entitled "Existence and Typology of Organizational Goals and Objectives". Some of the subjects referenced in those chapters are the subjects of more detailed discussions in Appendix B, particularly in Chapter B4 in the sections entitled "Atomistic Utilitarianism", and "Atomism and Methodological Individualism"; and in Chapter B5 in the sections entitled "Individual Determination of Utility" and "Independent Rational Informed Actors".

<sup>14</sup> See the discussion in Chapter Five, particularly in the section entitled "Structure, Process, and Personnel".

<sup>15</sup> See the discussion in Chapter Six, particularly in the sections entitled "Existence and Typology of Organizational Goals and Objectives" and "Organizational Goals and Intraorganizational Goals".

## SHORT-TERMISM, LONG-TERMISM, AND INDEFINITE EXISTENCE

### The Problem Stated

#### *Purpose and Scope of This Discussion*

As generally conceived, short-termism is considered to be the tendency to over-emphasize short-term objectives at the expense of long-term objectives. This will be considered in greater detail below. However, even this introductory statement presents a number of issues, including, what are the objectives of the corporation, in general and in the instant case; the respective salience of those objectives; how those objectives may be classified, on the one hand, as short-term, and on the other hand, as long-term; how their attainment might be measured; how the pursuit, achievement, and measurement of those objectives are inter-related; and how the structure and processes of the corporation relate to the foregoing. Other primary questions relate to the right amount of emphasis to be placed on short-term and on long-term objectives, whether the answer to this question is affected by the salience of those objectives, how the presence of under-emphasis and over-emphasis can be determined, and whether such determinations are affected by the identity of the person or entity making such determination.

This section will present evidence, both empirical and anecdotal, concerning the existence and perceived existence of short-termism and of its adverse and non-adverse effects. It presents a brief and summary explanation of how economic, personnel, and organizational elements influence intertemporal decision-making. It advances some explanations from relevant literature concerning the relationship between market influences more remote or external to the corporation and organizational influences more proximate or internal to the corporation.

It also presents the conclusions of some commentators concerning how disclosure obligations may affect the behaviour of the corporation and its internal organization, as well as how the corporation and its internal organization may, on the one hand, moderate and reduce or, on the other hand, attenuate and increase, the effects of external influences, including market and regulatory influences, on organizational reaction to such influences.

The corporate perspective enables us to envision the effects that such pressure to maximize short-term results at the expense of long-term benefit may have on the structure, processes, and personnel of the corporate organization, as well as the effects that the structure, processes and personnel of

the corporate organization may, in turn, have on pursuit of such short-term results. These will be developed in the discussion below.

In considering the personnel aspect of the organization, we will examine, separately, the particular perspectives of, and pertaining to, various organizational participants, including the board of directors, the CEO, CFO, and other members of the top management team (TMT) and other levels of management, operational functions, divisions, and SBUs, and other personnel. As this work considers shareholders and other suppliers of capital as having a dual aspect, as external claimants with respect to its legal entity exterior, and as internal to its organization in some respects and in at least some situations, we will also identify possible impacts of short-termism as an external influence on such capital providers as mixed participants or quasi-participants in its internal organization.

### ***A Historical Perspective***

While often thought to be a phenomenon of the present millennium, or even more recent times, the debate was actively pursued in the nineteen eighties, at least. An influential author who has focused attention on the debate is Kevin Lavery.<sup>16</sup> He identifies Drucker, Hayes and Abernathy, and Jacobs as proponents of the existence and inefficacy of short-termism, short-sightedness with respect to investments especially in advanced technologies with long-term payoffs; and, on the other hand, Jensen and Williamson as sceptics, arguing that efficient markets optimize the trade-off between short-term results in long-term investment over the long-term,<sup>17</sup> an argument which, we maintain, appears to rely on a strong form of the efficient market hypothesis. Lavery notes that underinvestment by firms in resources and capabilities necessary to acquire or maintain

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<sup>16</sup> Lavery's doctoral dissertation (supervised by leading strategy thinker Richard P. Rumelt) at the University of California (Los Angeles) was in this subject area, entitled *Time Preferences, Time Horizons, and Strategic Choice: Towards an Understanding of Organizational Myopia*.

<sup>17</sup> Kevin J Lavery, "Managerial Myopia or Systematic Short-Termism? The Importance of Managerial Systems in Valuing the Long-Term" (2004) 42:8 *Management Decision* 949 at 949. He cites: P Drucker, "A Crisis of Capitalism" (1986) *Wall Street Journal* at 31; RH Hayes and WJ Abernathy, "Managing Our Way to Economic Decline" (1980) 58:4 *Harvard Business Review* 67; MT Jacobs, *Short-term America: The Causes and Cures of our Business Myopia* (Boston, MA: Harvard Business School Press, 1991); MC Jensen, "The Takeover Controversy: Analysis and Evidence" (1986) 4 *Midland Corporate Finance Journal* 6; and OE Williamson, "Perspectives on the Modern Corporation" (1984) 24 *Quarterly Review of Economics and Business* 64.

competitive advantage may have important negative consequences for individual firms, and for the countries in which they operate.<sup>18</sup>

More recently, short-termism has been the focus of considerable discussion. In 2013, McKinsey & Company (“McKinsey”) and the Canada Pension Plan Investment Board (“CPPIB”) established Focusing Capital on the Long Term (“FCLTGlobal”) whose objective is “to encourage a longer-term focus in business and investment decision-making” by “developing practical tools and approaches to support longer-term behaviors across the investment value chain.”<sup>19</sup> The prominence of these leading organizations as sponsors of this initiative and their aggressive furtherance of the same have attracted considerable attention to it.

In a 2013 article in the Harvard Business Review, Dominic Barton, the global managing director of McKinsey, and Mark Wiseman, the Chief Executive Officer of CPPIB, note that: “Since the 2008 financial crisis and the onset of the Great Recession, a growing chorus of voices has urged the United States and other economies to move away from their focus on “quarterly capitalism” and toward a true long-term mind-set.” Despite this, they say, “the shadow of short-termism has continued to advance—and the situation may actually be getting worse. As a result, companies are less able to invest and build value for the long term, undermining broad economic growth and lowering returns on investment for savers.”<sup>20</sup>

Barton and Wiseman claim that the main source of the problem “is the continuing pressure on public companies from financial markets to maximize short-term results”. They argue that a “crucial breakthrough would occur if the major players in the market, particularly the big asset owners, joined the fight — something we believe is in the best interests of their constituents”.<sup>21</sup> To counter pressures from financial markets to maximize short-term results, Barton and Wiseman call on large investors to take actions which are in the best interests of their own constituents,

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<sup>18</sup> *Supra* note 17, citing Jacobs, *supra*, and Michael E Porter, "Capital Disadvantage: America's Failing Capital Investment System" (1992) 70:5 Harvard Business Review 65.

<sup>19</sup> See the Focusing Capital on the Long Term web site at <https://www.fcltglobal.org/>.

<sup>20</sup> Dominic Barton and Mark Wiseman, "Focusing Capital on the Long Term" (2014) 92:1/2 Harvard Business Review 44 at 45-46. Finance and investment literature, in the main (but arguably not to the point of establishing a firm convention in this regard), refers to "short-termism", rather than "short termism"; and similarly, to "long-termism", rather than "long termism". Except in quotations, we will generally use the hyphenated versions of the terms: namely, "short-termism" and "long-termism".

<sup>21</sup> *Ibid* at 46.

whether pensioners in the case of retirement plans, shareholders in the case of corporations, or otherwise.

***Intertemporal Decision Making, Short-Termism, Temporal Traps, and Myopia***

The indefinite existence of the corporation requires consideration of intertemporal decision making, which, in turn, requires explanation of a number of salient concepts. Favouring actions in the short-term that have detrimental consequences in the long-term is generally considered to be genuine “short-termism”; as distinct from problems in making judgments as a result of which preferences respecting short-term consequences are dominant over those respecting long-term consequences,<sup>22</sup> a phenomenon which is identified by Marginson and McAulay as “myopia”, meaning, in effect, the difficulty of assessing long-term consequences, irrespective of whether this difficulty results in judgments which are, or are not, suboptimal in their effects.

Laverty identifies a phenomenon known as a “temporal trap”, a decision in which the choice that is best for the long term is different from the choice which is best for the short term. He notes that “while it might appear at first that temporal traps are inherent in all strategic decisions,” research indicates that “the degree to which this tradeoff is present for an individual manager making a single decision varies.”<sup>23</sup> In effect, a temporal trap requires that a decision be made between short-term and long-term preferences. Of course, positing the existence of a “trap” assumes that both short-term and long-term preferences cannot be accommodated or, at least, cannot be accommodated equally. Thus, while an intertemporal trade-off may be required in a given situation, its nature and extent may depend, at least in part, upon the affect and other characteristics of the decision-maker concerned, including economic, personal and organizational influences.

Laverty asserts that the existence of trade-offs between short-term and long-term concerns is positively associated with undervaluing the long-term. In his 2004 study of UK companies, a majority of which were in industries requiring long-term investments, he suggested that some firms may be “better than others in limiting the degree to which temporal traps are inherent in their culture, routines, and processes.” For example, where progress toward long term goals is more the

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<sup>22</sup> David Marginson and Laurie McAulay, "Exploring the Debate on Short-Termism: A Theoretical and Empirical Analysis" (2008) 29:3 Strategic Management J 273 at 274. This article has attracted a great deal of attention and has been widely cited, although less widely than Laverty's 1996 article. The two articles review a wide swathe of the literature and theorization concerning the debate and, for that reason, are referenced extensively here.

<sup>23</sup> *Supra* note 17 at 951, citing J Platt, "Social Traps" (1973) 28 American Psychologist 64.

prerogative of individual managers, temporal traps are greatly reduced, as compared with situations in which progress towards long-term goals is reported but managers are judged on short-term performance.<sup>24</sup> In effect, short termism, as an attitude, may be an effect not only of “external” pressures from shareholders, the market, and the investment community generally, but also of “internal” perceptions and pressures, such as positive and negative sanctions relating to short term performance, from individuals and groups of individuals within the corporation.

Moreover, within a particular organization, certain structures, routines, and processes can reduce (or, we would argue, increase) the quantum and salience of temporal traps. In this respect, it is important to note Laverty’s finding that seeking long-term goals, while only measuring, evaluating, and presumably compensating primarily short-term performance, tends to focus the managers on temporal traps. On the other hand, a decreasing emphasis on quarterly performance as a measure of managerial achievement, quality, and compensation tends to reduce the effect of temporal traps. Of course, this is but one example of the ways in which organizational structure and processes can be affected by, and, in turn, can affect, external influences.

Indeed, in a 2000 study of perceptions of short-termism by American and Swedish managers, Segelod cast doubt on what appeared to be while the main difference between them, namely, “the Swedes’ claim that stock market reaction is of little relevance to the balance between the short- and the long-term.”<sup>25</sup> He proposed an alternative explanation: whether the managers had an external or an internal locus of control. He referred to a study of Canadian managers which found that those with an internal locus of control followed a more innovative, risky and forward-oriented strategy than those more influenced by external demands;<sup>26</sup> and a study of American managers of public port and ancillary facilities, which found that insiders did not really care about what others thought about the organization, unless the outsiders were considered as a threat to its identity.<sup>27</sup>

Locus of control is but one example of how factors personal to the decision-maker, including those relating to his or her affect, as well as economic and organizational factors, may influence decision-

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<sup>24</sup> *Supra* note 17 at 957.

<sup>25</sup> Esbjorn Segelod, "A Comparison of Managers' Perceptions of Short-Termism in Sweden and the U.S." (2000) 63 *International J Production Economics* 243 at 252.

<sup>26</sup> *Ibid*, citing D Miller, M Kets de Vries, and JM Toulouse, "Top Executive Locus of Control and Its Relationship to Strategy-Making, Structure and Environment" (1982) 25:2 *Academy Management J* 337.

<sup>27</sup> *Supra* note 25 at 252, citing JE Dutton and JM Dukerich, "Keeping an Eye on the Mirror: The Role of Image and Identity in Organizational Adaptation" (1991) 34:3 *Academy Management J* 517.

making, including that of an intertemporal nature. Whether or not affected by locus of control, Swedish managers indicated that anticipated market growth and political risk, both largely external and having primarily economic aspects, were more important influences in their decision-making than quarterly performance.

Segelod's comments about management perceptions are useful. Individuals and groups within the organization may characterize and respond to "pressure", as persuasive, controlling, or otherwise, to different degrees and in different ways. As noted, this may depend, in part, on the extent to which they have an external or an internal "locus of control". It may also depend on other personal, as well as economic and organizational, influences. As Lavery noted above with respect to temporal traps, a corporation's culture, routines and processes may have a significant effect. So may its organizational structure. We will return to this point further, below.

### ***External and Internal Influences on Intertemporal Decision Making***

In effect, much of the argument and debate on short-termism has concerned whether capital markets are myopic<sup>28</sup>, and whether "chief executives of listed companies are pressured into trading long-term performance for short term performance in order to meet stock market expectations, and especially in order to secure fluid and impatient capital".<sup>29</sup> Marginson and McAulay acknowledge Michael Porter's argument that the transient nature of capital markets in the United States provides some explanation of managerial short-termism.<sup>30</sup> However, as noted by Lavery, by Marginson and McAulay, and by Porter, "there is surprisingly little research that answers the questions raised

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<sup>28</sup> *Supra* note 25.

<sup>29</sup> *Ibid.*

<sup>30</sup> *Supra* note 22, citing Porter, *supra* note 3. Porter compared the capital markets of the United States, Germany, and Japan. The most recent of these highly influential empirical studies, by Marginson and McAulay, *supra* note 22, was published in March 2008, just before the global financial crisis of that year became apparent. See the discussion in note 3434 below. As other commentators, such as and Barton and Wiseman suggest, it might have been thought that that crisis would promote a resurgence of interest in short-termism and in its implications. That might have involved consideration of the relationships among the economy, society, and polity of nation-states, their differential experiences of the crisis, and might have sought to derive some explanations or hypotheses concerning these matters. It is not that these matters have not been investigated at all, but, rather, that they have not been investigated in the thorough-going economy-society-polity perspective recommended here. See, for example, the "case study" type article by Cate Reavis, "The Global Financial Crisis of 2008: The Role of Greed, Fear, and Oligarchs", MIT Sloan School of Management, Massachusetts Institute of Technology, Case 09-093 (Rev March 16, 2012), available at: <https://mitsloan.mit.edu/LearningEdge/CaseDocs/09-093%20The%20Financial%20Crisis%20of%202008.Rev.pdf>. Accessed March 5, 2019.

by these arguments.”<sup>31</sup> In a 1993 study of UK corporations, David Miles commented to like effect.<sup>32</sup> We will refer to more of this research below.

The argument concerning “patient” and “impatient” capital engages discussion of cultural and structural influences in an economy and polity, which has been the subject of consideration, in the “varieties of capitalism” literature<sup>33</sup>, which was influential at that time.<sup>34</sup> We submit that the “patience/impotence” continuum of capital commitment reflects, and is reflected in, the nature of the relationship between providers of equity (and, to some extent, debt) capital and the corporation concerned. To the extent that capital providers participate in the internal organization of the corporation, they may be said to be among the constituents of that organization, as evidencing some commitment to it, and are implicated in its intertemporal tradeoffs. At the same time, of course, such capital providers engage in an external or legal relationship with the corporation as claimants upon its assets and resources, whether current, medium-term or long-term (as in the case

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<sup>31</sup> *Supra* note 22 at 252.

<sup>32</sup> David Miles, "Testing for Short Termism in the UK Stock Market" (1993) 103 *Economic J* 1379 at 1379. He cites authorities on both sides of the debate, including, for the existence of short-termism: a speech by former British Chancellor of the Exchequer Nigel Lawson, a speech by Alan Greenspan from 1990, W Law, "A Corporation is More Than Its Common Stock" (1986) 64:3 *Harvard Business Review* 80; and A Cosh, A Hughes, and A Singh, *Takeovers, Short-Termism and Finance-Industry Relations in the UK*. (Cambridge, UK: Department of Applied Economics, Cambridge, 1990). For those denying the existence of short-termism, he cites: Michael Jensen, (1986). "The Takeover Controversy: Analysis and Evidence" (1986) 4 *Midland Corporate Finance J* 6; and "Eclipse of the Public Corporation" (1989) 67:5 *Harvard Business Review* 61; P Healy, K Palepu and R Rubak, "Does Corporate Performance Improve After Mergers?" NBER Discussion Paper No. 3348 (Cambridge, MA: National Bureau of Economic Research, 1990); T Boone Pickens, "Professions of a Short-Termer" (1986) 64:3 *Harvard Business Review* 75; J Woolridge, "Competitive Decline and Corporate Restructuring: Is A Myopic Stock Market to Blame?" (1988) 1:1 *J Applied Corporate Finance* 23; and P Marsh, *Short Termism on Trial* (London: Institutional Fund Managers' Association, 1990).

<sup>33</sup> Leading proponents of this varieties of capitalism (“VOC”) perspective are, of course, Peter Hall and Davis Soskice, whose highly influential book is *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press: 2001). Portions of that book circulated widely in draft form during much of the preceding decade. Its political economy, institutional, and historical perspective is, in many ways, consonant with the corporative perspective delineated in the present work.

<sup>34</sup> The financial crisis of 2008, which was experienced throughout most, if not all, significant economies, has, of course, motivated a great deal of research and theorizing as to its causes and as to how it might have been prevented then and how similar developments might be prevented in the future. The VOC perspective, engaging as it does, not only with the economy of a country but also with aspects of its society and polity, might have been expected to have been more influential than it has been to date in those discussions and debates. This may reflect a dominant neoclassical or liberal economic perspective that the economy is largely, if not entirely, a separate field from society and the polity, and that the latter cannot be subjected to rigorous mathematical modeling and is, therefore, less worthy of consideration by economists, even those of an institution or new institutional orientation. While the recent financial crisis was experienced globally, it appeared to have been experienced differentially among nation-states. Investigating the extent of and possible for such differences might have usefully engaged with aspects of the society and polity of those nation-states, as which the VOC perspective might have had or might in the future have some useful relevant observations. Of course, the VOC perspective and the corporative perspective both reject the insularity of “economic” and “private” pursuits as against social and political pursuits. The present work argues that such a distinction is largely an artifact of history and is no longer maintainable.



of debt capital) or residual (as in the case of common equity capital). Thus, the behaviour of shareholders may exhibit, from time to time, their legal counterparty status or their organizational participant status, or both. It is probably more accurate to consider their behaviour along continua involving two axes, one as legal counterparty and one as organizational participant.

### *The Calculus of Intertemporal Decision Making*

Decisions are, of course, situate in time, and are made with respect to information available at that time, sometimes with some awareness or knowledge as to, and as to the nature of, information that may be available in future. In some cases, decisions are postponed pending receipt of further information; such postponement may reduce the alternatives available. Intertemporal choice also raises the issue of how choices made at one point in time influence the options or choices available at later points in time. Lavery comments that the “concept of *intertemporal choice*, a characteristic of decisions “in which the timing of costs and benefits are spread out over time” is basic to the debate over economic short-termism”. He traces it “back at least as far as the writings of the philosophers John Stuart Mill, David Hume, and Jeremy Bentham—for each of whom the observed tendency of individuals to undervalue future outcomes was a unique situation that justified societal restraint of individual action”<sup>35</sup>, apparently as non-rational.

Intertemporal decisions implicate several issues, including, importantly, the anticipated timing of costs and benefits, the risk or certainty that such costs and benefits will eventuate, and the information available with respect to the same. As previously indicated, intertemporal decision-making involves economic, personal, and organizational influences. From an economic perspective, the “normative economic approach to intertemporal choice” is *discounted utility* (DU): “Outcomes in the future are discounted: A cash flow in the present is preferred to one of equivalent amount that occurs in the future. All else being equal, the greater the discount rate, or the longer the time horizon to the receipt of the cash flow, the lower the net present value (NPV).”<sup>36</sup> The application of the discount rate to the future cash flow or expenditure constitutes a discounted

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<sup>35</sup> Kevin Lavery, "Economic "Short-Termism": The Debate, the Unresolved Issues, and the Implications for Management Research and Practice" (1996) 21:3 *Academy Management Rev* 825 at 827 [emphasis in the original]. Lavery's cite to first quotation, for which the reference was omitted in the present text, is to: G Loewenstein & R Thaler, "Anomalies: Intertemporal Choice" (1989) 3 *J Economic Perspectives* 181 at 181.

<sup>36</sup> *Supra*, note 35 at 829. His cite is to I Fisher, *The Theory of Interest*. (New York: Macmillan, 1930) II.

cash flow (DCF) analysis, and the resulting NPV is compared with alternative investment choices in decision making.

Of course, the selection of an appropriate discount rate is critical to the proper determination of net present value. That selection involves, directly or indirectly, a myriad of assumptions about the future concerning the economy and the focal corporation, many of which may present intertemporal decision making considerations when considered separately and collectively.

### ***Empirical Research on Short-Termism***

Laverty finds that the “largest body of empirical evidence [concerning economic short-termism] investigates the stock market myopia explanation, whereas lines of research testing other claims are not so well-developed.”<sup>37</sup> Laverty’s important 1996 review of the economic short-termism debate incorporates a meta-review of empirical research and a meta-analysis of observations, conclusions and theorizations respecting the same. As such, it remains the most widely cited article on this general subject-matter, although Marginson and McAulay’s 2008 article has also been very well received.<sup>38</sup> Consequently, and for reasons of brevity, the discussion here focuses quite closely on these two sources.

In a 1993 study of the UK stock market, Miles tested the existence of short-termism by investigating whether the discount rates implicit in market valuations applied to cash flows which accrue in the longer term were too high, both absolutely and relative to rates applied to cash flows in the near term.<sup>39</sup> He found evidence that short-termism prevailed throughout much of the 1980s.<sup>40</sup> In particular, actual discount rates employed in the market were approximately 180% of independently determined rates: discount rates applied by the market to cash flows which accrued six months in the future were more appropriate to flows accruing in eleven months, while cash flows expected in five years were discounted as if they did not accrue for nine years.

Miles’ finding was that “projects with only a six month time horizon need, on average, to be 5% more profitable than is optimal if companies which undertake them are not to suffer a decline in stock market value; projects with five years to maturity, however, need to be around 40% more

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<sup>37</sup> *Ibid* at 837.

<sup>38</sup> An Internet search conducted on October 23, 2018 show that it had been cited 609 times, which is more than twice as often as Marginson and McAulay’s 2008 article, *supra* note 22, 248 times.

<sup>39</sup> *Supra* note 32.

<sup>40</sup> *Ibid* at 1391-3.

profitable than is optimal. On even the loosest definition of what constitutes clear sight this counts as serious myopia.” Likewise, he concluded: “Allowing for short-termism only to 'kick in' after five years suggests an even greater degree of excess discounting of long-term cash flows. The results reported... imply that cash flows accruing more than five years in the future are discounted at twice the rate of shorter term flows.”<sup>41</sup> Miles found it doubtful that these results reflect a plausible degree of risk aversion and a rational assessment of the underlying risk of projects, presenting a challenge to believers in efficient markets.<sup>42</sup>

Thus, Miles provides what appears to be persuasive evidence of capital market short-termism in economic terms, at least as measured by discounted cash flows. Market valuations of equities, at least in the UK during the period studied, did not reflect rational predictions of future cash flows appropriately adjusted for risk.<sup>43</sup> Miles also shows that conventional economic models do not satisfactorily explain why short-termism exists, or why it is or is not rational in economic terms.

### **Short-Termism and Long-Termism – On the Merits**

#### ***Intertemporal Decision Making and Indefinite Existence***

Considering the external and legal aspects of the corporation, it is difficult to avoid the conclusion that long-termism is a rational perspective in corporate decision-making. The corporation has a lifespan which is theoretically unlimited and, therefore, the time, if any, at which it might cease to exist cannot readily be determined.

While it is possible to provide when the corporation is established for its corporate existence to be terminated, as, for example, by means of a winding-up, at a particular point in the future, anecdotal evidence suggests that this is a very rare occurrence with respect to corporations.<sup>44</sup> However, some other investment vehicles, such as limited partnerships, general partnerships, joint ventures and other entities, do have termination or periodic reinvestment provisions. Thus, there is some definite point in the future at which capital and accrued income and other gains will be returned to investors or at which they may elect to reinvest such funds. In such a case, management of the investment

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<sup>41</sup> *Ibid* at 1393-4.

<sup>42</sup> *Ibid* at 1394.

<sup>43</sup> *Ibid* at 1395.

<sup>44</sup> See the discussion in Chapter One in the section entitled "The Corporation and Corporate Essentialism in Law" under the heading "Essential Attributes of the Corporation in Law" and the subheading "Indefinite Duration". See also the discussion earlier in this chapter in the section entitled "Legal and Organizational Context" under the heading "Declarative Law".

vehicle would be expected to “manage towards” that date, among other things, by targeting a terminal value that, together with distributions of earnings throughout the investment period, would yield a satisfactory return and, in turn, motivate reinvestment in that vehicle or in another vehicle managed by the same or related management group.

In the case of an operating business, however, the organizers are unlikely to be able to determine a point in the future at which such determination may be advantageous to all concerned. Terminating the existence of the corporation at some point in time may be significantly disadvantageous, or at other times significantly advantageous, to shareholders, or to some of them, or to other corporate constituents. Termination at some points in time may disproportionately reward the contributions of some corporate constituents as against others. For example, with respect to a newly established business which requires significant front-ended investment before generating any or any significant returns, winding-up the corporation at a point in time at which the investment has been recouped but either no earnings or no significant earnings have been generated might satisfy lenders and providers of equity capital by way of preferred shares, but would not likely satisfy common shareholders. As with other types of organizations, the continuance of the corporation itself may be a significant goal of the corporation.<sup>45</sup> This might have implications in terms of other subordinate goals, both short-term and long-term.

### ***Balancing Short-Term and Long-Term Horizons***

Suitably emphasizing long-term and short-term time frames entails avoiding over-emphasis on either long-term or on short-term horizons. The optimal balance as between short-term and long-term time frames may differ from one corporation to another. Malcolm Salter observes that “many businesses need to manage both short-term and long-term horizons”, which can be tricky.<sup>46</sup> On the one hand, when “managers are running a business or investing in markets with little “edge”—that is, with little differentiation in products or services—short-term time horizons and opportunistic

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<sup>45</sup> See the discussions in Chapter Three in the section entitled "Barriers to Unified Action" under the headings "Complex and Multiple Goals" and "Official Goals and Unofficial Goals", and in Chapter Six in the section entitled "Existence and Typology of Organizational Goals and Objectives", particularly under the heading "Existential Goals and Objectives". See, also, for example, references in the seminal article by Philip Selznick, "Foundations of the Theory of Organization" (1948) 13:1 *American Sociological Review* 25 at 30. Continued existence of an organization may be threatened by a breakdown of the common understanding of its character and objectives.

<sup>46</sup> Malcolm S Salter, "How Short-Termism Invites Corruption... And What to Do About It" (2012) Harvard Business School Working Paper 12 – 094 (Boston: Harvard Business School, April 12, 2012) at 3. Available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2247545](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2247545).

investing are often the way to go. In such a world of commodity products and services, a strategy of making a series of sequential short-term investments and commitments can be economically justifiable.” On the other hand, where a business or investment has some sustainable advantage and short-term risks can be hedged and opportunity costs minimized, a long-term time horizon makes the most sense.<sup>47</sup>

Appropriate attention to short-term horizons is required in order to sustain the existence of the corporation beyond the short-term and into the medium-term, and then into the long-term. As Segelod’s survey showed, there must be a balance between long term projects and cash-generating projects. This may require developing a “portfolio” of projects, lines of business, or businesses within the corporation or within a corporate group; in effect, a species of diversification of investments internal to the corporation or relevant corporate group, unit or sub-unit. The existence of a conflict between seeking short-term or long-term profit may be somewhat illusory since, if short-term profit is low, the loss of impetus erodes the future return of long-term investments to some extent. Thus, attention must be paid both short-term and long-term cash flow and profits.<sup>48</sup> Insolvency has very immediate and short-term consequences.

Without generating “sufficient cash-flow to be able to develop your long-term projects and make them profitable...you cannot utilize the profitable business opportunities which your long-term investments create.”<sup>49</sup> Segelod’s study also demonstrated that top management “must constantly communicate the long-term vision and kindle the employees’ enthusiasm for its realization” so that the whole organization shares the vision with the result that all pull their weight and avoid internal dissension. “Then, you have to follow this vision up in the short-term to see that you are on the right track.”<sup>50</sup> As Segelod’s findings show, the realization of a long-term vision and its progressive implementation over the short-term require support not only from the external capital markets but also from internal or more proximate organizational actors, such as employees.

As previously indicated, shareholders, as providers of equity capital by way of common shares, may be considered to participate in the corporation in both its external and internal aspects, as having legal rights enforceable against the corporation and as a participant in its internal

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<sup>47</sup> *Ibid.*

<sup>48</sup> *Supra* note 25 at 251.

<sup>49</sup> *Ibid.*

<sup>50</sup> *Ibid.*

organization, according to some continuum having regard to their respective activities.<sup>51</sup> As previously noted, holders of common shares who are “invested” in the corporation for the long-term and who engage in dialogue with its board of directors and management may be considered as more “internal” or “proximate” to the corporation and its organization than short-term shareholders, who may be considered as relatively more “external” to the corporation and its organization.<sup>52</sup>

Ensuring an appropriate balance and thereby contributing to the continuity of a useful organization is both economically rational and beneficial to society and the polity. Society and the polity benefit by the creation of surplus value over the term of the existence and operation of the corporation, as well as from the social and political benefits provided by such corporations.

It is important to note that this balancing of short-term and long-term perspectives does not necessarily entail making decisions which have optimal effects at every point in time or, indeed, at any particular point in time. Lavery averts to Schumpeter’s statement that “A system—any system, economic, or other—that at every given point in time fully utilizes its possibilities to the best advantage may yet in the long-run be inferior to a system that does so at no given point in time, because the latter's failure to do so may be a condition for the level or speed of long-run performance.”<sup>53</sup> Among other things, long-term optimization, in at least some cases, may militate against short-term optimization.

### ***Delay and Risk of Cash Flow, Budgeting, and Non-Cash Flow Considerations***

Of course, using discounted utility (DU) as the normative economic approach to intertemporal choice accounts only for time delay with respect to the receipt of cash flows. It does not take account of any risk with respect to the fact of receipt of the cash flows. As Lavery explains, the normative model for decision-making under uncertainty is expected utility (EU), which does take

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<sup>51</sup> See the discussion in Chapter Seven in the section entitled "The Corporation the Legal Entity, the Organization, and the Participants", particularly under the heading "Categories of Organizational Participants" and under the subheading "Shareholders";

<sup>52</sup> See the discussion in Chapter Eight in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning", especially under the heading "Shareholders"; and in Chapter Nine in the section entitled "Organizational Analysis, Capital Lock-In, and Transferable Equity Interests", notably under the heading "Shareholders"; and in the section entitled "Management Ownership Separation and Organizational Participants", particularly under the heading "Shareholders".

<sup>53</sup> *Supra* note 35 at 827, citing J Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper & Brothers, 1942) at 83.

risk into account, with the result that a riskless cash flow is preferred to a risky cash flow with an identical expected value.<sup>54</sup> He follows Prelec and Loewenstein in saying that "time and uncertainty are typically correlated with one another in the real world" and that "anything that is delayed is almost by definition uncertain."<sup>55</sup> In other words, any non-immediate receipt of funds is subject to a risk discount, as well as a time delay discount.

In addition, as might be expected, an economic model properly employing risk-adjusted discounted cash flows would nonetheless ignore any consequences of decision-making that do not have consequences immediately referable to cash flows. Consequently, such a model would not be expected to reflect intangible and hard to quantify payoffs from investment.<sup>56</sup> However, the application of funds for such investments could affect cash flow and free cash flow calculations.

Segelod reports on findings that the decentralized type of budgeting undertaken by US firms promotes investment in assets easy to measure and classify, and excludes investments in systems and capabilities important for the efficient coordination and use of those assets, which therefore fall through the cracks of such capital budget systems.<sup>57</sup> Arguably, both the increase in such investments as a result of expenditure of financial and other resources, and the reduction in such investments as a result of their use, amortization or depreciation, might properly be reflected in capital budgets; however, this is apparently not the case.

Yet it may be precisely those investments in organizational systems and capabilities, or as we would say, in the organization's structure, process and personnel, that may have the most significant effect on the performance, and even survival, of the corporation. In effect, though, however possible it may be to model returns involving intangible and hard to quantify payoffs from investments, such items are not commonly included in budgets of American companies. If those investments are not appropriately recognized (and valued) internally by those who are charged with such budgetary functions, we must conclude that their recognition by others is even more problematic.

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<sup>54</sup> *Supra* note 35 at 829.

<sup>55</sup> *Ibid* at 830, citing Drazen Prelec and George Loewenstein, "Decision Making over Time and under Uncertainty: A Common Approach" (1991) 37:7 *Management Science* 770 at 784.

<sup>56</sup> *Supra* note 35 at 830.

<sup>57</sup> *Supra* note 25 at 245, citing CY Baldwin and KB Clark "Capital-Budgeting Systems and Capabilities Investments in U.S. Companies after the Second World War" (1994) 68:1 *Business History Rev* 73.

It may be that the level of aggregation discourages this, in effect, because the type of discrimination required in order to generate, include, and appreciate such factors in performance models and budgets may be present at lower levels of the organization, such as a function, division, or business unit, on a less aggregated basis, but not at a higher or corporate level, especially those at which performance and performance-related compensation is more closely assessed. In order to avoid performance-based penalties in consequence of shortfalls from goals that are considered to be “hard”, rather than “stretch”, goals, estimates and targets that may be more granular, fine, nuanced, and at lower levels of the organization (and may be used at lower levels as estimates or targets at such levels) may not be reflected in the fixed goals agreed with higher or corporate levels of the organization. In addition, of course, performance may be measured before the long-term adverse consequences of making short-term decisions becomes apparent.

In such a model, seeking to report increasing profits in the short-term may sacrifice the long-term economic health of the corporation.<sup>58</sup> This may be exacerbated by the skewing of management incentives in that respect, and, in particular, aligning CEO compensation with stock prices which reflect speculative deviation from fundamental stock pricing models, which may, in turn, encourage CEOs to pursue a short-term speculative projects even at the expense of long-term fundamental value.<sup>59</sup>

### ***Budgeting and Reporting for the Value of the Organization***

In summary, economic models of budgeting and performance may differ significantly at different levels of the organization, but, at all levels, may undervalue the structure, processes, and personnel aspects of the corporation’s organization. As we will discuss below, the recognition of intangible assets, such as goodwill, may be a relatively simple process when it relates to payment of a premium for acquisition of a business whose operations are subsequently consolidated, for accounting purposes, with that of the acquiring corporation; in which case the premium is treated for accounting purposes as “goodwill”. However, recognition of the value of other intangible assets

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<sup>58</sup> *Supra* note 35 at 831-2, citing HT Johnson and RS Kaplan, *Relevance Lost* (Boston: Harvard Business School Press 1987); and RS Kaplan "The Evolution of Management Accounting" (1984) 59 *Accounting Rev* 390.

<sup>59</sup> See Patrick Bolton, José Scheinkman and Wei Xiong, "Executive Compensation and Short-Termist Behaviour in Speculative Markets" (2006) 73:3 *Rev Economic Studies* 577. As at October 23, 2018, an Internet search revealed that this article had been cited 534 times, apparently making it the most-cited article on the link between executive compensation and short-termism.



developed within the existing business of the company whose financial statements are presented may be more complex, more subjective, and thus more subject to challenge and doubt.<sup>60</sup>

Accordingly, current accounting rules do not generally permit recognition of internally generated intangible assets on a company's balance sheet,<sup>61</sup> generally because they are not "separable" (capable of being sold, assigned, transferred, licensed, etc.) and hence are not identifiable.<sup>62</sup> This test attempts to respond to a number of issues, including the difficulty of valuing the same; the difficulty of establishing the period over which such intangible assets will be used, and hence the period over which they are required to be amortized; and the dangers of valuing, and then revaluing the same in any subsequent accounting period, giving rise to the possibility of the use of such valuations of internally generated intangible assets for earnings management or other types of "gaming" financial disclosure.

This creates a curious anomaly: acquired intangibles can, but internally developed intangibles cannot, be reflected on the corporate balance sheet for accounting purposes. Acquired intangibles have arguably been valued to some extent by the market, as reflected in the acquisition price. This is somewhat problematic in itself; yet the internally developed intangibles, which may be much more critical to the corporation's performance and future existence, are not reflected on the balance sheet for accounting purposes, although, ideally, at least, they are taken into account by the market in determining its enterprise value.

This does not, in fine, present a compelling argument as to why mature complex corporations should not undertake this endeavour, at least as a supplement to formal required financial disclosure, and should not be supported in this effort by sophisticated investment analysts, shareholders, and other capital market participants. This support would, of course, involve engagement with the reporting corporation in discussing factors relevant to determining the value

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<sup>60</sup> Other, more expert, critics have also suggested that the mode by which an intangible asset is acquired does not affect the way in which it is employed in the reporting corporation's system of value creation. See, for example, Anne Wyatt and Margaret A Abernethy, "Framework for Measurement and Reporting on Intangible Assets" Working Paper 12/03 (Melbourne: Intellectual Property Research Institute of Australia, 2003), available at: <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.132.4414&rep=rep1&type=pdf>.

<sup>61</sup> International Accounting Standards Board, *International Accounting Standard 38 Intangible Assets (IAS 38)* rev ed May 12, 2014 (London: International Accounting Standards Board, 2014). See summary at: <https://www.ifrs.org/issued-standards/list-of-standards/ias-38-intangible-assets>. Specific determinations made by the IFRS Interpretations Committee concerning IAS 38 are available at: <https://www.ifrs.org/supporting-implementation/supporting-materials-by-ifrs-standard/ias-38/#agenda>.

<sup>62</sup> Goodwill arising from contractual or other legal rights, such as in a business combination are accounted for in accordance with IFRS 3, and is outside the scope of IAS 38. *Supra* note 61.

of such intangibles. Such engagement may, in turn, promote more granular examination by the reporting corporation itself, which would then be discussed with these capital market participants, to various levels of iteration.

This is particularly important at a point in time at which intangibles represent such a high portion of assets reflected on the balance sheets of major corporations, as discussed below.<sup>63</sup> This may facilitate generation of more meaningful balance sheets (and other financial statements) that can be used to supplement required accounting disclosures. The potential problems, including potential litigation, connected with disclosure of such non-standard reporting cannot be ignored, but may be less serious than might be apparent upon initial consideration, as argued below.

### **Short-Termism, Earnings Reporting, and Earnings Guidance**

#### ***Internal Financial Modeling***

Not only may a corporation employing such economic and financial modelling methods for its internal decision-making at the corporate level tend to overweight short-term performance, but in assessing the performance of its divisions, subsidiaries, or other business units, it may do the same. We have suggested other reasons, including asymmetric information and incentives, for this above.

Laverty indicates that because the multidivisional structure creates “brutal pressures on management to perform in the present” as measured by quarterly and annual reports, this may impair motivation for divisional managers to engage in long-term investment, which may be critical to the firm’s long run well-being.<sup>64</sup> However, according to Segelod, studies show that divisional managers tend to believe that corporate level managers emphasize short-term performance measures more than they actually do, and that, instead, such measures are supplemented by other types of communication.<sup>65</sup>

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<sup>63</sup> See the 2018 survey conducted by Brand Finance plc, *Global Intangible Finance Tracker (GIFT) 2018 - An Annual Review of the World's Intangible Value – October 2018* (London: Brand Finance plc, October 2018, available at <https://brandfinance.com/images/upload/gift.pdf>). As described in that report at 24, the total enterprise value of the world’s publicly traded companies was US\$109.3 trillion at the beginning of 2018, US\$57.3 trillion of which (52%) represented intangible assets, US\$43.7 trillion of whose value (40% of total enterprise value) was not disclosed in the financial statements. Some other surveys show even higher percentages of intangible assets in relation to enterprise value. As shown at 36-37, the value of the intangibles of some companies exceeded their respective enterprise values.

<sup>64</sup> *Supra* note 35 at 832.

<sup>65</sup> *Supra* note 25 at 245, citing H Barton, D Brown, J Cound, P Marsh, K Willey, "Does Top Management Add Value to Investment Decisions?" (1992) 25:5 Long Range Planning 43.

This may produce a feedback loop in which divisional managers, in such belief, accentuate short-term performance measures more than expected, or intended, by their superiors. As noted, better communication of expectations of those at higher levels of the hierarchy, and alignment of incentives accordingly, may contribute to a more realistic perception and alignment of those expectations. This finding has both legal and organizational implications.

### *Frequency of External Disclosure*

In a 2014 paper, Gigler, Kanodia, Sapra, and Venugopalan demonstrate that frequency of disclosure affects firms' project selection strategies. Specifically, the authors purport to show that the price pressure created by high reporting frequency induces managers to adopt a short-term perspective (which they describe as "managerial myopia") in choosing the firm's investments (i.e. projects, research, new lines of business, etc.); while, on the positive side, the market discipline thus imposed imposes a reactive discipline with respect to decision-making that decreases the probability of undertaking negative net present value projects.<sup>66</sup>

Presumably, however, some of those projects may have long-term benefits, which such capital market discipline might restrain the firm from capturing. Gigler et al show that, while frequent financial reporting has an effect on managerial myopia: "Capital market impatience alone, however extreme, cannot alone produce the kind of price pressure that induces managerial myopia. Sustaining managerial myopia requires a combination of impatience in the capital market, information imperfections, and frequent financial reporting."<sup>67</sup>

Indeed, they claim to demonstrate that "if the market and manager have same information, managerial short-termism cannot be caused by price pressure, *no matter how impatient the firm's current shareholders are.*"<sup>68</sup> Of course, information asymmetry as between corporate level management and "the street" is endemic; and accordingly, assuming otherwise is unrealistic. "Realistically, managers make choices based on large amounts of detailed information, collected at considerable expense, that is either unavailable to outsiders or difficult to interpret by outsiders", information which is "usually soft, sensitive, and unverifiable" and which "cannot be and is not

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<sup>66</sup> F Gigler, C Kanodia, H Sapra, and R Venugopalan, "How Frequent Financial Reporting Can Cause Managerial Short-Termism: An Analysis of the Costs and Benefits of Increasing Reporting Frequency" (2014) 52:2 J Accounting Research 357 at 357.

<sup>67</sup> *Ibid* at 365.

<sup>68</sup> *Ibid* at 367 [emphasis in the original].

disclosed in mandatory financial statements that are disseminated to the world at large, nor can it be disclosed on a voluntary basis.”<sup>69</sup>

Not only is the quantum of information available to management greater than that available to “the Street”, but such information is also more detailed and disaggregated, as well as more nuanced and generally qualitatively superior, in part, as just noted, because it reflects information not easily identified, or disclosed, by management. For example, it may reflect appraisals of the ability of the corporation to react to prospective events or developments, anticipated or otherwise. These, and other appraisals may depend, in part, upon greater knowledge of the organization’s structure and processes, and of the qualities and propensities of its personnel, a type of know-how highly relevant and particular to the organization concerned.

Consequently, it may be said that the capital markets rely on “hard” information that is relatively easily available and digestible. Analysts and others who engage in significant effort and perhaps expense to develop detailed information, which includes “soft, sensitive, and unverifiable” information concerning the firm and its environment, may find themselves less pushed to rely solely on “hard” information disclosed by the corporation, and more capable of producing a more nuanced perspective on its historical and likely future performance, results and prospects. This may be expected to produce significant rewards for the analysts and intermediary organizations concerned and for their clients and customers. It may be argued that the eventual diffusion of such more nuanced perspective into the market may improve the accuracy of short-term and long-term equity (and even debt) pricing by the capital markets.

In the absence of effective generation and diffusion of this kind of more nuanced information concerning corporate performance and prospects, quarterly financial and other reports do provide some informational content. However, this information asymmetry between internal and external actors may significantly affect corporate behaviour. A 2005 survey of more than 400 chief financial officers found that almost 80% of respondents would decrease long-term discretionary spending, such as for research and development, advertising, maintenance and hiring, or even give up positive net present value projects, in order to meet short-term earnings targets, to avoid punishment by the capital markets. The authors thus reveal “unambiguous managerial intent to

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<sup>69</sup> *Ibid* at 367-8.

burn economic value to meet financial reporting goals.”<sup>70</sup> Of course, information concerning the alternative uses of funds to attain real economic value, rather than short-term profits, would have been available to the reporting corporations, but not usually to “the Street”.

Further, to the extent that management chooses to disclose to the market information which is “soft, sensitive and unverifiable”, it not only risks the “street” making inferences from such information that are different from its own inferences (for example, because it may have other relevant information not disclosed or which cannot possibly be disclosed, but that affects the interpretation of the information disclosed), but also the prospect of potentially incurring liability based upon such disclosures. This possibility may eventuate, for example, if market actors experience adverse results from their reliance on such information.

Even if such liability is successfully avoided, the prospect of its incurrence may be expected to dampen the management’s ardour to share its information with “the street”. The effect of a “safe harbour” for such disclosure is discussed in more detail below. As further discussed below, corporate and securities law disclosure requirements, as well as formal accounting conventions, are highly relevant in this regard.

### ***Earnings Guidance and Frequency***

Many public companies attempt to supplement their “hard” disclosures in financial statements, management discussion and analysis of operations (“MD &A) and similar formal documents with information thought to be useful to the shareholders, other investors, and to the capital markets generally. Some of these disclosures may be required pursuant to securities law and stock exchange requirements. In addition, many corporations provide earnings guidance, guidance as to the financial results expected in a subsequent quarter or financial year.

Often, such earnings guidance is provided in quarterly earnings calls, which are conference calls held by the issuer with shareholders, other investors, analysts who follow or “cover” it, and other interested parties. Commonly, the CEO and CFO of the corporation concerned present the financial results of the quarter (and year, in the case of the last quarter) and outlook for the next quarter or year, as the case may be. Often, at the outset of the earnings call, the moderator or counsel for the

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<sup>70</sup> JR Graham, CR Harvey, and S Rajgopal, “The Economic Implications of Corporate Financial Reporting” (2005) 40 *Journal of Accounting and Economics* 3 at 66.

corporation will read a statement providing suitable cautionary language, in effect, indicating that the “forward-looking” statements made in the earnings call and associated materials are not guarantees or accurate indications of future activities and performance. A sample appears in the footnote below.<sup>71</sup>

### ***Adoption of Earnings Guidance***

As Malcolm Salter indicates, the practice of providing quarterly “earnings guidance” became more common in the United States after Congress passed the Private Securities Litigation Reform Act of 1995, which effectively protected executives and their companies from legal liability stemming from statements made in connection with suitable cautionary language about projected performance over the next quarter. This change in American federal law provides a useful illustration of the interrelationship between changes in statutory and other law, on the one hand, and changes in the interaction among the corporation and its legal and organizational participants. In this case, the expected benefits of this “earnings guidance” were expected to include improved earnings multiples and share prices and reduced volatility. Salter maintains that these benefits did not ensue, citing a 2006 McKinsey study “which found no evidence that frequent earnings guidance affects valuation multiples, or reduces the volatility of share prices. Frequent guiders did

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<sup>71</sup> By way of example, a recent quarterly information report available to the writer for certain instruments (“Notes”) issued by a special purpose vehicle or special purpose entity engaged only in holding other securities contained several paragraphs under the heading “Important Legal Disclosures”, two of which were as follows:

Certain statements in this presentation may constitute “forward-looking” statements that involve known and unknown risks, uncertainties and other factors that may cause the activities of the [Issuer] and the actual returns, values and liquidity of the [] Notes to be materially different from any future activities, returns, values or liquidity expressed or implied by such forward-looking statements. Forward-looking statements typically include words such as “may”, “will”, “expect”, “believe”, “plan”, “intend” and other similar terminology. These statements reflect [the Issuer]’s current plans and expectations regarding future activities, events, returns, values and liquidity and speak only as of the date of this presentation and are subject to revision in all respects.

Forward-looking statements involve significant risks and uncertainties, should not be read as guarantees of future returns, values or liquidity and will not necessarily be accurate indications of whether or not such returns, values or liquidity will be achieved. Due to various risks and uncertainties inherent in the capital markets or otherwise facing the asset management industry, actual activities and events and the actual performance, values or liquidity of the [] Notes may differ materially from those reflected or contemplated in any forward-looking statements. Although any forward-looking statements contained in this presentation are based upon what the provider of the statement and its advisors believe are reasonable assumptions, [The Asset Manager] cannot assure you that actual activities, events, returns, values or liquidity will be consistent with these forward-looking statements. Any forward-looking statements are made as of the date of being included in this presentation.

While this example relates to debt securities, much of the cautionary language used in it is commonly also used, *mutatis mutandis*, with respect to equity securities, and derivative and other securities.

not receive superior valuations in the marketplace—regardless of the year, industry, or size of the company.”<sup>72</sup>

Instead, “the only significant effect that McKinsey observed was an increase in trading volumes when companies begin issuing earnings guidance”, which could simply reflect trading by hyper-traders (such as day traders) and hedge fund managers with little interest in companies’ long-term prospects. According to Salter, in addition to the expenditure of management time, McKinsey concluded that the entire process “can be a powerful incentive for management to focus excessive attention on the short term; to sacrifice longer-term, value-creating investments in favor of short-term results; and, in some cases, to manage earnings inappropriately from quarter to quarter to create the illusion of stability.”<sup>73</sup>

While it might have been hoped that this kind of “safe harbour” would produce, as between the corporation and its organizational participants and other more external parties, the kind of nuanced discussion of results and outlook that ideally would feature in internal corporate discussions, this does not appear to have been the result. Instead, it appears that the information provided in earnings guidance from a corporate or other issuer was taken into account by analysts following the issuer in formulating quarterly and annual targets for earnings, price/earnings multiples, and share prices, and in generating “consensus” targets, which are aggregates based on the targets of analysts derived individually. This is thought to contribute to the short-term orientation of the markets.

Further, this kind of “earnings guidance” is thought to be associated with earnings management. Salter refers to a massive study of quarterly conference calls<sup>74</sup> in which the researchers “found a predictable relationship between calls where participants used language indicating short time horizons and efforts to manage earnings. The researchers also found that the short-termism of investors seemed to beget short-term behavior by executives—and that short-term-oriented

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<sup>72</sup> *Supra* note 46 at 13.

<sup>73</sup> *Ibid* at 14, citing McKinsey & Co., “Weighing the Pros and Cons of Earnings Guidance: A McKinsey Survey” McKinsey Quarterly March 2006. Revised as: Peggy Hsieh, Timothy Koller, and SR Rajan, “The Misguided Practice of Earnings Guidance” (March 2006) McKinsey Q. Available at: <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/the-misguided-practice-of-earnings-guidance?reload>.

<sup>74</sup> F Brochet, M Loumiot, and G Serafeim, “Short-Termism, Investor Clientele, and Firm Risk” Working Paper No. 1999484 (Boston: Harvard Business School, February 4, 2012), available at: <https://www.hbs.edu/faculty/conferences/2012-imo/Documents/Francois.pdf>. Substantially the same article appears under the title “Speaking of the Short-Term: Disclosure Horizon and Managerial Myopia” (2015) 20 *Rev Accounting Studies* 1122, also available at <http://ssrn.com/abstract=1999484> or <http://dx.doi.org/10.2139/ssrn.1999484>.

companies tended to attract short-term investors.”<sup>75</sup> This suggests of course, that providing additional long-term-oriented information, by way of guidance or otherwise, may attract long-term investors. In any event, what researchers describe as a formulaic or standardized approach to providing earnings guidance that may be safer from a legal standpoint, although less informative, than more fulsome guidance. In such an environment, variances from standardized practice may even be assumed to have an information content that was not intended.

### *Elimination of Earnings Guidance*

However, the elimination of earnings guidance also has consequences. Chen, Matsumoto, and Rajgopal studied firms that stopped providing earnings guidance between October 2000 and January 2006 (“stoppers”), differentiating between those that publicly announced this (“announcers”) and those that did not (“quiet stoppers”). They found that firms that stopped guidance had poor performance in the preceding twelve months and regularly missed analysts’ expectations, were uncertain about immediate future prospects, and had experienced decreased analyst coverage. They also found that such firms also had a high percentage of long-term institutional investors, suggesting that such firms were attempting to focus on the long-term rather than on the short-term.<sup>76</sup>

They reasoned that firms with a higher percentage of long-term institutional investors likely face less pressure to disclose good news immediately, since such news would be revealed in the ordinary course in connection with earnings announcements and long-term investors do not, by definition, trade frequently.<sup>77</sup> While both announcers and quiet stoppers experienced declines in share price, these differences were more pronounced with respect to announcers but dissipated in the six months following the announcement.<sup>78</sup> They found that despite calls by prominent investors, practitioner groups, and academics for firms to renounce earnings guidance, relatively few firms had done so, and only when the decision was beneficial to them.<sup>79</sup>

They found that stopper firms as a group did not experience a significant increase in overall return volatility or a decrease in analyst following, but did experience a greater increase in dispersion

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<sup>75</sup> *Supra* note 46 at 14-15.

<sup>76</sup> Shuping Chen, Dawn Matsumoto, and Shiva Rajgopal, "Is Silence Golden? An Empirical Analysis of Firms that Stop Giving Quarterly Earnings Guidance" (2011) 51 *J Accounting and Economics* 134 at 135.

<sup>77</sup> *Ibid* at 143.

<sup>78</sup> *Ibid* at 146.

<sup>79</sup> *Ibid* at 149.



among analyst forecasts and a decrease in the accuracy of analyst forecasts. They argue that while both return volatility and forecast dispersion are measures of uncertainty, the absence of earnings guidance likely has a more direct effect on forecast dispersion than on stock return volatility.<sup>80</sup> They suggest that the increase in forecast error occurs because analysts are not able to independently generate similar levels of information and forecast earnings in the absence of guidance.

We would suggest, in addition, that the increase in forecast error and in forecast dispersion may indicate a difference in efforts and abilities among analysts, who may be more oriented towards the needs of retail investors than of institutional investors, many of whom rely less on outside analysts. Further, we would suggest that since management of a company providing earnings guidance is considered to be more knowledgeable about its prospects than outsiders, outsiders may place greater reliance on management guidance than on the forecasts of independent analysts. Of course, management also has the capacity to direct efforts to attainment of its earnings guidance, whether by generally dispersed efforts to achieve targets or by specific earnings management activities. In addition, it is apparent that prospective changes in declarative or common law may have anticipated consequences in terms of legal and intraorganizational relationships; and that even voluntary changes made by corporations in required or permitted compliance practices, such as disclosure, may also have such effects. Accordingly, advance consideration of proposed legal changes from a corporative perspective is advisable.

### ***Earnings Guidance and Short-Termism***

#### The Investment Professional Perspective

The CFA Institute is the largest association of investment professionals in the world.<sup>81</sup> It has more than 135,000 members in 170 countries and territories, the largest numbers of whom are engaged as portfolio managers, investment analysts, executives, consultants, risk managers and corporate financial analysts. The top 10 employers of CFA charter holders include JP Morgan Chase, PwC, HSBC, Bank of America Merrill Lynch, UBS, Ernst & Young, RBC, Citigroup, Morgan Stanley, and Wells Fargo. Its Centre for Financial Market Integrity and the Business Roundtable Institute

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<sup>80</sup> *Ibid.*

<sup>81</sup>Information concerning the CFA Institute was obtained from its web site, at: <https://www.cfainstitute.org/about/Pages/index.aspx>. Accessed July 6, 2016.

for Corporate Ethics initiated the “Symposium Series on Short-Termism” which, among other things, resulted in the publication of a report on the insights of its panel of symposia participants and other research entitled “Breaking the Short-Term Cycle” (the “CFA Report”).<sup>82</sup>

Predictably, it stated that “*Short-termism* refers to the excessive focus of some corporate leaders, investors, and analysts on short-term, quarterly earnings and a lack of attention to the strategy, fundamentals, and conventional approaches to long-term value creation.” It noted that “excessive short-term focus combined with insufficient regard for long-term strategy can tip the balance in value-destructive ways for market participants, undermine the market’s credibility, and discourage long-term value creation and investment”, indicating that such “short-term strategies are often based on accounting-driven metrics that are not fully reflective of the complexities of corporate management and investment.”<sup>83</sup>

The panel’s conclusions are not, of course, unique, but their expression by such an organization as the CFA Institute, whose members are deeply involved in the investment industry and include some of the world’s most respected financial analysts, is noteworthy. Its report drew attention to the emphasis placed on quarterly earnings and on earnings guidance, often thought to provide a channel of communication with investors and to intensify management’s focus on achieving financial targets.

#### Negative Effects of Earnings Guidance

It concluded that its recommendations provided a better roadmap to achieving these objectives. It found: “Although there may be certain benefits to providing earnings guidance, the costs and negative consequences of the current focused, quarterly earnings guidance practices are significant, including (1) unproductive and wasted efforts by corporations in preparing such guidance, (2) neglect of long-term business growth in order to meet short-term expectations, (3) a “quarterly results” financial culture characterized by disproportionate reactions among internal and external groups to the downside and upside of earnings surprises, and (4) macro-incentives for companies to avoid earnings guidance pressure altogether by moving to the private markets.” Additionally, it found that “earnings guidance contributes to an

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<sup>82</sup> Dean Krehmeyer, Matthew Orsagh, and Kurt N Schacht, “Breaking the Short-Term Cycle” (Charlottesville, VA, USA: CFA Institute/ Business Roundtable Institute for Corporate Ethics, 2006) at 11.

<sup>83</sup> *Ibid* at 4.

illusion of complete business predictability, a faulty premise for both companies and their investors.”<sup>84</sup>

In addition, then, to a preference for short-term results over-term growth, it was thought that quarterly earnings guidance contributed to an illusion of “complete business predictability”, one of the results of which was that variations from earnings guidance were seen as “surprises” which incurred disproportionate reactions inside and outside the company, the awareness of which sometimes give rise to earnings management activities.

That predictability premise is, of course, quite inconsistent with the risk willingly assumed by companies and their investors. The complexity, volatility and unpredictability of the business environment external to the corporation gives rise to business opportunities which may be accurately perceived and acted upon by some business actors, whose market value will be expected to increase, but not by others, to opposite effect. The ability of such organizations to perceive and respond to these changes and opportunities are likely to be affected not only by economic or industry factors but also by their company-specific attributes, including the structure, processes and personnel characteristics of its organization.

Of course, the panoply of factors affecting the business of a particular company or industry strain the limits of rational consideration. Those factors and how they might impact the instant company and industries in which it operates must not only be selected, but must also be weighted for salience individually, as well as in comparison with other relevant factors. They also must be constantly reassessed in light of changing conditions. Some environments are highly dynamic. Even in an environment that is not highly dynamic, changes in the environment can sometimes be almost entirely unpredictable and massive in effect. Apart from “black swans”<sup>85</sup>, the effects of disruptive technologies may fit this description.<sup>86</sup> Even these simple remarks indicate the complexity of deriving and achieving such predictions.

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<sup>84</sup> *Ibid* at 5.

<sup>85</sup> Nassim Nicholas Taleb, *The Black Swan: The Impact of the Highly Improbable* (New York: Random House, 2007.)

<sup>86</sup> Clayton M Christenson, *The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail* (Boston: Harvard Business Review Press, 1997).

Both endeavours are highly sensitive to organizational factors specific to the corporation concerned.

#### The Earnings Guidance Life Cycle

It may be that the accentuated attention paid to earnings guidance contributed to its decreased prevalence. The CFA Report cited research indicating that the number of companies providing quarterly guidance decreased from 75 percent in 2003 to 52 percent in 2006; that the number of companies providing annual guidance increased from 38 percent to 82 percent in the same period; and that 43 percent of companies provided guidance only annually.<sup>87</sup> Of the companies that did not provide earnings guidance, more than 60% provided qualitative statements about market conditions and trend information that might impact its business, between 40% and 60% provided industry-specific information and qualitative statements about high-level performance measures, and slightly less than 40% provided quantitative information concerning business measures and/or assumptions and estimates/forecasts of selected factors that might drive earnings.<sup>88</sup> Companies eliminating quarterly earnings guidance clearly attempted to provide more high-level and long-term information of a qualitative nature. That type of information might allow observers to derive a more accurate perception of the industry (or industries) in which it operates, the company's position therein, and management's assessment of the interaction of those two elements, and how it plans to proceed to generate longer-term positive results.

In one survey of CFA Institute members, 76 percent of respondents supported companies moving away from quarterly earnings guidance. Of those supporters, 96 percent further agreed that companies should provide additional information on the fundamental, long-term drivers of the business.<sup>89</sup> The research just mentioned suggests that many companies, whether or not providing such guidance, provide some kind of outlook on factors that might affect long-term performance.

Some of these may relate to the industries in which the company operates, while others might relate to the extent to which the company is involved in those industries as compared with others, and still other factors may relate to attributes more particular to the company itself, including its strategy. These more individuated attributes may also include the structure, processes, and

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<sup>87</sup> *Supra* note 82.

<sup>88</sup> *Ibid* at 6.

<sup>89</sup> *Ibid*.

personnel of the company, and adaptations required to those organizational attributes in order to successfully adapt to its environment and achieve its goals. Of course, as noted previously, variations and results from earnings guidance have both external and internal effects. Arguably both of these, and certainly the internal effects, are best known to the company itself.

Accordingly, the CFA panel developed an “earnings guidance lifecycle” to improve guidance on the basis of company-specific and industry characteristics. The major determinants of this lifecycle are industry categorization, whether the company is established or has a longer product cycle, on the one hand; or is more dynamic and has a shorter product cycle on the other; and the size of the company, whether its market capitalization is towards the lower end of the spectrum (“smaller-cap”) or the higher end of the spectrum (“larger-cap”).

The panel suggests that “an early-stage, small-capitalization company with a shorter-term product/service cycle”, which is likely to be covered by few analysts, and may need to raise capital frequently “may not have the strategic option of providing less than quarterly guidance.” Later, growth and diversification of products, services, and markets, may enable it to tolerate potential fluctuations in volatility and investor sentiment that may occur with less frequent earnings guidance. “Still later in the corporate life cycle, the company may have matured to the point of focusing on managing the business for the long term and have little need to provide earnings guidance to outside sources.”<sup>90</sup>

#### Voluntary Disclosure, Information Asymmetry, and Organizational Participation

Of course, a key objective of communicating with investors is to satisfy their expectations as to timeliness and content. The CFA Report suggested that companies adopting an “earnings guidance lifecycle” perspective should, at the time of its adoption, indicate its implications for disclosure at later points in time, by stating what effect the attainment of certain standards will have on the frequency, reduction, or elimination, of eliminating earnings guidance.<sup>91</sup>

A company applying such lifecycle perspective to earnings guidance could determine, in the light of what it considers to be the primary value-drivers of its business, the factors, time-horizons, and metrics most relevant to its strategy and future performance. For example, it could highlight ways in which aspects of its structure, process, and personnel are suited to its business and may be

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<sup>90</sup> *Ibid* at 8.

<sup>91</sup> *Ibid*.

adapted in future. This might allow analysts and others to develop an appreciation of these attributes and, concomitantly, how they may be positively and negatively affected by future developments, including, proposals for restructurings, spinoffs, and other changes.

Treating the shareholders not only as legal counterparties but also as organizational participants, a corporation would take shareholder expectations into account and would actually discuss them with shareholders. Thus, the corporation would have an opportunity to explain and discuss these proposals with its shareholders and analysts covering the company in order to reach some common understanding as to the nature of earnings guidance and other disclosure to be provided by the company in the future. This market influence may be expected to ensure that the company does not provide earnings guidance that is biased so as to only show positive results. In turn, shareholders and analysts might negotiate to obtain the information they consider most relevant to their appraisal of the company's strategy and performance.

By fostering greater understanding of the company's performance and prospects over a longer term, the company is better enabled to attract shareholders whose objectives are more consonant with its own objectives over the longer term. Of course, just as research cited above<sup>92</sup> indicates that companies that pay more attention to short term results attract investors with short-term objectives, it might be expected that research not yet conducted should demonstrate that companies whose managements are more focused on the long-term will attract investors with the same focus, that is to say, real investors attuned to fundamental value creation rather than traders acting in accordance with market indicators.

As discussed above, risk is endemic to investment, and trading, in equities. A party investing in an equity security is taking a position in the company that such investor expects to generate positive results in terms of value accretion, as measured to at least some extent by market price. Eliminating myopia in relation to the subject investment insofar as possible is said to permit a more accurate perception of value over short, medium, and long terms. To the extent that this improves the assessment of value over the long-term, this is expected to impact the market price in the short term. Thus, improved understanding of a company's long-term prospects should be expected to

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<sup>92</sup> See Salter, *supra* note 46 at 15, and discussion referring to sources mentioned *supra* note 46.

result in less sensitivity to short-term market influences, and thus to less volatility in its own share price.

Reducing the information asymmetry as between the board of directors and management, on the one hand, and investors, analysts and other market participants, on the other, should contribute to such understanding by the public markets. After all, investors are not only being asked to invest in the present value of future cash flows, but in the underlying organization forecast to generate them. Confidence in the board and management, in the past, at the instant time and at various times in the future, and the ability of its members to effectively anticipate and accommodate changing factors in the external and internal environment is, or should be, a principal factor in making an investment. Reducing information asymmetry permits investors, analysts and other market participants to better understand and judge the performance of the board and management and the organization as a whole. It also permits them to assess the alignment of the organization's structure, processes and personnel with the other such organizational elements, and their congruence with its goals and objectives, both independent and instrumental.

The shareholder, whether taking a share position for the short-term, medium-term, or long-term, is, in effect, investing in the organization as an organization, and not simply in a financial instrument issued by the corporate legal entity that represents certain rights and liabilities for the holder. It is the organization that will determine the "real life" ability of the corporate legal entity to meet the legal claims and investment expectations of its shareholders.

Accordingly, we continue to maintain that the legal and organizational aspects of the corporation cannot veridically be modelled separately from each other. Legal aspects, influences, and changes must be assessed in relation to the corporation's more organizational aspects, influences and changes; while organizational aspects, influences, and changes must be assessed in relation to the corporation's legal aspects, influences, and changes. For example, as we have seen, legal requirements concerning disclosure of short-term results or quarterly guidance may impact organizational performance.

## Short-Termism, Goal Incongruence, and Value Corruption

### *Short-Termism and Organizational Corruption*

Malcolm Salter argued that the collapsed time horizons of short termism undermine ethical standards and promote institutional corruption,<sup>93</sup> defined as “institutionally supported behavior that—while not necessarily unlawful—undermines a company’s legitimate processes and core values, weakening its capacity to achieve espoused goals and eroding public trust in the institution.”<sup>94</sup>

The purport of his argument is that short termism may conflict with its long-term objectives and core values, some of which are processual, or instrumental, in nature. In fact, short termism may not only conflict with legitimate processual aspects of the organization and its values, but may also conflict with structural and personnel aspects of the same. Salter maintains that institutionally supported behaviour that weakens a company’s ability to adhere to pursue and achieve its goals in accordance with its values, such as by impairing its structure, its process and its personnel and their ability to pursue those primary goals and values is, *ipso facto*, goal-incongruent and value-incongruent, and is, accordingly, inconsistent with, disrespectful of, and destructive of, its principal and predominant goals and values. Salter’s argument that this amounts to institutional corruption, regardless of moral or legal considerations, must be understood in this context.

As we have argued elsewhere, group, business unit, or subunit behaviour may also be impacted by, and may themselves impact, the organization’s goals and values. In this context, short termism as practiced in one business unit, for example, may conflict not only with its particularized long-term objectives and values but may also conflict with short-term objectives and values at those higher levels of the organization and, as well, with long-term objectives and values at those higher levels. Salter does not explore these aspects of the problem, however, he finds that the “shorter the time period for measuring individual and organizational performance, the larger the rewards and penalties directly tied to these short-term measures, and the weaker the accountability for long-term adverse consequences, the greater the incentive for institutions and their executives to secure short-term rewards by gaming society’s rules, tolerating institutional conflicts of interest, violating

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<sup>93</sup> *Supra* note 46 at 6.

<sup>94</sup> *Ibid* at 2.



common decency or other standards of fair conduct, and resorting to cronyism as a way of maximizing self-interest.”<sup>95</sup>

In effect, he argues that short termism incents behaviour that is inimical to the interests of the organization, and the society and polity in which it is situated. The present work has established that individual behaviour is affected by identification with, socialization by, and other effects of membership in, various levels of the organization, including the organization as a whole, and its various groups, and subunits. As we have seen, the level of the organization with which an individual has the closest association tends to exert the greatest influence on individual behaviour. Often, this is the business unit. However, influences of other levels of the organization may be brought to bear with such force and threat of possible penalties that they may assume a greater influence than the more immediate focal group.

In this sense, what Salter refers to as institutional corruption, and which we might denominate as organizational corruption, may not be involved at all. Instead, higher levels of the organization may be endeavouring to promote goal congruence and value congruence at those higher levels, but the focal group, whether a division or group, a business unit, or a smaller unit of a business unit, such as a sub-unit, may be endeavouring to promote, instead, goals and values which are seen as inimical (or, at least, less preferred or less central) at higher levels of the organization, but which are central to the focal group concerned.

In effect, what might be perceived as organizational corruption may, instead, be intra-organizational group corruption, the corruption of some particular division, group, business unit or subunit, which is effectively contained within that focal group, may not extend beyond it, and thus may not represent as high order a threat to the organization as it would if it was more pervasive. The behavioural hypothesis that Salter advances and the examples that he provides must be understood to be subject to these qualifications.<sup>96</sup>

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<sup>95</sup> *Ibid* at 6-7.

<sup>96</sup> *Ibid* at 7. Salter cites, as examples, the corporate governance scandals in the first decade of the 21st century, including "accounting shenanigans at WorldCom, HealthSouth, Adelphia Communications, Global Crossing, Dynegy, Cendant, Qwest, Rite Aid, Computer Associates, Sunbeam, Hollinger International, Xerox, AIG, Fannie Mae, and Freddie Mac, and the dramatic collapse of Enron—a category-defining case of institutional corruption." He also mentions the savings and loan (S & L) crisis and other financial crises of the 1980s and the 2008 financial crisis, noting that "such corrupt behavior persisted after Congress passed the Sarbanes-Oxley Act in 2002, in response to the accounting scandals of the 2000s."

### *Short-Termism and Intraorganizational Incentives*

For present purposes, it is not necessary to examine each of Salter's conclusions. The pursuit of results that are closer to the focal point in time and, consequently, are perceived as involving less risk; that is, overvaluing short-term benefits and undervaluing long-term benefits, has been shown to be quite common. This might obtain at the higher levels of the organization and, as well, at lower levels of the organization, and might influence participants in the organization, including officers, managers and employees, and, of course, shareholders.

When the compensation of an individual is determined by the performance of the organization as determined at various levels within the organization, individuals may be expected to be motivated to make efforts to maximize that performance. This is particularly important inasmuch as the influences of the more immediate focal group may be more significant than influences from less proximate levels of the organization.<sup>97</sup> For example, members of the finance group at Enron may have responded more to intra-group influences than to influences outside the finance group.

Unfortunately, Salter does not engage in this kind of intra-organizational analysis. He does, however, note that his claim about the ill effects of the collapsed time horizons is "consistent with research showing how compensation for executives—especially bonus contracts—influences accounting choices, efforts to manage corporate earnings, and strategies designed to boost stock prices artificially"; with "claims of legal commentators that compensation based on short-term employment contracts, stock-based compensation, and maximization of stock price is a key driver of short-termism and its ill-effects"; with claims of organizational economists "that executives with significant personal stakes in some economic outcome may jeopardize the long-run interests of owners, such as the market value and integrity of the institution"; and with ongoing research by social scientists on the psychological effects of money on short-term human behaviour.<sup>98</sup>

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<sup>97</sup> See the discussion in Chapter Four in the section entitled "Groups of People or Social Units", especially under the heading "A Social Unit or Group of People"; in Chapter Five in the sections entitled "Organizational Structure" and "Organizational Personnel"; and in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals".

<sup>98</sup> *Ibid* at 7-8. His references to each sentence, in order, are to PM Healy, "The Effect of Bonus Schemes on Accounting Decisions" (1985) 7 *Journal of Accounting and Economics* 85; DI Bergstresser and T Philippon, "CEO Incentives and Earnings Management" (2006) 80 *Journal of Financial Economics* 511; E Goldman and SL Slezak, "An Equilibrium Model of Incentive Contracts in the Presence of Information Manipulation" (2006) 80 *Journal of Financial Economics* 603; and L Peng and A Röell, "Managerial Incentives and Stock Price Manipulation" (2014) 69:2 *Journal of Finance* 487; for the first sentence, the review by R Sappideen, "Focusing on Corporate Short-Termism" (2011) *Sing JLS* 412 for the second sentence; MJ Jensen and WH Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and

Short termism can, no doubt, lead to some incentives that are goal- and value-incongruent. Accelerating short-term results can lead to successive iterative demands for more and better results. Recognizing earnings in an earlier, rather than a later, financial period may improve earlier period financial results, but may make it more difficult to hit targets for the later financial period. Even in terms of compensation, acceleration of compensation based on short-term performance, for example in the case just posited, may leave the compensated executive in some cases worse off, in comparative terms, than otherwise.

Of course, the higher value and lower risk attached to payments closer in time to the time in question seems to make the tradeoff worthwhile as a matter of discounted utility. It is often argued that the executive compensated is implicitly wagering on the length of his employment period in relation to the time of payoff, such that later payoffs are not only perceived to be more valuable and less risky in general terms, but also in terms of likelihood of still being employed at such time. In this regard, Salter concludes that proposals “for reorienting an organization to focus on its long-run health [by] restructuring financial incentives to reflect this commitment” generally involve: employing longer time periods for measuring corporate and managerial performance and paying incentive-based awards; including qualitative criteria when evaluating individual and institutional performance; deferring a portion of annual incentive awards, so it can be clawed back given malfeasance or a significant reversal of corporate results; and basing the vesting of stock grants and options on longer-term metrics—such as several years of earnings in excess of the company’s (risk-adjusted) cost of capital—and extending the required holding period of exercised stock options.<sup>99</sup>

Salter reported that by the end of 2009 some 64 percent of the country's 100 largest companies had begun to use “clawbacks”, requiring executives to return part of their pay under certain conditions, such as malfeasance – up from only 17.6 percent in 2006.<sup>100</sup> One might expect that the threat of clawbacks due to significant reversals of corporate results, such as by reason of financial restatements or longer-run impacts of earlier adverse decisions, might be a more effective deterrent to excessive short-termism than clawbacks due to malfeasance. There is no doubt, however, that

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Ownership Structure” (1976) 3:4 *Journal of Financial Economics* 305 for the third sentence; and to work by Mahzarin Benaji and colleagues at Harvard University, for the last sentence.

<sup>99</sup> *Supra* note 46 at 23.

<sup>100</sup> *Ibid.*

both are likely to be conducive to the long-term interests, goals, and to the basic values of many prudently run corporations that expect to survive well into the future. Of course, devising compensation programmes that do not require clawbacks is still preferable.

## **Interaction of Short-Termism with the Organization**

### ***Transmission Within the Organization***

Marginson and McAulay comment on a difficulty, posited by Laverty, with the argument that capital market pressures foster short-termism: namely, how senior executives demonstrate to owners and investors that the firm's assets are being managed to maximize value.<sup>101</sup> In this task, the senior executives are confronted by at least two examples of information asymmetry: one as between senior executives and investors, and another as between senior executives and other levels of managers within the firm.

In regard to the latter, Marginson and McAulay argue that “the extent to which senior executives are able to demonstrate good short-term performance at firm level depends in part on the performance of those in lower-status positions, who must also be prepared to trade long-term performance for short term results.” This operates by means of hierarchical contagion, which “begins with senior management short-termism, driven by belief in market myopia, and proceeds by transmitting this imperative down through the management levels below the most senior.”<sup>102</sup>

The mechanism by which short-termism is transmitted into, and within, the organization is an important item for consideration. Mark Roe finds that the information transmission mechanism in the current era for transmitting short-termism from stock markets into the boardroom and thence into the corporation more broadly is, firstly, “shareholder activism and executive compensation, with boards more willing to fire CEOs if short-term financial results are poor because directors fear for their own jobs or reputations” and, secondly, senior management, whose compensation is significantly based on stock market returns, who attempt to achieve the target stock market returns in order to maximize such variable compensation.<sup>103</sup> Roe concludes that transmission of stock market short-termism inside the corporation causes “boards and senior managers to forgo long-

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<sup>101</sup> *Supra* note 22 at 275, citing Laverty, *supra* note 35 at 834.

<sup>102</sup> *Ibid* [citations omitted].

<sup>103</sup> Mark J Roe, "Corporate Short-Termism – In the Boardroom and in the Courtroom" (2013) 68 *Bus Law* 977 at 985.

term value maximization for short-term results, often managing and sometimes manipulating earnings, all toward the end of pleasing the stock market.”<sup>104</sup>

Here, we may recall Segelod’s discussion of the results of his survey of short-termism in Sweden, the United States, and the United Kingdom. In effect, boards of directors and managers of corporations are subject to the influence of short-termism from the capital markets only where such boards and managements assign importance to such influences. His study showed that Swedish managers assign relatively less importance to these influences than do managers in the United States and in the United Kingdom. While some of this may be culturally dependent, some part of this difference may be attributable to relative differences in the sensitivity of the relevant capital markets and to differing economic, individual and organizational factors.

Roe ignores the latter and considers only pressure from capital markets as relevant influences on the board and senior management. Consequently, he concludes that proponents of managerialism may try to find ways to reduce these market pressures. He dissents from arguments that longer terms for directors and greater board and managerial autonomy from the market would foster sensible long-term corporate behaviour, citing evidence that persistent references to short-term horizons by management in communications with investors and a short-term investor base with higher turnover than average were covariant.<sup>105</sup> In effect, corporations and their investors over time may come to share performance horizons. This result is quite consistent with the corporative perspective, which, among other things, involves development of certain shared expectations as between the corporation and shareholders. Of course, the fact that communications were so characterized does not mean that they necessarily reflect the values of such management.

While Roe does not attempt to analyze the transmission of the short-term orientation from higher to lower levels of management, Marginson and McAulay do. They argue that information asymmetry between high and lower levels of management may persist in both directions simultaneously. In effect, even if more senior management attempts to encourage downwards transmission of short-term orientation, the information required by more senior management in its decision-making is, to a great extent, generated by those at lower levels of management.<sup>106</sup> This suggests that information supporting short-termism may not be generated or may be withheld from

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<sup>104</sup> *Ibid.*

<sup>105</sup> *Ibid* at 986.

<sup>106</sup> *Supra* note 22 at 275.

upper transmission if and to the extent that lower levels of management are not in agreement with the short-term orientation of senior management. Indeed, the downward transmission theory was not supported by the results of their study.

### ***Environmental Uncertainty and Short-Termism***

Before addressing individual and organizational dimensions of corporate decision-making more generally, some further mention must be made about the position of lower levels of management subjected to short-term pressures from above. Marginson and McAulay explain that the information deficiency apparent in intertemporal decision-making has been extensively researched at the level of the individual through the concept of role ambiguity, the difference between the information a person needs to fulfil a role and the information available.<sup>107</sup> Their reading of the research is that environmental turbulence (in very general terms, volatility or relatively unpredictable discontinuities in an environment)<sup>108</sup>, which is one form of perceived environmental uncertainty, is a source of role ambiguity; and, further, that role ambiguity, role conflict, and perceived environmental uncertainty are distinct constructs that nevertheless positively covary with each other. Thus, role ambiguity, role conflict, and role overload are each associated with short-termism.<sup>109</sup>

Marginson and McAulay posit that in an environment fraught with uncertainty, an individual may find gratification in pursuing outcomes which are more certain.<sup>110</sup> This may cause the decision-maker to displace a long-term orientation, which might be beneficial in circumstances of high turbulence and volatility, in favour of a short-term orientation with results that are more certain. In this sense, short termism may be seen as a coping behaviour (and, therefore, having some utility, to the decision-maker and others) in circumstances which are dynamic and potentially threatening.<sup>111</sup>

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<sup>107</sup> *Ibid* at 277.

<sup>108</sup> A definition in similar terms is employed in Jerayr Haleblan and Sydney Finkelstein, "Top Management Team Size, CEO Dominance, and Firm Performance: The Moderating Roles of Environmental Turbulence and Discretion" (1993) 36:4 *Academy Management J* 844 at 845.

<sup>109</sup> Chapter Four discusses role conflict in the section entitled "Groups of People or Social Units" under the heading "A Social Unit or Group of People", notably in relation to social comparison theory and social identity theory.

<sup>110</sup> *Ibid*.

<sup>111</sup> See the discussion in Chapter Six in the section entitled "Organization Goals and Intraorganizational Goals" and therein under the heading "Intraorganizational Goals, Power, and Loyalty" under the subheading "Theories of Intraorganizational Power". Buffering or dampening uncertainty arising from changes in the internal or external environment may be useful for the organization and its intraorganizational components, which may accrue power and

Of course, while turbulence and stability are often considered in strategy literature as aspects of the external environment, they may also be characteristics of functions, divisions or business units considered in relation to parts of the organization external to the subject function, division or business unit. We suggest that role ambiguity, role conflict, and perceived environmental uncertainty may also be characteristics of internal units, in which event short-termism may be a coping mechanism for those internal units, as well as for the members of such internal units. If this research is correct, we submit that greater availability of relevant information, greater simplification or prioritization of social identities or roles, and greater awareness of environmental changes and their salience may help to foster attitudes more consistent with long-term orientations.

### ***Short-Termism at the Business Unit Level***

In their study, Marginson and McAulay investigate organizational dimensions of short termism, and, in particular, whether short termism at the intrafirm level may result from social influence, a tendency for the views and opinions of individuals to be shaped by information and attitudes of significant social referents, such as colleagues, coworkers, or influential outsiders. They examine whether conformity as to a short-termist orientation might occur at the level of both the work group and the business unit or function.<sup>112</sup> Such work groups may exist at the level of the chief executive and top management team, as well as at lower levels.

These workgroups and business units may be highly salient to the individual's construction of his or her social identity as discussed earlier in this work, especially in Chapter Four.<sup>113</sup> As has been done in this work, Marginson and McAulay refer to the importance of the functional area or strategic business unit in establishing and reinforcing some conformity of views and opinions concerning what is desirable and appropriate by means of a range of socialization processes, "including recruitment, selection, indoctrination, training, mentoring, career ladders, and both professional and functional affiliations".<sup>114</sup> The salience of the procedures, views, and goals associated with those experiences is reinforced by positive feedback and rewards from peers and superiors for adherence to generally accepted norms and standards. Thus, the "individual is thus

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influence accordingly. Individuals making decisions on behalf of the organization and such components may be expected to accrue power and influence directly and indirectly as a result of such actions.

<sup>112</sup> *Supra* note 22 at 278.

<sup>113</sup> See, in particular, the discussion in the section entitled "Groups of People or Social Units" and therein under the heading "A Social Unit or Group of People".

<sup>114</sup> *Supra* note 22 at 278.

likely to develop, over time, a mode of behavior that is consistent with the particular procedures, attitudes, goals, and standards of a profession, function, or SBU.”<sup>115</sup>

While the relationship is not well established, they hypothesize that “the manager’s short-termism is related to the situationally derived socialization processes occurring at the level of the function or the business unit”. However, they acknowledge that this relationship may vary as a result of exposure to different attitudes, goals, standards, or norms. “In effect, short-termism may be socially legitimized as an accepted form of institutional behavior.”<sup>116</sup>

In effect, the results of their study supported Laverty’s suggestions that short termism was affected by both individual and organization level factors.<sup>117</sup> Importantly, they find that the socialization processes of the strategic business unit or SBU are such that its members attach a high degree of salience to its processes, views and goals.

They suggest that collective myopia may be an attribute of a strategic business unit (SBU) and offer two examples: one in which managers are able to make joint sense of their immediate context but are not able to assess the broader consequences of their actions; and another in which the group may be able to make sense of the present or immediate future but are unable to monitor emerging patterns of events, with the result that current actions lead inadvertently to detrimental outcomes in the longer-term future.<sup>118</sup> In addition, collective myopia may be said to result from perceptions of individuals or SBUs which, when aggregated, fail to provide a clear indication of action likely to be successful; in effect, where a lack of panoptic perspective occludes a veridical perception.

It may be that the degree of socialization of members of the SBU is sufficiently high that with respect to certain matters they are at a high level of agreement. However, the interaction of the focal business unit with another business unit not in agreement with the focal business unit on the same matters may, if heeded, produce some reflexive re-examination of the subject, either as between the two business units or within the focal business unit. It can readily be seen that the singleness of vision which may, in some cases, characterize one business unit, with respect to a given subject, say short-termism or collective myopia, may be counteracted to some extent, at least, by processes of aggregation of perspectives before proceeding to, or by decision-making and

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<sup>115</sup> *Ibid.*

<sup>116</sup> *Ibid* at 277 [citations omitted].

<sup>117</sup> *Ibid.*

<sup>118</sup> *Ibid* at 287.



decision-making processes at, a higher level of the organization. As noted, this interaction (among others) may promote a reconsideration of the subject within the focal business unit.

Similarly, employing some kind of “devil’s advocate” function or process may challenge the focal business unit in the perception commonly held by its members. A challenge may also come from the immediately higher level within the hierarchy. However, certain processual rules or practices may reduce the likelihood of challenges arising at successively higher levels: it may be assumed by the decision-maker concerned that the second or third level below had knowledge not available to the focal decision-maker, such that tampering with conclusions reached at that level should be resisted.

### ***Defending Intraorganizational Goals Against Short-Termism***

Just before proceeding to examine the implications of short termism for constituents of the corporation, and before considering it explicitly from a corporative perspective, it is appropriate to recall that the corporation, as an organization, has a number of goals and objectives, economic and other, the salience of which differs as among them. While it is intended that the structure and processes of the corporation be congruent with the attainment of such goals and objectives, or, at least, the more salient goals and objectives, this cannot be assured. However, it may be expected that the corporation, as an organization, may seek to accomplish its most salient goals and objectives, and to adopt and to vary or modify aspects of its structure and processes which are not congruent with its hyper-salient goals and objectives. As Malcolm Salter observes, excessive short-term orientation may interfere with such hyper-salient goals and objectives and the structure and processes adopted to realize them, weakening its capacity to achieve declared goals, and perhaps involving gaming applicable legal regulations and persistently violating accepted norms of fairness.<sup>119</sup>

A question that arises is how the structure and processes of the corporation (or any other organization) is employed, of their own motion or otherwise, or can be employed, to preserve its structure, processes, and core values, goals and objectives. Related questions that arise concern, firstly, the effectiveness of such autonomous or otherwise directed mechanisms; and secondly, the means, if any, by which their effectiveness may be promoted by external regulation and

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<sup>119</sup> Salter, *supra* note 46 at 2. See also the discussion above in the section entitled "Short-Termism, Goal Incongruence, and Value Corruption".

governance, acting on such mechanisms or independently of them. Without knowing how these mechanisms operate within the organization, however, external regulation and governance may be ineffective, less effective than it otherwise might be, or even counter-effective, in the sense of promoting or effecting unsought or undesirable results. In a sense, these consequences of external regulation and governance may be unanticipated if, and to the extent that, they are not or cannot be anticipated, by reason of lack of investigation or other lack of knowledge and awareness.

In this way, the short-termism debate, like the discussion of other regulatory issues in previous chapters, focuses attention on the ways in which the organization which is internal to the corporation is affected by external factors, such as external regulation and governance of the corporation as a legal entity. This engages the corporative perspective.

The following sections will proceed, firstly, to discuss ways in which short-termism is perceived to affect the constituents of the organization, internally and externally, as an organization and as the legal entity; secondly, proposals for reform; and, thirdly, to evaluate those proposals in the light of the considerations presented in this section and in the chapters discussing regulatory matters generally, and in the light of the corporative perspective more generally.

## **Interaction of Short-Termism with Organizational Participants**

### ***Shareholders***

The relationship between short-termism and shareholders, both as legal counterparties of, and as an organizational participants in, the corporation has been canvassed in this chapter to date. That relationship is often considered to be evoked merely by referring to “short-termism” and its corollary “long-termism”.<sup>120</sup>

### ***The Board of Directors***

This section advances the previous discussion of short termism and the board of directors by considering the effect of short-termism pressures on the affect and behaviour of directors, as reported by directors, and by Barton and Wiseman.<sup>121</sup> As noted above, directors reported that they

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<sup>120</sup> See the discussion in the present chapter in the section entitled "Short-Termism, Long-Termism and Indefinite Existence" under the headings "The Problem Stated", "Short-Termism and Long-Termism – On the Merits", and "Short-Termism, Earnings Reporting, and Earnings Guidance".

<sup>121</sup> See the discussion in the section entitled "Short-Termism, Long-Termism and Indefinite Existence" under the headings "The Problem Stated", and, in particular, under the heading "A Historical Perspective".

themselves were the greatest source of pressure to overemphasize short-term financial results and underemphasize long-term value creation.<sup>122</sup>

As discussed previously, directors, like other members of the organization, may experience role ambiguity. In addition to a lack of information with which to perform his or her responsibilities, an individual may also experience a lack of confidence stemming not only from informational disadvantages, but also from environmental turbulence and dynamism. In effect, short-termism pressures on directors may not be counteracted by them for a number of reasons, including lack of information, experience, and perhaps interest, in medium-term or long-term goals and strategies. Barton and Wiseman reported on whether directors surveyed considered that their boards fully comprehended company strategy strategies (34%); were completely aware of how their firms created value (22%); and had a strong understanding of the dynamics of their firms' industries (16%).<sup>123</sup> In effect, by expressing role ambiguity, directors may be signalling a reluctance to tackle strategic issues.

As many authors have lamented, it is often thought that boards of directors devote insufficient time and attention to long-term strategy (which may exacerbate role ambiguity), and, all too frequently, concentrate, instead, on regulatory or "check the box" compliance matters. To avoid this, some boards circulate regulatory filings and commentaries on them in advance of the board meeting at which they are to be considered, present a short summary at the meeting, invite questions and comments from directors, and then pass the appropriate board resolutions summarily. In many cases, these "check the box" compliance matters may not require much in the way of "heavy lifting" by the board in the sense of keen and serious thought and discussion. This may suit some directors, particularly since, according to Barton and Wiseman, director recruitment seldom prioritizes independent thinking or appropriate business expertise.<sup>124</sup>

While discussions of board of director recruitment and of business strategy in general are beyond our present remit, these issues may affect the reluctance of corporations to change strategies;<sup>125</sup> their continued adherence, instead, to strategies which are failing or otherwise require modification

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<sup>122</sup> Dominic Barton and Mark Wiseman, "Where Boards Fall Short" (2015) Harv Bus Rev 98 at 100.

<sup>123</sup> *Ibid.*

<sup>124</sup> *Ibid.*

<sup>125</sup> *Ibid* at 102.

instead of pursuing a credible new strategy that will take years to bear fruit;<sup>126</sup> and their tendency to adopt strategies that are not original, unique, or particularly well suited to them, but which are common to other participants in the industry.<sup>127</sup> For example, Barton and Wiseman report negative effects from maintaining constant levels of capital allocation over long periods of time as among various business units, but positive effects from strategically adapting and redeploying capital.<sup>128</sup>

The duties of directors to act in the best interest of the corporation, whether arising by statute or at common law, must be understood in relation to the corporation's legal essentialist characteristics, including the time horizon of the corporation's existence, which, as we have noted, is indefinite and potentially unlimited. Consequently, boards which overemphasize short-term considerations at the expense of long-term considerations may not be acting in accordance with their duties. While this may present challenges, as mentioned above, it is nonetheless required, for, as Barton and Wiseman conclude: "Nothing suggests that the role of a loyal and prudent director is to pressure management to maximize short-term shareholder value to the exclusion of any other interest. To the contrary, the logical implication is that he or she should help the company thrive for years into the future."<sup>129</sup>

As noted above, and as discussed by Lavery and by Marginson and McAulay, boards function as working groups and, as such, are affected by the socialization and other processes of such groups. Consequently, recruitment criteria for directors which include reputations for independent thinking, which Barton and Wiseman find are rare, may improve opportunities for re-examination of various matters, including long-term strategy. Positive contagion can be initiated among the group itself, particularly by new recruits, or by outside influencers, such as key shareholders.

### ***Chief Executive Officers, Chief Financial Officers, and Top Management Teams***

The effects of short-termism on chief executive officers ("CEOs"), chief financial officers ("CFOs"), and other members of the top management team ("TMT") are not likely to be uniform. Among other things, CEOs and CFOs may each have separate and distinct statutory and regulatory duties and responsibilities which are unique to that position alone, and are not shared by other members of the TMT. Of course, each member of the top management team will normally have

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<sup>126</sup> *Ibid* at 100-101.

<sup>127</sup> See the discussion of Interbrew, *ibid* at 103.

<sup>128</sup> *Ibid* at 102.

<sup>129</sup> *Ibid* at 100-101.

duties and responsibilities that are unique to the position held, as noted previously.<sup>130</sup> At the same time, all members of the management team, including the CEO and CFO, may have other duties and responsibilities in common, such as the reporting of criminal and other violations by members of the organization. Various TMT members, course, we also have duties the performance of which are highly dependent upon the performance of salient duties by other TMT members, resulting in significant situations of interdependence.

Laverty, quoting Peter Drucker, claims that American managements feel constantly pushed by money managers' quests for higher quarterly earnings and fear of takeover bids "toward decisions they know to be costly, if not suicidal, mistakes." Laverty claims that undervaluing the future "is a *symptomatic* description of U.S. firms that have failed to make critical investments and thereby have lost technological leadership and the ability to sustain competitive advantage or even competitive parity."<sup>131</sup>

Whether or not the method of transmission of investor short-termism is from investors from the board and thence to the CEO or directly from investors to the CEO, as previously discussed, that pressure was felt by CEOs 20 years ago, according to Peter Drucker. Thomas Palley describes two paths of research on managerial short-termism: one relating it to financial market imperfections, and another relating it to CEO and manager careers.<sup>132</sup> While the former has been discussed to least some extent above, some remarks about the latter may be in order.

One argument is that managers undertake short-term projects with a rapid return in order to build up their reputations and the perceptions of their "talent" by superiors. Palley's model assumes, on the one hand, managerial mobility, and on the other hand, managerial rewards, each of which are tied to current profitability of their existing firm. This may lead them to choose projects with higher returns earlier in the project's life even if they have intrinsically lower net present values, simply because this locks in immediate rewards rather than "rewards that the manager may not be around to enjoy."<sup>133</sup>

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<sup>130</sup> See the discussion in Chapter Nine in the section entitled "Central Management Independent of Equity Ownership" and therein under the headings "Top Management Team Stability and Organizational Stability" and "Management Ownership Separation and Organizational Participants".

<sup>131</sup> *Supra* note 35 at 830-831, quoting Peter F Drucker, "A Crisis of Capitalism", Wall Street Journal September 30, 1986, at 31 [references in quotations generally omitted].

<sup>132</sup> Thomas I Palley, "Managerial Turnover and the Theory of Short-Termism" (1997) 32 J Economic Behavior & Organization 547 at 547-8.

<sup>133</sup> *Ibid* at 548.

Palley suggests that risk averse managers adopt a short-term orientation. Firstly, they form portfolios of projects to spread their own reward risk; and secondly, as their probability of quitting declines, they invest more in long-term-projects with a higher net present value.<sup>134</sup> In turn, managerial turnover affects the degree of short termism: “economies characterized by a high level of managerial turnover will tend to exhibit a greater degree of short-termism.” Other factors which may moderate this interaction include cultural and social attitudes toward corporate loyalty and job mobility, actions of managers intended to increase the probability of receiving an outside job offer, and firms providing incentives designed to get managers to adopt a long term perspective.

Palley suggest that the role of managerial action in influencing the probability of “quits” can be illustrated by assuming that, like shareholders, ‘poaching’ firms only observe, and make offers based on, managers’ current performance, and make offers on the basis of this performance. Managers, knowing this, have a further incentive to engage in short-termism in the hope of inducing improved outside job offers at compensation levels which reflect current performance.<sup>135</sup>

In effect, as investor and board short-termism or other factors increase CEO turnover, the CEO’s own short-termism may be expected to increase. Similarly, as short-term pressures from the CEO accelerate departures of top management team members and other members of management, the short-term orientations of the TMT and other management levels may be expected to increase. Presumably, these effects have been experienced in North American and European economies in recent years. For example, Salter references research indicating that the average CEO turnover is now approximately 16.8% per annum with the result that the average term of the CEO is now less than 6 years.<sup>136</sup>

As well, economies in which short-term pressures are reduced, such as those in which capital is more “patient”, may be expected to have lower levels of management turnover and, consequently, lower levels of management short-termist orientation. This accords with the comments of other researchers noted above in relation to Germany, Japan, and Sweden. While equity in American firms is generally “fluid capital” which moves rapidly based on perceptions of opportunities for

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<sup>134</sup> *Ibid* at 554.

<sup>135</sup> *Ibid* at 554-5.

<sup>136</sup> Salter, *supra* note 46 at 12.

near term appreciation,<sup>137</sup> capital in Japan and Germany is evidently not as impatient, as the debt and equity providers have more long-term relationships with the corporations and their executives. Lavery indicates that this greater “bottom-line” orientation increases pressure for short-term results. Equity shares have become commodities, and this “commoditization of share ownership” results in fewer shareholders being willing to hold shares for a longer period or being concerned about the details of the corporation and its business.<sup>138</sup>

Thus, it can be seen that the more external environment of the corporation, including the polity and political economy, affect aspects of its (more obviously internal) organization, personnel, and processes, and concomitant behaviour. In our discussion below of quarterly earnings reports and guidance, made necessary by regulatory and capital market requirements, we will suggest that these requirements incur costs, not only directly, but also indirectly. These may include costs imposed by adjustments to behaviour within the organization necessitated by these external requirements.

### ***Management and Employees Generally***

Much of the commentary in the preceding section, concerning directors, can be considered as applicable to various levels of management and, in some cases, to non-management employees. Due to space and time constraints, we will not elaborate on these further at the present time, but will pass on to the more general analysis of relationships between short-termism and the organization.

### ***Lenders, Suppliers, Customers, and Communities***

The positions of lenders, suppliers, and other trade creditors, as legal counterparties and as organizational participants may be affected by short-termism. The effect may depend, at least in part, upon the duration and the committed or expected term of the relationship between the counterparty/organizational participant and the corporation itself. This may also be true of customers, communities and polities. For example, a supplier or customer which has had a brief and non-proximate relationship with the corporation may take comfort in the corporation pursuing

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<sup>137</sup> Lavery, *supra* note 35 at 833, citing ME Porter, "Capital Disadvantage: America's Failing Capital Investment System" (1982) 70:5 Harvard Business Rev 65. See also Marginson and McAulay, *supra* note 22 at 274 to like effect.

<sup>138</sup> *Supra* note 35 at 833-4, citing MT Jacobs, *Short-term America: The Causes and Cures of Our Business Myopia* (Boston: Harvard Business School Press, 1991).

a largely short-term orientation. On the other hand, suppliers or customers with long-term relationships and long-term contracts with the corporation are likely to consider an excessively short-term orientation as a cause for concern.

### **Relationships Between the Organization and Short-Termism**

As we have seen, many analysts consider short-termism to be primarily, if not exclusively, an external influence brought to bear on the corporation from without. As we have argued, many influences within the external (or less proximate) environment of the corporation may affect it as an external legal entity and as animated by the organization within the corporation. As we have argued, as is the case with other organizations, corporations involve groups of individuals which seek to accomplish predominant and less dominant goals and objectives by adopting structures and processes and involving personnel, as groups, units, subunits, and individually. The approach taken in this work, which we have denominated as “corporative”, takes into account the dualistic nature of the corporation as an external legal entity and as an internal organization within the legal entity itself.

### ***A Multidisciplinary Model***

In this regard, the problem of short termism presents itself as apt for consideration from the corporative perspective. Indeed, while not taken from or explicitly applying the corporative perspective, Lavery expressly applies economic, organizational, and individual influences on decision-making to the short termism debate. Consequently, his research represents a useful starting point for demonstrating this multidisciplinary perspective on corporate behaviour. Lavery models decision-making at top levels of the corporation as resulting from “economic (*E*), organizational (*O*), and individual (*I*) influences, which affect decisions (*D*) both directly and through interaction. These decisions affect the firm's economic performance (*P*). The combination of the subject firm's decisions and the decisions of other firms determines what I describe as collective outcomes (*C*). The firm's performance and collective outcomes also constitute economic influences, completing a feedback loop.”<sup>139</sup>

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<sup>139</sup> *Supra* note 35 at 840-841.



### ***Economic Influences on Decision Making***

In Laverly's model, the "economic dimension includes the "ground rules" for economic performance, incorporating elements such as consumer preferences, the time horizons inherent in particular investments, the cost of capital, changing technologies, competitors' decisions, and the relationship between the firm's actions and its stock price. The organizational dimension includes processes and structures for making decisions. The individual dimension includes cognition and judgment in managerial choice."<sup>140</sup>

The outcome of these decisions, the economic performance of the corporation, may be measured by output, market share, profit, stock price and market value, and may involve both short term and long-term considerations. The collective outcomes which he mentions apparently refer to the totality of the decisions of individual firms as embodied in their respective performances. According to his model, economic influences include feedback effects from performance of the focal corporation and relevant industry. "For example, poor firm performance may hamper the firm's ability to make large investments." Industry outcomes, "such as decreased level of labor training or the absence of essential suppliers" may influence decisions "by increasing or reducing the attractiveness of particular investments."<sup>141</sup>

### ***Individual Influences on Decision Making***

At his time of writing, in 1996, Laverly claimed that evidence concerning bounded rationality and biases and nonrational heuristics used by individuals in decision-making had not yet been incorporated into debates over economic short-termism and, in particular, how observed intertemporal choice in individuals deviates systematically from the normative prescriptions of discounted utility (DU).<sup>142</sup> However, he follows Herbert Simon's conclusion that behaviour is intendedly, but only limitedly, rational,<sup>143</sup> and Bazerman's observation that individuals employ heuristics, which are "standard rules and implicitly direct our judgment [and] serve as a mechanism for coping with the complex environment surrounding our decisions".<sup>144</sup>

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<sup>140</sup> *Ibid* at 841.

<sup>141</sup> *Ibid* at 841-2.

<sup>142</sup> *Ibid*.

<sup>143</sup> HA Simon, *Administrative Behavior* (New York: Macmillan, 1947) at xxiv.

<sup>144</sup> MH Bazerman, *Judgment in Managerial Decision Making*, 3d ed, (New York: Wiley, 1984).

Laverty argues that biases, which may include heuristics, involve systematic deviations from rational decision-making. These may include biases that overvalue short-term outcomes at the expense of future outcomes.<sup>145</sup> In support of the latter, he cites studies by Thaler, finding discount rates as high as 277% as between present and specified future dates of payment, and as high as 89% with respect to trade-offs between immediate purchase price and long-run operating costs.<sup>146</sup>

Other biases which he mentions include preference reversal, where individuals plan to be more farsighted in future behaviour than they are in present behaviour,<sup>147</sup> and hyperbolic discounting, where the discount rate increases as the payoff date approaches, so that the smaller, nearer choice becomes more attractive compared to the larger, more distant choice.<sup>148</sup> In addition to discounting because of time delay, Laverty notes that discounting because of uncertainty or risk, namely, in determining expected utility (EU) is also relevant to intertemporal decision-making. For example, any non-immediate payment engages not only delaying the receipt of payment but also the implicit risk that the payment will not occur.

Other research, such as that of Tversky and Kahneman, confirms the existence of loss aversion, in which losses loom larger than corresponding gains,<sup>149</sup> and by Shelley that short-term losses loom larger than short-term gains whereas temporal discounting results in a relative diminishing of the importance of loss aversion regarding long-term prospects.<sup>150</sup> Laverty posits that managers avoid short-term risk “but they are more tolerant of risk over the longer run because they believe they will have time to gather information and reduce the likelihood or size of a negative outcome.” However, when long-run investments “require short-term sacrifices, the negative short-term outcomes loom disproportionately large.”<sup>151</sup>

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<sup>145</sup> *Supra* note 35.

<sup>146</sup> RH Thaler, "Some Empirical Evidence on Dynamic Inconsistency" (1981) 8 *Economics Letters* 201.

<sup>147</sup> G Loewenstein, "The Fall and Rise of Psychological Explanations in the Economics of Intertemporal Choice" in G Loewenstein and J Elster, eds, *Choice Over Time* (New York: Russell Sage Foundation, 1992) 3.

<sup>148</sup> G Ainslie, "Derivation of "Rational" Economic Behaviour from Hyperbolic Discount Curves" (1991) 81:2 *American Economic Rev* 334.

<sup>149</sup> *Supra* note 35 at 843-4.

<sup>150</sup> *Ibid.*

<sup>151</sup> *Ibid* at 844.

### *Organizational Influences on Decision Making*

Laverty examines research on group and organizational processes, which he says he had not at that time been applied to short-termism, that render an organization “unable or unwilling to pursue strategies that reflect an optimal valuation of the future”.<sup>152</sup> He maintains that organizational inertia preserves an organization’s core features, such as its stated goals, forms of authority, core technology, and strategy, against changes that might more rapidly respond to changes in the organization’s external environment. Such inertia helps to maintain its organizational identity.<sup>153</sup> However, by limiting the rate of change in the range of future possibilities open to the organization, such that it cannot change as quickly as changes in its external environment, inertia increases its likelihood of failure.

As we maintain in this work, in order to succeed over the long-term, a corporation must survive in the short-term and in the medium-term. Laverty admits that a course of action reflecting optimal intertemporal choice, especially over a long run, is sometimes inconsistent with survival. “Few firms are in a position to sustain losses over a prolonged period, even if there is a positive NPV for these losses and their associated payoffs.” Choices permitting short run survival may sometimes risk or even assure long-term failure.<sup>154</sup>

Group and organizational processes relevant in this regard include the “Asch phenomenon” where a mistake in judgment is expressed and defended by colleagues of the person opining; “groupthink”, which Laverty describes as the tendency of groups to reject and even punish ideas that diverge too far from orthodoxy; escalation of commitment, the tendency of decision-makers to persist in and to increase investment in failing courses of action; the latter reflecting both group pressures to rationalize past decisions that later appear mistaken; and an individual psychological tendency to self-justification, which expresses itself in an unwillingness to admit past mistakes.<sup>155</sup>

Laverty also avers to the organizational theory, not then part of the economic short-termism debate, concerning findings that temporal orientation is in part socially constructed; which suggests that norms from social structures may affect the degree to which managers focus on the

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<sup>152</sup> *Ibid* at 844.

<sup>153</sup> *Ibid* at 845.

<sup>154</sup> *Ibid* at 853.

<sup>155</sup> *Ibid* at 845-6.

short-term and on the long-term.<sup>156</sup> The social structures and affiliations in which they participate, inside and outside their firms, affect how they construe what is desirable and what is possible.<sup>157</sup>

What DiMaggio describes as “preconscious understandings the organizational actors share” often determine the choice of strategies.<sup>158</sup> As shown by Meyer and Zucker, elements other than economic performance constitute selection pressures that affect the survival of organizations.<sup>159</sup> For example, Lavery suggests that discounted cash flow analysis may be justified more by general acceptance conveying legitimacy than by economic efficiency; and that particular types of investment are legitimized through forces beyond the boundaries of any single firm, including professional standards and norms across groups and organizations.

It appears, then that decision makers within an organization are affected by norms and social influences experienced by the decision-maker manager through affiliations external to the organization, as well as within the organization. This would suggest that external orientations to short term results have an effect on the decision-maker which may be counteracted to some extent by a long-term orientation within the organization or, on the other hand, exacerbated by a short-term orientation within the organization. Likewise, the adoption by a decision-maker of a long-term orientation involves influences both without and within the organization. For example, the optimal prospects for increasing the long-term orientation of management decision-making would appear to involve both external and internal pressures in that direction.

#### Intraorganizational Information and Agenda Transmission

We have also averted to how the process of information selection within organizations affects decision-making. Lavery averts to salient studies, including one demonstrating that “decisions are made at successive levels (from bottom to top) of the firm; structure is important because it affects the set of choices presented to the decision maker.” Another shows that “structure determines the sequence in which conflicts are resolved, and agendas evolve as conflicts flow upward to top

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<sup>156</sup> Lavery cites PL Berger & T Luckman. *The Social Construction of Reality* (Garden City, NY: Anchor Books, 1966).

<sup>157</sup> Lavery cites MS Feldman & JG March, "Information in Organizations as Signal and Symbol" (1981) 26:2 *Administrative Science Q* 171.

<sup>158</sup> Lavery cites J DiMaggio, "Interest and Agency in Institutional Theory" in LG Zucker, ed, *Institutional Patterns and Organizations: Culture and Environment* (Cambridge, MA: Ballinger, 1988) 3.

<sup>159</sup> Lavery cites: MW Meyer & LG Zucker, *Permanently Failing Organizations*. (Newbury Park, CA: Sage, 1989).

management. Thus, choices are made based upon the alternatives presented, not from the full range of options that were considered at lower levels.”<sup>160</sup>

As we have argued in this work, neither the full range of options nor the full range of information relevant to those options considered is presented at successively higher levels of management. This suggests that the extent to which decision-making is short-term or long-term in orientation is largely determined at lower organizational levels. Other aspects of the structure, process, and personnel of the organization are relevant to such determination. For example, as a result of bottom-up capital budgeting and investment review processes, lower level managers screen out projects, as a result of which top managers consider only projects that have made it through one or more levels of screening. Lavery indicates that “Because the time horizon of an individual's responsibility is inversely proportional to his or her level in the organization, it may well be that certain long-term considerations will not "bubble to the top" in many organizations.”<sup>161</sup>

Correspondingly, if long-term considerations are determined at higher levels of the organization then, to be relevant to the organization, this determination will have to be reflected, in turn, in downwardly directed pressures effected by means of structural, processual, and personnel influences. If external norms are directed towards long-term considerations, this may be expected to affect all levels of management to some degree. The presence of internal norms directed towards long-term considerations may vary at different levels of the organization and the effectiveness of such internal norms at any focal level may be affected by their perceived salience and intensity at that level. This will, in turn, be affected by group, as well as individual, perceptions. As the most immediate determinant of social identity, group perceptions are likely to be most relevant to any individual decision-maker.

Lavery says that studies of decision biases support the idea that group dynamics will tend to mitigate at least obvious mistakes intertemporal choice problems, and that the heuristics and biases of individual decision-makers which may tend to cause economic short-termism may not do so if they are counteracted by organizational and economic decision influences.<sup>162</sup> He concludes that

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<sup>160</sup> Lavery cites JL Bower, *Managing the Resource Allocation Process*, rev ed, (Boston: Harvard Business School Press, 1986); and TH Hammond, & PA Thomas, "The Impossibility of a Neutral Hierarchy" (1989) 5:1 *JL Econ & Org* 155.

<sup>161</sup> Lavery cites E Jaquez, *A General Theory of Bureaucracy* (London: Heineman, 1976).

<sup>162</sup> *Supra* note 35 at 849.

while understanding group and organizational influences on intertemporal choice problems extremely complex undertaking, it is important to the debate on short-termism.

Generally, information about the long-term is less available than information about the short-term, producing pressure to produce in the present. Moreover, due to preference reversal, long-term prospects, which are not undervalued in isolations, are overwhelmed by very short-term concerns. While “communicating a long-run vision is a fundamental challenge for top managers”, the criticality of such challenge is directly proportional to the sacrifices required in the short term in order to achieve long-run goals. When long-run prospects require some sacrifice of with short-term performance, top managers must attempt to improve the quality and availability of information by sharing the long-run vision in order to “to provide—in advance—a context for short-term results”.<sup>163</sup> For example, the need to invest in and nurture complex capabilities in environments of accelerating change taxes existing analytical tools, such as specifying future cash flows associated with capabilities, which are less easily measured than investments in equipment.<sup>164</sup>

Laverty argues that discounted utility may not be an appropriate framework for valuing uncertain long-term prospects; instead, an options framework may be more appropriate. He argues that the options framework posited by Myers recognizes that the payoff to investment is not simply the direct cash flow from the investment but also includes a new set of opportunities that would not have been possible without the original investment.<sup>165</sup> A larger project can be broken into smaller parts, each of which can be evaluated in terms of both cash flow and the options it creates. Delay also gives the decision-maker more time to gather information to reduce the uncertainty.<sup>166</sup> Thus, while Eisenhardt observed that most strategic different decisions “can be postponed indefinitely”, breaking down a strategic decision into smaller parts would allow information gathered since the last partial decision to be applied to the next decision, and so on. In a technological field, being competitive at in the future may involve a series of discrete investments over time in new

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<sup>163</sup> *Ibid* at 852.

<sup>164</sup> *Ibid* at 853.

<sup>165</sup> *Ibid* at 854. He cites SC Myers, "Finance Theory and Financial Strategy" (1984) 14:1 *Interfaces* 126.

<sup>166</sup> *Supra* note 35 at 854. His reference is to RS Pindyck, "Irreversibility, Uncertainty, and Investment (1991) 29:3 *J Economic Literature* 1110.

generations of technologies, applying cumulative and path-dependent learning at each level of decision-making.<sup>167</sup>

Indeed, we would argue that such decision segmentation also presents a feedback loop in which the prior decision which was not as advantageous as another alternative available at the time the prior decision was made can, if necessary, be reversed and some other alternative, either one available at that time or which has become available in the interim, might be assessed as preferential and pursued accordingly. One of the concomitants of such decision segmentation is that the decision-maker is able to take into account not only the advantages of various courses of action but the cost of dropping a course of action at a future decision point and adopting, instead, an alternate course of action.

As Lavery argues, economic considerations and economic assumptions prove inadequate on their own as explanations of intertemporal decision-making, since “our world is, in fact, teeming with short-term/long-run trade-offs” to such an extent “that intertemporal choice is basic (if often implicit) in managerial work.”<sup>168</sup>

Lavery’s model of management decision-making in terms of economic, personal and organizational influences and his discussion of how they operate has been shown to be consistent with the corporate perspective of this work. External influences from the broader society and polity, as well as from the investment community, may affect decision-makers. Influences internal to the organization, including its structure, processes, and personnel, may affect the groups, units and subunits in which decision-makers are situated. All of these influences will affect intertemporal choices, including the balance between short-term and long-term costs and benefits. Importantly, intertemporal decision-making requires consideration and balancing of: firstly, the legal interests of the corporation and its counterparties as they may be instantiated over time; and secondly, the organizational expectations of the corporation and its organizational participants and they may be instantiated over time; in each case, across a temporal horizon which is indefinite and may be perpetual. The effect of some decisions on the one hand, may be to forestall, and, on the other hand, to forgo or limit, reaching certain decisions in the future; which may have the result

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<sup>167</sup> *Supra* note 35 at 854. His reference is to K Eisenhardt, "Making Fast Decisions in High-Velocity Environments" (1989) 32:3 *Academy Management J* 543.

<sup>168</sup> *Supra* note 17 at 855.

that present decisions affecting legal rights and duties and organizational expectations may constrain legal and organizational relationships for some definite or indefinite time period in the future.

As indicated, intertemporal decisions may be approached differently by the corporation than by its legal counterparties or organizational participants, in part, because of significant information asymmetries obtaining between the corporation and such parties. Corporative analysis can assist in identifying such asymmetries, their consequences in legal and organizational terms, and how they might best be addressed, by reduction or otherwise. To this subject, our attention now turns.



**CONCLUSION:  
THE CORPORATIVE CORPORATION OF THE FUTURE  
PURPOSE AND SCOPE OF THIS CHAPTER**

**Previous Chapters of This Book**

This work has identified as the “corporative theory” of, or the “corporative perspective” on, the corporation: a conception of the corporation as involving both a legal entity, that is to say, a rights-and-duty-bearing entity engaged with various legal counterparties (the external or “outward-facing” attitude of the corporation), and as an organization involving human beings as actors on behalf of the corporation and as organizational participants (the internal or “inward-facing” attitude of the corporation).

Part 3 of the book, in Chapters Seven through Ten inclusive, investigated: firstly, the “organizational essentialist characteristics” of organizations generally and of the corporation, in particular; secondly, the extent to which the legal essentialist characteristics of the corporation and its organizational essentialist characteristics were interrelated; and thirdly, the relationships, on the one hand, between the corporation as a legal entity and its various legal counterparties; and, on the other hand, between the corporation as an organization and its various organizational participants.

Chapter Ten considered the fifth and last “legal essentialist characteristic” of the corporation, namely its possible perpetual existence, which entails its possible survival beyond that of any human counterparty or organizational participant. This raises issues relating not only with respect to intertemporal decision making, but also with respect to intergenerational decision making and intergenerational duty: namely, the extent to which a focal corporation should take into account not only existing, but also possible future, legal counterparties and organizational participants, including communities and polities.

**This Chapter**

The first section of this chapter, by way of conclusion, summarizes the argument of the book as a whole; and the final section, identifies, firstly, a number of concerns related to the space and place of the corporation in the economy, society and the polity, both at national and transnational levels; and secondly, a number of initiatives which are complementary to the corporate theory of, or perspective on, the corporation; both in order to situate corporative theory in an appropriate place

and space relative to pending and possible future developments in corporate law and corporate legal theory, some further discussion of which concludes the book.

## **THE CORPORATIVE RESPONSE TO CORPORATE THEORY**

This work is considered to be distinctive as a work of corporate legal theory in at least three respects: firstly, the theory that it advances; secondly, the methodology pursued; and, thirdly, the breadth and scope of its research and conclusions; as explicated below.

## **CORPORATIVITY – THEORY AND PERSPECTIVE**

### **Legal Entity and Organization**

A fundamental, effectively existential, problem of corporate law and legal theory is explaining how a non-corporeal entity which bears rights and duties, and is, therefore, a legal entity can take action in the “real world”, which is a world of corporeal individuals and entities.<sup>1</sup> Taking action requires that one or more individuals animate, personate, or “vivify” the corporation: it requires (ultimately or proximately) at least one human person to enliven it or bring it to life “in reality”.<sup>2</sup>

A related fundamental problem which arises concerns the nature of the legal and other relationships between the corporation, as a legal entity, on the one hand, and the animating individual person or persons, on the other hand.<sup>3</sup> In the event that the corporation involves more than one animating individual person, those individual persons, the book argues, may, and in fact do, constitute an “organization”, a term which is generally considered to mean, firstly, a social unit or group of persons; who, secondly, collaborate or take collective action; thirdly, with respect to achieving

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<sup>1</sup> This observation is made in various places in the book too numerous to chronicle exhaustively, however, useful discussion appears in Chapter A3 in the section entitled “The Corporation as Principal” under the heading “The Representative Role of the Board”. See also the discussions in Chapter Seven in the sections entitled “The Corporation, the Legal Entity, the Organization, and the Participants” and “The Separate Legal Entity, the Organization, and the Individual Human Actor”, and in Chapter Eight in the section entitled “Implications of Organizational Analysis for Limited Liability and Asset Partitioning”.

<sup>2</sup> As noted in several places in the book, the “black box” of the corporation in classical and neoclassical economic theory ignores this and hence “invisibilizes” the organization. See, for example, the discussion in Chapter Two immediately preceding, and in the section entitled, “The Neoclassical Firm as a Single Economic Actor”. With respect to need for the separate legal entity to act through individual human actors, see the discussions in Chapter Ten in the section entitled “Legal and Organizational Context” under the heading “Relation to Other Legal Essentialist Attributes”; and the discussion in Chapter Seven in the sections entitled “The Corporation, the Legal Entity, the Organization, and the Participants” and “The Separate Legal Entity, the Organization, and the Individual Human Actor”.

<sup>3</sup> Chapter Three discusses some of the variants in corporate-organizational relationships.

common results or goals and objectives.<sup>4</sup> These three attributes of the organization referred to in this book as “organizational essentialist attributes”.

Collaborating or taking collective action (“organizing”) toward such goals typically requires the engagement of structures, processes, and personnel (each an element of the “organization”) considered, in an intendedly rational manner, to be conducive to attaining such goals.<sup>5</sup> These structural, processual, and personnel attributes impact the organization, and thereby the corporation, and the attributes which are legally essential to it as a corporation (“legal essentialist attributes”).<sup>6</sup> The book contends that such impacts must be investigated, understood, and taken into account by legislators and regulators, legal academics and practitioners, jurists, those charged with enforcement of legislation and regulations, and other participants in legal discourse of, or relating to, the corporation.

### **The Corporation as Organization**

It is generally agreed that organizations may have economic objectives, including engaging in business activities in pursuit of economic goals. Thus, the modern business corporation may constitute an organization if it exhibits all of the organizational essentialist characteristics. That it does so is established in Part 3 of the book.<sup>7</sup>

Exposition of research and theory in the book demonstrate that the goals of the modern business corporation are not exhausted by the pursuit of profit.<sup>8</sup> In fact, as noted below, maximizing profit may not even be its predominant or preeminent goal.<sup>9</sup> It also has various other goals and objectives

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<sup>4</sup> Discussions of the attributes of the “organization”, including its “organizational essentialist attributes”, appear in several sections of the text; however, particularly extensive discussion occupies all of Chapter Four and continues in Chapters Five and Six.

<sup>5</sup> *Ibid.*

<sup>6</sup> See, in particular, the discussion of “legal essentialist attributes” in Chapter One, especially in the section entitled “The Corporation and Corporate Essentialism in Law” and further discussion in Chapters A1, A2, and A3. The interaction of “legal essentialist attributes” inter se and with “organizational essentialist attributes” is explicated in much of the remaining text commencing with Chapter Seven.

<sup>7</sup> See the discussion in Chapter Six, notably under the heading “Existence and Typology of Organizational Goals and Objectives”.

<sup>8</sup> See the discussion in Chapter Three, especially in the sections entitled “Barriers to Unified Action” under the headings “Complex and Multiple Goals, “Official Goals and Unofficial Goals”; and “Organizations as Political Systems” under the heading “Organizations as Polities” et seq; and Chapter Six, particularly under the headings “Existence and Typology of Organizational Goals and Objectives” and “Organizational Goals and Intraorganizational Goals”.

<sup>9</sup> *Ibid.*

(such as its continuance), some of which are end goals and others instrumental goals.<sup>10</sup> The book shows that various groups, subgroups, and individuals within the corporation may pursue, to various degrees, their own goals, which may or may not accord with goals of the overall organization.<sup>11</sup> The pursuit of such goals may involve direct external engagement with third parties outside the boundaries of the corporation as a legal entity.<sup>12</sup>

Research and theory referenced in the book illustrate how groups, subgroups, and individuals within the corporate legal entity may engage in competitive processes to acquire power and influence vis-à-vis the organization as a whole; often based, at least in part, upon the focal group's capacity to satisfy resource requirements and to address contingencies affecting the organization as a whole.<sup>13</sup> Such intraorganizational power and influence may affect the focal group's pursuit of goals, including determining which goals of the organization and its groups, subgroups, and individual participants are pursued, to what degree, and how they are prioritized inter se, by the focal group within the focal group and otherwise.<sup>14</sup>

Such a panoply of goals and objectives tends to produce conflict within the organization and, similarly, within its groups and subgroups. The resolution of such conflicts is often considered to be effected by means of a superordinate goal or superordinate process.<sup>15</sup> The book demonstrates that, although profit maximization has been disproven as a superordinate goal, the generation of "sufficient" profit to continue its activities, which may be considered to be an "optimal" level of profit, is often considered to be, if not a superordinate goal, then, at least, a highly significant one.<sup>16</sup> This is contrary to classical and neoclassical, but not other, economic theory.<sup>17</sup>

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<sup>10</sup> See the discussion in Chapter Six, particularly under the headings "Existence and Typology of Organizational Goals and Objectives" and "Organizational Goals and Intraorganizational Goals".

<sup>11</sup> *Ibid.*

<sup>12</sup> *Ibid.*

<sup>13</sup> See the discussion in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals".

<sup>14</sup> *Ibid.*

<sup>15</sup> See the discussion in Chapter Six, particularly under the heading "Existence and Typology of Organizational Goals and Objectives".

<sup>16</sup> *Ibid.*

<sup>17</sup> *Supra* note 2.

### **The Corporative Theory of, or Perspective on, the Corporation**

This work advances a theory of, approach to, or perspective on, the corporation which holds that the corporation must be analyzed both as a legal entity and as an organization.<sup>18</sup> The attributes of the corporation which are considered to be essential to its role and status as a legal entity taking action in that capacity concomitantly engage with attributes of the corporation as an organization by which it is instantiated, and takes action, in the real world.<sup>19</sup>

Some of the legal essentialist characteristics of the corporation may be said to be outward-facing inasmuch as they concern its legal actions which are relatively more extracorporate or external (described in the book as relating to its “hard outer shell”), while others are more inward-facing inasmuch as they concern its legal actions which are relatively more intracorporate or internal actions (relating to its “soft inner core”).<sup>20</sup> The panoply of these characteristics must be understood as a whole with respect to the theorization of the corporation if any theory of corporate law is to have meaningful consequences in terms of explanatory, predictive, and effective capacity and utility vis-à-vis corporate law and attendant academic, practice, legislative, and judicial considerations.<sup>21</sup>

Many of the assumptions and generalizations which have commonly arisen, been employed, and have had significant influence, in respect of corporate law and legal theory,<sup>22</sup> particularly those emanating from classical and neoclassical economics, have failed to recognize this “dual nature” of the corporation. The book delineates some of the attendant consequences of such failure, both concerning the place of the corporation in the economy, society, the polity and the state as spheres of action<sup>23</sup> and concerning its mode of action in the economy and otherwise.<sup>24</sup>

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<sup>18</sup> See the discussions in Chapter Six, particularly in the sections entitled "Existence and Typology of Organizational Goals and Objectives" and "Organizational Goals and Intraorganizational Goals"; and in Chapter Ten.

<sup>19</sup> *Ibid.*

<sup>20</sup> See the discussion in Chapter One in the section entitled "The Corporation in Law and in Discourse" and "The Corporation and Corporate Essentialism in Law".

<sup>21</sup> *Ibid.*

<sup>22</sup> See the discussion in Chapter One in the section entitled "Assumptions About the Corporation".

<sup>23</sup> See the discussion in Appendix A.

<sup>24</sup> See the discussion in Appendix A, in Chapters A1 and A2.

## **THE METHODOLOGY OF THIS BOOK**

The methodology of this work is highly original, if not actually unique, at least in terms of corporate legal theory. Rather than proceeding purely by abstract reasoning or deductive reasoning (although often without empirical support, other than anecdotes, or appeals to “common sense”) to advance a theory of the corporation, the work employs a methodology which is more akin to inductive or empirical reasoning. The author denominates this as a “descriptive” or “descriptivist” approach.<sup>25</sup>

## **WHAT IS? CORPORATE LAW AND CORPORATE GOVERNANCE TODAY**

### **Framing the Corporation**

This methodology involves inquiring, firstly, what legal theorists, practitioners, jurists, and other knowledgeable commentators consider the corporation to be, as a matter of law; which may be phrased as asking what is that which is identified as a corporation by, and within, that particular knowledgeable community.<sup>26</sup>

While alternative formulations are possible, for purposes of discussion, this approach identifies the corporation as having the following essential attributes: 1. It is a separate legal entity or rights-and-duty-bearing entity. 2. It is characterized by asset partitioning and limited liability. 3. Contributors to its equity capital possess certain rights vis-à-vis the corporation, which normally exclude a right to demand a return of capital, but normally include a right of the contributor or its successors in interest to transfer those rights, and, at least in the case of a public corporation, to do so relatively freely. 4. It possesses “management ownership separation”: the rights to participate directly in its central management are independent of equity ownership (although equity owners do have certain other rights with respect to such central management, relating to its authorization, advice, and accountability). 5. Its duration of existence is normally indefinite. The book identifies these as its “legal essentialist attributes”.<sup>27</sup>

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<sup>25</sup> See the discussion in Chapter One in the section entitled "The Corporation in Law and in Discourse".

<sup>26</sup> *Ibid.*

<sup>27</sup> See the discussion in Chapter One in the section entitled "The Corporation and Corporate Essentialism in Law", and the more detailed explication of the individual legal essentialist attributes in Chapters Seven through Ten inclusive.

## **Instantiating the Corporation in Law**

Part 1 and Appendix A of the work proceed by examining whether, how, and to what extent, these legal essentialist attributes of the corporation are instantiated by modern corporate law in the modern business corporation.<sup>28</sup> This involves examining four significant statutes concerning modern business corporations: the Canada Business Corporations Act<sup>29</sup> and the Ontario Business Corporations Act,<sup>30</sup> which are the most significant such statutes in Canada; the Delaware General Corporation Law,<sup>31</sup> which governs a significant majority of public corporations operating in the United States; and the Model Business Corporations Act of the American Law Institute,<sup>32</sup> which is the model for the current or proposed corporate statutes of many of the other states.

This examination also considers some aspects of relevant common law which are relevant to such statutory corporate law insofar as that common law expands, extends, amplifies, or completes the same. The legal essentialist attributes identified by the expert corporate law community are found to be instantiated in the actual corporate law surveyed in the book.

This examination of statutory and common law relating to the corporation also investigates the interrelationship among the several legal essentialist attributes of the corporation, and considers how such interrelationships are relevant to, and are expressed in, these leading corporation statutes. This investigation necessarily engages issues concerning how the corporation, as an incorporeal legal entity, takes action, both internally and externally. These issues, which relate to the corporation's organizational attributes, are examined further in Part 3 of the book.

## **WHY THIS? ASSUMPTIONS ABOUT THE CORPORATION**

### **The Corporation as Instantiated in Discourse**

Part 2 of the book, supplemented by Appendix A, investigates issues concerning why these "legal essentialist" attributes of the corporation have been thus identified, and why they have been instantiated as such in modern corporate law. This inquiry engages a second data set, discussed in

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<sup>28</sup> See the discussion in Chapter One in the section entitled "The Corporation and Corporate Essentialism in Law", and in Chapters A1 through A3 inclusive relating to the instantiation of those characteristics in modern corporate law statutes.

<sup>29</sup> RSC 1985, c C-44 [CBCA].

<sup>30</sup> RSO 1990, c B.16 [OBCA].

<sup>31</sup> 8 Del Code, c 1, § 101 [DGCL].

<sup>32</sup> American Bar Association, *Model Business Corporation Act Annotated*, 4th ed, (Chicago: American Bar Association, 2008) [MBCA].

more detail in Appendix B; namely, discourse concerning the corporation, and in particular, assumptions and generalizations concerning the corporation and the economy, and its relationship to society, polity, and the state.

The economic objectives of the corporation necessarily prioritize, in such examination, but are not limited to, assumptions and generalizations of an economic nature, most notably those of classical and neoclassical economics. Such assumptions and generalizations underlie the role of the corporation, as a separate legal entity, in taking action, by and through human individuals, in the real world which is the place and space of human individuals. Important as it is to appreciate the role of such assumptions and generalizations in legal and other discourse concerning the firm and, in particular, the modern business corporation, so, too, is the means by which they take action simultaneously in the “real” and in the “legal” worlds which is the particular focus, and contribution, of corporative theory. Accordingly, the examination of the assumptions and generalizations upon which corporate legal action is predicated is contained in Appendix A of the book, not to in any way minimize its importance, but so as not to unduly burden the main task of the book which, as noted, concerns the corporation as legal and organizational actor.

### *Macro-Level Assumptions*

In this regard, Appendix B of the book identifies and examines a number of macro-level assumptions and generalizations with respect to: firstly, the interrelationship among the economy, society, polity, and state, including: 1. the separation of economic, social and political functions (considering selected archaeological, historical, and other evidence and theory from ancient and classical times to the present);<sup>33</sup> 2. the situation of the economy in the “private” sphere of action (considering, primarily, the economy of classical Greece and Rome);<sup>34</sup> 3. the actual and analytical separation of the “private” and “public” spheres (considering analysis by Habermas, Arendt, and certain liberal thinkers);<sup>35</sup> 4. the distinctive mode of analysis of the economy (considering atomistic conceptions of man in economics and other disciplines);<sup>36</sup> and 5. the distinctiveness and

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<sup>33</sup> See the discussion in Appendix B in Chapter B1, especially in the section entitled “Separation of Economic, Social, and Political Functions”.

<sup>34</sup> See the discussion in Appendix B in Chapter B1, especially in the section entitled “The Situation of the Economy in the “Private” Sphere”.

<sup>35</sup> See the discussion in Appendix B in Chapter B1, especially in the section entitled “Actual and Analytical Separation of Private and Public Spheres”.

<sup>36</sup> See the discussion in Appendix B in Chapter B2, in the section entitled “The Distinctive Mode of Analysis of the Economy”.



independence of the economy from its ambient society and the polity (considering, as an alternative, the embeddedness analysis of Polanyi and Granovetter);<sup>37</sup> secondly, the firm in classical and neoclassical economics (as discussed in the immediately following paragraph); and, thirdly, the corporation as an economic actor (as discussed thereafter).

### *Micro-Level Assumptions*

A discussion of the purpose and methodology of economic theory in Appendix B of the book is followed by examination, further explication, and criticism (from economic, sociological, organizational, institutional, political, political economy, philosophical, and legal, perspectives), of some assumptions and generalizations of classical and neoclassical economics, including: 1. atomistic utilitarianism;<sup>38</sup> 2. atomism, and methodological individualism;<sup>39</sup> 3. individual determination of utility;<sup>40</sup> 4. similarity of desires and utility;<sup>41</sup> 5. the mismatch of desire and availability;<sup>42</sup> 6. the complete independence, rationality, and information, of individual market actors;<sup>43</sup> 7. the prevalence of utilitarian, independent, market transactions;<sup>44</sup> and 8. the equilibrium of market prices.<sup>45</sup>

### *Evaluation of Assumptions and Generalizations*

Appendix B of the book establishes that these assumptions and generalizations, as expressed in classical and neoclassical economics, have been demonstrated, by economic and other theorization and research, to be: 1. not only highly contestable, but, generally, at variance with alternative (and usually subsequent) theorization and research; 2. incomplete, inadequate, and even erroneous; and 3. lacking in explanatory and predictive capacity and utility. Accordingly, such assumptions and

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<sup>37</sup> See the discussion in Appendix B in Chapter B3, especially in the section entitled "The Economy and Its Function as Distinct and Independent from the Society and the Polity".

<sup>38</sup> See the discussion in Appendix B in Chapter B4, especially in the section entitled "Atomistic Utilitarianism".

<sup>39</sup> See the discussion in Appendix B in Chapter B4, especially in the section entitled "Atomism and Methodological Individualism".

<sup>40</sup> See the discussion in Appendix B in Chapter B4, especially in the section entitled "Individual Determination of Utility".

<sup>41</sup> See discussion in Chapter Appendix B in Chapter B4, especially in the section entitled "Similarity of Desires and Utility".

<sup>42</sup> See the discussion in Appendix B in Chapter B4, especially in the section entitled "Desire and Availability Mismatch".

<sup>43</sup> See the discussion in Appendix B in Chapter B4, especially in the section entitled "Independent Rational Informed Actors".

<sup>44</sup> See the discussion in Appendix B in Chapter B4, especially in the section entitled "Utilitarian Independent Market Transactions".

<sup>45</sup> See the discussion in Appendix B in Chapter B4, especially in the section entitled "Market Prices Tend Towards An Equilibrium".

generalizations cannot reasonably be relied upon in framing a theory of the corporation, or in framing policy, legislating, regulating, adjudicating, or otherwise deliberating or acting, with respect to the corporation as instantiated in the modern world. Thus, a new model is required.

### ***The Corporation as Economic Actor***

The focus of corporative theory concerns how an entity constituted, and recognized, by law as bearing rights and duties in its own separate and distinct capacity can take action in the “real world” by and through the instrumentality of individual human beings. With respect to the corporation as an economic actor, the book maintains that classical and neoclassical economics employs a model of the firm centered on an entrepreneur; which is completely devoid of organizational attributes, anthropomorphizes the firm, and, accordingly, “invisibilizes” the firm as a social construct. This prevents robust, or even meaningful, examination of classical and neoclassical hypotheses, and their explanatory and predictive capacities.<sup>46</sup>

Consequently, quite apart from the problematic generalizations and assumptions of classical and neoclassical economics (as noted above), its model of the firm also cannot be reasonably relied upon in framing a theory of the corporation or in framing policy, legislating, regulating, adjudicating, or otherwise deliberating or acting with respect to the corporation as instantiated, and as acting, in the modern “real” world. This has been demonstrated by theorization and research in economics and other disciplines, justifying search for a new model.<sup>47</sup> The corporative theory of, or perspective on, the corporation is such a model.

### ***Research of the Corporation in Modern History and Today***

In accordance with its descriptive or descriptivist approach, Part 2 of the book goes beyond investigation of theoretical discourse concerning the firm to investigate discourse of a more empirical nature: namely, that relating to the history of business corporations in America,<sup>48</sup> primarily in the nineteenth and twentieth centuries.<sup>49</sup> It presents data relating to the development

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<sup>46</sup> See the discussion in Chapter Two in the section entitled "Purpose and Scope of This Chapter and Chapter Three".

<sup>47</sup> See the discussion in Chapter Two in the section entitled "The Neoclassical Firm as A Single Economic Actor".

<sup>48</sup> See the discussion in Chapter Two in the sections entitled "Empirical Observation of the Firm In Action"; and "Purpose and Methodology of Business History".

<sup>49</sup> See the discussion in Chapter Two in the section entitled "History of the Development of the Modern Business Corporation".

of the business corporation in that environment, primarily as chronicled by the eminent business historian, Alfred D. Chandler, Jr.<sup>50</sup>

Part 2 attempts to answer the question what the modern business corporation has been, in recent history, and is, today, in terms of its features as experienced “in the real world”, particularly with respect to its structure, processes, and personnel, that is to say, its organizational, features. It compares those features, as so explicated, with the legal essentialist attributes of the corporation discussed in Part 1, and explicated in greater detail in Appendix A, of the book. This includes considering organizational barriers to unified action, including the diffusion of rationality, information and decision-making within the organization; and its adherence to complex and multiple goals, both official and unofficial;<sup>51</sup> and implications of these barriers with respect to resolving conflicts implied by the same, including considering: the corporation as a conflict system for internal and external conflicts, joint preference ordering in economic theory, and political aspects of intraorganizational operations, including the formation of coalitions.<sup>52</sup> Part 2 also investigates the development of the multidivisional form (“MDF”), and the multinational enterprise (“MNE”), and their effects on legal and organizational features of the underlying business enterprise.<sup>53</sup>

## **HOW, INSTEAD, TO ANALYZE THE CORPORATION: A CORPORATIVE THEORY OF CORPORATE LAW AND GOVERNANCE**

### **The Organization and the Corporation**

Finally, Part 3 of the book analyzes the organization, employing a methodology similar to that adopted with respect to the corporation in Part 1 and Appendix A. It investigates the definition and essential characteristics of the organization employed by reputable and knowledgeable, even authoritative, commentators, including organizational theorists and practitioners;<sup>54</sup> considers each of the characteristics identified by them as essential to the organization;<sup>55</sup> and investigates whether

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<sup>50</sup> *Ibid.*

<sup>51</sup> See the discussion in Chapter Three in the section entitled “Barriers to Unified Action”.

<sup>52</sup> See the discussion in Chapter Three in the section entitled “Organizations as Political Systems”.

<sup>53</sup> See the discussion in Chapter Three in the section entitled “Forms of Corporations – Legal and Organizational Variants”.

<sup>54</sup> See the discussion in Chapter Four in the section entitled “Working Definitions and Formal Definitions”.

<sup>55</sup> See the discussion in Chapter Four in the sections entitled “Groups of People or Social Units”;

these essentialist characteristics of the organization (“organizational essentialist attributes”) are also instantiated in the modern business corporation, both in law and in fact.<sup>56</sup>

It then proceeds to investigate how the organizational essentialist attributes and other attributes instantiated in the corporation as organization affect each of the legal essentialist attributes of the corporation as instantiated in the modern business corporation;<sup>57</sup> namely, SLE status;<sup>58</sup> limited liability and asset partitioning;<sup>59</sup> capital lock-in with transferable equity interests;<sup>60</sup> management ownership separation;<sup>61</sup> and indefinite duration of corporate existence.<sup>62</sup>

### ***Essential Attributes of the Organization***

These organizational essentialist attributes include: 1. being, or involving, a social unit or group of people; 2. which takes collaborative or collective action; 3. in a manner rationally intended to achieve some common result, goal or objective.<sup>63</sup>

### ***Theorization and Research of the Organization and the Corporation Compared***

The data set here includes theorization, empirical, and other observations: firstly, of organizations, by sociologists, social psychologists, and social theorists, such as Max Weber, Philip Selznick, Egon Bittner, Meyer Zald, Henri Tajfel and John Turner, Leon Festinger, Blake Ashforth and Fred Mael, and Robert Merton;<sup>64</sup> and, secondly, of corporations, by management theorists and practitioners, ranging from Henri Fayol, Frederick Winslow Taylor, Mary Parker Follett, and Chester Barnard, to Herbert Simon, James March, Alfred D. Chandler, Jr., and others.<sup>65</sup>

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<sup>56</sup> See the discussion in Chapter Four in the section entitled "Groups of People or Social Units"; in Chapter Five in the sections entitled "Structure, Process and Personnel", "Organizational Structure", "Organizational Process", and "Organizational Personnel"; and in Chapter Six.

<sup>57</sup> See the discussion in Chapters Seven, Eight, Nine, and Ten.

<sup>58</sup> See the discussion in Chapter Seven in the section entitled "Separate Legal Entity".

<sup>59</sup> See the discussion in Chapter Eight in the section entitled "Limited Liability and Asset Partitioning".

<sup>60</sup> See the discussion in Chapter Nine in the section entitled "Capital Lock-In with Transferable Equity Interests".

<sup>61</sup> See the discussion in Chapter Nine in the section entitled "Central Management Independent of Equity Ownership".

<sup>62</sup> See the discussion in Chapter Ten.

<sup>63</sup> *Supra* note 54.

<sup>64</sup> This information appears in the various chapters in Part 3, but is particularly concentrated in Chapters Seven and Eight.

<sup>65</sup> This information appears in Part 2, especially in Chapter Two in the section entitled "History of the Development of the Modern Business Corporation", and in Chapter Three in the section entitled "Forms of Corporations – Legal and Organizational Variants"; and in the various chapters in Part 3, but most especially in Chapters Four and Five.

### *Goals*

The data set considered here also encompasses extensive theoretical and empirical information concerning goals: firstly, of different natures, including official, unofficial, operative, instrumental, ultimate or end, superordinate, and subordinate, goals; and, secondly, obtaining at the macro-organizational level and at various intraorganizational (group and subgroup) levels.<sup>66</sup>

### *Intraorganizational Organizations and Operations*

Theoretical and empirical information concerning intraorganizational power and influence, as well as identification, loyalty, and commitment, and the sources of each of the same, is also reviewed, in order to facilitate comprehension of attendant organizational complexities.<sup>67</sup> The effect of the exercise of such power and influence on organizational decision making and action are shown to be extremely significant, including: the ability to control information and sanctions (both positive and negative), to mitigate uncertainty, to provide scarce and critical resources, to define what is critical to the organization, and to provide leadership, in each case, as expressed in real and meaningful leadership action.<sup>68</sup> Such essential information cannot be reliably deduced from a corporation's organizational chart, by reason of these matters and by reason of the existence of informal structures, relationships, and even informal organizations, within the focal organization.<sup>69</sup>

The book proposes that significant intraorganizational groups and subgroups should be examined as to whether they constitute intraorganizational organizations, that is, as possessing organizational essentialist attributes; and essays some consideration of this question in the book, with respect to both the board of directors and other organizational components. Such examination and such proposal for examination are thought to be highly original, if not unique. Further research and development of this proposal, both empirically and theoretically, would be required in order to unequivocally substantiate the existence of the organizational organizations. However, conceptual disaggregation of organizations into components consisting of intraorganizational organizations would allow much greater scope for organizational and corporative analysis, as its unit of

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<sup>66</sup> This information appears in various chapters in Part 3, but is particularly concentrated in Chapter Six.

<sup>67</sup> This information appears in various chapters in Part 3, but is particularly concentrated in Chapter Six, especially in the section entitled "Organizational Goals and Intraorganizational Goals".

<sup>68</sup> *Ibid.*

<sup>69</sup> Relevant discussion appears in various chapters in Part 3, most notably in Chapter Five in the section entitled "Organizational Structure".

theorization and investigation would be in much greater supply and may be more amenable to more discriminating theorization and research.<sup>70</sup>

*The Dominant Coalition – Board of Directors and Top Management Team*

Theory and research discussed in the book indicates that the composition of the board of directors, and the top management team, constituting, either individually or collectively, the “dominant coalition” identified by organizational theorists and experts, may, and should, vary with strategic and other influences and developments, both inside and outside the organization.<sup>71</sup> The structure, processes, and personnel (including composition) of that group are shown to be extremely important.<sup>72</sup>

The book examines whether the board of directors can be meaningfully analyzed as an intraorganizational organization and the possible implications of such analysis. As with respect to other intraorganizational groups, such structured analytic examination is thought to be highly original, if not unique. Such examination, which is outlined but not completed in detail in the book, is held to be valuable with respect to the governance of the corporation as a macro-organization.<sup>73</sup>

The question has particular importance with respect to the board of directors, which is the primary actor of, for, and on behalf of, the corporation. Its investigation may identify divergences between the goals of the corporation as organization and those of the board of directors as a constituent group. This may enable consideration of questions such as: whether the board as an intraorganizational organization employs or purports to employ the same superordinate goal or process as the corporation as organization; whether it prioritizes official, operative, actual, instrumental, or ultimate, goals in the same way; how any differences can be managed, contained, or otherwise optimized; and what degree of convergence is required to be achieved. The importance of these issues, which also arise with respect to other intraorganizational groups, is particularly attenuated at the board level.

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<sup>70</sup> Relevant issues are discussed in various places in the text, including in Appendix B in Chapter B3, especially in the sections entitled "Mark Granovetter's Embeddedness" and "Polanyi and Granovetter Compared"; and in Appendix B in Chapter B4, particularly in the sections entitled "Atomistic Utilitarianism" and "Atomism and Methodological Individualism".

<sup>71</sup> See the discussion in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals", most notably under the heading "The Dominant Coalition as Intraorganizational Group".

<sup>72</sup> *Ibid.*

<sup>73</sup> *Supra* note 70.

## **Conclusion – Essentialist Attributes of the Corporation and the Organization Compared**

The book demonstrates that the interrelationship among legal essentialist elements of the modern business corporation provide opportunities for its long-term continuance as a legal entity, provided, of course, that such continuance is facilitated by the history, currency, and future prospects, of its business operations.<sup>74</sup> It demonstrates, too, that organizational essentialist elements of the human organization which animate and vivify the corporation are adaptable, as a matter of rational intentional action or otherwise, to developments in its ambient environment, both externally and internally, so as to facilitate the long-term continuance of the organization, as such organization, and of the corporation as a legal entity.<sup>75</sup>

### **1. THE BREADTH AND SCOPE OF THIS BOOK**

#### **The Corporation and the Economy, Society, Polity, and the State**

This work seeks to situate the corporation within a notional place or space bounded in various ways by the “larger” places and spaces of the economy, the society, the “private” and “public” spheres, the polity, the state, and supranational entities.<sup>76</sup> It demonstrates the notional fluidity, malleability, and even partial fungibility of those “larger” places and spaces as among themselves, and thereby seeks to legitimize the analysis of the place and space of the corporation as “mapping onto” those other places and spaces variously, in whole or in part, and in different respects.<sup>77</sup>

The business enterprise and, in particular, the modern business corporation, is shown to be situated in relation to ambient external and internal environments which are themselves characterized by certain economic, social, private and public, political, statal, transnational, and supranational aspects. Those aspects, it is demonstrated, affect the corporation, both as a legal entity (in its outward-facing, external, or “hard shell” aspect or in its external environment), and as an organization (in its inward-facing, internal, or “inner core” aspect or in its internal environment).

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<sup>74</sup> Supporting references appear throughout Part 3, particularly in Chapters Seven and Ten.

<sup>75</sup> *Ibid.*

<sup>76</sup> See the discussion in Appendix B in Chapters B1, B2, and B3.

<sup>77</sup> *Ibid.*

## The “Black Box” of the Corporation

Assumptions and generalizations of classical and neoclassical economics which underlie treatment of the firm as a “black box” (within which inputs are somehow converted into outputs) and which are not amenable to inquiry within that paradigm are contested, and ultimately rejected, in the book by consideration of other paradigms of economics (including institutional and evolutionary economics), and of other disciplines.<sup>78</sup> These alternative paradigms facilitate “opening”, and inquiring into, that “black box”, which is demonstrated to be the “black box” of the organization.<sup>79</sup> The revealed contents of that “black box”, or, at least, those contents which relate generally to its organizational aspects (as explicated by leading organizational theorists and practitioners), are “mapped onto” that part of its contents which are, more specifically, “legal”, inasmuch as they relate to the firm as a legal entity and, more specifically, to the modern business corporation as a legal entity possessing certain legal essentialist characteristics.<sup>80</sup>

In the course of this inquiry, early organizational theory, such as that of Max Weber, is also challenged, and found to require modification, by organizational theorists and practitioners and by theorists and practitioners in cognate and other disciplines.<sup>81</sup> Analyzing the modern business corporation as an organization reveals the unsoundness of certain assumptions and generalizations (many adopted from classical and neoclassical economics) which prevail with respect to its attributes as a rights-and-duty-bearing entity.

## The Corporative Corporation

### *SLE Status, Limited Liability, and Asset Partitioning*

The book illustrates how business units of a particular corporation, whether divisions or subsidiaries, may act separately from each other, and may even compete with each other, in its

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<sup>78</sup> This is the focus of discussion throughout Part 2 of the book. See, in particular, the discussion in Chapter Two in the section entitled “The Neoclassical Firm is Single Economic Actor”, especially therein under the headings “The ‘Black Boxes’ of Economic Theory”, “The Model of the Firm and Its Lack of Organizational Attributes”, and “The Entrepreneurial Model of the Neoclassical Firm and Economic Action”.

<sup>79</sup> Opening the “black box” of the firm of classical and neoclassical economics occupies much of Parts 2 and 3 of the book.

<sup>80</sup> These examinations are concentrated in Part 2 with respect to organizational aspects, and in Part 3 with respect to the interrelationship of organizational essentialist attributes and legal essentialist attributes.

<sup>81</sup> See the discussions in Chapter Four, especially in the section entitled “Groups of People or Social Units”; and in Chapter Five, particularly in the sections entitled “Structure, Process, and Personnel” and “Organizational Structure”.



external environment, including with respect to markets for sales and for supplies;<sup>82</sup> and also in its internal environment, competing (among other things) for resources, revenue opportunities, and recognition; and that such actions are ordinarily not much affected by status as SLE or otherwise.<sup>83</sup>

On the other hand, SLE status may become significant with respect to business units which are declining or failing. They may be “walled off” into SLEs if not already constituted as such; and may be “walled off” from intensive involvement or interference by higher organizational levels once it is determined that such decline or failure cannot be averted; in which event other business units may be sought to be insulated from the liability of the focal business unit.<sup>84</sup> However, if such higher order involvement antedates such determination, attempts at insulation are less likely to be effective.<sup>85</sup>

### ***Management Ownership Separation and Intraorganizational Decision Making***

Accordingly, for many reasons, some of which are discussed in the book, determining the identity of makers of decisions and the information available to them at the relevant time, such as for the purpose of assigning responsibility or “blame”, likely presents much more substantial difficulties than might otherwise be thought.<sup>86</sup> Decision makers, information, and other relevant determinants may not be situated entirely within the bounds of the focal SLE.<sup>87</sup> Hence, attributing decisions or failures to make decisions to particular individuals and groups, whether for managerial, legal or regulatory purposes, presents difficulties.

Members of business units of the focal corporation are shown to be affected by business unit level identity, commitment, goals, incentives, and disincentives, which are proven to be more powerful

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<sup>82</sup> See the discussion in Chapter Five in the section entitled “History of the Development of the Modern Business Corporation”, most notably under the headings “The Visible Hand: The Managerial Revolution in American Business” and “Administrative or Organizational Development and Economic Theory”; and in Chapter Six in the section entitled “Forms of Corporations – Legal and Organizational Variants”.

<sup>83</sup> See the discussions in Chapter Three in the section entitled “Forms of Corporations – Legal and Organizational Variants”; and in Chapter Six in the section entitled “Organizational Goals and Intraorganizational Goals”.

<sup>84</sup> See the discussion in Chapter Eight in the section entitled “Implications of Organizational Analysis for Limited Liability and Asset Partitioning”.

<sup>85</sup> *Ibid.*

<sup>86</sup> For example, see the discussion in Chapter Five, particularly in the section entitled “Organizational Structure” and therein under the headings “Informal Structure and Relationships” and “Formal Organizations and Informal Organizations”.

<sup>87</sup> *Ibid.* See also the discussion in Chapter Seven, particularly in the section entitled “The Corporation, the Legal Entity, the Organization, and the Participants” and therein especially under the heading “The Borders of the Corporation and the Borders of the Organization”; and in the section entitled “The Separate Legal Entity, the Organization, and the Individual Human Actor” and therein under the heading “Effects of Separate Legal Entity Status on Organizational Structure”.

at lower organizational levels, but such persons are also affected by their higher level equivalents.<sup>88</sup> The effects of informal relationships and even an “informal organization” within the formal organization are also shown to be highly significant. Such relationships and such informal organization may extend far beyond the focal SLE itself, and may include a myriad of SLEs at various organizational levels within the business enterprise owned or controlled by the ultimate parent corporation.<sup>89</sup> Thus, the application of organizational analysis to the modern business corporation not only problematizes much prevailing “legal treatment” of the corporation in discourse and in action, but also presents opportunities for its improvement and increased efficacy.

### ***Management Ownership Separation, Equity Lock-in, and Transferability***

The lock-in of equity capital, its generally free transferability, and the day-to-day independence of management from equity ownership, combined with broad management powers, including powers over return of capital and distribution of earnings, permits corporations to enter into long-term undertakings with considerable freedom from debt and equity holders, markets, and otherwise.<sup>90</sup>

The assignment of broad management powers to the board of directors insulates the board, on a day-to-day basis, from shareholder interference.<sup>91</sup> Shareholders are accorded powers to elect directors, to receive information concerning the corporation, and to express their “voice” at meetings of shareholders and otherwise.<sup>92</sup> However, their rights in respect of corporate operations arise principally in exceptional circumstances, such as the right to approve extraordinary corporate transactions.<sup>93</sup> Because shareholders are not entitled, as such, to participate in day-to-day

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<sup>88</sup> A number of sections of the text are relevant in this regard, including the discussions in: Chapter Four in the section entitled “Groups of People or Social Units”; Chapter Five in the sections entitled “Organizational Structure”, “Organizational Process” and “Organizational Personnel”; Chapter Six in the section entitled “Organizational Goals and Intraorganizational Goals”; Chapter Seven in the section entitled “Separate Legal Entity” and therein under the heading “The Separate Legal Entity, the Organization, and the Individual Human Actor”; and Chapter Eight in the section entitled “Implications of Organizational Analysis for Limited Liability and Asset Partitioning”, especially under the heading “Managers and Other Employees”. See also Chapter Nine in the section entitled “Central Management Independent of Equity Ownership”.

<sup>89</sup> *Supra* note 85.

<sup>90</sup> See the discussion in Chapter Two; and in Chapter Nine in the section entitled “Central Management Independent of Equity Ownership”.

<sup>91</sup> See the discussion in Chapter Three, especially in the sections entitled “Legal and Management-Related Rights of Shareholders” and “Informed Voting by Shareholders”.

<sup>92</sup> *Ibid.* Other shareholder rights are discussed in the section of Chapter A2 entitled “Shareholder Rights Beyond Voting”.

<sup>93</sup> See the discussion in Chapter A2, especially in the section entitled “Legal and Management-Related Rights of Shareholders”. See also Chapter Nine in the section entitled “Central Management Independent of Equity Ownership”.

management of the corporation, their “exit” from equity ownership can normally be effected simply by transfer of their shares, without any adverse effect on its management.<sup>94</sup>

The book argues that information currently available publicly, both from the corporation and from capital market participants, concerning the focal public corporation cannot normally enable parties outside that corporation (and, arguably, even within it) to fully understand the “value drivers” of its businesses, either individually or collectively.<sup>95</sup> These value drivers include considerations relating to its strategy, structure, processes and personnel; namely, relating to its organization.<sup>96</sup>

Consequently, a considerable information asymmetry exists, especially with respect to organizational matters, as between shareholders and management of the corporation.<sup>97</sup> This information asymmetry affects the exercise of certain significant shareholder rights beyond voting in the exceptional circumstances in which they may be available.<sup>98</sup> The exceptional nature of shareholder rights beyond electing directors may also reflect asymmetries of interest as among various corporate participants, including duration of participation,<sup>99</sup> as discussed under the next heading.

Information asymmetries can be reduced by formal and informal communication between the board and TMT with shareholders and prospective shareholders, the “Street” (or the investment community generally), and others.<sup>100</sup> The opportunity to directly exercise such “voice” may be expected, firstly, to reduce the exercise of “exit”, at least if it results from dissatisfaction with management, rather than from other portfolio adjustments; and, secondly, to improve the quality

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<sup>94</sup> See the discussion in Chapter Nine in the section entitled "Central Management Independent of Equity Ownership".

<sup>95</sup> See the discussions in Chapter A2 in the section entitled "Informed Voting by Shareholders"; in Chapter Seven in the section entitled "Separate Legal Entity" notably under the heading "The Corporation, the Legal Entity, the Organization, and the Participants"; and in Chapter Ten in the section entitled "Short-Termism, Long-Termism, and Indefinite Existence", especially under the heading "Short-Termism and Long-Termism – On the Merits" and therein under the subheadings "Balancing Short Term and Long Term Horizons" and "Budgeting and Reporting for the Value of the Organization"; and also under the heading "Short-Termism, Earnings Reporting, and Earnings Guidance".

<sup>96</sup> *Ibid.*

<sup>97</sup> This is discussed, explicitly and implicitly, in numerous places in the book. For example, see the discussions in Chapter Eight in the sections entitled "Limited Liability and Asset Partitioning", particularly under the headings "Asset Partitioning and Policy Considerations"; and "Implications of Organizational Analysis for Limited Liability and Asset Partitioning", especially under the headings "Shareholders", "Board of Directors", and "Officers".

<sup>98</sup> *Supra* note 93.

<sup>99</sup> See the discussion in Chapter Ten, especially in the sections entitled "Interaction of Short-Termism with the Organization" and "Interaction of Short-Termism with Organizational Participants".

<sup>100</sup> This point is made in various portions of the text, including in Chapter A2 in the section entitled "Legal and Management-Related Rights of Shareholders", particularly under the initial headings ending with "Shareholder Exit, Voice, and Loyalty".

of shareholder evaluation of exceptional actions or transactions proposed by management, which may increase support for the same and may decrease support for proposals from shareholders and others with disparate interests.<sup>101</sup>

Importantly, however, a primary determinant of the value of the corporation, and hence the market value of its shares, relates to its ability to: adopt sound objectives; a strategy aligned with their accomplishment; a structure, and process, personnel, and other attributes conducive to the attainment of the same; and to execute such strategy effectively.<sup>102</sup> These are all attributes of the organization as such.<sup>103</sup> They influence attainment of its goals and objectives,<sup>104</sup> which normally include generating adequate profitability to maintain its existence,<sup>105</sup> and, in that connection, satisfying, or one might even say satisficing, the interests of participants sufficient to that end.<sup>106</sup> As the following discussion will indicate, both attainment (on the “upside”) and the avoidance of non-attainment (on the “downside”) of its goals are very much affected by such organizational considerations.<sup>107</sup>

### ***The Indefinite Term of Corporate Existence***

The book demonstrates that organizational continuance is considered to be an existential objective of every organization, including a modern business corporation.<sup>108</sup> As the corporation generally has no limits on the duration of its existence, the corporation, acting by and through its primary actor, its board of directors, could conceivably persist indefinitely, outlasting its immediate participants, although not their successors.<sup>109</sup> Accordingly, the corporation may adopt views of its

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<sup>101</sup> *Ibid.*

<sup>102</sup> Observations to this effect are made in numerous sections of the book, including in Chapter Two in the section entitled "History of the Development of the Modern Business Corporation", particularly in reference to Alfred D Chandler, Jr., under the heading "Strategy and Structure"; in Chapter Five; and in Chapter Nine in the section entitled "Central Management Independent of Equity Ownership".

<sup>103</sup> References to this effect are replete throughout the book, however, Chapter Five is entirely devoted to the subject and places it in appropriate context for the book.

<sup>104</sup> See the discussion in Chapter Two in the sections entitled "The Visible Hand: The Managerial Revolution in American Business", and "Administrative or Organizational Development and Economic Theory".

<sup>105</sup> See the discussion in Chapter Six in the section entitled "Existence and Typology of Organizational Goals and Objectives".

<sup>106</sup> *Ibid.* See also the discussion in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals"; and in Chapter Three in the section entitled "Organizations as Political Systems".

<sup>107</sup> *Supra* note 105.

<sup>108</sup> See the discussion in Chapter Six in the section entitled "Existence and Typology of Organizational Goals and Objectives" and therein under the heading "Existential Goals and Objectives".

<sup>109</sup> See the discussions in Chapter Ten generally, but particularly in the section entitled "Legal and Organizational Context" and therein under the headings "Relation to Other Legal Essentialist Attributes" and "Problems of Intertemporal Choice"; and in Chapter Seven in the sections entitled "The Corporation, the Legal Entity, the

interests which extend far beyond those of present participants, perhaps taking into account the internal and external environments expected to obtain in twenty, fifty, or even one hundred years, from the focal time.<sup>110</sup>

Consequently, these board determinations may take into account the interests not only of present, but also of future: holders of debt and equity; employees; pensioners; suppliers; customers; creditors; places in which it operates; other participants in the ambient economy, society, polity, state, and beyond.<sup>111</sup> The continued success of such corporations, in varying businesses and of varying sizes, is important to the present and future prosperity of the relevant economy, society polity, and state, and vice versa.<sup>112</sup> This is indicated by the consequences, arguably catastrophic, of the failures of massive business corporations, such as Enron Corporation, Lehman Brothers Holdings Inc., and the steps taken to avert the near-failures of other corporations, such as General Motors Corporation, Chrysler Corporation, and The Bear Stearns Companies, Inc. The difficulties of size and reduced tractability which characterize large corporations, the time horizon of their existence unless otherwise truncated, and the depth and dispersal of consequences of their demise or substantial retrenchment of operations should promote caution by the board and others.

Corporate failures such as those mentioned impose costs not only on immediate participants, but also on participants whose involvement is less proximate, not only in relationship, but also in temporal, terms.<sup>113</sup> Of course, the cost-benefit analysis of possible corporate courses of action should take into account not only the positive prospects of success, but also the negative costs of failure and adoption of a new course of action.<sup>114</sup> Treating costs borne by non-immediate participants as externalities may ignore their importance to the ambient economic, social, political,

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Organization, and the Participants" and "The Separate Legal Entity, the Organization, and the Individual Human Actor".

<sup>110</sup> *Ibid.* Of particular note are observations in Chapter Ten in the section entitled "Short-Termism, Long-Termism, and Indefinite Existence" under the heading "Short-Termism and Long-Termism – On the Merits" and therein under the subheading "Intertemporal Decision Making and Indefinite Existence".

<sup>111</sup> *Ibid.* The discussion in Chapter Ten in the section entitled "Short-Termism, Long-Termism, and Indefinite Existence" under the heading "Short-Termism and Long-Termism – On the Merits" and therein under the subheading "Balancing Short Term and Long Term Horizons" is particularly noteworthy in this regard.

<sup>112</sup> This point may seem beyond contention and is noted or assumed in a great deal of academic writing in disparate fields. A particularly useful examination of the relationship between corporate well-being and the well-being of the society and polity from the perspective of corporate strategy is undertaken in: Michael E Porter and Mark R Kramer, "Creating Shared Value" (2011) 89:1/2 Harvard Bus Rev 62, throughout the article, but notably at 66, 68-9, 72, 74, 75, and 77. See "Shared Value, Corporate Strategy, and Corporative Theory" below.

<sup>113</sup> *Supra* notes 111, 112 and 113.

<sup>114</sup> This is a matter of simple logic; however, it is often not taken into account by business management or commentators

statal, and other environments.<sup>115</sup> Across-the-board corporate failures are detrimental to the creation of surplus value and the associated well-being of participants in these various environments.<sup>116</sup>

Accordingly, it can be seen that corporative theory facilitates integrating the theory of the corporation more closely with, firstly, prevailing notions of corporate social responsibility; and, secondly, with the corporation's ambient economic, social, political, statal, transnational and supranational environment.

### **The Distinctiveness of the Corporative Corporation**

In this and other chapters of the book, reference has been made, from time to time, to stakeholder theory,<sup>117</sup> and to team production theory,<sup>118</sup>, principally in support of corporative theory. Those theories have been distinguished from corporative theory insofar as those theories are principally concerned with the economic interests of those parties whom corporative theory identifies as being simultaneously legal counterparties and organizational participants. It is not the intention here to discuss those theories except for the purpose of differentiating them from corporative theory in that particular.

#### ***The Stakeholder Corporation Distinguished***

As reported by Freeman and Reed,<sup>119</sup> prominent (and early) exponents and developers of stakeholder theory,<sup>120</sup> the word "stakeholder" was "coined in an internal memorandum at the

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<sup>115</sup> Porter and Kramer comment that commoditization of input factors and exerting maximum bargaining power of suppliers to drive down prices may strike down the productivity of such suppliers and the quality of their products and services to the ultimate detriment of both parties. *Supra* note 113 at 70.

<sup>116</sup> *Ibid.*

<sup>117</sup> See, in particular, the discussion in Chapter Seven in the section entitled "Separate Legal Entity", and, especially, under the heading "The Corporation, the Legal Entity, the Organization, and the Participants", and therein under the subheading "Organizational Participants, Stakeholders, and Corporate Social Responsibility". The notes to the text provide references to some of the significant literature on stakeholder theory. See also the discussion in that chapter in the same section under the heading "Legal Structure, Organizational Structure, and Value of a Diversified Enterprise".

<sup>118</sup> See, in particular, the discussion in Chapter Eight in the section entitled "Implications of Organizational Analysis for Limited Liability and Asset Partitioning" and, especially, under the heading "Board of Directors" and therein under the subheading "Board as Mediating Hierarch".

<sup>119</sup> R Edward Freeman and David L Reed, "Stockholders and Stakeholders: A New Perspective on Corporate Governance" (1983) 25:3 California Management R 88.

<sup>120</sup> One commentator refers to Freeman's "seminal piece", RE Freeman, *Strategic Management: A Stakeholder Approach* (Boston: Pittman: 1984). See Timothy J Rowley, "Moving Beyond Dyadic Ties: A Network Theory of Stakeholder Influences" (1997) 22:4 Academy Management R 887 at 887.

Stanford Research Institute in 1963”<sup>121</sup>, to refer to “those groups without the support all of which the organization would cease to exist”, a list of which originally included “shareholders, owners, customers, suppliers, lenders, and society.”<sup>122</sup>

Freeman and Reed propose that the term is used in a “wide sense”, meaning any identifiable group or individual who can affect the achievement of an organization’s objectives or who is affected by the achievement of an organization’s objectives”, including, in the wide sense of the term “public interest groups, protesters, government agencies trade associations, competitors, unions, employees, customer segments, shareowners and others”.<sup>123</sup> Their “narrow sense” of the term is “any identifiable group or individual on which the organization is dependent for its continued survival”, including “employees, customer segments, certain suppliers, key government agencies, shareowners, certain financial institutions, as well as others”.<sup>124</sup>

Whichever sense of the term is applied, stakeholders generally exercise power or influence in relation to the corporation which is primarily and directly economic, although some, such as governments and consumer groups,<sup>125</sup> have power or influence which Freeman and Reed describe as “political”, but which has economic manifestations, Of course, both senses of the term, but most particularly the narrow sense, engages the “resource dependence” perspective of strategy as discussed earlier in this book.<sup>126</sup> Except for the focus on purely economic interests, stakeholder analysis, perspective, or theory has certain commonalities with its corporative counterparts. However, even stakeholder formulations which acknowledge that, in the course of balancing stakeholder claims, firms may adopt social objectives, as well as economic objectives, generally are seen to consider social objectives solely as a “secondary modifying and constraining influence” on its economic objectives, which are considered primary.<sup>127</sup>

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<sup>121</sup> *Supra* note 120 at 89.

<sup>122</sup> *Ibid.*

<sup>123</sup> *Ibid* at 91.

<sup>124</sup> *Ibid.*

<sup>125</sup> *Ibid* at 94.

<sup>126</sup> See, in particular, the discussion in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals", especially under the heading "Intraorganizational Goals, Power, and Loyalty" and therein under the subheadings "Theories of Intraorganizational Power", "Distribution of Intraorganizational Power – Formal and Informal", "Intraorganizational Politics", "The Dominant Coalition as Intraorganizational Group", "Organizational Goals and Corporate Operations" and "Goals of Corporations".

<sup>127</sup> *Supra* note 120 at 89. The authors make particular reference in this regard to: Igor Ansoff, *Corporate Strategy: An Analytic Approach to Business Policy for Growth and Expansion* (New York: McGraw-Hill, 1965) at 33-35.

In the early 1970s Harvard Business School undertook a project examining how the corporation can “respond proactively to the increased pressure for positive social change”, linking analysis of social issues with corporate strategy and organization, which it called “the corporate social responsiveness model.”<sup>128</sup> In 1977, The Wharton School began a “stakeholder project” to enable executives “to formulate and implement corporate strategy in turbulent environments.”<sup>129</sup> Both initiatives focused on potential or actual impact on the corporation. Indeed, Freeman and Reed maintain that it is “arguable whether responsiveness to nonmarket stakeholders is in the long-term interest of the corporation”; instead, appealing to the corporation’s enlightened self-interest as a reason for taking stakeholder concerns into account, rather than appealing to “utilitarian notions of greatest social good or altruism or social responsibility.”<sup>130</sup> The economic focus is clear.

Although they do not, of course, analyze the corporation as simultaneously implicating a legal entity and an organization, as does corporative theory, many leading commentators on stakeholder theory definitely approach the corporation from an organizational perspective. Indeed, Freeman and Reed acknowledge that their analysis applies to all types of organizations, such that “throughout our analysis one may substitute “organization” for “corporation,” since other organizational forms have stakeholders as well.”<sup>131</sup> Rowley argues that organizations must address a set of stakeholder expectations, requiring identification of the identity and types of influence exerted by such stakeholders; and that a stakeholder theory of the firm must also generate an understanding of how firms respond to these influences.<sup>132</sup> In addition to resource dependence constraints, organizations are subject to institutional, including governmental, constraints, and to network effects, including those relating to the density and centrality of its relationships.<sup>133</sup>

Of course, corporative theory considers both legal relationships involving legal expectations as between the corporation and its various counterparties, and organizational relationships involving expectations among the organization and its various organizational participants. Rowley argues that explaining how organizations respond to their stakeholders requires “an analysis of the

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<sup>128</sup> *Ibid* at 90. They reference its output as including: R. W. Ackerman, “How Companies Respond to Social Demands” (1973) 51:4 Harvard Business Review; R. W. Ackerman, *The Social Challenge to Business* (Cambridge, MA: Harvard University Press, 1975); and R. W. Ackerman and R. A. Bauer, *Corporate Social Performance: The Modern Dilemma* (Reston, VA: Reston, 1976), as well as other books and articles.

<sup>129</sup> *Supra* note 120 at 91.

<sup>130</sup> *Ibid* at 106 (in note 28).

<sup>131</sup> *Ibid* at 104 (in note 6).

<sup>132</sup> Rowley, *supra* note 121 at 889-890.

<sup>133</sup> *Ibid*, especially at 892-895 and 895-900.



complex array of multiple and interdependent relationships existing in stakeholder environments”,<sup>134</sup> which is consistent with corporative theory. Most, if not all of the parties identified by stakeholder theory as “stakeholders” or by corporative theory as simultaneously “legal counterparties” and as “organizational participants” make some contribution to value creation, either by positive action or by not taking negative action.<sup>135</sup>

To somewhat similar effect, this book has maintained that the “legal” and the “organizational” relationships in which the corporation finds itself, that is to say, its “environment” or the “place and space” which it occupies must be assessed on a multivariate basis, taking into account all such relationships, particularly those essential to its legal and to its organizational status.<sup>136</sup>

Also consistent with corporative theory is the observation of Freeman and Reed that the role of the board of directors in “stakeholder management”, analogous in corporative theory to counterparty/organizational participant management, not only involve situations of “typical ‘us against them’ confrontation” but also to cases “where it is much harder to see ‘us’ and ‘them’.”<sup>137</sup> In corporative theory, questions may arise about “which us is us” and “which them is them”, given that each individual party other than the corporation is separate and distinct from it, both legally and organizationally.

### ***The Team Production Corporation Distinguished***

In their seminal paper on the subject, Margaret Blair and Lynn Stout treat team production as a purely economic phenomenon “where a productive activity requires the combined investment and coordinated effort of two or more individuals or groups”.<sup>138</sup> As an early serious attempt by economists to explore the issue, they reference<sup>139</sup> another seminal paper by Herman Alchian and Harold Demsetz, in which team production was defined, in effect, as production in which several

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<sup>134</sup> *Ibid* at 890.

<sup>135</sup> Lenore Palladino and Kristina Karlsson, "Towards "Accountable Capitalism": Remaking Corporate Law through Stakeholder Governance" Roosevelt Institute Issue Brief (New York: Roosevelt Institute, 2018) at 14. Available at: <http://rooseveltinstitute.org/wp-content/uploads/2018/10/Towards- 'Accountable-Capitalism'-issue-brief-1.pdf>.

<sup>136</sup> See, in particular, the discussion in Chapter Ten in the sections entitled "The Corporation, the Legal Entity, the Organization, and the Participants" and "The Separate Legal Entity, the Organization, and the Individual Human Actor". The chapters following also give effect to this principle.

<sup>137</sup> *Supra* note 120 at 101.

<sup>138</sup> Margaret M Blair and Lynn A Stout, "A Team Production Theory of Corporate Law" (1999) 85:2 Va L Rev 247, at 249.

<sup>139</sup> *Ibid* at 265.

types of resources are used, the product is not a sum of separable outputs of each cooperating resource, and not all resources used in such production belong to one person.<sup>140</sup>

Blair and Stout also reference<sup>141</sup> a 1982 paper by Bengt Holmstrom which concluded that it was impossible for a monitor seeking to write an employment contract with an agent to design a contract that prevented shirking the agent's duties while still allocating all of the joint output from team production to members of the team.<sup>142</sup> They argue that horizontal interactions among team members, not just the principal-agent relationship, contribute significantly to, and are perhaps the most important source of, the economic gains to be derived from team production.<sup>143</sup> Following Rajan and Zingales,<sup>144</sup> Blair and Stout argue that parties, each of whom make an irrevocable commitment of resources to a joint enterprise at least some of which is specific and non-transferable, may cede control over those resources and all outputs to a third party who does not make any firm-specific investment, but mediates disputes among team members about the allocation of duties and rewards as a kind of mediating hierarch.<sup>145</sup> In the case of the public corporation, all rights to the resources and outputs are owned by the corporation, but control is exercised by the board of directors, which makes decisions on its behalf.

Participants in the public corporation, "including shareholders, employees, and perhaps other participants such as creditors or the local community – enter into a "*pactum subjectionis*" under which they yield control over inputs and key outputs (time, intellectual skills, financial capital) to the hierarchy", and thus agree not to specific terms or outcomes "but to participate in the process of internal goal setting and dispute resolution", "that is especially useful in situations where team production requires several different team members to make various kinds of enterprise-specific investments and projects that are complex, ongoing and unpredictable."<sup>146</sup> This accords with the arguments made in Chapter Eleven of the present book which construed the firm as a socio-political conflict system in which joint preference ordering was achieved by means of a

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<sup>140</sup> Armen A Alchian and Harold Demsetz, "Production, Information Costs, and Economic Organization" (1972) 62 *American Economic Rev* 777 at 79.

<sup>141</sup> *Supra* note 139 at 268.

<sup>142</sup> Bengt Holmstrom, "Moral Hazard in Teams" (1982) 13 *Bell J Economics* 324, at 325-328.

<sup>143</sup> *Supra* note 139 at 269-270.

<sup>144</sup> Raghuram G Rajan & Luigi Zingales, "Power in the Theory of a Firm" (1998) 113:2 *Quarterly J Economics* 387.

<sup>145</sup> *Supra* note 139 at 275-279.

<sup>146</sup> *Ibid* at 278.

superordinate process, namely, board decision-making, rather than by means of a superordinate goal.<sup>147</sup>

As discussed under the immediately preceding heading “Stakeholder Theory”, both that theory and team production theory differ from corporative theory in that the interests addressed by those theories are primarily, if not exclusively, economic in their nature. Corporative theory, which engages with the organization as an organization, recognizes other goals and objectives, interests, and values.

### **Implications of Corporative Theory**

As shown in the book, research and theorization concerning the organization and, in particular, the business organization, in many disciplines and fields has generated significant knowledge concerning organizational behaviour and effectiveness, which organizational analysis is available to assist not only those involved in its management, but also those analyzing issues concerning the corporation as a legal entity. Such corporative analysis has implications for corporations, their boards, CEOs and top management teams; for regulators, legislators, and courts seeking to promote, restrain, or adjudicate certain corporate behaviours; and for legal academics and practitioners seeking to make sense of modern business corporations, their operations, and their behaviour.

If corporations are expected to generate surplus value which benefits the society, the polity, and the state, then academics, practitioners, legislators, jurists, and regulators of corporate law and governance must recognize the corporative nature of the modern business corporation, as implicating both an incorporeal separate legal entity and the organization which animates and vivifies it as an actor in the real world. The legal essentialist attributes of the corporation and how they are affected by the essentialist attributes of organizations require knowledgeable and prudent investigation and analysis. This constitutes a distinctly “legal” endeavour. It is highly appropriate that investigation of these issues and of their significance as a matter of law not be ignored by those who are best placed to appreciate their legal import and attendant consequences.

This work maintains, therefore, that the corporative theory of, or approach to, the modern business corporation which it sets forth explicates the dual nature of the modern business corporation as

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<sup>147</sup> See the discussion in Chapter Three, especially in the sections entitled “Barriers to Unified Action” and “Organizations as Political Systems”.

both a legal entity and an organization and thus contributes to understanding it. Moreover, the corporative theory or perspective also provides valuable and useful hypotheses in such analysis; and can also be used to delineate the contours of the “toolkit” required for its further investigation. It is hoped that the corporative theory or corporative perspective outlined in this book will stimulate further investigation, research, and theorization along these lines. The author looks forward to participating in those endeavours.

Future work planned by the author in this regard includes corporative analysis of such subjects as: the history of the business corporation from ancient Greece and Rome to the present; the “short termism and long termism” debate; shareholder activism; the structure, composition, processes, and behaviour of, and “best practices” for, boards of directors; corporate social responsibility; corporate and personal liability for criminal and administrative offenses and other actions; and the future of the modern business corporation. For such future discourse, the present work articulates a foundation.

### **WHY NOW? CHALLENGES TO CAPITALISM AND TO THE CORPORATION, AND THE RESPONSE OF CORPORATIVE THEORY**

This book has been organized into three sections. The first of these asks: What is? What is the law concerning corporations and corporate governance today? The second section asks: Why this? Why is the law the way it is? What assumptions and generalizations underlie it? The third section asks: How can the corporation be analyzed? And how should it best be analyzed? It proposes the corporative theory of, or perspective on, corporate law and corporate governance for this purpose. The book’s answers to these first three questions have been summarized in the first part of this conclusory chapter.

Yet, as this book concludes, it is appropriate to ask another related question: Why now? What makes corporative analysis timely and useful? What conversations does it join and how can it meaningfully contribute to them? This final section of the concluding chapter identifies, by way of example, a number of contemporary developments and issues that implicate the corporation, and indicates how corporative analysis can contribute to discussion and resolution of the same.

## CHALLENGES TO CAPITALISM AND THE CORPORATION

### Contemporary Challenges to Capitalism

Challenges to capitalism are contemporaneous, critical, and continuing. In 2011, Michael Porter and Mark Kramer noted that “The capitalist system is under siege. In recent years business increasingly has been viewed as a major cause of social, environmental, and economic problems. Companies are widely perceived to be prospering at the expense of the broader community.”<sup>148</sup>

### *Challenges to Society and the Polity*

At the same time, global issues of climate change and the environment and transnational flows of goods and services, people, and resources now present challenges, many of which exist quite independently of the behaviour of corporations, addressing some of which are beyond, not only their capacity, but also the capacity of nation states. Planned and possible solutions to these problems involving nongovernmental organizations and international organizations have been threatened by difficulties in securing the necessary agreements of the underlying nation states, in part because of challenges to their economic well-being, particularly in the aftermath of the Financial Crisis of 2008, and in part because of problems in sustaining the democratic welfare state and the “administered market” of 20th and post-20th-century (“contemporary”) capitalism.

These developments have implications at the levels of society and at the level of the polity. Increasingly, the prevalence of short-termism has been noted, not only in the financial community with respect to financial investments and the economy more generally,<sup>149</sup> but also in the ambient society and polity. In Great Britain, The Oxford Martin Commission for Future Generations (“Oxford Martin Commission”), considered what it described as “the increasing short-termism of modern politics” accompanied by “our collective inability to break the gridlock which undermines attempts to address the biggest challenges that will shape our future.”<sup>150</sup> These risks, challenges and opportunities present themselves simultaneously in, and responses must engage, economic, social, and political aspects of those phenomena.

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<sup>148</sup> *Supra* note 113 at 64.

<sup>149</sup> See the extensive discussion in Chapter Thirteen.

<sup>150</sup> The Oxford Martin Commission for Future Generations, *Now for the Long Term: The Report of the Oxford Martin Commission for Future Generations* (Oxford, United Kingdom: Oxford Martin School, University of Oxford, October 2013) [*Oxford Martin Report*] at 6.

Part 2 and Appendix B of the present work establish that certain generalizations and assumptions of classical and neoclassical economics can no longer be regarded as accurate or useful, such as: the separation of economic, social, political functions; the situation of the economy and the “private” sphere, the actual and analytical separation of the “private” and “public” spheres; the distinctive mode of analysis of the economy; and the distinctiveness and independence of the economy from the society and the polity.<sup>151</sup> Instead, it was established that the economy is “embedded in” the society and the polity. Indeed, it could even be argued that the economy, the society and the polity are “embedded in” each of the others.<sup>152</sup>

As a result, human activity cannot be disaggregated into elements which are exclusively “economic”, or “social”, or “political”. Rather, many human activities can be regarded as simultaneously instantiating economic, social, and political behaviour, goals, and objectives. Human behaviour is not solely utilitarian in its objective or operation, nor is “utility” determined by atomistic individuals acting independently, wholly rationally, and with complete information.<sup>153</sup> This is equally true with respect to behaviour which may be characterized as significantly “economic”, “social”, or “political” in its orientation. Consequently, finding solutions to problems caused by human activity, as well as responding to challenges and opportunities presented by such activity, call for holistic approaches.

In this regard, the Oxford Martin Report observed that: “As the world slowly emerges from the devastating Financial Crisis, it is time to reflect on the lessons of this turbulent period and think afresh about how to prevent future crises.”<sup>154</sup> It concluded that “humanity is at a crossroads. This could be our best century ever, or our worst. The outcome will depend on our ability to understand and harness the extraordinary opportunities as well as manage the unprecedented uncertainties and risks.”<sup>155</sup> This observation relates to the fourth question asked by the present book: Why now? Why must we seek a new paradigm that simultaneously explains and operationalizes the corporation in the economy, society, and polity? The Oxford Martin Report answers this, in effect, by saying: Because we must. We cannot delay.

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<sup>151</sup> The text in Appendix B, in Chapters B1, B2, and B3, advances these discussions.

<sup>152</sup> The “embeddedness” of the economy in the society and the polity is discussed in Appendix B in Chapter B3.

<sup>153</sup> This is the subject of discussion in Appendix B, Chapters B4 and B5.

<sup>154</sup> *Supra* note 151 at 6.

<sup>155</sup> *Ibid.*

### *Challenges to, and the Blaming of, the Corporation*

Retrenchment of the operations of, and confidence in, corporations doing business at transnational, national, regional, and local levels and corresponding changes in the economy, society and polity are considered to have resulted in part from the Financial Crisis and its aftermath,<sup>156</sup> in part from the transformation of the generation of supply of products and services involving technological change (which appears, according to Belenzon et al. to be intensifying over time)<sup>157</sup> employing computers and the Internet (a kind of subsequent post-industrial revolution, or Second or Third Great Transformation),<sup>158</sup> and in part from challenges to the spirit and ethos of late 20th century capitalism, which seemed to give rise to a new post-modern or contemporary capitalism.<sup>159</sup> Julian Birkinshaw compares the impact on work and society of the technological transition from the “industrial era” of the recent past to the “digital era” of the present as “equally profound” as the earlier transition from the preindustrial to the industrial era.<sup>160</sup>

In the new millennium, cries arose for a new order which would be determined to restrain what was seen as the worst excesses of a system which appeared to have resulted in “gaming” the system during the Financial Crisis, iterative periods of massive corporate failures, widespread unemployment and underemployment, creation of excessive wealth in a relatively few hands (partly as a result of the development and introduction of transformational technologies), and income and wealth disparities which not only followed a period of relative prosperity shared by a broad middle class, but which actually exceeded those disparities seen during much of, and arguably even beyond, the preceding century.

Very recently, The British Academy published a document in November 2018 setting forth a framework entitled “Reforming Business for the 21st Century: A Framework for the Future of the Corporation” (the “Framework”).<sup>161</sup> This reported on the first phase of its project entitled “The

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<sup>156</sup> Sharon Belenzon, Assaf Hamdani, Niron Hashai, Eugene Kandel, and Yishay Yafeh. "Technological Progress and the Future of the Corporation (2018) (forthcoming) 6(s1) J British Academy at 19.

<sup>157</sup> *Ibid* at 3. See also *supra* note 119 at 6.

<sup>158</sup> Julian Birkinshaw, "How is Technological Change Affecting the Nature of the Corporation?" (2018) (forthcoming) 6 (s1) Journal of the British Academy at 5. See also the discussion in Chapter Ten of this book in the section entitled "History of the Development of the Modern Business Corporation".

<sup>159</sup> Such capitalism has variously been viewed as "a return to the robber barons" of the early 20th century and, in effect, as "financialized" capitalism.

<sup>160</sup> *Supra* note 159 at 3.

<sup>161</sup> The British Academy, *Reforming Business for the 21st Century: A Framework for the Future of the Corporation* (London: The British Academy, November 2018). A number of the research papers prepared for the Framework are referenced in the present chapter, including: Belenzon et al, *supra* note 126; and Birkinshaw, *supra* note 128.

Future of the Corporation”, which it describes as “one of the most ambitious programs of research and undertaken to date on the current state and future prospects of business.”<sup>162</sup> The fact that it is the British Academy which is sponsoring the project is highly significant. It is the United Kingdom’s national body for the humanities and social sciences and, accordingly, engages with academics in diverse subject-areas.

The British Academy has recognized that business is not alone in being confronted by various economic, environmental, political and social challenges, and scientific and technological opportunities, the implications of which challenges and opportunities require to be researched.<sup>163</sup> The British Academy observes that such research “is vital now because of people’s concerns about rising inequality, increasing globalization, declining trust and the impact that new technologies will have on employment” and because the solutions proposed separately by governments and by business differ, and “have been found wanting”, making appropriate “a debate about the way in which business will be conceived, managed and regulated over the coming decades.”<sup>164</sup>

The British Academy has concluded that “the proposition that the purpose of business is to increase its profit, with the rules of the game preventing excesses, is not sufficient for the 21st century.”<sup>165</sup> The “profit as sole purpose” proposition, of course, has been challenged in the present work.<sup>166</sup> The Framework claims that the perspective developed in the first stage of its research program, undertaken by 31 academics from the humanities and social sciences with guidance from 25 business leaders, “lays the foundation for a radical reformulation of the concept of the firm,”<sup>167</sup> and “sets out a new framework for business in the 21st century”, as part of a program “which aims to contribute to redefining business in the 21st century and building trust between business and society.”<sup>168</sup> It is apparent from anecdotal observation that many members of society and the polity

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<sup>162</sup> *Ibid*, Colin Mayer (Academic Lead), "Foreword: A Radical Reformulation of the Concept of the Firm" at 5. Examinations of various aspects of this problem are discussed later in this chapter in the section entitled "Contemporary Responses to Challenges", particularly under the heading "Initiatives to Recognize and Report "Value Drivers" of Contemporary Corporations".

<sup>163</sup> *Ibid*.

<sup>164</sup> *Supra* note 162, Sir David Cannadine, "Preface", at 3.

<sup>165</sup> *Supra* note 162 at 10.

<sup>166</sup> See the discussions in Chapter Nine in the section entitled "Existence and Typology of Organizational Goals and Objectives", and therein especially under the heading "Existential Goals and Objectives"; and in the section entitled "Organizational Goals and Intraorganizational Goals", and therein particularly under the heading "Goals of Corporations"; and in Chapter Six in the section entitled "Organizations as Political Systems".

<sup>167</sup> *Supra* note 162.

<sup>168</sup> *Supra* note 165.



in countries having highly developed economies agree with the need for such reformulation. The extent to which this foundation is, or can be, so laid remains open.

Corporations, seen as the paradigmatic vehicle of the pursuit of capitalism, have been widely attacked as monomaniacal entities or anthropomorphized “creatures” or “artificial persons” devoted solely to the pursuit of “their own” maximum profit and wealth, irrespective, and to the exclusion, of other goals and interests, societal, national or otherwise.<sup>169</sup> As noted previously, this view persists, at least partly involving the anthropomorphization of the corporation, which is facilitated by its (mis)description as a “legal person”, instead of simply referring to it as a legal entity or “rights-and-duty-bearing entity”, as argued in Chapter One of this book. Instead, the present work has established that corporations also constitute organizations: namely, social units or groups of persons collaboratively carrying out certain activities with a view to accomplishing certain common goals and objectives; the individual human actors participating in which also engage in various extraorganizational activities in pursuit of other goals and objectives.<sup>170</sup>

As individual human beings, organizational participants bring with them to the organization all of their individual human attributes, including needs for affiliation, society and community, some of which needs are pursued within the organization, and others without it.<sup>171</sup> As noted earlier in this chapter, the organization of human individuals which enables the corporation as a legal entity to take action in the real world has certain economic objectives (which are by no means realistically epitomized as “maximizing profit at all costs”);<sup>172</sup> but, in respect of its organizational essentialist characteristics, is similar to, or even identical with, other organizations having different objectives, such as universities, labour unions, fraternal benefit societies, religious organizations, charitable, philanthropic and eleemosynary institutions.<sup>173</sup>

Concerns about excessive “financialization”, the commodification of corporate shares, separate and apart from the underlying rights and obligations which they represent vis-à-vis the corporation

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<sup>169</sup> An articulate exposition of such a position is Joel Bakan, *The Corporation: The Pathological Pursuit of Profit and Power* (Toronto: Penguin Canada, 2004).

<sup>170</sup> See the discussion in Chapters Four through Six inclusive.

<sup>171</sup> *Ibid.* These subjects are discussed most particularly in Chapters Four and Five.

<sup>172</sup> See the discussion above in the section entitled “Corporativity – Theory and Perspective” and therein under the heading “Legal Entity and Organization”.

<sup>173</sup> See the discussion in Chapter Four in the section entitled “Groups of People or Social Units” particularly with respect to the observations of Max Weber in this regard. See also Chapter Five in the section entitled “Structure, Process, and Personnel”.

itself, and the related generation of profits and income unrelated to corporate and social productivity, among other things,<sup>174</sup> have been identified as quintessential examples of “gaming” the system and rewarding unproductive or even counterproductive behaviour. Such concerns have been accompanied by a considerable debate over long-termism and short-termism, both as related to buying and selling shares, and as such trading affects corporate operations.<sup>175</sup>

In turn, that debate among managers, owners, and corporations and other business entities issuing and creating financial assets, has led to consideration of issues relating to the nature and purpose of the corporation, the interests of the corporation and its legal counterparties and organizational participants, and the concomitant interests of the society and polity, in each case over very lengthy periods of time.<sup>176</sup>

### **New Paradigm Corporations**

As the transnational economy and individual national economies transformed from producing and generating products and services to now developing and promoting “disintermediation” mechanisms relating to such products and services and new “digital” products and services,<sup>177</sup> the scope and scale of business organizations has likewise changed:<sup>178</sup> principally, from massive multinational enterprises involving considerable financial capital and “hard assets” (often involving world production mandates) which previously dominated business activity (to the extent that about 80% of the capital of US corporations was represented by tangibles),<sup>179</sup> very often to enterprises and even “virtual” enterprises (some small or medium-size and others extremely large) involving little financial capital and little property, plant and equipment (types of “manufactured capital”) and other tangible capital, but whose reason for being and whose competitive advantage, if any, significantly involves intellectual or ideational productivity and different kinds of capital

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<sup>174</sup> This broad definition of the term “financialization” comports with that of Greta R Krippner, “The Financialization of the American Economy” (2005) 3 Socio-Economic Rev 173 at 174, as: “a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production”.

<sup>175</sup> See the discussion in Chapter Ten in the section entitled “Short-Termism, Long-Termism, and Indefinite Existence”.

<sup>176</sup> *Ibid.*

<sup>177</sup> *Supra* note 157 at 2, 3. See the discussion of “platform” businesses later under the present heading.

<sup>178</sup> Belenzon et al. also suggests that it is not possible to predict the effects of technology on such matters in the future. *Supra* note 157 at 22.

<sup>179</sup> Colin Mayer, “Reinventing the Corporation” (2016) 4 J British Academy 53 at 54.

development and deployment than has been the case previously. These corporations are sometimes referred to here as “new paradigm corporations” or “NPCs”.

On the other hand, many digital technology firms are extremely large. Julian Birkinshaw indicates that “the emergence of tech giants has highlighted the superiority of platform-based business models” that bring users and providers of services together more efficiently, described here as a species of disintermediation, compared to hierarchical or traditional linear business models, at least “in markets for digital goods”.<sup>180</sup> These include products or services that are “primarily digital”, such as music, movies, books, games, and news, and physical products that are “digitally enabled”, such as cars, telephones, and homes.<sup>181</sup>

In effect, the massive size of some corporations today has been influenced by the fact that: digital products “are susceptible to network effects, whereby the value experienced by when user increases as the number of other users increase”; they often have “greater switching costs for users”; they are “non-rivalrous” in the sense that “many people can use the same product or service at the same time” (indicating, at least to this author, a very high limitation on output); they are often “co-created” with users; and there is no point at which economies of scale diminish, thereby effectively limiting the size of firms.<sup>182</sup>

Technology, including artificial intelligence, has become increasingly sophisticated to the point that “digital technology is gradually replacing large number of jobs that were traditionally being done by humans.”<sup>183</sup> Platform businesses, digital firms, and other NPCs threaten patterns and structures of traditional employment and present a challenge to redeploying human economic effort into alternate channels of activity.

Birkinshaw finds that “the trend towards computer-based automation... is likely to result in wide-scale unemployment”, incited by competitive pressures.<sup>184</sup> Revenue per employee at digital firms such as Uber, Apple and Google is approximately twenty times higher than at traditional firms such as Starbucks or McDonald’s.<sup>185</sup> Accordingly, digital firms are much less sensitive in terms

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<sup>180</sup> *Supra* note 159 at 2.

<sup>181</sup> *Ibid* at 6.

<sup>182</sup> *Ibid* at 7.

<sup>183</sup> *Ibid*.

<sup>184</sup> *Supra* note 159 at 2 and at 21.

<sup>185</sup> *Ibid* at 8.

of revenue and perhaps other financial metrics than are traditional firms to cutbacks or other declines in their workforce. In the result, they may be more willing to undertake such measures.

Birkinshaw explains, further, that platform businesses, which involve a “platform” or “a technological interface that mediates transactions between two or more sides” differ from traditional businesses in that they, firstly, “offer increasing returns to scale” and are often “winner takes all” businesses; and, secondly, “often operate in a very low-cost way, with few assets”.<sup>186</sup> He segments “digital firms” into “pure digital firms”, such as Facebook and Uber; platform-enabled firms, such as Amazon and Apple; traditional firms selling digital products, such as The Financial Times and Experian; and digital service providers, such as Oracle and TCS, “who build the infrastructure and services that enable digital firms to function”.<sup>187</sup>

### **New Paradigm Corporations and Traditional Corporations Compared**

Belenzon et al. opine that “corporations today find themselves threatened by disruptive technological changes that jeopardize the very existence of some companies, while forcing others to adopt new technologies and business practices to join the revolution rather than be buried by it.” Yet “technology giants - some of them are newcomers - seem to grow stronger every year, threatening many industries.”<sup>188</sup>

As a result, “traditional firms are also going out of business more often than they used to. Studies have shown that a firm’s “lifespan” on the S&P 500 has dropped from 35 years to about 15 years over the last 30 years. And the number of high-profile bankruptcies, especially in the retail and technology sectors, is on the rise.”<sup>189</sup> Birkinshaw argues that “while this process of creative destruction is ultimately good for society, the short-term costs when large firms downsize or even go out of business are huge.”<sup>190</sup> The effect of such new and disruptive technologies,<sup>191</sup> of course, is not only felt by corporations and their employers but, more broadly, by the economy, society, and the polity in terms of increasing structural and other unemployment, as lately experienced.

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<sup>186</sup> *Ibid.*

<sup>187</sup> *Ibid* at 6. See also discussion at 8.

<sup>188</sup> *Supra* note 157 at 3.

<sup>189</sup> *Supra* note 159 at 9.

<sup>190</sup> *Ibid* [reference omitted]. Of course, he cites Schumpeter with respect to his concept of “creative destruction”: Joseph A Schumpeter, *The Theory of Economic Development* (Cambridge, MA: Harvard University Press: 1934).

<sup>191</sup> Clayton Christensen, *The Innovator's Dilemma: When New Technologies Cause Great Firms To Fail* (Cambridge MA: Harvard Business Review Press, 1997).

Some observers conclude that digital firms and NPCs generally are changing their thinking about goals and objectives. Birkinshaw claims that they are frequently experimenting with alternatives to “linear alignment”, or “defining an intended outcome, say five years into the future, and then [defining] the specific plans and targets for all the various parts of the firm over the coming years, to ensure that outcome is achieved.”<sup>192</sup> However, “the state of flux in the marketplace makes it very hard to commit to explicit long-term targets” and reduces the scope of action of intraorganizational participants, with the result that “many digital firms are using more fluid objective-setting procedures, and relying on broad expressions of purpose to generate coherent activity from their employees”, a principle referred to as “obliquity”, which is “the notion that goals are often best achieved when pursued indirectly.”<sup>193</sup> This conclusion is highly suspect. As argued in this book, external environments which are highly volatile require more frequent and more significant adaptations to the strategy of industry participants, which can be highly effective when employing extensive information and adapting strategic and tactical plans accordingly.<sup>194</sup>

Technological innovation has also dramatically reduced information asymmetries. It permits information to be aggregated and disaggregated more readily and to be made available more readily at different levels of the organization. This may result in certain information that previously might have been “winnowed out” by personnel at lower levels to reach and to receive consideration at higher levels. Extant information can also be verified at such levels. Similarly, information previously maintained only at higher levels of the organization may, in some cases, be available for access at lower levels. This may subject decisions made at higher levels to challenge at parallel or lower hierarchical levels of the organization. It also facilitates collective decision making.<sup>195</sup>

### **New Capital, Value-Drivers, and Reporting**

It is increasingly acknowledged that these new paradigm corporations are much more dependent than traditional corporations upon intangibles, including what The International Integrated

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<sup>192</sup> *Supra* note 159 at 12.

<sup>193</sup> *Ibid.* He cites: John Kay, *Obliquity: Why Our Goals are Best Achieved Indirectly* (London: Profile Books, 2011.)

<sup>194</sup> A classic exposition appears in Kathleen M Eisenhardt, "Making Fast Strategic Decisions in High-Velocity Environments" (1989) 32:3 *Academy Management J* 543. The effect of power and influence in such environments is investigated in Kathleen M Eisenhardt and LJ Bourgeois III, "Politics of Strategic Decision Making in High-Velocity Environments: Towards a Midrange Theory" (1988) 31:4 *Academy Management J* 737.

<sup>195</sup> *Supra* note 159 at 12.

Reporting Council (“IIRC”)<sup>196</sup> identifies in its Framework (the “Framework”) as intangible capital: individual human participants (identified by accounting and economics as “human capital”), certain intellectual property, trademarks, and the like (“intellectual capital”), “organizational capital” (structure, processes, and “know-how”); “social and relationship capital” (involving institutions, stakeholders, communities, and networks, and shared norms, values and behaviour), and natural capital, including “common goods” such as air, light, and other natural resources.<sup>197</sup>

The identification and denomination of such intangibles as “capital” does not, of course, create any “new” capital, but merely recognizes that resources that are not tangible may be employed by a corporation for its benefit. Often, these species of intangible capital are developed or “earned” by the corporation, are central to its “value proposition”, and may even be pre-eminent “value-drivers” of its business.<sup>198</sup>

One result is that traditional financial reporting has come to be considered less meaningful with respect to NPCs and other modern business corporations than with respect to corporations pursuing more traditional business models. As noted above, intangible capital now represents 80% of the capital of US corporations, an exact reversal from the paradigm which obtained for most of the 20th century.<sup>199</sup> Even in 1975, according to Birkinshaw, 17% of the market value of the S&P 500 represented intangibles, but by 2015, 84% of their value was intangibles, although the statistics likely understate the change “because the S&P 500 includes many traditional industrial firms as well as digital firms.” As an extreme example, Birkinshaw reports that less than 1% of Spotify’s market value in 2018 was represented by tangible assets.<sup>200</sup>

These types of intangible capital principally involve various aspects of the organization of the business of the corporation. There is increasing recognition that such assets, which account for the level of innovation, productivity, planning and strategy, and foresight of such corporations will, in the future, account for much of their competitiveness, success, and durability, including NPCs.

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<sup>196</sup> Integrated Reporting is promoted by The International Integrated Reporting Council [IIRC], *The International <IR> Framework* (London: The International Integrated Reporting Council, 2013), available at: <http://integratedreporting.org/wp-content/uploads/2015/03/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf>.

<sup>197</sup> *Ibid* at 11-12.

<sup>198</sup> *Supra* note 96.

<sup>199</sup> *Supra* note 140.

<sup>200</sup> *Supra* note 159 at 14.

## CONTEMPORARY RESPONSES TO CHALLENGES

### Integrated Reporting

Accounting proposals originally developed in the closing years of the 20th century to take account of the sustainability of reporting corporations,<sup>201</sup> by taking into account their performance on environmental, social, and governance (ESG) dimensions,<sup>202</sup> have been further developed into “integrated reporting” proposals, which take account of the intangible capital of the reporting corporation, and the means by which it is employed by the corporation, together with other elements employed in generating value, in order to present “a holistic picture of the combination, interrelatedness and dependencies between the factors that affect the organization’s ability to create value over time”, in the short, medium, and long terms, including how the organization balances short, medium and long-term interests.<sup>203</sup> The International Integrated Reporting Council (IIRC) emphasizes that determining “how best to disclose its unique value creation story in a meaningful and transparent way” is the responsibility of the board of directors.<sup>204</sup>

These accounting and reporting proposals have also been affected by other proposals concerning the relationship between corporations, on the one hand, and society and the polity, on the other, and by proposals relating to the pro-social behaviour of corporations. Proposals of this nature have related, among other things, to Corporate Social Responsibility (CSR) initiatives, business ethics concerns, and other stakeholder management, sustainability and corporate citizenship initiatives.

### Positive Social Change

One such proposal is the “Positive Social Change” (PSC) approach, which focuses on “transformational processes to advance societal well-being”.<sup>205</sup> PSC considers corporations and other organizations as positive change mechanisms, which may be engaged, along with other

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<sup>201</sup> Robert G Eccles and Birgit Spiesshofer, "Integrated Reporting for a Re-Imagined Capitalism" (2015) Harvard Business School Working Paper 16 – 032 at 3. Available at: [https://www.hbs.edu/faculty/Publication%20Files/16-032\\_3860cfaa-ebd3-4d7e-ac9a-53272ca8cc2d.pdf](https://www.hbs.edu/faculty/Publication%20Files/16-032_3860cfaa-ebd3-4d7e-ac9a-53272ca8cc2d.pdf).

<sup>202</sup> *Ibid.*

<sup>203</sup> *Supra* note 197 at 16.

<sup>204</sup> *Supra* note 197.

<sup>205</sup> Ute Stephan, Malcolm Patterson, Ciara Kelly & Johanna Mair, "Organizations Driving Positive Social Change: A Review and an Integrative Framework of Change Processes" (2016) 45:2 J Management 1250 at 1250 [emphasis in the original]. The authors include in PSC a number of concepts, including "shared value", discussed below; "inclusive growth" as used by G George, AM McGahan, & J Prabhu, "Innovation for Inclusive Growth: Towards a Theoretical Framework and a Research Agenda" (2012) 49 J Management Studies 661; and "base of the pyramid" (BoP) markets as per CK Prahalad, & SL Hart, "The Fortune at the Bottom of the Pyramid" (2002) 26 Strategy and Business 54.

private incentives, to implement a PSC strategy which takes into account the legitimate claims of what its adherents describe as “internal stakeholders” (such as employees, directors, shareholders) and “external stakeholders” (identified as including customers, suppliers, lenders, governments, unions, and the local and general public).<sup>206</sup>

Stephan et al., the proponents of PSC, criticize research which “mainly focuses *inward* on organizational activities and rarely explores how these activities may have *external* effects stimulating societal well-being beyond organizational boundaries.”<sup>207</sup> Accordingly, Stephan et al. undertake a research review examining research of organizational activities with both inward and external focus. This approach makes common cause with corporative analysis. Of course, corporative theory, unlike stakeholder theory, does not focus primarily on economic interests, and, instead, considers the groups identified by PSC strategy as internal and external stakeholders to be, simultaneously, legal counterparties of the corporation and participants in its organization.

### **Shared Value, Corporate Strategy, and Corporative Theory**

Another example, proposing a conceptual reorientation of the relationship between a corporation and society, is Michael Porter’s “Creating Shared Values” (CSV) approach, which stresses the mutual interdependency between the competitiveness of the corporation and the well-being of the society in which it is embedded. Porter, arguably today’s pre-eminent strategy thinker, and his collaborator, Mark Kramer, have approached issues relating to the social purpose of corporations and to corporate social responsibility from the lens (es) of strategy and competition. Their 2006 article, “Strategy & Society: The Link Between Competitive Advantage and Corporate Social Responsibility”,<sup>208</sup> has been widely cited and extremely influential, as was their 2011 article, “Creating Shared Value: How to Reinvent Capitalism – and Unleash a Wave of Innovation and Growth”.<sup>209</sup> References to the latter will facilitate discussion of possibly holistic relationships among strategy as approached by corporations, by society, and by the polity.

Porter & Kramer define “shared value” as “policies and operating practices that enhance the competitiveness of a company while simultaneously advancing the economic and social conditions

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<sup>206</sup> *Ibid.*

<sup>207</sup> *Ibid* at 1251.

<sup>208</sup> Michael E Porter and Mark R Kramer, "Strategy & Society: The Link Between Competitive Advantage and Corporate Social Responsibility" (2006) 84:12 Harvard Business Rev 78.

<sup>209</sup> Michael E Porter and Mark R Kramer, "Creating Shared Value: How to Reinvent Capitalism – and Unleash a Wave of Innovation and Growth" (2011) 89:1/2 Harvard Business Rev 62.



in the communities in which it operates”, creating which shared value “focuses on identifying and expanding the connections between societal and economic progress” in which “value” is “defined as benefits relative to costs”.<sup>210</sup> Although contested,<sup>211</sup> as might be expected with any theory, the Porter provenance ensures that the concept of shared value will continue to be taken seriously in the business academia and in strategy consulting for some time.<sup>212</sup>

Although neither of these articles were consulted in the course of the development of corporative theory, as presented in this book, certain aspects of their approach have significant commonalities with corporative theory. Importantly, these authors respond articulately to challenges to capitalism and to the corporation, but do so within the framework of business academic orthodoxy, particularly in the area of strategy, in which area Porter is highly revered. Corporative theory likewise is informed by, and aligned with, accepted business academic frameworks. It is considered that this improves the likelihood that corporative theory, like shared value theory, will be credible to businesses and business academics alike. Of course, corporative theory also aligns itself with practical and theoretical legal approaches, orthodox and otherwise. Thus, the relationship between shared value theory and corporative theory merits significant attention here.

### ***Economic Value and Shared Value***

The 2011 article identifies the need for a more sophisticated form of capitalism, one “imbued with a social purpose,” arising “not out of charity but out of a deeper understanding of competition and economic value creation”,<sup>213</sup> which “recognizes new and better ways to develop products, serve markets, and build productive enterprises”, and which the authors consider as the “next evolution in the capitalist model”.<sup>214</sup>

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<sup>210</sup> *Ibid* at 66.

<sup>211</sup> See, for discussion: Thomas Beschoner, "Creating Shared Value: The One-Trick Pony Approach" (2014) 1:17 *Business Ethics J Rev* 106.

<sup>212</sup> See Andrew Crane, Guido Palazzo, Laura J Spence, and Dirk Matten, "Contesting the Value of 'Creating Shared Value' "(2014) 56:2 *California Management Rev* 130. Responding to the latter, which acknowledges the "wide and positive attention" the 2011 article received, Porter and Kramer, while acknowledging the important contributions of others in this area, claim that "using the profit motive and the tools of corporate strategy to address societal problems, a practice that is growing rapidly in part motivated by the shared value concept, can contribute greatly both to the redemption of business and to a better world." They also opine that "the reason our article has drawn so much attention is that it provides an overall, strategic view of how to think about the role of the corporation in society, which not only incorporates and extends past scholarship on corporate philanthropy, CSR, and sustainability, but also distinguishes CSV as a distinct, powerful, and transformational model that is embedded in the core purpose of the corporation." This is also the point of the corporative theory of the corporation.

<sup>213</sup> *Supra* note 210 at 77.

<sup>214</sup> *Ibid*.

Porter and Kramer argue that creating economic value by creating societal value completely accords with self-interest, involving “a broader conception of Adam Smith’s invisible hand” in which society’s overall interests are posited to be served by all companies individually pursuing shared value connected to their particular businesses, thereby serving society’s overall interests. In turn, creation (and, perhaps more importantly, pursuit) of shared value would legitimize corporations and facilitate governments in pursuing policies that would foster and support business. Thus, “survival of the fittest would still prevail, but market competition would benefit society in ways we have lost.”<sup>215</sup> Shared value is good for business, according to them, as well as good for society.

### *Strategy and Shared Value*

Porter and Kramer connect these observations to strategic theory insofar as it maintains that business success arises out of creating “a distinctive proposition that meets the needs of the chosen set of customers”, and that competitive advantage arises from how a firm “configures the value chain, or the set of activities involved in creating, producing, selling, delivering, and supporting its products or services.”<sup>216</sup> Consequently, they maintain that a company can create economic value by creating societal value: firstly, by reconceiving products and markets; secondly, by redefining productivity in the value chain; and, thirdly, by building supportive industry clusters at the company’s locations. Finally, “improving value in one area gives rise to opportunities [to create shared value] in the others.”<sup>217</sup> The first subject is canvassed under this heading, and the second and the third under the heading “The Value Chain, Suppliers, Employees and Locations” below.

As to reconceiving products and markets, they say that products should be configured in accordance with the needs of society more broadly, not just with respect to the needs of consumers of particular products or services. The present book suggests that such an approach involves an assessment of “need” or “demand” characterized dynamically and intertemporally; that is to say, in terms of how such “need” or “demand” may present itself in various time frames;<sup>218</sup> hence, developing products and services which anticipate future need or demand is more efficient and effective for corporations and for society at large. Among other things, it eliminates the

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<sup>215</sup> *Ibid.*

<sup>216</sup> *Ibid* at 66.

<sup>217</sup> *Ibid* at 67.

<sup>218</sup> Reference is made to the earlier discussion of intertemporal decision-making in Chapter Thirteen.

consumption of input factors used in producing goods and services which may later be replicated in “new and improved” versions whose previous iterations are then discarded. In effect, this book invites both corporations and their legal counterparties/organizational participants to more fully consider their needs and demands in a larger temporal framework, thereby accommodating a greater proportion of a corporation’s organizational participants.

Porter and Kramer assert that “in advanced economies, demand for products and services that meet societal needs is rapidly growing.” In effect, “societal needs, not just conventional economic needs, define markets.”<sup>219</sup> This aligns with the statements made by this author in the preceding paragraph. Consumers of a particular product or service, however widely or narrowly defined, even apart from intertemporal considerations, are multifaceted: whether individuals, corporations, or other entities, their activities are not exhausted by consumption of that one particular product or service. Instead, they have other needs and objectives.

Consumption is also affected by non-consumer driven factors which may implicate both consumers and other organizational participants. Porter and Kramer argue that businesses are often far more effective than governments or nonprofits in “marketing that motivates customers to embrace products and services to create societal benefits”.<sup>220</sup> They suggest, then, that consumers of products and services, at least implicitly, want producing corporations to pursue shared value, such that meeting the demand to pursue shared value (even, we would argue, if not yet articulated) is conducive to success.

If they are correct about what customers expect, their claimed demand for shared value may, depending on the interests of other participants, support the corporation taking action as Porter and Kramer suggest. Particularly important for present purposes, they posit a much more nuanced theory of strategy and customer demand which is consistent with organizational participants generally having a broad range of interests (including societal interests), only some of which are economic, which customers, as well as other organizational participants, take into account, and also expect corporations to take into account.

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<sup>219</sup> *Supra* note 210 at 65.

<sup>220</sup> *Ibid* at 67.

### *The Economic Model*

Porter and Kramer maintain that “business and society have been pitted against each other for too long”, partly because “economists have legitimized the idea that to provide societal benefits, companies must temper their economic success”, since social improvements constrain the corporation by raising costs and reducing profits.<sup>221</sup> Similarly, the interests of business and society are viewed as opposed when society imposes taxes, regulations and penalties which force firms to “internalize” externalities, or bear social costs which the firm does not otherwise have to bear, such as pollution.<sup>222</sup> Such opposition, they say, has characterized the thinking of both corporations and governments, each of which “has assumed that the other is an obstacle to pursuing its goals and acted accordingly”. Firms “have largely excluded social and environmental considerations from their economic thinking”, in effect, considering “the broader context in which they do business as a given” and resisting “regulatory standards is invariably contrary to their interests”, thus leaving the matter of solving social problems entirely to governments and NGOs.<sup>223</sup>

These arguments have considerable anecdotal and other support. This book has argued that the “corporative corporation”, the corporation of corporative theory, acting through its first-instance animators, the board of directors, must take into account not only the rights and obligations of legal counterparties of the corporation, but also the expectations of such parties as organizational participants in the corporation, as well as the expectations of the corporation in respect of such organizational participants. Social and environmental considerations, and a corporation’s capacity to affect them, are also critical aspects of the ambient environment of any corporation, requiring consideration in recognizing and effecting appropriate adjustments to its strategy and structure.

### *The Economic Model and Corporative Theory*

This book has characterized the classical and neoclassical economic theory of the firm as a theory of production (and, as Porter and Kramer agree, not a very useful one) in which the firm is a “black box” taking input factors and somehow generating output. It is argued that this “invisibilizes” the action by which the firm/corporation combines input factors to generate output, action which involves the structure, process, people and goals of the corporation as organization.

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<sup>221</sup> *Ibid* at 64-65.

<sup>222</sup> *Ibid* at 65.

<sup>223</sup> *Ibid*.

The present book has likewise argued that “business” or “the economy” is inseparable from the relevant society and polity: the corporation is not divorced from, but instead is immersed for “embedded” in, the society and polity; and society and the polity interpolate themselves into the corporation.<sup>224</sup> Legal counterparties of, and organizational participants in, the corporation are not one-dimensional actors who act only in relation to their involvement with the corporation.<sup>225</sup> Instead, they are multidimensional actors who take part in a broad range of economic, social, and political activities. When they engage with the corporation in some particular, it cannot be assumed that such engagement constitutes the whole range of their possible action or engagement, or that such engagement with the corporation exhausts all of their expectations of the corporation.<sup>226</sup>

It is also been demonstrated in this book that “the corporation” is not a gargantuan monolith which acts, everywhere and always, as a single actor in relation to all actors other than itself. Instead, the book has shown that components of the organization may take action vis-à-vis the organization as a whole, vis-à-vis other organizational components, or vis-à-vis external parties in interest.<sup>227</sup> The corporative approach permits deconstruction of the faceless, monolithic economic “thing” which is sometimes said to be a legal “person” but devoid of “personal” attributes, and, as such, is characterized by many as unattractive and as the “ugly” corporation.

### *Strategy and Corporative Theory*

This book has demonstrated that the means by which a corporation seeks to generate surplus value, which is to say generates outputs the value of which is greater than the inputs (which may be considered as surplus value or “profit”) involves ongoing collection and assessment of information about the external environment by the corporation, consideration of such information in relation

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<sup>224</sup> See Appendix B, Chapter B3 in the section entitled “The Economy and Its Function as Distinct and Independent from the Society and the Polity”.

<sup>225</sup> See the discussion in Chapter Five in the section entitled “Organizational Structure” and therein especially under the headings “Formal Structure and Relationships”, “Informal Structure and Relationships” and “Formal Organizations and Informal Organizations”; and in the sections entitled “Organizational Process” and “Organizational Personnel”.

<sup>226</sup> *Ibid.*, especially in the sections entitled “Organizational Process” and “Organizational Personnel”.

<sup>227</sup> See the discussion in Chapter Three, particularly in the sections entitled “Organizations as Political Systems” and “Forms of Corporations – Legal and Organizational Variants”; and the discussion in Chapter Six in the section entitled “Organizational Goals and Intraorganizational Goals”.

to the corporation's strategy and structure (as well as processes and personnel), and modification of that strategy and structure as necessary or appropriate from time to time.<sup>228</sup>

For example, the availability of certain resources to the corporation may change: they may become more or less expensive, more or less plentiful or scarce, and more or less amenable to substitution. Theory and research indicate that a board of directors can be extremely useful in this regard, by identifying environmental developments (of which they become aware through their external activities) which may require a suitable response by the corporation;<sup>229</sup> for example, the diffusion of corporate governance developments<sup>230</sup> Thus, Porter and Kramer are going back to "basic principles" of strategy and competition when they require that attention be directed to all relevant aspects of the external environment. Considering external developments and extrapolating them and their effects over the long term increases awareness of their importance to the corporation over various time frames and is required by, and consistent with, corporate theory.

### ***Corporate and Community Benefit***

Porter and Kramer relate corporate competitiveness and community well-being: "A business needs a successful community, not only to create demand for its products but also to provide critical public assets and a supportive environment",<sup>231</sup> while, on the other hand, "a community needs successful businesses to provide jobs and wealth creation opportunities for its citizens." Thus, they say that "public policies that undermine the productivity and competitiveness of businesses are self-defeating".<sup>232</sup> We would interpret or extend their meaning of "community" here to include the ambient society and polity and, arguably, regional and global communities.

In effect, a corporation whose strategy is inimical to or significantly adversely affects the relevant community is imposing a constraint on its own health and well-being over time frames of various

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<sup>228</sup> See the discussion in Chapter Two in the section entitled "History of the Development of the Modern Business Corporation"; and in Chapter Nine.

<sup>229</sup> See the discussion in Chapter Six in the section entitled "Organizational Goals and Intraorganizational Goals", particularly under the headings "Theories of Organizational Power" and "Organizational Goals and Corporate Operations".

<sup>230</sup> One example is the spread of "poison pills" and "golden parachutes" which may have signaled their growing acceptability to investors: see Gerald F Davis and Heinrich R Greve, "Corporate Elite Networks and Governance Changes in the 1980s" (1997) 103:1 *American J Sociology* 1. It is been shown that CEOs also seek advice and new perspectives on strategic issues from members of their external advice networks: see Michael L McDonald, Poonam Khanna, and James D Westphal, "Getting Them to Think Outside the Circle: Corporate Governance, CEOs' External Advice Networks, and Firm Performance" (2008) 51:3 *Academy Management J* 453.

<sup>231</sup> *Supra* note 210 at 66.

<sup>232</sup> *Ibid.*

duration. Similarly, a community which becomes unsuccessful and dysfunctional is not likely to be able to supply the resources the corporation requires over various time frames. In this regard, it is well-known that economic assistance by developed countries to less developed countries which increases their GNP can, at certain levels, increase their demand for consumer products, which expands markets for businesses in sponsoring and other countries.<sup>233</sup>

Porter and Kramer argue that management thinking over the previous two decades focused on increasing sales, and that, facing growing competition and pressures from shareholders for short-term performance, “managers resorted to waves of restructuring, personnel reductions, and relocation to lower-cost regions, while leaving balance sheets to return capital to investors”, which often resulted in “commoditization, price competition, little true innovation, slow organic growth, and no clear competitive advantage.”<sup>234</sup> They call for “a deeper understanding of productivity and a growing awareness of the fallacy of short-term cost reductions (which often actually lower productivity or make it unsustainable).”<sup>235</sup>

At the same time, “the communities in which companies operate perceive little benefit even as profits rise” but, instead, “perceive that profits come at their expense” in terms of “high unemployment, local business distress, and severe pressures on community services.”<sup>236</sup> In effect, the focal corporation is failing to meet the expectations of the relevant community, apparently to detrimental effect, just as corporative theory would indicate. Both corporative analysis and common sense suggest that such community, even if without redress against the focal corporation, would have to absorb costs resulting from corporate actions that increase taxes and service costs.

Porter and Kramer indicate that the significance of connections with the communities in which companies operated reduced as companies became less vertically integrated, and relied more on outside vendors, outsourcing and offshoring, while operating in so many locations that they “no longer recognize a home – but see themselves as “global” companies.”<sup>237</sup> However, the corporation

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<sup>233</sup> Analysis of consumer demand is the subject of a myriad of research and theoretical work. One meta-review is that of Anton P Barten, "The Systems of Consumer Demand Functions Approach: A Review" (1977) 45:1 *Econometrica* 23.

<sup>234</sup> *Supra* note 210 at 66.

<sup>235</sup> *Ibid* at 69.

<sup>236</sup> *Ibid* at 66.

<sup>237</sup> *Ibid*.

suffers real costs attributable to the relocation and dislocation of operations. Repeating like behaviour in another community may be expected to have similar results, such as cost reiteration. Porter and Kramer argue that “a company’s value chain inevitably affects – and is affected by, numerous societal issues, such as natural resource and water use, health and safety, and equal treatment in the workplace”, and that many “so-called externalities actually inflict internal costs on the firm, even in the absence of regulation or resource taxes” eliminating which benefits both the society and the corporation, creating “shared value”.<sup>238</sup> In so doing, corporative theory would maintain that the corporation and individuals comprising the society and the society itself, as its legal counterparties and organizational participants, seek fulfilment of their respective expectations.

These observations call attention to the “black box” of the firm in economic theory, which this book has described as a theory of production, and has criticized its overly simplistic approach even to production, as well as its failure to look within the “black box” at the structure, processes, personnel and other elements of the firm or corporation comprising its organization. Such an understanding has been found to be incomplete, particularly as compared with corporative theory.

Excessive focus on financial or accounting “cost” and “profit” fails to take into account the dimensions of those terms which are not purely financial, alternative measures of productivity and success, and the profit motive in terms of “sufficing” profit or seeking an optimal level of profit which will, ideally contribute to the likelihood of success and prosperity over the short, medium, and long terms. In so doing, such approaches misspecify not only the “value-drivers”, but also the goals and objectives, of business and of economic activity generally, as demonstrated in this book.

### ***The Value Chain, Suppliers, Employees, and Locations***

According to Porter and Kramer, transforming the value chain involves adjusting energy use and logistics, resources (such as water, raw materials and packaging), procurement, distribution, employee productivity, and location. As to procurement and employee productivity, they argue that improving the well-being of suppliers and employees can create shared value which will benefit the focal corporation. In effect, commoditizing and exerting maximum pressure on suppliers to decrease prices, as well as outsourcing of suppliers in lower-wage locations, can be

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<sup>238</sup> *Ibid* at 68.



counterproductive. In fact, “marginalized suppliers cannot remain productive or sustain, much less improve, their quality”, whereas by “increasing access to inputs, sharing technology, providing financing, companies can improve supplier quality and productivity [which they say may often be better than lower prices] while ensuring access to growing volume”. Stronger suppliers may have less environmental impact, making them more efficient.<sup>239</sup> These observations are consistent with corporate analysis, which considers not only the legal rights of counterparties but also the expectations of organizational participants, in both cases over various time frames.

Porter and Kramer maintain that previous practices of holding down wage levels, reducing benefits, and offshoring may be disadvantageous, pointing to the “positive effects that a living wage, safety, wellness, training, and opportunities for advancement for employees have on productivity”.<sup>240</sup> They also argue that it is no longer true that the cheaper the location, the better. Previous thinking to this effect was founded on the low cost of logistics, the rapid flow of information, the global nature of markets, and low energy costs. There is also “greater recognition of the productivity cost of highly dispersed production systems and the hidden costs of distant procurement”. They argue that high transportation costs and the ability to restock in small quantities may make it advantageous to move some activities closer to home and to have fewer major production locations.<sup>241</sup>

It can be seen that these arguments, at bottom, criticize the “black box” model of the firm as a model of production, which fails to take into account other aspects of the firm’s operations, including, importantly, marketing its products and services, as well as obtaining inputs. It may be expected that pressure on suppliers is not unique to the industry in which a particular corporation operates and that price reductions by that corporation’s suppliers will impact the costs of its suppliers, including their own suppliers and employees, resulting in reductions in business profits and individuals’ incomes, and thereby demand for products and services, more broadly.

### ***Government and Civil Society***

Porter and Kramer maintain that society does not care what types of organizations create shared value; instead, “what matters is that benefits are delivered by those organizations – or combinations

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<sup>239</sup> *Ibid* at 70.

<sup>240</sup> *Ibid* at 71.

<sup>241</sup> *Ibid*.

of organizations – that are best positioned to achieve the most impact for the least cost” such that traditional divisions between the responsibilities of business and those of government or civil society should give way to efficiency considerations.<sup>242</sup>

This argument works both ways. One consequence is that business should not necessarily oppose government activity which can more efficiently provides products and services that were previously supplied by business corporations. Importantly, society and the polity, as legal counterparties and organizational participants, must recognize the contributions of corporations which create such shared value and ensure that the benefits of shared value are allocated appropriately.

### ***Regulation***

Porter and Kramer acknowledge that regulation is necessary for well-functioning markets, but stipulate that the design and implementation of regulation determines whether regulation benefits society by encouraging companies to pursue shared value or disbenefits society by working against shared value, perhaps even to the extent of making trade-offs between economic and social goals inevitable. They argue that regulations that enhance shared value “set goals and stimulate innovation” and “highlight a societal objective and create a level playing field to encourage companies to invest in shared value rather than maximize short-term profit.”<sup>243</sup>

They argue that such regulations: 1. set clear and measurable social goals; 2. set performance standards, not the methods of achieving them; 3. establish phase-in periods for meeting standards “which reflect the investment or new-product cycle in the industry” and give “time to develop and introduce new products and processes in a way consistent with the economics of their business”; 4. implement systems for measuring and reporting performance to regulators who can construct reasonable benchmarking data to motivate continuous improvement; and 5. require efficient and timely reporting of results to the regulator, who can audit them as required.<sup>244</sup> Of course, such regulatory objectives are more common and easier to enunciate than to implement. However, their suggestions as to the nature of phase-in standards takes a realistic approach not always adopted.

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<sup>242</sup> *Ibid* at 73.

<sup>243</sup> *Ibid* at 74.

<sup>244</sup> *Ibid*.

They argue that “business and government will become more aligned on regulation in many areas” as shared value principles become more widely accepted and companies come to understand that well-constructed regulation can foster economic value creation to the benefit of both the regulated companies and the society. They also admit that “regulation will be needed to limit the pursuit of exploitation, unfair, or deceptive practices in which companies benefit at the expense of society”.<sup>245</sup> It might be thought that companies attuned to shared value creation would realize that those proscribed practices benefit them, as legitimate businesses, as well as society more generally.

Corporative theory acknowledges the need to design and implement regulation that recognizes the “corporative” nature of the modern business corporation, including how that affects its interaction with legal counterparties and organizational participants, including regulators. Regulation which is appropriate from the perspective of corporative theory must be attentive to the various legal, as well as organizational, relationships with such parties, and how those relationships are interrelated. This requires that those who design and implement regulation have, and be motivated and incented, to exercise appropriate knowledge of such matters, as to which this book is a beginning.

### ***Conclusion***

Porter and Kramer conclude that “not all profit is equal” and that “profits involving a social purpose represent a higher form of capitalism – one that will enable society to advance more rapidly while allowing companies to grow even more”, resulting in “a positive cycle of company and community prosperity, which leads to profits that endure”.<sup>246</sup> Further, shared value “will also reconnect company success and community success in ways that had been lost in an age of narrow management approaches, short-term thinking, and deepening divides among society’s institutions.”<sup>247</sup>

As noted here, the concept of shared value has the considerable merit of relating societal needs and demands to corporate strategy and the need to align the conceptualization of products and markets, production, and other factors, such as location, with societal expectations and the expectation of organizational participants generally. As strategists, Porter and Kramer’s focus on strategy is more acute than the present work, whose focus is on the corporation itself. However,

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<sup>245</sup> *Ibid.*

<sup>246</sup> *Ibid* at 75.

<sup>247</sup> *Ibid* at 77.

shared value theory and corporative theory share a number of commonalities, as described above. Importantly, their focus on corporate strategy illuminates a number of the salient aspects of corporative theory. Responding to contemporary articulation of the demands of society and the polity on capitalism and on the corporation require approaches that integrate the corporation, the economy, the society, and the polity. As discussed in the next section, this challenge has been taken up by a number of initiatives emanating from business, government, and the academy.

### **Initiatives to Recognize and Report “Value Drivers” of Contemporary Corporations**

Many modern corporate law statutes, sometimes by means of incorporation of applicable securities law, such as the CBCA, require annual disclosure of considerable detail about the corporation and its business, with the objective of describing the corporation’s “value creation story” (as the IRRC expresses such objective), including factors which are considered to be involved in its achieving or failing to achieve its goals and objectives, such as risk factors; competitive considerations, market conditions, product lifecycle considerations, and other market-related factors; research and development and other input factors; outlook for the business, and the like.<sup>248</sup>

It is often said that concerns about possible legal exposure and the confidential and proprietary nature of the corporation’s strategy inhibit full and fair disclosure of these matters pursuant to legal requirements.<sup>249</sup> At the same time, however, concerns about the sustainability of business models and national economies and other considerations relating to the ambient environment of the corporation, both physical and social, have motivated initiatives to improve disclosure of these matters, as well as matters more immediately and directly related to the present business carried on by the corporation.<sup>250</sup> This book would argue that “demand pull” for such disclosure, coming

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<sup>248</sup> For example, such information is required in the information circular required to be prepared for meetings of shareholders in accordance with sections 149 and 150 of the CBCA, section 55 (1) of the regulations thereunder and, by means of incorporation by reference, National Instrument 51-102 *Continuous Disclosure Obligations* adopted by the Canadian Securities Administrators, a collective body each of whose members are individually assigned jurisdiction to administer the securities legislation of a province or territory of Canada. See: Canadian Securities Administrators, National Instrument 51-102 *Continuous Disclosure Obligations*, rev ed June 7, 2018, available at: [https://www.osc.gov.on.ca/en/SecuritiesLaw\\_51-102.htm](https://www.osc.gov.on.ca/en/SecuritiesLaw_51-102.htm).

<sup>249</sup> Liability concerns include exposure to securities, regulatory and other litigation with respect to alleged misrepresentations. Assumptions with respect to the uniqueness of a corporation's strategy are often unrealistic and, in any event, often ignore considerations of historical development and path dependence that concern the adoption of a particular strategy, related structure, and methods of implementation. For example, see the discussion in Chapter Five in the section entitled "History of the Development of the Modern Business Corporation" and therein under the headings "Strategy and Structure" and "The Visible Hand: The Managerial Revolution in American Business"; and the discussion in Chapter Six in the section entitled "Forms of Corporations – Legal and Organizational Variants".

<sup>250</sup> Some of these initiatives are chronicled under the headings below.

from legal counterparties and organizational participants whose legitimate expectations the corporation may see as justifying such disclosure may be more effective, ultimately, in promoting such disclosure than “regulatory fiat”.

Considerations relating to the possible adverse effects of corporate decisions and social and economic developments, such as led to the Financial Crisis of 2008 and earlier crises and collapses of large corporations (such as Enron and WorldCom), on the society and polity in which environment the corporation is situated have led to concerns about the place of the corporation in the ambient society and polity. These concerns have been expressed in calls to develop new theoretical and practical approaches to the role of corporations and economic activity in the society and polity, a kind of “reimbedding” them in their natural environment, as envisioned in this book.

Business groups, self-regulatory organizations, regulators, legislators, and various departments of government have taken the initiative to examine various aspects of these issues. A few of the most significant of these are briefly referenced below.

#### ***A4S Accounting for Sustainability***

In Britain, in 2004, the Prince of Wales’ charitable foundation established an initiative entitled “A4S Accounting for Sustainability”, which aims to “inspire action by finance leaders to drive a fundamental shift towards resilient business models and a sustainable economy, including transforming financial decision-making “to enable an integrated approach, reflective of the opportunities and risks posed by environmental and social issues”.<sup>251</sup>

In turn, again led by the Prince of Wales, the A4S Accounting Bodies Network, established in 2008, brought together accounting bodies from across the globe in more than 181 countries, representing two thirds of accountants worldwide. Its key objective is to use “its combined knowledge to support members and students to account for sustainability, providing the competencies and frameworks required to build a sustainable economy within which individuals and organizations can thrive”.<sup>252</sup>

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<sup>251</sup> A4S Accounting for Sustainability, online at: <https://www.accountingforsustainability.org/content/a4s/corporate/en/about-us/overview.html>, at “A4S Aims”.

<sup>252</sup> *Ibid.*

### *The Kay Review*

More broadly, over the past five to ten years there have been calls to develop new theoretical and practical approaches to the role of corporations and economic activity in the society and polity, a kind of “reimbedding” them in their natural environment. Responses to these calls have included initiatives taken by a previous British government, led by David Cameron, with the objective of improving the competitiveness of British business. Those steps included commissioning “The Kay Review of UK Equity Markets and Long-Term Decision Making” (the “Kay Review”) whose final report was submitted in July 2012 (the “Kay Report”);<sup>253</sup> planning for the implementation of that report as reflected in a document issued by the Department for Business Innovation & Skills entitled “Ensuring Equity Markets Support Long-Term Growth – The Government Response to the Kay Review, November 2012;”<sup>254</sup> and that department’s report on implementation of the Kay Review entitled “Building A Culture of Long-Term Equity Investment – Implementation of the Kay Review: Progress Report October 2014” (the “Implementation Report”).<sup>255</sup>

The Kay Review involved extensive consultation with businesses and business associations (including financial intermediaries, asset managers, and pension funds and other “ultimate” investors), nongovernmental organizations and other interested parties, government and regulatory agencies and bodies, academic, and other parties. As legal counterparties and organizational participants, the perspectives of such parties are highly relevant to such analysis, from a corporative perspective.

The Implementation Report relates a number of initiatives taken by the government of the day and others pursuant to the recommendations of the Kay Review. The Financial Reporting Council (FRC) published an updated Stewardship Code<sup>256</sup> which emphasized engagement in long-term

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<sup>253</sup> John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making Final Report July 2012* (London: The National Archives, 2012). Available at: [www.bis.gov.uk/kayreview](http://www.bis.gov.uk/kayreview).

<sup>254</sup> UK Department for Business Innovation & Skills, *Ensuring Equity Markets Support Long-Term Growth – The Government Response to the Kay Review, November 2012* (London: The National Archives, 2012). Available at: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/253457/bis-12-1188-equity-markets-support-growth-response-to-kay-review.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253457/bis-12-1188-equity-markets-support-growth-response-to-kay-review.pdf).

<sup>255</sup> UK Department for Business Innovation & Skills, *Building a Culture of Long-Term Equity Investment – Implementation of the Kay Review: Progress Report October 2014* (London: The National Archives, 2014). Available at: <https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/06/bis-14-1157-implementation-of-the-kay-review-progress-report.pdf>.

<sup>256</sup> Financial Reporting Council, *The UK Stewardship Code September 2012* (London: The Financial Reporting Council Limited, 2012). Available at: [https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-\(September-2012\).pdf](https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-(September-2012).pdf).

company strategy as recommended by the Kay Review.<sup>257</sup> In response to the Kay Review's recommendations on improving reporting and dialogue in the investment chain so as to meet long-term investment objectives, in October and November 2013 the government acted<sup>258</sup> to reform the corporate narrative reporting framework to make annual reports less burdensome, more relevant, and more focused on company strategy,<sup>259</sup> and removed mandatory quarterly reporting requirements.<sup>260</sup> The FRC later issued new guidance on narrative reporting.<sup>261</sup>

The government also commissioned independent research of metrics and models used by long-term investors to assess company and investment performance. These were published with the Implementation Report.<sup>262</sup> The government also responded to the Law Commission review of the fiduciary duties of investment intermediaries and concerning related government departments, as recommended by the Kay Review.<sup>263</sup> It also introduced a number of reforms concerning remuneration of directors, including a requirement for a binding vote of shareholders on such remuneration.<sup>264</sup> The FRC amended its Corporate Governance Code accordingly.<sup>265</sup> The Implementation Report reviewed a number of other actions taken by the government and many others proposed to be taken thereafter.

Many of these proposals were casualties of the change in government which took place in June 2016, following the United Kingdom referendum on the European Union ("Brexit"). This is unfortunate not only for the United Kingdom but for the observers of the "living laboratory" thereby constituted.

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<sup>257</sup> *Supra* note 255, especially at 11-18.

<sup>258</sup> *The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013* No.1970 (UK). Available at: <https://www.legislation.gov.uk/ukdsi/2013/9780111540169>. See also *supra* note 254, especially at 19-25.

<sup>259</sup> *Supra* note 255, especially at 19-20.

<sup>260</sup> *Ibid.*, especially at 19.

<sup>261</sup> *Ibid* at 20, and see Financial Reporting Council, *FRC Guidance on the Strategic Report June 2014* (London: The Financial Reporting Council Limited, 2014). Available at: <https://www.frc.org.uk/getattachment/2168919d-398a-41f1-b493-0749cf6f63e8/Guidance-on-the-Strategic-Report.pdf>.

<sup>262</sup> *Supra* note 255 at 21-25. A summary of the Research Paper appears at 23-25.

<sup>263</sup> *Supra* note 255 at 26-32.

<sup>264</sup> *Ibid* at 41-46, noting, at 42, the amending legislation: *The Enterprise and Regulatory Reform Act 2013(UK)*, 2013, c.24, available at: <http://www.legislation.gov.uk/ukpga/2013/24/contents>; and *The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013*, available at: <http://www.legislation.gov.uk/uksi/2013/1981/contents/made>.

<sup>265</sup> *Supra* note 255 at 41-47, especially at 45, citing: Financial Reporting Council, *FRC Update to Corporate Governance Code, September 2014* (London: The Financial Reporting Council Limited, 2014). Available at: <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/September/FRC-updates-UK-Corporate-Governance-Code.aspx>.

### ***The Oxford Martin School – “Now for the Long Term”***

There were also many other non-government initiatives in this regard. In October 2013, the Oxford Martin School at the University of Oxford published *The Report of the Oxford Martin Commission for Future Generations* entitled “Now for the Long Term”,<sup>266</sup> which, firstly, provided a synopsis of global megatrends and the key challenges on which action was considered essential within five broad categories: society, resources, health, geopolitics, and governance; secondly, identified five “shaping factors that impact the ability to get things done”: institutions, time, political engagement and public trust, complexity, and culture; and, thirdly, offered “practical, overarching recommendations to overcome the gridlock of modern politics and shift mindsets towards the long-term” arranged around five principles: creative coalition; innovative, open and reinvigorated institutions, revaluing the future, investing in younger generations, and establishing a platform of understanding.<sup>267</sup>

The Oxford Martin Commission’s “revaluing the future” principle involves taking steps to focus business on the long-term, including implementing recommendations made by the Group of 30 on Long-term Finance,<sup>268</sup> which involve developing long-term accounting frameworks, long-term financial institutions and working with various parties, such as the World Business Council for Sustainable Development,<sup>269</sup> to develop a sustainability assessment for listed companies, concentrating on “long-term value creation and absolute performance, taking into account portfolio turn, remuneration incentives, length of investments, shareholder voting rights, organizational talent and tenure, time dedicated to long-term strategy deliberations, and innovative capacity”, which would also reinforce the proposals of the Kay Report.<sup>270</sup>

### ***Sustainability Accounting Standards Board***

About the same time, in North America, investigations of mandatory sustainability reporting and the development of key sustainability performance indicators were undertaken. A report entitled

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<sup>266</sup> The Oxford Martin School, *The Report of the Oxford Martin Commission for Future Generations – Now for the Long Term* (Oxford: Oxford Martin School, University of Oxford, 2013).

<sup>267</sup> *Ibid* at 6.

<sup>268</sup> The Group of Thirty Working Group on Long-term Finance, *Long-term Finance and Economic Growth* (Washington, DC: The Group of Thirty, 2013). Available at: [https://group30.org/images/uploads/publications/G30\\_LongtermFinanceEconGrowth.pdf](https://group30.org/images/uploads/publications/G30_LongtermFinanceEconGrowth.pdf).

<sup>269</sup> See: <https://www.wbcsd.org>. It describes itself as a "global, CEO-led organization of over 200 leading businesses working together to accelerate the transition to a sustainable world, at <https://www.wbcsd.org/Overview/About-us>.

<sup>270</sup> *Supra* note 253.



“From Transparency to Performance: Industry-Based Sustainability Reporting on Key Issues”<sup>271</sup> was released in October 2010 by the Initiative for Responsible Investment at the Hauser Centre for Non-Profit Organizations at the Harvard Kennedy School of Government. In turn, that report influenced the development of the Sustainability Accounting Standards Board, publicly launched in October 2012, whose mission is to develop and disseminate standardized sustainability disclosure standards to enable evaluation of financial information sustainability information, including risks and opportunities, to provide a complete view of corporate performance, and to improve performance on the sustainability issues most likely to impact long-term value creation.<sup>272</sup>

### ***International Integrated Reporting Council***

In 2010, the Global Reporting Initiative (“GRI”),<sup>273</sup> which had been established to develop reporting and assurance standards for social and environmental reporting, and the A4S Accounting for Sustainability Project jointly formed the International Integrated Reporting Committee, later renamed the International Integrated Reporting Council (“IIRC”), to develop integrated reporting at a global level.<sup>274</sup> IIRC indicates that “the primary purpose of an integrated report is to explain the providers of financial capital how an organization creates value over time” which, it says, “benefits all stakeholders interested in an organization’s ability to create value over time, including employees, customers, suppliers, business partners, local communities, legislators, regulators and policy-makers.” Integrated thinking “is the active consideration by an organization of the relationships between its various operating and functional units and the capitals that the organization uses or affects” and “leads to integrated decision-making and actions that consider the creation of value of the short, medium and long term.”<sup>275</sup>

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<sup>271</sup> Steve Lydenberg, Jean Rogers, and David Wood, *From Transparency to Performance: Industry-Based Sustainability Reporting on Key Issues* (Cambridge, MA: Initiative for Responsible Investment, 2010).

<sup>272</sup> Sustainability Accounting Standards Board, online at: <https://www.sasb.org>.

<sup>273</sup> See: <https://www.globalreporting.org>. See also: Cynthia A Williams, "The Global Reporting Initiative, Transnational Corporate Accountability, and Global Regulatory Counter-Currents" (2016) 1 UC Irvine J of International, Transnational, and Comparative Law 67.

<sup>274</sup> See: <http://integratedreporting.org>.

<sup>275</sup> The International Integrated Reporting Council, *The International <IR> Framework*, (London: International Integrated Reporting Council, 2013). Available at: <https://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf>.

### ***Coalition for Inclusive Capitalism and Focusing Capital on the Long Term***

The Coalition for Inclusive Capitalism (“CIC”),<sup>276</sup> established in 2008, “engages leaders across business, government and civil society in the movement to make capitalism more equitable, sustainable, and inclusive”. It involves asset managers, asset owners and public companies and includes some of the largest public pension funds and private fund managers. Its membership includes the Canada Pension Plan Investment Board and McKinsey & Company, whose CEOs had previously (in 2013) taken the initiative to establish Focusing Capital on the Long Term, which resulted in the foundation of FCLTGlobal<sup>277</sup> in July 2016 with BlackRock, The Dow Chemical Company and Tata Sons. CIC members and influencers also include founders and members of Focusing Capital on the Long Term and FCLTGlobal, and others involved in The British Academy project described below.

### ***The Embankment Project for Inclusive Capitalism***

CIC and accounting firm EY established the Embankment Project for Inclusive Capitalism<sup>278</sup> in March 2017. It acknowledges that the introduction of new technologies, the rise of major new economic markets, and the disruption of entire industries have created significant business opportunities but also “more challenges, coming from more places, than ever before”, the heightened scrutiny of business decisions, and a short-term orientation to ensure immediate business survival even at the expense of future success. The Embankment Project seeks to develop metrics by which to measure value generation over the long-term, thereby driving “broad-based prosperity by creating value for shareholders, customers, employees and, and society alike”.<sup>279</sup>

### ***The British Academy – The Future of the Corporation Project***

The British Academy recently embarked on a project concerning “The Future of the Corporation”<sup>280</sup> and published a document in November 2018 setting forth a framework entitled

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<sup>276</sup> See: <https://www.inc-cap.com>.

<sup>277</sup> See: <https://www.fcltglobal.org>.

<sup>278</sup> See: <https://www.inc-cap.com/embankment-project>.

<sup>279</sup> Embankment Project for Inclusive Capitalism, *Embankment Project for Inclusive Capitalism (EPIC) Report – November 16, 2018* (London: Embankment Project for Inclusive Capitalism, 2018) at 3. Available at: <https://www.epic-value.com/static/epic-report-web-df894ad112b70406d9896c39f853deec.pdf>.

<sup>280</sup> See: <https://www.thebritishacademy.ac.uk/programmes/future-of-the-corporation>.

“Reforming Business for the 21st Century: A Framework for the Future of the Corporation”.<sup>281</sup> This project is highly significant since the British Academy is the United Kingdom’s national body for the humanities and social sciences and the project involves many subject-matters.

It proposes “a reconceptualization of the corporation around purpose” involving three principal elements: corporate purpose, “the reason why corporation exists, what it seeks to do and what it aspires to become”, of which profit is only a product; commitment to trustworthiness, involving commitment “to the various parties that are involved in the delivery of those purposes and vice-versa”, and which create “reciprocal benefits for the firm, its stakeholders and society”, based on relations of trust; and a culture enabling trustworthiness, relying on “clearly articulated values that are adopted consistently in the culture of the corporation”. The document proposes that it be actioned by means of five “levers”: ownership, corporate governance, regulation, taxation, and investment.<sup>282</sup>

### ***World Economic Forum – The New Paradigm***

The World Economic Forum undertook an initiative somewhat similar to the British Academy’s project. At its request, Martin Lipton and certain of his partners at the law firm Wachtell, Lipton, Rosen & Katz prepared and, in September 2016, issued “The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth”.<sup>283</sup>

Marty Lipton recently described it (when introducing an updated version) by saying: “In essence, *The New Paradigm* conceives of corporate governance as a voluntary collaboration among corporations, shareholders, and other stakeholders to achieve sustainable long-term value and resist short-termism. It provides a roadmap for boards to demonstrate that they are providing thoughtful, engaged oversight and that management is diligently pursuing credible, long-term

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<sup>281</sup> The British Academy, *Reforming Business for the 21st Century: A Framework for the Future of the Corporation* (London: The British Academy, 2018). Available at: <https://www.thebritishacademy.ac.uk/publications/reforming-business-21st-century-framework-future-corporation>.

<sup>282</sup> *Ibid* at 8.

<sup>283</sup> Martin Lipton, *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth* (Washington DC: International Business Council of the World Economic Forum, 2016.) Available at: <http://www.wlrk.com/docs/thenewparadigm.pdf>.

business strategies.”<sup>284</sup> He admits that it “does not solve all the problems that corporations will continue to face, including challenges stemming from technological disruption, globalization, social media, and political instability, but it does take a significant step toward enabling corporations to better realize their potential to be drivers of broad-based socioeconomic prosperity today and in the future.”<sup>285</sup>

### **Relation of These Initiatives to Corporative Theory**

These initiatives are only a few examples of those recently or currently in progress, but indicate some of the scope and scale of such initiatives generally.<sup>286</sup> Corporations and organizations of corporations, governments, academic organizations, think tanks, and other organizations are focusing attention on what the roles of business and of business corporations should be in the future. The present book has demonstrated important aspects of those roles as observed in North America for about the past two centuries, as well as at the present time.

Corporative analysis engages with, and has the capacity to improve the effects of, all the initiatives surveyed. It is timely, makes a significant contribution to discussion and understanding of the corporation, and has the capacity to be highly useful in this respect. By and large, these initiatives are broadly consistent with, or, perhaps more aptly, are generally “not inconsistent with”, corporative theory. However, they generally lack an overall integrative mechanism, such as a unifying legal or organizational theory, which “makes sense” of such proposals in a larger legal and organizational context appurtenant to the corporation. This is discussed further in the next section.

### **The Limited Responses of Existing Corporate Legal Theory**

Existing corporate legal theory, including stakeholder theory and team production theory, focuses exclusively, or almost exclusively, upon the economic interests of the parties engaged in generating products and services by means of a firm, which are available in a public market for purchase and subsequent consumption. The book establishes that such existing corporate legal

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<sup>284</sup> Martin Lipton, Steven A. Rosenblum, Karessa L. Cain, Sabastian V. Niles, Amanda S. Blackett and Kathleen C. Iannone, "It's Time To Adopt *The New Paradigm*", (February 11, 2019) Harvard Law School Forum on Corporate Governance and Financial Regulation [emphasis in the original].

Available at: <https://corpgov.law.harvard.edu/2019/02/11/its-time-to-adopt-the-new-paradigm>, at 7.

<sup>285</sup> *Ibid.*

<sup>286</sup> *Ibid.*

theory relies upon classical and neoclassical economic generalizations and assumptions that are no longer accepted or considered tenable, including among most economists, and in any event, that do not generate satisfactory explanations, predictions, and guides to action. Perhaps even more importantly, extant corporate legal theory lacks a “toolkit” by means of which such particular legal theory can be readily applied to problems which present themselves, such as long-termism versus short-termism, sustainability, corporate social responsibility, and the fair apportionment of the shared value created by corporations with others.

Instead, extant corporate legal theory fails to focus on what is distinctively “legal” about the issues presented for consideration and, accordingly, ignores the distinctive contribution which legal commentators can make to discussions which also involve members of other disciplines and professions. The distinctive contribution of legal issues and approaches, and hence of legal commentators, to such problems, once ceded, cannot be easily regained. Accordingly, contemporary debates and discussions are dominated by contributions from other disciplines and professions and in which their expertise dominates, with legal input often reduced to the mechanics of implementing policy solutions devised by others, often without meaningful legal contributions.

Further, extant corporate legal theories are largely applied *ex post facto*: that is to say, only after the issue has been framed without reference to legal parameters. Such framing effects tend to “leave behind” the distinctiveness of legal analysis with respect to the corporation. The “logic” and methodology underlying extant corporate legal theory, if they exist separately from non-legal corporate theory, often becomes melded with the logic and methodology of other non-legal theoretical approaches. The result is often a “de-legalized” examination of the problem.

### **The Unlimited Responses of Corporative Theory**

#### ***Advantages of Combining Theory and Methodology***

The corporative theory of, or the corporative perspective on, the corporation involves a distinctive methodological approach. Generally speaking, it involves consideration of available information in order to arrive at some specification of the issue to be considered. Then, it investigates the problem with a characteristic theoretical and methodological approach.

The methodology of corporative theory with respect to any individual legal issue involves examining the five “legal essentialist characteristics” of the corporation: separate legal entity

status, limited liability and asset partitioning, management ownership separation, transferability, and indefinite duration; and the three “organizational essentialist characteristics” of an organization as: firstly, a social unit or group of people; secondly, who collaborate or cooperate; thirdly, towards the attainment of a common goal or objective. Corporative methodology investigates which legal essentialist attributes and organizational essentialist attributes are primarily engaged, and how they are engaged, by the issue under consideration.

Corporative analysis examines the respective interests of the corporation and its legal counterparties, as a legal entity, and, on the other hand, of the corporation and its organizational participants, as an organization; and considers the interrelationship of those interests with each other in relation to the matter under discussion. It seeks to comprehend legal and organizational relationships in a context which engages not only one, but both, sets of relationships. Of course, many organizational theorists, including Weber, consider relationships to obtain where certain behaviour can be predicted and expected by one party of the other, and hence is “appropriate” or “justified”. This attitude is not uncommonly expressed by legal theorists.

Corporative analysis recognizes that the interests of counterparties in legal relationships with corporation as a legal entity and the interests of organizational participants in relationships with the corporation as an organization are not exhausted by economic interests. The book demonstrates that the social identity of directors, CEOs and CFOs, other TMT members, officers, managers, and other employees is involved in their participation in the organization. Less immediately, often this is also true of individuals involved as, or with, the corporation’s suppliers, distributors and customers, particularly those who have exclusive or long-term relationships with the corporation.

Consequently, when organizations like Enron or Arthur Andersen fail, the damage suffered by employees, for example, is not limited to economic injury, but also includes injury to self-perceptions (being seen as “the best and brightest”, “the smartest guys in the room”, or “the best accountants”), and to work, social, and other relationships (often involving those emanating from activities such as sports teams, charitable efforts, speaking or reading clubs, and the like). Losing one’s job means losing all of that, and all at once.

Intraorganizational transfers from one division or subsidiary to another or from one region or country to another may increase the dependence of individuals on the corporation as a source of extracurricular activity and meaning. At the same time, the relationships of individuals as legal

counterparties of the corporation as a legal entity, and as organizational participants in the corporation as an organization, may transcend barriers of limited liability and asset partitioning, such that the individuals concerned may identify with Enron as the ultimate parent corporation without necessarily acknowledging any constraints of that nature, resulting from their engagement with a second, third, or fourth tier subsidiary or other non-immediate relationship with Enron itself.

The book shows that organizational roles do not strictly define the involvement of organizational participants, who also have extraorganizational goals, values, commitments, and interests. Corporations do, however, engage in socialization processes to inculcate organizational goals and values and to create organizational identification and organizational commitment, which tend to promote loyalty and the exercise of “voice” in respect of intraorganizational disagreement, rather than the exercise of “exit” or its functional equivalent in the circumstances.

Individuals may exhibit organizational identification, organizational commitment, and loyalty to the particular business units or functions in which they are engaged. Some of these intraorganizational groups or components, including the board of directors and including the TMT, may be considered to constitute intraorganizational organizations themselves. They may pursue goals and objectives which only partially correspond with those of the organization as a whole. Sanctions, whether positive (incentives) or negative (penalties or disincentives), including those directed to observing legal requirements, must operate at the appropriate organizational level and in the appropriate manner. Framers of legal requirements, incentives, and penalties must take such matters into consideration.

In conjunction with legal rights and obligations, intraorganizational relationships may sometimes, given due consideration and appropriate methodological application, be “levered” to influence societally optimal behavioural, including performance (or increased performance) of desired behaviour and non-performance (or reduced performance) of societally disapproved behaviour. The ability to construct such leverage mechanisms depends, necessarily, upon proper corporative analysis of the legal and organizational relationships engaged, most especially in relation to legal essentialist and organizational essentialist attributes.

### ***Quantifying Corporative Relationships***

It is clear that recognizing the legal essentialist characteristics and the organizational essentialist characteristics most directly engaged by a particular issue and analyzing the issue with respect to

those characteristics in the manner discussed previously is key to corporative analysis. That enables a determination of the propinquity or centrality and the salience of both the relevant corporation-counterparty legal analysis and the corporation-participant organizational analysis. The discussion under the present heading illustrates but one example of how such centrality and salience may be conceptualized for the purpose of being operationalized; and how these concepts may be used to implement change by way of legal and organizational relationships in such relationships or otherwise.

Let us envision the propinquity or centrality, and the salience, of the corporation-counterparty legal relationship (“L relationship” or “LR”) and the corporation-organizational participant organizational relationship (“O relationship” or “OR”), which might be described, collectively, as the centrality and salience of the corporative relationship (“CR”) between them, as being represented by a series of concentric circles with the corporative relationships having greater propinquity and salience depicted as closer to the centre of the concentric circles. It is acknowledged, of course, that LR and OR can be mapped separately by means of such concentric circles, and that a methodology for converting separate LR and OR mappings into a combined CR mapping, if it is possible, has not yet been developed. Instead, each of these mappings is suggested as a means of simplifying and concretizing the underlying intellectual constructs.

We might identify the circle at the centre as the corporation itself. Without seeking accuracy but for the purpose of demonstration only, we might consider the relationship between the corporation and its CEO and CFO to be represented by placement in the first band or within the first concentric circle surrounding the centre, which we might refer to as a “CR 1 level relationship”, with the others denominated accordingly. For purposes of demonstration only, members of the TMT might be considered to be in the second circle (“CR 2”), other officers might be in the third, with senior managers, middle managers, and lower-level managers in the fourth, fifth, and sixth circles, and other employees in the seventh circle.

Major suppliers, distributors, and customers in long-term contractual relationships with the corporation might be placed within the third or fourth circle, while other suppliers might be placed in the fifth, sixth, and seventh circles, again, for purposes of illustration only. Important lenders, whether term or revolving, by reason of the term of the legal relationship or the duration of the organizational relationship, or both, might be placed in third circle or tier. Depending upon the



circumstances, controlling shareholders might be a level CR 1 or CR 2 level relationship, major but not controlling shareholders at a level CR 2 or CR 3, influential institutional shareholders might be at a level CR 4 or CR 5, while significant retail shareholders might be at a level CR 7 or CR 8, and non-significant retail shareholders might be at a level CR 9 or CR 10.

Assuming that it does not enjoy any preferential tax or other treatment, municipalities and communities in which the focal corporation has important plants or offices might be in the eighth circle; the province or state might be in the ninth circle; and the corresponding nation-state might be in the tenth circle. We will assume that the relevant society or polity may be placed within the same circle as the government with respect to which it is engaged. Assuming that the corporation does not supply consumer-branded products or services and that its business is not particularly dependent upon or sensitive to environmental considerations, “the environment” might be at a level CR 11 or CR 12, while environmental activists who may be in a position to influence various levels of shareholders and employees might be at a level CR 6 to CR 8. Of course, all these assignments of corporative relationships are not intended to be realistic other than as illustrations.

### *Applying Corporative Theory to Effect Change*

Effecting change consequent upon corporative analysis would involve taking into account all the foregoing considerations. After determining how the relevant legal and organizational essentialist characteristics engage with the issue at hand, a counterparty/organizational participant wants to encourage some change with respect to the corporation’s behaviour would consider how to employ the foregoing centrality and salience analysis to that purpose.

This would include approaching other counterparty/organizational participants having legal or organizational interests (or both) which are similar to that of the change proponent with a view to making common cause. Such approaches may be particularly advantageous where the other counterparty/organizational participant may be perceived to have a CR rating higher than that of the initiating proponent. As noted below, the proponents of the Equator Principles may be seen as having implicitly employed something like this kind of corporative approach. It involves, literally, “taking the relationship to a new level”, that is to say, increasing its centrality and salience, by

cooperation with other counterparties/organizational participants or otherwise. This may have characterized, at least in part, the promulgation of the Equator Principles.<sup>287</sup>

Considered in a manner which vastly oversimplifies the process involved there for the purpose of providing a dramatic illustration of the type of influence and change process envisioned by corporative analysis, it may be argued that by ultimately influencing major financial institution lenders: firstly, to adopt the Equator Principles and to enshrine them in principles and practices with respect to approval of loan agreements with borrowers; secondly, to report them on the Equator Principles Association website; and, thirdly, with respect to the same to designate countries that are considered to have “robust environmental and social governance, legislation systems and institutional capacity designed to protect their people and the natural environment” in connection therewith; the proponents of the Equator Principles raised the level of combined legal and organizational relationship (previously characterized as the corporative relationship or “CR”) from level CR 11 or CR 12 to level CR 3, based on the assumptions described here.

Thus, getting the attention of, and commitment from, those major lenders enabled the proponents of the Equator Principles to get the attention of, and commitment from, relevant borrowers, in this case through the instrumentality of the loan arrangements themselves. In this sense, the proponents relied on “demand pull” and “participant pull”, the desire of the financial institutions concerned to derive the reputational advantages and hence market advantages desired by some of their legal counterparties and organizational participants, including customers.<sup>288</sup> Of course, the actual process leading to the promulgation of the Equator Principles was considerably more complex than

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<sup>287</sup> Equator Principles Association, *The Equator Principles III June 2013*, online at: [https://equator-principles.com/wp-content/uploads/2017/03/equator\\_principles\\_III.pdf](https://equator-principles.com/wp-content/uploads/2017/03/equator_principles_III.pdf). See also Cynthia A Williams and John M Conley, "Global Banks as Global Sustainability Regulators: The Equator Principles" (2011) 33:4 *Law & Pol'y* 542; and Olaf Weber and Emmanuel Acheta, “The Equator Principles: Do They Make Banks More Sustainable?” (February 2016) The United Nations Environment Programme, Inquiry into the Design of a Sustainable Financial System, Working Paper 16/05, online at: [http://unepinquiry.org/wp-content/uploads/2016/02/The\\_Equator\\_Principles\\_Do\\_They\\_Make\\_Banks\\_More\\_Sustainable.pdf](http://unepinquiry.org/wp-content/uploads/2016/02/The_Equator_Principles_Do_They_Make_Banks_More_Sustainable.pdf).

<sup>288</sup> A useful review and analysis of non-state market-driven governance systems, both transnational and domestic, is Benjamin Cashore, "Legitimacy and the Privatization of Environmental Governance: How Non-State Market-Driven Governance Systems Gain Rule-Making Authority" (2002) 15:4 *Governance: An International Journal of Policy, Administration, and Institutions* 503. Concerning market-driven governance, see also: Peer Zumbansen, "Happy Spells? Constructing and Deconstructing a Private Law Perspective on Subsidiarity" (2015) King's College London Dickson Poon School of Law Legal Studies Research Paper Series: Paper No. 2015-31.

the vastly oversimplified version set forth here as an exaggerated or dramatized illustration of how corporative theory and corporative relationships may be applied.

Nevertheless, that simplified example demonstrates how increasing the centrality and salience of legal and organizational relationships contributes to increasing the power and influence of legal counterparties and organizational participants vis-à-vis the focal corporation itself. It also illustrates how corporative analysis can facilitate the employment of corporative relationships to affect corporate behaviour in both its inward-facing and outward facing aspects; and sometimes in ways which are preferable to, and more powerful than, exterior regulation by more “outside” parties such as governments and their attendant regulatory authorities.<sup>289</sup>

Put simply, this involves the employment and application of intraorganizational participation by various organizational participants, including governmental entities in some cases, in the organization itself, instead of, or as supplementary to, external legal regulation of the corporation by government as a legal counterparty external to the corporation as a legal entity. These matters are expected to be examined more fully in future work.

### ***An Invitation***

In the result, corporative theory provides both a theory and a methodology. Its validity and efficacy may be assessed in relation to its explanatory power, predictive capacity, and capacity of meaningful instantiation in action in “the real world”. It is submitted that its contributions in that regard validate the theory, and that it does so in ways not characteristic of other extant theories of the corporation. Further applications to other critical issues and assessments of the theory await.

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<sup>289</sup> Concerning the merits of self-governance as opposed to external governance, see: Peer Zumbansen, "Rethinking the Nature of the Firm: The Corporation as a Governance Object" (2012) 35 Seattle U LR 1469.

**CHAPTER A1:  
CORPORATE ESSENTIALISM  
AND  
CORPORATE ORGANIZATION IN LAW**

As is explored in more detail in Chapter Four, the term “organization” is generally understood to mean, in effect, a group of persons acting collectively to satisfy some commonly agreed need (or needs) or to pursue one or more commonly agreed goals or objectives. As such, an organization has some structure, pursues its objectives in accordance with certain processes, and involves individual actors or groups of actors, who may be referred to as its “personnel”. Modern business corporations also are, contain, or involve, organizations, which have certain economic or “business” goals and objectives, as demonstrated by the previous review of certain leading corporate statutes.

**PART A – PARADIGMATIC ATTRIBUTES OF THE CORPORATION**

A corporation is endowed by law, statutory or otherwise, with certain characteristic legal attributes which have been described here, roughly, as follows: 1. The corporation is a separate legal entity (“SLE”), which is to say that it is recognized in law as a rights-and-duty-bearing entity, further particulars of which are set forth in the relevant corporate legislation. 2. The corporation is characterized by asset partitioning and limited liability. 3. Interests in its equity or capital are “locked-in”, but are transferable. 4. Its management is centralized and independent of the “owners” of its capital or equity. 5. Unless otherwise determined, it has indefinite duration.

As a legal entity, it might be expected that the characteristic legal attributes of the corporation might impact the relevant organizational characteristics and vice versa. That is to say, those characteristic legal attributes might affect its choices, and the attributes, of its legal structure, processes, and personnel. At the same time, those characteristic legal attributes of the corporation as a matter of law might affect not only its organization as a matter of law, but also its characteristic organizational attributes, both formal and informal.

This chapter, which deals with the organization of the corporation in law, will examine the statutory assignment of rights, responsibilities and liabilities among corporate participants, principally as between the shareholders and the board of directors. As discussed above, the principle that shareholders, as capital contributors and participants, are not entitled, as such, to participate in management of the entity (as opposed to partnerships, for example), is instantiated

statutorily by assigning responsibility for management of the corporation to the board of directors, although, in exceptional cases, this paradigm may be varied in concrete instances by prescribed action reserving certain “management” type rights to the shareholders.

This paradigm, of course, raises questions concerning the extent to which shareholders may or should have vestigial rights with respect to management or oversight of management, which might include, but may not be limited to, rights to elect and remove directors. The circumstances in which this management-by-board paradigm may be varied are generally limited to ones in which the shareholders are unanimous on such variation and where the corporation concerned is not a publicly listed or traded entity.

As suggested in this section, the corporate attributes of capital lock-in and transfer rights, which are also related to the separation of “management” and “ownership”, which we may refer to as the “management ownership separation” attribute, give rise to concerns about situations in which rights of management or other shareholders or possibly others may be exercised in an abusive manner such as to merit claims to relief by the shareholder (s) affected, and, as well, about situations in which such abuses might affect transferability of the shares held by the shareholders affected. These matters are discussed under the headings “Management Responsibility for Running the Business” in the present chapter, and “Legal and Management-Related Rights of Shareholders” and “Shareholder Rights Beyond Voting” in Chapter Three.

Further, the attribute of the corporation that it constitutes a single entity in law raises for consideration the subjects of extra-corporate action, the ways in which the corporation acts “in the world” with respect to entities external to itself, and intra-corporate action, the ways in which the corporation acts in relation to its participants, that is to say, with respect to entities internal to the corporation, as participants in its internal organization. These matters are discussed in Chapter Four under the heading “Organizational Liability for Acts of Corporate Actors”.

In effect, this discussion of the statutory paradigm of the organization of the corporation in law engages not only the internal and external structure of the corporation, but also the processes, internal and external, by which it is permitted to take lawful action, and the personnel through whom it may take such action. Thus, it explicates aspects of both the essential legal attributes of the corporation as a separate legal entity as a matter of law, and its essential and other organizational attributes as exemplifying and instantiating a species of organization. Accordingly,

this section will discuss the means by which the essential legal attributes are instantiated in modern corporate law statutes. This will afford some comparative analysis of the means by which these attributes are instituted statutorily.

## **PART B – MANAGEMENT ROLE OF THE BOARD OF DIRECTORS**

### **Statutory Role**

As noted above, under most modern corporate statutes, the role of the board is to manage or supervise the management of the business and affairs of the corporation. For example, this is the case in the CBCA and the OBCA, which provide, in effect, that subject to any unanimous shareholder agreement, the board of directors shall manage or supervise the management of the business and affairs of the corporation.<sup>1</sup>

The Delaware General Corporation Law provides that “[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”<sup>2</sup> While the author is not aware of the frequency with which powers of management or direction are assigned otherwise than to a board of directors, one would expect that it would be relatively low. However, there may be some cases in which board powers and duties are limited and assigned to others, for example, in the case of shareholder agreements to which all shareholders are parties.

The language of the Model Business Corporation Act, whose provisions have been adopted as the basis of state corporation laws in a majority of American states, is slightly different. It states that:

- (a) Except as provided in section 7.32, each corporation must have a board of directors.
- (b) All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors,

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<sup>1</sup> *Canada Business Corporations Act*, RSC 1985, c C-44, s 102 [CBCA]; *Business Corporations Act*, RSO 1990, c B.16, s 115 [OBCA]. These provisions codify previously existing law concerning the powers of the board of directors. The leading case of *Automatic Self-Cleansing Filter Syndicate Co v Cuninghame*, [1906] 2 Ch 34 (Eng CA), confirmed that the authority of the board of directors to manage the corporation was not subject to any overriding authority of the shareholders in general meeting. In particular, the directors ignored the results of a vote of shareholders to sell the assets of the subject corporation on terms previously agreed with a particular purchaser, considering such sale not to be in the best interest of the corporation. The court held that under the memorandum and articles of the corporation, the directors had the full powers of the corporation, except where an extraordinary resolution of the shareholders was required, and could act independently of, and even contrary to, the opinion of a majority of the shareholders.

<sup>2</sup> General Corporation Law, 8 Del Code, c 1, § 141(a) [DGCL].

subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32.<sup>3</sup>

Section 7.32 deals with shareholder agreements among all the shareholders of a corporation and is somewhat similar to a unanimous shareholder agreement under the OBCA and CBCA. Shareholder agreements authorized under that section may restrict the authority of the board of directors. As noted above, such an agreement terminates when a corporation becomes a public corporation as defined in section 1.40 (18 A), which term means “a corporation that has shares listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national securities association”.

Thus, in such jurisdictions, subject to permitted limitations, the board of directors is empowered and required to manage or to supervise (CBCA/OBCA), or to manage or direct (DGCL), or simply to direct (MBCA), the management of the business and affairs of the corporation. In the CBCA and the OBCA, the term “business” is not defined, but the term “affairs” is defined to mean “the relationships among the corporation, its affiliates, and the shareholders, directors and officers of such bodies corporate but does not include the business carried on by such bodies corporate”.<sup>4</sup> Neither term, “business” nor “affairs”, is defined, although both are used, in the DGCL or in the MBCA.

Thus, the Canadian statutes specifically authorize and empower the board to manage or supervise the management of relationships among the corporation and certain of its primary constituents, namely its shareholders, directors and officers. Interestingly, the term “affairs” as so defined, does not expressly include relations between any of the specified parties and the board of directors itself. This may be because to do otherwise would vest complete authority over such relationships in the board, without recognizing any rights and responsibilities of the other parties. Certainly, there is no doubt that the board may manage relationships between individual directors and such other parties. Accordingly, it may simply be that the collective actions of the board of directors itself

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<sup>3</sup> American Bar Association, *Model Business Corporation Act Annotated*, 4th ed, (Chicago: American Bar Association, 2008), s 8.01(a)-8.01(b) [MBCA]. A valuable discussion of the history, development, interrelationship, and comparison, of the DGCL and the MBCA appears in Jeffrey Gorris, Lawrence A Hamermesh & Leo E Strine, Jr, “Delaware Corporate Law and the Model Business Corporation Act: A Study in Symbiosis” (2011) 74:1 Law & Contemp Probs 107.

<sup>4</sup> *CBCA*, *supra* note 1, s 2(1). The definition in s. 1 (1) of the OBCA is substantially identical. Internet searches failed to disclose any authority, judicial or otherwise, or any commentary with respect to the latter term in general, apart from consideration solely in respect of its use as a term of art in the context of the oppression remedy.

were considered in drafting the statute to be adequately represented by the word “directors” alone. The subject seems unaddressed by commentaries on the section. Importantly, however, these statutes expressly recognize that relationships, legal and arguably otherwise, exist or may exist among these various corporate constituents, and that such relationships may be managed by the board.

As discussed elsewhere in this chapter and later in this Part, the scope of the management authority and responsibility vested in the board of directors by statute and its divorcement from equity ownership by such management, unlike in the case of other business entities, particularly when combined with capital lock-in, is, to some extent, intermediated by other statutory mechanisms. These include the election of, duties of, and ability to remove, directors, the ability of shareholders to oppose management nominees for election as directors, the ability to raise matters for consideration at meetings of shareholders, and the power and authority to approve transactions considered to be fundamental to the corporation, and its business and affairs, including those transactions affecting the rights and respective entitlements of corporate participants. In these ways, the corporate statutes instantiate and operationalize the essentialist attributes of the corporation.

### **Duties of Directors**

Under most modern corporate statutes, directors have a duty of good faith, which is often referred to as their fiduciary duty, and which is referred to here as their “duty of loyalty”. They also have a duty of care. For example, s. 122 of the CBCA and s. 134 of the OBCA provide, in effect, that every director and officer of a corporation in exercising their powers and discharging their duties shall (a) act honestly and in good faith with a view to the best interests of the corporation (the “duty of good faith” or “duty of loyalty”); and (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances (the “duty of care”). These sections also require directors and officers to comply with the Act, the regulations, articles, by-laws and any unanimous shareholder agreement (which we shall refer to here as the “duty of compliance with corporate law” or “duty of compliance”).

They provide, too, that no provision in a contract, the articles, the by-laws or a resolution relieves a director or officer from the duty to act in accordance with the statute and the regulations, or relieves him or her from liability for a breach thereof. As can be seen, these provisions apply not



only to directors but also to officers. However, both Canadian statutes recognize that directors and officers cannot be expected themselves to possess the information necessary to make all requisite decisions and thus must frequently rely on information supplied by others.

Under subsection 123 (5) of the CBCA, a director has complied with his or her duties “if the director relied in good faith on (a) financial statements of the corporation represented to the director by an officer of the corporation or in a written report of the auditor of the corporation fairly to reflect the financial condition of the corporation; or (b) a report of a person whose profession lends credibility to a statement made by the professional person.” Thus, the type of reliance which, on its own, relieves a director from liability is quite circumscribed indeed.

The equivalent OBCA provision, subsection 135 (4), somewhat broadens the scope of permissible reliance. Compliance with duty occurs “if the director exercised the care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances, including reliance in good faith on, (a) financial statements of the corporation represented to him or her by an officer of the corporation or in a written report of the auditor of the corporation to present fairly the financial position of the corporation in accordance with generally accepted accounting principles; (b) an interim or other financial report of the corporation represented to him or her by an officer of the corporation to present fairly the financial position of the corporation in accordance with generally accepted accounting principles; (c) a report or advice of an officer or employee of the corporation, where it is reasonable in the circumstances to rely on the report or advice; or (d) a report of a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by any such person.”

In effect, reliance in good faith upon any of the documents or reports stipulated in paragraphs (a) through (d) only avails the director if and to the extent that such director otherwise meets the standard of care required. Accordingly, a director has to determine whether reliance on such documents or reports evidences the exercise of “the care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances”. Not only must the standard be satisfied generally to amount to compliance with duty, but it must be satisfied specifically with respect to reliance on such documents or reports.

With respect to Delaware corporations, the DGCL refers to a fiduciary duty and a duty of loyalty obliquely in that it allows such duties to be limited in prescribed manners in the certificate of

incorporation.<sup>5</sup> In particular, under s. 102 (b) (7), personal liability of directors for breach of the duty of care, but not the duty of loyalty (and the related duty to act in good faith), may be eliminated or limited. The content of these duties, then, are determined at common law, and the relevant case law is very extensive and complex, thereby preventing its review here.<sup>6</sup>

As is well known, Delaware courts apply the “business judgment” rule, which, until 1985, at least, protected directors who acted in accordance with their business judgment from liability except in, and protected shareholders only against, extreme cases of incompetence.<sup>7</sup> The business judgement rule, as applied in Delaware, protects directors from liability in respect of their business judgement provided that they act in good faith, with the degree of care of an ordinarily prudent person in such circumstances, and reasonably believe the decision to be in the corporation’s best interests.<sup>8</sup> In effect, the court will defer to, and will not review such decisions. In 1985, the Delaware Supreme Court decision in *Smith v. Van Gorkom*<sup>9</sup> found the directors liable for a breach of their duty of care, although they were found to be acting in good faith. This caused great consternation. Section 102 (b) (7) was enacted, apparently in response to that finding, the following year, thus restoring the status quo ante.<sup>10</sup>

The Model Business Corporations Act creates both duties. It provides, in section 8.30 (a), that “[e]ach member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the

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<sup>5</sup> DGCL, *supra* note 2, § 102(b)(7). As noted in the article cited in footnote 83 below, this was enacted in 1986, apparently in response to the *Smith v. Van Gorkom* decision discussed here.

<sup>6</sup> For example, for the duty of care, see the discussion in Stephen J Lubben & Alana J Darnell, “Delaware’s Duty of Care” (2006) 31:2 Del J Corp L 589; and for the fiduciary duty and duty of loyalty, see Randy J Holland, “Delaware Directors’ Fiduciary Duties: The Focus on Loyalty” (2009) 11:3 U Pa J Bus L 675. The latter article offers the perspective of a Justice on the Supreme Court of Delaware. A useful discussion written from *the* perspective of practitioners appears in William M Lafferty, Lisa A Schmidt & Donald J Wolfe Jr, “A Brief Introduction to the Fiduciary Duties of Directors Under Delaware Law” (2012) 116:3 Penn St L Rev 837. A more academic perspective is provided by a leading corporate law professor, Lyman Johnson, in “Delaware’s Non-Waivable Duties” (2011) 91:2 BUL Rev 701.

<sup>7</sup> See Lubben & Darnell, *supra* note 6 at 590.

<sup>8</sup> Useful and often cited reviews of the rule appear in S Samuel Arsht, “The Business Judgment Rule Revisited” (1979) 8:1 Hofstra L Rev 93-134; Bayless Manning, “The Business Judgment Rule and the Director’s Duty of Attention: Time for Reality” (1984) 39:4 Bus Lawyer 1477; Daniel R Fischel, “The Business Judgment Rule and the *Trans Union* Case” (1985) 40:4 Bus Lawyer 1437.

<sup>9</sup> 488 A (2d) 858 (Del Supt Ct). See also articles after that decision, including Leo Herzl & Leo Katz, “*Smith v. Van Gorkom*: The Business of Judging Business Judgment” (1986) 41:4 Bus Lawyer 1187; Lynn A Stout, “In Praise of Procedure: An Economic and Behavioral Defense of *Smith v. Van Gorkom* and the Business Judgment Rule” (2002) 96:2 Nw UL Rev 675.

<sup>10</sup> Edward Rock and Michael Wachter, “Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants” (2002) 96:2 Nw UL Rev 651 at 652.

corporation”, and, in s. 8.30 (b), that “[t]he members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.”<sup>11</sup>

In connection with these duties, the MBCA recognizes that directors act collectively and, further, that it is often appropriate for them to rely on information provided by others, including, from time to time, other directors. Consequently, section 8.30 (c) requires a director to disclose or cause to be disclosed to other board or board committee members “information not already known by them but known by the director to be material to the discharge of their decision-making or oversight functions” unless it would violate a legal duty, legally enforceable confidentiality obligation, or professional ethics rule. As the Official Comment notes at page 264, this makes explicit a moral or a legal obligation which has often been considered to obtain, but the statutory provision is separate from any common law duty.

Since directors make decisions both individually, in respect of each of their own positions relating to an issue, and collectively, as a board, in taking board decisions, it makes sense that information not legally restricted from such disclosure should be disclosed by a director to the other directors, lest there arise some imputation to all of them of knowledge possessed by only some of them.

Further, unless the director has knowledge that makes reliance unwarranted, such director is entitled to rely on the performance of officers or employees “whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports or statements provided” as specified in section 8.30 (f) (1) and (3) “to whom the board may have delegated, formally or informally by course of conduct, the authority or duty to perform one or more of the board’s functions that are delegable under applicable law”.

Under section 8.30 (e), in discharging board or board committee duties, a director “who does not have knowledge that makes reliance unwarranted is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, prepared or presented

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<sup>11</sup> MBCA, *supra* note 3, s 8.30. A thorough review and analysis of the duty of good faith in Delaware law and more broadly, but not specifically addressing the MBCA provision, is that of Melvin A. Eisenberg in “The Duty of Good Faith in Corporate Law” (2006) 31:1 Del J Corp L 1. A comparison of the MBCA provision then in force with the applicable Delaware law from the perspective of practitioner later jurist (Chief Justice of the Delaware Supreme Court) appears in Norman Veasey & WE Manning, “Codified Standard – Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law” (1980) 35:3 Bus Lawyer 919.

by any of the persons specified in subsection (f).” In addition to the officers and employees, and the board committees mentioned previously, section 8.30 (f) entitles directors to rely on “legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the director reasonably believes are matters (i) within the particular person’s professional or expert competence or (ii) as to which the particular person merits confidence”. As the Official Comment notes at page 267, this might include not only parties who are licensed with respect to the activity concerned, such as lawyers, accountants and engineers, but also those with special skills and experience, such as investment bankers, geologists, management consultants, actuaries, appraisers, and private investigators.

Other specific duties are also imposed. Some of the statutes, such as the CBCA and the OBCA, also contain specific provisions relieving a director from liability. For example, sections 135 and 123, respectively, provide that a director may dissent from actions of the board by taking on certain prescribed options, in which case such director avoids liability for such actions.

In summary, the modern corporation statutes mentioned specifically impose on directors the duties of loyalty, care, and compliance. As is discussed in Chapter Four under the heading “Organizational Liability for Acts of Corporate Actors” and its sub-headings, particularly “The Agency Relationship in Law” and “The Principal-Agent Relationship Inter Se”, these fiduciary and other duties are similar to and are derived from duties of agents to principals and trustees to beneficiaries (in the case of fiduciary duties of directors) at common law.

The discussion in Chapter Four below demonstrates that agency law principles continue to apply to actors within the corporation who are not subject to obligations expressly codified in the statutes, which means, in effect, those who are in a level of the corporate hierarchy below directors and officers. The scope of the term “officer” under the corporate statutes will be discussed later in this chapter.

It is recognized that directors and officers must rely on others for certain information and advice. The parties responsible for information on which the directors may rely include the corporation’s officers, employees, auditors, and other persons who are actual or putative experts in the subject-are concerned and who are, generally, acting as its agents with respect to the matter concerned. In this way, the common law of agency has “filtered into” the statutory law of the corporation.

As a separate legal entity, the directors rely upon officers and employees who are internal the corporation, as well as auditors, counsel and others, acting as agents and otherwise, who are external to the corporation, but whose actions are, to some degree, “internalized” by reason of their adoption into internal processes, at least vis-à-vis other external parties. In relying upon the personnel by means of whom the corporate entity and its organization carry on operations, the board is also relying upon its internal structure and processes. These matters upon which they are entitled to place reliance, namely, structure, processes and personnel, are ones over which the board has authority and responsibility, and they are also attributes of its internal organization.

As noted, other “external” parties, such as the auditors, regular external corporate counsel, ongoing investment banking advisors, and regularly engaged management consultants may also participate in its organization. This is particularly the case with respect to the auditors, who have a formal legal role by statute. Thus, the legal essentialist attributes of the corporation discussed above affect the corporation’s organization and operations.

Of course, officers and employees of the related corporations, unless they are also officers and employees of the focal corporation, do not qualify as officers or employees of the focal corporation as a separate legal entity and, accordingly, reliance upon them does not protect a director statutorily unless, of course, the “skills and expertise” provision has, or is accepted to have, application.

These observations raise questions concerning the “boundaries of the organization” within the corporation and, in particular, the extent to which the boundaries of the organization may be confined or limited to, or, on the other hand, may extend beyond, the boundaries of the corporation as a legal entity. In effect, the external parties upon which the board actually relies may be outside the legal boundaries of the corporation but may be considered by organizational participants to be, in some respects, within, or part of, the organization itself for certain limited purposes. On the other hand, it is only where such parties are actually engaged by the focal corporation itself, rather than, say, by a parent corporation, subsidiary, or other affiliate corporation, that the legal entitlement to reliance may be said to unequivocally arise.

This recalls the discussion amongst economists concerning the respective boundaries of the market and, on the other hand, of the firm.<sup>12</sup> For example, Rock and Wachter consider these boundaries

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<sup>12</sup> Of course, the leaders in these discussions include Coase, Williamson, Holmstrom and Milgrom, Roberts, and Tirole. See e.g. RH Coase, “The Nature of the Firm” (1937) 4:16 *Economica* 386; Oliver Williamson, *Markets and*

as matters of economic logic.<sup>13</sup> In the present case, as lawyers and legal theorists, what concerns us is the respective boundaries between the corporation, as a legal entity, and the organization which animates and vivifies it. However, those legal boundaries and constraints may be at variance with economic and organizational boundaries and constraints.

The nature of the corporation as involving or implicating an organization is more fully explicated in Part 3 of this book. However, for the purpose of the present discussion, considering an organization as a group of people structured and managed in order to accomplish some goal or objective, it can be seen that the group or some part of it must structure and manage the group towards attainment of such goal or objective.

Rational pursuit of such ultimate goal or objective is ordinarily pursued by seeking to achieve what might be called “subultimate” goals or objectives, which may be more proximate or immediate, on the one hand, or, on the other hand, purely instrumental. The means by which any organization pursues its ultimate or subultimate goals or objectives may be subject to significant contestation among the members of the organization. Their rational pursuit may be facilitated by imposing specific duties and responsibilities on its ultimate decision makers as they determine how the organization will pursue its various goals and objectives.

As is discussed further in Part 3, the organization which animates or vivifies the corporation, thereby enabling it to take action, is, of course, a group of persons, within which various groups and subgroups may themselves act (perhaps even as intraorganizational organizations) within the corporation’s organization. Accordingly, each of these groups and subgroups may have its own subultimate, proximate, and instrumental goals and objectives. The alignment and synchronization of those group and subgroup goals and objectives with those of the corporation itself are important to the overall management of the corporation.

In the case of the corporation, the statutes assign to the board of directors the duty, responsibility, and authority to manage or supervise its business and affairs. They also impose specific duties and

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*Hierarchies: Analysis and Antitrust Implications* (New York: Free Press, 1975); Oliver Williamson, “Transaction-Cost Economics: The Governance of Contractual Relations” (1979) 22:2 *JL & Econ* 233; Oliver Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985); Bengt Holmstrom & John Roberts, “The Boundaries of the Firm Revisited” (1998) 12:4 *J Economic Perspectives* 73; Bengt Holmstrom & Paul Milgrom, “Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design” (1991) 7 *JL Econ & Org* 24; Bengt Holmstrom & Paul Milgrom, “The Firm as an Incentive System” (1994) 84:4 *American Economic Rev* 972; Bengt Holmstrom & Jean Tirole, “Transfer Pricing and Organizational Form” (1991) 7:2: *JL Econ & Org* 201.

<sup>13</sup> Rock & Wachter, *supra* note 10 at 652.

responsibilities, namely, the duties of loyalty, care, and compliance, which may be considered as constraining the behaviour of the board in the course of pursuing the organization's ultimate and subultimate goals and objectives. These duties also seek to create alignment or congruence among the goals and objectives of the corporation, those of the board, and those of individual directors.

In the case of the corporation, the duties of loyalty, care, and compliance are imposed on directors in connection with the instantiation of central management (by the board), the separation of such management (by the board) from equity ownership (by shareholders), and the related locking-in, and transferability of, capital. The imposition of such duties is thought to provide equity owners and other corporate constituents with some degree of assurance that the ultimate ends or ultimate goals and objectives of the corporation will be pursued rationally and effectively.

### **Indemnification of Directors**

Under section 124 of the CBCA and section 136 of the OBCA, a corporation may indemnify a current or former director or officer "against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment, reasonably incurred by the individual in respect of any civil, criminal, administrative, investigative or other proceeding in which the individual is involved because of that association with the corporation" provided that the individual "acted honestly and in good faith with a view to the best interests of the corporation" and "in the case of a criminal or administrative action or proceeding that is enforced by a monetary penalty... [t]he individual had reasonable grounds for believing that the individual's conduct was lawful." The statutes also provide that a corporation may, with court approval, indemnify such individual in respect of derivative actions. An individual who is eligible for indemnity on such grounds is entitled to indemnity if such person was not judged by the court or other competent authority to have committed any fault or omitted to do anything that the individual ought to have done.

Under section 145 of the DGCL, the corporation's general power to indemnify is expressed in similar terms, but it also extends to employees and agents. It is also specifically provided that "the termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which the person reasonably believed to be in or not opposed to the interests of the corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that the person's conduct was lawful." The requisite

determinations must be made in each specific case by a majority, even though less than a quorum, of directors or a committee of directors, who are not parties to such action, suit or proceeding, or if there are no such directors or if such directors so direct, by independent legal counsel in a written opinion, or by the stockholders. It appears that a shareholder determination would always suffice.

The MBCA differentiates among the corporation's abilities to indemnify directors, officers, and employees or agents. In the case of directors, this ability is expressed in Section 8.51 in terms similar to the CBCA and the OBCA, except that s. 8.51 distinguishes between conduct in an official capacity and conduct in other cases. The discussion of agency law below will show that such distinction is made in agency law more generally, and is relevant to liability of the principal, as well as indemnity, for the relevant actions.

In the case of conduct in an official capacity, the director must have reasonably believed that his or her conduct was in the best interest of the corporation, while in other cases, he or she must only have reasonably believed that such conduct was at least not opposed to the best interests of the corporation. Indemnification by the corporation is required where a director was "wholly successful, on the merits or otherwise, in the defense of any proceeding to which the director was a party because he or she was a director of the corporation." Indemnification of officers is the subject of section 8.56, which is discussed below in relation to the duties of officers.

Such rights of indemnification are sought to be justified on the grounds that each director is considered to be acting for the benefit of the corporation, and not in his or her interests. In many, if not most, cases in with respect to public companies, the extent of personal benefit derived by assuming directorial responsibilities would be quite inadequate as compared with potential liability if the business judgment of such a director was not protected, and if such indemnification was not available.

The discussion of agency law below, especially under the heading "Duties of Officers and Employees" and in Chapter A3, will demonstrate that, in the absence of applicable provisions in the relevant corporate statutes or other statutes, intracorporate agents, like other agents generally, may be entitled to indemnification from their corporate principal. Thus, while the corporate statutes codify indemnification rights and obligations at the level of the hierarchy with which they expressly deal, other somewhat similar rights may obtain at other levels of the organizational hierarchy. Unlike the other statutes, the MBCA provisions purport to extend statutory indemnity



provisions to employees and agents, which may enlarge, reduce, or conflict with, common law agency rights and obligations.

### **Delegation of Powers**

Sections 115 of the CBCA and 127 of the OBCA provide, in effect, that directors of a corporation may appoint from their number a managing director (who must be a resident Canadian under the CBCA) or a committee of directors and delegate to such managing director or committee any of the powers of the directors. It is clear that the person or persons appointed as managing director or as members of such a committee must themselves be directors.

Under both statutes, no managing director and no committee of directors has authority to submit to shareholders any question or matter requiring their approval; fill a vacancy among the directors or in the office of auditor, or, under the CBCA, appoint additional directors or, under the OBCA, appoint or remove any of the chief executive officers, however designated, the chief financial officer, however designated, the chair or the president; issue securities except as authorized by the directors; in the case of the CBCA, issue shares of a series under section 27 except as authorized by the directors; declare dividends; purchase, redeem or otherwise acquire shares issued by the corporation; pay a commission on the sale of shares of the corporation (under certain specified sections); approve a management information circular; approve a take-over bid circular, directors' circular, or in the case of the OBCA an issuer bid circular; approve certain financial statements; in the case of the OBCA, approve an amalgamation or an amendment to the articles; or adopt, amend or repeal by-laws.

It is notable that most of these matters reserved for action by the full board affect the relationship, or involve the interface, between the board and the shareholders, or involve related disclosures and potential liabilities arising from such relationship or interface. In such circumstances, it is considered appropriate that such matters be considered by the board of directors as a whole. While there may be some disagreement with particular limitations in this regard, the general principle is quite sensible.

The OBCA does, in paragraph 127 (3)(b), but the CBCA does not, require that each of the CEO, CFO, Chair, and President be appointed and removed only by the full board, and not by any managing director or committee of directors. Thus, the OBCA appears to attach greater importance to those appointments and removals than to those of other officers. This seems appropriate in the

light of the authority and responsibilities attaching to those positions by reason of corporate and securities law, including, in some cases, the authority to appoint subordinate officers who, in turn, may have considerable authority and responsibilities.

Paragraph 141 (c) (2) of the DGCL, creates extensive powers of delegation, permitting the full board to designate one or more committees consisting of as few as one director, to designate one or more directors as alternate members of any committee to act at a meeting in the place of any absent or disqualified director, and, if permitted by the bylaws, permitting such committees to appoint other directors to act in a particular meeting.

It also stipulates, in effect, that any such committee, to the extent provided in the resolution of the board of directors, or in the bylaws of the corporation, shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation, and may authorize the seal of the corporation to be affixed to all papers which may require it. It provides, however, in effect, that no committee has power or authority to approve or adopt or recommend to stockholders any action or matter (other than the election and removal of directors) expressly required to be submitted to stockholders for approval; or to adopt, amend or repeal any bylaw. This limited restraint on board delegation accords the board much greater flexibility in determining how it will exercise its management authority than do the CBCA and OBCA.

Section 8.25 of the MBCA likewise permits the full board to create one or more committees and to appoint one or more directors to any such committee, unless the statute, the articles of incorporation or bylaws provide otherwise. The rules pertaining to board procedures apply likewise to its committees. No committee may authorize or approve distributions, except according to a formula or method, or within limits, prescribed by the board: approve or propose to shareholders action that the statute requires to be approved by shareholders; or fill vacancies on the board or, if the articles, bylaws or the resolution creating committee so provide, on any of its committees. These restrictions on delegation are thus wider than in the DGCL, but much narrower than in the Canadian statutes.

As the Official Comment notes, in some cases, the creation of certain committees, such as a nominating and compensation committee, audit committee, or a corporate governance committee, may be required by listing standards and public securities markets, but in other cases may be

appropriate to improve efficiency, especially for larger and in more diffuse boards of directors, or when decisions are required to be made on short notice or require particular expertise not shared by all members of the board. However, wholesale delegation of authority to a committee to the point of abdication of responsibility by the full board is inappropriate and undesirable. As noted in the Official Comment, delegation by a divided board to one faction of the board may usurp basic board functions and may further enhance such factionalism.

The Official Comment indicates that the prohibitions against delegation are limited, in effect, to actions that substantially affect the rights of shareholders or are fundamental to the governance of the corporation. As indicated above, these principles are also applied in the CBCA and OBCA, as well as the DGCL.

In particular, while the directors have the power and authority to manage or supervise the management of the corporation, in the case of certain fundamental changes, the shareholders are accorded the power to approve or disapprove of certain of their decisions. Of course, such power of approval or disapproval cannot be considered to constitute management or supervision of the management of the corporation. Such power also operates at a very high level of decision-making and in quite exceptional circumstances.

In summary, however, subject to: firstly, certain requirements as to what powers may not be delegated; and secondly, to certain requirements of corporate law, securities law, listing or other authorities and regulators, requiring the existence of certain committees, and their consideration of stipulated matters; and thirdly, to any restrictions in the charter documents; the power of the board to fashion the structure by which the corporation is organized is essentially unlimited. This recognizes the enabling nature of corporate statutes, and the principle that the directors should be left to devise a structure that they consider appropriate (even if not necessarily the most appropriate) to the business and affairs of the corporation, and to revise and refine it from time to time based on their renewed assessments in that behalf.

In addition to limitations on the content of the powers which may be delegated, which may be described as “substantive” limits, the board, like other delegators of authority, may impose restrictions as to the means by which delegated powers may be exercised, which may be described as “procedural” or “processual” limits. Subject to the restrictions just described, the board of

directors of the corporation is free to delegate power subject to such substantial and to such processual limitations as it may think appropriate.

Consequently, the board may configure and reconfigure the organization of the corporation as it considers appropriate in order to accomplish its goals and objectives. The corporate statutes make clear that the board's freedom and authority in this regard extends not only to its personnel, but also to its structure and processes. As we have maintained previously, these "central management" powers and responsibilities are consistent with other corporate essentialist attributes.

The separation of management from equity ownership ("management ownership separation") ensures that equity owners are not disadvantaged as a result of the corporation having to change its organization as a result only of a change in equity ownership. A partnership may have to change its internal organization as a result of the departure from the partnership of one partner, requiring formation of a new partnership, if it is desired to continue the business. Because partners who depart are unable to take part in the management of partnership business, the departure of one partner may require a reconfiguration of the partnership's structure, processes, and personnel. For example, the manager responsibilities of the departing partner may have to be assigned to another existing or to a new partner. This may require a reconfiguration of the partnership's structure and processes. As to its personnel, one member of management departs and may or may not be replaced by another, who may or may not be an equity owner.

In a partnership, it may not be possible to transfer an equity interest except by transmission of law. It can readily be seen that permitting the transfer of an equity interest of a general partner would, on its face, permit the new partner to take part in the management of the partnership business, without the consent and approval of the other general partners.

Of course, such transfers are possible in the case of limited partnerships, where limited partners are not able to participate in the management of the limited partnership business. In such cases, the general partner and the other limited partners need not be concerned about the management capabilities and capacities of the new limited partner, his or her interest in participating in management, and the effect of such participation on management otherwise, including such matters as divisions of powers and authorities, and the extent of cooperation and collegiality to be expected in the event of such management participation.

Capital lock-in, in the case of the corporation, prevents withdrawals of capital which might impact the corporation's capacity to carry on its business and which might require it to change its structure, such as by going out of a particular line of business or selling a division; its operating processes, such as eliminating intracorporate purchases or sales as a result of the termination of a particular line of business or divestment of a particular division; and its personnel, such as by way of layoffs of management and other employees. As noted in Chapter One in the discussion of transferable equity interests and capital lock-in as an essential legal attribute, Margaret Blair and Lynn Stout have emphasized the importance of capital lock-in with respect to investment in specialized assets and development of a specialized organization the benefits of which are expected to accrue to the corporation only when measured over a long term.<sup>14</sup>

Accordingly, centering management authority in the board of directors and separating management authority from equity ownership not only permits the board to "organize" the corporation as it sees fit, in terms of its structure, processes, and personnel, but is also consistent with the other essential legal attributes of the corporation. Thus, it is an expression of corporate legal essentialism.

### **Board Appointment of Chief Executive Officer, Other Officers, and Other Management**

Most modern corporate statutes provide for the appointment of officers. For example, the CBCA<sup>15</sup> and the OBCA<sup>16</sup>, in effect, state that subject to the articles, the by-laws or any unanimous shareholder agreement, the directors may designate the offices of the corporation, appoint as officers persons of full capacity, specify their duties, and delegate to them powers to manage the business and affairs of the corporation, except, in the case of the CBCA, certain prescribed powers to do anything referred to in subsection 115(3); and further, that a director may be appointed to any office of the corporation; and two or more offices of the corporation may be held by the same person.<sup>17</sup> The board's ability to delegate these powers was discussed in the immediately preceding section.

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<sup>14</sup> Two of the most significant of the articles in which they have explored these issues are Margaret M Blair, "Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century" (2003) 51:2 UCLA L Rev 387 at 388-89; Lynn A Stout, "On the Nature of Corporations" (2005) 2005:1 U Ill L Rev 255 at 255-6.

<sup>15</sup> CBCA, *supra* note 1, s 121.

<sup>16</sup> OBCA, *supra* note 1, s 133.

<sup>17</sup> CBCA, *supra* note 1, s 121. The excepted powers are those referred in s. 115 (3) of the CBCA relating to higher order matters affecting shareholders and share capital. These matters are also not delegable to a committee of directors, except as authorized by the full board.

The modern corporate law model assumes that the board (or some committee or delegate thereof) appoints the officers of the corporation and determines their duties and powers. Subsection 142 (a) of the Delaware statute provides, *inter alia*, that “[e]very corporation organized under this chapter shall have such officers with such titles and duties as shall be stated in the bylaws or in a resolution of the board of directors which is not inconsistent with the bylaws”; and that “[a]ny number of offices may be held by the same person unless the certificate of incorporation or bylaws otherwise provide.” S. 142 (b) states that “[o]fficers shall be chosen in such manner and shall hold their offices for such terms as are prescribed by the bylaws or determined by the board of directors or other governing body.”<sup>18</sup>

In effect, s. 142 (b) of the DGCL permits the bylaws or the board (or other governing body) to empower the selection of officers otherwise than by selection by the board of directors. It is possible for the bylaws or the board to authorize the CEO (or any other officer) to determine what offices should be appointed and to authorize such CEO (or other officer) to determine what persons should be appointed to which offices, as officers of the corporation.

Section 8.40 of the MBCA provides, *inter alia*, that “[a] corporation has the offices described in its bylaws or designated by the board of directors in accordance with the bylaws”; that “[t]he board of directors may elect individuals to fill one or more offices of the corporation; that an officer may appoint one or more officers if authorized by the bylaws or the board of directors”; and that “[t]he same individual may simultaneously hold more than one office in a corporation”.<sup>19</sup>

Accordingly, unlike the Canadian statutes, the DGCL and the MBCA both permit the bylaws or the board of directors to authorize the CEO (or any other officer) to create the offices and to appoint officers. Section 8.41 of the MBCA also expressly permits the board, subject to, and to the extent consistent with, the bylaws, to authorize an officer to prescribe the duties of other officers, saying that “[e]ach officer has the authority and shall perform the duties set forth in the bylaws or, to the extent consistent with the bylaws, the duties prescribed by the board of directors or by direction of an officer authorized by the board of directors to prescribe the duties of other officers.”<sup>20</sup> The

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<sup>18</sup> DGCL, *supra* note 2, § 142.

<sup>19</sup> MBCA, *supra* note 3, s 8.40.

<sup>20</sup> *Ibid*, s 8.41.

authority of the duly authorized officer making the appointment to prescribe the duties of the officer so appointed is not expressly dealt with, but, rather, is implicit, in the DGCL provision.

Consequently, it appears that under both American statutes, the CEO could be accorded authority to determine what offices should be appointed, what their duties should be, and what persons should be appointed to such offices. Consequently, the CEO might be authorized by the board to appoint all subordinate officers. Alternatively, the CEO could be authorized by the board to appoint all officers who are his or her direct reports, and the officers who report directly to the CEO could be authorized to appoint, in turn, officers who report directly to them, for example. Indeed, the officer authorized to appoint other officers need not be the CEO at all and the appointments made need not relate to the function otherwise (that is to say, except for such appointment authority) performed by the officer receiving delegation to make such appointments.

It appears, however, that the duties of officers must be prescribed, if not by the board, then by direction of an officer authorized by the board to do so. While it is not free from doubt, this may allow an officer authorized by the board, who might be the CEO, to prescribe the duties of other officers and may also permit an officer authorized by the board to direct some officer or officers to prescribe the duties of other subordinate officers. It does not seem to be necessary that the appointing officer be the hierarchical superior, in terms of reporting, of the officer appointed. The limits of these powers are not clear, however, as it appears, that there are no cases of relevance discussing this provision.<sup>21</sup> It is thought that the body or officer who appoints such officer (or, the author would suggest, the body or officer who delegates such right of appointment) must ordinarily approve the removal of that officer.<sup>22</sup>

### ***Methods, and Evidence, of Appointment of Officers***

It is not clear how prevalent is the practice of officers appointing other officers. For example, section 5.2 of the bylaws of Alphabet Inc. (formerly Google Inc.) provides that the board “shall appoint the officers of the corporation except such officers as may be appointed in accordance with the provisions of Sections 5.3 of these bylaws, subject to the rights, if any, of an officer under any

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<sup>21</sup> Richard E Wood, “Hiring, Firing, and Setting the Compensation of Corporate Officers: Who Has the Authority?” (2006) 19:2 Benefits LJ 77 at 80.

<sup>22</sup> *Ibid*, citing: William Meade Fletcher, Fletcher Cyclopedia of the Law of Private Corporations, § 357.

contract of employment.”<sup>23</sup> Section 5.3 provides that: “The Board may appoint, or empower the chief executive officer of the corporation, to appoint, such other officers and agents as the business of the corporation may require. Each of such officers and agents shall hold office for such period, have such authority, and perform such duties as are provided in these bylaws or as the Board may from time to time determine.”<sup>24</sup>

The effect of those provisions is that the bylaws or the Board, as the case may be, determine which offices exist, for what period, and the authority and duties of those offices. However, the Board may empower the CEO to appoint persons to those offices upon the terms determined by the bylaws or the board of directors. It appears, however, that despite the existence of authority permitting such appointments, the appointments of executive officers, at least, of Alphabet Inc. are, as a matter of fact, made or approved by the board.<sup>25</sup> Its proxy materials do not indicate whether or not officers below the executive level are appointed by the board or otherwise. There appears to be little research or other information on appointment of officers by CEOs of Delaware corporations or corporations incorporated in states whose incorporation statutes are modelled on the MBCA.<sup>26</sup>

Appointments of officers by the board of directors are, of course, memorialized in the minutes of the board of directors. Indeed, one view is that a person is an officer if appointed by the board as such, or is an officer if appointed by the board even without specifying such person as an officer. Thus, a review of the corporate charter (the instrument of incorporation), by-laws, unanimous

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<sup>23</sup> Alphabet Inc, *Amended and Restated Bylaws of Alphabet Inc. (effective as of October 2, 2015)*, online: <[https://abc.xyz/investor/pdf/amended\\_and\\_restated\\_bylaws.pdf](https://abc.xyz/investor/pdf/amended_and_restated_bylaws.pdf)>. Last accessed March 12, 2019. The term “executive officers” is defined for this purpose in Rule 3b-7 under the Securities Act of 1934, as amended, to mean a company’s “President, any vice president...in charge of a principal business unit, division, or function (such as sales, administration, or finance) and any other officer who performs a policy making function, or any other person who performs similar policy making function for the [company]”. Richard Wood points out that this definition applies under The Securities Exchange Act of 1934, (Pub. L. 73–291, 48 Stat. 881, enacted June 6, 1934, codified at 15 U.S.C. § 78a et seq.) for the purpose of determining, among other things, those persons who are required to be listed as executive officers in the Form 10-K annual report and in the annual meeting proxy statement.

<sup>24</sup> *Ibid.*

<sup>25</sup> Alphabet Inc, *Notice of 2016 Annual Meeting of Stockholders and Proxy Statement (29 April 2016)* at 15, online: <[https://abc.xyz/investor/pdf/2016\\_alphabet\\_proxy\\_statementpdf](https://abc.xyz/investor/pdf/2016_alphabet_proxy_statementpdf)>. Last accessed March 12, 2019.

<sup>26</sup> The author has conducted internet searches using appropriate terms but without success. Richard Wood’s comment that there is not much case law may suggest that the appointment of officers by other officers are *not* sufficiently infrequent as to result in challenges to such appointments. It may be that terminations of such officers appointed by the CEO or other officer other than terminations by the board of directors are retroactively approved by the board of directors, or are subject to contractual provisions that make discussion of the present point unnecessary. Further, terminations may require the approval of the board or the appropriate committee where such termination involves compensation.



shareholder agreement (for “private” companies) and minutes of the board would normally permit a determination of the identity and, to at least some degree, the (broad) scope of authority of officers it appoints.

However, where the CEO or some other officer is permitted to effect the appointment of other (normally subordinate) officers, no method of such appointment is prescribed, at least in the statute, and, accordingly, no memorialization in any prescribed form is required by the statute. In consequence, unless some particular form of appointment and memorialization is prescribed by the board, non-board appointments of officers, and hence the identity and scope of responsibilities of such officers, may be more difficult to conclusively determine.

Whatever the original means or instrument of appointment, the amendment or revocation of such an appointment is not specifically required to be effected in any prescribed manner. As a result, such changes may be effected orally by the appointing officer and, perhaps in some circumstances, by the delegate or delegates of such appointing officer. The appointing officer might even appoint one person to supervise the officer concerned, and retain or delegate to another person entirely (that is, a person who is not the supervisor) the power to amend or revoke such appointment or authority. This may be found to present significant evidentiary problems in particular cases.

It can be easily seen, as well, that, to a much greater extent even than a board appointment, appointment of officers by a CEO or other authorized officer or officers introduces a possibility of overlapping, duplicative, or conflicting authorities among officers. While there are many other cogent reasons to permit such non-board appointments, this fact alone makes assignment of responsibility by officers in concrete instances, certainly *ex post*, and often even *ex ante*, somewhat problematic. This may be important in situations in which the corporation is found liable for some tortious, criminal or quasi-criminal, or other, action or inaction, and some assignment of blame, legally or even just internally, to the “responsible” individual officer(s) is sought to be effected. Of course, these factors may also complicate “after-action” reviews which are initiated for the purpose of avoiding problems of the relevant nature in the future.

Even where officers are formally appointed by the board of directors, it is often argued that the senior most officer of the corporation, today normally denominated as the “Chief Executive Officer” or CEO, effectively controls the appointment of all other officers. It is maintained that the CEO determines what officers shall be appointed in terms of positions and persons, and that this

is part of his or her determination of the structure of the internal organization of the corporation. Some observers argue that the board is not normally in a position to determine the best way to structure the corporation's internal organizational structure, nor, further, to identify and to assess the candidates and their suitability for particular positions, because the directors lack the detailed knowledge required. Such observers often argue that the CEO seeks to control such information in order to ensure that only he or she possesses the information relevant to such determinations.<sup>27</sup>

Whether or not these observations are correct, there is no doubt that the most senior members of the management of a corporation (which we will refer to as the "top management team" or "TMT") are expected to work closely with the CEO in performing their duties and responsibilities. As such, it is generally recognized that the CEO should have at least a significant, if not decisive or determinative, role with respect to their selection, duties and responsibilities, and tenure and termination of office. Thus, there may be a discrepancy between formal authority, power, or influence, which may reside in the board of directors, and actual authority, power, or influence, which may reside in the CEO and, in some cases, in other members of the TMT.

#### ***Apparent or Ostensible Authority of Directors, Officers, and Others***

Subsections 18 (1) and 18 (2) (d) of the CBCA and section 19 (d) of the OBCA each provide, in effect, that no corporation and no guarantor of an obligation of the corporation may assert against a person dealing with the corporation or against a person who acquired rights from the corporation that a person held out by a corporation as a director, officer, or agent (or, in the case of the CBCA, a mandatary) of the corporation has not been duly appointed or has no authority to exercise the powers and perform the duties that are customary in the business of the corporation or usual for a director, officer or agent (or, in the case of the CBCA, a mandatary), except where the person has or ought to have: in the case of the CBCA, knowledge of a situation described in subsection 18 (1); or, in the case of the OBCA, by virtue of the person's position with or relationship to the corporation, to that effect.

These provisions quantify and expand the indoor management rule insofar as it relates to outsiders being able to rely on the ostensible authority of persons purporting to act on behalf of the

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<sup>27</sup> See Wei Shen, "The Dynamics of the CEO-Board Relationship: An Evolutionary Perspective" (2003) 28:3 *Academy Management Rev* 466 at 472; Richard F Vancil, *Passing the Baton: Managing the Process of CEO Succession* (Boston: Harvard University Press, 1987).

corporation.<sup>28</sup> As is well known, that rule was established in 1856 in the case of *Royal British Bank v. Turquand*.<sup>29</sup>

The Official Comment on the authority of officers' provision in section 8.41 of the MBCA acknowledges that, in addition to their statutory authority, corporate officers may be clothed with apparent or ostensible authority by reason of corporate conduct on which other persons may reasonably rely. Professor Deborah DeMott, who was the Reporter for the Restatement of the Law, Third, Agency 2006,<sup>30</sup> does not refer to any provisions of either the DGCL or the MBCA which deal with apparent or ostensible authority, which subjects are, however, dealt with in the Restatement.<sup>31</sup>

### **Remuneration of Directors, Officers, and Others**

Section 125 of the CBCA and section 137 of the OBCA provide that subject to the articles, the bylaws or any unanimous shareholder agreement, the directors of the corporation may fix the remuneration of directors, officers and employees of the corporation.

In the case of the DGCL, section 141 (h) provides that unless otherwise restricted by the certificate of incorporation or bylaws, the board of directors has authority to fix the compensation of directors. It makes no provision with respect to the compensation of officers.

Section 8.11 of the MBCA empowers the Board of Directors to fix the compensation of directors, unless the articles are bylaws provide otherwise. However, Chapter 8 of the MBCA does not contain any similar provision with respect to compensation of officers.

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<sup>28</sup> See Robert Yalden, Janis Sarra, Paul D Paton, Mark Gillen, Ronald Davis, and Mary Condon, *Business Organizations: Principles, Policies and Practice* (Toronto: Emond Montgomery Publications, 2008) at pp. 297-8 and related discussion at 295-301. The OBCA provision was applied in *Sherwood Design Services Inc v 872935 Ontario Ltd* (1998), 3 OR (3d) 576, 158 DLR (4th) 440 (CA).

<sup>29</sup> *Royal British Bank v Turquand* (1856), 119 ER 886, 6 El & Bl 327 (Ex). Discussed and applied in *Canadian Laboratories Supplies Ltd v Engelhard Industries of Canada Ltd*, [1979] 2 SCR 787, 97 DLR (3d) 1.

<sup>30</sup> Deborah A DeMott, ed, *Restatement of the Law Third, Agency*, vols 1-2 (Philadelphia: American Law Institute, 2006).

<sup>31</sup> Deborah A DeMott, "Agency in the Alternatives: Common-Law Perspectives on Binding the Firm" in Robert W Hillman & Mark J Loewenstein, eds, *Research Handbook on Partnerships, LLCs and Alternative Forms of Business Organizations* (Cheltenham: Edward Elgar, 2015), 81. The article refers, by contrast, to statutory provisions concerning other statutory business forms, most notably, limited partnerships and limited liability corporations.

Accordingly, since the board is empowered to appoint officers under both the DGCL and the MBCA, the power to fix their compensation must be considered to be a necessary corollary of the appointment power.

Of course, the effect of these provisions is that the board as a whole has authority to fix the compensation of directors, and in the CBCA and OBCA, that of officers and employees. Those provisions, then, determine what authority within the corporation may take action to legally bind the corporation in such respect. These provisions recognize, however, that while the board may not be disempowered, as a matter of corporate law, from determining compensation for the stipulated classes of persons, this may have been effected, as a practical legal matter, by legally binding contractual provisions entered into between the corporation, as a legal entity, and an individual director, officer, or employee, as the case may be. While the board might determine to compensate an officer otherwise than in accordance with his or her contract, and this would be legally binding on the corporation as a matter of corporate law, it would result in the corporation being in breach of its legally binding agreement with such officer, as a matter of contract law.

Where the board or its delegate (the “board”, in this section) appoints or determines the compensation of a director or an officer, the board is acting as the ultimate decision-making authority of the corporation in respect of the relationship between the individual director or officer, as the case may be, and the corporation. For example, if there are seven directors, denominated for the purpose of this example as individuals A through G inclusive, when the board, comprised of individuals A through G acting as the board of directors as the corporation, determines the compensation of A (or any other director) as a director (assuming, for purpose of this example, that it, and A, can do so within the conflict rules applicable), it is making a decision on behalf of the corporation as a legal entity vis-à-vis that individual, considering that individual as a party separate from the corporation. In effect, A through G, as the board, are dealing with A in his or her capacity as an individual. A, as a member of the board, is involved, then, in making a collective decision binding the corporation in respect of A’s rights and obligations to the corporation, and its correlative rights and obligations to him.

This can be analyzed as involving a distinction between A’s collective identity as part of the board, and his individual identity as a director, (notionally) separate from the board and the corporation. In effect, A is acting as a member of the collective decision-making authority for the corporation,

the board, and separately, individually, as a person or party engaging in legal relations with the corporation. As will be outlined below in connection with the corporative perspective developed in this work, directors and officers, and employees generally, may be considered both as external third parties with whom the corporation deals as a single legal entity, and constituents of its internal organization, which instantiates and animates the corporation as an actor in relation to other actors.

This chapter investigates the means by which the essential attributes of the corporation, as a legal entity acting as such “in the real world”, are instantiated in the corporation as a matter of corporate law, thereby affecting its internal organizational attributes, including its structure, processes, and personnel. The issue of remuneration for directors, officers, and employees of the corporation, and the example mentioned above each draw attention to the attributes of the organization that animates or instantiates the corporation as an actor in the real world. Those organizational attributes are affected by, and also enact, instantiate, or operationalize its essentialist attributes or some of them, in some respects. Those are explored further in this chapter.

### **Removal and Resignation of Officers**

Neither Part X of the CBCA nor Part IX of the OBCA deal with the removal or resignation of officers. However, the board’s power to appoint officers is considered to implicitly include the power to replace incumbent officers. More generally, however, a power of appointment is usually considered to include the power to revoke or terminate such appointment.<sup>32</sup> Under section 141 (b) of the DGCL, each officer holds office until such officer’s successor is elected and qualified or until the earlier resignation (at any time upon written notice) or removal of such officer.

Section 8.43 of the MBCA provides that an officer may resign at any time by delivering notice to the corporation, which time it is effective unless a later effective time is specified. An officer can also be removed either by the board; by the officer who appointed such officer, unless the bylaws or the board provide otherwise; or by any other officer authorized by the bylaws or the board. As indicated in the Official Comment, while an employment agreement with an officer is binding on the corporation, the refusal of a board to appoint or renew the appointment of such officer entitles the person to sue for damages but not for specific performance of the contract. Likewise, section 8.44 provides that the appointment of an officer does not of itself create contract rights; removal

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<sup>32</sup> *Supra* note 28 at 539.

of an officer does not affect the officer's rights, if any with the corporation; and resignation of an officer does not affect, the corporation's contract rights, if any, with the officer.

As in the case of remuneration, the validity of the removal or resignation of an officer, as a matter of corporate law, are not completely determinative of the rights of the respective parties. Instead, the agreements between the officer and the corporation will determine the rights and obligations of the parties, whether or not any breach has taken place, and the consequences as a matter of contract law, agency law, common law, and other statutory law. While corporate law may determine the position of the officer or former officer as a representative of the corporation, when acting on its behalf, as a legal actor, vis-à-vis other legal actors, in respect of the relationship between the officer and the corporation, corporate law may be determinative of the presence or absence of officer status but is arguably less important, in terms of that relationship, than contract or other legal specifications.

Considering the position of the officer vis-à-vis the internal organization of the corporation and vis-à-vis other internal constituents, it can readily be seen that a change of officer status does not necessarily involve organizational consequences. That is to say, someone who is in charge of the manufacturing function at a certain corporation who resigns or is removed as "Vice-President, Manufacturing" does not automatically thereby lose his or her role as the person in charge of the manufacturing function. Such a change resonates in the "external" or "legal" structure of the corporation as a legal actor, but not necessarily in its "internal" or "organizational" structure.

On the other hand, the promotion of the same individual to "Senior Vice-President, Manufacturing" may have some external or legal consequences, but may or may not have any internal or organizational consequences in terms of the role as senior-most person in the manufacturing function. That is not to say, however, that enhancements in prestige, income, and other accompaniments of the position may not accrue as a result of the new appointment. At the same time, if the subject individual is only formally in charge of that function, and another individual exercises informal authority and, as a result, is "really" in charge of the function, this change in status vis-à-vis the corporation as legal actor might even be entirely bereft of organizational consequences. These distinctions will be explored further in later parts of the book.

## Part C – DUTIES OF OFFICERS AND EMPLOYEES

### Statutory Duties under Corporate Law

Some corporate statutes do not distinguish between the statutory duties and standards of performance of such duties imposed on directors and those imposed on officers. This is the case in the CBCA and the OBCA. The duties imposed on officers, namely, a duty of good faith, and a duty of care, and a duty of compliance with corporate law, and the standards of conduct imposed in that regard, are the same for officers as for directors.<sup>33</sup> This approach is discussed further in Chapter A3 under the heading “The Representative Role of the Board”.

The Delaware corporate statute does not impose any specific statutory duties on officers nor prescribe any standards for the conduct of any duties of officers. Accordingly, the duties of officers under Delaware law arise at common law, most notably under agency law and by analogy from the law of trusts, and by contract. However, s. 141 (e) fully protects directors in the performance of their duties “in relying upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation’s officers or employees, or committees of the board of directors, or by any other person as to matters of the member reasonably believes are within such other persons professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.” Although the statute does not create an affirmative duty on officers or employees in this regard, it does permit reliance by directors if such officers or employees did have a duty, whether explicit or implicit.

In the case of the MBCA, the standards of conduct for officers are prescribed in section 8.42. Under subsection 8.42 (a), an officer, when performing in such capacity, is required to act in good faith; with the care that a person in a like position would reasonably exercise under similar circumstances; and in a manner the officer reasonably believes to be in the best interests of the corporation. Since an officer may act in a personal capacity, these duties apply only when such person is acting as an officer. These duties are similar to the duties of directors under the MBCA.

However, unlike the DGCL, the MBCA imposes an explicit ordinary course reporting duty and a “whistle blower” duty on officers. Subsection 8.42 (b) specifies that “[t]he duty of an officer includes the obligation: (1) to inform the superior officer to whom, or the board of directors or the

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<sup>33</sup> CBCA, *supra* note 1, s 122; OBCA, *supra* note 1, s 134.

committee thereof to which, the officer reports of information about the affairs of the corporation known to the officer, within the scope of the officer's functions, and known to the officer to be material to such superior officer, board or committee; and (2) to inform his or her superior officer, or another appropriate person within the corporation, or the board of directors, or a committee thereof, of any actual or probable material violation of law involving the corporation or material breach of duty to the corporation by an officer, employee, or agent of the corporation, that the officer believes has occurred or is about to occur.”

The first duty, the obligation of an officer to report information about the affairs of the corporation that is within the scope of that officer’s functions known about officer, and known by that officer to be material to that officer’s direct report, is highly significant. It obligates officers to communicate material information within the scope of his or her functions to the officer, board, or committee to which such officer reports. The objective, then, is to ensure that, as a matter of corporate law, material information is communicated to each successively higher level of the organization to facilitate proper decision-making and supervision, including varying any outstanding, or introducing any new, remedial or other instructions.

The duty to inform set forth in s. 8.42 (b) (2), the so-called “whistle-blowing” duty, was introduced in the 2006 revisions of the MBCA, in response to various situations in which such provisions might have had some utility, and to the introduction of such a duty in securities law. In particular, the provision seeks to mitigate or avoid “Enron-type situations” involving wrongdoings that were uncovered only after the fact.<sup>34</sup>

Subsection 8.42 (c) specifies that “[i]n discharging his or her duties, an officer who does not have knowledge that makes reliance unwarranted is entitled to rely on: (1) the performance of properly delegated responsibilities by one or more employees of the corporation whom the officer reasonably believes to be reliable and competent in performing the responsibilities delegated; or (2) information, opinions, reports or statements, including financial statements and other financial data, prepared or presented by one or more employees of the corporation whom the officer reasonably believes to be reliable and competent in the matters presented or by legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or

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<sup>34</sup> Balotti, R Franklin, & Megan W Shaner, “Safe Harbor for Officer Reliance: Comparing the Approaches of The Model Business Corporation Act and Delaware's General Corporation Law” (2011) 74:1. *Law & Contemp Probs* 161 at 163.



expertise the officer reasonably believes are matters: (i) within the particular person's professional or expert competence or (ii) as to which the particular person merits confidence.”

The Official Comment in relation to the latter provision states that:

The proper delegation of responsibilities by an officer, separate and apart from the exercise of judgment as to the delegatee's reliability and competence, is concerned with the procedure employed. This will involve, in the usual case, sufficient communication to the end that the delegatee understands the scope of the assignment and, in turn, manifests to the officer a willingness and commitment to undertake its performance. The entitlement to rely upon employees assumes that a delegating officer will maintain a sufficient level of communication with the officer's subordinates to fulfill his or her supervisory responsibilities. The definition of "employee" in section 1.40(8) includes an officer; accordingly, section 8.42 contemplates the delegation of responsibilities to other officers as well as to nonofficer employees.

In effect, since every officer is obliged to “report up” material information that is within scope, and since every officer is entitled to “rely down” on employees to perform responsibilities that are properly delegated to them provided that the officer reasonably believes them to be reliable and competent in performing such responsibilities, every officer, as well as every director, is entitled to assume that material information will be transmitted to the appropriate level and that responsibilities properly delegated to persons reasonably believed to be reliable and competent will be duly performed. As the Official Comment suggests, this may involve not only appropriate supervision but also communication of relevant information by the superior officer to the inferior officer as and when required or appropriate.

Subsection 8.42 (d) states that “[a]n officer shall not be liable to the corporation or its shareholders for any decision to take or not to take action, or any failure to take any action, as an officer, if the duties of the office are performed in compliance with this section. Whether an officer who does not comply with this section shall have liability will depend in such instance on applicable law, including those principles of section 8.31 that have relevance.” Officer liability to the corporation or the shareholders does not feature prominently in many discussions of corporate law, however, as the Official Comment notes:

In some cases, failure to observe relevant standards of conduct can give rise to an officer's liability to the corporation or its shareholders. A court review of challenged conduct will

involve an evaluation of the particular facts and circumstances in light of applicable law. In this connection, subsection (d) recognizes that relevant principles of section 8.31, such as duties to deal fairly with the corporation and its shareholders and the challenger's burden of establishing proximately caused harm, should be taken into account. In addition, the business judgment rule will normally apply to decisions within an officer's discretionary authority. Liability to others can also arise from an officer's own acts or omissions (e.g., violations of law or tort claims) and, in some cases, an *officer* with supervisory responsibilities can have risk exposure in connection with the acts or omissions of others.

Despite these obligations of declaratory law, however, in their work examining the fiduciary duties of officers, Lyman Johnson and David Millon concluded that, historically, officers appear not to have been sued for fiduciary wrongdoing in such capacity.<sup>35</sup> Of course, officers who are also directors may have been sued in their capacity as directors. This will be discussed further below.

### **Duties at Common Law**

The common law imposes certain duties on officers of a corporation. Where the officer is an employee of the corporation, those duties may extend beyond those imposed on employees generally. For example, senior officers have common law duties not to compete with the corporation, not to disclose information which is confidential to the corporation, and not to pursue corporate opportunities.<sup>36</sup>

All officers and all employees have a common law duty of loyalty, that is, a duty to act in good faith with respect to the corporation; and a duty of care. These duties arise from agency law and are discussed in greater detail in Chapter A3. For example, according to Johnson and Millon, the duty of loyalty includes not acting adversely to the principal without consent; not acting on behalf of one with interests adverse to the principal without consent; not competing with the principal; not wrongly appropriating a corporate opportunity; providing an accounting to the principal for profits; and not using or wrongly communicating confidential information.<sup>37</sup>

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<sup>35</sup> Lyman PQ Johnson & David Millon, "Recalling Why Corporate Officers Are Fiduciaries" (2005) 46:5 Wm & Mary L Rev 1597 at 1609.

<sup>36</sup> A leading case in the area remains *Canadian Aero Service Limited v O'Malley*, (1973), 40 DLR (3d) 371, [1974] SCR 592 - 1973. An excellent commentary which appeared soon after the decision and still remains useful is Stanley M Beck, "The Quickening of Fiduciary Obligations: *Canadian Aero Services v O'Malley*" (1975) 53:4 Can Bar Rev 771.

<sup>37</sup> *Supra* note 35 at 1611-2.

In the case of officers, the duty of loyalty may go further than requiring the officer not to betray the interests of the corporation, but may also extend to a more affirmative duty to act solely in the interests of the corporation in that capacity.<sup>38</sup> As Johnson and Millon indicate, this would require an officer to advance the well-being of the corporation, not simply to refrain from harming it.<sup>39</sup>

Breach of duty by an officer or employee may result in liability. A review of the circumstances in which such liability may arise is beyond the scope of the present discussion. As in the case of breaches of statutory duty, breaches of common law duties of officers are not often the subject of litigation. Johnson and Millon posit four possible reasons for this: Firstly, most breaches of officer duties are dealt with internally, by intracorporate sanction, such as discharge, reprimand, adjustment of compensation, demotion, or delayed promotion, and most discharges of officers involved severance packages which also include releases of claims. Secondly, lawyers for shareholders, for boards, and even judges, may not (fully) appreciate the distinctive fiduciary obligations owed by officers to the corporation's agents, which arise separately from and in addition to any contract obligations. Thirdly, there is a lack of knowledge of agency law principles, which are relevant to the duties of persons who are only officers, but which are not the subject of attention where an officer is also a director. Fourthly, until the nineteen eighties, the majority of most boards of directors were also officers. Thus, litigation against officers as such was relatively unusual.<sup>40</sup>

The "fiduciary" duties of directors and of officers, as agents, and otherwise, are discussed in Chapter A3 below.

### **Indemnification of Officers**

As indicated above, under sections 124 of the CBCA and 136 of the OBCA, the provisions relating to indemnification permitted by a corporation of a current or former officer are the same as with respect to a current or former director and, accordingly, generally require compliance with the duty of good faith. Again, as indicated above, section 145 of the DGCL also permits the indemnification of directors and officers in the same circumstances, but also extends the scope of permitted indemnification to employees and agents.

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<sup>38</sup> *Ibid* at 1629.

<sup>39</sup> *Ibid*.

<sup>40</sup> *Ibid* at 1611-2.

In effect, officers who are not directors may be, and are entitled to be, indemnified to the same extent as a director, and may even be indemnified beyond the director level, subject to stated limits. Importantly, there can be no indemnification for liabilities, in effect, arising in connection with wrongful acts with respect to the corporation (other than for expenses of the proceeding concerned), improper receipt of financial benefits, intentional infliction of harm to the corporation or the shareholders, or for an intentional violation of criminal law. An officer who is also a director benefits from both sets of indemnification rights if the conduct that is the subject of the proceedings relates solely to acts in the capacity of an officer.

Section 8.56 (a) of the MBCA provides for indemnification of officers in great detail, saying that “[a] corporation may indemnify and advance expenses under this subchapter to an officer of the corporation who is a party to a proceeding because he or she is an officer of the corporation: (1) to the same extent as a director; and (2) if he or she is an officer but not a director, to such further extent as may be provided by the articles of incorporation, the bylaws, a resolution of the board of directors, or contract except for: (A) liability in connection with a proceeding by or in the right of the corporation other than for expenses incurred in connection with the proceeding or (B) liability arising out of conduct that constitutes (i) receipt by the officer of a financial benefit to which he or she is not entitled, (ii) an intentional infliction of harm on the corporation or the shareholders, or (iii) an intentional violation of criminal law.

Sections (b) and (c) further provide that: “(b) The provisions of subsection (a) (2) shall apply to an officer who is also a director if the basis on which he or she is made a party to the proceeding is an act or omission solely as an officer”; and “(c) An officer of a corporation who is not a director is entitled to mandatory indemnification under section 8.52, and may apply to a court under section 8.54 for indemnification or an advance for expenses, in each case to the same extent to which a director may be entitled to indemnification or advance for expenses under those provisions.

The differences between director and officer indemnification in the DGCL may be considered to reflect the greater capacity for officers to engage in self-dealing, at least in terms of appropriating and awarding financial benefits, as well as their greater capacity to inflict intentional harm on the corporation or its shareholders, and to intentionally breach criminal laws. In each of these cases, officers, employees and agents may have greater opportunities to engage in conduct which is not

observed by others or, if observed, is ignored or not reported, or to collude with others in the organization.

As is discussed under the two previous headings and in Chapter A3 below, the positions of director and officer are not directly comparable. Directors are not agents. Agents are required to act in accordance with the limitations on their authority and other terms of their agency arrangements. They are also required to act in accordance with the lawful instructions of their principal. This is the case with officers, who are required to comply with instructions of the board of directors, and if applicable, duly authorized more senior officers. They are “agents” of the corporation.

However, if and to the extent that directors are hypothesized as agents of the corporation, there is no other party who is empowered to give them instructions. Instead, directors are “agents” only in the sense that they are the individual persons having the capacity, and having been granted the authority, to act on behalf of the corporation. The statutes reviewed empower the directors to manage or supervise the business and affairs of the corporation.

While the scope of directors to manage the corporation may be restricted under some statutes, such as in Delaware, such that this might be considered to be part of the arrangements under which they are required to operate, this is not the case under most statutes. The restrictions on board authority and the consequent assumption of directorial rights and obligations that arise with respect to unanimous shareholder agreements do not apply in the case of public corporations, which is the predominant concern of this work. This subject will be further explored in Chapter Four.

The MBCA does not expressly provide for indemnification of employees or agents, according to the Official Comment, “because the concerns of self-dealing that arise when directors provide for their own indemnification and expense advance (and sometimes for senior executive officers) are not present when directors (or officers) provide for indemnification and expense advance for employees and agents who are not directors or officers.” As the comment suggests, the self-dealing argument is more applicable to more senior officers, however determined, than to officers more generally. The Official Comment also argues that “the rights of employees and agents to indemnification and advance for expenses derive from principles of agency, the doctrine of *respondeat superior*, collective bargaining or other contractual arrangements rather than from a corporation statute. It would be presumptuous for a corporation statute to seek to limit the indemnification bargain that a corporation may wish to make with those it hires or retains.”

This is consistent with the observation of the present work that statutory law relating to the organization of the corporation concerns itself only with the very highest levels of the organization. This is recognized by the Official Comment in its observation that the “same standard applicable to directors and officers may not be appropriate for office workers and hazardous waste workers, brokers and custodians, engineers and farm workers. None of their roles or responsibilities are prescribed by the Model Act.”

In effect, the MBCA recognizes certain limitations of corporate law in this respect, namely, its lack of suitability or even incapacity to deal with the structure and processes of the corporation at anything but the highest levels: in this case, the levels of directors and of officers of the corporation. It also recognizes that, at those other levels, such matters may be more appropriately dealt with by means of contract and common law, rather than by corporate and by statutory law. Instead, as the indemnification example indicates, the corporation’s relationship with, and its capacity to act by and through, employees and agents is the proper subject of other statutory enactments and common law principles and case-law. The corporative perspective adopted in this book will support this attitude to corporate legislation and associated rulemaking.

Generally speaking, corporate law is enabling, and permits corporations subject to its jurisdiction to devise structures and procedures suitable for them. Indeed, that ability is often highly prized as conducive to innovation and success. This work will return to these subjects below and in the chapters following.

#### **PART D - MANAGEMENT RESPONSIBILITY FOR RUNNING THE BUSINESS**

As discussed, in a corporation of any significant size, the board of directors of the corporation is not responsible for managing the corporation but, instead, is responsible for supervising or directing its management. This has been discussed above.

##### **General Matters**

The actual management of the corporation is the purview of its properly appointed officers and employees. The allocation of such responsibility may be determined in part by reference to formal documents of the corporation, including its articles or certificate of incorporation, its bylaws, the resolutions of its board of directors, and contracts of employment.

Where some particular officer is, or some particular officers are, given authority to appoint other officers, such appointments may be effected by means of some one or more documents or otherwise. In certain cases, the only evidence of appointment may be a contract of employment for the officer concerned. In some cases, an officer promoted from within the organization may or may not be subject to an employment agreement relating to his or her present position, but may be subject to other more detailed agreements, such as non-disclosure, confidentiality, and other types of agreements. Where that officer is not an employee of the corporation, the appointment may be contained in an agency or other agreement between the corporation and the officer concerned.

Consequently, defining the limits of a particular officer's formal authority, and identifying relationships among the formal authority of officers may themselves be problematic. However, the effects of the informal organization on the exercise of real authority may be even more problematic. These issues, canvassed above, will be discussed in more detail in Part 3 of this work.

## **Capital**

Of course, a major decision for any business is the quantum of capital required, the apportionment of capital as between debt and equity capital, and the terms and conditions attaching to such capital.

### **Share Capital**

#### *Share Characteristics*

Sections 24 of the CBCA and 22 of the OBCA require all shares of the corporation to be without nominal or par value. Under sections 25 of the CBCA and 23 of the OBCA, subject to the terms of those sections, the articles, the bylaws and any unanimous shareholder agreement and to any preemptive rights under section 28 of the CBCA or section 26 of the OBCA, as the case may be, shares may be issued at such times, to such persons, and for such consideration, as the directors determine. As to the latter, if so provided in the articles or, in the case of the OBCA only, in a unanimous shareholder agreement, no shares may be issued unless first offered to shareholders as provided therein. This is referred to as a "pre-emptive right". All such shares are non-assessable and the holders are not liable to the corporation or to its creditors in respect thereof.

Section 151 of the DGCL permits the Corporation to issue shares with the voting and other rights expressed in the certificate of incorporation or, where expressly authorized in such certificate, in a board resolution providing for the issuance of such stock. Consequently, what it describes as

“preferred” or “special” stock may be issued. Section 102 (b) (3) negates pre-emptive rights except to the extent that such rights are expressly granted in the certificate of incorporation.

Sections 152, 153, and 156 of the DGCL permit the issuance of partly paid or assessable shares, as well as fully paid and nonassessable shares, and also permits the issuance of shares with or without par value. Those sections require the board to determine the consideration for the issuance of the shares, unless the certificate of incorporation requires that the stockholders make such determination. Under section 161, the directors may issue or take subscriptions for additional shares of capital stock up to the amount authorized in the corporation’s certificate of incorporation.

Section 2.02 (b) of the MBCA permits the articles to set forth a par value for shares but does not require the same. The general powers of the corporation in section 3.02 include the powers to borrow money and issue notes, bonds and other obligations, which may be convertible into or include the option to purchase other securities of the corporation. As previously noted, section 6.01 requires that one or more classes or series of shares have unlimited voting rights and that one or more classes or series be entitled to receive the net assets of the corporation upon dissolution. One class or series may have both attributes and more than one class or series may have such attributes. Under section 6.03, shares possessing both attributes must be outstanding at all times that any shares are outstanding. Under section 6.30, shareholders do not have a preemptive right to acquire the corporation’s unissued shares except to the extent that the articles of incorporation so provide.

Section 6.02 permits the corporation to delegate to the board the power to establish terms of a class or series none of which yet been issued, but these terms must be set forth in an amendment to the articles of incorporation which is effective before such shares are issued. Although the interests authorized to be created under section 6.01 are generally “equity” rather than “debt” securities, the Official Comment notes that it is possible to create classes or series of securities under section 6.01 that have some of the characteristics of debt securities and hence are “hybrid securities”.

The powers of the directors in each of these jurisdictions to issue shares is so extensive that exercise of such powers, even just by way of increasing the number of shares outstanding, may affect entitlement to, or exercise of, the most basic rights of shareholders, namely, voting rights and rights to the remaining property of the corporation upon any termination of its existence. Consequently, among other things, the directors’ powers may affect or even determine who has voting control of the corporation. Of course, these powers are subject to constraints, not only



statutorily but also by way of common law. Some of these constraints are exercisable by action of the shareholders. This will be dealt with further in the next chapter.

### ***Dividends***

As previously noted, under sections 127 of the CBCA and 115 of the OBCA, the directors' power to declare dividends cannot be delegated to a managing director or committee of directors. Under 151 (c) of the DGCL, entitlement to dividends must be set forth in the certificate of incorporation or, if authorized therein, in the board resolution issuing the shares. Section 6.01 (c) states that articles of incorporation may authorize one or more classes or series of shares that entitle the holders to distributions, including dividends that may be cumulative, noncumulative, or partially cumulative. Section 6.40 empowers the board of directors to authorize and the corporation to pay distributions to shareholders subject to restrictions in the articles of incorporation and the solvency restriction in subsection 6.40 (c).

The power of the board of directors to declare dividends aligns with its power to manage or supervise the management of the business of the corporation. It can determine the funds required to implement its business plan and may declare dividends on classes and series of shares having no fixed entitlement to dividends and may declare or withhold from declaring (and hence accrue or accumulate) dividends on classes and series of shares having some fixed entitlement to dividends. Declaration of dividends invokes various solvency and director liability provisions.

### **Borrowing**

Generally, the board of directors has the power to borrow money on the credit of the corporation and without authorization of the shareholders. Sections 189 of the CBCA and 184 of the OBCA each provide that the articles or bylaws or a unanimous shareholder agreement may provide otherwise. Section 122 (13) of the DGCL provides that every corporation has power to make contracts, incur liabilities, borrow money, issue notes and bonds and other obligations, and secure any of its obligations. The general borrowing power of a corporation contained in section 3.02 (7) of the MBCA, which applies unless its certificate of incorporation provides otherwise, is, of course, exercised by the directors under section 141 (a) except as provided in such certificate.

Accordingly, unless otherwise restricted, such as by means of its charter documents, the board enjoys complete statutory power and authority to determine the capital structure, both as to equity

capital and as to debt. Creating new classes of shares may involve amending the charter documents, which may invoke shareholder approval. Some classes of shares which have a fixed preferential right to dividends which accrue if not declared may limit the ability of the board to declare dividends on the common shares, and this limitation may be attenuated when the dividend obligation is in arrears. The corporation may also determine to issue debt which has rights of conversion into equity, or debt which is accompanied by rights to acquire equity. Except as limited by other general and specific duties, the board has complete authority in this regard.

### **Conflicts of Interest**

Modern business corporation statutes attempt to constrain possible opportunities for self-dealing by directors and officers. One mechanism for this is a requirement that directors and officers declare their interests in significant contracts or transactions. Among other things, this permits the directors or the non-interested directors where the declarant is a director to take such matters into account in assessing the reasoning and possible biases attendant upon, and the appropriateness of, the contract or transaction. However, it does rely upon the non-conflicted directors to avoid any possible bias or favouritism towards the declaring director.

Such mechanisms also attempt to constrain self-dealing by rotation or exchange, for example, whereby one director or group of directors is permitted some benefit by way of a conflict of interest on the understanding or expectation that similar treatment will be accorded the non-conflicted director(s) or officer(s) in other situations.

At the same time, these mechanisms recognize that it may be advisable and in the best interests of the corporation for a corporation to be able to take advantage of a contract or other arrangement in which someone or more directors are interested, provided, that is, that there are other non-conflicted directors who may consider an approve it, and, if there are not, that the contract is approved by the shareholders. This recognizes the collective responsibility of the board of directors and provides an alternative to absolute prohibition of such contracts or arrangements.<sup>41</sup>

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<sup>41</sup> For example, in the 1880's, the general rule in the United States was that any contract between an interested director and a corporation was voidable at the instance of the corporation or its shareholders, without regard to the fairness of unfairness the transaction. See the discussion in Harold March, Jr, "Are Directors Trustees? Conflict of Interest in Corporate Morality" (1966) 22:1 Bus Lawyer 35 at 36-39.

Constraining such self-dealing is, of course, necessary and appropriate in view of the plenary powers of management assigned to the board of directors and its delegates. Only those having such management authority may be expected to acquire knowledge of, and the ability to restrain, such self-aggrandizement at the expense of the corporation. Shareholder authority with respect to the appointment of directors (and related matters) is not only of limited relevance, but operates only *ex post facto*; and, thus, is of limited utility *ex ante* the impugned conduct. However, the prospect of shareholder approval of conflict transactions based upon full and complete information raises for consideration the question of the interrelationship between the management prerogative of the board of directors and the oversight rights of shareholders, many other instances of which will be considered in the immediately following chapter.

The common law on the subject evolved considerably from an American rule of absolute prohibition in the nineteenth century. Harold Marsh, Jr. indicates that by 1910 the general rule in the United States was that a contract between a director and the corporation which he was a director was valid if approved by a disinterested majority of his fellow directors and, if challenged by the court a court was not found to be unfair or fraudulent; however, the contract in which a majority of directors was interested was voidable at the instance of the corporation or its shareholders.<sup>42</sup> According to Marsh, by 1960 the general rule in the United States was that no transaction between a corporation and any or all of its directors was automatically voidable at the instance of a shareholder, whether or not approved by a disinterested majority of the board; but that a court review such a contract and would invalidate it if it was found under rigid and careful scrutiny to be unfair to the corporation.<sup>43</sup> By that time, however, statutory intervention had taken or was taking place in a number of states.<sup>44</sup>

Sections 120 of the CBCA and 132 of the OBCA require a director or officer to disclose to the corporation the nature and extent of any interest that he or she has in a material contract or a material transaction, actual or proposed, with the corporation if the director or officer is a party to the same, if the director or officer acts in a similar capacity of such party or, in the case of the CBCA, has a material interest in such party. Such disclosure must be made, generally, at the first meeting at which the proposed contract or transactions is first considered, or, if not then interested,

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<sup>42</sup> *Ibid* at 39-40.

<sup>43</sup> *Ibid* at 43.

<sup>44</sup> *Ibid* at 46-48.

at the first meeting after he or she becomes interested, or, if he or she becomes interested after the contract is made or transaction entered into, at the first meeting after he or she become so interested.

Of course, since an officer who is not also a director may not know that a contract or transaction or proposed contract or transaction is to be, is being, or has been considered, at a meeting of directors, declarations of interest by interested persons who are only officers and not directors are required to be made after the officer becomes aware that the contract or transaction or proposed contract or transaction is to be, or has been, considered a meeting of directors. Where such contract is one that, in the ordinary course of the corporation's business would not require approval by the directors or shareholders, the director or officer must disclose it in writing to the corporation or request have it entered in the minutes of the meetings of the board or its committees, as the case may be.

Unless it relates to remuneration, indemnity or insurance, or is with an affiliate, both statutes provide that such director shall not vote on any resolution to approve the contract or transaction and, in the case of the OBCA, shall not attend any part of a meeting of directors during which the contract or transaction is discussed. In the latter case, if this results in no quorum, the remaining directors are deemed to constitute a quorum; and if all directors are so interested, the contract or transaction may be approved only by the shareholders. Both statutes provide for the giving of a continuing disclosure that the relevant director or officer is a director or officer of or has a material interest in a specified person.

Upon approval of the contract or transaction after the prescribed disclosure of interest, the director or officer is not accountable to the corporation or its shareholders for any profit or gain realized from the contract or transaction, and the contract or transaction is neither void nor voidable by reason only of that relationship or being counted in the quorum, provided that the contract or transaction was reasonable and fair to the corporation at the time it was so approved.

Both statutes provide, further, that, in spite of any failure to comply with the disclosure of interest requirements, a director or officer is not accountable for any profit from the contract or transaction, and it is not invalid, by reason only of such interest, provided that such contract or transaction is approved or confirmed by special resolution at a meeting of shareholders, after disclosure of the interest to them "in a manner sufficient indicate its nature" and if it was "reasonable and fair to the

corporation when it was approved and confirmed”. Thus, while the directors may approve a director-interested contract or transaction if reasonable and fair to the corporation, the shareholders may do so even if the same is not reasonable and fair to the corporation.

Section 144 of the DGCL does not deal with the issue of accountability by directors or officers with respect to contracts in which they are interested, but deals only with contracts or transactions between a corporation and one or more of its directors or officers; or between a corporation and any other corporation, partnership, association or organization of which one or more of its directors or officers are directors or officers or in which they have a financial interest.

Such contracts or transactions are not void or voidable solely for that reason, nor solely because such director or officer is present at, participates in, or votes at a meeting of the board or committee which authorizes the contract or transaction, provided that the material facts as to the relationship or interest and as to the contract or transaction are known or disclosed to the board, the committee, or the shareholders; and the contract or transaction is authorized or approved in good faith; and is fair as to the corporation as of the time of such authorization, approval or ratification.

Section 8.61 (b) of the MBCA provides, in effect, that a “director’s conflicting interest transaction” may not be enjoined, rescinded or give rise to an award of damages or other sanctions against the director on the grounds that the director has an interest respecting the transaction, provided that the director’s actions comply with section 8.62, or the shareholders’ actions comply with section 8.63, or the transaction, judged according to the circumstances at the relevant time, is established to have been fair to the corporation.

All the relevant terms are defined in section 8.60, including a “director’s conflicting interest transaction” which involves a transaction affected or proposed to be effected by the corporation to which the director is a party, or respecting which the director had knowledge and had a material interest therein known to the director, or respecting which, the relevant time, the director knew that a related person was a party or had a material financial interest. The term “material financial interest” is defined to mean “a financial interest in a transaction that would reasonably be expected to impair the objectivity of the director’s judgment when participating in action on the authorization of the transaction”. The term “related person” is broadly defined to include a spouse and various relatives, and an entity controlled by them, or by the director. The “required disclosure” means disclosure of the existence and nature of the director’s conflicting interest and

“all facts known to the director respecting the subject matter of the transaction that a director free of such conflicting interest would reasonably believe to be material in deciding whether to proceed with the transaction”.

The MBCA provisions are drafted so as to align, generally, with securities law and stock exchange listing requirements with respect to directors, and hence are somewhat more detailed than equivalent provisions in the other statutes, except, of course, that its provisions do not apply to officers.

As will be demonstrated in Chapter A3, in exercising, in accordance with its duties, its ability to approve director-interested contracts or transactions, subject to certain limitations, the board, collectively, seeks to supervise certain duties of individual directors, namely, those interested in certain contracts or transactions. These duties of individual directors are often analogized to those of trustees but can also be seen as similar to the duties of agents. The board, on the other hand, is acting, in its collective capacity, on behalf of the corporation itself.

Chapter A3 argues that the function of the board of directors is distinctively different from that of trustees or agents, but that the function of officers is more clearly aligned with the function of other agents, including lower-level employees. Accordingly, while board approval of director-interested contracts or transactions may be analogized to beneficiary approval of trustee-interested contracts or transactions or to principal approval of agent-interested contracts or transactions, board approval of officer-interested contracts or transactions may be meaningfully analogized only to the latter. The utility of such analogies is discussed further in Chapter A3.

## **PART E – CONCLUSION**

The authority of the board of directors to manage or to supervise the management of the corporation is plenary, and extends to many matters affecting the rights of shareholders and others vis-à-vis the corporation; however, it is subject to certain statutory limitations, which are discussed in the following chapter, and to certain other limitations of declarative law.

Certain limitations of statutory law relate to oversight of the board by shareholders. Such rights of oversight, such as with respect to particular fundamental transactions, do not conflict with the corporate essentialist attribute of central management separated from equity ownership, and these oversight rights and other rights of voice and exit give effect to capital lock-in and equity

transferability. The nature of such shareholder rights and their relationship to the essential legal attributes of the corporation will be explored in the following Chapter A2.

## **CHAPTER A2: CORPORATE ESSENTIALISM AND EQUITY OWNERS**

### **PART A – LEGAL AND MANAGEMENT-RELATED RIGHTS OF SHAREHOLDERS**

#### **Relationship to the Defining Legal Attributes of the Corporation**

As discussed above, the fundamental attributes of the corporation include: its status as a separate legal entity, or rights-and-duty bearing entity, with potentially unlimited lifespan, a status which implicates its other fundamental attributes; the locking-in of its capital such that capital may not be withdrawn freely by its contributor; the transferability of equity interests in the corporation; asset partitioning involving the limited liability of owners and of the corporation for liabilities of the other; and, in relation to the foregoing matters, the separation of equity or capital interests in the corporation from management of the entity, which is often expressed in terms of the separation of ownership and management; and indefinite duration. Of course, these attributes are highly salient in respect of the development of the “public” corporation, meaning a corporation whose shares are available to members of the public generally and may be listed and posted for trading on a recognized stock exchange or other share or securities market, which is the focus of this book.

The implications of the foregoing have been widely considered by knowledgeable authors and commentators and cannot be permitted to detain the present inquiry at this point. However, they give rise to important questions relating to the mechanisms by which management can be selected and changed, the influences which holders of equity interests may be expected to bring upon management of the corporation, in both ordinary and extraordinary circumstances, and the implications, on the one hand, of employing, and, on the other hand, losing, the ability to transfer one’s equity interest to someone else at a price which might be considered to bear some relationship to its intrinsic, or even market, value. These will be discussed below.

#### **Voting and Related Rights of Shareholders, and Corporate Legal Essentialism**

Matters relating to selecting, monitoring, and changing management may be considered to relate to the ability of a holder of equity interests to express his or her “voice” in that regard. Holders of common shares normally are entitled to vote for the election or removal of directors, to propose certain matters for consideration by the shareholders generally, and to exercise a “right of veto” with respect to certain transactions which are regarded as fundamental to the corporation. These voting and other rights provide shareholders with some say over who will be the directors



responsible for management of the corporation. They also provide shareholders with a “voice” in respect of the management of the corporation.

Thus, they facilitate the institution of centralized management and its separation from equity ownership, as well as capital lock-in, which is also facilitated by transferability of shares. Accordingly, these shareholder rights are important in respect of the essentialist attributes of the corporation. This chapter will examine how they are instantiated in the modern business corporation.

Similarly, matters relating to the transfer of such equity interest, in whole or in part, may be considered to represent that holder’s “exit” from his or her participation in the corporation. Shareholders who wish to liquidate their investment in the corporation, perhaps due to dissatisfaction with the performance of management, may transfer and monetize it. Such transferability can be considered as part of the “tradeoff” for central management, its separation from equity ownership, and the extensive management powers enacted in most corporate statutes. This chapter will also consider how rights of transferability, a key essential attribute of the corporation, are operationalized in the corporate statutes considered here.

Shareholders have rights to propose nominees for the election of directors, to attempt to procure their election, and to propose matters for consideration at meetings of shareholders. They are permitted to exercise certain collective action in those regards. It can immediately be seen, therefore, that shareholder activities in relation to management, as matters of “voice”, may involve activities which may be considered, in some way or other, as intrinsically “political” vis-à-vis management and, perhaps, vis-à-vis other shareholders, and even the corporation itself. On the other hand, shareholder activities in relation to “exit” represent a termination of the particular shareholder’s interest in the corporation which, in the case of a public corporation, is frequently seen as primarily economic in nature.

In Part 3 of this work, it will be established that other participants in the corporation, both as a legal entity and as an organization, engage in activities some of which may be considered as primarily economic in terms of their objectives, but may be considered to be highly political in their performance. Such participants may include directors, officers, and other employees.

### **Exit and Voice as Responses to Organizational Decline**

Albert Hirschman's book, *Exit, Voice, and Loyalty*<sup>1</sup>, may be usefully considered in this regard. Its subtitle, "Responses to Decline in Firms, Organizations, and States" indicates that its theme concerns responses to performance decline in organizations having primarily economic, social, and political goals and objectives. He says that "under any economic, social, or political system, individuals, business firms, and organizations in general are subject to lapses from efficient, rational, law-abiding, virtuous, or otherwise functional behavior", accidental or otherwise, some of which dysfunctional behaviour or misbehaviour is tolerated. However, he says "lest the misbehavior feed on itself and lead to general decay, society must be able to marshal from within itself forces which will make as many of the faltering actors as possible revert to the behavior required for its proper functioning."<sup>2</sup>

As Hirschman suggests, the factors contributing to such failure may be wholly or partly endogenous or exogenous (such as accident). As an example of the former, organizational personnel may exhibit shortfalls from expected behaviour. From the perspective of the organization, this may also involve defects in, failures of, or failures to observe, the prescribed structure and processes. Hirschman argues that exit belongs to the realm of economics, while voice belongs to the realm of politics. This argument will be considered in due course.

### **Shareholders and Other Corporate Participants**

Interestingly, given the later uses of the terms "exit" and "voice" in relation to public companies and their shareholders, and the relationship between them, this relationship is nowhere discussed in these terms in his work. Instead, Hirschman's analysis at the micro-economic level primarily concerns the relationship between a firm and its customers.

Hirschman maintains that exit "is the sort of mechanism economics thrives on. It is neat - one either exits or one does not; it is impersonal - any face-to-face confrontation between customer and firm with its imponderable and unpredictable elements is avoided and success and failure of the organization are communicated to it by a set of statistics; and it is indirect - any recovery on the part of the declining firm comes by courtesy of the Invisible Hand, as an unintended by-product

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<sup>1</sup> Albert O Hirschman, *Exit, Voice, and Loyalty: Responses to Declines in Firms, Organizations, and States* (Cambridge: Harvard University Press, 1970).

<sup>2</sup> *Ibid* at 1.

of the customer's decision to shift". On the other hand, "in all these respects, voice is just the opposite of exit. It is a far more "messy" concept because it can be graduated, all the way from faint grumbling to violent protest; it implies articulation of one's critical opinions rather than a private, "secret" vote in the anonymity of a supermarket; and finally, it is direct and straightforward rather than roundabout. Voice is political action par excellence."<sup>3</sup>

In effect, Hirschman argues that exit, in his case by customers rather than by investors, is a phenomenon of microeconomics, while voice, even when practiced by customers, is a phenomenon, not of microeconomics, but of politics. While it may be maintained that the exercise of voice has some "political" aspect inasmuch as it aims to affect supplier behaviour, it is also obvious that customers exercise voice in respect of their economic relationship with the supplier.

However, Hirschman's analysis of exit is very much intrinsically economic, not only in terms of the supply of capital to and investment in the firm, but also as it concerns the supply by the firm of products to customers in an impersonal market. This is also the emphasis of Michael Jensen's much-cited 1993 article, "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems".<sup>4</sup>

Of course, when Hirschman was writing, in 1970, a wide dispersion of share ownership among many small shareholders was typical in public corporations, and holders of larger blocks of shares, such as institutions, had not yet demonstrated significant interest in engaging in any meaningful shareholder activism with respect to their investee companies. Instead, mass exit, effected by way of a takeover bid, and often resulting in a change of control of the corporation, was considered by leading expositors of this mechanism, such as Henry Manne,<sup>5</sup> to be more meaningful and effective, especially as a means of disciplining management.

The members of an organization or persons or groups within or affected by an organization who may be in a position to observe and to respond to organizational decline would include, in the case of a business corporation, not only customers, who are the focus of Hirschman's attention, but also suppliers, employees, directors, and shareholders. Members of these constituencies might exercise

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<sup>3</sup> *Ibid* at 15.

<sup>4</sup> Michael C Jensen, "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems" (1993) 48:3 J Finance 831. Time does not permit discussion of this important article, nor that cited in the next footnote. The scope of both is too great for meaningful comment here.

<sup>5</sup> Henry G Manne, "Mergers and the Market for Corporate Control" (1965) 73:2 J Political Economy 110.

rights of voice and exit as well. For example, a 1999 study by Brown and Maloney found that outside directors of underperforming firms often choose to resign rather than to challenge inside directors and management in boardroom discussions and deliberations, thereby exercising their right of exit, rather than voice.<sup>6</sup>

The relationship between the benefits and disbenefits of exit may be significantly different for other corporate constituents, for example for suppliers, and for employees, as compared with shareholders. Suppliers and employees may have some dependence on continuing their relationship with the corporation in order to secure benefits over a long term. In fact, they may be prepared to incur certain short term disbenefits in the hope of securing greater benefits over a longer term. While this may not be the case, uniformly, with respect to suppliers and employees, there may be a greater preponderance of willingness to effect such tradeoffs than with respect to shareholders at large.

Of course, the concepts of “exit” and “voice” may be useful beyond a context of organizational decline. In fact, even with respect to customers, these concepts may apply in the context of ongoing relationships, whether contractual, regular, ongoing, habitual, or otherwise. They may be seen as not only responses to organizational decline, but also as responses to regular or irregular shortfalls from expected performance, in which case voice may invite a performance improvement, and exit may document the extent and even duration of performance inadequacy or nonperformance. Exit and voice may also be seen as responsive to other dissatisfactions.

### **Dynamics of Shareholder Exit and Voice**

Shareholders in modern business corporations that are publicly traded have certain opportunities for “voice”, such as by way of voting against directors, writing to or meeting with management or directors, and making shareholder proposals; and for “exit”, by means of selling their shares. These rights of shareholders are discussed further below.

Alex Edmans reviews research on the use of voice and exit by large shareholders, often referred to as “blockholders”, finding that “although most of the early research on blockholder governance has focused on voice, a recent literature has analyzed a second governance mechanism — trading

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<sup>6</sup> William O Brown Jr & Michael T Maloney, “Exit, Voice, and the Role of Corporate Directors: Evidence from Acquisition Performance” (1999) Claremont McKenna College Working Paper, online: <<http://ssrn.com/abstract=160308>>.

a firm's shares, otherwise known as "exit," following the "Wall Street Rule," taking the "Wall Street Walk," or "voting with your feet." In effect, "if the manager destroys value, blockholders can sell their shares, pushing down the stock price and thus punishing the manager ex post. Ex ante, the threat of exit induces the manager to maximize value."<sup>7</sup>

Of course, it is not only blockholders who can exercise the options of voice and exit, but also other shareholders. Blockholders, however, can avail themselves of the extra significance attached to their voices and exits when they engage with management or choose not to do so. They also benefit from economies of scale in incurring costs relating to exercising voice, which holders of smaller numbers of shares do not. As is frequently observed, the costs and difficulties of organizing concerted action among large number of diffuse shareholders is one that is not usually susceptible of recoupment by the organizing shareholder. This is often referred to as a "collective action" and as a "free riding" problem.<sup>8</sup>

Edmans suggests that exit and voice became a subject of research in corporate governance only relatively recently, and apparently separately, without regard to their interactions. He says that "the few papers that study voice and exit together assume the same blockholder engages in both, but in reality, different blockholders have expertise in different strategies. Moreover, it would be fruitful to study how voice and exit interact with other, nonblockholder governance mechanisms."<sup>9</sup>

We will have occasion to examine these matters further in connection with our discussion of hedge fund activism later in Chapter Ten in the section entitled "Short-Termism and Long-Termism – On the Merits" under the heading "Balancing Short Term and Long Term Horizons" where we briefly argue in favour of, and reference research supporting, the proposition that certain hedge fund activist mechanisms may promote or increase organizational decline, rather than contributing to arresting or reducing it. This can take place when external governance initiatives, which are largely generic and not specifically adapted to the particular corporation concerned, conflict with otherwise effective internal governance mechanisms within the organization.

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<sup>7</sup> Alex Edmans, "Blockholders and Corporate Governance" (2014) 6:1 Annual Rev Financial Economics 23 at 24.

<sup>8</sup> An article which is frequently regarded as presenting perhaps the most influential and often cited discussion of the subject is Sanford J Grossman & Oliver D Hart, "Takeover Bids, The Free-Rider Problem, and the Theory of the Corporation" (1980) 11:1 Bell J Economics 42. There is an extensive literature concerning these matters, with respect to which limitations of space and the scope of this work do not permit closer examination.

<sup>9</sup> *Supra* note 7 at 45.

This conflict between external and internal governance mechanisms may be expected to occur in many cases in which different time frames for measuring organizational success, decline, or improvement are applied by relevant parties in interest or by observers. That is to say, activist hedge fund investors may be seeking to attain somewhat different goals and objectives over different time periods than may be the case with management and with long-term institutional or other investors.

Another fundamental issue in this regard is that parties external to the corporation may not be aware of the ways in which its organizational structure, processes and personnel contribute to successful performance. Accordingly, it may be desirable to place considerable weight, subject to appropriate reduction for self-interest, of course, on internal organizational concerns and their relation to internal governance mechanisms which are articulated by the board and management of the corporation. Their greater and sometimes even intimate knowledge of the focal corporation's organization, including its structure, processes and personnel, and the relation of such matters to its strategy, goals and objectives, may be expected to provide a more informed and accurate assessment than might be made by external observers.

### **Loyalty**

Hirschman discusses the activation of voice as a function of loyalty, saying, with respect to customers, that whether customer-members will favour voice over exit will depend upon how they weigh its certainties against the uncertainties of an improvement in the deteriorated product; and upon how they estimate their ability to influence the organization. He argues that the likelihood of a customer exercising voice increases with the degree of loyalty to the product or organization.

Further, he argues that a member with considerable attachment to a product or organization will often search for ways to make herself more influential and, conversely, that a member who wields or thinks she wields considerable power in the organization may become convinced that she can get it "back on track" and may develop a strong affection for the organization with respect to which she exercises such power.<sup>10</sup> In effect, an individual who lacks, and does not expect to acquire, influence can remain loyal provided he or she expects that someone will act or that something will happen to improve matters. Hirschman argues that loyalty is not irrational but can serve the socially

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<sup>10</sup> *Ibid* at 77-78.

useful purpose of preventing deterioration from being cumulative,<sup>11</sup> that is to say, from continuing, even, perhaps at an accelerating rate. Thus, we can conclude that loyalty may be highly rational in some or, perhaps, in many instances.

Hirschman claims that loyalty increases the cost of exit; that it may redress the balance in some cases in which exit might be preferred to voice because the effectiveness of voice depends on the discovery of new ways of exerting influence and pressure toward recovery; and that the usefulness of loyalty depends on the closeness of the available substitute.<sup>12</sup> Although his examples relate to loyalty to products and to countries, similar considerations may be relevant to shareholder loyalty. A shareholder who thinks that a corporation presents some unusually attractive proposition over his investment horizon, which is not easily replicable, may be prompted by this and other loyalty inducing influences to exercise voice, rather than exit. On the other hand, if the investment is highly fungible, all other things being equal, exercising voice may be more costly than exit.

### **Shareholder Exit, Voice, and Loyalty**

We may conclude that loyalty promoting activities may tend to dissuade exit, particularly at times when exit, and, perhaps, especially mass exit, may be undesirable for the corporation, such as in responding to takeover bids or proxy contests. Meeting regularly and consulting with significant shareholders, engaging in shareholder relations “reach outs” to shareholders generally, and providing relevant and usable information to the investment community concerning the corporation’s “value proposition” as an investment may be expected to increase shareholder loyalty and prevent shareholder defection, by way of decreasing receptivity to takeovers, proxy proposals, and other actions hostile to the board and management of the corporation, assuming, of course, that the latter are not acting in a fashion which is significantly or obviously self-interested. In fact, as discussed below in relation to shareholder activism, research has supported the effectiveness of such activities in this regard.

“Exit” and “voice” in the context of shareholder-management relations express the rights of transferability and limited management rights to elect, monitor, and replace management accorded to shareholders in connection with the assignment of plenary management rights to the board of directors. As mentioned above, these are among the legal essentialist attributes of the corporation.

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<sup>11</sup> *Ibid* at 79.

<sup>12</sup> *Ibid* at 80.

## Voting in Relation to Directors

Modern corporate statutes require that at least one class of shares have voting rights, which must be stipulated, like other rights, privileges, restrictions and conditions attaching to the shares, in the articles of incorporation and in the case of certain corporate statutes, in a unanimous shareholder agreement for non-public companies only. Thus, the articles may provide for classes of shares, and for series of shares within a class of shares to vote separately, either generally or with respect to particular matters.

Under section 140 of the CBCA and section 102 of the OBCA, unless the articles provide otherwise, each share of a corporation entitles the holder to one vote at a meeting of shareholders.

Section 151 of the DGCL provides that classes of stock or series of stock within a class may have such voting powers, full or limited, or no voting powers, as stated and expressed in the certificate of incorporation or any amendment thereto or in any board resolution issuing shares pursuant to authority expressly vested pursuant to such certificate of incorporation or amendment thereto. It also expressly provides (as does the MBCA) that these matters may be made dependent upon “facts ascertainable outside” such document or board resolution.<sup>13</sup>

Section 6.01 (c) of the MBCA states that the articles of incorporation may authorize one or more classes or series of shares that have special, conditional, or limited voting rights, or no right to vote, except to the extent otherwise provided in the statute. It permits the terms of shares to vary among holders of the same class or series of shares so long as such variations are expressly set forth in the articles of incorporation. The mechanics of class and series voting are set forth in section 7.25. Section 7.21 states that unless otherwise provided in the articles of incorporation, each outstanding share is entitled to one vote on each matter voted on at a shareholders’ meeting.

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<sup>13</sup> Subsection 151 (g) requires the filing of a certificate of designation with corporate authorities in order to become effective. Of course, such a provision may raise questions concerning whether or not the “facts” upon which the issuance of shares depends according to the charter or board resolution do, in fact, actually obtain. This may be particularly important where the directors elected issue “blank check” preferred shares or shares containing “poison pill” provisions increasing voting rights in the event of certain external actions, including the making of tender offers or other proposals for corporate combinations that are not approved by the board of directors of the target. As a matter of corporate law, questions may arise concerning the “facts” relied upon in such certificate of designation. These issues are discussed, for example, in C Stephen Bigler & Seth Barrett Tillman, “Void or Voidable? – Capturing Defects in Stock Issuances under Delaware Law” (2008) 63:4 Bus Lawyer 1109.



Each of the statutes mentioned contains provisions relating to the determination of the shareholders entitled to vote at a meeting, the requisite quorum for a meeting, notice of meeting, and other similar matters. A review of such matters, and indeed, a review of the effectiveness of shareholder voting generally, is beyond the scope of the present work.

### ***Voting for the Election of Directors***

As the review above has indicated, and as is generally well known, the board of directors of the corporation manage or supervise the management of its business and affairs. In this regard, the board may appoint committees or subcommittees of the board and may delegate to them and to a managing director certain duties. They are also empowered to appoint officers.

In effect, the board of directors is empowered under corporate law to determine virtually all aspects of its internal organization, including its structure, processes, and its personnel. In the case of a public corporation, which is not permitted to have a unanimous shareholder agreement, the only statutory limitations on the board's authority are those contained in its charter documents, and in securities law, stock exchange or other market requirements. Consequently, the power to elect directors is the most notable authority shareholders may exercise with respect to the ordinary day-to-day operations of the corporation.

Sections 106 of the CBCA and 119 of the OBCA require shareholders to elect directors at the first meeting of shareholders and at each succeeding annual meeting at which such election is required, to hold office for a term expiring not later than the close of the third annual meeting of shareholders following such election. Unless a term is expressly stated, a director ceases to hold office at the close of the first annual meeting of shareholders after election. The term of office of each director need not be the same as that of each other director.

As a matter of practice, directors of both CBCA and OBCA corporations which are “public” in common parlance<sup>14</sup> are elected for one year terms. However, recent amendments to the CBCA (the “2018 Amendments”)<sup>15</sup> require, inter alia, annual elections for every “distributing corporation”, a

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<sup>14</sup> The CBCA provisions apply to “distributing corporations”, *infra*, note 16, while the OBCA provisions apply to “offering corporations”. In effect, under s 1 (1) and (6) of the OBCA, an “offering corporation” is a corporation that has filed a prospectus or equivalent under Ontario law in respect of its securities any of which are outstanding, which is not subject to an order of the Ontario Securities Commission deeming otherwise.

<sup>15</sup> *An Act to amend the Canada Business Corporations Act, the Canada Cooperatives Act, the Canada Not-for-profit Corporations Act and the Competition Act*, S.C. 2018 – Bill C-25 (the “2018 Amendments”).

term defined in section 2 of the CBCA and section 2 of the Regulations under the Act.<sup>16</sup> Other provisions of the 2018 Amendments have been enacted but not yet proclaimed, which affect voting for directors, however, they do not directly affect the balance of management authority as between the board of directors and shareholders, and, accordingly, are not discussed here in detail.<sup>17</sup>

Under sections 107 of the CBCA and 120 of the OBCA, the articles may provide for cumulative voting, which allows shareholders to cast a number of votes per share held equal to the number of directors to be elected. Under sections 108 of the CBCA and 121 of the OBCA, a director ceases to hold office when he or she dies or resigns, is validly removed, or becomes disqualified to be a director.

Under section 216 of the DGCL, directors are elected by a plurality of the votes entitled to vote on the election of directors and either present in person or represented by proxy at the meeting.

Subsection 7.28 (a) of the MBCA states that, unless otherwise provided in the articles of incorporation, directors are elected by a plurality of the votes cast by the shares entitled to vote in the election at a meeting at which a quorum is present. Subsection 7.28 (b) permits cumulative voting only if so provided in the articles of incorporation.

### ***Voting for the Removal of Directors***

Under sections 109 of the CBCA and 122 of the OBCA, the shareholders may by ordinary resolution at a special meeting (CBCA) or at an annual or special meeting (OBCA), remove any

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<sup>16</sup> Canada Business Corporation Regulations, 2001, SOR/2001-512. The term “distributing corporation” includes a corporation that is a “reporting issuer” under the securities legislation of a province or territory of Canada, one that has filed a prospectus or registration statement under provincial law or under the law of a jurisdiction outside Canada, or is listed and posted for trading on a stock exchange in or outside Canada. The term also includes a corporation that is involved in, formed for, resulting from or continued after an amalgamation, a reorganization, an arrangement or a statutory procedure, if one of the participating bodies corporate is a corporation which is a distributing corporation, but excludes a corporation subject to an exemption or order under provincial legislation or regulation with effect that the corporation is not a reporting issuer thereunder.

<sup>17</sup> Certain provisions of the 2018 Amendments come into force only upon proclamation, to take place upon concurrent adoption of relevant regulations. These include provisions requiring majority (not plurality) voting and separate (not slate) voting for the election of directors (for prescribed corporations, expected to include certain, but *not* all, distributing (public) corporations, which now must be held annually (preventing staggered boards); and permitting shareholders to vote for or against director nominees. Previously, voting shareholders could only vote for or withhold from voting in respect of such election. The expressions “class of prescribed corporation” and “prescribed circumstances” in relation to inclusions and exceptions refer, in effect, to determinations effected in the regulations made pursuant to the statute, which regulations have not yet been adopted at the date of writing. Proposed amendments to the OBCA implementing similar provisions were introduced in Bill 101, Enhancing Shareholders Rights Act, 2017, a private members’ bill, which received Second Reading March 9, 2017, before the change in government on June 7, 2018. As result, its enactment is uncertain.

director or directors from office. Of course, directors elected by any class or series of shares may only be removed by ordinary resolution at a meeting of the holders of such class or series of shares.<sup>18</sup>

Under sections 110 and 123 of those statutes, respectively, a director is entitled to receive notice of, to attend, and to be heard at every meeting of shareholders. A director who resigns or receives notice of or learns of a meeting of shareholders called for the purpose of removing him or her from office is entitled to submit a written statement giving the reasons for such resignation or the reasons for opposing any proposed action or resolution. Such a statement is required to be distributed to shareholders, either separately or as part of the required management information circular.<sup>19</sup>

While the power and authority to manage the corporation inheres in the board of directors, collectively, as discussed here and elsewhere, each director is elected separately, even if as part of a proposed slate of directors, and has separate rights and obligations vis-à-vis the corporation. The right to make representations directly to shareholders concerning his or her proposed removal as a director allows such director to account for his or her performance as a director and to reply to any criticisms.

Dissident shareholders may propose the removal of a single director, a number of directors, or the whole board. In the latter two cases, each of the directors may submit a separate statement. In fact, each statute does not expressly permit collective statements; that is, they do not expressly require a collective statement to be distributed to shareholders. In the case of a board of, say, nine directors, such separate statements could, when aggregated, run to a considerable length and their preparation and distribution might incur significant costs and might even reduce the attention thus received.

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<sup>18</sup> The OBCA provision was applied in *Tancho-Defyurus (GP) Inc v Masotti*, 2013 ONSC 2043, finding that the court lacked the power under the OBCA to remove a director in a proceeding in which the oppression remedy was neither pleaded nor sought by way of relief. Citing the *London Finance Corporation Limited v Banking Service Corporation Limited* (1923), 23 OWN 138 (Ont HC); *Stephenson v Vokes* (1896), 27 OR 691 (Ont HC), the court held that common law directors could not be removed from office during the term for which they were elected or appointed. It followed the decision in *Stelco Inc (Bankruptcy), Re*, 75 OR (3d) 5, 253 DLR (4th) 109 (CA) [*Stelco Inc*], finding, paragraph 51, judicial removal of directors to be an exceptional remedy that is rarely exercised, both because of judicial reluctance to interfere in the internal management of corporate affairs, and because of well-established deference to the directors' exercise of business judgment in managing the business and affairs of the corporation. The OBCA expressly gave authority to remove directors to shareholders (absent alternative provision in a unanimous shareholders' agreement).

<sup>19</sup> Failure to give such notice to a director of an OBCA corporation has been held to invalidate the purported removal of that director in *Kaiser v Borrilia Holdings Inc* (2007), 32 BLR (4th) 306, 2007 CanLII 18729 (ON SC). Failure to give such notice was held, in all the circumstances, to amount to oppressive conduct in *Castillo v Xela Enterprises Ltd et al*, 2015 ONSC 6671.

Under subsection 141 (k) of the DGCL, any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors, subject to class or series voting rights and to any cumulative voting provisions.

Section 8.08 of the MBCA permits the shareholders to remove one or more directors with or without cause, unless the articles require cause; directors elected by particular class or series of shareholders can be removed only by such shareholder; cumulative voting provisions that apply to election of directors also apply to their removal; and a director may be removed by the shareholders only at a meeting called for such purpose and the notice of the meeting must state that the purpose, or one of the purposes, of the meeting is removal of the director.

It must be borne in mind that removal of directors by express action is an alternative to waiting until the next annual general meeting to oppose election of such directors, to propose alternative nominees as directors and, if necessary, to conduct a proxy contest for this purpose. Removal of one or more directors is more immediately effective and, accordingly, may reflect a higher degree of urgency or concern. For example, such action may be a response to perceived breaches of the duties of loyalty, care and compliance, or perceived incompetence or inefficiency,<sup>20</sup> as discussed above; but may also be a response to differences of opinion over proximate, instrumental, or subultimate goals and objectives, arising from changes in the shareholder base, or otherwise.

Accordingly, the threat of being removed as a director, especially prior to the completion of one's term, is considered to provide some motivation for directors to adhere to acceptable standards in

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<sup>20</sup> By way of example, Cheffins remarks on the use of such provision to "orchestrate the removal of disloyal or ineffective managers". Brian R Cheffins, "Current Trends in Corporate Governance: Going from London to Milan Via Toronto" (1999) 10:1 Duke J Comp & Intl L 5 at 33. Cheffins also refers to Ronald J Daniels & Jeffrey G Macintosh, "Toward a Distinctive Corporate Law Regime" 29:4 Osgoode Hall LJ 863 at 884-85. The considerable literature on the subject includes the foundational article by Manne, *supra* note 5, with particularly relevant comments 112-3 and 119, noting the attractiveness of corporate takeovers as opposed to bankruptcies as methods of effecting changes in corporate control; and the highly influential and much cited article by Michael C Jensen & Richard S Ruback, "The Market for Corporate Control: The Scientific Evidence" (1983) 11:1 J Financial Economics 5. An early study by Dodd and Warner reported that even failed proxy contests contributed to the creation of higher stock prices. It may be that targets benefit in such cases from increased visibility and the opportunity for shareholders to exercise voice, which may be expressed in support for management contributing to failure of the bid. See Peter Dodd & Jerold B Warner, "On Corporate Governance: A Study of Proxy Contests" (1983) 11:4 J Financial Economics 401.

their conduct as directors.<sup>21</sup> Removal for these reasons is considered to affect the reputation of the director or directors concerned.<sup>22</sup>

Fama and Jensen argue that there is a market for the services of outside directors who, accordingly, “have incentives to develop reputations as experts in decision control”.<sup>23</sup> Indeed, when demands on directors were less arduous than at present, the number of directorships held was considered to represent the director’s reputation in the external markets for directors.<sup>24</sup> David Yermack notes that most studies of the market for outside directors have found “some evidence that fewer offers for new directorships are made to a board members of firms that perform poorly”.<sup>25</sup>

Removal of directors may also be effected by a successful bidder after the takeover bid or tender offer has been completed. Successful bidders are normally unwilling to wait until the next annual

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<sup>21</sup> The motivational effect of the threat of such removal, including whether it exists, and how it operates, is discussed in the considerable literature including: E Norman Veasey, “Should Corporation Law Inform Aspirations for Good Corporate Governance Practices – or Vice Versa?” (2001) 149 U Pa L Rev 2179. See also materials cited in footnotes 19 and 20 below.

<sup>22</sup> Measuring the reputation of directors presents difficulties, which are often subsumed in the practice of treating the number of board seats held by a particular individual as a measure of his or her reputation. Reputation standing may also be consistent with membership on boards of large, particularly prestigious, or highly regulated corporations, such as banks. The increase in the amount of time required in order to discharge board responsibilities effectively has reduced the number of board seats typically held by even prominent directors (depending on their perspective), which as likely made using the number of board seats held as a proxy for reputation somewhat more problematic.

<sup>23</sup> Eugene F Fama & Michael C Jensen, “Separation of Ownership and Control” (1983) 26:2 JL & Econ 301. See also E Fama, “Agency Problems and the Theory of the Firm” (1980) 88:2 J Political Economy 288. The monitoring and other functions of directors engage a vast literature. For example, a meta-review of corporate governance (mainly board and audit committee) and accounting issues alone is undertaken in Joseph V Carcello, Dana R Hermanson & Zhongxia (Shelly) Ye, “Corporate Governance Research in Accounting and Auditing: Insights, Practice Implications, and Future Research Directions” (2011) 30:3 Auditing 1. This might be styled a “meta-meta-review” inasmuch as it reviews twelve literature review or meta-analysis papers together considering 250 papers. Of course, they all relate only to accounting issues.

<sup>24</sup> Porrsnit Jiraporn, Manohar Singh & Chun I Lee, “Ineffective Corporate Governance: Director Busyness and Board Committee Memberships” (2009) 33:5 J Banking & Finance 819 at 820; citing circumstances adversely affecting the number of outside board memberships: S Gilson, “Bankruptcy, Boards, Banks and Blockholders: Evidence on Changes on Corporate Ownership and Control When Firms Default” (1990) 27:2 J Financial Economics 355 (bankruptcy or other financial distress); S Kaplan & D Reishus, “Outside Directorships and Corporate Performance” (1990) 27:2 J Financial Economics 389 (dividend cuts); J Coles & CK Hoi, “New Evidence on the Market for Directors: Board Membership and Pennsylvania Senate Bill 1310” (2003) 58:1 J Finance 197 (hiring CEOs following retirement); Brown & Maloney, *supra* note 6.

<sup>25</sup> David Yermack, “Remuneration, Retention, and Reputation Incentives for Outside Directors” (2004) 59:5 J Finance 2281 at 2281. Yermack notes that this effect of poor performance includes directors of firms that experience financial distress, cut dividends, opt out of stringent anti-takeover provisions, and hire their CEOs as board members are directors following retirement, citing many of the studies referenced in the immediately preceding footnote. Of course, Yermack’s article predates that of Jiraporn et al. Bujega et al. report that directors with multiple directorships, considered to be a measure of reputation, have a lower rate of removal after a successful takeover bid. They also report that when the target has better pre-takeover performance, the percentage of directors replaced is lower. See Martin Bugeja, Raymond Da Silva Rosa & Andrew Lee, “The Impact of Director Reputation and Performance on the Turnover in Board Seats of Target Firm Directors” (2009) 36:1-2 J Business Finance & Accounting 185.

general meeting in order to replace the board and thereby assert control of the corporation unless, of course, the date of the next scheduled meeting is relatively proximate.<sup>26</sup> Needless to say, the propriety of proceedings undertaken to remove directors is a frequent subject of judicial challenge.<sup>27</sup>

This right of removing directors in exceptional circumstances may be seen as part of the “trade-off” involved in separating management from equity ownership, as well as capital lock-in and share transferability, and as permitting shareholders to exercise rights of voice, rather than rights of exit. Such removal rights are, therefore, intrinsically related to corporate legal essentialism.

### **Approval of Director-Interested Contracts or Transactions**

As discussed previously, it is important that directors declare the nature and extent of any interests that they may have been in any proposed contract or transaction with the corporation or its affiliates in order that the declaring director’s fellow directors be able to identify the nature and extent of such interest, appreciate its significance, and assess the role of the conflicted director accordingly, and in order to discourage reciprocity of self-dealing. It is also important that the interested director not participate in the portion of the meeting that concerns such proposed contract or transaction, as this may give rise to opportunities for the conflicted director to act favourably towards the matter at hand, and to encourage adoption of the proposed contract or transaction by the remaining directors, and may facilitate perceptions of deliberately conferring, or even trading, benefits in this way.

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<sup>26</sup> As noted in the immediately preceding footnote, director reputation and target performance may sometimes mitigate against or delay the removal of all of the directors of the target.

<sup>27</sup> Often proceedings are taken which seek the removal of directors by the court. Such proceedings are often coupled with oppression claims or with restructurings in insolvency under either the *Companies Creditors Arrangement Act*, RSC 1985, c C-36 [CCAA], or the *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 [BIA]. Also see the following cases under the CBCA: *Stelco Inc*, *supra* note 15; *Ivaco Inc, Re* (2006), 83 OR (3d) 108, 275 DLR (4th) 132 (CA); *Catalyst Fund General Partner I Inc v Hollinger Inc* (2006), 79 OR (3d) 288, 266 DLR (4th) 228 (CA). See also the cases cited in notes 15 and 16, for example, and the discussion in the section of this chapter entitled “Shareholder Rights Beyond Voting” under the heading “Oppression Remedy”.

Furthermore, although the board is empowered to act collectively, each director is required to make his or her own decision with respect to each matter considered. Except in situations in which the declaration is required to be made, and is made, before the consideration and approval of the proposed contract or transaction, a director is entitled to assume that each of the other directors, is also approaching the subject in consideration free of extraneous influences. The statutes normally provide curative provisions where such a contract or transaction is approved by the board without the conflicted director, and hence the board, being aware of the circumstances giving rise to the conflict.

Where a conflict is declared, the non-conflicted directors may wish to consider, among other things, the attitude which the conflicted director manifests in relation to the conflict. They may consider that the circumstances provide information as to the conflicted director's attitude to real, perceived, or possible violations of moral or legal obligations and other relevant norms and practices. Accordingly, these situations may provide information to other directors, about the interested director and otherwise, which is much more extensive than the circumstances of the situation at hand. The non-conflicted directors may take such information into account in determining whether or not, firstly, to approve the subject contract or transaction, and secondly, to submit to shareholders.

As indicated previously, in circumstances in which it is not possible for the board of directors to approve the proposed contract or transaction itself, the matter may be put forward to the shareholders for approval, by special resolution under the CBCA and the OBCA, which approval is effective provided that the shareholders are given adequate disclosure of the interest and that the contract or transaction is reasonable and fair to the corporation at the time at which it is approved or confirmed. Again, this permits shareholders to permit conflict of interest situations to persist in cases in which they consider them advantageous to the corporation.

As is the case in other respects, the ways in which the statutes address director conflict situations bespeak the tradeoffs among powerful central management divorced from equity ownership and the other legal essentialist attributes of the corporation.

### **Approval of Matters Submitted to Shareholders by Directors**

Section 146 of the DGCL states that a corporation may agree to submit a matter to a vote of its stockholders whether or not the board of directors determines at any time subsequent to approving such matter that such matter is no longer advisable and recommends that the stockholders reject or vote against the matter. Section 13.40 of the MBCA provides that a corporate action described in section 13.02 (a) may not be contested nor may it be enjoined, set aside or rescinded, in a proceeding by a shareholder after the shareholders have approved the action, subject to certain exceptions, principally involving procedural defects, procurement by fraud, material misrepresentation or omission that makes statements made misleading, or a corporate action that is an interested transaction, as described in section 13.01.

In effect, shareholder approval may shield certain matters from judicial review and, thus, such matters may be submitted to shareholders for approval in order to acquire such shielding. While the MBCA makes this objective quite explicit and obviously acceptable, the other statutes also permit shareholder approval to be employed for this purpose. Indeed, it may be conjectured that this is the almost inevitable purpose of submitting such conflict transactions to shareholders, rather than taking some sounding of acceptability or proper purpose.

### **Voting to Approve or Disapprove Fundamental Actions or Transactions**

Various actions or transactions which are considered to be fundamental to the corporation or to its shareholders, or to both, are required to be submitted to shareholders for approval before becoming effective. The following review demonstrates that shareholder approval for such fundamental actions or transactions evidences a species of “reinvestment” intention; that is, an indication by the shareholder concerned and the shareholders supporting such initiative of willingness to continue their investment in the corporation or to “reinvest” in the altered entity, rather than to “disinvest” or liquidate such investment. As discussed below, certain protective devices are provided statutorily, such as appraisal and oppression mechanisms, with respect to certain modes of desired disinvestment.

As noted previously, these statutory provisions instantiate, and also attempt to effect, the tradeoffs already described among, and so ameliorate a strict adoption of, the legal essentialist attributes of the corporation.



### *Articles of Amendment*

The corporate charter, styled articles of incorporation under the CBCA and the OBCA, as well as the MBCA, and certificate of incorporation under the DGCL, referred to here as the “corporate charter” or “charter”, sets forth details of the share capital of the corporation, the attributes of its shares, including voting rights, rights, if any, to dividends, and rights upon dissolution of the corporation. In the case of the DGCL, the business or purposes which the corporation is to conduct or promote may, but need not, be limited to those stated in the certificate of incorporation.

The MBCA requires the articles of incorporation to set forth the number of shares which the Corporation is authorized to issue, and if there is more than one class of shares authorized, the attributes of each class must be included in the articles. Otherwise, the contents of the articles of incorporation may be determined, to a large extent, by the preferences of the incorporators, although some of the more common provisions that are permissible and relatively common are listed in the statute.

The extensive scope of the charter documents, of course, raises the possibility that amendments thereto may be more or less significant to particular shareholders, and may even be critical to a particular shareholder’s investment in the corporation, such that amendment of certain charter provisions may necessitate or make appropriate or desirable the termination of such investment. In some cases, with respect to privately held corporations, the charter documents may be carefully designed to align with the various capacities and interests of the shareholders, sometimes likened to or described as an “incorporated partnership”.

Accordingly, subject to some exceptions for matters that are generally considered to be quite minor in nature, amendments to the charter documents generally require shareholder approval, in the cases of the CBCA and the OBCA by special resolution pursuant to sections 173 and 168, respectively, including class or series votes, also by special resolution, where specially affected. Under sections 2(1) and 1(1) of the CBCA and the OBCA, respectively, the term “special resolution”, in effect, means a resolution passed by at least two thirds of the votes cast on such resolution at a special meeting duly called for the purpose of considering the resolution.

With respect to certain amendments to the articles, certain shareholders may be entitled to exercise a right of dissent and appraisal under sections 190 of the CBCA and 185 of the OBCA. Under both statutes, these rights arise if the corporation resolves to amend its articles to add, remove or change

any restrictions on: the issue transfer or ownership of shares of a class or series; or the business or businesses that the corporation may carry on; or the powers that the corporation may exercise.

Although discussed in more detail under that heading below, this right provides an opportunity for shareholders to avoid the power of the majority to force these new provisions on dissenting shareholders and to avoid selling their shares in the market. In this regard, it provides a remedy for shareholders whose ability to exercise voice, by voting and otherwise, has been ineffective, and whose ability to exercise a right of exit may be ineffective or unsatisfactory. Consequently, such right reflects the balancing that obtains among the legal essentialist attributes of the corporation, most notably as between capital lock-in and free transferability of interest.

In the case of the DGCL, amendments must be approved by a majority of all outstanding shares under section 242, voting as a class or even series (voting as a class), even where not otherwise entitled to vote, if, among other things, the proposed amendment would alter the powers, preferences or special rights of that class or series so as to affect them adversely.

Chapter 10 of the MBCA deals with amendment of the articles and bylaws. Under section 10.03, any amendment must be adopted by the board and submitted to the shareholders for approval except that under section 10.05 certain routine “housekeeping” matters that do not affect substantial rights in any meaningful way, as described in the Official Comment, do not require any shareholder vote. Where a shareholder vote is required, under section 10.05, classes and series of shares that are entitled to vote separately vote separately on the amendment.

Under section 10.03, where the board approves the amendment and submits it to the shareholders for approval (as is required), the board is required to recommend approval unless special circumstances apply. As noted in the Official Comment, these include situations where a board cannot act by reason of conflict of interest or where a board is deadlocked, but agrees that shareholders should be able to consider the amendment.

Section 10.03 (c) states that the “board of directors may condition its submission of the amendment to the shareholders on any basis”. As the Official Comment notes, among the conditions which may be imposed by the board are provisions that the amendment is not deemed to be approved: unless approved by a specified vote of the shareholders, or by one or more specified classes or series of shares, voting as a separate voting group, or by a specified percentage of disinterested shareholders; or if shareholders holding more than a specified fraction of outstanding shares

exercise appraisal rights. Otherwise, under section 10.03 (f), only a majority of votes cast is required provided that there is a quorum consisting of at least a majority of the votes entitled to be cast on the amendment.

In the result, the board of directors exercises a much higher degree of control over adopting articles of amendment under the MBCA than under the other statutes. Similar provisions apply with respect to other fundamental changes under the MBCA, as discussed below. Thus, in this respect, the MBCA tradeoff between management independence of equity ownership and the other essential attributes greatly favours central management over its monitoring by shareholders.

### ***Bylaw Amendments***

Under section 103 of the CBCA and section 116 of the OBCA, unless otherwise provided in the articles, by-laws or a unanimous shareholder agreement (not applicable to public companies), by-laws that regulate the business or affairs of the corporation may be adopted, amended, and repealed by ordinary resolution of the directors. Such by-laws are effective until confirmed, confirmed, amended, or rejected at the next meeting of shareholders.<sup>28</sup>

Under section 109 of the DGCL, the bylaws of the corporation may contain any provision not inconsistent with law or its certificate of incorporation relating to its business, the conduct of its affairs, its rights or powers, or the rights or powers of its stockholders, directors, officers or employees. Unless otherwise provided in the certificate of incorporation, and unless the bylaws are adopted, amended or repealed by the incorporators, but, after payment for its stock, the power to adopt, amend or repeal bylaws is in the stockholders entitled to vote; but the certificate of incorporation may confer this power on the directors, except that such provision does not divest or limit the power of the stockholders to adopt, amend or repeal bylaws. This permits the directors to exercise initial authority over the content of the bylaws, without a “sunset” provision as in the Canadian statutes, as one example of the “management friendliness” ascribed to the DGCL.

Section 2.06 of the MBCA provides that the bylaws of the corporation may contain any provision that is not inconsistent with law or the articles of incorporation. Unless reserved to the shareholders

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<sup>28</sup> Some guidance concerning these matters as provided in *Wells v Melnyk* (2008), 92 OR (3d) 121, 46 BLR (4th) 112 (Sup Ct). A bylaw passed immediately prior to a contested meeting of shareholders which reduced the quorum for meetings of shareholders generally was held to be ineffective for the purposes of that meeting, when passed that meeting, because of noncompliance with the applicable notice requirements. It may be significant, however, that the subject matter of the bylaw related to rights of shareholders which, in the case at hand, were significantly affected.

“in whole or in part” (for example, by way of specific articles, or sections, or subjects, or topics) in the articles, or in sections 10.21 (which may impose a supermajority requirement for the election of directors) or 10.22 of the statute (which may impose a plurality requirement for the election of directors), either the shareholders or the directors may amend or repeal bylaws generally; provided that the shareholders in amending, repealing or adopting a bylaw may expressly provide that the board may not amend, repeal or reinstate that bylaw.

Accordingly, the significance of the power of to amend bylaws is recognized in each of the statutes. The weighting of the power and authority of the board to manage the corporation as against shareholder influence with respect to such management is balanced somewhat differently in each. This implicates the overall assignment of essentialist legal attributes of the corporation.

### *Amalgamation*

Sections 181 of the CBCA and 174 and 175 of the OBCA allow two or more corporations to amalgamate and continue as one corporation.<sup>29</sup> Under sections 183 and 176, respectively, directors of each amalgamating corporation are required to submit the amalgamation agreement for approval by the shareholders and by each class or series of shareholders, as a special resolution. Each share carries the right to vote on the amalgamation agreement, even if such shares are nonvoting otherwise.

Section 251 of the DGCL permits two or more corporations to merge into a single corporation, which may be any one of the constituent corporations, pursuant to an agreement of merger, or may consolidate into a new corporation formed by the consolidation, pursuant to an agreement of consolidation. The first requirement is that the directors pass a resolution approving the merger agreement or consolidation agreement and declaring its advisability. Under section 251 (f), approval of shareholders of a constituent corporation surviving the merger is not required unless: required by its certificate of incorporation; it amends the certificate of incorporation in some respects; each share of such constituent corporation does not become an identical share of the surviving corporation after the merger; the shares to be issued or delivered under the plan of

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<sup>29</sup> The Supreme Court of Canada has held that no "new" company is created and no "old" company is extinguished upon such amalgamation. Instead, they continue in their new identity as the amalgamated corporation. See *R v Black & Decker Manufacturing Co*, [1975] 1 SCR 411, 43 DLR (3d) 393 rev'g [1973] 2 OR 460, 34 DLR (3d) 308 (CA); *Witco Chemical Co v Oakville (Town)*, [1975] 1 SCR 273, 43 DLR (3d) 413, rev'g [1973] 2 OR 467, 34 DLR (3d) 315 (CA), aff'g [1972] 3 OR 712 (H Ct J).

merger, fully diluted, exceed by at least 20% the number of shares outstanding immediately prior to the merger.<sup>30</sup>

Further, under section 251 (h), unless expressly required by its certificate of incorporation, no approval is required, in effect, where the constituent corporation merging has a class of shares listed on a national securities exchange or has more than two thousand shareholders of record. In that case, the merger becomes effective as soon as practicable following the consummation of a qualifying offer pursuant to which the merger consummates an offer for all of the outstanding stock of such constituent corporation that otherwise would be entitled to vote on the merger. Such offer-for-all may be conditional on a minimum number or percentage tender, may exclude certain stock owned by parties having stipulated relationships to the offeror, and may involve separate offers for separate classes or series of stock of such constituent corporation.

As a result, shareholders of public companies who do not tender to such an offer may not have an opportunity to vote on the ensuing merger. Furthermore, the fairness of the offer may be somewhat problematic.<sup>31</sup> Section 262, however, provides appraisal rights in certain circumstances.

Section 11.02 of the MBCA permits one or more domestic entities or foreign business corporations or other eligible entities to “merge into a new domestic business corporation to be created in the merger in the manner provided in this chapter [11].” This permits a much broader class of merging parties than do the other statutes. It is interesting that whereas the MBCA creates a new corporation as a result of the merger, into which the previously existing corporations merge, the DGCL allows

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<sup>30</sup> This provision became effective August 1, 2013. It was considered in a series of cases including: *In re Zale Corp Stockholders Litig*, 2015 WL 5853693 (Del Ct Ch); *In re Zale Corp Stockholders Litig*, 2015 WL 6551418 (Del Ct Ch); the latter of which was affirmed by the Delaware Supreme Court in *Singh v Attenborough*, 2016 WL 2765312 (Del Sup Ct); *Corwin v KKR Financial Holdings LLC*, 125 A (3d) 304 (Del Sup Ct 2015); and *In re Volcano Corporation Stockholder Litigation*, 2016 Del Ch Lexis 99. Ultimately, the *Volcano* decision held that a tender of shares by a majority of shareholders who were fully informed and not coerced had a “cleansing effect” similar to a shareholder vote and, accordingly, the standard of review applicable to the board of directors’ decision to approve the merger, as the second step in a two-step merger transaction, was the business judgment rule, as would be applicable in a one-stage merger, rather than the “entire fairness” rule. See Robert S Reder & Stephanie Stroup Estey, “Sell-Side Financial Advisors in the M&A Crosshairs” (2016) 68 Vand L Rev En Banc 279; Robert S Reder, “Delaware Supreme Court Clarifies “Cleansing Effect” of Fully-Informed Stockholder Vote”, (2016) 68 Vand L Rev En Banc 219; Robert S Reder, “Delaware Chancery Court Extends “Cleansing Effect” of Stockholder Approval Under KKR to Two-Step Acquisition Structure” (2016) 69 Vand L Rev En Banc 227.

<sup>31</sup> Among the many excellent discussions of the duties, and standards of review, of boards of directors in Delaware are: Lyman PQ Johnson, “Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose” (2013) 38:2 Del J Corp L 405; and Lyman Johnson, “Delaware’s Non-Waivable Duties” (2011) 91:2 BU L Rev 701.

the merging entities to create a new corporation or to continue the existence of one or the other of the constituent corporations. This seems to indicate a different perspective on the nature of merger.

Section 11.03 provides for a share exchange whereby a domestic corporation may acquire shares in exchange for, or for a combination of, shares or other securities, interests, obligations, rights to acquire shares or other securities, or cash or property.

Except under sections 11.04 (g), which applies where the articles expressly limit or eliminate separate class or series voting rights, and 11.05, where a parent and subsidiary, or two subsidiaries, merge, after the directors adopt a plan of merger or plan of share exchange they must submit the plan to shareholders for approval with a recommendation of the shareholders approve the plan. The latter requirement has certain exceptions, similar to those with respect to approval of amendments to the articles under section 10.03.

Section 11.04 contains provisions applicable where shareholder approval is required, which are similar to those in section 10.03 and related sections with respect to amendments to the articles. As with amendments to the articles, the board can impose conditions on submission of a plan to shareholders, such as approval by a higher vote (in numbers or by percentage), by separate classes, by disinterested shareholders, or a condition that not more than a certain percentage or number of shareholders exercise appraisal rights.

While the board has the power to initiate and enter into the amalgamation agreement under each of the statutes, shareholder approval is required under the CBCA and OBCA, but is not required in some circumstances under the DGCL or MBCA. The greater authority accorded to the board under the latter American statutes reflects a higher prioritization of management power over other essentialist characteristics.

### ***Continuance – Export and Import***

Another example of a fundamental change requiring shareholder approval is the continuance of the domestic corporation into a foreign jurisdiction such that it ceases to be subject to the laws of the original domestic jurisdiction (referred to as an “export” of the corporation), and acceptance of a foreign corporation by the domestic jurisdiction of a corporation or other entity as a domestic entity subject to domestic regulation (referred to as an “import” or “domestication”).

In the case of exports, sections 188 of the CBCA, 181 of the OBCA (which also requires approval of the corporate authorities, principally to ensure that the corporation's rights and obligations continue, unaffected), 390 of the DGCL and s. 9.20 (b) of the MBCA, respectively, apply. Generally, they require shareholder approval, by special resolution in the CBCA and OBCA, as to which each share carries a right to vote whether or not it otherwise carries the right to vote; and create dissent or dissent and appraisal rights (CBCA and OBCA) or appraisal rights (MBCA), which rights are discussed further below. No dissent or appraisal rights exist under the DGCL. In the case of the MBCA, such appraisal rights arise if the shareholder does not receive shares having terms at least as favourable to the shareholder in all material respects and without dilution as the shares originally held.

In the case of imports, sections 187 of the CBCA, 180 of the OBCA, 388 of the DGCL, and 9.20 (a) of the MBCA apply. Section 388 of the DGCL permits a variety of non-United States entities to become domesticated as a Delaware corporation. These include a corporation, limited liability company, statutory trust, business trust or association, real estate investment trust, a common-law trust, or any other unincorporated business or entity including a general partnership (including a limited liability partnership) or limited partnership. As noted in the Official Comment, there are virtually no restrictions or limitations on the terms and conditions of a domestication, except that they have to be set forth in the plan of domestication. This is arguably appropriate, since the laws of the external jurisdiction would be expected to apply to its export. The types of entities that may be imported into Delaware corporate law as corporations may be surprising, last considered in light of the immediately foregoing observation. As well, this may be seen as an indication of the competitiveness of Delaware vis-à-vis other American states.<sup>32</sup>

Quite clearly, exporting the corporation from the law of one jurisdiction to another may have extremely important consequences for shareholders and others, including with respect to the balance of power as among directors, shareholders, and others. The lack of appraisal rights under the DGCL is significant in this regard. However, significant common law protections may exist in

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<sup>32</sup> The subject of competition among states for charters and the Delaware case, has given rise to considerable discussion among academics, jurors, and practitioners. An article which is widely cited in this regard is Roberta Romano, "The State Competition Debate in Corporate Law" (1987) 8 *Cardozo L Rev* 709. A Canadian perspective on the debate is provided by Ronald J Daniels, "Should Provinces Compete? The Case for a Competitive Corporate Law Market" (1991) 36:1 *McGill LJ* 130.

some situations. In general, these protections arise as a result of the application to the instant transaction of the business judgment rule, whose terms are beyond the scope of the present work.<sup>33</sup>

### ***Arrangement and Reorganization***

Section 192 of the CBCA and section 182 of the OBCA permit a corporation to apply to court for an order approving an arrangement “where it is not practicable for a corporation that is not insolvent to effect a fundamental change in the nature of an arrangement under any other provision of this Act”. Other than the “not practicable” requirement, and ensuring that the corporation is not insolvent (in which case other legislation applies), no guidance is given concerning the determination of whether the court should approve the arrangement proposed. As a result, while the case law provides some guidance to applicants and others, the approval of each arrangement is very fact specific.<sup>34</sup>

The types of transactions included in the definition of an “arrangement” include a capital reorganization, an amendment of the articles, an amalgamation, a liquidation, and a dissolution. As Chris Nicholls observes, while the word “arrangement” might suggest that it might be intended for use by distressed corporations (but which, under the CBCA, we would note, are not actually insolvent) this provision is often used in connection with structure and complex business acquisitions and complex organizations, such as spin offs.<sup>35</sup> A corporation which is insolvent as defined in subsection 192 (2) is unable to undertake an arrangement under subsection 192 (3) of the CBCA.<sup>36</sup>

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<sup>33</sup> A useful review, by a Delaware Supreme Court Justice, is Randy J Holland, “Delaware Directors’ Fiduciary Duties: The Focus on Loyalty” (2009) 22:3 U Pa J Bus L 675.

<sup>34</sup> In the case of *Re Electrohome Ltd* (1998), 40 BLR (2d) 210, 4 CBR (4th) 239 (Ont SC), Spence J describes some of the relevant considerations as distilled from previous cases, but, unusually, by way of a memorandum appended to the decision. The relevant principles are now set forth in the Supreme Court of Canada's decision in *BCE Inc v 1976 Debentureholders*, 2008 SCC 69, [2008] 3 SCR 560 [*BCE*]. Other major cases include: *Canadian Pacific Ltd* (1990), 73 OR (2d) 212, 70 DLR (4th) 349 (H Ct J) (application dismissed); *Canadian Pacific Ltd (Re)*, 30 OR (3d) 110, 1996 CanLII 8029 (Gen Div); *Stelco Inc (Re)*, 2007 CanLII 46175 (Ont Sup Ct J); *Masonite International Inc (Re)*, 56 CBR (5th) 42, 2009 CanLII 40563 (Ont Sup Ct J); *Magna International Inc (Re)*, 2010 ONSC 4123, 101 OR (3d) 736; *Magna International Inc (Re)*, 2010 ONSC 4685, 101 OR (3d) 721 (Div Ct).

<sup>35</sup> Christopher Nicholls, *Corporate Law* (Toronto: Edmond Montgomery, 2005) at 455-456.

<sup>36</sup> OBCA and CBCA corporations which are insolvent may, instead, seek relief under the *BIA*, *supra* note 24, or the *CCAA*, *supra* note 24. The *CCAA* may be used where the corporation is not insolvent and is often used to make compositions with creditors. Thus, both statutes may be employed to vary the “bargain” among corporate participants, even extending to legal essentialist attributes. Among the leading sources of authority concerning the statutes are: Janis Sarra, *Creditor Rights and the Public Interest: Restructuring Insolvent Corporations* (Toronto: University of Toronto Press, 2003); and Janis P Sarra, *Rescue! The Companies’ Creditors Arrangement Act* (Toronto: Carswell, 2007). Where an order is made under the *BIA* approving a proposal, the corporation may file articles of reorganization



The requirements for a special resolution and as to voting are similar to those with respect to other fundamental changes. As the court must approve the arrangement, as proposed or as amended as the court may direct, no dissent rights automatically arise under section 190 of the CBCA and section 185 of the OBCA, although they may be accorded to shareholders by the court. As only the corporation may initiate an arrangement, it must be initiated by the board of directors and cannot be initiated by other parties in interest, such as shareholders.

Unlike other fundamental changes, which are initiated by the board but approved by the shareholders, the arrangement mechanism substitutes court approval for shareholder approval as a means of attempting to balance the respective interests of the participants in the corporation. This effects a different accommodation of essentialist attributes. It also permits fundamental changes to be made to the charter documents and underlying fundament of the corporation in cases where shareholder approval is not likely to be forthcoming, such as in cases of shareholder deadlock.

The DGCL and the MBCA do not appear to contain any equivalent statutory provisions.

An arrangement must be distinguished from a reorganization. Section 191 of the CBCA and section 186 of the OBCA deal with a reorganization, which is defined to mean an order made under section 241 of the CBCA or under section 248 of the OBCA, respectively, dealing with the oppression remedy;<sup>37</sup> under the Bankruptcy and Insolvency Act (Canada);<sup>38</sup> or, in the case of the CBCA only, under “any other Act of Parliament that affects the rights among the corporation, its shareholders and creditors”, or, in the case of the OBCA provision only, under the Companies Creditors Arrangement Act (Canada).<sup>39</sup> All these provisions effect or may effect substantial changes in the articles of the corporation, effect to which is given, as a matter of corporate law, by the issuance of articles of reorganization. Although the issuance of the court orders themselves often requires some vote or indication of preference by shareholders, a vote is not required as a

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under section 191 of the CBCA, receipt of which results in a certificate of amendment to the corporation's articles. OBCA companies can restructure as a matter of federal insolvency law under the BIA or under the CCAA but must amend their articles accordingly, very often by way of arrangement. Often, the creditor restructuring provisions and corporate restructuring provisions, federal or otherwise, are combined in a single set of judicial proceedings.

<sup>37</sup> These sections deal with the oppression remedy, which is discussed, *infra*, in the section entitled “Shareholder Rights Beyond Voting”.

<sup>38</sup> *Supra* note 27.

<sup>39</sup> *Supra* note 27. As the names of the statutes suggest, orders under the BIA and the CCAA may affect the rights of debtors, creditors, and others.

matter of corporate law for approval of the articles of reorganization, and no dissent and appraisal rights arise under section 185 of the OBCA.

### ***Sale or Lease of All or Substantially All the Property of the Corporation***

Another type of fundamental change or transaction which requires shareholder approval is a sale, lease or exchange “of all or substantially all the property of a corporation other than in the ordinary course of business of the corporation” under subsections 189 (3) and 184 (3) of the CBCA and OBCA, respectively. The requirements for a special resolution and as to voting are similar to those with respect to other fundamental changes. Dissent rights arise under section 190 of the CBCA and section 185 of the OBCA.

Such a sale, of course, would ordinarily be expected to have the effect of terminating the corporation’s existing business. Of course, the proceeds of such a sale may be employed in a similar business or in a quite different business; however, such a sale may represent a change in the investment originally made by the shareholder at the time of acquisition of the shares. Redeployment of the proceeds may likewise constitute a form of reinvestment by such shareholder in the “new” business. Accordingly, shareholder approval is appropriate. Shareholders may not, however, initiate a sale of such assets, either by entering into an agreement for such purpose or by passing a resolution authorizing the execution and performance of such an agreement. Such power of management is reserved to the directors. The directors retain the power and authority to exercise such powers of management even if in so doing they are acting contrary to the expressed wish of the shareholders.<sup>40</sup>

A leading case on the interpretation of these provisions is *Benson v. 3rd Canadian General Investment Trust Ltd.*, which held that in determining whether the sale required a special resolution, a qualitative test of whether the sale of the assets concerned would fundamentally change the nature of the corporation’s business was preferable to a purely quantitative test based on the value of the assets being sold.<sup>41</sup> Citing that case, a sale to a wholly owned subsidiary was held not to

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<sup>40</sup> *Automatic Self-Cleansing Filter Syndicate Automatic Co v Cunningham*, [1906] 2 Ch 34 (Eng CA).

<sup>41</sup> *Benson v Third Canadian General Investment Trust Ltd* (1993), 14 OR (3d) 493, 13 BLR (2d) 265 (Gen Div). Cited by way of *obiter* in *GATX Corp v Hawker Siddeley Canada Inc*, 27 BLR (2d) 251 at para 81, 1996 CanLII 8286 (Ont SC): “In determining whether a sale involves ‘substantially all’ of the assets of a corporation, the Courts have tended to look beyond a mere ‘quantitative’ test. That is, the exercise requires more than simply comparing the value of the asset in question with the total value of the corporation’s assets and deciding where the resultant percentage crosses the line and becomes ‘substantially all’ of the assets. Rather, the Courts will look at the relationship between the asset in question and the nature of the company’s operations as a whole, taking into account the quantitative aspects of the

engage the application of the provision in *Canadian Broadcasting Corporation. Pension Plan v. BF Realty Holdings Ltd.*<sup>42</sup> This is interesting in that a broader enterprise concept involving common ownership supplanted a strict application of the separate legal entity approach.

Section 271 of the DGCL requires approval of such a sale by holders of the outstanding voting stock entitled to vote, but does not accord votes to all shares, and does not require class or series voting, the latter presumably because all classes and series of shares are equally affected. It considers the property of subsidiaries as property of the corporation.

Section 12.01 of the MBCA provides that, unless the articles otherwise provide, no approval of shareholders of the corporation is required to sell, lease, exchange or otherwise dispose of any or all of the corporation's assets in the usual and regular course of business. Under section 12.02, any other sale, lease, exchange, or disposition of assets requires approval of the shareholders if such disposition would leave the corporation without a significant continuing business activity. A corporation is conclusively deemed to have retained a significant continuing business activity if it retains a business activity that represented at least 25% of the total assets at the end of the most recently completed fiscal year, and 25% of either income from continuing operations before taxes or revenues from continuing operations for that fiscal year, in each case on a consolidated basis.

Unless the articles of the board require a greater vote or a greater quorum, such approval is to be given by shareholders at a meeting at which at least a majority of the votes entitled to be cast on the disposition are represented. As in cases of other fundamental changes, the board may impose conditions on its submission of such disposition of the shareholders. Such a transaction generally gives rise to appraisal rights under section 13.02.

Like other fundamental changes, these fundamental sale or lease transactions invoke differing statutory accommodations of the corporate essentialist attributes.

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case in the process but trying to determine on an overall basis whether the sale will have the effect of fundamentally changing or destroying the nature of the corporation's business because 'it is a sale of a part of the business so integral as to be essential for the transaction of its ordinary day-to-day business'."

<sup>42</sup> *Canadian Broadcasting Corp Pension Plan v BF Realty Holdings Ltd* (2002), 10 BLR (3d) 188, 18 CBR (4th) 181 (Ont SC).

### ***Approval of Fundamental Changes - Summary***

As demonstrated above, the power of the board of directors as a matter of corporate law to manage or supervise the management of the business and affairs of the corporation engages some limits with respect to certain fundamental changes or transactions, which, generally speaking, involve the legal rights of its participants. Often, they relate, broadly speaking, to its “affairs” in the sense of the relationships among the corporation, its affiliates and the shareholders, directors and officers of such bodies corporate (but not including the business carried on by such bodies corporate). Indeed, they often involve the realignment of rights of shareholders vis-à-vis the corporation. Sometimes, they involve changes in the authority of the board of directors vis-à-vis the corporation. Some of the latter cases involve realignments of the authority as between directors and shareholders with respect to the corporation.

As in the case of certain other shareholder rights, the right to approve fundamental changes, especially when combined with other remedies, notably the shareholders’ dissent and appraisal or appraisal remedy, is intended to operate as a sort of “fail-safe” mechanism, restraining self-dealing and other forms of opportunism by directors, and by the controlling plurality, or majority, of shareholders.

From a corporative perspective, changes in the legal rights of participants in respect of the legal entity in terms of corporate law must be considered in relation to the effect of these changes on the functioning of the organization and its structure, processes, and personnel. As has been shown, however, the effects of corporate law largely concern structural matters, and sometimes processes, in relation to the legal rights of participants; and they are principally concentrated at the board-shareholder level and with respect to that interface.

### **Shareholder Rights to Initiate Consideration of Certain Matters**

As will be described in more detail below, the rights of shareholders to initiate consideration of certain matters by the directors and management, as well as by shareholders, by bringing those matters to the attention of shareholders generally, has become more significant in recent years.

This is been the result, in part, of changes and shareholding patterns involving the balance of institutional and “public” shareholders, including “odd lot” shareholders (shareholders who acquire, hold, or sell less than a “board lot” or usual trading quantity, of such shares). As

institutional investors, such as insurance companies and large corporations, and administrators of benefit plans, such as pension plans and retirement plans (including registered retirement savings plans in Canada and section 401 (k) savings plans in the United States), have come to represent an increasingly large, even dominant, proportion of public company shareholdings, and have increased in size such that meaningful management of their portfolios often requires reasonably large minimum investments, they have become more active in asserting these rights.

Principally, these involve enabling shareholders to assert some “voice” in matters affecting the corporation. These rights include making shareholder proposals and requisitioning meetings of shareholders. Shareholder remedies, including those alleviating compulsory or inadequate provisions relating to “exit” from share ownership, will be discussed separately.

### ***Shareholder Proposal***

Sections 137 of the CBCA permits a registered holder or beneficial owner of shares that are entitled to be voted at an annual meeting to submit to the corporation notice of any matter that the person proposes to raise at the meeting (a “proposal”); and to discuss at the meeting any matter in respect of which the person would have been entitled to submit a proposal. In order to be eligible to submit a proposal, a person must have been a registered holder or beneficial owner of the minimum number of shares required for at least the prescribed period, or must have the support of persons who, in the aggregate, satisfy these conditions.<sup>43</sup>

A corporation that solicits proxies is required to set out in, or attach to, the management proxy circular the proposal and any supporting statement of the proposer meeting prescribed requirements. A proposal supported by not less than five per cent of the shares or class of shares entitled to vote at the meeting may include nominations for the election of directors. A corporation is not required to include in the management proxy circular a proposal if: it does not satisfy prescribed notice requirements; it clearly appears that its primary purpose is to enforce a personal claim or address a personal grievance against the corporation or its directors, officers or security holders, it does not relate in any significant way to the business or affairs of the corporation; it has been the subject of a prior proposal by the same proposer within a prescribed period that was not proceeded with; if substantially the same proposal was submitted to a prior meeting and was

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<sup>43</sup> Only the registered owner is “entitled to vote” and, accordingly, to submit a proposal: *Verdun v Toronto-Dominion Bank*, [1996] 3 SCR 550, 139 DLR (4th) 415.

defeated; or if the rights so conferred are being abused to secure publicity. It is apparent, of course, that these matters require determination based on all the relevant circumstances, with the result that determining and applying relevant principles is complicated accordingly. As discussed under the next heading with respect to shareholder requisitions for meetings, the grounds for refusing to include proposals and for refusing to requisitioning meetings are the same. Consequently, the case law frequently deals with both issues.<sup>44</sup>

A corporation receiving such proposal which refuses to include the proposal in its management proxy circular is required to provide notice of such refusal and of the reasons for refusal within a prescribed period of time. The proposer may make application to court restraining holding of the meeting or making any further order that it thinks fit, and a corporation or any person claiming to be aggrieved by a proposal may apply to court for an order permitting the corporation to omit the proposal from management proxy circular and to make such an order as it thinks fit. Any person claiming to be aggrieved by a corporation's refusal to include such a proposal in the management proxy circular may likewise apply to court.<sup>45</sup>

Until recently, Section 99 of the OBCA was substantially similar but with certain variations of terminology and otherwise. Amendments to it were effected in 2017 by means of the Cutting Unnecessary Red Tape Act (the "2017 Amendments").<sup>46</sup> At the request of a person submitting notice of a proposal, the corporation is required to include a statement in support of the proposal and the proposer's name and address in the management information circular (if required) or notice of meeting (otherwise).<sup>47</sup> In the case of an offering corporation,<sup>48</sup> notice of a proposal must be

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<sup>44</sup> For example, in *Watkin v Open Window Bakery Ltd*, 26 BLR (2d) 301, 1996 CanLII 8284 (Ont SC), it was determined on the facts that the sole purpose of requesting a meeting was to advance claims in a shareholders' action,, and not for a bona fide purpose related in any significant way to the business or affairs of the corporation. That court applied the decision in *Cappuccitti v Bank of Montreal* (1989), 46 BLR 255 (Ont HC), which held on the facts that the proposal was purely designed to embarrass the bank and to give the applicant leverage in a lawsuit with the Bank concerning the applicant's guarantee of a loan.

<sup>45</sup> In the case of *Paulson & Co Inc v Algoma Steel Inc* (2006), 79 OR (3d) 191, 14 BLR (4th) 104 (Sup Ct J), the court held that the meeting was required to be "called" within the period stated in the statute, but that the scheduling of a requisition meeting was a matter left to the business judgment of the directors, to be determined by the directors acting honestly, in good faith and with a view to the best interest of the corporation; and that the court should defer to such business judgment provided that it was within a range of reasonableness.

<sup>46</sup> The *Cutting Unnecessary Red Tape Act*, SO 2017, c. 20 – Bill 154. Royal Assent received November 14, 2017 (the "2017 Amendments").

<sup>47</sup> *Supra*, note 42 s. 8(1), repealing and substituting s. 99(2) and (3).

<sup>48</sup> *Supra*, note 14.

submitted not less than 60 days before the anniversary date of the last annual meeting if proposed to be raised at an annual meeting or, otherwise, the date of the proposed meeting.<sup>49</sup>

Any proposal made by a proposer who submitted a proposal that was included in a management information circular or notice of meeting but failed to present such proposal at the meeting of shareholders need not be included in such a document subsequently.<sup>50</sup> Proposals that are substantially similar to proposals submitted to a previous meeting within five years or other prescribed period which did not receive a minimum level of support specified in s. 99 (5.4) need not be included in the management information circular or notice of meeting, as the case may be.<sup>51</sup>

Neither the DGCL nor the MBCA contain any provision similar to or equivalent to the proposal mechanism, however, federal securities law, in particular, Rule 240.14a-8 of the Securities Exchange Act of 1934,<sup>52</sup> creates some rights that are similar in this respect and in respect of which there is extensive case law. Such matters of securities law exceed the limitations of our review.

Of course, it is generally beyond the capacity of shareholders to initiate corporate action, except by means of statutory and other remedies. Accordingly, while a proposal may be used to bring the matter to the attention of the directors and management, generally speaking, it has no binding effect. However, successful passage of a proposal, significant support for proposal, or even just the making of a proposal, the initiation of a proposal may have some persuasive effect on the board and management. In some cases, securities laws promote such actions, as in the case of “say on pay”.

A 2010 study by Ertimur, Ferri and Stubben considered the increased likelihood of boards implementing non-binding majority-vote governance-related shareholder proposals, the major determinants of which implementation were found to be shareholder pressure, as measured by the voting outcome and the influence of the proponent of the proposal, the nature of the specific proposal, and the acceptance of such proposals by corporate peers. It also found that listening to shareholder “voice” had positive consequences for board members. Implementation of such proposals were associated with a reduction of approximately one-fifth in director turnover at the

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<sup>49</sup> *Supra*, note 42 s. 8(2), repealing and substituting s. 99 (5) (a).

<sup>50</sup> *Supra*, note 42 s. 8(3), repealing and substituting s. 99 (5) (c) and (d).

<sup>51</sup> That period increases from 3 per cent for a first meeting, to 6 percent for a second meeting, and to 10 percent for subsequent meetings.

<sup>52</sup> The Securities Exchange Act of 1934 (Pub. L. 73-291, 48 Stat. 881, enacted June 6, 1934, codified at 15 U.S.C. § 78a et seq.

target firm and a like reduction in target firm directors losing board seats in other firms. It appears that implementing such proposals is regarded as positive behaviour by directors, who are rewarded (or, at least, not disbenefited) accordingly.<sup>53</sup>

Under sections 103 (5) of the CBCA and 116 (5) of the OBCA, a shareholder can make a proposal to make, amend, or repeal a by-law.<sup>54</sup> Under the OBCA, if such proposal is adopted by the shareholders at a meeting, it becomes immediately effective and does not require any further confirmation. In other words, this type of shareholder proposal can be binding on the corporation in accordance with its purported effect, provided that it is otherwise lawful. For example, a by-law requiring advance notice of nominations for election as directors (commonly called an “advance notice bylaw”) could be repealed by means of a shareholder proposal which is adopted at a meeting of shareholders. Consequently, this provision may be seen as limiting or derogating from the general and extensive management powers of the board, although only to the extent otherwise permitted to be effected by means of by-laws.<sup>55</sup>

At the very least, the proposal mechanism provides an opportunity for shareholders to voice concerns about the corporation’s business and affairs. In some cases, the exercise of such voice may be motivated, in part, by the shareholder’s loyalty to the corporation and in other cases by a

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<sup>53</sup> See Yonca Ertimur, Fabrizio Ferri & Stephen R Stubben, “Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals” (2010) 16:1 J Corporate Finance 53.

<sup>54</sup> *Piikani Investment Corporation v Piikani First Nation*, 2008 ABQB 775, involved a complex situation concerning a shareholder proposal to amend the articles and bylaws of the subject corporation which held funds received by the Piikani First Nation in settlement of certain land claims against Canada and the Province of Alberta. The matters at issue related to alleged differences between the settlement agreement providing for the creation of the corporation and the corporation's actual articles and bylaws. It is a textbook example of the manifold issues, complex and otherwise, that can be brought before a court with respect to such shareholder procedural matters. The settlement agreement was held to be a unanimous shareholder agreement under section 146 of the CBCA as a result of which it was held that the bylaws had to comply with such agreement”, both “as a foundational document” (para 88) and as a unanimous shareholder agreement (para 91).

<sup>55</sup> In *Wells v Melnyk*, *supra* note 28, however, the ability of the board to control the bylaws even in the absence of a shareholder proposal to amend the bylaws was contested. The withdrawal of proxies immediately before the scheduled meeting of shareholders, which had the effect of denying a quorum, was met by a board resolution purporting to amend the bylaws to reduce the quorum. The meeting which was then held was found by the court to be improperly constituted as the quorum reducing bylaw was invalid for lack of notice and lack of shareholder approval. The requirement of section 103 (2) of the CBCA that any bylaw passed by the directors had to be submitted to the shareholders “at the next meeting of shareholders” was strictly interpreted, although section 103 (3) provided that the board resolution was effective until confirmed, amended or rejected or until it ceased to be effective under subsection 103 (4) by reason of being rejected by shareholders or not being submitted to shareholders. The court’s interpretation of these provisions meant that the entitlement of shareholders to vote at a meeting of shareholders could not be affected by board action taken immediately before the meeting. Of course, it was to avoid this result that the quorum reducing bylaw was passed by the board. The shareholders' statutory right to approve certain board actions (in this case, an amendment of the bylaws) was thereby protected.



desire to increase the current market value of its shares, in both cases as an alternative, or as preparatory, to the shareholder's sale of shares, thereby exercising a right of exit. As will be discussed below, shareholders with a significant interest in the corporation and who engage in regular dialogue with the board and management may enjoy influence which might obviate the necessity of bringing a proposal; however, the ability to initiate a proposal may facilitate and encourage such dialogue.

Like shareholder approval of fundamental transactions, the shareholder proposal mechanism provides shareholders with a right of voice which may operate in connection with loyalty to mitigate against a shareholder seeking to exit the investment, in at least some cases. As such, it engages with the centrality of management, separation of management from ownership, capital lock-in, ownership of assets and exclusive subjection to liabilities, and transferability attributes of the corporation, which are essential to it being a corporation.

### ***Requisition for a Meeting of Shareholders***

Sections 143 of the CBCA and 105 of the OBCA empower the holders of not less than five per cent of the issued voting shares of a corporation to requisition the directors to call a meeting of shareholders for the purposes stated in the requisition. The directors are required to call such meeting unless: a record date has been fixed and notice given; the directors of called a meeting of shareholders and given notice; or the business of the meeting stated in the requisition (which we will here call "unsuitable business") does not require this.

This unsuitable business is business in respect of which a proposal may also be disqualified. In fact, the disqualification provision of the requisition sections incorporates by reference the disqualification provisions in the proposal sections. If the directors do not within twenty-one days of receiving such requisition call a meeting, any shareholder who signed the requisition may call the meeting, in which case the corporation is required to reimburse such shareholder for the expenses reasonably incurred and requisitioning, calling and holding the meeting.<sup>56</sup>

As in the case for proposal, the ability of the shareholders to pass resolutions which will be legally effective are subject to the limitations of corporate law and other law. However, this procedure may be employed where shareholders are empowered to effect results, such as in the case of the

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<sup>56</sup> See the discussion in the text accompanying, and the text in, notes 26-28 above.

removal of directors. Of course, there is a significant body of case law concerning these provisions. Under sections 144 of the CBCA and 106 of the OBCA, in these and other circumstances resort may be had to the court which may order a meeting to be called, held, and conducted in the manner that the court directs.<sup>57</sup>

There is no equivalent provision in the DGCL. Section 7.02 (a) (2) of the MBCA requires a corporation to call a special meeting if the holders of at least 10% of all the votes entitled to be cast on an issue proposed to be considered at the proposed special meeting deliver to the corporation one or more written demands for the meeting describing the purpose or purposes for which it is to be held, provided that the articles may fix a lower percentage or a higher percentage not exceeding 25% of such votes.

The Official Comment notes that one or more factions of shareholders may demand meetings at roughly the same time or that a single or changing faction of shareholders may request consecutive, overlapping, or repetitive meetings; and that, in such cases, the responsible corporate officers have some discretion as to the calling and purposes of the meeting. They may refuse to call a meeting for a purpose identical or similar to that purpose for which a previous special meeting was held in the recent past or to decline to call a special meeting where an annual meeting will be held in the near future. Where the corporation does not call a meeting within the prescribed period of time, a shareholder who signed such a demand may apply to court under section 7.03 for an order calling such meeting.

Consequently, the statutory requisition power, where available, may be used not only to give “voice” to shareholder concerns but also, in certain cases, to implement permitted actions, including removal of directors. Such removal, in turn, could facilitate a change of management and of corporate policies. Accordingly, this power can be seen as one of intermediate effect in monitoring and in seeking to moderate behaviour, particularly excessive behaviour, of the board

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<sup>57</sup> The cases which concern these issues include: *Canadian Jorex Limited v 477749 Alberta Ltd* (1991), 117 AR 222, 85 Alta LR (2d) 313 (CA) (concerning the power of the board of directors to cancel a meeting of shareholders previously called); *Airline Industry Revitalization Co v Air Canada* (1999), 45 OR (3d) 370, 178 DLR (4th) 740 (Sup Ct J); *Sparten Establishment v International Telepresence (Canada) Inc*, 1999 CanLII 6293 (BC SC); *Environmental Management Solutions Inc v D'Addario*, 11 BLR (4th) 286, 2005 CanLII 51351 (Ont Sup Ct J) [*Environmental Management Solutions*] (an application to restrain the holding of a meeting); *Wells v Melnyk*, *supra* note 28; *Goodwood Inc v Cathay Forest Products Corp*, 2013 ONSC 2696 (an application for costs of a meeting); *Marks v Intrinsyc Software International Inc*, 2013 ONSC 727 (complaint concerning an alleged delay in scheduling a meeting requisitioned by the applicant); *Wells v Bioniche Life Sciences Inc*, 2013 ONSC 4871.

or of a controlling shareholder exercising control or influence over the board. It may be used to redress imbalances obtaining from time to time vis-à-vis the corporate essentialist attributes.

Such requisition pursuant to corporate law might also thereby effect changes in the internal organization of the corporation, involving its structure, processes and personnel. Legislators and regulators concerned with the availability of proposal, requisition and other shareholder mechanics giving them voice and even power with respect to taking actions binding on the corporation would be well to consider such relationships.

## **PART B – INFORMED VOTING BY SHAREHOLDERS**

As demonstrated above, the power to vote for the election of directors is perhaps the most important right of shareholders. It enables the shareholders to select the directors, who have the right and the power, as a matter of corporate law, to manage or supervise the management of the business and affairs of the corporation. The board of directors has plenary authority in this respect, subject only to qualifications principally relating to fundamental transactions, self-dealing, and significant abuses of authority. In order to be said meaningfully to possess and exercise such “oversight”, “review”, or “residual” power and authority, however, shareholders must be informed about the relevant matters. Positive corporate law imposes obligations on the board of directors to this end.

### **Proxy Solicitation and Voting**

In recognition of the inconvenience that that might be consequent upon the necessity to attend meetings of shareholders in person, most modern corporate statutes permit the holders of voting shares to appoint a person, known as a proxyholder, to represent the shareholder at a meeting and to attend and vote and act on behalf of the shareholder as if the shareholder were personally present at the meeting. Section 147 and following of the CBCA and section 109 and following of the OBCA may be cited as examples. The ostensible purpose of such provisions is to permit participation at meetings by shareholders who might otherwise be unable to be personally present. Generally speaking, a proxyholder is required to attend and comply with the directions of the shareholder concerned. For example, this is required by sections 152 of the CBCA and 114 of the

OBCA. Detail of the requirements as to the use of, and as to the form and contents of proxies are prescribed by regulations under each statute.<sup>58</sup>

For a number of reasons, including some relating to the real or perceived legitimacy of the process and result, most modern corporate statutes require management of a “public” corporation (in effect, a “distributing corporation” under the CBCA<sup>59</sup> and an “offering corporation” under the OBCA<sup>60</sup>) to solicit proxies from the shareholders generally, as in section 149 of the CBCA and sections 111 and 112 of the OBCA. This broadens the base of shareholders represented at a meeting, beyond those attending the meeting in person or executing proxies of their own motion. It also provides some indication of the extent of support by shareholders generally for the incumbent board of directors. Shareholders and others may also solicit proxies, for example under sections 150 of the CBCA and section 112 of the OBCA. Among other things, this permits shareholders to organize themselves to oppose management proposals for the election of directors or relating to certain substantive matters or both.

Organizers of dissident campaigns may be able to avail themselves of an exception from the proxy requirements where the total number of shareholders is proxies are solicited is fifteen or fewer under subsection 150 (1.1) of the CBCA or 112 (1.1) of the OBCA. Soliciting proxies by public broadcast, speech or publication does not by itself require preparation of a circular by reason of subsections 150 (1.2) and 112 (1.2) of the CBCA and OBCA, respectively. The adequacy of proxy circulars, management or dissident, and whether they are required in any particular case are frequently challenged in court.<sup>61</sup>

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<sup>58</sup> For the CBCA, the *Canada Business Corporations Regulations*, SOR/2001-512, especially at ss. 54 and 67-69 inclusive, and, for the OBCA, RRO. 1990, Reg 62, especially at ss. 27-29.3 inclusive.

<sup>59</sup> *Supra* note 16.

<sup>60</sup> *Supra* note 14.

<sup>61</sup> For example, in *Polar Star Mining Corporation v Willock* (2009) 96 OR (3d) 688, 57 BLR (4th) 71 (Sup Ct J), the issuance of press releases prior to distribution of a dissident proxy circular was held not to merit the order sought which would restrain further breaches by the dissident. Reliance on the safe harbour provision of subsection 150 (1.1) was upheld by the court in *Smoothwater Capital Partners LP I v Equity Financial Holdings Inc*, 2014 ONSC 324 [*Smoothwater Capital*]. The court there cited, *inter alia*, two of the leading cases on proxy solicitation: *Western Mines Ltd v Sheridan*, [1975] BCJ No 54 (SC), in which the court found, in all the circumstances, that the letter sent could not be considered to be “reasonably calculated” to result in the procurement, withholding, or revocation of a proxy under the equivalent provision of the *Business Corporations Act (British Columbia)*, SBC 2002, c 57; and *Brown v Doby*, 28 OR (2d) 745, 111 DLR (3d) 418 (H Ct J). Some discussion of these issues appears in L Getz, “Proxies – The Meaning of Solicitation” (1976) 1 Can Bus LJ 472; and BG Hansen, “Annual Survey of Canadian Law – Corporation Law” (1978) 10:1 Ottawa L Rev 617.

## Proxy Solicitation and Mandated Disclosure

Most modern corporate statutes recognize the considerable information asymmetry between management and shareholders at large and attempt to reduce this asymmetry to some degree by requiring a certain level of disclosure in regard to the election of directors and in relation to other matters as to which the shareholders exercise an approval/disapproval function. In connection with its solicitation of proxies, which is mandatory for “public corporations”,<sup>62</sup> management is required to distribute to shareholders, the directors, and the auditor a base disclosure document, which is known as a “management proxy circular” under section 150 of the CBCA and an “information circular” under section 112 of the OBCA. Shareholders soliciting proxies are required, subject to certain exceptions, to distribute a “dissident’s proxy circular”.<sup>63</sup>

The requirements as to the form and contents of such circulars are quite extensive, and are prescribed in regulations under the respective statutes.<sup>64</sup> Although interesting, these must be treated as beyond the scope of the present work. As might be expected, however, compliance with those requirements are frequently challenged by those in opposition to the proponents of the circular.<sup>65</sup>

An annual meeting of shareholders is required under section 133 of the CBCA and section 94 of the OBCA. Notice is required to be given under sections 135 of the CBCA and 96 of the OBCA. The normal business of an annual meeting consists of consideration of the financial statements and the auditor’s report, election of directors and reappointment of the incumbent auditor. All other business is considered to be special business. In effect, where the only business to be considered is annual meeting business, extensive disclosure of the background of directors, their compensation by way of cash, stock options and otherwise, and that of management is required.

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<sup>62</sup> OBCA, S. 111. This applies, effectively, to distributing corporations. CBCA s. 149, applying, effectively to “offering corporations”, *supra*, note 44.

<sup>63</sup> CBCA, s. 150; OBCA, s. 112. See discussion under the immediately preceding heading in the text.

<sup>64</sup> *Supra* note 47; especially, in the case of the CBCA, at ss. 55-66 and, in the case of the OBCA, ss.30-42 inclusive.

<sup>65</sup> In *Smoothwater Capital*, *supra* note 48, the court held that the term “solicitation” was to be defined broadly in an inclusive manner and that the existence of a solicitation is a question of fact, on the nature of the communication of the circumstances of its transmission, citing HR Nathan and ME Voore, *Corporate Meetings Law and Practice* (Toronto: Thomson Reuters Canada, 1995) (loose-leaf). Among the leading cases on compliance with the standard of disclosure are: *CI Covington Fund v White*, [2000] OJ No 4589 (Sup Ct) at para 46; *Deluce Holdings Inc v Air Canada* (1992) 12 OR (3d) 131, 98 DLR (4th) 509 (Gen Div); *UPM-Kymmene Corp v UPM-Kymmene Miramachi Inc* (2004), 250 DLR (4th) 526, 183 OAC 310 (CA).

Where any special business is to be transacted the meeting, sections 135 of the CBCA and 96 of the OBCA require the nature of that business to be stated in the notice in sufficient detail to permit the shareholder to form a reasoned judgment thereon and to contain the text of the relevant special resolution.<sup>66</sup>

Such provisions are intended to ensure that shareholders are able to exercise their voting rights in a meaningful way. This confers some legitimacy on the voting process and binds shareholders, other corporate participants, and the investment community generally to the result, not only in legal, but also in practical, and even moral, terms. It also seeks to encourage feelings of fairness by, confidence in, and loyalty towards the directors and management, and seeks to discourage exit due to diminished perceptions of fairness, confidence and loyalty.

These objectives are reinforced by the powers of the court under the relevant corporate statutes. Both sections 144 of the CBCA and 106 of the OBCA empower a shareholder, a director, or the corporate regulator to apply to court for an order that a meeting be called, held and conducted in a manner that the court directs. Such order may be made if it is impracticable to call or to conduct the meeting in the manner prescribed by the articles, the by-laws, or the statute or for any other reason that court thinks fit.<sup>67</sup>

An application to court may also be made under sections 145 of the CBCA and 107 of the OBCA by a corporation, shareholder or a director to determine any controversy with respect to an election or appointment of a director or auditor. The court may restrain the party concerned from acting pending determination of the dispute, may declare the result of the disputed election or appointment, may order a new election or appointment and provide directions in the management of the business and affairs of the corporation in the interim; and may determine the voting rights of shareholders and the of persons claiming to own shares.<sup>68</sup>

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<sup>66</sup> Cases concerning the standards of disclosure and compliance therewith include: *Environmental Management Solutions*, supra note 46; *Wells v Melnyk*, supra note 25; *Meson Capital Partners LLC v Aberdeen International Inc*, 2015 ONSC 532, which left the determination to an independent chair of the meeting, who was appointed by the court.

<sup>67</sup> The relevant case law includes many of the cases referenced here, including those cited in footnotes 35 and 37.

<sup>68</sup> The ruling of the President of the corporation, acting as chairman of a meeting of shareholders in accordance with the bylaws went to the Supreme Court of Canada in *Blair v Consolidated Enfield Corp*, [1995] 4 SCR 5, 128 DLR (4th) 73, holding that such person was entitled to indemnification, despite a personal interest in the outcome of the decision, provided that he acted honestly and in good faith.

The considerable extent of such powers, although narrower than in respect of the oppression remedy, do permit the court to intrude into the relationships among the constituents of the corporation. The DGCL, in sections 225 and 227, and the MBCA, in section 7.29A, have provisions of this general nature. As the official comment to the MBCA indicates, such provisions seek to prevent the corporation from being immobilized as a result of such controversies.

Of course, elaborate rules deal with many details affecting a shareholder's entitlement to vote; which are too extensive to review here. However, considering that the right to elect and remove directors is a principal, perhaps even the principal, right of shareholders, this attention to detail is usually considered to be entirely appropriate.

In addition to the requirements of corporate law, of course, extensive provisions of securities law may also apply to the process of shareholder meetings and related disclosure. As indicated above, these are beyond the purview of the present work.

## **Proxy Contests**

### ***Significance of Proxy Contests***

Of course, organizing or participating in a dissident campaign can be regarded as a means of expressing shareholder voice, by exercising the shareholders' superintendence or monitoring function vis-à-vis the board, as well, perhaps, as advancing the prospect of shareholder "exit". In the case of a proxy contest, the shareholder may be participating in Manne's "market for corporate control", three mechanisms of which he identifies as the proxy fight, direct purchase of shares, and the merger.<sup>69</sup> Manne identifies these mechanisms as ways of affecting control of the corporation.

Both proxy contests and takeover bids prominently display the trade-offs made in connection with establishing the corporation as a legal entity; most notably, the associations among the legal

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<sup>69</sup> See the discussion of exit and voice in the early sections of the present chapter. See also Manne, *supra* note 5 at 112 and 114, respectively. Although this article is cited most frequently for its foundational discussion of the "market for corporate control generally, and for its discussion of "residual claimants", it has a useful early discussion of proxy fights as an alternative to share purchases as a means of acquiring control, at pp. 114-115. The foundational article (usually cited as to the economics and organization of the firm) by Armen A Alchian & Harold Demsetz, "Production, Information Costs, and Economic Organization" (1972) 62:5 *American Economic Review* 777, likewise discusses the difficulties of monitoring in cases of team production, at pp. 780-781, the advantages of assigning the monitoring function to a residual claimant, at pp. 782-73; and the use of proxy battles or stock purchases for such purposes to displace existing management or to modify managerial policies, at p. 788. See also the early study by Richard M Duvall & Douglass V Austin, "Predicting the Results of Proxy Contests" (1965) 20:3 *J Finance* 464, reviewing all proxy contests between 1956 and 1960, and finding that the targets of proxy contests tended to have lower rates of return on network and lower profit margins than their peers.

essentialist characteristics of capital lock-in and transferability of shares, such that investors who are unable to demand a return of their capital may nevertheless liquidate their investment by transferring shares; and central management independent of, but, at least theoretically, selected by, accountable to, monitored by, and with certain rights of approval allocated to, equity ownership, such that the corporation is managed by powerful central authority regardless of changes in its ownership, while equity owners possess certain vestigial authority.

Many of the same considerations are relevant in the context of takeover bids; however, their regulation is primarily effected by means of securities law, which has been identified as beyond the scope of the present work. For this reason, some effort will be devoted here to “unpacking” some of the implications of these relationships in the context of the proxy contest.

Henry Manne, averting to the separation of ownership and control identified by Berle and Means, and to the inability to discern “any control relationship between small shareholders and corporate management”, asserts that “the market for corporate control gives to the shareholders both power and protection commensurate with their interest in corporate affairs”.<sup>70</sup> In this regard, Alchian and Demsetz argue that both proxy battles and stock purchases “concentrate the votes required to displace existing management or modify managerial policies”.<sup>71</sup>

Thus, both may be considered to implicate the relationship between the allocation of extensive powers of management to the board of directors and the lock-in of capital, on the one hand, and the residual election, monitoring and other management-related rights, as well as the transferability of interest of equity owners, on the other. Of course, all of the foregoing corporate essentialist attributes and allocations of corresponding rights also relate to the other corporate essentialist attributes of separate legal entity status, and limited liability and asset partitioning.

Needless to say, especially where dissident shareholders propose alternative candidates for election as directors, such action may be expected to be opposed by the existing board and management,<sup>72</sup> who have the not insignificant, and arguably considerable, advantages of

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<sup>70</sup> Manne, *supra* note 5 at 112. The reference to the extent of interest of small shareholders refers to the necessity for them to assert their “power” and to claim “protection” in order to avail themselves of either.

<sup>71</sup> Alchian & Demsetz, *supra* note 69 at 788.

<sup>72</sup> In many cases, dissidents respond to proposals made by management for the reelection of incumbent directors, a situation which itself is likely to precipitate conflict. Bebchuk and Stout consider these advantages to be extremely formidable. See Lucian A Bebchuk, “The Myth of the Shareholder Franchise” (2007) 93:3 Va L Rev 675; Lynn A Stout, “The Mythical Benefits of Shareholder Control” (2007) 93:3 Va L Rev 789.



incumbency, control over the proxy apparatus, and ability to charge the expenses of the proxy battle to the corporation (in "real-time" and regardless of success),<sup>73</sup> resulting in a proxy contest, "proxy battle", or "proxy fight".<sup>74</sup> Consequently, as noted by Oliver Hart and others, engaging in a proxy contest involves the dissidents in a substantial "free rider" problem in which the dissidents incur the costs and risks of success and possible reimbursement, while other shareholders may benefit without making any such contribution.<sup>75</sup>

There is a vast literature too extensive to review here concerning the purpose of conducting such proxy contests,<sup>76</sup> including removing "managers" who fail to maximize shareholder wealth<sup>77</sup>, and acquiring practical or effective control over the subject corporation,<sup>78</sup> without necessarily acquiring (and incurring the expense of acquiring) a majority or significant minority equity ownership position);<sup>79</sup> the effectiveness of proxy contests, whether in terms of success in achieving

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<sup>73</sup> Manne, *supra* note 5, notes that incumbents, unlike dissidents who are likely to be reimbursed for proxy contest expenses only if they are successful, are able to finance proxy contest expenses from corporate funds. See also John Pound, "Proxy Contests and the Efficiency of Shareholder Oversight" (1988) 20 J Financial Economics 237, attributing some of the management advantage, at p. 237, to "inefficiency in the system of proxy vote solicitation". Bebchuk and Kahan agree that cost and other rules favour incumbents and argue that corporations should be free to adopt rules more favourable to challengers. See Lucian Arye Bebchuk & Marcel Kahan, "A Framework for Analyzing Legal Policy Towards Proxy Contests" (1990) 78:5 Cal L Rev 1071.

<sup>74</sup> Management, whether considered as the majority of the board of directors or the top management team ("TMT") normally is highly incited to resist: A study by Harry DeAngelo & Linda DeAngelo, "Proxy Contests and the Governance of Publicly Held Corporations" (1989) 23 J Financial Economics 29, concludes that a proxy contest is a serious threat to management tenure.

<sup>75</sup> Oliver Hart, "Corporate Governance: Theory and Implications" (1995) 105:430 Economic Journal 678 at 682-683.

<sup>76</sup> The literature mentioned in the foregoing footnotes may be cited in this regard, however, additional contributions continue apace. Canadian contributions at a conceptual and practical level include: Leon Getz, "The Alberta Proxy Legislation: Borrowed Variations on an Eighteenth Century Theme" (1970) 8:1 Alta L Rev 18; Ronald J Daniels & Jeffrey G MacIntosh, "Toward a Distinctive Canadian Corporate Law Regime" (1991) 29:4 Osgoode Hall LJ 863; Jeffrey G MacIntosh, "Institutional Shareholders and Corporate Governance in Canada" (1996) 26 Can Bus LJ 145; Stuart B Morrow, "Proxy Contests and Shareholder Meetings" (2003) 36 UBC L Rev 483.

<sup>77</sup> DeAngelo & DeAngelo, *supra* note 74, analyzing 60 proxy contests for board seats on exchange-listed firms from 1978 to 1985, found that less than one fifth of the sample firms remained independent and run by the same management team three years later. Changes in the top management team may be immediate or delayed.

<sup>78</sup> See Manne, *supra* note 5 at 112, 114; and discussion in footnotes 5 and 52 above.

<sup>79</sup> Manne, *supra* note 5 at 114. Although this article is cited most frequently for its discussion of "residual claimants", it advances a useful early discussion of proxy fights as an alternative to share purchases as a means of acquiring control: pp. 114-115. He notes that prices often rise on the proxy fight announcement reflecting both a rise in market price of the vote and the discounted value of potential gain and share price in the event that the dissidents succeeds.

the stated objective<sup>80</sup> or otherwise;<sup>81</sup> their effect (including on the corporation's management team, strategy, share price, and performance);<sup>82</sup> and other related matters.

### *Consequences of Proxy Contests*

Importantly, proxy contests have important consequences for the reputation of the incumbent directors involved.<sup>83</sup> Specifically, Fos and Tsoutsoura found that contested nominations attract more intensive media coverage for all directors nominated, including the incumbents, especially after the results of the contest become known.<sup>84</sup> They concluded that such publicity contributes to the significant career cost which is imposed on incumbent directors after a proxy contest: such directors are likely to lose directorships not only in the targeted company, but also in other corporations; and not only when such other corporations are themselves targeted subsequently, but even when there is no proxy contest at all. This is considered to attest to the depreciation of the value of such directors in the directorial labour market after a proxy contest.

They found that incumbent directors who keep their seats at the target company after a proxy contest are expected to lose seats on the boards of other corporations, while incumbent directors who are replaced are expected to lose board seats at an even higher rate. This effect is most pronounced with respect to independent directors.<sup>85</sup> Accordingly, it appears that the proxy contest focuses attention not only on corporate performance, but also on corporate governance in terms of

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<sup>80</sup> See, for example, Lee Harris, "Corporate Elections and Tactical Settlements" (2014) 39 J Corp L 221, finding, at pp. 246 and 250, that the majority of investors acting as dissidents comprised a small number of activist institutional investors, who employed proxy contests as one of their investment strategies, and who often acquired holdings in the target companies for the purpose of conducting such activities; and, at pp. 250-251, in order to precipitate advantageous changes in target activities.

<sup>81</sup> See Roberta Romano, "Less Is More: Making Institutional Investor Activism and Valuable Mechanism of Corporate Governance" (2001) 18:2 Yale J Reg 174 at 183; Randall S Thomas & James F Cotter, "Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction" (2007) 13:2-3 J Corporate Finance 368 at 376. A useful historical study is that by Stuart L Gillan & Laura T Starks, "The Evolution of Shareholder Activism in the United States" (2007) 19:1 J Applied Corporate Finance 55.

<sup>82</sup> See, for example, Dodd & Warner, *supra* note 17, finding that although dissidents generally fail to secure a majority of the board, they often acquire some board seats, and also finding that proxy contests, regardless of outcome, are associated with increased share price.

<sup>83</sup> See the discussion of director reputation in the previous section under the heading "Voting for the Removal of Directors". The "stigma" attached to losing a director's position in a proxy contest is arguably less severe than losing it as a result of a shareholders' removal resolution.

<sup>84</sup> Vyacheslav Fos & Margarita Tsoutsoura, "Shareholder Democracy in Play: Career Consequences of Proxy Contests" (2014) 114:2 J Financial Economics 316 at 329-331.

<sup>85</sup> *Ibid* at 334.

the involvement of the directors in that regard. While this may be advantageous for shareholders, directors may want to avoid such contests and attention.

Dodd and Warner's early and extensively cited study examined all of the proxy contests (96) for the election of directors conducted between July 1, 1962 and January 31, 1978 with respect to corporations listed on the New York Stock Exchange and the American Stock Exchange. They found that most dissidents failed to obtain a majority of seats on the board, but gained some seats in more than half of the cases; however, proxy contests generally increased stock prices, apparently by improving corporate performance.<sup>86</sup>

Those results were largely replicated in Ikenberry and Lakonishok's 1993 study of 97 proxy contests during the period 1968-1987,<sup>87</sup> which found that the corporations that were targets of proxy contests had experienced negative abnormal returns and deteriorating operating performance prior to announcement of the contest.<sup>88</sup> Where dissidents acquired at least one seat on the target board, such targets had "remarkable" increases in operating income before depreciation, but where all of the incumbent directors were returned, there was a short-term decline in that benchmark, but a continued upward trend somewhat later.<sup>89</sup>

Mulherin and Poulsen examined 270 proxy contests over the 1979-1994 time, finding 116 cases in which the proxy contest was followed by a takeover bid, which was successful in 63 instances, resulting in significant share price increases, but in decreases where the bid was not successful.<sup>90</sup> They found that the key determinant of share price for companies involved in proxy contests which were not followed by takeover bids was the replacement of the senior most officer. In 85 cases in

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<sup>86</sup> Dodd & Warner, *supra* note 17 at 402. As noted in footnote 62, Manne, attributed this to the announcement of a proxy contest, which thereby increases, albeit temporarily, the value of the vote attached to the shares. Post-event studies vary in their conclusions. Some of the variance is attributable to the different methodologies employed.

<sup>87</sup> David Ikenberry & Josef Lakonishok, "Corporate Governance Through the Proxy Contest: Evidence and Implications" (1993) 66:3 J Business 405.

<sup>88</sup> *Ibid* at 431. These are often identified as characteristics which attract the attention of activist investors. See also Michael C Jensen & Jerold B Warner, "The Distribution of Power Among Corporate Managers, Shareholders, and Directors" (1988) 20 J Financial Economics 324; Michael S Weisbach, "Outside Directors and CEO Turnover" (1988) 20 J Financial Economics 431.

<sup>89</sup> Ikenberry & Lakonishok, *supra* note 72 at 431. As to the short-term decline, there is evidence that market participants allow new management some tolerance with respect to earnings variations, which may be attributable to the tendency of new management to take an earnings "bath" in order to leave behind past problems of the previous management. See Daniel W Collins & Linda DeAngelo, "Accounting Information and Corporate Governance: Market and Analyst Reactions to Earnings of Firms Engaged in Proxy Contests" (1990) 13:3 J Accounting & Economics 213.

<sup>90</sup> J Harold Mulherin & Annette B Poulsen, "Proxy Contests and Corporate Change: Implications for Shareholder Wealth" (1998) 47:3 J Financial Economics 279 at 299.

which the dissidents gained at least one seat on the board, the CEO was replaced in 68 (80%). They also found that 71% of the firms with management turnover engaged in significant corporate restructuring, including liquidations, sales of major divisions or significant asset pools, plant closings or substantial write-downs of assets.<sup>91</sup>

Mulherin and Poulsen concluded that investors anticipate that dissident success in acquiring board seats will be followed by management turnover, and thence in a share price increase; however, they anticipate that where there is no management turnover, the share price will tend to decrease. When dissidents did not win seats, firms that nevertheless replaced senior management did experience a share price increase, while the others had a share price decrease.<sup>92</sup>

There are, of course, a myriad of other studies of proxy contests; however, as noted above, there is at least some evidence that proxy contests can achieve meaningful corporate governance and other results in many cases. Such acknowledgement may contribute to validating the trade-offs that are implicit in the corporate form, as reflected in its legal essentialist characteristics.

### ***Settlement of Proxy Contests***

Many proxy contests are settled before election as between the dissidents and management on terms varying in their acceptability to the respective parties. An empirical study of such settlements by Lee Harris in 2014,<sup>93</sup> which purports to be the first such study,<sup>94</sup> examined 191 contested elections over a four-year period from 2006 to 2009. It found that firms with poor short-term or immediate past returns (rather than long-term returns), low price-to-book values, and whose dissidents have a significant ownership stake were more likely to settle.<sup>95</sup>

Harris found that directors of such firms anticipate that a contested shareholder vote may result in a replacement on the grounds of performance; and are less confident that they will be offered future board positions; and, consequently, settle the proxy contest in an attempt to avoid these consequences.<sup>96</sup> Dissidents, who are normally activist investors, may be motivated to settle by the

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<sup>91</sup> *Ibid* at 305.

<sup>92</sup> *Ibid* at 302.

<sup>93</sup> Lee Harris, "Corporate Elections and Tactical Settlements" (2014) 39:2 J Corp L 221.

<sup>94</sup> *Ibid* at 224.

<sup>95</sup> *Ibid* at 247. As Harris notes at pp. 251-2, those same factors affect selection of targets by activist investors.

<sup>96</sup> *Ibid* at 230.

desire to obtain representation on the board and then to be able to influence other directors to make beneficial changes, including changes to the management team.<sup>97</sup>

Harris maintains that settlements allow directors to sidestep a shareholder vote, keep themselves and management in place, and avoid giving shareholders a meaningful choice about the identity of directors and the strategic direction of the firm.<sup>98</sup> He argues that contested elections provide an opportunity for “rank-and-file shareholders to express their satisfaction or dissatisfaction with the existing management team” and thereby participate in and influence firm behaviour, which is meaningful because contested elections are so rare.<sup>99</sup>

Thus, settlements are less desirable for average shareholders, especially because there is reason to think that “as a matter of human psychology, a formal vote may enhance shareholder power, even in cases where managers are not ousted and the challenge fails”, such that “in theory, a formal vote they have a unique disciplinary effect on managerial behavior”.<sup>100</sup> Accordingly, even if the dissidents do not acquire representation of the board in consequence of the contested election, “the disciplinary effect on managers remains”, such that managers become more responsive to shareholder interests.<sup>101</sup>

Accordingly, proxy contests present an opportunity, in the context of declarative corporate law, to consider the instantiation, and interaction, of legal essentialist attributes, and the interactions of such instantiations, each in “real world” or concrete circumstances. While the scope of the present work does not permit the more detailed examination of these considerations more generally, it is thought that the example of proxy contests can illustrate the benefits of a more detailed examination more generally.

### **Financial Disclosure**

In the case of “public” companies, the modern corporate statutes require extensive disclosure of information to shareholders. Sections 155 of the CBCA and 154 of the OBCA require the directors to place before shareholders at every annual meeting comparative financial statements meeting

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<sup>97</sup> *Ibid* at 247-8.

<sup>98</sup> *Ibid* at 248.

<sup>99</sup> *Ibid* at 246.

<sup>100</sup> *Ibid* at 248.

<sup>101</sup> *Ibid* at 249.

certain prescribed standards, the report of the auditor, and any other information required by the articles, the bylaws or any unanimous shareholder agreement. Both the CBCA, in sections 148 and following 158 and 162, and the OBCA, require that the shareholders appoint auditors, who must meet certain requirements as to qualifications and independence. They also have the power to remove auditors under sections 165 of the CBCA and 149 of the OBCA.

Sections 158 of the CBCA and 159 of the OBCA require the directors to approve, and sections 159 of the CBCA and 154 of the OBCA require them to deliver, the financial statements to shareholders. The rights and duties of the auditors are prescribed by statute, particularly in sections 168 and following of the CBCA, and 151 and following of the OBCA.

These rights include the right under sections 170 of the CBCA and 153 of the OBCA to obtain information from directors, officers, employees and agents. In order for shareholders to have access to certain base financial information complying with certain stipulated standards, so as to be able to exercise their “choice” and “oversight” roles with respect to the board’s “central management” function, the auditors who are appointed by, and report to, the shareholders are afforded statutory rights to obtain information from “central management” which might not be available otherwise to shareholders or their agents. The generation, custody, and employment of the information to which the auditors may gain access might otherwise have been regarded as a prerogative of the “central management” function upon which this right of the auditors might otherwise have been seen as impinging.

Sections 171 of the CBCA and 158 of the OBCA require corporations that are “public”, in effect, to have an audit committee, which is required to review the financial statements prior to their approval by the full board of directors. The objective, of course, is that a group smaller than the full board of directors, being composed of persons with suitable background, experience, and qualifications, and a majority of whom are not officers or employees, should be able to consider, to review with the auditors, and to reach informed conclusions concerning, the requisite matters in more detail and with enhanced judgment than might be possible for the full board otherwise.

Extensive requirements of securities law applicable in the provinces and territories of Canada regulate these matters extensively, concerning, in particular, the independence and qualifications

of members of the audit committee and related matters. These are beyond the scope of the present work, which deals with the corporate law, including corporate declarative law.<sup>102</sup>

The members of the audit committee are subject to potential liability for breaches of duty under the provisions generally applicable to directors under sections 122 of the CBCA and 134 of the OBCA. The standards of care and good faith, respectively under subsection 123 (4) and (5) of the CBCA and 135 of the OBCA, are considered to be affected by the background, experience, and qualifications of audit committee members.<sup>103</sup>

Changes of auditor, whether by way of resignation or otherwise, trigger certain disclosure obligations by the corporation and may entitle the auditors to provide certain disclosures to shareholders under sections 168 of the CBCA and 149 of the OBCA. Certain provisions of securities law, regulatory authorities, and stock or other trading exchanges may also apply.<sup>104</sup> Delaware has no requirements for such disclosure (thereby leaving the matter to securities law), while the MBCA's limited requirements in s. 16.20 primarily have in view corporations that are not subject to federal securities law.

The disclosure requirement of the corporate law statutes facilitates the division of authority in respect of management between the board of directors, as possessor of and actor with respect to such authority, on the one hand, and the owners of the equity capital of the corporation (which is locked-in but rights in respect of which are transferable), on the other hand, who have no rights to participate directly in management but have certain rights to select, opine on, and change management.

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<sup>102</sup> The sources of Canadian securities law are extensive. For example, a text by Mary Condon, Anita Anand & Janis Sarra, *Securities Law in Canada* (Toronto: Emond Montgomery, 2005), at 17-23, identifies these as including: provincial securities statutes, regulations and rules, National and Multilateral instruments, national and local policies, Staff Notices, Self-Regulatory Organization (SRO) rules or policies, appellate court decisions, regulatory decisions, orders, rulings made by provincial securities commissions and International Organization of Securities Commissions (IOSCO). In the case of Ontario, much of this material is available on the website of the Ontario Securities Commission. See: <[http://www.osc.gov.on.ca/en/SecuritiesLaw\\_irps\\_index.htm](http://www.osc.gov.on.ca/en/SecuritiesLaw_irps_index.htm)>.

<sup>103</sup> CSA requirements with respect to audit committees are set forth in National Instrument 52-110 – *Audit Committees*, OSC NI 52-110, (2004) 27 OSCB 3252 (26 March 2004) and its Companion Policy 52-110 – *Audit Committees*, OSC 52-110CP, (2004) 27 OSCB 3264 (26 March 2004). Proposals with respect to their further amendment were set forth in CSA Consultation Paper 52-404 *Approach to Director and Audit Committee Member Independence*, OSC CSA Consultation Paper, (26 October 2017).

<sup>104</sup> CSA requirements with respect to auditor oversight and changes of auditors are principally contained in National Instrument 52-108 – *Auditor Oversight*, OSC NI 52-108 (9 October 2014) and *Companion Policy 52-108 – Auditor Oversight*, OSC 52-108CP (9 October 2014).

The owners of equity capital have no explicit rights to the assets, or have any liability in respect of obligations, of the corporation as a separate legal entity. Access to the ability to acquire some minimal level of meaningful knowledge of the business and affairs of the corporation is considered to be essential to a meaningful exercise of these shareholder rights. As can be seen, the rights of corporate statutory law accorded in this behalf under the statutes examined do, in fact, instantiate the essential legal attributes of the corporation as such.

## **PART C – SHAREHOLDER RIGHTS BEYOND VOTING**

### **Right to Sell or Transfer Shares**

As discussed above, the right to sell or transfer the shares is related to key attributes of the corporation as a matter of law; namely, the independence of management and ownership, on the one hand, and the lock-in of capital (except for capital which is made, by its terms, redeemable at the option of the shareholder or the corporation), on the other. The lack of any necessary relationship between ownership of the equity capital of the corporation and its management, facilitates the transferability of that equity capital. Unlike other types of entities, the capacity to direct the business entity is not a direct consequence of ownership over equity capital of the entity.

The equity capital provider's inability to demand a return of capital from the entity, the so-called "lock-in" effect, when combined with the absence of a right to manage the entity, forces the shareholder who is dissatisfied with management performance may motivate the equity capital provider to liquidate its investment in the entity. However, such equity capital provider may elect to sell the shares in a voluntary transaction to another party, who thereby assumes the same position in law. As noted above, such a change of share ownership does not, of itself, affect the creditworthiness of the entity.

Consequently, it is extremely important that the shareholder's freedom to alienate his or her shares be protected. In circumstances in which there may be no free market for those shares, or in which there may be a reduced, little, or no, prospect of receiving a fair value for those shares, alternative non-market mechanisms are provided under some corporate statutes.

The principal mechanism whereby shareholders can initiate the transfer of their shares in such circumstances is the dissent and appraisal remedy; but, in the case of certain modern Canadian statutes, the oppression remedy is also available. As the purchase of shares from a shareholder by



the corporation or the payment of compensation relating to the purchase of shares are only examples of the plenary power of the court in relation to the oppression remedy, its discussion will be left to the remedy section below.

A shareholder's right to determine when to hold such shares and when to sell or transfer shares voluntarily may be considered to be limited by the existence of rights of others to acquire such shares compulsorily, that is to say, where the shareholder is forced to sell or transfer shares involuntarily. However, the right to sell or transfer shares in transactions that are voluntary on the part of both the seller and the purchaser may be considered to be expanded in cases in which a shareholder has a right to force another party to acquire shares in certain circumstances. Both of these matters are discussed below under the heading "Compulsory and Compelled Acquisitions".

### **Dissent and Appraisal Rights**

As previously discussed, shareholders who dissent in the prescribed manner from special resolutions approving certain fundamental transactions are entitled to be paid by the corporation the value of their shares as determined in the prescribed manner. These fundamental transactions include certain amendments to the articles of incorporation, amalgamations, export of the corporation to another jurisdiction, arrangements, and sales, transfers, or leases of all or substantially all the assets of the corporation other than in the ordinary course of business, as well as going-private transactions and squeeze-out transactions.

Sections 190 of the CBCA and 185 of the OBCA allow a shareholder to dissent in respect of all shares held and to be paid the fair value of such shares by taking action in the prescribed manner, a detailed review of which is beyond our present purpose.<sup>105</sup> Where a corporation fails to make an offer to pay an amount the directors considered to be the fair value as determined in a detailed statement accompanying the offer, the dissenting shareholder may apply to court to fix such a fair value.<sup>106</sup>

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<sup>105</sup> Discussions of the appraisal remedy in Canada and in the United States include: Note, "Valuation of Dissenters' Stock Under Appraisal Statutes" (1966) 79:7 Harv L Rev 1453; Daniel R Fischel, "The Appraisal Remedy in Corporate Law" (1983) 8:4 American Bar Foundation Research J 875; Bayless Manning, "The Shareholder's Appraisal Remedy: An Essay for Frank Coker" (1962) 72:2 Yale LJ 223; Vern Krishna, "Determining the 'Fair Value' of Corporate Shares" (1987) 13:2 Can Bus LJ 132; Jeffrey MacIntosh, "The Shareholders' Appraisal Right in Canada: A Critical Reappraisal" (1986) 24:2 Osgoode Hall LJ 201.

<sup>106</sup> As might be expected, there are numerous cases in which a court seeks to determine such "fair value", including determining the proper principles applicable in that regard. These cases include *Brant Investments Ltd v KeepRite Inc* (1987), 3 OR (3d) 289, 80 DLR (4th) 161 (CA), an oppression remedy case which, among other things, determined,

The DGCL contains no such provision; however, Chapter 13 of the MBCA deals with what it describes as “appraisal rights”. As mentioned above, these arise in connection with various fundamental transactions, including mergers or share exchanges, certain asset sales, certain amendments to the articles, certain domestications, and certain conversions to nonprofit status or conversions into a nonprofit entity and certain conversions into an unincorporated entity. The MBCA provides an exception for corporations whose shares trade in organized market, which have at least 2,000 thousand shareholders and which have a market capitalization by way of public float of at least \$ 20 million. Effectively, then, appraisal rights not available under the MBCA with respect to most significant public companies.<sup>107</sup> As in the case of the CBCA and the OBCA, the exercise of appraisal rights under the MBCA involves compliance with extensive procedures set forth in Chapter 13. As noted in the Official Comment, the existence of a viable public market is thought to provide a proxy for differences of opinion that might obtain among shareholders as to the fair value of the shares concerned.

The absence of appraisal rights from the DGCL significantly limits shareholder protection against being “locked in and frozen out” as unwilling shareholders who are unable to secure reasonable compensation for their shares in public or other markets. However, the Delaware courts may provide some relief in certain situations. This subject is beyond the scope of the present work.

### **Compulsory and Compelled Acquisitions**

The attributes of the legal entity, the corporation, have been previously discussed; including, in particular, the relationship between capital lock-in and the ability of the shareholder to transfer his or her shares for value in a voluntary, negotiated, market transaction, whether face-to-face or impersonally in an organized market. However, in certain situations involving a public corporation, such as after a public takeover bid for all the shares of a certain class (a “bid-for-all”)

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in *obiter*, that a premium for “forcible taking” could be awarded in some cases (but not in the instant case) and that an enhanced value might be awarded in appropriate cases (but not in the instant case), particularly involving force outs, due to the synergies anticipated from the transaction; *Domglas Inc v Jarislowky, Fraser & Co.* (1980), 13 BLR 135 (Que. S.C.), *aff’d* (1982), 138 DLR (3d) 521, 22 BLR 121 (Que CA); *Ford Motor Company of Canada Ltd v Ontario Municipal Employees Retirement Board*, ), 79 OR (3d) (ON CA); 263 DLR. (4th) 450; 12 BLR. OAC 61; *Smeenk v Dexeigh Corp* (2006), 74 OR (2d) 385, 72 DLR (4th) 609 (H Ct J).

<sup>107</sup> See Robert Yalden, Janis Sarra, Paul D Paton, Mark Gillen, Ronald Davis, and Mary Condon, *Business Organizations: Principles, Policies and Practice* (Toronto: Emond Montgomery Publications, 2008) (“Yalden et al.”) at 978. It indicates that the appraisal remedy was formerly restricted by the OBCA to non-public offering corporations, but this restriction was later deleted and never appeared in the CBCA; and, further, that a large number of states (20 at that time) had (in the previous 30 years) abolished appraisal rights for firms with shares listed on a stock exchange or which are otherwise widely traded.

as a result of which only a very small percentage of the shares remain outstanding in the hands of parties other than the original offeror, some complex considerations arise which may call for abridgement of the paradigmatic shareholder rights.

Where, after a bid-for-all, a small percentage of shares remains outstanding, unless the shareholder has a right to require the corporation to purchase or redeem his or her shares (a “right of retraction”), which is not currently the case with respect to common shares or equity shares, the capital lock-in attribute of the corporate legal structure prevents the shareholder from demanding the return of his or her investment. At the same time, the reduction in the percentage of shares not owned by the offeror and so comprising the “public float”, as well as in the number of holders of such shares, will normally restrict both the liquidity and depth of the market for such shares, with the result that bid and ask prices, as well as transaction prices, may be highly volatile and may not suitably reflect the fair value of such shares. The liquidity and depth of the market, as well as its transparency, are considered to be indicative of effectively functioning securities markets.<sup>108</sup>

From the perspective of the original offeror, the existence of a small number and percentage of shares in the public float outstanding after the bid (sometimes called a “rump”) may restrict the ability of the offeror to deal with the target company as originally contemplated, for example, as a wholly-owned subsidiary, whose financial statements are consolidated with those of the acquiror (either in toto, or without discount for minority interest). Thus, it may be advantageous for both the offeror and for rump shareholders to be quit of each other.

Consequently, section 206 of the CBCA provides, in effect, that if within one hundred and twenty days after the date of a takeover bid, the bid is accepted by the holders of not less than ninety per cent of the shares of any class of shares to which the takeover bid relates, other than those held at the date of the bid by the offeror and its affiliates and associates, the offeror is entitled, on complying with that section, to acquire the shares held by dissenting offerees on the same terms as the takeover bid. This is generally referred to as a “force-in” right, as it is a right to force the

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<sup>108</sup> There is an extensive literature on these matters. Some of the articles, which consider all three of the factors mentioned, albeit from somewhat different perspectives and with somewhat different results, include: Marco Pagano & Ailsa Roell, “Transparency and Liquidity: A Comparison of Auction and Dealer Markets with Informed Trading” (1996) 51:2 *J Finance* 579; Ananth Madhavan, “Security Prices and Market Transparency” (1996) 5:3 *J Financial Intermediation* 255; Craig Pirrong, “Market Liquidity and Depth on Computerized and Open Outcry Trading Systems: A Comparison of DTB and LIFFE Bund Contracts” (1996) 16:5 *J Futures Markets* 519; and Frank L Heflin, Kenneth W Shaw & John J Wild, “Disclosure Policy and Market Liquidity: Impact of Depth Quotes and Order Sizes” (2005) 22:4 *Contemporary Accounting Research* 829.

non-accepting shareholders to tender their shares to the offer or on the same terms as the original bid. A “dissenting offeree” is, in effect, a shareholder (or subsequent holder) of the class of shares for which a bid-for-all is made who does not accept the takeover bid.

The offeror triggers this right by giving a notice which must include a statement of the right of the dissenting offeree to elect to transfer such shares or to exercise their rights of appraisal under this section. A dissenting offeree who does not give notice of exercise of the appraisal rights is deemed to have elected to transfer the shares to the offeror on the same terms as the original bid. The section contains detailed provisions as to its operation.

Under section 206.1 of the CBCA, if a shareholder of shares of a distributing (i.e. “public” corporation) does not receive an offeror’s notice under section 206 within prescribed time limits, such shareholder may require the offeror to acquire those shares, again on the same terms as the original offer.

The OBCA contains provisions in sections 187 and 188 that are similar to section 206 and in section 189 that are similar to section 206.1.

The DGCL and MGCA appear to contain no equivalent provisions. Consequently, apart from any relevant common law or securities law, minority shareholders lack this kind of statutory protection. This is particularly concerning, since two-tiered tender offers, in which the price offered in the second tier or tranche, by way of subsequent tender offer or merger, is lower than that offered in the first, were long (but are no longer) permitted under federal securities law. Although there are many useful discussions of this subject<sup>109</sup>, a review of them exceeds the purview of this work.

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<sup>109</sup> See, for example, Joseph A Grundfest, “Two-Tier Tender Offers: A Mythectomy” (Address delivered at the United Shareholders Association Annual Meeting, 15 June 1987), online: <<https://www.sec.gov/news/speech/1987/061587grundfest.pdf>>; C Steven Bradford, “Stampeding Shareholders and Other Myths: Target Shareholders and Hostile Tender Offers” (1990) 15 J Corp L 417; Holger H Muller & Fausto Panunzi, “Tender Offers and Leverage” (2004) 119:4 QJ Economics 1217; and Armando Gomes, “Takeovers, Freezeouts, and Risk Arbitrage” (2012) Working Paper, online: <<http://apps.olin.wustl.edu/faculty/gomes/takeovers.pdf>>. While Grundfest argues that actual two-tier tender offers had become less common at his time of writing, the compulsory acquisition of stub shares by way of freezeout merger after the original tender offer continues, according to Gomes, although at the original tender offer price or at an appraisal price. Gomes, at p. 2, says that more than 90 percent of all tender offers in the U.S. are any-or-all offers immediately followed by a second-step freezeout merger in which the acquiror compulsorily acquires untendered shares at the tender offer price, once the minimum fraction of sharer acquired to approve a freezeout merger has been tendered. Tender offers are regulated by the Williams Act enacted in July 1968. As discussed by Gomes at p. 6, Rule 14d-10 thereunder requires that a tender offer must be made to all shareholders and that each shareholder must be paid the highest consideration paid to any other shareholder during the offer.

## **Remedies of Shareholders and Others**

Participants in the corporation and in its business and affairs, including but not limited to shareholders, may be entitled to pursue various statutory remedies. Section 238 of the CBCA defines the term “complainant” to mean, in effect, a current or former registered holder or beneficial owner of a security of a corporation or of any of its affiliates, a current or former director or officer of a corporation or any of its affiliates, the Director (the regulator appointed under the statute) or “any other person who, in the discretion of a court, is a proper person to make an application under this Part.” Subsections 2(2) through 2(5) of the CBCA define the term “affiliate” and related terms.

The court’s ability to recognize as a complainant any person who, in its discretion, is a “proper person” to make an application permits the court to determine what participants in the corporation and in its business and affairs, and what other persons even beyond this, may seek relief. Relief may be sought by means of derivative actions and by means of the oppression remedy. In respect of those two matters, the provisions of the CBCA and OBCA are effectively the same. Some other Canadian statutes also have similar provisions. For the sake of simplicity, we will refer only to the CBCA here.

### ***Derivative Actions***

Under sections 239 of the CBCA and 246 of the OBCA, a complainant may apply to court for leave to bring an action in the name of and on behalf of the corporation or any of its subsidiaries, or to intervene in an action to which any such body corporate is a party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate. However, the court must be satisfied that: the complainant has given the prescribed notice to the directors of the corporation or its subsidiary, if they have not taken action within the prescribed time (CBCA) or if the court is satisfied that the directors will not bring, diligently prosecute or defend or discontinue the action (OBCA); the complainant is acting in good faith; and it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.

Under sections 240 of the CBCA and 247 of the OBCA, the court may make various orders, including an order authorizing the complainant or any other person to control the conduct of the action; giving directions for the conduct of the action; directing any amount adjudged payable by a defendant in the action to be paid, in whole or in part, directly to former and present security

holders of the corporation or its subsidiary, instead of to the corporation or subsidiary; and requiring the corporation or its subsidiary to pay reasonable legal fees incurred by the complainant in connection with the action.

Derivative actions are dealt with in sections 327 of the DGCL, and 7.40 and following of the MBCA. The only generally applicable substantive provision of the DGCL relating to derivative actions is section 327, which requires that the plaintiff be a stockholder **at** the time of the transaction complained of or successor to such stockholder by operation of law. The MBCA also requires that the shareholder “fairly and adequately represents the interests of the corporation in enforcing the right of the corporation”, and that such shareholder make a demand to the board that it take suitable action and it is not done so within the prescribed period. Its provisions are much more extensive than those of the DGCL.

The derivative action allows complainants, who are not limited only to shareholders, with the approval and subject to the directions of the court, to circumvent the power of the directors with respect to certain legal actions and proceedings. Ordinarily, the power to manage or supervise the management of the business and affairs of the corporation would include matters relating to legal actions and proceedings.

Because the term “affairs” in the CBCA and OBCA means “the relationships among the corporation, its affiliates and the shareholders, directors and officers of such bodies corporate” (but not their business) the management prerogative of the directors unless otherwise restricted, specifically and expressly includes all matters relating to those relationships. This would, of course, include such matters as compliance with, and breaches of, the duties of directors and the consequences of the same. Accordingly, absent remedies such as the derivative action, directors might not be held accountable for their behaviour in circumstances in which this might be appropriate.

In effect, the remedy lies where the court is satisfied that: the prescribed demand has been made for the directors to take action; the complainant is acting in good faith; and such action appears to be interests of the corporation or subsidiary. In effect, the court may at any time make any order it thinks fit. This may include assuming or authorizing others, including but not limited to the complainant, and subject to any directions of the court made at any time, to assume control over the conduct of the action.

As is well known, the “business judgment” rule expresses the deference that courts generally exhibit towards the determinations of directors made prudently and diligently with respect to business matters. In the leading case of *Aronson v. Lewis* the business judgment rule was stated as “a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”<sup>110</sup> This is considered to be appropriate for many reasons not the least of which are, firstly, that responsibility for such matters is assigned by law to the directors; and, secondly, that judges are considered to possess less information relevant to, and be less experienced in, the matters affecting, and in making, business decisions.<sup>111</sup>

These considerations may be dispositive in most cases, and particularly relating to the underlying substance of the matters that may be an issue in the litigation. However, on the assumption that the court is comfortable that the information, likely including expert evidence, adduced before it, justifies proceeding in such manner, the court hearing the application with respect to the derivative action is not itself making a determination on the merits but is merely determining that the matter at issue should be brought before another appropriate trier of fact, which it presumably would do only in situations in which this is appropriate. It might be done, for example, where there is some evidence of self-dealing among the directors or by a controlling shareholder.

The nature of the determination the court is asked to make in connection with an application for a derivative action and in subsequent applications and orders relates to judicial proceedings and, accordingly, is of a nature that courts make all the time. Indeed, the court granting the derivative action application is thereby ensuring that another appropriate trier of fact may have the opportunity to adjudicate the issue or issues concerned, based upon the evidence before it, and subject to the usual legal standards, including, where appropriate, the business judgment rule.

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<sup>110</sup> In a useful short discussion of the rule, Yalden et al, *supra* note 107 at 720, attribute the origin of this terminology to the case of *Schlensky v Wrigley*, 237 NE (2d) 776 (Ill CA 1968). Leading Delaware and other American cases include: *Zapata Corp v Maldonado* 430 A (2d) 779 (Del SC 1981); *Aronson v Lewis*, 473 A (2d) 805 (Del SC 1984), at 782; and *Smith v Van Gorkom*, 488 A (2d) 858 (Del SC 1985). The case law and literature are extremely extensive and, accordingly, are well beyond the scope of the present work. In Canada, as noted by Yalden et al., courts have generally applied the rule only upon proof that the directors were diligent and acted on reasonable grounds, and provided that there was no fraud, illegality, or conflict of interest.

Recent leading Canadian cases include *Peoples Department Stores Inc (Trustee of) v Wise*, 2004 SCC 68, [2004] 3 SCR 461; and *BCE*, *supra* note 34; both of which are discussed further in connection with the oppression remedy in the next following section.

<sup>111</sup> Observations such as these are being not infrequently in judicial decisions. Of course, courts also differ as to the extent of deference to be extended to the expertise of specialized tribunals.

Accordingly, while the derivative action constitutes some intrusion upon the prerogatives of the board of directors in terms of its legal responsibilities in respect of the corporate entity, it is exceptional in nature and antique in origin.<sup>112</sup> Similarly, its intervention in the internal organization of the corporation is relatively limited, as it engages the structure, processes and personnel of the corporation only at the board, which is the highest, level. The remedy gives effect to the legal essentialist attributes of the corporation.

### ***Oppression Remedy***

The drafters of the oppression remedy, which was adopted in the new CBCA in 1975, considered by way of example a predecessor provision in the United Kingdom, section 210 of the UK Companies Act of 1948.<sup>113</sup> Christopher Nicholls explains that it offered a remedy less drastic than winding up a company, where winding up would have been justified on just and equitable grounds, but which would bring an end to the matters complained of without bringing an end to the company itself.<sup>114</sup> However, it was little used and apparently only successfully applied on two occasions.<sup>115</sup>

The version adopted and subsequently developed in the CBCA is vastly different from its UK predecessor and is considered to be “the broadest, most comprehensive and most open-ended shareholder remedy and the common law world.”<sup>116</sup> The definition of the term “complainant” is that contained in section 238 of the CBCA, discussed above. It permits the court to exercise its discretion to determine who is a proper party.

Christopher Nicholls has observed that the courts “have been somewhat wary of too readily permitting creditors to launch oppression actions”;<sup>117</sup> but have permitted this in appropriate cases, such as by the Supreme Court of Canada in the case of *People’s Department Stores Inc. v. Wise*.<sup>118</sup> Although the scope of the present work precludes any attempt at an extensive review of the

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<sup>112</sup> The important case of *Foss v Harbottle* (1843), 67 ER 189, 2 Hare 461 (Ch), established that the proper plaintiff in the case of an injury to the company as the company itself; that the court would not interfere if the alleged injury could be confirmed or ratified by a majority of members (today, shareholders) in a general meeting; but that the court might intervene in other cases, such as where no other adequate remedy existed.

<sup>113</sup> *Companies Act, 1948* (UK), 11 & 12 Geo VI, c 38.

<sup>114</sup> *Supra* note 34 at 420-421.

<sup>115</sup> *Ibid*, citing Frank Iacobucci, Marilyn L Pilkington & J Robert S Prichard, “Canadian Business Corporations” (Toronto: Canada Law Book, 1977) at 202; Bruce Welling, *Corporate Law in Canada: The Governing Principles*, 2nd ed (Toronto: Butterworth’s, 1991) at 555.

<sup>116</sup> Stanley M Beck, “Minority Shareholders’ Rights in the 1980s” in *Corporate Law in the Eighties, Special Lectures of the Law Society of Upper Canada* (Don Mills, ON: Richard De Boo, 1982) 311 at 312.

<sup>117</sup> *Supra* note 32 at 426.

<sup>118</sup> *Supra* note 60.



considerable scholarship on this subject, a review of the statutory provisions is, of course, appropriate to our descriptivist analysis of statutory law relating to the corporation.

Under subsection 241 (2) if the court is satisfied that: (a) any act or omission of the corporation or any of its affiliates effects a result, or (b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner, or (c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner; that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer, the court may make an order to rectify the matters complained of.

Thus, regard may be had to: (a) the results of acts or omissions of the corporation (called herein the “results” test); (b) the manner in which the business or affairs are or have been carried on or conducted (the “manner of conduct” test); and (c) the manner of exercise of the powers of the directors (the “exercise of power” test). We will refer to these tests, that is to say, the results test, the manner of conduct test, and the exercise of power test, collectively, as determining the “scope of review”.

If any of these are determined to be either: (A) oppressive (“oppressive”); (B) unfairly prejudicial to the interests of any security holder, creditor, director or officer (“unfairly prejudicial”); or (C) unfairly disregards the interests of any security holder, creditor, director or officer (“unfairly disregards”); then an order to rectify the matters complained of may be issued.<sup>119</sup> We will refer to these determinations, collectively, as determining the “characterization” of the matter considered within the scope of review.

Thus, the scope of review under section 241 relates to matters for which the directors are responsible as a matter of corporate law but, except for the exercise of power test, is not limited to their actions or omissions but, instead, comprehends actions or omissions of, within, and relating to, the corporation. Accordingly, it may include a wide range of participants in the activities of the corporation.

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<sup>119</sup> Note that the note that the letter designations in the preceding paragraph of this text appear in section 241 (2) but that the letter designations in the paragraph against which this footnote appears have been added by the author so as to separate each of the three alternatives mentioned. Consequently, capital letters have been used in the latter case to distinguish them from the lettering system used in the text of the statute.

The characterization determined as a result of investigating matters within the scope of review specifically references the interests of certain participants, namely, security holders, creditors, directors, and officers, however, it is not absolutely clear from a strict reading of the section whether conduct determined to be “oppressive” must be oppressive in relation to those enumerated interests. The repetition of the phrase “of any security holder, creditor, director or officer” in relation to the language relating to the unfairly prejudicial determination and again in the language relating to the unfairly disregards determination but which is not present in relation to the language relating to the oppressive determination supports this conclusion. However, subsequent interpretation of the oppressive determination renders this point moot as, in effect, the cases (including the *BCE* case discussed in the next paragraph) interpret the word “oppressive” as relating to interests of the named corporate participants, at least. It may also relate to interests of other participants.

The nature of the remedy is discussed authoritatively by the Supreme Court of Canada in 2008 in the *BCE* case as follows:

The oppression remedy focuses on harm to the legal and equitable interest of a wide range of stakeholders affected by oppressive acts of a corporation or its directors. This remedy gives a court a broad jurisdiction to enforce not only what is legal but what is fair. Oppression is also fact specific: what is just and equitable is judged by the reasonable expectations of the stakeholders in the context and in regard to the relationships at play.

In assessing a claim of oppression, a court must answer two questions: (1) Does the evidence support the reasonable expectation asserted by the claimant? and (2) Does the evidence establish but that the reasonable expectation was violated by conduct falling within the terms “oppression, “unfair prejudice” or “unfair disregard” of a relevant interest? For the first question, useful factors from the case law in determining whether a reasonable expectation exists include: general commercial practice; the nature of the corporation; the relationship between the parties; past practice; steps the claimant could have taken to protect itself; representations and agreements; and the fair resolution of conflicting interests between corporate stakeholders. For the second question, a claimant must show that the failure to meet the reasonable expectation involved unfair conduct and prejudicial consequences under s. 241.

Where conflicting interests arise, it falls to the directors of the corporation to resolve them in accordance with their fiduciary duty to act in the best interests of the corporation. The cases on oppression, taken as a whole, confirm that this duty comprehends a duty to treat individual stakeholders affected by corporate actions equitably and fairly. There are no absolute rules and no principle that one set of interests should prevail over another. In each case, the question is whether, in all the circumstances, the directors acted in the best interests of the corporation, having regard to all relevant considerations, including – but not confined to – the need to treat affected stakeholders in a fair manner, commensurate with the corporation’s duties as a responsible corporate citizen. Where it is impossible to please all stakeholders, it will be irrelevant that the directors rejected alternative transactions that were no more beneficial than the chosen one.<sup>120</sup>

In effect, the term “interests” has been conflated into “reasonable expectations”. The latter seems to invoke considerations of the circumstantial context, as well as legitimacy. Before discussing the importance of this, it is well to examine the extensive scope of the possible remedies available under section 241 (3) which are, accordingly, quoted directly from the statute:

In connection with an application under this section, the court may make any interim or final order it thinks fit including, without limiting the generality of the foregoing,

- (a) an order restraining the conduct complained of;
- (b) an order appointing a receiver or receiver-manager;
- (c) an order to regulate a corporation’s affairs by amending the articles or by-laws or creating or amending a unanimous shareholder agreement;
- (d) an order directing an issue or exchange of securities;
- (e) an order appointing directors in place of or in addition to all or any of the directors then in office;

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<sup>120</sup> *BCE*, *supra* note 34. This summary, which is considerably more succinct than the relevant text of the reasons for judgment but fairly reflects it, is from the official headnote.

- (f) an order directing a corporation, subject to subsection (6), or any other person, to purchase securities of a security holder;
- (g) an order directing a corporation, subject to subsection (6), or any other person, to pay a security holder any part of the monies that the security holder paid for securities;
- (h) an order varying or setting aside a transaction or contract to which a corporation is a party and compensating the corporation or any other party to the transaction or contract;
- (i) an order requiring a corporation, within a time specified by the court, to produce to the court or an interested person financial statements in the form required by section 155 or an accounting in such other form as the court may determine;
- (j) an order compensating an aggrieved person;
- (k) an order directing rectification of the registers or other records of a corporation under section 243;
- (l) an order liquidating and dissolving the corporation;
- (m) an order directing an investigation under Part XIX to be made; and
- (n) an order requiring the trial of any issue.

Under subsection 241 (4), where the court directs an amendment of the articles or bylaws pursuant to section 241 (3) (c) no further amendments can be made without the consent of the court or until a court otherwise orders. Subsection 241 (5) dispenses with the dissent rights of shareholders under section 190. This is appropriate since the investigations possible and remedies available under section 241 are so much more extensive.<sup>121</sup>

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<sup>121</sup> The exercise of these powers has been chronicled in many studies, including: Stephanie Ben-Ishai & Poonam Puri, "The Canadian Oppression Remedy Judicially Considered: 1995- 2001" (2004) 30:1 Queen's LJ. 79; Brian R Cheffins, "An Economic Analysis of the Oppression Remedy: Working Towards a More Coherent Picture of Corporate Law" (1990) 40:4 UTLJ 775; Brian R Cheffins, "The Oppression Remedy in Corporate Law: The Canadian Experience" (1988) 10:3 U Pa J Intl L 305; Jeffrey G MacIntosh, "Bad Faith and the Oppression Remedy - Uneasy Marriage or Amicable Divorce?" (1990) 69:2 Can Bar Rev 276; Jeffrey G MacIntosh, "The Oppression Remedy: Personal or Derivative?" (1991) 70:1 Can Bar Rev 29; Jeffrey G MacIntosh, "The Retrospectivity of the Oppression Remedy" (1987) 13 Can Bus LJ 219; Ian M Ramsay, "An Empirical Study of the Use of the Oppression Remedy" (1999) 27:2 Austl Bus L Rev 23; Mary Anne Waldron, "Corporate Theory and the Oppression Remedy" (1981-82), 6 Can Bus LJ 129. An interesting comparison with American legal remedies appears in Deborah DeMott, "Oppressed

## Oppression as a Legal, Organizational, and Corporative Remedy

### *The Power to Fashion New Entity Law*

The powers of the court in applying the oppression remedy include powers to vary or set aside contracts or transactions, including requiring the purchase of shares by another shareholder or by the corporation itself, powers to replace directors or appoint additional directors, and powers to liquidate or dissolve the corporation. In this regard, Christopher Nicholls observes that “one of the most important practical implications of the oppression remedy is that it can be used to impose personal liability on a corporation’s shareholders, directors, or officers (or others) under circumstances where, as a matter of common law, no such personal liability would necessarily be imposed.”<sup>122</sup>

In fact, imposing personal liability despite the corporate paradigms of asset shielding and entity shielding is only one example of how the powers of the court under section 241 can be used to vary the paradigmatic legal attributes of the corporation. Instead, in connection with the oppression remedy, which arises, of course, statutorily as a matter of corporate law, not only may the court remediate oppressive conduct within normal corporate law parameters, but it may also abrogate, vary or amend the essential characteristics or attributes of the corporation as a single legal entity, including the singularity or exclusivity of its liability with respect to its own obligations.

Considered from this perspective, the court can fashion new “entity law” for the corporation under the authority of the statute, which may be, however, quite different, and separate, from the statutory paradigm of the corporation as a legal entity. In fact, various commentators, including Professor Nicholls in his knowledgeable discussion of the subject in the work cited, appear not to have fully identified this aspect of the remedy. To restate it: the oppression remedy permits a court, in fashioning a remedy, and while operating under the guise of the authority conveyed in a corporation law statute, to revise and refashion the paradigmatic attributes of the corporation as a legal entity, which are conveyed in statute law, as well as in common law.

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But Not Betrayed: A Comparative Assessment of Canadian Remedies for Minority Shareholders and Other Corporate Constituents” (1993) 56:1 Law & Contemp Probs 181.

<sup>122</sup> *Supra* note 32 at 433, citing *Budd v Gentra* (1998), 43 BLR (2d) 27, 111 OAC 288 (CA); *Re Sidaplex-Plastic Suppliers Inc v The Elta Group Inc* (1998), 40 OR (3d) 563, 162 DLR (4th) 367 (CA); and *Piller Sausages & Delicatessens Ltd v Cobb International Corp*, 35 BLR (3d) 193, 2003 CanLII 35795 (Ont Sup Ct J), aff’d [2003] OJ No 5128 (QL)(CA).

### *Entity Law as Organizational Law*

Thus, the oppression remedy may be seen to permit or even to implicitly adopt a corporative perspective: it enables the possible reconciliation of the “hard” outer shell or legal rights exterior of the corporation as a legal entity with the “soft” inner organization, involving such attributes as structure, process and personnel, within.

As the present review has demonstrated, the statutory law which establishes a corporation as a separate legal entity and which accords to it certain often-described paradigmatic attributes operates at a very high level, dealing principally with matters relating to the rights of shareholders, and the rights and duties of directors and officers, and to a limited extent (which we have not reviewed here) with the rights of secured creditors; but does not deal significantly with the rights of other participants in the corporation, such as employees, agents, trade creditors and other parties contracting with the corporation, pensioners, unions, and legal jurisdictions and communities in which a corporation operates or which it otherwise affects. Of course, some of these matters form the subject-matter of other statutes.

Thus, this book maintains that statutory corporate law deals only to a very limited extent and in a very limited fashion with matters relating to the actual organization which animates the corporation and pursues its goals and objectives. That is not, of course, an argument that academics, jurists, and practitioners involved in corporate law should confine their attentions only to statutory corporate law, or even declarative corporate law incorporating common law as well as statutes. Instead, the limited sphere of operation of statutory corporate law vis-à-vis organizational matters necessitates the examination of a broader range of organizational research and theory in order to devise test, and sustain a theory of corporate law and legal theory in a much broader perspective, namely, as organizational law and legal theory.

As will be argued subsequently, the interests of participants in many organizations, including the corporation, and, in particular, the public corporation, may differ significantly from the interests of other participants, and the interests even of any particular participant, which may also change over time. To the extent that participation in the corporation is negotiated by and among its participants at the time of its inception, subsequent negotiations may be required from time to time, if not regularly, constantly or perennially, in order to readjust and realign the interests of

participants with each other and with the corporation. Such renegotiations may result in changes in reasonable expectations, at least, if not also in amendments to actual contracts.

Hence, ascertaining the reasonable expectations of relevant organizational parties may involve not just matters that may be considered to be purely “legal”, such as provisions of the corporate charter, bylaws, board and committee resolutions, and contracts, but also intracorporate rules, norms, and practices that are engaged by its formal and informal organization, structure, processes, and attributes of its personnel.

### *Aligning Participants’ Reasonable Expectations and Legal, and Organizational, Form*

Supporters of the “nexus of contracts”<sup>123</sup> and “incomplete contracts”<sup>124</sup> perspective on the corporation may argue that such readjustments and realignments are necessitated by the necessary “incompleteness” of the contracts originally formed. As will be argued in later chapters, this view

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<sup>123</sup> The objective of this work is to effect a descriptive analysis of the corporation, to demonstrate the lack of explanatory power of certain assumptions underlying alternative theories of the corporation, and to set forth a new, corporative, perspective on the corporation. Accordingly, this work has not set forth any significant expositions and critiques of alternative theories of the corporation. However, they are numerous and extensive. In relation to nexus of contracts theory, some of the earlier work includes the classic expositions in Michael Jensen & William Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure” (1976) 3:4 J Financial Economics 305, and other leading exponents such as Frank H Easterbrook & Daniel R Fischel, “The Corporate Contract” (1989) 89:7 Colum L Rev 1316 and other related articles and in their book *The Economic Structure of Corporate Law* (Cambridge, MA: Harvard University Press, 1991); the critique of their approach in Lewis A Kornhauser, “The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel” (1989) 89:7 Colum L Rev 1319; and a discussion of developments in William Bratton, “The Economic Structure of the Post-Contractual Corporation” (1992) 87 Nw UL Rev 180. Jensen and Meckling relied, in turn, on work of Oliver Williamson, such as Oliver E Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: Free Press, 1975); Oliver E Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* (New York: Free Press, 1985); and Oliver E Williamson, “The Theory of the Firm as Governance Structure: From Choice to Contract” (2002) 16:3 J Economic Perspectives 171. With respect to both nexus of contracts theory and incomplete contract theory, a leading work is by Bengt R Holmstrom & Jean Tirole, “The Theory of The Firm” in R Schmalensee & RD Willig, eds, *Handbook of Industrial Organization*, vol I (New York: Elsevier, 1989) 61. See also Bengt Holmstrom & John Roberts, “The Boundaries of the Firm Revisited” (1998) 12:4 J Economic Perspectives 73.

<sup>124</sup> The literature on incomplete contract theory includes: Philippe Aghion & Patrick Bolton, “An Incomplete Contracts Approach to Financial Contracting” (1992) 59:3 Rev Economic Studies 473; Ian Ayres & Robert Gertner, “Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules” (1989) 99:1 Yale LJ 87; Charles J Goetz & Robert E Scott, “Principles of Relational Contracts” (1981) 67:6 Va L Rev 1089; Gillian K Hadfield, “Judicial Competence and the Interpretation of Incomplete Contracts” (1991) 23:1 J Leg Stud 159; Oliver Hart, “An Economist’s View of Fiduciary Duty” (1993) 43:3 UTLJ 299 at 299. One of the most important contributions is Oliver Hart’s expositive article “Incomplete Contracts and the Theory of the Firm” (1988) 4:1 JL Econ & Org 119. See also Oliver Hart & J Moore, “Property Rights and the Nature of the Firm” (1990) 98:6 J Political Economy 1119. The extensive literature on relational contracts includes George Baker, Robert Gibbons & Kevin J Murphy, “Relational Contracts and the Theory of the Firm” (2002) 117:1 QJ Economics 39; and, in the management literature, Laura Poppo & Todd Zenger, “Do Formal Contracts and Relational Governance Function as Substitutes or Complements?” (2002) 23:8 Strategic Management J 707. Each of these has been extensively cited in other studies.

adopts assumptions of classical and neoclassical economics which will be argued to be, at the very least, highly contestable, and inadequate as a basis for prediction and action. In many of their more influential formulations, such nexus of contracts and incomplete contracts perspectives ignore the social, and even political, bases on which such contracts are constructed.

It might be expected that any “contracts” relating to participation in the corporation would be constructed so as to be enforceable in respect of the corporation as a legal entity, without the requirement of any additional or supplemental contractual provisions. Accordingly, as a matter of the legal theory of the corporation, and the instantiation of that theory by means of corporate law statutes creating the corporation as a separate legal entity, the nexus of contracts and incomplete contracts theories in relation to the corporation involve a certain circularity. That is, they assume that contracts which are legally effective may be renegotiated in such a way as to continue to be legally effective, as amended, and that contracts of this nature may be legally enforced, in effect, as a matter of corporate law.

Supporters of such theories might argue that the oppression remedy instantiates their theories; however, such argument is ineffective and unsatisfying. In fact, the oppression remedy acknowledges that the reasonable expectations of corporate participants may not be reflected in any binding agreements, that any relevant binding agreements may not be updated so as to correspond with “reality on the ground” in terms of the expectations of the affected parties, and that this may never occur, and may never even be intended by the affected parties.

Instead, the oppression remedy invites the court to look beyond contracts to the reality within which the participants operate and to give effect to the reasonable expectations of organizational participants, quite apart from any considerations of legal rights and duties, whether contractual, statutory, or otherwise. In this way, the court has the opportunity to “do equity” among the participants. In proceeding in this manner, the court may be seen to be invoking equitable principles that are related to the organization, and to its structure, processes and personnel, rather than being related to the corporation as a legal entity. In fact, the court may be seen as invoking “organizational equity” rather than “corporate entity legal equity”.

In this respect, the legal entity and, perhaps a lesser extent, its formal organization and the relationships among participants in such formal organization, may each “lag behind” the informal organization and informal relationships which will be demonstrated in Chapters Four and



following to be endemic in all formal organizations. Indeed, it may be that the informal organization and informal relationships achieve greater prominence in the “reasonable expectations” of organizational participants than do their formal counterparts.

As argued here, the corporative perspective, among other things, invites policymakers, legislators, regulators, and courts to consider and take into account implications for, and characteristics of, the internal organization of the corporation, and not merely the superficial legal characteristics of the corporation as a legal entity. As such, the oppression remedy and the concrete fact situations in which it is sought to be invoked present themselves as providing immediate opportunities for the exercise of the corporative perspective. The application of the corporative perspective in such circumstances may also demonstrate its relevance in other legal contexts, including those invoking corporate, as well as other legal, considerations.

Of course, at a fundamental level and quite apart from specifically applying the corporative perspective to oppression remedy situations, in addition to demonstrating the panoply and plenary powers that the court has in connection with the oppression remedy, as discussed above, the scope and basis of exercise of such powers facilitate a new interpretation of the corporation as involving both legal entity and organizational aspects, which is characteristic of the corporative perspective advanced in this work.

The oppression remedy directs our attention to the understanding that may be said to be prevalent among constituents of the corporation, who seek to accomplish its goals and objectives, but taking action as human actors in the real world on its behalf: that is to say, by permitting the separate legal entity to function as an organization. To that subject our attention now devolves.

**CHAPTER A3:  
INTRACORPORATE ORGANIZATION IN LAW**

**PART A – ORGANIZATIONAL LIABILITY FOR ACTS OF CORPORATE ACTORS**

As discussed previously, one of the defining attributes of a corporation is that it is a separate legal entity, which signifies here that it is a separate rights-and-duty-bearing entity as a matter of law. Some of the implications of the status have been discussed under the heading “Legal Attributes of the Corporation”. A key question which presents itself in this connection is how an inanimate incorporeal entity is able to acquire and exercise rights and, likewise, to assume and discharge duties and obligations.

In keeping with the methodology of this work in seeking to investigate the nature the corporation and to formulate a legal theory of the corporation which is both susceptible of verification and in testing, but also has significant explanatory capacity, this section will not investigate other theoretical explanations offered for this problem. Instead, it will seek to describe the explanations offered as a matter of corporate law, statutory and otherwise, and common law. This will facilitate a transition to other elements of our descriptive analysis, such as examining and challenging assumptions underlying corporate law and corporate legal theory, and explicating a new, corporative, perspective.

As will be further discussed below, a classical or neoclassical economic analysis of the firm employs certain concepts of agency. For an inanimate incorporeal legal entity to take action requires the presence of at least one human individual who is capable of taking actions in the real world. As is well known, the word “actor” derives from the Latin verb “ago, agere”, meaning “to do” or “to act”. Similarly, the word “agent” derives from the same Latin verb, hence meaning “someone who does something”, “someone who acts”, “someone who takes an active role”, or “someone who produces a specified effect”. The sense of the word in which it means “someone who acts on behalf of another” is a more particular usage. Both senses are relevant in the present case.

As Deborah DeMott indicates, “widespread use of agency terminology in academic disciplines like economics, philosophy, and literary studies does not necessarily parallel the content of the common law of agency.”<sup>1</sup> With respect to the latter, DeMott’s procedure is similar to that

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<sup>1</sup> Deborah DeMott, “The Lawyer as Agent” (1998) 67 Fordham L Rev 301 at 302 [DeMott, “Lawyer as Agent”].

employed here in connection with the corporation: she first distinguishes “the elements that must be present in a relationship to characterize it as one of agency and the legal consequences that follow from this characterization”; and observes that “confusion and circularity result of analysis proceeds in the opposite direction.”<sup>2</sup>

In the economic model of the firm, the proprietor, the owner of, and supplier of capital to, the firm engages another person as an employee or agent to perform work on behalf of the proprietor within the “firm”, which is the sole proprietorship. That person, who may be denominated as the manager, in turn engages and directs the work of other employees. The manager, or some employee or other, may enter into contracts on behalf of the firm, binding the firm with respect to the same. Likewise, the manager or some employee may engage in activities on behalf of the firm which may cause damage or injury to parties outside the firm. These contracts and injurious actions may result in contractual rights and liability and in non-contractual rights or tortious or other liability, respectively.

In the economic model of the firm, “agency costs” are costs that arise as a result of the separation of management and ownership, as identified by Berle and Means.<sup>3</sup> The owner incurs agency costs by reason of engaging separate management. These costs include extraction of economic “rents”, costs in excess of those necessary for the performance of the management services, often taking the place of benefits secured by management without the express knowledge or agreement of the owners, and including performance of management duties at a level of fidelity and competence below that envisioned in or required by the arrangements calling for such management. Agency costs also include the costs to the principal of monitoring the performance of the agent.<sup>4</sup>

The economic concept of agency thus involves an agency relationship between ownership and management, in a simple model in which a single owner, or sole proprietor, engages a single

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<sup>2</sup> *Ibid.*

<sup>3</sup> Adolf A Berle & Gardiner C Means, *The Modern Corporation and Private Property*, (New York: Macmillan, 1932). Roberta Romano refers to this as “the master problem” in corporate law research. See Roberta Romano, “Metapolitics and Corporate Law Reform” (1984) 36:4 *Stan L Rev* 923 at 923.

<sup>4</sup> The extensive literature on the subject includes: Michael C Jensen & William H Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure” (1976) 3:4 *J Financial Economics* 305; Eugene F Fama & Michael Jensen, “Separation of Ownership and Control” (1983) 26:2 *JL & Econ* 301; James S Ang, Rebel A Cole & James Wuh Lin, “Agency Costs and Ownership Structure” (2000) 55:1 *J Finance* 81; Mark S Mizruchi, “Berle and Means Revisited: The Governance and Power of the Large U.S. Corporations” (2004) 33:5 *Theory & Society* 579; Benjamin Klein, “Contracting Costs and Residual Claims: The Separation of Ownership and Control” (1983) 26:2 *JL & Econ* 367; Oliver E Williamson, “Organization Form, Residual Claimants, and Corporate Control” (1983) 26:2 *JL & Econ* 351; Harold Demsetz, “The Structure of Ownership and the Theory of the Firm” (1983) 26:2 *JL & Econ* 375.

manager as an employee of the sole proprietor, thereby constituting the organization as a “firm” for economic purposes. Of course, there may be more than one “owner” or “proprietor”, in which case the manager is considered to be the agent for the shareholders at large.<sup>5</sup>

This is different from the legal concept of agency which will be discussed in this chapter, whereby a principal appoints an agent to perform certain duties with respect to the business itself. In the economic model, each of the principal, or owner, and the agent, in this case the manager, adopt certain duties and responsibilities in consequence of the economic agency relationship and the particular, contractual and other, arrangements between them. The economic model of agency concerns itself primarily with the owner-manager relationship and its associated agency costs. Any situation other than a firm owned by a single owner-manager is considered to involve agency costs arising from management’s shirking and consumption of perquisites.<sup>6</sup>

As to the legal relationship of agency, Deborah DeMott notes that the legal consequences of the agency relationship have a dual aspect: they include both “inward-looking” consequences, namely, those applicable to the rights and duties as between the agent and the principal; and the “outward-looking consequences applicable to the agent’s interactions with third parties”. Both types of consequences are limited to the scope of the agency relationship<sup>7</sup>, determined as a matter of law, through such doctrines as actual authority, apparent authority, and ratification.<sup>8</sup>

In turn, the duties of the manager, as agent, may involve that manager acting as agent of the principal both “internally”, inside the firm, and “externally”, outside the firm. Such manager may authorize certain agents, both within and without the firm, to engage other sub-agents, in effect, to create further agency relationships, which might be denominated in respect of the head agency relationship in pursuance of which such action is taken as “sub-agency” relationships. Again, as will be shown in this chapter, the legal relationship of agency is different from the economic concept of agency.

However, again as shown in the following section, the economic analysis of the firm, which purports to rely upon the “agency” relationship between owners or shareholders and a manager,

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<sup>5</sup> See e.g. Eric W Orts, “Corporate Law and Business Theory” (2017) 74:2 Wash & Lee L Rev 1089 at 1091.

<sup>6</sup> See the extremely widely cited article by Ang, Cole & Lin, *supra* note 4 at 81-2. They find that agency costs are affected by ownership structure, as predicted by Jensen and Meckling, *supra* note 4, and by Fama & Jensen, *supra* note 4.

<sup>7</sup> DeMott, “Lawyer as Agent”, *supra* note 1 at 306.

<sup>8</sup> *Ibid* at 306-307.

does not engage sufficiently with the legal relationship of agency both inside and outside the firm, or with the nature of the “firm” itself, which it by and large ignores or invisibilizes. Indeed, as recently as 2010, a widely cited article by management academics in strategy and organization lamented the failure of corporate governance literature to go beyond economic and finance concepts of agency theory and to take into account the legal environment, and legal theories, of the firm;<sup>9</sup> and proposed treating the corporation itself as the principal, thus aligning agency theory more closely with legal doctrine and precedent.<sup>10</sup> Of course, it is this principal-agent relationship between the corporation and its management which is posited by traditional corporate law and by agency law.<sup>11</sup>

The simple model of the firm in economics and finance does not adequately explain how legal agency can be much more widely distributed than between only owner and manager. It also does not explain who or what the owner of the firm is when that firm is a separate legal entity, such as a corporation. In that regard, it also does not explain who or what acts as principal, in economic or in legal terms, in that case.

As is discussed below, the concept of management or the board of directors acting as “agent” for the shareholders alone is extremely problematic, as a matter of law, legal theory, and otherwise. The argument that the board of directors or management is the agent of the corporation itself is also problematic. If the principal of the corporation is the corporation itself, apart from the obvious regressivity, and hence disutility, of the definition, a fundamental question in that regard is how that principal is enabled to take any action, including, but not limited, to action to appoint a manager or a management for the legal entity.

These issues will be discussed further below. For the present, we will consider the issues surrounding agency as a legal concept which are primarily relevant, or in some way distinctive, in the context of the corporation. That is to say, we will tend to focus on legal issues that are salient

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<sup>9</sup> See Luh Luh Lan & Loizos Heracleous, “Rethinking Agency Theory: The View from Law” (2010) 35:2 *Academy Management Rev* 294 at 294. A search of the citations of this article conducted on January 26, 2018 indicated that it been cited 250 times. This may attest to the relative “freshness” of its subject matter and conclusions.

See:

<[https://www.google.ca/search?source=hp&ei=FBrWsXJHYazgKV96HAAg&q=Rethinking+Agency+Theory%3A+The+View+From+Law&oq=Rethinking+Agency+Theory%3A+The+View+From+Law&gs\\_l=psyab.13..0.2700.2700.0.4412.1.1.0.0.0.90.90.1.1.0....0...1c..64.psy-ab..0.1.89....0.ij6\\_rtPw1Qc](https://www.google.ca/search?source=hp&ei=FBrWsXJHYazgKV96HAAg&q=Rethinking+Agency+Theory%3A+The+View+From+Law&oq=Rethinking+Agency+Theory%3A+The+View+From+Law&gs_l=psyab.13..0.2700.2700.0.4412.1.1.0.0.0.90.90.1.1.0....0...1c..64.psy-ab..0.1.89....0.ij6_rtPw1Qc)>.

<sup>10</sup> Lan & Heracleous, *supra* note 9 at 301.

<sup>11</sup> Romano, *supra* note 3 at 1091.

where the economic “firm” is composed of more than a single owner and a single employee/manager; namely, where it is an organization. This necessarily entails omitting or reducing focus on agency law principles salient in respect of the non-organizational firm or business enterprise. This will permit greater attention be paid to agency law as applied in relation to the business corporation as a separate legal entity as a matter of law.

### **Master and Servant Law**

It is generally conceded that employment law originated, in common law jurisdictions, from the law of master and servant. In turn, the law of master and servant reflected the transition of the English economy from one with an agrarian emphasis to one with an industrial emphasis. Servants, whether working in the fields or in the household, very often worked for a master who was resident at the place of work.

Of course, as a result of many developments in society and the economy, the need for workers for an increasingly industrialized economy increased. Urban environments were also the setting for the practice of trades and crafts, in which masters trained apprentices, who often progressed either by continuing with their masters as servants or tradesmen or by setting up their own establishments and, in turn, engaging apprentices or servants. This process in Britain and in the United States is chronicled by a recent article which looks at the transformation of the master-servant relationship as a result of the separation of household-based activities into either home-based or workplace-based activities.<sup>12</sup>

Of course, a master was liable with respect to all contracts made by the servant with the master’s authority or which he later adopts by ratification.<sup>13</sup> In his influential article, Harold J. Laski commented that “If a master choose to give orders to his servant, no one can fail to understand why he should be held liable for the consequences of their commission. Nor is the case in substance different when he ratifies his servant's act.” He argues that when what is done for the master is expressly done for him with “his approval is tacitly, but obviously, to accept the act as his own; and that is true no less where the ratification is implicit, than where it is expressly made manifest.

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<sup>12</sup> Evelyn Atkinson, “Out of the Household: Master-Servant Relations and Employer Liability Law” (2013) 25:2 Yale JL & Human 205.

<sup>13</sup> See e.g. Samuel Comyn, *Law Relative to Contracts and Agreements Not Under Seal* (London: A Strahan, 1807) at 600.

No one, however, deems it necessary to take objection to liability which is consequent upon a general negligence.”<sup>14</sup>

The proposition that a master should be liable for actions of a servant within express authority is easily maintainable within contract law as an action impliedly authorized by the master. The relationship between the actor and the person authorizing or empowering the actor to act on his or her behalf is one of agency. A servant or employee may also be seen as the agent of the master or employer. Seavey asserts that the difference between a servant and any other agent is that the servant is under a more complete control than is a non-servant.<sup>15</sup> The legal relationship of agency involves “three legally cognizable dealings – between the principal and the third party, the principal and the agent, and the agent and the third party”.<sup>16</sup>

As such agent, the servant or employee can be regarded as an “extension” of the master or employer. DeMott maintains that the agent functions as the principal’s representative, as an extension of the principal, the agent does so while retaining its own separate legal personality.<sup>17</sup> This is reflected, says Seavey, in the Latin saying: *Qui facit per alium facit per se*: He who acts through another does the act himself.<sup>18</sup>

In this regard, Dowrick averts to the legal fiction which treats the agent and the principal as one person.<sup>19</sup> Seavey begins his discussion of the rationale of agency by quoting Oliver Wendell Holmes concerning “the absorption *pro hac vice* of the agents legal individuality into that of the principal”.<sup>20</sup> This principle is considered to apply not only to the master-servant or employer-employee relationship but also to relationships of guardianship, trusteeship, and executorship. All

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<sup>14</sup> Harold J Laski, “The Basis of Vicarious Liability” (1916) 26:2 Yale LJ 105 at 105.

<sup>15</sup> Warren A Seavey, “The Rationale of Agency” (1920) 29:8 Yale LJ 859 at 866. Professor Seavey succeeded Floyd Mechem as Reporter for The First Restatement of Agency of the American Law Institute, partly as a result of “attaining visibility as an agency law scholar” with the publication of this article.

<sup>16</sup> CW O’Hare, “Agency, Infancy and Incapacity” (1970) 3:3 U Tasm L Rev 312 at 312.

<sup>17</sup> Deborah A DeMott, “The Contours and Composition of Agency Doctrine: Perspectives from History and Theory on Inherent Agency Power” (2014) 2014:5 U Ill L Rev 1813 at 1816.

<sup>18</sup> *Supra* note 15 at 860.

<sup>19</sup> See FE Dowrick, “The Relationship of Principal and Agent” (1954) 17:1 Mod L Rev 24 at 24. He describes both the “one person” concept and the maximum *qui facit per alium facit per se* as legal fictions.

<sup>20</sup> *Supra* note 15 at 859, citing Oliver Wendell Holmes, *The Common Law* (Boston: Little, Brown & Company, 1881) at 232 and more expansive expressions of his views in “Agency – I” (1891) 4 Harv L Rev 345; and “Agency – II” (1891) 5 Harv L Rev. 1.

agency relationships are not necessarily created as a matter of contract between principal and agent. This is often the case with to guardianship, trusteeship and executorship relationships.<sup>21</sup>

Donald Langevoort notes that “[t]he garden of agency law was planted at a time when the paradigm principal-agent relationship involved two natural persons”<sup>22</sup> but acknowledges that today, by contrast, “by far, most principals are firms, not people”, and increasingly, firms of substantial size.<sup>23</sup> In fact, “[t]hat corporation law builds on the foundation of agency law is beyond doubt. Almost every corporate employee with discretionary responsibilities is an agent”.<sup>24</sup>

A corporation may be bound by the contracts entered into by an employee or other agent who is authorized to contract on behalf of the corporation; but may also be bound by contracts which are not authorized but where the employee or agent was ostensibly or apparently representing the corporation. In the first case, liability would arise where it was reasonable for the third-party contracting with the corporation to believe that the employee or agent had actual authority; and in the second case, liability would arise where the corporation allowed the employee or agent to appear to have authorization.<sup>25</sup>

However, the argument that the master authorized tortious commitment of an action by a servant or agent, is more subject to contestation on the grounds that the authorization envisioned performance of only lawful acts. Tortious liability for actions not authorized by the master is a different proposition still; however, as Laski points out, a servant may perform acts incidental to the master’s business without express authority for their performance.<sup>26</sup>

In fact, the amount of detail required to be provided to convey express authority otherwise would be unduly burdensome, and would frustrate the effectuation of many tasks. Still more subject to contestation is the proposition that a master should be liable for acts done in positive disobedience

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<sup>21</sup> Seavey, *supra* note 15 at 859.

<sup>22</sup> Donald C Langevoort, “Agency Law Inside the Corporation: Problems of Candor and Knowledge” (2003) 71:4 U Cin L Rev 1187 at 1188-89.

<sup>23</sup> *Ibid.*

<sup>24</sup> *Ibid* at 1191.

<sup>25</sup> Eric W Orts, *Business Persons: A Legal Theory of the Firm* (Oxford: Oxford University Press, 2013) at 137-38 [Orts, *Business Persons*]. This work attempts to analyze firms and corporations as “business persons” and so to derive a legal theory of the firm or of the corporation, rather than an economic one. However, the “business person” approach and its connection to “the corporation as a legal person” imposes limitations which are somewhat problematic in this regard.

<sup>26</sup> *Ibid* at 107.



to a command, or that the master may be “at first acquaintance...anxious to repudiate”.<sup>27</sup> Clearly, subjecting the master to liability for omissions is also subject to a high level of contestation.

The liability of the firm or the corporation for contractual and tortious liabilities incurred by a servant, employee, or agent is discussed further in the immediately following section.

### **The Agency Relationship in Law**

It has been previously observed that corporate law is built on the foundation of agency law”.<sup>28</sup> Accordingly, before discussing further details of intracorporate agency matters, some discussion of agency law more broadly may be appropriate at this juncture.

The elements, and various definitions, of the agency relationship at common law were reviewed in 1920 by Warren Seavey, an eminent expert on the subject. Determining that the agency relation involves power, fiduciary relationship, and control, he finds that “agency is a consensual relationship in which one (the agent) holds in trust for and subject to the control of another (the principal) a power to affect certain legal relations of that other.”<sup>29</sup> Dowrick describes agency as a fiduciary relation,<sup>30</sup> and avers to the well-known fact that the roles of the Court of Chancery and its principles of equity were applied, and extensively applied in the 18th and 19th centuries, to agency cases in which the agent had abused the confidence of the principal.<sup>31</sup>

<sup>27</sup> *Ibid.*

<sup>28</sup> Langevoort, *supra* note 22 at 1191. See also Eric W Orts, “Shirking and Sharking: A Legal Theory of the Firm” (1997) 16:2 Yale L & Pol’y Rev 265 [Orts, “Shirking and Sharking”].

<sup>29</sup> Seavey, *supra* note 15 at 868. Among the authors whose definitions and related comments are reviewed by Seavey (using his citations for this purpose) are those of, whom Seavey succeeded as Reporter of the Restatement (*supra* note 15) in Floyd R Mechem, *A Treatise on the Law of Agency*, 2nd ed (Chicago: Callaghan 1914), especially sec. 26, note 2; Edward Jenks, William Searle Holdsworth, Robert Warden Lee, William Geldart, and John Charles Miles., eds, *A Digest of English Civil Law* (London: Butterworth & Co, 1905), s 121; Ernest W Huffcut, *The Law of Agency*, 2nd ed (Boston: Little, Brown, 1901), Ch 5; Street, “Trusteeship and Agency” (1892) 8 Law Q Rev 220; and Austin W Scott, “Liabilities Incurred in the Administration of Trusts” (1915) 28:8 Harv L Rev 725 at 737.

<sup>30</sup> *Supra* note 19 at 28, citing: *Re Hallett’s Estate* (1880), 13 Ch D 696 at 709; *Regal (Hastings) Ltd v Gulliver*, [1942] UKHL 1, [1942] 1 All ER 378 at 392; *Nordisk Insulinlaboratorium v CL Bencard (1934) Ltd*, [1952] 2 All ER 1040 at 1042; *Snell on Equity*, 23rd ed., p. 173; Powell, *Law of Agency*, p. 26; *Bowstead on Agency*, 11th ed., p. 85; Salmond & Winfield, *Law of Contracts*, p. 262. Cf. *Restatement of Agency*, 5 13; Seavey, 29 Yale L.J., p. 863.

<sup>31</sup> *Supra*, note 19, at 28, citing *Burdett v Willett* (1708), 23 ER 1017, 2 Vern 628; *White v Lincoln* (1803), 32 ER 395, 8 Ves Jr 363; *Pearse v Green* (1819), 37 ER 327, 1 Jac & W 135; *Lupton v White* (1808), 33 ER 817, 15 Ves Jr 432; *Massey v Banner* (1820), 37 ER 367, 1 Jac & W 241; *Lees v Nuttall* (1829), 39 ER 21, 1 Russ & M 53; *Lees v Nuttall* (1834), 39 ER 1157, 2 My & K 819; *Rothschild v Brookman* (1831), 6 ER 699, 2 Dow & C1 188; *Austin v Chambers* (1838), 7 ER 598, 6 C1 & F 1; *Clarke v Tipping* (1846), 50 ER 352, 9 Beav 284; *Bentley v Craven* (1853), 52 ER 29, 18 Beav 75; *Gray v Haig* (1855), 52 ER 587, 20 Beav 219; *Turnbull v Garden* (1869), 9 Bar Rep 219; *Burdiak v. Garrick* (1870), LR 5 Ch 233; *Parker v McKenna* (1874), LR 10 Ch 96; and *Armstrong v Jackson* (1917), 2 KB 822 at 826.

The American Law Institute's *Restatement (Third) of Agency* (the "Restatement") provides a useful definition of the term of agency" as "the fiduciary relationship that arises when one person (a "principal) manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act."<sup>32</sup> The Restatement usefully and succinctly summarizes the American law, both state and federal, concerning other aspects of agency law, many of which are also common to Canadian and English law.

Consequently, for reasons of brevity and to prevent undue diffusion of attention, this chapter will employ its "restatement" as a statement of such current Canadian, American, and English law, rather than delving into the extensive, complex, and highly fact-based case law of such jurisdictions. The development of the Restatement, like other Restatements authored by the American Law Institute, is such that it is highly respected as an accurate statement of the law by members of the bench and bar alike, as well as being both easily comprehensible and well ordered.

In particular, section 2.01 of the Restatement states that an "agent acts with actual authority when, at the time of taking action that has legal consequences for the principal, the agent reasonably believes, in accordance with the principal's manifestations to the agent, that the principal wishes the agent so to act".<sup>33</sup> Under section 2.02, the consequences of actual authority are as follows: "(1) An agent has actual authority to take action designated or implied in the principal's manifestations to the agent and acts necessary or incidental to achieving the principal's objectives, as the agent reasonably understands the principal's manifestations and objectives when the agent determines how to act. (2) An agent's interpretation of the principal's manifestations is reasonable if it reflects any meaning known by the agent to be ascribed by the principal and, in the absence of any meaning known to the agent, as a reasonable person in the agent's position would interpret the manifestations in light of the context, including circumstances of which the agent has notice and the agent's fiduciary duty to the principal. (3) An agent's understanding of the principal's

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<sup>32</sup> Deborah A DeMott, ed, *Restatement of the Law Third, Agency*, vol 1 (Philadelphia: American Law Institute, 2006), s 1.01 [*Restatement*].

<sup>33</sup> See also Eric Rasmusen, "Agency Law and Contract Formation" (2004) 6:2 *Am L & Econ Rev* 369 at 372. In addition to actual express authority, which arises by explicit agreement between the principal and agent, actual authority also includes actual or implied authority, which involves an explicit agreement which, while it does not specifically authorize the particular action in question, the agent may infer that such authority has been delegated to him. This is distinct from apparent or ostensible authority. See also p. 373.

objectives is reasonable if it accords with the principal's manifestations and the inferences that a reasonable person in the agent's position would draw from the circumstances creating the agency.”

Thus, acts reasonably understood by the agent to be designated or implied in manifestations to the agent or reasonably understood by the agent to be necessary or incidental to achieving the principal’s objectives are considered to be done with actual authority. Section 2.03 provides that “[a]pparent authority is the power held by an agent or other actor to affect a principal’s legal relations with third parties when a third party reasonably believes the actor has authority to act on behalf of the principal and that belief is traceable to the principal’s manifestations.”

Section 2.05 of the Restatement creates an estoppel with respect to ostensible or apparent authority, inasmuch as: “A person who has not made a manifestation that an actor has authority as an agent and who is not otherwise liable as a party to a transaction purportedly done by the actor on that person's account is subject to liability to a third party who justifiably is induced to make a detrimental change in position because the transaction is believed to be on the person's account, if (1) the person intentionally or carelessly caused such belief, or (2) having notice of such belief and that it might induce others to change their positions, the person did not take reasonable steps to notify them of the facts.”

In connection with torts, section 2.04 provides that “[a]n employer is subject to liability for torts committed by employees while acting within the scope of their employment.”

In respect of contract, as in tort, criminal and administrative law, these comments invoke the concepts of vicarious liability and *respondeat superior*, as the same developed at common law. These matters will be discussed further below.

### **Vicarious Liability and *Respondeat Superior***

As discussed, firms, including corporations, must act through human agents. Accordingly, the firm or corporation may be held liable for the acts of its agents with respect to torts and, in some jurisdictions, with respect to criminal and administrative offenses. As Eric Orts indicates, for at least three hundred years in the Anglo-American legal tradition, under the principle of vicarious liability, firms have been held strictly liable as principals for the actions or material omissions of

their agents who are employees when they cause wrongful harm to third parties in acting or failing to act within the scope of their employment<sup>34</sup>

Such absolute liability of the principal for the misconduct of someone, the agent, whose activity the principal directs constitutes, as Kraakman says, a form of strict secondary liability. He describes the principal vehicle in the common law for “holding principals liable for the torts and other delicts of their agents” as the legal doctrine of *respondeat superior*, which is the legal doctrine that “principals are jointly and severally liable for the wrongs committed within the ‘scope of employment’ by agents whose behavior they have the legal right to control (‘servants’).”

In fact, Kraakman claims that “most corporate liability for torts, and in the United States for crimes as well, is vicarious liability imposed under *respondeat superior* or a similar doctrine.”<sup>35</sup> Kraakman even argues that direct corporate liability, such as “when the independent actions of several corporate agents cumulatively result in a business tort, although no single agent is individually culpable” so as to found “liability of corporate principals is best conceptualized as vicarious liability for the failure of the firm’s management to supervise its employees.”<sup>36</sup>

It is thought that such liability of the principal encourages supervision *ex ante* and discovery of misconduct *ex post*.<sup>37</sup> In this regard, Laski cites Bentham, to the effect that: “The obligation imposed upon the master,” he says, “acts as a punishment, and diminishes the chances of similar misfortunes. He is interested in knowing the character, and watching over the conduct of them for whom he is answerable. The law makes him an inspector of police, a domestic magistrate, by rendering him liable for their imprudence.”<sup>38</sup> Laski describes this as “important truth” namely, that

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<sup>34</sup> *Supra* note 25 at 139.

<sup>35</sup> Reinier H Kraakman, “Vicarious and Corporate Civil Liability” in Michael Faure, ed, *Tort Law and Economics* (Cheltenham: Edward Elgar, 1999), Part II, c 5 at 669.

<sup>36</sup> *Ibid* at 670.

<sup>37</sup> *Ibid* at 676-7, citing other articles of which he is a co-author, namely, Jennifer H Arlen & Reinier H Kraakman, “Controlling Corporate Misconduct: A Comparative Analysis of Alternative Corporate Incentive Regimes” (1997) 72:4 *UL Rev* 687; and Reinier H Kraakman, “Corporate Liability Strategies and the Costs of Legal Controls” (1984) 93:5 *Yale LJ* 857; and articles by leading commentator Alan Sykes, as follows: Alan O Sykes, “An Efficiency Analysis of Vicarious Liability Under the Law of Agency” (1981) 91:1 *Yale LJ* 168; Alan O Sykes, “The Economics of Vicarious Liability” (1984) 93:7 *Yale LJ* 1231; Alan O Sykes, “The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines” (1988) 101:3 *Harv L Rev* 563. See also two articles, still of interest today, regarding the policy issues attending vicarious liability by William O. Douglas (later Associate Justice): William O Douglas, “Vicarious Liability and Administration of Risk I” (1929) 38:5 *Yale LJ* 584; and William O Douglas, “Vicarious Liability and Administration of Risk II” (1929) 38:6 *Yale LJ* 720.

<sup>38</sup> Laski, *supra* note 14 at 113, citing Jeremy Bentham’s *Collected Works: Principles of Penal Law* (Edinburgh: William Tait, 1843).

“if we allow the master to be careless of his servant's torts we lose hold upon the most valuable check in the conduct of social life.”<sup>39</sup>

In his text on vicarious liability, Baty mentions a number of cases from the last half of the nineteenth century in which courts attributed the malice of the employee to the principal in finding the employer liable for torts committed that required the presence of express malice or other improper motive.<sup>40</sup> Laski says that, by 1800, liability had been extended far beyond cases in which the employee has express authority to act, such that “special authority apart, the duties assigned to a servant give him the power to bind his master in such contracts as come within the scope of his employment.” He says that, in fact, “the law goes further, and makes the master generally liable for his servant's torts so long as they are fairly and reasonably to be traced to his service, though no burden is thrown upon the employer where no such connection can be shown.”<sup>41</sup>

As noted above, vicarious liability in tort may extend beyond actual authority and even beyond apparent or ostensible authority.<sup>42</sup> Laski points out that even defining “scope of employment” as “consisting in acts incidental or natural to the servant’s occupation, we are only on the threshold of our difficulties. For there has been the most widespread divergence of opinion as to what comes within the scope of such acts, and no statistical measurement is at all possible.”<sup>43</sup> In effect, in applying the principles, each case is in itself a separate issue.<sup>44</sup>

Laski goes so far as to suggest that it may be sufficient to establish that the servant is acting “for the master’s benefit”.<sup>45</sup> In this regard, he says that “[t]he employment of a servant to perform certain functions must, on the whole, mean his employment to perform them as he deems best fitted, in his interpretation of his instructions, to serve his master's interest.”<sup>46</sup> However, the master

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<sup>39</sup> Laski, *supra* note 14 at 114.

<sup>40</sup> T Baty, *Vicarious Liability* (Oxford: Clarendon Press, 1916) at 69.

<sup>41</sup> Laski, *supra* note 14 at 108, citing, among others: as to scope of employment, *Nickson v Brohan* (1710), 10 Mod 110; *Hibbs v Ross* (1866), 1 QB 534; *Watteau v Fenwick Co* (1892), 67 LTNS 831; *Langan v G W Ry Co* (1874), 30 LTNS 173; as to tracing, *Limpus v Gen Omnibus Co* (1867), 1 H & C 526; *Stevens v Woodward* (1881), 50 LJ 231 (QB); *Dyer v Munday*, [1895] 1 QB 742; and as to negating of liability for lack of demonstrated connection, *McManus v Crickett* (1800), 1 East 106; *Croft v Alison* (1821), 4 B & Ald 590; *Stevens v Woodward*, (1881), 50 LJ 231 (QB); *Allen v L & SWR* (1870), 6 QB 65; *Abrahams v Deakin*, [1891] 1 QB 516.

<sup>42</sup> Orts, *Business Persons*, *supra* note 25 at 140.

<sup>43</sup> Laski, *supra* note 14 at 115-6.

<sup>44</sup> *Ibid* at 114.

<sup>45</sup> *Ibid* at 115.

<sup>46</sup> *Ibid* at 120.

“is not liable for the acts of the servant which are shown to be clearly unconnected with his service”.<sup>47</sup>

Fleming James, Jr., observed, to similar effect, that if the servant is engaged in performing what he is hired to do, the master is liable for the servant’s negligence in the manner of carrying out that performance even if the servant’s conduct consists in acts or omissions which have been specifically forbidden, or if the servant uses a forbidden means or instrumentality in carrying out the assigned task, at least where the means chosen fall within the range of what the master might reasonably expect the servant to use.<sup>48</sup> As he notes, also, in addition to authorized work, the master is also liable for acts that may “fairly and reasonably [be] regarded as incidental to the work specifically directed or which [are] usually done in connection with such work.”<sup>49</sup>

As demonstrated above, the Restatement applies many of these common law principles, with reference, of course, primarily to American law (which it purports to restate). However, as previously noted, agency law is quite similar in all the Anglo-American jurisdictions, and in some other common law jurisdictions. Under subsection 7.03 (1), a principal is subject to direct liability to a third party harmed by an agent’s conduct and when either (a) the agent has actual authority or the conduct is ratified; or (b) the principal is negligent in selecting, supervising, or otherwise controlling the agent; or (c) another agent of the principal to whom such duty is delegated fails to use care to protect other persons or their property. Under subsection 7.03 (2), a principal is subject to vicarious liability to a third party harmed by an agent’s conduct when either (a) the agent is an employee who commits a tort while acting within the scope of employment; or (b) the agent commits a tort when acting with apparent authority in dealing with a third party on or purportedly on behalf of the principal.

Section 7.07 sets out the scope of employment for the purposes of section 7.03, which is generally as indicated above, saying that “(1) An employer is subject to vicarious liability for a tort committed by its employee acting within the scope of employment. (2) An employee acts within the scope of employment when performing work assigned by the employer or engaging in a course

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<sup>47</sup> *Ibid.* He cites: *McManus v Crickett*, *supra* note 41; *Croft v Alison*, *supra* note 41; *Hoar v Maine Central RR Co*, 70 Me 65 (Me 1880); *Garvey v Dung*, 30 How Pr 315 (NY 1866); *Driscoll v Scranton*, 165 Mass 348 (Mass 1896); *Pittsburgh FW & C Ry Co v Maurer*, 21 Oh St 421 (Ohio 1870).

<sup>48</sup> Fleming James Jr, “Vicarious Liability” (1954) 28:2 Tul L Rev 161 at 174.

<sup>49</sup> *Ibid* at 180.

of conduct subject to the employer's control. An employee's act is not within the scope of employment when it occurs within an independent course of conduct not intended by the employee to serve any purpose of the employer.” Subsection 7.07 (3) states that “For purposes of this section, (a) an employee is an agent whose principal controls or has the right to control the manner and means of the agent's performance of work, and (b) the fact that work is performed gratuitously does not relieve a principal of liability.”

The tests set out in s. 7.07 reflect the common law principles outlined above. Of course, the section makes it clear that no vicarious liability arises for an act that occurs within an independent course of conduct of the employee, that is to say, one not intended by the employee to serve any purpose of the employer, often referred to as a “frolic” of the employee’s own.

As discussed above, section 7.08 deals with vicarious liability in cases of apparent authority, as follows: “A principal is subject to vicarious liability for a tort committed by an agent in dealing or communicating with a third party on or purportedly on behalf of the principal when actions taken by the agent with apparent authority constitute the tort or enable the agent to conceal its commission.”

As provided in section 7.07 of the Restatement, the employer does not, but the employee may, incur liability for an act that “occurs within an independent course of conduct not intended by the employee to serve any purpose of the employer” (again, often called a “frolic” of the employee’s own). Section 7.01 provides that an agent is subject to liability to a third party harmed by the agent’s tortious conduct and that, unless an applicable statute provides otherwise, an actor remains subject to liability although the actor acts as an agent or an employee, within actual or apparent authority, or within the scope of employment. Thus, it is possible for both the employer and the employee to incur liability to third parties.

Where such joint liability arises, employers, such as a corporation, may agree to indemnify the employees concerned and, in connection therewith or otherwise, may provide insurance coverage with respect to such situations. As the present chapter has shown, corporate legislation in various jurisdictions permits, in certain circumstances, and, in others requires, the corporation to indemnify directors and officers, and in some cases, other employees and agents, in these respects.

## **The Principal-Agent Relationship Inter Se**

The relationship between the principal and the agent inter se is a matter of both contract and common law. Section 8.01 of the Restatement imposes a fiduciary duty on the agent to act loyally for the principal's benefit in all matters connected with the agency relationship, while section 8.08 imposes on the agent a duty to act with the care, confidence, and diligence normally exercised by agents in similar circumstances. Section 8.02 refers to a duty of the agent not to acquire a material benefit from a third party in such connection, while section 8.03 imposes on the agent a duty not to deal with the principal as, or on behalf of, an adverse party in that connection.

Of course, it is the common law, and not the Restatement itself, which "imposes" these duties and obligations; however, using the "imposition" language in this text permits some abbreviation of otherwise much longer summaries of the law, and, accordingly, will be employed here from time to time. As noted, the Restatement actually recognizes, declares, or summarizes the common law.

Other duties of the agent include a duty in section 8.04 not to compete with the principal or to take action on behalf of or otherwise assisting the principal's competitors; a duty in section 8.05 not to use property of the principal for the purposes of the agent or a third party, and not to use or communicate confidential information of the principal for such purposes; a duty in section 8.07 to act in accordance with the express and implied terms of any contract between them; a duty in section 8.09 to act only within the scope of the agent's actual authority and to comply with lawful instructions of the principal; and a duty under section 8.10 to act reasonably and to refrain from conduct that is likely to damage the principal's enterprise.

The agency agreement may accord the agent, on the one hand, a very wide discretionary authority as to what may be done in pursuance of the agency, or, on the other hand, a very narrow discretionary authority. In addition to the terms of the agency agreement, the authority of the agent may be circumscribed, further, by lawful instructions that the principal gives, generally (as standing instructions) or from time to time. The agent's responsibility includes not only acting only within his or her actual authority, but also acting reasonably in connection with the mandate.

As will be seen, issues as to the scope of discretionary authority and the ability of the principal to give and the duty of the agent to follow lawful instructions are especially important facts which differentiate the corporation and the board of directors from a principal-agent relationship. This is discussed in more detail in the next following section.



The Restatement recognizes a general duty to provide information, in section 8.11, and a specific duty in connection with securing the consent of the principal, in section 8.06. As to the first of these, unless the agent has a superior duty to another person, section 8.11 imposes a duty to use reasonable effort to provide the principal with facts that the agent knows, has reason to know, or should know, subject to any manifestation by the principal, when the agent knows or has reason to know that the principal would wish to have those facts or that the facts are material to the agent's duties to the principal.

The duty of individual directors to inform their fellow directors of conflicts of interest, and where such duty obtains, the duties to advise fellow directors information known to the subject-director seem to take inspiration from this principle, considering the full board of directors as, or as representing or animating, the corporation as principal. As noted above, section 8.30 (c) of the MBCA specifically imposes this duty on directors. It may be considered to be related to the duty of disclosure in agency law, as opposed to trust law, which strictly proscribes such conflicts. This is discussed further under the heading "Intracorporate Agency".

Section 8.06 makes effective the principal's consent to conduct that would otherwise constitute a breach of duty, provided that in obtaining such consent the agent acts in good faith, discloses all material facts that the agent knows, has reason to know or should know would reasonably affect the principal's judgment (unless already known or the desire to know them is negated); and otherwise deals fairly with the principal. Importantly, to be operative, the consent must relate to either a specific act or transaction or acts or transactions of a specified type that, in either case, could reasonably be expected to occur in the ordinary case of the agency relationship. Thus, with respect to transactions that are extraordinary, either liability for breach of duty cannot be waived by the principal, or, if that is possible, it must be done in the most express terms.

Again, for example, the consent of the board to conduct that would otherwise breach a director's duty by reason of conflict of interest, which, strictly speaking is given by way of approval of the contract or transaction involving such conflict of interest, may be considered as related to this principle of agency law.

By comparison, the summary of the duties of principals contained in the Restatement is much simpler; it comprises only three sections. Section 8.13 indicates that a principal has a duty to act in accordance with the express and implied terms of any contract between the principal and the

agent. The obligation, then, extends beyond the actual express terms of the contract to include any terms that might arise by implication, presumably from law, custom, or dealings between the parties. It parallels the agent's obligation in section 8.07.

Quite apart from contract, however, section 8.15 states that a principal has a duty to deal with the agent fairly and in good faith. It provides, further, that this includes a duty to provide the agent with information about risks of physical harm or pecuniary loss that the principal knows, has reason to know, or should know are present in the agent's work but unknown to the agent. For example, the principal may be aware of some defect not known to the agent in the product or services provided to customers that might result in a risk of physical harm or financial loss to customers, the agent, or others, that are involved in the work of the agent. This may be seen as similar to, but more limited than, the duty of the agent under section 8.11 to inform the principal of certain facts, facts that are ones that the principal would wish to have or that are material to the agent's duties, that the agent either knows, has reason to know or should know.

Under section 8.14 of the Restatement, a principal has a duty to indemnify an agent in accordance with the terms of any contract between them; and, unless otherwise agreed, when the agent makes a payment within the scope of the agent's actual authority, or that is beneficial to the principal (subject to a limited exception); or when the agent suffers a loss that fairly should be borne by the principal in light of their relationship.<sup>50</sup> As noted previously, as a matter of corporate law, by statute, in some jurisdictions a corporation is permitted, in some cases, and in some cases, is required, to indemnify directors, officers, employees, and other agents. These statutory permissions and obligations give effect to agency principles relating to indemnification.

## **PART B – THE CORPORATION AS PRINCIPAL**

### **Authority of Principal Divided Between Board and Shareholders**

As discussed in Chapters A1 and A2, the fundamental attributes of the corporation include: its status as a separate legal entity, or rights-and-duty bearing entity, a status which implicates its other fundamental attributes; the locking-in of its capital such that capital may not be withdrawn freely by its contributor; the transferability of equity interests in the corporation; asset partitioning involving the limited liability of owners and of the corporation for liabilities of the other; and, in

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<sup>50</sup> See, for example, the discussion by Dowrick, *supra* note 19 at 88.

relation to the foregoing matters, the separation of equity or capital interests in the corporation from management of the entity, which is often expressed in terms of the separation of ownership and management.

It has been demonstrated in those chapters that modern corporate statutes generally provide, in effect, that the board of directors shall manage or supervise the management of the business and affairs of the corporation. Save for the exceptional circumstances for which statutory provision is made, as is noted in Chapter A1, the board of directors need not even take into account the wishes of the shareholders.<sup>51</sup> While the statutes do not define precisely of what such “management” consists, the duty and responsibility assigned thereby is quite clearly extremely extensive, as indicated not only by the usual import of such term, but also by reference to the specific duties and responsibilities which accompany the general management duty and responsibility as delineated in the statutes. Of course, the statutes also provide the board with considerable discretion concerning the means by which the board may organize such management.

As demonstrated in those chapters, while the statutes assign the board of directors plenary management authority, they also provide shareholders, who, as equity owners, have no intrinsic or automatic right to participate in management of the corporation as such shareholders, with certain rights in respect of the selection of the directors, the approval of fundamental transactions, and the expression of their views concerning management of the corporation to other equity owners and to the board of directors.

As has been shown, the powers which the corporation may exercise, as a separate legal entity, are usually expressed either by analogy to those of a natural person or are extensively prescribed, in which case any adverse consequences of acting in excessive the prescribed powers are usually eliminated by statutory rescission of the common-law rule of ultra vires. As noted previously, stipulating that a corporation has the rights and powers of a natural person signifies that a corporation has the legal capacity to engage in any activities which may be undertaken by a natural person. We have noted that this does not necessarily entail, of course, that the corporation is a

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<sup>51</sup> See the material in Chapter A1 under the heading "Management Role of the Board of Directors" and, in particular under the subheading "Statutory Role". See also the discussion in note 1 there concerning the leading case of *Automatic Self-Cleansing Filter Syndicate Co v Cuninghame*, [1906] 2 Ch 34 (Eng CA), and see the case report itself as to the latter point.

person in the view of the law, or that a corporation has legal personality, or that a corporation is possessed of legal personhood.

It is obvious, of course, that a statutory stipulation that a corporation has the legal capacity to engage in any activities which may be undertaken by a natural person does not implicate the statute as conveying to the corporation the practical or factual capacity to engage in such activities. For example, the statute does not convey the capacity to exercise, or to engage in the sensory movement, or intellectual capacities, or physical capacities, of which a natural person is possessed. This gives rise to the question as to how a corporation engages in activities or takes actions.

Investing the board of directors with responsibility for management of the corporation is generally taken to affirm that the board is the first-order actor in relation to the corporation. That is to say, subject to certain legal limitations, as previously discussed, the board has the power and authority to take action on behalf of the corporation. In terms of the corporation acting as a separate legal entity, the actions taken, or authorized, by the board of directors in pursuance of such power and authority are recognized, as a matter of law, as being those of the corporation. This might be considered as a rule of corporate authorization or as a rule of corporate recognition. It will be referred to here as the “corporate act rule”.

Pursuant to the corporate act rule, any actions taken by others purportedly or impliedly on behalf of the corporation that contravene board actions or authorizations are considered, in the first instance, not to be those of, nor those authorized by, the corporation. However, the corporate act rule has been modified, with the intention of eliminating injustice, by a rule known as the “rule in *Turquand’s* case” or the “indoor management rule”.<sup>52</sup>

As stated in a later Canadian case, “where an outsider dealing with a corporation satisfies himself that the transaction is valid on its face to bind the corporation, he need not inquire as to whether all of the preconditions to validity that the corporation’s internal law might call for have in fact been satisfied.”<sup>53</sup> As noted in Chapter A1 in the section entitled “Management Role of the Board of Directors under the subheading “Apparent or Ostensible Authority of Directors, Officers, and Others”, this rule has been modified by sections 17 and 19 of the CBCA and OBCA, respectively.

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<sup>52</sup> *Royal British Bank v Turquand* (1856), 119 ER 886, 6 El & Bl 327 (Ex); discussed and applied in *Canadian Laboratories Supplies Ltd v Engelhard Industries of Canada Ltd*, [1979] 2 SCR 787, 97 DLR (3d) 1.

<sup>53</sup> *Sheppard v Bonanza Nickel Mining Co of Sudbury* (1894), 25 OR 305 (Ch D) at 310.

Broadly speaking, a corporation cannot deny the due appointment and the customary or usual authority of a person it holds out as a director, officer or agent of the corporation.<sup>54</sup>

Each of the common law “indoor management” rule and the statutory rules is consistent with the principles of agency law concerning ostensible or apparent authority. Reference is made to the preceding Part A of the present chapter.

### **Respective Capacities of the Board and of Shareholders to Initiate Action**

If the corporate act rule recognizes as corporate acts, in law, acts that are taken by, or in pursuance of, the board of directors’ lawful powers of management, the question arises whether the board of directors is then acting as a principal who may appoint agents and sub-agents. Whether or not the board is acting as a principal in so acting, it is clear that its management power and authority allows it to appoint such agents and sub-agents. It is also clear that other parties who may subsequently abrogate, amend, or fail to approve board actions or authorizations in the exceptional circumstances in which such action is required or permitted cannot, in the first instance, be considered as principals in relation to the corporation. This refers, of course, to the approval or amendment powers of shareholders in exceptional circumstances.

It is also clear that shareholders are not, and do not act as, principals in relation to the corporation. The board of directors, rather than the shareholders, is empowered to manage the corporation and the shareholders are not entitled to give instructions to the board concerning such management.<sup>55</sup> Thus, the board cannot be considered to be an agent of the shareholders, collectively, acting as principal. Likewise, the shareholders have no general power to set aside the actions of the board.<sup>56</sup>

The statutory powers of shareholders to approve, amend, or reject actions proposed by the board are powers which are exercised in specific instances after the fact. They cannot, as such, initiate any management action.<sup>57</sup> Their statutory powers to make proposals to the board are just that:

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<sup>54</sup> *Turquand’s case*, the indoor management rule, and the statutory provisions are discussed in the case of *Sherwood Design Services Inc v 872935 Ontario Ltd* (1998), 3 OR (3d) 576, 158 DLR (4th) 440 (CA).

<sup>55</sup> See discussion in note 1 above and in the accompanying text.

<sup>56</sup> *Ibid.*

<sup>57</sup> As noted in Chapter A2 in the section entitled “Shareholder Rights to Initiate Consideration of Certain Matters”, the shareholders are empowered to make proposals and to requisition meetings for certain purposes. However, while proposals passed by a majority of shareholders may exercise some normative persuasive effect on the directors, such proposals are *not* legally binding. See Robert Yalden, Janis Sarra, Paul D Paton, Mark Gillen, Ronald Davis, and Mary Condon, *Business Organizations: Principles, Policies and Practice* (Toronto: Emond Montgomery Publications, 2008) (“Yalden et al.”) at 550.

powers to make proposals for consideration by the board with knowledge of the extent of shareholder interest in the same, not powers to give instructions. But their power to determine who will exercise the power of management, which is vested in the board of directors, is a right similar in nature to that exercisable by a human being who might be acting as principal.

In fact, although the board of directors may be considered to exercise most of the powers which a human “principal” would have with respect to appointing another human “agent”, a limited number of the powers exercisable by a human “principal” are allocated to the shareholders vis-à-vis their relationship to the board of directors. Consequently, as Langevoort remarks, the division of “rights and responsibilities normally allocated to the principal in a simple enterprise... between the board of directors and the shareholders, albeit with a strong bias toward board primacy as it relates to the running of the corporation’s affairs”<sup>58</sup> entails that neither the board or the shareholders is a real principal. Neither of them alone is “actually able to make the choices principals are normally entitled to make”.<sup>59</sup> At least, neither of them can make such choices solely on their own.

However, as Professors Johnson and Millon state in an important article from 2005, the board “is endowed with plenary governance authority and is the body most centrally responsible for the well-being of the corporate enterprise”,<sup>60</sup> although it normally vests the actual management function in others, whom it appoints as officers, who act pursuant to its direction. Accordingly, Johnson and Millon say that the board, as governing body, is required to monitor and evaluate those to whom management is been delegated.<sup>61</sup> They argue that “organizational principals – be they corporations, churches, universities, or other groups – differ from individual principals” in this respect, namely, that an organization, as such, lacks human capacity.

The present work has suggested that the corporation, as a separate legal entity, is “animated” or “vivified”, in the first instance, by the board of directors. That is to say, they “bring it to life” or enable it to act. The board “represents” the corporation to, and personifies it within the “real world” of human actors both within and without the corporation. As will be argued more fully in Part 3 of this work, the corporation, as a separate legal entity, must be considered as intrinsically linked to

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<sup>58</sup> Langevoort, *supra* note 22 at 1191.

<sup>59</sup> *Ibid.*

<sup>60</sup> Lyman PQ Johnson & David Millon, “Recalling Why Corporate Officers Are Fiduciaries” (2005) 46:5 Wm & Mary L Rev 1597 at 1607.

<sup>61</sup> *Ibid* at 1602.

the persons and groups of persons who enable it to function in the real world. That implicates the corporation as involving an organization, by which is meant a group of persons acting collectively in endeavouring to achieve or accomplish one or more commonly held goals or objectives.

All of this indicates that the board of directors is not the “agent” either of the shareholders or of the corporation itself. Instead, as we have said, the board “animates” or vivifies” the corporation and enables it to act in the “real world” among individual human actors. Unlike an agent, the board of directors exercises, within the scope of its authority, the powers of the corporation. This can be distinguished from an agency situation, as explained by Dowrick, in which the power of one party, the agent, to alter the legal relations the other party “is a reproduction of the power possessed by the latter to alter his own legal position” such that “the power conferred by law on the agent is a facsimile of the principal’s own power.”<sup>62</sup>

This is unlike the board of directors’ relationship with the corporation for, without the board of directors or other animating party, the corporation is unable to act at all. Furthermore, Dowrick’s descriptions are quite apt with respect to the relationship between the board of directors and the principal officers of the corporation. Equally well, Pollock’s description of the effect of agency seems quite useful with respect to the board-officer relationship, but not with respect to the corporation-board relationship, when he says that “by agency the individual’s legal personality is multiplied in space”.<sup>63</sup>

In effect, Pollock provides an appealing visual motif which is particularly apt in the case of a corporation or other organizational principal. Each of the corporation’s employees, to the extent that they act as agents, present or re-present the legal capacity of the corporation. As we have maintained, while the legal capacity so produced or multiplied is that of the corporation, and while the board of directors may act on its behalf in appointing agents, the board is not itself an agent of the corporation. At the same time, of course that “replicated” legal capacity enables the corporation to function on a very large scale, often involving a great number of employees, businesses, plants, offices, regions, countries, and continents.

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<sup>62</sup> Dowrick, *supra* note 19 37.

<sup>63</sup> *Ibid.* Dowrick quotes this, describes it as a “penetrating” analysis; citing: Sir Frederick Pollock, *Principles of Contract* (13th ed) (London: Wentworth Press 1950) at 45.

## Nature of the Duties and Responsibilities of Directors

While the board may be seen to represent the corporation as principal, it is clear that the board is not itself, as a matter of law, the principal in relation to other parties acting on behalf of the corporation. Firstly, its powers of management which are, in the first instance, plenary (within the limitations of statutory and constating documents), do not extend as far as the rights of a principal acting as owner with respect to his or her own property. For example, the board cannot lawfully commit the tort of waste. Secondly, the directors, individually and collectively, exercise powers and bear duties and responsibilities towards the corporation itself. Principals are not considered to have “duties” towards themselves.

Admittedly, the nature of the duties of directors is subject to some contestation, but need not be determined here. Whatever the nature of such duties, however, principals have no duties towards themselves as such. The statutory duties of loyalty, care, and compliance may all be considered, in some senses, as fiduciary, that is, as having some similarities to those of a trustee towards beneficiaries. There also similar to the duties of agents towards their principals.

Indeed, as Professor Hazen observes, prior to 1984, the MBCA referred to the duties of directors as “fiduciary duties”, and he observes that the deletion of this description in the 1984 revision “was not intended to change the current law relating to directors’ and managers’ responsibility [but,] [r]ather, the reformulation was designed to eliminate unhelpful analogies to the law of trusts. As others have shown however, the trust analogy has been very useful.”<sup>64</sup> Although the duties of the board of directors bear some similarities to the duties of trustees and to the duties of agents, they are quite distinctive. Again, a lengthy discussion of this subject is beyond our present mandate.

Subject to the terms of the statutes and the constating documents of the relevant corporation, the board’s power to manage exceeds the powers of both trustees and agents. Professor Hazen argues that the directors, as corporate managers, “should and can take risks that ordinary trustees cannot” and “are encouraged to be less risk averse than trustees in their pursuit of economic gain for the corporation.”<sup>65</sup> Indeed, the directors must balance the risks and opportunities of certain courses of action, and pursue a course of action consistent with the corporation’s goals and objectives.

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<sup>64</sup> Thomas Lee Hazen, “The Corporate Persona, Contract (and Market) Failure, and Moral Values” (1990) 69:1 NCL Rev 273 at 280.

<sup>65</sup> *Ibid.*



As we have indicated, both the trustee and the agent paradigms are inadequate by themselves as descriptions of the function of the board of directors. Rock and Wachter comment that “[t]he corporate relationship is thus at the opposite pole from the trust or agency relationship – open ended in time and scope, transactionally intensive, and often involving physical assets that are illiquid and difficult to value. The corporate director thus needs more flexibility to deal with evolving events than does the trustee.”<sup>66</sup> In effect, managing or supervising the management of a business is intrinsically different from exercising the responsibilities of a custodian or curator of assets. Assuming appropriate levels of risk proportionate to anticipated benefit and goals is consistent with directorial duties in respect of the business and its objectives.

### **The Representative Role of the Board**

#### *Actor on Behalf of the Corporation*

There is no doubt, however, that the board of directors of the corporation, as its highest authority, is considered to represent the corporation for the purpose of agency law. Whether or not the board is, as such, an agent of the corporation, which is its principal; is itself the principal; or is something in between the two; or is something else entirely; is subject to considerable contestation, as has been previously mentioned.

Donald Langevoort, for example, concedes that the board holds the ultimate decision-making authority with respect to the corporation as a distinct juristic entity<sup>67</sup>, but nonetheless treats the board, at the very top of the corporate pyramid, as a principal with respect to the officers and employees. In effect, he assumes that the board is the ultimate superior in the corporate pyramid. Eric Orts sees the board as the “top-level representative of the firm”, which, in such capacity, acts “as a ‘principal’ for purposes of hiring and delegating authority to agents”.<sup>68</sup>

This may be considered to be something less than an assertion that the board is the principal; instead, Orts maintains that as a principal or some analogous form of expression, it acts as if it is a principal. The argument of this chapter is that, as representing the corporation and, as its highest

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<sup>66</sup> Edward Rock & Michael Wachter, “Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants” (2002) 96:2 Nw UL Rev 651 at 666.

<sup>67</sup> *Supra* note 22 at 1194.

<sup>68</sup> *Supra* note 25 at 59.

order representative, taking action on its behalf, the board acts as a principal would act if the principal was a natural person, rather than a separate legal entity.

As our review in Chapters A1 and A showed, while most of the attributes of the principal in a principal-agency relationship inhere in the board of directors, there is some sharing of these attributes as between the board and the shareholders. However, while shareholders exercise some authority which might be considered to be consistent with that of a principal, even in those situations, the board of directors, rather than the shareholders, is the party empowered to take action, vis-à-vis the shareholders or otherwise, on behalf of, and in the name of, the corporation.

Langevoort, for example, observes that “on close inspection, in many ways the basic purpose of corporation law is to address the question of who the "principal" is in the corporate setting.”<sup>69</sup> Its collision with the simplicity of agency law arises, in his estimation, because “corporation law complicates relationships by making the principal a fiction for purposes of its agency relationships, and then spends much of its effort pretending that it is nonetheless meaningful to think of the corporate principal as if it were real.”<sup>70</sup> Langevoort concludes that although senior managers act as principals, they are actually agents and that “[b]oards of directors are closer in theory to principals, but even they are fiduciaries beholden to some abstraction of the corporation.”<sup>71</sup>

Despite his somewhat misleading “fiction” characterization, Langevoort appears to recognize that the “problem” of characterizing the nature of the board of directors arises from the simple failure of an entity to be able to take action without involving human persons. It is submitted that many of the problems associated with the characterization of the corporation as a fiction, a discussion of which extends beyond the scope of the present work, arise from this distinction between the legal entity and the actors representing, impersonating, or taking action on behalf of that entity. Characterizing the corporation simultaneously as a legal entity and as an organization avoids these difficulties. This characterization is effected by means of the corporative theory or perspective set forth in this work.

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<sup>69</sup> *Supra* note 22 at 1191.

<sup>70</sup> *Ibid* at 1231.

<sup>71</sup> *Ibid*.

### *Compared to Trustee and Agent Roles*

Johnson and Millon conclude that, as a matter of law and as reflected in the Restatement of Agency and case law, neither the board as a whole nor individual directors are agents of either stockholders or the corporation.<sup>72</sup> It is also apparent that the types of fiduciary duties incumbent upon directors do not arise in connection with an exclusively trustee-beneficiary relationship and, for the reasons set forth above, also do not arise as a result of a relationship which is strictly, in law, solely one of principal and agent. In distinguishing the duties of directors from those of trustees, Rock and Wachter refer to the first Restatement of Trusts as providing “a comprehensive articulation of the classical law of trusts.”<sup>73</sup>

They also indicate: “According to the Restatement, a trustee has the following duties: to administer the trust; to act with loyalty to the beneficiaries; s not to delegate; to keep and render accounts; to furnish information; to exercise reasonable care and skill; to take and keep control; to preserve trust property; to enforce claims; to defend actions; to keep trust property separate; to make the trust property productive; to pay income to beneficiaries; and to deal impartially with beneficiaries. A trust relationship is a "fiduciary" relationship and the duties that arise out of it are "fiduciary" duties.”<sup>74</sup>

As demonstrated in Chapter A1, the declarative law obligations of directors are much broader and much less specific in their nature. As demonstrated in the present chapter, a primary obligation of agents is adhering to the instructions of the principal. As discussed, in the context of ordinary management matters, no one other than the board of directors has the capacity to provide such instructions on behalf of the corporation, as principal.

The nature of the relationships between the board as a whole and the corporation and between individual directors in the corporation differs from conventional trustee-beneficiary and also from conventional principal-agent relationships, which are considered to be primarily contractual arrangements. Rock and Wachter adopt the argument of theorists of the firm such as Coase, Williamson, Hart, and others that “when costs are high enough, transactions are brought inside the

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<sup>72</sup> *Supra* note 60 at 1605.

<sup>73</sup> *Supra* note 66 at 653.

<sup>74</sup> *Ibid.*

firm. For transactions inside the firm, the firm's authority structure replaces the market's command structure."<sup>75</sup>

The remit of the board involves managing or supervising the management of the corporation. The board is at the apex of the firm's authority structure and, because the board represents the corporation, it is difficult to conceive of the board negotiating its remit and compensation with "the corporation". Thus, as Rock and Wachter observe, "[t]he corporate relationship is thus at the opposite pole from the trust or agency relationship – open ended in time and scope, transactionally intensive, and often involving physical assets that are illiquid and difficult to value. The corporate director thus needs more flexibility to deal with evolving events than does the trustee."<sup>76</sup>

In fact, corporate directors must be afforded extensive, almost complete, discretion, subject to their duties of care, loyalty and compliance, in exercise of their duties as such. Their powers to manage the business and affairs of the corporation are, in the first instance unlimited. This is recognized by the business judgment rule, which accords directors considerable discretion in exercising their judgment in making business decisions.<sup>77</sup> An investigation of this interesting but complex subject exceeds our present mandate, which, at present, is to situate the board of directors and individual directors within the hierarchy of the formal organization of the corporation and to explain their respective relationships with the corporation and with organizational subordinates.

In the result, for the purposes of taking action on behalf of the corporation, the board of directors represents the corporation and is its highest authority for the purpose of agency law. It is important in this regard, to maintain distinction between the legal role of the board of directors and the legal role of officers. As has been demonstrated, the role of the board, as a matter of statute law, is to manage or supervise the management of the corporation. Likewise, as a matter of statute law, the board may delegate, within prescribed limits, certain roles or functions to officers and other employees of the corporation. Generally speaking, the roles and functions of officers derive from such delegation by the board.

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<sup>75</sup> Rock & Wachter, *supra* note 66 at 665.

<sup>76</sup> *Ibid* at 666.

<sup>77</sup> The business judgment rule is discussed in Chapter Three, particularly in Part C – Shareholder Rights Beyond Voting and thereunder beneath the heading "Remedies of Shareholders and Others".

### ***Rights and Duties Differ from Trustees and Agents***

As discussed above, the board of directors may be seen acting both as the top-level actor (but not agent) of the corporation and as the embodiment of the corporation as principal in engaging (other) agents. As a matter of corporate law, when acting as the top-level actor of the corporation, it is logical that the board of directors have rights and duties somewhat similar to those of a trustee or agent, *mutatis mutandis*, in relation to the corporation, as principal. But as the only party capable of forming and giving expression to the will of the corporation with respect to matters of its ongoing management, the board acts in the capacity of, that is to say, as if it were, principal in relation to other agents of the corporation appointed by or pursuant to its authority and subordinate to the same. In effect, for most purposes, the Chief Executive Officer and other officers of the corporation act as highest-order agent of the corporation as principal, as represented by the board. Thus, the officers of the corporation, for most purposes, act as if the board was the principal.

Corporate law, which provides rights to the board of directors, also imposes liabilities, some of which rights and liabilities differ from those of the trustee in trust law or of the agent and agency law. As shown in Chapter A1, in most jurisdictions, these provisions are most extensive with respect to directors and officers.

It is noteworthy that the board has certain collective rights, duties and responsibilities and that each director has certain individual rights, duties, and responsibilities. For example, an oppression remedy may lie with respect to the past, present and possible future exercise of the powers of the directors, that is to say, collectively in many cases, although perhaps individual in some cases; yet the court may among other things, replace any of the directors, thereby applying a remedy which might be considered personal in nature with respect to actions taken by the board collectively. However, as noted above, an individual director has rights which are personal, such as the right to attend meetings of the board and the right to contest shareholder actions for his or her removal.

As the embodiment or personation of the corporation, however, it is the board of directors, rather than any individual director (unless authorized by the board), which acts, collectively, as the principal or as the highest-level actor on behalf of the principal, which is the corporation, vis-à-vis subordinate agents. This is recognized in many ways, including the requirement that individual directors disclose conflicts of interest to the full board, which is similar to the disclosure required

by agents to the principal.<sup>78</sup>The vesting of collective authority in a defined group of persons gives rise to a number of questions which cannot be permitted to detain us here, but all of which are discussed extensively in the respective literatures. These questions include: Why a board?<sup>79</sup> What historical and institutional factors may have attributed to the adoption of a model of collective exercise of authority?<sup>80</sup> What structure and processes do or should boards adopt in an effort to

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<sup>78</sup> For example, see the discussion of such disclosure by agents to their principals, by Dowrick, *supra* note 19 at 29ff.

<sup>79</sup> An excellent discussion of this point appears in Stephen M Bainbridge, “Why a Board? Group Decision-Making in Corporate Governance” (2002) 55:1 Vand L Rev 1; and in certain of his other writings, including: Stephen M Bainbridge, “Director Primacy: The Means and Ends of Corporate Governance” (2003) 97:2 Nw UL Rev 547; and Stephen M Bainbridge, “Director Primacy and Shareholder Disempowerment” (2006) 119:6 Harv L Rev 1735.

<sup>80</sup> Among the most useful discussions are: Franklin A Gevurtz, “The European Origins and the Spread of the Corporate Board of Directors” (2004) 33:3 Stetson L Rev 925; Franklin A Gevurtz, “The Historical and Political Origins of the Corporate Board of Directors” (2004) 33:1 Hofstra L Rev 89; Franklin A Gevurtz, “The Function of ‘Dysfunctional’ Boards” (2008) 77:2 U Cin L Rev 391.

discharge their responsibilities and functions?<sup>81</sup> Does board composition affect board performance?<sup>82</sup> Can improved board performance result in improved corporate performance?<sup>83</sup>

Whatever the origin, nature, and objective of collective action, however, there is no doubt that it is facilitated, among other things, by trust and respect among the directors. Accordingly, requirements such as disclosure of conflicts of interest, which apply to the individual directors, are intended, in turn, to facilitate such trust and respect. Of course, such disclosure also enables the

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<sup>81</sup> Useful literature on this subject includes: Ronald J Gilson & Reinier Kraakman, “Reinventing the Outside Director: An Agenda for Institutional Investors” (1991) 43:4 *Stan L Rev* 863; the foundational article by Benjamin E Hermalin & Michael S Weisbach, “The Effects of Board Composition and Direct Incentives on Firm Performance” (1991) 20:4 *Financial Management* 101 [Hermalin & Weisbach, “Effects”]; Lynne L Dallas, “The Relational Board: Three Theories of Corporate Boards of Directors” (1996) 22:1 *J Corp L* 15; Jill E Fisch, “Taking Boards Seriously” (1997) 19:2 *Cardozo L Rev* 265; Margaret M Blair & Lynn A Stout, “A Team Production Theory of Corporate Law” (1999) 85:2 *Va L Rev* 247; Donald C Langevoort, “The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability” (2001) 89:4 *Geo LJ* 797; Benjamin E Hermalin & Michael S Weisbach, “Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature” (April 2003) *Economic Policy Rev* 7; Lynne Dallas, “The Multiple Roles of Corporate Boards of Directors” (2003) 40 *San Diego L Rev* 781; Lynn A Stout, “The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance” (2003) 152:2 *U Pa L Rev* 667; Rakesh Khurana & Katharina Pick, “The Social Nature of Boards” (2005) 70:4 *Brook L Rev* 1259; Tamar Frankel, “Corporate Boards of Directors: Advisors or Supervisors?” (2008) 77:2 *U Cin L Rev* 501; Lawrence A Cunningham, “Rediscovering Board Expertise: Legal Implications of the Empirical Literature” (2008) 77:2 *U Cin L Rev* 465; US, Federal Reserve Bank of New York, *Corporate Performance, Board Structure, and Their Determinants in the Banking Industry*, by Renée B Adams & Hamid Mehran (Staff Report No 330) (New York: FRB of New York, 2008); and Lisa M Fairfax, “The Uneasy Case for the Inside Director” (2010) 96 *Iowa L Rev* 127.

<sup>82</sup> Useful contributions to this literature include: Victor Brudney, “The Independent Director – Heavenly City or Potemkin Village?” (1982) 95:3 *Harv L Rev* 59; Laura Lin, “The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence” (1996) 90:3 *Nw UL Rev* 898; the enormously influential article by Dan R Dalton, Catherine M Daley, Alan E Elstrand & Jonathan L Johnson, “Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance” (1998) 19:3 *Strategic Management J* 269; and Sanjai Bhagat & Bernard Black, “The Uncertain Relationship Between Board Composition and Firm Performance” (1999) 54:3 *Bus Lawyer* 921; Amy J Hillman, Albert A Cannella & Ramona L Paetzold, “The Resource Dependence Role of Corporate Directors: Strategic Adaptation of Board Composition in Response to Environmental Change” (2000) 37:2 *J Management Studies* 235; April Klein, “Audit Committee, Board of Director Characteristics, and Earnings Management” (2002) 33:3 *J Accounting & Economics* 375 (highly cited, finding that director independence improves financial monitoring); Amy J Hillman & Thomas Dalziel, “Board of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives” (2003) 28:3 *Academy Management Rev* 383; a very useful review article by Catherine M Daily, Dan R Dalton & Albert A Cannella, “Corporate Governance: Decades of Dialogue and Data” (2003) 28:3 *Academy Management Rev* 371; and Rachel A Fink, “Social Ties in the Boardroom: Changing the Definition of Director Independence to Eliminate “Rubber-Stamping” Boards” (2006) 79:2 *S Cal L Rev* 455.

<sup>83</sup> Among the useful contributions to this literature are: the foundational article by Bhagat & Black, *supra* note 82; the extremely widely cited and influential article by Mark S Beasley, “An Empirical Analysis of the Relation between the Board of Director Composition and Financial Statement Fraud” (1996) 71:4 *Accounting Rev* 443; the enormously important article by Sanjai Bhagat & Bernard Black, “The Non-Correlation Between Board Independence and Long-Term Firm Performance” (2001) 27:2 *J Corp L* 231; and an important article by David F Larcker, Eric C So & Charles CY Wang, “Boardroom Centrality and Firm Performance” (2013) 55:2-3 *J Accounting & Economics* 225 (arguing that well-networked directors may contribute to firm performance).

board of directors, collectively, to take the appropriate action to insulate it from any collective liability for its decisions, as well to protect such decisions for the benefit of the corporation.

The dissent rights of directors allow individual directors to “opt out” of collective responsibility for board decisions. However, strictly speaking, the legal liability for breaches of duty and entitlement to any defenses in respect of the same apply to each director individually. Thus, for example, disclosure of conflicts of interest by a director provides each director with some protection from liability individually, even though such disclosure of interest is provided to the board as a whole. In acting upon disclosure, however, each director may have individual liability based upon such director’s individual circumstances.

Consequently, indemnification of individual directors (and officers) is permitted, subject to certain limitations, but not required, under the corporate statutes surveyed above. This indemnification is in respect of the individual director’s participation in a collective action. Thus, corporate law recognizes the individual agency of individual directors while, the same time, recognizing that the individual director, as agent, unless authorized by the board, can take no action with respect to subordinate agents except in combination with other individual directors acting, collectively, as the board of directors.

In this regard, it is important to notice that much of the corporate essentialist discourse, including, unfortunately, some corporate legal essentialist discourse, elides, consciously or unconsciously, the board of directors, on the one hand, and officers and employees, on the other, into an undifferentiated concept of “management”. While this may be appropriate in many circumstances, it is important to differentiate the two as a matter of law, as the discussion the next section will illustrate.

## **The Role of the Chief Executive Officer and Other Top Management Team Members**

### ***Top Level or Superior Agents***

#### ***Appointment of CEO and Other Officers***

Our examination of the corporate statutes in Chapter A1 revealed that under the CBCA and OBCA, the directors designate the offices of the corporation, appoint officers, specify their duties, and delegate to them powers to manage the business and affairs of the corporation subject to certain



limitations prescribed in the statutes. Under the DGCL, the method of appointment of officers may be prescribed by the bylaws or by resolution of the board of directors.

Under the MBCA, the bylaws or the board determine the offices of the corporation; whose duties may be prescribed either by the board or to the extent permitted by the bylaws, by one or more officers; and such officers may be appointed accordingly. Of course, this permits the Chief Executive Officer or CEO of DGCL or MBCA corporations to appoint other officers directly; whereas under the Canadian statutes, the appointment of other officers is made, at least formally, by the board itself.

*Representation and Superior Agency – BOD and CEO Relationship*

Johnson and Millon argue that in a public corporation the directors do not exercise their statutory power to manage “because realistically, they cannot” and that and that, instead, the real management function is vested in others appointed by the board, as officers, who act under the board’s direction.<sup>84</sup> These officers act as agents of the corporation and, as such, are in a fiduciary relationship with the corporation. Having delegated management of the corporation to its corporate officers, as agents, the board, acting on behalf of the corporation which lacks human capacity, acting as governing body, must monitor and evaluate the performance of the persons to whom they have delegated management of the corporation.<sup>85</sup>

The effectiveness of the board in performing its role of monitoring the CEO and the TMT generally is, of course, affected by a number of factors, not the least of which are ability, time, and interest. As discussed in Chapter Five and following in connection with organizational aspects of the corporation, another significant determinant of the effectiveness of board monitoring is the information available to the board, its appropriate selection, scope, relevance, informed and fair presentation of alternatives, as well as other related factors. Such information not only assists in evaluating the merits of decisions at hand, but also assists in evaluating the decision making and other abilities of the CEO and the TMT. Unfortunately, a more thorough discussion of this interesting subject and literature is beyond the scope of the present work.<sup>86</sup>

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<sup>84</sup> *Supra* note 60 at 1607.

<sup>85</sup> *Ibid* at 1602.

<sup>86</sup> The considerable literature on the subject includes: Barry D Baysinger & Henry N Butler, “Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition” (1985) 1:1 *JL Econ & Org* 101; the usually influential and widely cited article Michael S Weisbach, “Outside Directors and CEO Turnover” (1988)

Acting as the “top-level representative of the firm”, in hiring and delegating certain management authority to agents, in this case, corporate officers, the board may likewise authorize those corporate officers to engage and delegate authority to lower-order agents, or sub-agents.<sup>87</sup> In agency law generally, whether an agent can engage one or more sub-agents is determined by the arrangements between the principal and the agent.<sup>88</sup> Dowrick indicates that an agent may not delegate his powers to a sub-agent without express authority to effect such appointment.<sup>89</sup> Within the context of the corporation, higher order agents may be expected to have such express authority. As noted previously, however, the broad management authority delegated to CEOs or to officers generally, may present some confusion concerning the role of such officers.

In view of the very broad range of authority normally delegated to CEOs, Orts says that “top executives in business corporations often play a dual role’, both as “top-level “superior agents” who have been delegated (by the firm’s shareholders and boards of directors) significant power and authority to act on behalf of the organization as a whole” and also “as the embodiment of the corporation itself as a “quasi-principal” for most business purposes regarding other internal agents as well as external third parties.”<sup>90</sup>

However, considering the CEO as a “quasi-principal”, as Orts suggests, may be considered as accurate only in the sense that an agent appointing any other subagent might be considered, for certain relevant purposes, or from a certain perspective, to be the principal with respect to such

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20:1-2 J Financial Economics 431; John W Byrd & Kent A Hickman, “Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids” (1992) 32:2 J Financial Economics 195; Randolph P Beatty & Edward J Zajac, “Managerial Incentives, Monitoring, and Risk Bearing: A Study of Executive Compensation, Ownership, and Board Structure in Initial Public Offerings” (1994) 39:2 Administrative Science Q 313; Beasley, *supra* note 83; Benjamin E Hermalin & Michael S Weisbach, “Endogenously Chosen Boards of Directors and Their Monitoring of the CEO” (1998) 88:1 American Economic Rev 96; Kose John & Lemma W Senbet, “Corporate Governance and Board Effectiveness” (1998) 22 J Banking & Finance 371; Nikos Vafeas, “Board Meeting Frequency and Firm Performance” (1999) 53:1 J Financial Economics 113 (finding that board meeting frequency is related to firm value); Hermalin & Weisbach, “Effects”, *supra* note 81; Biao Xie, Wallace N Davidson III & Peter J DaDalt, “Earnings Management and Corporate Governance: The Role of the Board and the Audit Committee” (2003) 9:3 J Corporate Finance 295; Adam C Pritchard, SP Ferris & M Jagannathan, “Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments” (2003) 58:3 J Finance 1087; and KV Peasnell, PF Pope & S Young, “Board Monitoring and Earnings Management: Do Outside Directors Influence Abnormal Accruals?” (2005) 32:7-8 J Business Finance 1311.

<sup>87</sup> This is discussed, in particular, above, in Part A entitled “Organizational Liability for Acts of Corporate Actors”, and below, in the present section, and, also, under the heading “Officer Status – Intracorporate Agency; citing leading discussants, including DeMott, Johnson and Millon, Kempin, Langevoort, and Orts.

<sup>88</sup> See e.g. Dowrick, *supra* note 19 at 40.

<sup>89</sup> *Ibid.*

<sup>90</sup> Orts, *Business Persons*, *supra* note 25 at 59. Strictly speaking, top executives are appointed by the shareholders only under statutes, and in cases, in which this is authorized by corporate bylaws.

subagent. Considering the CEO as “the embodiment of the corporation itself” effects an improper and unnecessary elision of board and CEO boundaries and functions. There is no doubt that Orts knows this, but is struggling with the familiar problems concerning the nature of the corporation as an incorporeal entity and the necessity of explaining how it can take action. This difficulty is compounded, of course, by the historical characterization of boards as appointed by, and subservient to, the CEO. As a matter of fact, and, importantly, as a matter of law, it is the board of directors which can properly be considered as “the embodiment of the corporation itself”.

Of course, when the corporation is treated as principal and the board is treated as representing or acting in the place of the corporation as principal in a principal-agent relationship, then when the board appoints the CEO or other officers directly, it may be argued that such appointees should be considered as a highest order, superordinate, or ultimate, agent of the corporation. As noted, characterizing the corporation as principal and the board as agent is highly problematic, unnecessarily complexifying, misleading, and fundamentally inaccurate.

#### *Complexity of BOD Role*

This work has argued that the board of directors animates and vivifies the corporation: it enables the corporation to act in a world of in which action is undertaken by individuals or human actors. It also represents the corporation or “re-presents” itself as, and on behalf, of the corporation to other human actors as the group of human individuals which identifies the corporation to those other human actors. As has been argued previously, the role of the board of directors vis-à-vis the corporation does not satisfy the requisites of an agency relationship. Hence, it is difficult to characterize the role of the board vis-à-vis the corporation as being an agent of the corporation, as principal.

#### **Comparison of Duty of Directors with Duty of Officers**

Chapter A1 shows that the CBCA and the OBCA do not distinguish between the statutory duties and standards of performance of directors, on the one hand, and officers on the other hand. The Delaware corporate statute does not deal with these matters in respect of officers at all, thus leaving these matters to, common law, and, in particular, to agency law.

Section 8.42 (a) of the Model Business Corporations Act imposes a duty on officers to act in good faith; with the care that a person in a like position would reasonably exercise under similar

circumstances and in a manner the officer reasonably believes to be in the best interests of the corporation. There is no express duty of loyalty. Accordingly, Johnson and Millon view this as “a statutory duty of care only. Violations of the duty of loyalty and other duties of an agent, therefore, are not governed by this statute. The statute essentially adopts a “reasonable care” standard of behavior.”<sup>91</sup>

Section 8.42 (d) provides, in effect, that the upon compliance with such standard the officer is not liable to the corporation or its shareholders, but also provides, in effect, that liability for noncompliance will depend upon applicable law, including the section 8.31 duty to deal fairly with the corporation and its shareholders. Johnson and Millon conclude that “[t]he reference to “applicable law” is murky. If “applicable law” means agency law - which it should – under established agency principles, the agent is clearly liable to the principal for any damage caused by the agent's breach of duty.”<sup>92</sup>

Subsection 1.40 (8) states that the term “employee” includes an officer but not a director; however “a director may accept duties that make the director also an employee”. In effect, a director, whether or not also an officer, may, in certain circumstances, be considered as an employee. An officer always enjoys both officer and employee status. Consequently, section 8.44 provides that appointment as an officer “does not itself create contract rights” nor does his or her removal or resignation from office affect contract rights as between the corporation and the officer.

### **Agency Law Duties**

As discussed above under the immediately preceding subheading “Top Level or Superior Agents”, while the CBCA and OBCA expressly impose duties of care, loyalty, and compliance on officers, as well as on directors, the DGCL imposes no such duties, while the MBCA imposes only a duty of care. In each of these cases, however, the common law, primarily by way of the law of agency, applies to officers, as well as the directors, in cases in which the relevant statute is silent, including without limiting the generality of the same, situations to which the statute does not expressly apply. Consequently, where the statutory limits of corporate law are not applicable to the relationships between the board of directors, individual directors, and officers, on the one hand, and the

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<sup>91</sup> Johnson & Millon, *supra* note 60 at 1633.

<sup>92</sup> *Ibid.*

corporation, on the other hand, it is frequently agency law to which resort is had for the legal principles relevant to the situation.

For example, an officer who is not a director who causes loss to the corporation by breaching the duties of care, confidence, or diligence, is subject to liability to the corporation on a standard of negligence.<sup>93</sup> However, the liability of a director, say of a Delaware corporation, arises only in cases of gross negligence, but subject to a deferential standard of review, the business judgment rule which requires a presumption that in making a business decision directors “acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”<sup>94</sup>

Of course, a comparison of the relevant statutory duties to the duties imposed by agency law and otherwise at common law leads inexorably to the conclusion that the principles enshrined in the statutes were based, not only on previous statutes as judicially interpreted, but also on agency law, and on the common law more generally. This relationship may complexify the interpretation of statutory duties, since the agency and other common law which are the basis of, or at least the background to, the duties adopted in the relevant statute, may not be identical with the terms of which such duties are expressed in the relevant statute. This may lead to interpreting statutory law against the background of the common law, not necessarily only in circumstances in which the statutory law is otherwise silent.

## **Officer Status**

### ***Internal and External Functions***

The officers who are directly appointed by the board (as “direct agents” or “highest level agents”) often cause the appointment of other officers who are formally appointed by the board of the CBCA and OBCA or, under the DGCL and MBCA, may actually appoint such other officers themselves (both of which may be distinguished from direct agents by referring to them as “second level agents” or “subordinate agents”).

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<sup>93</sup> Deborah A DeMott, “Corporate Officers as Agents” (2017) 74:2 Wash & Lee L Rev 847 at 862-63 [DeMott, “Corporate Officers”]. She specifically commends the article by Melvin A Eisenberg, “The Divergence of Standards of Conduct and Standards of Review in Corporate Law” (1993) 62:3 Fordham L Rev 437 at 448, as regards assessing the difference between standard of conduct and standard of review in the corporate context.

<sup>94</sup> *Aronson v Lewis*, 473 A (2d) 805 (Del Sup Ct 1984) at 812.

It has not always been recognized that officers act as agents of the corporation not only with respect to parties external to the corporation with whom the corporation deals as a legal entity, but also with respect to persons internal to the corporation who are, accordingly, part of its internal organization. This is recognized, for example, by Professor Kempin, who says that “the officers of a corporation, like the mythical Janus, face in two directions. On the one hand they function as a part of the internal organizational structure of a corporation” and “supervising subordinate officers and employees” in which capacity “they do not deal with persons outside the corporation. On the other hand, officers often have duties with regard to the world beyond the corporation. They purchase material for the corporation, negotiate for the purchase or sale of real property, hire and fire, borrow money, and enter into all the various kinds of contracts essential to corporate existence.”<sup>95</sup>

The distribution of such duties as between internal and external agency functions may vary significantly: “Internal management may be the sole duty of some officers. Other officers may have few internal responsibilities, since their primary function is to deal with third persons outside the corporation. Between these two extremes a given officer may have some internal and some external duties.”<sup>96</sup>

Professor Kempin considered that only the external activities constituted the officer as an agent of the corporation, observing that “considerable confusion of thought has resulted from the intermittent failure of courts and writers to separate these two entirely different and distinct functions of corporate officers”, which “omission is understandable because the term “officer” relates strictly to the internal management of a corporation, and of itself does not necessarily bestow agency power to deal with third persons.”<sup>97</sup>

He argues that when officers deal with third persons, “their agency powers do not derive from the fact that they are officers, but from specific agency power given them to deal with persons outside the corporation” and maintains that “for purposes of analysis it may be well to adopt the terminology used in *Rosenblum v. New York Central R.R. Co.* which referred to the agent-officer

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<sup>95</sup> Frederick G Kempin Jr, “The Corporate Officer and the Law of Agency” (1958) 44:8 Va L Rev 1273 at 1273.

<sup>96</sup> *Ibid.*

<sup>97</sup> *Ibid.*

as an "officer of the business" and the officer with purely internal powers as an "executive officer."<sup>98</sup>

This distinction may be merely semantic. In any event, as our discussion of the "executive function" in Chapter Six shows, almost a century ago, Chester Barnard, in his classic study of the subject from a management perspective, distinguished very clearly between executive functions and non-executive functions, in such a way as to suggest that executive functions are carried out by executive officers.<sup>99</sup> At the very least, it may be suggested that the distinction between executive and non-executive officers connotes some degree of seniority of the former over the latter.<sup>100</sup>

Certainly, common usage, at least in modernity, would support the views, firstly, that not all officers with purely internal powers are non-executive officers; and, secondly, that not all officers with purely internal powers are "executive officers". Accordingly, Kempin's definition of the term "executive officer" is not supported by more modern usage, Barnardian or otherwise, which often describes "executive officers" as performing policy-making functions.<sup>101</sup>

However, Kempin's distinction between "officers of the business" who act as external agents of the corporation, on the one hand, and executive officers or officers, with their internal function, on

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<sup>98</sup> *Ibid* 1273-74. Kempin's citation for the case is: *Rosenblum v New York Central RR Co*, 162 Pa Super 276, 57 A (2d) 690 (1948).

<sup>99</sup> Chester I Barnard, *The Functions of the Executive* (Cambridge: Harvard University Press, 1938).

<sup>100</sup> This distinction is also recognized in securities law, where the definitions of such terms tend to be related to the purpose and other relevant circumstances of the applicable provision. For example, an officer, under the *Securities Act*, RSO 1990, c S.5 is defined in section 1 (1) to include (a) a chair or vice-chair of the board of directors, a chief executive officer, a chief operating officer, a chief financial officer, a president, a vice-president, a secretary, an assistant secretary, a treasurer, an assistant treasurer and a general manager; (b) every individual who is designated as an officer under a by-law or similar authority of the registrant or issuer; and (c) every individual who performs functions similar to those normally performed by an individual referred to in clause (a) or (b). Although the terms "senior officer", "management", and "senior management" are used in that statute, for example in relation to authorization of press releases relating to material changes in section 75, Canadian Securities Administrators (CSA) Staff Notice 55-314 *Insider Reporting Exemptions* indicated that such provisions would rely, instead, on the term "officer", rather than the term "senior officer", which term included the five highest-paid employees of an issuer. See CSA, *CSA Staff Notice 55-314 Use of the Terms "Senior Officer", "Officer" and "Insider" in National Instrument 55-101 Insider Reporting Exemptions*, OSC CSA Notice, (2007) 30 OSCB 1606). That Staff Notice was withdrawn by NI 50 55-104, April 30, 2010, and replaced by National Instrument 55-104 *Insider Reporting Requirements and Exemptions*, effective February 1 2017, online at: <https://www.osc.gov.on.ca/en/14014.htm>. It continues, however, to rely on the term "officer". Where used therein, under s. 1.4 (1) and (2) that term has the meaning attributed to it under securities legislation.

<sup>101</sup> Canadian Securities Administrators, National Instrument 51-102 – *Continuous Disclosure Obligations* adopted by the CSA defines the term "executive officer" to mean, "for a reporting issuer, an individual who is (a) a chair, vice-chair or president; (b) a vice-president in charge of a principal business unit, division or function including sales, finance or production; or (c) performing a policy-making function in respect of the issuer". See *Continuous Disclosure Obligations*, NI 51-102, online at: [https://www.osc.gov.on.ca/en/SecuritiesLaw\\_51-102.htm](https://www.osc.gov.on.ca/en/SecuritiesLaw_51-102.htm).

the other hand, draws attention to the distinction identified in the present work between the corporation as a legal entity and the organization “within” the corporation which animates and vivifies it. It is Kempin’s executive officers, whom we would denominate simply as officers, who function, according him, “as a part of the internal organizational structure of a corporation”. Thus, he assumes that the actions of his agent-officers or his “officers of the business” are undertaken solely in relation to parties outside the corporation, such that they are not part of its internal organizational structure.

While Kempin’s distinction may have some analytical utility, the distinction is taken too far. If, as a matter of fact, his “agent-officers” are not part of the corporation’s internal organizational structure, then they would be unable to undertake their external functions which necessitate internal liaison. In fact, even mere external agents of the corporation, or outside the corporation, require some liaison, this time externally, with individuals who are part of its internal organizational structure. Furthermore, the internal agency function of “officers” and even of employees more generally is too important to be marginalized or under-emphasized by such terminological choices.

### ***Officers as Agents of the Corporation***

Interestingly, Johnson and Millon note that “[w]ithin the field of corporate governance, the undoubted legal status of corporate officers *as agents* is rarely noted. The agency status of officer seems to be far more significant to the issue of whether, in a particular case, officers have power to affect the corporation’s relationship with third parties than to the issue of fiduciary duties owed by officers, as agents, to their corporate principal.”<sup>102</sup>As previously argued in this work, and as further emphasized in the present and in the next subsection entitled “Intracorporate Agency”, an officer of the corporation is also ipso facto, an agent of the corporation, which is his or her principal.

Indeed, Johnson and Millon take pains to distinguish between the duties of the directors, as representative of the principal, and hence as fiduciaries, but not as agents, as compared with the fiduciary duties of corporate officers, which they incur by reason of acting as agents of the principal.<sup>103</sup> As already noted, we maintain that the board of directors, as such, is not an agent of

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<sup>102</sup> Johnson & Millon, *supra* note 60 at 1609 [emphasis in the original].

<sup>103</sup> *Ibid* at 1605-07, 1625-26, 1636-37.



the corporation and that an individual director acting solely in his or her capacity as a member of the board of directors is likewise not an agent of the corporation.

DeMott emphasizes this with her observation that “like any agent, an officer lacks discretion to ignore unambiguous directions receive from the principal” saying, also, that “as an agent an officer does not have a right unilaterally to redefine the scope of her authority.”<sup>104</sup> She points out that unlike directors, who have a duty of care, officers have duties of care, competence, and diligence and that the difference in these duties is “tied to the fact that officers, like other agents, are chosen on the basis of the skills and knowledge that they possess (or claim to possess), which range from highly specialized to very general.”<sup>105</sup> Of course, unlike directors, officers are able, at least notionally, to negotiate with the corporation concerning an applicable standard of performance with respect to performance of their duties.<sup>106</sup>

The officers who supervise subordinate officers and employees working in plants and departments of the corporation are, like those subordinate officers and employees, part of the internal organizational structure of the corporation. As discussed in Chapter Four, all such officers occupy “offices” in the Weberian sense.<sup>107</sup> However, those subordinate officers and employees are also persons, third parties to the corporation, with whom the corporation deals as a legal entity, through the instrumentality or agency of the board or some supervising officer. Again, this is recognized by Weber and by other organizational theorists.

In respect of such legal dealings, the subordinate officers and employees are, as a matter of law, external parties each of whom have their own legal rights and duties vis-à-vis the corporation. For example, employees may be subject to employment or collective agreements which make these legal rights and duties explicit and may amplify upon those otherwise applicable. Alternatively, their legal rights and duties may be determined by agency law and other common law principles. The corporative theory or corporate perspective adopted in this work assists in understanding these relationships.

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<sup>104</sup> *Supra* note 93 at 867.

<sup>105</sup> *Ibid.*

<sup>106</sup> *Ibid* at 869.

<sup>107</sup> Max Weber, *Economy and Society: An Outline of Interpretive Sociology* (Berkeley: University of California Press, 1978). In particular, see the discussion in Chapter Fourteen in Part A – Groups or Social Units under the heading “Max Weber on Organizations and Related Matters”.

Deborah DeMott acknowledges that the term “officer” generally identifies a person entrusted with “administrative and executive functions but not persons who lack “judgment or discretion as to corporate matters.”<sup>108</sup> She characterizes “officer” status as having both an “externally-oriented role as an agent” and “an internally oriented perspective”.<sup>109</sup>

She notes that the title or position held by an officer may create apparent authority in the holder to do acts conventionally associated with an officer holding a like title or position. However, a corporation, for its own purposes, may assign an officer’s title to an employee “either as an honorific reward or to enable the employee to perform specified tasks on the corporation’s behalf, despite the fact that the employee’s job duties and tell no executive or supervisory functions.”<sup>110</sup> This is also consistent with the corporation’s authority under most statutes to determine what offices and officers it will create.<sup>111</sup> In the result, characterization of employees as officers may not only create rights by the officer against the corporation but may also enlarge the corporation’s potential liability to third parties. The absence of a specific functional designation (such as “Vice President, Sales”) may negative the existence of actual or apparent authority to bind the corporation.<sup>112</sup>

When an officer, whether a direct agent or otherwise, engages or hires subordinate officers or employees on behalf of the corporation, questions may arise concerning the relationship of the subordinate officer or employee to the appointing agent, on the one hand, and to the corporation, on the other hand. This is discussed in the next section.

## **Intracorporate Agency**

### ***Hierarchies of Agents***

It is now recognized, however, that, as Langevoort says, “[a]lmost every corporate employee with discretionary responsibilities is an agent”.<sup>113</sup> Consequently, the legal relationships within the

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<sup>108</sup> *Supra* note 93 at 871-872, quoting A Gilchrist Sparks III & Lawrence A Hamermesh, “Common Law Duties of Non-Director Corporate Officers” (1992) 48:1 *Bus Lawyer* 215 at 216.

<sup>109</sup> DeMott, “Corporate Officers”, *supra* note 93 at 872-873.

<sup>110</sup> This is particularly common in the financial services industry.

<sup>111</sup> DeMott discusses a case in which an employee, who was a vice president, and therefore an officer under the corporation’s bylaws would be entitled to indemnification and advancement of legal expenses was prosecuted for theft and transfer of computer files belonging to the corporation to a competitor whom the plaintiff joined as an employee. *Ibid* at pp. 873-876. See *Aleynikov v Goldman Sachs Group Inc*, 765 F (3d) 350 (3d Cir 2014).

<sup>112</sup> *Ibid* at 875-876.

<sup>113</sup> *Supra* note 22 at 1191. The position of employees without discretion is not relevant to the present discussion.

corporation's organization and hierarchy can be considered as a series or hierarchy of agency relationships.

This characterization is important because, as we have seen, declaratory corporate law, considered as statutory law only, deals explicitly only with the rights and duties of directors and officers of the corporation vis-à-vis the corporation, who are at the very top of the organizational hierarchy, implicitly leaving the rights and duties of other employees and agents, namely, those at the many lower levels of the organizational hierarchy, to be dealt with as a matter of common law, principally agency law. While such agency law may sometimes be supplemented by, or even conflict with employment agreements, collective agreements or other contracts, and even other statutes, sometimes agency law alone will be relevant to, and hence determinative of, the respective rights and obligations of the corporation and the employee or agent.

Donald Langevoort's laments that "To many legal academics, agency law is a backwater subject, long banished from the formal law school training except for brief introductory reference in corporations or business associations." This is in spite of the fact that agency law "permeates an extraordinary amount of everyday law, applying anyplace that one person (the agent) agrees to act on behalf of another (the principal) to carry out the principal's affairs under the principal's control. It covers most employment relationships, and a good bit else."<sup>114</sup> To like effect, Deborah DeMott observes that "[a]gency has not enjoyed much fashion within the legal academy in recent years."<sup>115</sup>

Yet, agency law is critical to the operations of a corporation. As Langevoort suggests, it is pervasive in the context of employees and officers of corporations. In a corporate hierarchy, there may be a very long series of levels in the "organizational chart" depicting successive levels of agents engaged by the corporation who are appointed, directly or indirectly, by or on behalf of the board of directors acting as the representative of the corporation, as principal. A question may arise as to whether a sub-agent appointed or engaged by, or reporting to, a higher-level agent has duties and responsibilities to the higher-level agent by whom he or she is appointed in addition to duties and responsibilities to the corporation, as the principal. This question may arise even where the

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<sup>114</sup> *Ibid* at 1188-89.

<sup>115</sup> Deborah A DeMott, "When Is a Principal Charged with an Agent's Knowledge?" (2003) 13 *Duke J Comp & Intl L* 291 at 318 [DeMott, "Agent's Knowledge"].

sub-agent is hired, appointed, or engaged, by or through a human resources department of the corporate principal.

As some of the examples below will indicate, this question is not insubstantial or inconsequential. It is but one example of what Langevoort calls “problems that involve the *interaction* among multiple agents – “systems” or team production problems – [which] are the ones where the simple application of agency law rules will most likely disappoint or confuse. When these systemic interactions go to the heart of the firm’s actions and how it is governed, agency law becomes too blunt an instrument.”<sup>116</sup>

In this regard, it is important to note that the corporate organizational structure normally has both vertical and horizontal dimensions. Thus, the complex structure of agency relationships is affected not only by hierarchical, or vertical, ordering but also by ordering horizontally, which often is effected in terms of function, product, or geography, and but may be ordered otherwise. Thus, the personnel within the organization are interacting not only with different levels of agents and sub-agents, variously appointed, but also with agents and sub-agents operating, for example, in different functions, with respect to different products, or in different geographic areas. The importance of effective and efficient delegation of authority and responsibility is obvious. This is particularly the case that the scale and scope of the corporation’s operations is extended or attenuated.

Consequently, Eric Orts maintains that “[l]aw explains the relationship of authority, power, and hierarchy in firms... [t]he essence of agency’s authority, power, and hierarchy”<sup>117</sup>, to such extent that “[w]ithout legal agency, business firms of any complexity are impossible.”<sup>118</sup> Accordingly, Orts argues that “[f]irms of more than one person are better described not as a nexus of contracts, but as a *nexus of agency relationships*.”<sup>119</sup>

### ***Agency Beyond Contract, and Agency Chains***

Orts also argues that legal agency, while most often created through a special kind of contract, is something more than a contract. “A contract alone does not create the open-ended relationships of

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<sup>116</sup> Langevoort, *supra* note 22 at 1231 [emphasis in the original].

<sup>117</sup> *Supra*, note 28 at 273.

<sup>118</sup> *Ibid* at 274.

<sup>119</sup> *Ibid* at 299 [emphasis in the original].

agency authority characteristic of most business firms”, in which employer and employee enter into “an agency relationship that extends beyond the explicit terms of the employment contract.”<sup>120</sup>

That legal agency is more than a contract is also indicated, he says, by the fact that “agency authority inheres in the board of directors” as a matter of corporate law “even for participants who join after the corporation is formed”, by which he must mean something like “after the contract establishing the corporation is agreed”. Orts also argues: “Firms are more than a matter of contracts because of the importance of the relationships of authority and power among principals and agents organized within a business entity.”<sup>121</sup> Of course, as seen from our review, authority and power are endemic in agency relationships.

Langevoort identifies a problem with agency law in the context of the corporation, inasmuch as “agency law itself has not systematically been evaluated to see whether, or how well, its black-letter rules fit when the principal is an organization and the problem under consideration operates that agency’s shared border with corporation law.”<sup>122</sup> The present work can attempt only a preliminary review of the discussion of that subject.

An analysis of the agency relationships within the corporation indicates the presence of an iterative scheme in which agents appoint subagents recursively, with the frequency and to the extent considered appropriate. Eric Orts observes that agency law and corporate law allow for the creation of “agency chains”, including “superior and subordinate co-agents” and “subagents” within the firm structure.<sup>123</sup>

Orts derives support from Deborah DeMott, the academic reporter for the Restatement, who says that “[m]ultiple agencies focused on the same agent, create multiple chains of imputation, attribution, and duties. Multiple agency chains may run parallel or may intersect and create conflicting duties to one degree or another.”<sup>124</sup> Demott’s remarks, of course, focus on the lawyer as agent for various clients, however, her comments are also appropriate to a situation which an individual person within a corporation functions as agent or sub-agent for various other individuals. Her description is particularly apt for the situation in which an individual has several

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<sup>120</sup> *Ibid* at 273.

<sup>121</sup> *Ibid*.

<sup>122</sup> *Supra* note 22 at 1189.

<sup>123</sup> *Supra* note 25 at 58. See also Orts, “Shirking and Sharking”, *supra* note 28 at 280-82.

<sup>124</sup> Orts, *Business Persons*, *supra* note 25 at 58, quoting DeMott, “Lawyer as Agent”, *supra* note 1 at 308-09.

reporting relationships, each in different capacities, as discussed under the immediately following heading.

Orts argues that subagents, including agents who are subordinate to superior agents, often owe allegiance to the same principal (by which he may mean the same “superior agent” or, perhaps, the firm itself), and says that to account for these more complex agency relationships, the law of agency recognizes that firms act as “organizational principals.”<sup>125</sup> In addition, of course, corporations and other business organizations may enter into agency relationships that are external to the firm and, hence, outside its strict legal boundaries.<sup>126</sup>

### *Agents for the Corporation, and Agents for Higher Order Agents*

Like the present work, but unlike many economic and other commentators, Orts does attempt to construct some kind of legal framework for the corporation’s internal legal structure. As DeMott points out, this internal legal framework may involve chains of agency relationships, whereby certain agents appoint sub-agents who in turn appoint lower-level subagents, and so on, which becomes extremely complex.

Ultimately, of course, all of the agency appointments relate to the same principal, at the apex of all these agency relationships, namely, the corporation, whose authority reposes in the board of directors. Although all of the agents and sub-agents may ultimately act on behalf of the same ultimate principal, the corporation, each may also be the agent or subagent, as the case may be, of a superior agent or subagent within the corporation whose authority that individual represents, and on whose behalf such individual acts in exercising his or her rights, duties and responsibilities.

In some cases, an employee may be appointed as agent or sub-agent of more than one superior agent. For example, someone employed in a particular department or function of the corporation may be posted to some other country and may be appointed to the department or function in that country by both a superior member of the department or function, acting as a superior agent, and to the other country by the “country head” or “regional head” or designee, again acting as a superior agent. Thus, the employee may have two titular superiors and, indeed, two superior agents to whom

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<sup>125</sup> *Supra* note 25 at 58.

<sup>126</sup> *Ibid* at 61.

the employee may owe duties, although subordinate to the employee's overall duties to the corporation, as the ultimate principal. This will be discussed later as "matrix reporting".

For example, Langevoort says that "every corporate agent has a duty of disclosure: the interesting questions are of what and to whom."<sup>127</sup> Normally, an employee would be required to report "the chain of command" to "his or her immediate superior in the chain of authority created under the direction of the board."<sup>128</sup> In the case posited, a question arises as to whether the employee is required, as an agent of the corporation, to report to both superior agents or to only one of them; and whether the employer is required, in the capacity as a sub-agent of each superior agent, to report to each of them.

In organizations denominated as "matrix" organizations, this is common. In some cases, one of the superior agents may be recognized as having an authority over the employee which is superior to that of the other superior agent. However, the "ultimate principal" is always the corporation itself. The cascading chains of agency relationships, when considered in relation to parallel cascading chains, and sometimes even longitudinal relationships or chains of relationships, may be described as a kind of "waterfall" or "cascade" of agency, authority, and responsibility.

Accordingly, in view of this complexity, it is perhaps not surprising that many legal theorists and commentators do not "drill down" into the principal-agent hierarchy within the corporation in this manner. Despite such reticence, it is clear that those principal-agent relationships may be analyzed, generally, as a matter of agency law, and, in some cases, as a matter of corporate law.

Of course, the legal relationships of principal and agent just described are just that: legal relationships. They are legal relationships that are established and exist in right of the corporation as a legal entity. Quite apart from legal relationships, there may also be other relationships that relate to the structure, processes, and personnel of the organization, both formal and informal.

### ***Agency Relationships, and Organizational Placement***

For example, considering some five levels of hierarchy of principal and agent relationships, from principal A to agent E and considering only the issue of actual authority, the authority which may be exercised at each level may be dependent, in part, upon such legal issues as the manifestations

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<sup>127</sup> *Supra* note 22 at 1210.

<sup>128</sup> *Ibid.*

and known objectives of each higher-level principal as known to the agent and, if not known to the agent, as might be interpreted by a reasonable person in the position of the agent, including circumstances in which the agent has notice and taking into account the fiduciary duty owed to the principal, as required under section 2.01 of the Restatement. The complexity of this analysis is further exacerbated by formal and informal organizational considerations.

As discussed under the heading “Hierarchies of Agents” above, the agency relationships within the organization engage both vertical (i.e. hierarchical) and horizontal dimensions. Actual, as well as apparent and ostensible, authority of the subject agent may be determined by his or her placement on the horizontal agency axis, as well as on the vertical agency axis. For example, if the horizontal axis gives effect to functional differentiations, a very simple organizational structure might differentiate among production or operations, finance and accounting, sales and marketing, and human and other resources might consider as being ranged from numbers 1 to 4 inclusive. It can readily be seen that the 5 hierarchical levels and the 4 functional spaces result in a matrix of some twenty basic (that is to say, direct, as between immediately adjacent locations) principal-agent relationships.

These rights and obligations of agency law apply, quite apart from the corporate law embodied in corporate statutes, unless and to the extent varied by the same, to directors, officers, employees, and other agents of a corporation. Consequently, as noted above, it cannot simply be assumed that a corporate statute exhausts the capacity of the law to affect matters relating to the internal organization of the corporation. These include matters that relate to corporate legal essentialism.

To mention but one important such instance, in order for the corporation to act as one party or legal entity vis-à-vis outsiders, and since the corporation can act only by and through human agents, some natural person must take action on its behalf with respect to a third party, say, entering into a contract. So acting calls into operation the principles of agency law. While some principles of corporate law may be involved in determining whether or not the putative agent acted with real authority, an investigation into the legal structure proceeding from the board to officers to lower levels of management ending with the putative agent will not be determinative of whether contractual relations with the third party have successfully been engaged. In addition to such matters, which may be quite relevant to actual authority, other principles of agency law, including



those relating to ostensible or apparent authority, affect whether or not the corporation is bound, as a matter of law, with respect to such third party.

An additional example of how agency law may apply to a corporation may be as follows. An individual employee of the corporation may have information that bears on a particular transaction, proposed or actual. In such case, the knowledge of the employee may be imputed to the principal. This may have the effect that another employee lacking such knowledge makes a decision to opposite effect from the decision that he or she would have made if in possession of such knowledge. Because the knowledge of the “knowing” employee is imputed to the corporate principal and thence to the second “transacting” employee, the relevant knowledge, although unknown to the second transacting employee, may be attributed to the corporation. One effect of such imputations is to reduce incentives to structure an organization “so that knowledge of bad facts is isolated to agents who are not otherwise implicated in the organization’s dealing with a third party.”<sup>129</sup>

Another useful example that presents itself is one in which the actions of two employees of the corporation vis-à-vis the same third party contradict each other. For example, one may affirm and another may deny the existence of a contract. In that case, the inquiry into actual legal authority may not be determinative. For example, one employee may have authority over the other. If that fact was or should have been known to the third party (which will be determined as a matter of agency law), the actual legal authority of one vis-à-vis the other may determine whether or not legal relations arose. In that regard, actual authority may be significantly affected by matters of corporate statutory law. But otherwise, agency law alone will provide the relevant legal principles for the determination of whether a contact has or has not come into being.

### ***Agency Relationships in Law as Distinctive***

It is worth being emphatic on this point. What determines the legal effect of actions of natural persons acting as agents of the corporation vis-à-vis the relationship between the corporation and a third party is the law of agency, not the concept of agency as employed by economists, political scientists, sociologists, philosophers, or others. The legal meaning of the term “agent” is much more circumscribed than the term as used in ordinary speech to indicate someone who acts on

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<sup>129</sup> See DeMott, “Agent’s Knowledge”, *supra* note 115 at 317-18. DeMott also discusses the situation in which the agent appointing a sub-agent is fixed with the knowledge and intention of the sub-agent. *Ibid* at 295-296.

behalf of another; while the legal concept of agency involves the person having authority to act on behalf of such other.<sup>130</sup>

The concept of agency in each of these disciplines and fields are, no doubt, worthy of respect within each such discipline or field, and may be worthy of some consideration and deference in the legal discipline or field. Importantly, they may be key elements in assessing the ways in which agency law should develop. However, such concepts, as used in other disciplines or fields, are not, as such, relevant to the determination of whether, as a matter of agency law as it exists today, and applying its principles and practices in a “legal” manner, a contract has arisen as a result of contract between a corporate agent and a third party.

As explained previously at a more general level, the lexicon and grammar of various disciplines and fields may be considered to be heterogeneous. Each discipline and field has its own vocabulary and rules of using its language. The words “type”, and “group”, and “family”, and “household”, to mention but a few such examples, have different meanings in one discipline or field from another. Developing a perspective on, or theory of, the nature of the corporation as a matter of law requires paying attention to the necessity of such discriminations. As noted above, corporate essentialism in law may be sensitive to corporate essentialist discourse in other disciplines and fields, but is, and should be, more sensitive to corporate essentialist discourse in law, here denominated as corporate legal essentialist discourse.

The analysis presented in Appendix B concerning common assumptions of economics and other disciplines and fields relating to the corporation will prove that such assumptions are highly susceptible to contestation, and, further, that they are not appropriate for immediate “translation” into legal discourse, and, in particular, corporate legal essentialist discourse, without considerable “linguistic” understanding, whereby the “translator” may be informed as to the differences in grammar, syntax, historical usage, and other linguistic characteristics. As noted previously, it is necessary not only to find the appropriate vocabulary in the legal field, but also to recognize differences in how the grammar of law and that of, say, economics, differ. To do otherwise is to invite, and, even more, to commit to, ambiguity, misunderstanding, and error.

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<sup>130</sup> Of course, this point is made by many legal authors. Dowrick does so in substantially these terms. *Supra* note 19 at 35.

## **Liability and Indemnification of Directors, Officers, and Others**

As has been maintained here repeatedly, corporations can act only through human agents. With respect to contracts, as discussed above, where the agent has actual authority, a contract entered into by an agent binds the corporation. As noted in section 6.01 of the Restatement and in the official comments on that section, an agent of the corporation acting with actual or apparent authority binds the corporation, but not themselves personally, to contracts. However, the principal may seek recovery from employees who enter into contracts exceeding their authority, in breach of express or implied terms of the contract between the corporation and the corporation, as noted in Restatement section 8.07.

Under section 8.09 (1) of the Restatement, an agent has a duty to take action only within the scope of the agent's actual authority and, under section 8.09 (2), to comply with all lawful instructions of the principal concerning the agent's actions on behalf of the principal. Thus, officers and other employees may be held liable for breaching instructions from the principal. As to such matters, Orts finds that "In these cases, courts tend to defer to business participants and the internal arrangements of authority within the firm" which often involves not attempting to recover damages "from a manager or employee who simply made a mistake in exceeding his or her authority. Rather than suing their own agents, most firms prefer self-help remedies, such as dismissing, demoting, or otherwise internally sanctioning the offending agent."<sup>131</sup>

Among other things, when the employer corporation takes proceedings in accordance with the contract, the other contracting party may not know that the agent's authority was exceeded or that that the agent was disciplined as a result. Where the corporation exercises internal discipline alone, the limits of such authority are thus not necessarily revealed to outside parties who may be enabled thereby to take such information into account in subsequent dealings. In this way, the legal relations (and even expectations) of the corporation with outside entities may not be affected by the employment internal discipline, however much its intracorporate or intraorganizational relations may be so affected. The position of the corporation with respect to directors and officers is discussed further below.

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<sup>131</sup> Orts, *Business Persons*, *supra* note 25 at 148.

As discussed above and in section 7.03 of the Restatement, the corporation may be subject to direct or vicarious liability where the agent has actual or apparent authority for tortious acts within the scope of employment. In some cases, both the corporation and the employee may be subject to joint liability in accordance with legal agency principles.<sup>132</sup> As Orts notes, firms may act to protect executives, managers and employees by allocating the risks of such liability primarily to the corporation by way of indemnification agreements and insurance.<sup>133</sup> In most cases, as he says, an agent who acts without authorization and in a manner that does not benefit the corporation is not entitled to indemnification under agency law. However, agency law,<sup>134</sup> as well as corporate law in some jurisdictions, permits indemnification for damages and expenses in connection with actions taken on behalf of the corporation.

Unlike agency law, many of the corporate statutes reviewed do not provide for mandatory indemnification, apparently for reasons of policy. As indicated in Chapter A1 above in the section entitled “Indemnification of Directors”, while the CBCA and the OBCA permit the corporation to indemnify directors and officers, the DGCL and the MBCA also permit it to indemnify other employees and agents. Subsection 145(a) of the DGCL permits a corporation to indemnify a person “if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful.” Section 8.51 of the MBCA is to similar effect. However, section 8.52 of the MBCA requires a corporation to indemnify a director “who was wholly successful, on the merits or otherwise, in the defense of any proceeding to which the director was a party because he or he or she was a director of the corporation”.

Indeed, arguably section 102 (b) (7) of the DGCL goes even further, for it permits the articles of incorporation to contain a provision “eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty” except for breach of the duty of loyalty, acts or omissions not in good faith, acts or omissions which involve intentional misconduct or a knowing violation of law, unlawful payment of dividends or unlawful

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<sup>132</sup> *Ibid.*

<sup>133</sup> *Ibid.*

<sup>134</sup> For a review, see Deborah A DeMott, “Indemnification and Advancement Through An Agency Lens” (2011) 74:1 Law & Contemp Probs 174 at 177; and Joseph W Bishop Jr, “Current Status of Corporate Directors' Right to Indemnification” (1956) 69:6 Harv L Rev 1057 at 1065.

stock purchases, or for any transaction from which the director derived an improper personal benefit.

Allowing the articles to eliminate or limit the financial consequences of breaches of fiduciary duty may, of course, be seen as typical of what many characterize as the “pro-management” stance of the Delaware statute generally. It is also possible, however to see it as permitting corporate constituents to allow directors to take levels of risk in pursuance of the corporation’s objectives which others, in part due to lack of information, might consider excessive. It is apparent that the exceptions from personal liability which apply despite provisions in the articles to contrary effect relate to the relationship between individual directors, as members of the group representing the corporation (albeit normally disempowered from acting individually), and the corporation, as principal. They apply separately to each individual director.

### **Conclusion - The Intracorporate Organization of the Corporation in Law**

#### ***The Corporation as Legal Entity, and as Legal Actor***

This Part One of the book has considered the essential, characteristic, or paradigmatic attributes of the corporation as adopted in certain leading corporate statutes. For the purposes of discussion, we have identified these as separate legal entity status; limited liability or asset partitioning; transferable equity interests and capital lock-in; central management Independent of “owners”; and indefinite duration or longevity. The chapters of the book up to this point have examined the ways in which these essential legal attributes have been given effect in such statutes to matters relating to the structure and processes of the corporation. They have also examined certain aspects of the common law, principally relating to agency law, which form part of the background of, and, in many cases, supplement, the interstices of statutory corporate law.

In this regard, these chapters have demonstrated that the corporation, as an idea and abstraction, is reified and instituted by means of declaratory law, both statutory and common law, and principally, in the common law, agency law, as a legal entity (that is, as a rights-and-duty bearing entity) possessing certain attributes; which legal entity is, however, dependent upon real or actual individual persons to act on its behalf or, as one may say, to instantiate itself, or perform acts on its behalf, in the real world and among other real or actual individuals. In this regard, Part One of the book has demonstrated how the paradigmatic legal attributes of the corporation have impacted the construction and institution of its structure and processes as a matter of statutory corporate law.

The thoroughgoing assignment of responsibility for determining the actions of the corporation, that is to say, managing or supervising its management, to a board of directors constitutes the board as the primordial actor in its ongoing day-to-day activities and also thereby constitutes the board as the representative of the corporation for such purposes. As demonstrated in this part of the book, such board of directors is subject to fiduciary duties, as its highest order representative, for which it is accountable to the corporation; and each director is also subject to fiduciary duties for which he or she is accountable, individually, to the corporation.

In this regard, the present chapter has considered how the corporation as a legal entity is enabled to take action. Accordingly, it surveyed the ways in which the corporate statutes selected for examination specify and concretize the rights and duties of the board of directors, of individual directors, and of individual officers, in their capacities as actors for, or on behalf of, or as agents of, the corporation.

Such rights and duties are generally consistent, with appropriate variations, in the case of the board and individual directors, with trust law, agency law, and the common law generally; and, in the case of officers, with agency law and the common law generally. As demonstrated here, the statutory principles of corporate law are also broadly consistent with agency and common-law principles relating to extra-corporate, that is to say, external or extrinsic, actions of agents, as well as intracorporate, that is to say, internal or intrinsic, actions of agents.

### ***The Law, Management of the Corporation, and the Corporate Actor***

The present chapter has also demonstrated the scope and flexibility of statutory corporate law in terms of the legal structure and processes of the corporation. Statutory corporate law engages at the highest structural and processual levels, namely, with respect to the board and its committees and officers, and is generally silent otherwise, implicitly leaving lower-level structural and processual issues to be dealt by means of higher-order structure and process, and by related agency and other common law.

As the corporate law form has become dominant as the principal legal form through which business enterprises conducted, so has the corporation become primary context in which agency law is applied in the contemporary business environment. Thus, as the statutory domain of directors' and officers' duties is sought to be applied or is considered as inapplicable, perhaps because its limits have been exceeded by the activities in question, the law of agency, together with other common

law, asserts itself as applying in the instant circumstances. The legal or other reader of judicial decisions must constantly bear in mind that the relevant boundaries, those between the statutory corporate law and other declaratory law, and the one hand, and those of agency and common law, on the other hand, may not always be clearly enunciated in judicial decisions, opinions, and commentary.

The present chapter has demonstrated that, whatever the role of individual directors and of individual officers in law, as a matter of law, the board of directors as a whole does not act as agent for the corporation as principal. Some of the consequences of this conclusion have been mentioned previously, however, the consequences of this conclusion with respect to corporate essentialist discourse can hardly be emphasized too forcefully. It is particularly important to attend to this before reviewing assumptions and generalizations, and in corporate essentialist discourse.

Quite simply, the concepts of agency, principal, and agent, and otherwise arising in the law of agency, much of which is not declaratory law but, instead, is, common law, are distinct from the concepts to which the same nomenclature is applied in other disciplines and fields. The relationships of agency, including the status and consequences of being denominated as principal or as agent, have specific and precise meanings in law. Those specific meanings are not necessarily common as among legal and non-legal disciplines or fields.<sup>135</sup> As recommended by the descriptivist methodology adopted in the present work, it is necessary to investigate the meanings attached to those terms outside of the legal environment and within the particular non-legal environment under review.

### ***The Law, Corporate Action, and Equity Owners***

As also demonstrated here, the shareholders of the corporation are possessed of certain rights, including rights relating to participation in its management, which are, however, principally limited to selection and oversight of directors and to approval or disapproval of certain fundamental transactions proposed by the directors. These aforementioned rights are supported by certain rights to information relevant to such matters. In exceptional circumstances, rights to

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<sup>135</sup> An excellent example of effective integration of legal and non-legal discourse concerning agency law is an article by an economist and business professor, Eric Rasmusen, *supra* note 33. Rasmusen closely consults both the Restatement of Agency, and the Restatements relating to other areas of law, as well as American case law and legal literature, in analyzing the economic efficiency of the common law of agency, concluding, at page 406, that it is "generally sensible in terms of economic efficiency".

initiate corporate actions and to oppose certain corporate actions, are provided statutorily. Also, in exceptional circumstances, appraisal and other rights provided statutorily seek to remedy inherent disadvantages of capital lock-in and transferability of equity interests.

The availability of derivative actions in certain circumstances provide a sort of “safety valve” against a board of directors which is considered to have failed its agency responsibilities to the corporation. While the statutory remedy of derivative actions permits a court to “interfere” in the assignment of management responsibility in this regard, the oppression remedy, by its terms, permits a court to “re-write” or realign arrangements among corporate participants on a “wholesale” or thoroughgoing basis. This affords an opportunity for courts to adopt and apply the corporative perspective advocated in the present work.

The writer is unaware of any significant endeavours to demonstrate the relative correspondence between statutory agency and common-law agency principles, or, the analysis of paradigmatic corporate attributes, in the fashion undertaken in this chapter and otherwise in the present work. Perhaps this is in error, in which case the contribution of the present chapter and present work may only be to organize discussions of these other subjects around a common central, in this case, corporative, perspective. As argued here, applying an empirical, verifiable, testable perspective to a description of the phenomenon of statutory corporate law may alone make some contribution to the analysis of such subject-matters.

## **CONCLUSION – PART 1 - GOING BEYOND PRESENT ASSUMPTIONS AND LAW**

### **The Corporation and Descriptivist Methodology**

The introduction to, and Part 1 of, this work have advanced a methodology denominated here as empirical or “descriptivist”. This work has proceeded, initially, by “describing” the corporation and the statutory framework of the corporation as observed “in the real world”. It has identified assumptions upon which theories of the “firm” or the “corporation” as an economic actor are thought to be based or which seem to be fundamental to such theories. These assumptions will be criticized in more detail in the following chapters.

Our descriptivist methodology has then proceeded to describe the statutory framework of the corporation as implicating its internal structure and processes considered from a legal perspective, and has identified the common law, and most notably agency law, background against which these



structural and processual “fundamental” elements have been developed and which apply in circumstances not specifically the subject of determination otherwise. Based upon our review and critique of assumptions, principally economic, and more particularly those derived from classical and neoclassical economic theory, the present work will propose a theory, described here as “corporative” theory or as evidencing a “corporative perspective”, the explanatory power of which can be assessed, tested, and developed empirically, against “real world” phenomena.

### **Descriptivist Derivation of Theory of the Corporation**

This descriptivist derivation of theory, notably, legal theory, and more especially, corporate legal theory, is notable in its differentiation, developmentally, from purely abstract theorization. Some support for this approach is provided by Herbert Hart, in his inaugural lecture as Professor of Jurisprudence at Oxford, *Definition and Theory in Jurisprudence*, delivered on May 30, 1953.<sup>136</sup>

Hart argues that when legal theories “spring from the effort to define notions actually involved in the practice of a legal system, they rarely throw light on the precise work they do there”<sup>137</sup> Instead, as Orts says, Hart’s argument is that beginning in this fashion, abstracted from the “practical reality of corporate law”, risks failing to describe the phenomenon sought to be defined. Further, “Inevitably, ideological baggage appears on the ground floor of any corporate theory if the first question asked is ‘What is a corporation?’”, according to Orts, and words like “corporation” are often neutral as between competing theories.

In the result, “corporate theorists who prefabricate various versions of “the corporation” separate themselves from the world of practice and “stand apart with their heads at least in the clouds”, Orts argues.<sup>138</sup> Accordingly, says Orts, “Hart brushes aside unhelpful debates, such as whether a firm is “a mere abstraction, a fiction, a metaphysical entity,” and he calls for closer attention to “the legal rules of the game” about how terms such as the “corporation” are actually used and what legal consequences follow.”<sup>139</sup>

Hart’s perspective on the nature of the corporation supports the present work’s “descriptivist” method of proceeding, which, broadly speaking, seeks to identify the attributes of the “corporation-

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<sup>136</sup> HLA Hart, “Definition and Theory in Jurisprudence” in HLA Hart, *Essays in Jurisprudence and Philosophy* (Oxford: Clarendon Press, 1983) 21.

<sup>137</sup> *Ibid* at 25.

<sup>138</sup> *Ibid*.

<sup>139</sup> *Supra* note 25 at 17.

in-use” or the “corporation-in-action” rather than the attributes of some “corporation-in-theory”, before then proceeding to theorize concerning the corporation and its instantiation and operation “in the real world”. The methodology of the present work, which is referred to herein as “descriptivist”, rather than the more common but highly contestable term “empirical”, may be considered to employ observation to generate a working description or definition of the corporation, which might be considered to relate to the corporation-in-use, as it describes or defines what is commonly the referent of the term “corporation”.

### **Definition and Theorization of the Corporation**

In this respect, Hart is found by Orts to maintain that “descriptions of these legal concepts and practice are required, rather than beginning from abstract attempts at philosophical definitions. Hart follows the legal theorist James Bryce in arguing that some “fundamental legal notions could perhaps not be defined, only described”.<sup>140</sup>

Instead of separating the exercise of theorizing the corporation from the world of practice, this work attempts to “throw light on the precise work” that the term “corporation” actually performs in the practice of a legal system, rather than separating our theorizing from the world of practice and “stand[ing] apart with [our] heads at least [and possibly more, as Hart hints] in the clouds.” Most importantly, of course, this work attempts to avoid impractical definitions that occlude, like clouds, perceptions otherwise possible, and possibly even veridical.

According to Orts: “Beginning with a definition or theory of the corporation is not especially helpful because the idea of a corporation is a complex one that presupposes a legal system. To say “corporation” is not like saying “chair” or “dog.” The reality to which “corporation” refers is more complex than an easily identifiable material thing or animal, and any attempt to force a preconceived theory on a complex legal reality results in what Hart calls “contrivances varying with tastes.” The idea of the corporation is complex precisely because it involves various relationships that presuppose the rules and principles, and methods of enforcement and compliance that compose a legal system. Describing the corporation, therefore, should not begin with a definition of what a corporation is.”<sup>141</sup>

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<sup>140</sup> *Ibid* at 108.

<sup>141</sup> Eric W Orts, “The Complexity and Legitimacy of Corporate Law” (1993) 50:4 Wash & Lee L Rev 1565 at 1572.

What this argument attempts to show is that a simple definition of the term “corporation” cannot be generated by virtue of the complexities which attend its attributes and the background to those attributes. These issues were considered by John Dewey in his magisterial article *The Historic Background of Corporate Legal Personality*.<sup>142</sup> Dewey identifies one type of definition “inherited from Greek logic reflecting a definite metaphysical conception regarding the nature of things”, which type of definition “proceeds in terms of an essential and universal inhering nature.”<sup>143</sup>

Dewey identifies a second mode of definition “which proceeds in terms of *consequences*” in which “a thing is –is defined as – what it does, “what – it – does” being stated in terms of specific effects *extrinsically* wrought in other things. This logical method was first stated by Charles S. Peirce as the pragmatistic rule: “Consider what effects, which might conceivably have practical bearings, we conceive the object of our conception to have. Then, our conception of these effects is the whole of our conception of the object”.<sup>144</sup>

To the extent that the present work employs a definition of the term “corporation”, it does so in the latter sense. As Dewey himself indicates, “the mode of definition, however, has no inherent dependence upon pragmatism as a philosophy except incidentally and epistemically.”<sup>145</sup>

### **Descriptivism and Theorization in This Work**

Instead of proceeding by definitional fiat to identify that which is a corporation as matter of abstract legal theory, this work examines its “meaning in use”, that is to say, what the signification of the term “corporation” is to drafters, interpreters, and users of corporate law statutes. It asks, as do linguistic and analytical philosophers: what it is that we mean by, or call, a corporation? What are the essential legal characteristics of that which we call, in law, a corporation?

Such a question is clearly one which is appropriate to the discipline or field of law; and may be expected to have a meaning in use in such discipline or field that differs from that in which the same term might (or might not) be used in other disciplines or fields. This is also true of other associated terms or concepts such as agency, whose meaning in law is quite distinct from that in which the same word is employed in economics, to mention but one example.

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<sup>142</sup> John Dewey, “The Historic Background of Corporate Legal Personality” (1926) 35:6 Yale LJ 655.

<sup>143</sup> *Ibid* at 660.

<sup>144</sup> *Ibid* at 660-661 [emphasis in the original], citing Charles Peirce, *Chance, Love, and Logic* (New York: Barnes & Noble, 1923) 45.

<sup>145</sup> *Supra* note 142 at 661.

Furthermore, this work has sought to explain how the essential characteristics of the corporation relate to each other, in principle, and as principles that are essentially “legal” principles, as well as in corporate law statutes (again, purely as matters of law), and to relate both of these areas of discussion to other common law and legal theory, including principles of agency law.

In order to prepare the way for a legal and organizational analysis of the nature of the corporation, denominated here as a corporative approach to, perspective on, or theory of, the corporation, it is necessary to identify, analyze, criticize, and, to some extent, circumscribe certain assumptions and concepts of economic theory, principally emanating from classical and neoclassical economics, that perpetuate confusion and error with respect to the legal theorizing of the corporation. To that task our attention now turns.

**APPENDIX B:  
WHY THIS?  
ASSUMPTIONS ABOUT THE CORPORATION**

**SECTION A:  
ASSUMPTIONS ABOUT THE ECONOMY, AND SOCIETY, THE POLITY, AND THE  
STATE AS SPHERES OF ACTION**

**INTRODUCTION - THE CORPORATION IN DISCOURSE**

A brief recapitulation of some of the discussion above may assist in appreciating the objectives of this part, and this chapter, of the book. Part 1 of the book, together with Appendix A, examines corporate law and corporate governance regimes adopted by the statutes and model statutes and other declarative law of leading Canadian and American jurisdictions. Proceeding from a description of the attributes which are generally agreed to be the essential, characteristic, defining, identifying, or paradigmatic attributes of the modern business corporation as set forth therein, Part 1 and Appendix A, examine the instantiation of those attributes in those statutes and other declarative law.

Part A of Chapter One denominated those attributes as “essential legal attributes of the corporation” or “essential attributes of the corporation in law” and those attributes, collectively, as “corporate legal essentialism”, distinguishing those terms from, in the first case, essential non-legal attributes and, in the second case, from non-legal and corporate essentialism. It also averted to the discussion of essential legal attributes of the corporation, denominating this as “corporate legal essentialist discourse” or, for the purposes of this work, which relates only to the corporation, “legal essentialist discourse”, and averted to the discussion of “essential” attributes of the corporation in non-legal discourse as “corporate essentialist discourse”.

Part A discusses the methodology of the book as a whole, which involves identifying and investigating the essential legal attributes of the corporation their instantiation in significant instances, in Part 1 and Appendix A of the book, followed by an investigation of corporate essentialist discourse, not limited only to legal essentialist discourse, in Part 2 of the book and in this Appendix B, which supplements Part 2. As indicated in Chapter One, much corporate essentialist discourse emanates from classical and neoclassical economics and, in consequence, is often not significantly “legal” in its nature; as a result of which, much corporate essentialist discourse is not easily translatable to legal essentialist discourse and much legal essentialist discourse is not easily translatable to corporate essentialist discourse emanating from non-legal

fields. As discussed there, barriers of terminology, frames of reference, subject matter disciplines and perspectives, methodology, and accepted investigatory procedures, and others, all complicate such translations or mappings.

In fact, corporate essentialist discourse of a non-legal nature is relatively limited in comparison with “firm essentialist discourse”, namely, non-legal discourse relating to the “firm” generally, including sole proprietorships, partnerships, limited partnerships, and other business forms, and is not limited to, or distinguished from, the corporation as a legal entity. Often, such non-legal discourse does not distinguish among the legal forms just mentioned by which “the firm” carries on business. Often, firm essentialist discourse is considered in relation to legal essentialist discourse without adequate consideration of these direct or indirect limitations. This is frequently the case with respect to assumptions or generalizations of classical and neoclassical economics.

Especially important in this regard is the realization that those assumptions or generalizations of classical and neoclassical economics do not generally reach a level of specificity which would facilitate their comparison, readily, easily, or generally, against legal essentialist characteristics. Lest it be thought that such difficulties of comparability might be a consequence of the directionality of comparison, it should be noted that the direction of comparison could proceed by taking each element of legal essentialism and asking what assumptions or generalizations of classical and neoclassical economics, or some other discipline, can be brought to bear to understand each element of legal essentialism, as well as those elements collectively. Such comparisons may be more useful in some cases, and at some levels of generalization, than with others. In many cases, identifying, assessing the salience of, and operationalizing points of comparison present substantial difficulties.

Part 2 of the main text and this Appendix A to the main text demonstrate, however, that perhaps the highest level of correspondence is found with respect to the “single legal entity” attribute. That is to say, the corporation, as a single legal entity, may be analyzed as an economic actor, as a social actor, or as a political actor, both internally and externally; and, correspondingly, may be analyzed as the situs of economic, social, and political action.

The question discussed in Part 2 and this Appendix, then, is what assumptions are conventionally made, explicitly or implicitly, in, or in relevant discourse concerning, Anglo-American law and legal theory about the corporation, particularly the modern business corporation or MBC. The

judgment made in this regard concerning the existence of such conventions is, necessarily, not only subjective but conclusory. The assumptions to which reference is made below are those which seem to underlie theoretical literatures and public discussions concerning the nature of the firm and the corporation, their role in the economy, society, and the polity, and in the statutory, regulatory, common law provisions relating to any of the foregoing.

Part 1 of this book demonstrates, however, that the statutory law governing the formation and governance of the modern business corporation does not expressly adopt any specific legal theory of the corporation or economic theory of the firm. Instead, it is notably agnostic in these respects. It treats the corporation as a single legal entity or “rights-and-duty bearing” entity having certain other defining characteristics, including limited liability and asset partitioning, transferable equity interests and capital lock-in, central management independent of ownership of “owners”, and indefinite and possibly unlimited duration. This may be said to be the “legal theory” that is enshrined in the corporate statutes.

To be sure, there is no doubt that the creation of the corporation as a legal entity represents a “concession” granted by government, the society, and the polity, as posited by “concessionary theory”; and that the corporation as a legal entity may be affected by legal contracts, norms, and practices and might, therefore, be described as the situs, network or nodal centre, point of connection or “nexus” of such legal contracts, norms, and practices, as posited by the “nexus of contracts” theory; that participants in the corporation combine as a team to produce goods or services and may negotiate the terms of their participation, as posited by “team production” theory; that the corporation is affected by various stakeholders within and without the corporation, as posited by “stakeholder” theory; and that the incorporators and other participants “combine” themselves or certain aspects of themselves, in social certain respects, as the corporation, as posited by social organism theory as held by Gierke and other late nineteenth century German theorists. However, as demonstrated above, statutory corporate law does not expressly or manifestly indicate its adoption of, or reliance upon, any such theory.

The agency law adopted in the statutes affecting the relationship between the board and the corporation, and between individual directors and officers and the corporation is likewise more or less agnostic as to the legal theory of the corporation or the economic theory of the firm. The same

may be said of concerning the relationships of other management and employee personnel to superior agents and to the corporation.

If not apparent in the statutory corporate law, then, the influence of assumptions of corporate legal theory of the corporation and of economic theory of the firm may be sought in purely theoretical discussions or in practical discussions seeking to characterize practical matters from a particular theoretical perspective. Such discussions may arise in respect of policymaking, drafting statutes and regulations, applying the same in a regulatory context, and in judicial consideration, both generally and in particular instances. Thus, such assumptions may arise in respect of both positive law statutory provisions and in respect of the common law.

Furthermore, certain aspects of securities law and practice, and attitudes of securities law regulators may be said to adopt these assumptions of microeconomic theory and, especially of the economic theory of the firm. The same may be true with respect to the judiciary, especially in jurisdictions such as Delaware and in other jurisdictions having particularly highly developed corporate and securities law courts, benches, or individual judges. Most significantly, of course, such observation applies with respect to the legal professoriate and the legal academic world more generally. Even those credited with developing or acting as leading proponents of such theories, such as Blair and Stout with team production theory, often express those “legal” theories in the language of economics and the economic theory of the firm and otherwise adopt such principles.

This work maintains that: in the main, the assumptions commonly made in academic and other discussions concerning the legal nature of the corporation and the theory of the corporation and the firm are not assumptions of law or of legal theory at all, but are, instead, assumptions of classical and neoclassical economics; such assumptions are of a purely theoretical and largely unverifiable nature; are generally not subject to empirical verification or to generating hypotheses that are empirically testable; and are largely unsupportable, or, at the very least, are highly contestable, empirically, and even logically. This conclusion arises from examination in this and the following chapters.

Advancing and critiquing these assumptions must necessarily involve: firstly, asserting the particular assumption or generalization; secondly, displaying and discussing its instantiation in various explications, whether by different authors or by different schools of interpretation; and thirdly, of course, criticizing the assumption or generalization and related claims. Consequently,



both expository and critical narratives will be set forth in this Part. Undertaking this work will therefore require significant references to and explanation of various literature.

As previously noted, this work does not set out to prove that each of the assumptions and generalizations is either, on the one hand, completely and irrevocably veridical or, on the other hand, completely and irrevocably erroneous. Instead it aims to examine the issues critically and, where appropriate, to cast doubt on the veracity of those assumptions, on their explanatory and predictive capacities, and on their efficacy for the purposes of understanding, and regulating, the behaviour of modern business corporations.

The transmogrification of economic theory and assumptions into assumptions of law and legal theory requires some affirmation of the merit of so proceeding beyond the mere assertion of the same. As is well known, even the language and procedures of economic theory are significantly distinct from those of legal theory to such an extent as to be productive of great confusion and consternation if not translated from that of the economic field into that of the legal field. All of these considerations complexify the project of generating a descriptivist account of the legal theory of the corporation which can be used to generate a working hypothesis or working hypotheses which can be verified and tested “in reality”. The difficulties attending such transmogrification will be demonstrated in this and the following chapters.

The extent to which such assumptions may be said to so underlie such positive and common law provisions and such theoretical and other discussions may vary according to various circumstances, including temporal, and the particular instantiations under discussion. However, broadly speaking, these assumptions may be explicated in several dimensions, the first of which are those related to the relationships among the economy, the society, the polity, and the state.

### **ASSUMPTIONS EXAMINED**

Certain assumptions of economic theory that have influenced Anglo-American law and legal theorizing concerning the modern business corporation relate to the relationships among the economy, society, the polity, and the state. These relationships will be explicated below.

As noted in Chapter One, this work reviews five principal assumptions in this regard:

1. Economic roles and functions are intrinsically distinct from other functions in a society or polity.

2. The economy engages, overlaps with, or is part of, the “private” sphere. It is fundamentally “private” in nature; as opposed to “public” in sense of being intrinsically related to its ambient society or polity. In such private sphere, parties interact with considerable freedom, largely by way of contract in the case of economic matters. Such contracts, relating to matters between the parties, are essentially private, and unaffected by public interests.
3. The private sphere is intrinsically separate and distinct from the public sphere. Matters of public interest include the constitution of the political entity or state, and any subdivisions, the manner of its exercise of authority, and any limitations on it, elections, regulation of crime, and protection of certain human, political or social rights, including economic rights, welfare rights, and the authorization and exercise of distributive or redistributive functions, such as taxation and provision of public goods and services. The economy does not engage those matters sufficiently directly to be considered other than as part of the private sphere.
4. The economy, as such, can be analyzed in a manner which is distinctive to it, and to the private sphere.
5. The economy, while related to the ambient society and polity, is distinct from, and operates intrinsically independently of, such society and polity.

### **CHAPTER B1:**

#### **ASSUMPTIONS ABOUT THE ECONOMY, AND SOCIETY, THE POLITY, AND THE STATE AS SPHERES OF ACTION**

##### **ASSUMPTION ONE - SEPARATION OF ECONOMIC, SOCIAL, AND POLITICAL FUNCTIONS**

As noted, the first assumption to be discussed is the assumption that, although the economy has some relationship to its social and political environs, the economy, that is to say, the production of goods and services for present or future consumption, is intrinsically distinct from other aspects of the social and political life of a given society or polity. Society, the economy, and the state are thus considered as separate and distinct categories for purposes of analysis. Economic activity is considered to take place in a distinct notional “place”. The economy is considered to constitute a separate “sphere” of activity.

The identification of economic activity as a field or sphere of activity separate and apart from other activities, including social and political activities, and of “the economy” as the agglomeration of

economic activities (which will suffice as a definition for present purposes) is one of ancient vintage, as is discussed below. This distinction has been a subject of discussion since ancient Greek and Roman times. Although the validity of this distinction has been the subject of considerable dispute, from time to time, it has been conceded relevance in the theory of the firm and, as borrowed therefrom, in the law and legal theory relating to the MBC. The merits of such distinction are discussed further below, in relation to assumption five. However, some preliminary remarks may be in order.

### **Origins of the Economy and the State - Archaeological and Historical Evidence**

As discussed, this work has adopted a descriptivist or empirical approach to analyzing the corporation. As such, it has examined the attributes of the corporation under statutes “creating” the corporation. In effect, this investigates the corporation “in the real world” in terms of what it is and what it does. This approach is also consistent with an analytical or linguistic philosophy approach which asks, in effect, what it is to which we refer when we refer to the corporation.

Consistent with this approach, this work now examines the attributes of the economy, society, and the polity, state, or government “in the real world” in terms of what each is and does. Although the scope of this book does not permit an in-depth consideration of sources from various disciplines, some empirical and historical perspective can be obtained from archaeological and anthropological investigations of the historical origins of the economy, society, and the polity, state or government. Such investigations demonstrate their origins and interrelationship almost six thousand years ago.

For reasons of economy and authority, the discussion under this heading will make extensive references to two leading authorities, namely, Professor Elman Rogers Service, and Professor Henry T. Wright. In 1977, Professor Wright, an investigational anthropologist, published a review article entitled “Recent Research on the Origin of the State”,<sup>1</sup> in connection with the centenary of the publication of Professor Lewis Morgan’s influential *Ancient Society*.<sup>2</sup> Wright’s discussion of the origins of government relied on Service’s *The Origins of the State and Civilization*,<sup>3</sup> which considered archeological evidence of state emergence in archaic civilizations.

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<sup>1</sup> Henry T Wright, “Recent Research on the Origin of the State” (1977) 6 Annual Rev Anthropology 379.

<sup>2</sup> Lewis H Morgan, *Ancient Society* (Cambridge: Harvard University Press, 1964).

<sup>3</sup> Elman Rogers Service. *Origins of the State and Civilization* (New York: Norton, 1975).

Wright observes that Service's focus is on the origins of "government", which Service defines as "a bureaucracy instituted to rule a populace by right of authority", treating a bureaucracy as a hierarchy of offices. Government begins with the first institutionalization of centralized leadership in "chiefdoms." According to Service, societies in this evolutionary stage "have centralized direction, hierarchical status arrangements with an aristocratic ethos, but no formal legal apparatus of forceful repression". Such societies use political power to organize the economy, but as "a redistributive, an allocative system, not an acquisitive system".<sup>4</sup>

While the state, for Service, originated with the use of force as an institutionalized sanction, he found that existing data concerning archaeologically attested archaic civilizations, did not indicate that the origin of the state was necessarily accompanied by forceful repression.

Wright explained that "[a]fter considering many cases of the development of institutionalized government, both ethnohistoric and archaeological, Service presents a series of conclusions" concerning "some general conditions which all efforts to explain state origins must take into account."<sup>5</sup> The most relevant conclusion for present purposes is that "[i]ntensification of production, and in particular irrigation agriculture, long precedes state emergence as a technique of local production units and only becomes a major focus of societal investment and higher political concern after state emergence."<sup>6</sup>

Service, says Wright, concluded that even the simplest society periodically requires its more esteemed members to act as leaders; that leadership becomes a regular activity when it is linked to the pooling and redistribution of commodities; that a chiefdom emerges when the office of leader comes to be regularly filled, typically by inheritance; and that the gradual progress of archaic civilizations shows that a state has emerged (from a chiefdom) when coercion is used in the society to correct "chiefly" failures.

For Service, then, and for Wright, even the emergence of a chiefdom is linked to pooling and redistribution of commodities, an activity generally described as economic in its nature. Their research on ancient societies led both of them to conclude, further, that the emergence of a state occurs after the intensification of production, especially agricultural production; and that after the

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<sup>4</sup> Wright, *supra* note 1 at 380. References are omitted from quotations from this work.

<sup>5</sup> *Ibid.*

<sup>6</sup> *Ibid.*

state emerges, activities that further intensify production become a major focus of societal investment and higher political concern.

For them, a chiefdom involves a central decision-making authority that is “differentiated from, though it ultimately regulates, decision-making regarding local production and local social process; but is not itself internally differentiated. It is thus externally but not internally specialized.”<sup>7</sup> Wright cites one example, in Hawaii, in which the flow of goods resulted from producing a surplus to local needs, primarily to enable central elites to demonstrate their elite status, and in which threats to subsistence resulted either in rebellions to replace the chief or war in order to acquire more resources. In either case, we might describe these as economic motivations.

For Wright a state is characterized by decision-making that is more differentiated, being specialized internally, with the result that “[i]n contrast to a developed chiefdom, a state can be recognized as a cultural development with a centralized decision-making process which is both externally specialized with regard to the local processes which it regulates, and internally specialized in that the central process is divisible into separate activities which can be performed in different places at different times.” This creation of a central process and division and specialization of its components has an important consequence: “Aspects of decision-making can be delegated with minimal fear that subordinate elements in the hierarchy will engage in effective independent action. Indeed, the dominant political strategy in higher-order decision-making is to encourage as much hierarchy and segmentation as possible in order to create contexts of organic solidarity.”<sup>8</sup> Wright explains that “[w]ith the wealth of regulatory capacity in a state development, the control of many local units and the administration of exchange economies or redistribution from pools of sustenance products is not difficult.”<sup>9</sup>

Wright clearly links the emergence of the state and economic activity. He also notes that conducting exchange and redistribution operations requires planning, and obtaining and verifying information. By way of example, he references the construction of irrigation canals in the state of Larsa in the right of King Sumuel about 1880 B.C. where, to eliminate falsification and distortion of information, information was obtained from independent, as well as official, sources, and cross-

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<sup>7</sup> *Ibid* at 381.

<sup>8</sup> *Ibid* at 383.

<sup>9</sup> *Ibid*.

checked, supplemented by regular and independent inspections involving complementary activities of two separate sets of officials.<sup>10</sup>

Wright finds that states differ from chiefdoms in many ways, including regulatory pattern, regulatory strategy, hierarchical structure, and oscillation of hierarchical pattern in time, many of which differences are archaeologically detectable and may enable specification of when the state emerges in any particular situation.<sup>11</sup> Relying on such archaeological evidence, he places the emergence of the state (within his definition, above) generally in Greater Mesopotamia at the beginning of the Uruk Period approximately 3700 B.C., almost two millennia earlier than the reign of Sumuel of Larsa.<sup>12</sup>

He concludes that the evidence indicates that “an administration controlled the movement of goods from production points to assembly points and thence to central points for aggregation and subsequent redistribution”<sup>13</sup> in a large area comprehending northern Iraq, Ancient Assyria, and southwestern Iran, Ancient Elam:

What social units did Uruk administrative networks control? Each had a major center in an agriculturally rich area, within which was a network of smaller administrative centers and production centers. Production in these networks was differently organized. For example, while some settlements seemed to be primarily concerned with agriculture and moved their products through central pools into redistribution networks, parts of central settlements were concerned with ceramics production and moved their products to agricultural settlements by nonredistributional means. The major centers, furthermore, controlled small centers in distant areas, some of which had special resources and some of which were on important travel routes.<sup>14</sup>

Wright says that research has defined the period of state emergence in Greater Mesopotamia and that, despite limited evidence, researchers have suggested that similar developments attended the development of the primary state in Mesoamerica.<sup>15</sup>

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<sup>10</sup> *Ibid* at 384-85, citing Stanley D Walters, *Water for Larsa: An Old Babylonian Archive Dealing with Irrigation* (New Haven: Yale University Press, 1977).

<sup>11</sup> Wright, *supra* note 1 at 385.

<sup>12</sup> *Ibid* at 386.

<sup>13</sup> *Ibid*.

<sup>14</sup> *Ibid* at 387 [citations omitted].

<sup>15</sup> *Ibid* at 393.

In effect, according to Wright, archaeological evidence concerning the origin of the state demonstrates that economic functions were not separate from organs of the society and the polity; instead, the development of the state (and even chiefdoms) was closely linked to the economy of the society concerned. For present purposes, the demonstration of these interrelationships based on archaeological evidence must suffer, for the time being, as “proof” of the same. This is consistent with the descriptivist and empirical methodology adopted in this work. Also consistent with this approach is the next step to which we now turn: identifying concepts of the state which may be expected to have differing degrees of utility in generating working and testable hypotheses.

### **Conceptions of the Polity, the State, and Government**

Certainly, the state can be conceptualized as distinct from both the economy and society, and arguably, even from the polity. Again, for reasons of economy, it is convenient to refer, extensively, to a useful 1984 review essay, entitled “Approaches to the State: Alternative Conceptions and Historical Dynamics”, by Stephen D. Krasner.<sup>16</sup> Krasner adopted the categories of conceptualization of the state identified in the literature by Roger Benjamin and Raymond Duvall, being: 1. The state “as government,” by which is meant the collective set of personnel who occupy positions of decisional authority in the polity.” 2. The state as “public bureaucracy or administrative apparatus as a coherent totality” and as an institutionalized legal order. 3. The state as ruling class. 4. The state as normative order.”<sup>17</sup>

Krasner concluded at that time, that, while certain political scientists, often following Dahl<sup>18</sup>, adopted the first position<sup>19</sup>, “[t]he dominant conceptualization in the non-Marxist literature is the state as a bureaucratic apparatus and institutionalized legal order in its totality.”<sup>20</sup>

As to the first view, Krasner, notes that “Benjamin and Duvall have referred to this formulation as “the state as the government” which treats the state as merely a collection of individuals who

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<sup>16</sup> Stephen D Krasner, “Approaches to the State: Alternative Conceptions and Historical Dynamics” (1984) 16:2 *Comparative Politics* 223.

<sup>17</sup> He cites Roger Benjamin & Raymond Duvall, “The Capitalist State in Context” [unpublished manuscript, archived at University of Minnesota] at 4-4 to 4-8, which later appeared as “The Capitalist State” in Roger Benjamin & Stephen L Elkin, eds, *The Democratic State* (Lawrence, Kan: University Press of Kansas, 1985); 19-57.

<sup>18</sup> Robert Dahl, *Who Governs?: Democracy and Power in an American City* (New Haven: Yale University Press, 1961).

<sup>19</sup> Krasner mentions as an example and discusses Eric Nordlinger, *On the Autonomy of the Democratic State*, (Cambridge: Harvard University Press, 1981).

<sup>20</sup> *Supra note* 16 at 224.

occupy role positions (those of governing authority) and who act as a group to govern. In this formulation, “[i]nstitutional imperatives and constraints, including general political beliefs, do not play a significant role... The pluralist universe is atomistic. Different societal groups and political leaders have different objectives and political resources. Public policy is the outcome of the resolution of vectors resulting from interests and resources. Formal, authoritative institutions are of little importance.”<sup>21</sup>

Such a construct must place the individuals and groups who constitute “the state as government” within the society or polity. The “state as government”, acting in that capacity, asserts control over matters within its purview. Because the outcome of vectors resulting from interests and resources is contingent, we would argue that the coalition of interests and resources that attains a successful outcome may, and in very many cases, will, often vary from time to time.

Thus, in this formulation, “the state as government” identifies a function, and directs attention to those who from time to time participate in its exercise (with different degrees of effectiveness), instead of attributing exercise of that function to a separate set of institutions of public bureaucracy or administration. Thus, “the state as government” is not a completely discrete function, group, or organization within the larger society or polity.

Krasner’s description of the pluralistic universe of society and the polity as “atomistic” does not necessarily entail that the human individual is the subject “atom”, as is often the case with economic characterizations, which purport to treat each human individual as a separate and distinct economic actor. Instead, Krasner’s unit of analysis, the ground-level category for many political purposes, is the societal group. The subject of this “atomism” and the appropriate unit of analysis as such “atom” will recur in various contexts below.

As against this, a “statist” orientation may be considered to posit more of a divide between the society or polity and the state, as “[s]tatist orientations take institutions and political beliefs more seriously. The political universe is not atomistic. Atoms are bound within stable molecules and compounds. The preferences of public officials are constrained by the administrative apparatus, legal order, and enduring beliefs. There are only a limited number of ways in which political actors can combine their resources. The nature of political resources is itself defined by institutional

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<sup>21</sup> *Ibid* at 227.



structures. The ability of a political leader to carry out a policy is critically determined by the authoritative institutional resources and arrangements existing within a given political system”.<sup>22</sup>

For Krasner, “[a] second distinction between sophisticated pluralist and statist views is that pluralism does not sharply differentiate public actors from their own society. Dahl's unit of analysis most closely related to the state is the political stratum, composed of subleaders and leaders. Members of the political stratum possess more political resources than ordinary citizens. Some of these resources are drawn from the public arena, including legality, but most derive from the society, including control over jobs and information. Individuals carry many of these resources with them both in and out of public office. Many important members of the political stratum never hold public office at all.”<sup>23</sup>

In effect, Dahl does not see political actors as sharply differentiated from their own society, nor the resources to which they have access as emanating otherwise than from the society. Consequently, for pluralists, public officials are relatively more constrained by societal pressures. On the other hand, “[s]tatist perspectives contrast individuals in and out of public office. Political leadership is closely related to official position. The administrative apparatus and legal order constrain preferences and provide means of influence. Political leaders are state actors pursuing either particular state goals or collective societal objectives and utilizing resources primarily derived from their official positions.”<sup>24</sup>

Krasner says that the third distinction “is that pluralist theories of leadership see public officials as relatively more constrained by societal pressures...The ability of leaders to alter the preferences of citizens depends upon the extent of agreement among leaders, and this in turn depends in large part on the degree to which they are drawn from the same "social strata." Only a coherent leadership cadre can change the desires of citizens.” Statist orientations, he says, “see political leaders as less constrained by societal forces. They can alter preferences using the state's own resources. They may even be able to change the distribution of political resources possessed by societal groups.”<sup>25</sup>

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<sup>22</sup> *Ibid* at 228.

<sup>23</sup> *Ibid*.

<sup>24</sup> *Ibid*.

<sup>25</sup> *Ibid*.

Krasner concludes that while the pluralist tradition in America has not entirely ignored the role of political leaders, “it has seen these leaders as being substantially constrained by societal forces, commanding resources that are derived from a wide variety of public and private sources, and functioning in a fluid, institutional environment which has a limited impact on the power and interests of actors.”<sup>26</sup> A statist perspective accords much more scope to leadership. He argues that some statist positions consider ideology not only as an instrument of governance, but as a goal of governance. Thus, “[i]deology may not only coordinate expectations and delineate legitimate modes of interaction between state institutions and societal actors, but it may also serve as a basic source of identity, and its preservation may be a consummatory function of the state. One of the critical purposes of the state is to represent symbolically the existence and unity of the political community.”<sup>27</sup>

Seeing the political community as a source of identity for its members, and seeing the state as having a role in enhancing and preserving that source of identity does not commit one to either of these approaches to the nature of the state. However, it does commit one to recognizing a relationship among society, the polity and the state, as do both the pluralist and statist approaches.

### **Economic Institutions and the State**

We have found that the archaeological evidence demonstrates that the origin of the state is rooted in economic and social functions, and that that modern conceptions of the state recognize the relationships among society, the polity, and the state, embracing economic and other matters. Such relationships continue to obtain in modernity, as discussed in this section and following.

In his important 1996 article, “Markets as Politics”<sup>28</sup>, Neil Fligstein examined the relationship between economic institutions and the state, noting: “One implication of my metaphor, “markets as politics,” is that states play an important role in the construction of market institutions. Why are states so important? The organizations, groups, and institutions that comprise the state in modern capitalist society claim to make and enforce the rules governing economic interaction in a given geographic area. Capitalist firms could not operate without collective sets of rules governing interaction.” He concludes that “modern capitalist states have been constructed in interaction with

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<sup>26</sup> *Ibid* at 229.

<sup>27</sup> *Ibid* at 228.

<sup>28</sup> Neil Fligstein, “Markets as Politics: A Political-Cultural Approach to Market Institutions” (1996) 61:4 *American Sociological Rev* 656.

the development of their economies, and the governance of economies is part of the core of state-building.”<sup>29</sup>

Fligstein claims that local context determines the extent and direction of state intervention into the economy, the content of laws, and their applicability to given firms and markets. By adopting and enforcing laws concerning property rights, governance structures and rules of exchange, states “provide stable and reliable conditions under which firms organize, compete, cooperate, and exchange” and under which stable markets can develop. He says that “it is likely that states are important to the formation and ongoing stability of markets. How they will be important and to what degree is a matter of context. Some states have greater capacities for intervention than others, and the likelihood of intervention depends on the nature of the situation and the institutional history of the state.”<sup>30</sup>

As the Varieties of Capitalism literature demonstrates<sup>31</sup>, the nature of state intervention in the economy may vary even among capitalist economies. Fligstein himself distinguishes between interventionist states and regulatory states. The former, such as France, “are involved in making substantive decisions for many markets. They may own firms, direct investment, and heavily regulate firm entries, exits, and competition in markets.” Regulatory states, such as the United States, “create agencies to enforce general rules in markets, but do not decide who can own what and how investments proceed.”<sup>32</sup> Of course, economies that are centrally managed by the state may be said to constitute the zenith of interventionism. In general, however, modern states and their economies must be considered to be closely related.

### **The Isomorphism of Modern Sovereign States, and Economic and Other Activities**

Whether the economy is capitalist or otherwise, the link between the state, society, and the economy is often seen as critical. Krasner explains that sovereign states “[i]nfluence the self-image of those individuals within their territory through the concept of citizenship, as well as by exercising control, to one degree or another, over powerful instruments of socialization.”<sup>33</sup> Indeed, “states are the most densely linked institutions in the contemporary world. Change the nature of

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<sup>29</sup> *Ibid* at 660.

<sup>30</sup> *Ibid* at 660-1 [citations omitted].

<sup>31</sup> Peter A Hall & David Soskice, eds, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001).

<sup>32</sup> Fligstein, *supra* note 28 at 661.

<sup>33</sup> Stephen D Krasner, “Sovereignty: An Institutional Perspective” (1988) 21:1 *Comparative Political Studies* 66 at 76.

states and virtually everything else in human society would also have to be changed.”<sup>34</sup> These observations are certainly an extremely forceful attestation to the closeness of the relationship between state and society.

In fact, there is an almost invariable tendency towards isomorphism, not only in the form of the sovereign state itself, but also with respect to its stated economic objectives, as the eminent John W. Meyer and his colleagues argue in their 1997 seminal article, “World Society and the Nation State”:<sup>35</sup>

As we develop our argument, we want to keep in the forefront a number of empirical observations about contemporary nation-states. First, nation-states exhibit a great deal of isomorphism in their structures and policies. Second, they make valiant efforts to live up to the model of rational actorhood. Third, and partly as a result of the second observation, they are marked by considerable, and sometimes extraordinary, decoupling between purposes and structure, intentions and results. Fourth, they undergo expansive structuration in largely standardized ways. The generality of these observations makes sense only if nation-states are understood as, in part, constructions of a common wider culture, rather than as self-directed actors responding rationally to internal and external contingencies.<sup>36</sup>

Meyer et al go on to indicate that the model of the modern nation-state as rational and responsible actor “is utterly dominant”, and that its features include “territorial boundaries and a demarcated population; sovereign authority, self-determination, and responsibility; standardized purposes like collective development, social justice, and the protection of individual rights; authoritative, law-based control systems; clear possession of resources such as natural and mineral wealth and a labor force; and policy technologies for the rational means-ends accomplishment of goals.”<sup>37</sup> Meyer et al find that “[n]ation-states are remarkably uniform in defining their goals [in constitutions and otherwise] as the enhancement of collective progress (roughly, gross domestic product [GDP] per capita) and individual rights and development (roughly, citizen enhancement and equality).”<sup>38</sup>

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<sup>34</sup> *Ibid.*

<sup>35</sup> John W Meyer, John Boli, George M Thomas, and Francisco O. Ramirez, “World Society and the Nation-State” (1997) 103:1 *American J Sociology* 144 [Meyer et al].

<sup>36</sup> *Ibid* at 151-2.

<sup>37</sup> *Ibid* at 153.

<sup>38</sup> *Ibid.*

In short, effectively all nation-states have economic goals, such as enhancement of GDP, and social or societal goals, such as individual rights and development. This speaks to the interconnectedness of the state, the economy, and the society.

Meyer, who pioneered the expression “world polity” in 1980<sup>39</sup> to analogize the international system to a domestic polity or civil society,<sup>40</sup> sees nation-states as fundamental actors in world society or in world polity and characterizes them as generally seeking to represent themselves as rational and responsible actors. Anecdotal evidence of this can be seen from numerous public denunciations of states widely considered as “rogue” states.

Meyer et al argue that nation-states are modeled on an external culture that cannot be imported wholesale as a fully functioning system, because they are often inconsistent with local practices, requirements and cost structures, as well as highly idealized and internally inconsistent.<sup>41</sup> These factors generate expansive structuration, the formation and spread of explicit, rationalized differentiated organizational forms, but Meyer et al. observe that “[t]he structuration of the nation-state greatly exceeds any functional requirements of society, especially in peripheral [impoverished] countries”.<sup>42</sup>

Despite attempts of “political and organizational theorists [who] try to explain the apparent irrationalities of specific structural changes as products of local constellations of power and interests—the delusions of a self-aggrandizing leader, perhaps, or the interests of dominant elites... in recent decades nation-states and other organizations have clearly expanded inordinately across many different social domains.”<sup>43</sup> Meyer et al. argue that despite distinct and complex histories, “nation-states ... all have expanded structurally in similar ways in the same historical period...to manage the expanding externally defined requirements of rational actorhood.”<sup>44</sup> Meyer and his colleagues attempt to account for such isomorphism by identifying “three processes by which world-societal elements authorize and fashion national states: the construction of identity

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<sup>39</sup> John W Meyer, “The World Polity and the Authority of the Nation-State” in Albert J Bergesen, ed, *Studies of the Modern World-System* (New York: Academic Press, 1980) 109.

<sup>40</sup> See also John W Meyer, “World Society, Institutional Theories, and the Actor” (2010) 36 *Annual Rev Sociology* 1.

<sup>41</sup> *Supra note* 35 at 154 [citations omitted].

<sup>42</sup> *Ibid* at 156.

<sup>43</sup> *Ibid*.

<sup>44</sup> *Ibid* at 156-57.

and purpose, systemic maintenance of actor identity, and legitimation of the actorhood of such subnational units as individuals and organized interests.”<sup>45</sup>

They argue that the process of state construction in world society is not independent of culture, just as domestic political processes are not independent of culture. In fact, they find that construction of nation-state identity and purpose involves conformity to world-wide models, often by simple mimesis and without consideration of their applicability, finding that “[t]hroughout modern history, dependent territories have moved to sovereign statehood at a steadily increasing rate that accelerated rapidly in the postwar period. Once sovereign, countries almost never revert to dependence. Even the breakup of the Soviet Union produced not dependent territories but formally sovereign nation-states, unprepared as some of the former republics were for this status.”<sup>46</sup>

According to Meyer et al., acceptance into this world society affects other aspects of the social structure of the domestic society of the state itself, in that: “Having committed themselves to the identity of the rationalizing state, appropriate policies follow—policies for national development, individual citizenship and rights, environmental management, foreign relations. These policies are depicted as if they were autonomous decisions because nation-states are defined as sovereign, responsible, and essentially autonomous actors. Taking into account the larger culture in which states are embedded, however, the policies look more like enactments of conventionalized scripts.” The authors find that “even if a state proclaims its opposition to the dominant world identity models, it will nevertheless pursue many purposes within this model. It will develop bureaucratic authority and attempt to build many modern institutions, ranging from a central bank to an educational system. It will thereby find itself modifying its traditions in the direction of world-cultural forms.”<sup>47</sup>

Meyer et al.’s arguments in this regard have a certain resonance with observation and experience. The world culture that he posits seems to have at least some of these effects, many of which directly impinge on the domestic society of the state concerned. In substance, his argument is that states

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<sup>45</sup> *Ibid* at 157. Part 2 of the book shows that these activities are common to organizations generally, not just those which are nation states.

<sup>46</sup> *Ibid* at 159.

<sup>47</sup> *Ibid*.

are cultural artifacts, not only of domestic society and culture, but of international or, for him, “world” society and culture. That world society in which a state is embedded imposes certain of its own artifacts on the domestic society and the state itself.

Meyer et al assert: “World-cultural principles license the nation-state not only as a managing central authority but also as an identity-supplying nation. Individual citizenship and the sovereignty of the people are basic tenets of nationhood.” In effect, states not conforming to those principles are not regarded as legitimate sources of identification for persons within their jurisdiction. Other basic tenets of nationhood include “the legitimacy and presumed functional necessity of much domestic organizational structure, ranging from financial market structures to organizations promoting individual and collective rights (of labor, ethnic groups, women, and so on). World-society ideology thus directly licenses a variety of organized interests and functions.”<sup>48</sup> In Meyer et al’s view, world society and world culture concede that function of the state with respect to the economy and its organizational structures. As will be demonstrated later, these aspects of the state are consistent with analyzing the state as a species of organization.

As was the case with the authors we have examined, for Meyer and his colleagues, society, the polity, and the economy cannot be assumed to be functionally separate. We submit that to the extent that bodies of discourse, whether economic or otherwise, embody such assumption, they must be in error, and their models inefficacious, in that respect. If that position is not accepted, then, as a minimum, our examination of this assumption casts substantial doubt on its validity, which warrants further critical attention to theories and models that substantially rely on it.

#### **ASSUMPTION TWO - THE SITUATION OF THE ECONOMY IN THE “PRIVATE” SPHERE**

Next, we consider the second assumption, which is that the economy engages, overlaps with, is part of, or is situated in, the “private sphere”. That is not to say that there may not be other spheres of action which are also part of the “private” sphere, but, instead, to say that the economy is fundamentally “private” in nature. For the present, this can be understood as connoting that it is not so intrinsically related to that society or polity that it can be regarded as “public” in nature.

It is assumed, further, that in this private sphere, parties interact with considerable freedom, largely by way of contract in the case of economic matters. Such contracts are essentially private in nature,

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<sup>48</sup> *Ibid* at 160.

relating to matters between the parties, and are essentially unaffected, at least directly, by public interests. It is considered that as long as the parties have contractual capacity, and contract freely, and meet other standards stipulated as necessary for contractual probity and efficacy, the arrangements that the parties devise, by means of contracts or otherwise, should be given full effect within their limits to accomplish the purposes sought. The scope of the private sphere, and its relationship to the economy are discussed under the next heading.

### **The Ancient Economy and the Household**

The word “economy”, of course, derives from the Greek word “*oikonomia*”, meaning “management (or administration) of a household” or “household management”<sup>49</sup>, which, in turn, is derived from the words “*oikos*” or “*okia*”, terms referring in some way to an extended family unit or household, much like the Latin word “*familia*”, and from the word “*nomos*” meaning “managing” or “*neimen*” meaning “manage”. Of course, even the meaning of the words is not completely free from doubt.

A small diversion here will make a useful point. Douglas MacDowell, considered by many to be a leading, if not the foremost, authority on Greek law during his lifetime, suggested that certain statements attributed to Socrates in Xenophon's *Oikonomikos* appeared to clearly distinguish between *oikos* meaning “property” and *okia* meaning “house”. He says that Attic writers of the fifth and fourth centuries much more often referred to a house as “*okia*” rather than as “*oikos*” but admits that *okia* can also mean 'property' or 'family'.<sup>50</sup> MacDowell takes issue with Aristotle as failing to recognize differences between legal usage and common usage:

[E]ven in lawcourt speeches by Attic writers *okia* does not invariably mean 'house'; sometimes it means 'family', and sometimes it means 'property'. In Aristotle's *Politics* the distinction between *okia* and *oikos* breaks down altogether, and he uses both words indiscriminately in his account of the nuclear family. But in this paper I am not concerned with Aristotle but with Athenian law. In legal contexts it is more usual for *okia* to mean 'house' and for *oikos* to mean either 'property' or 'family', and so I shall observe that distinction.<sup>51</sup>

<sup>49</sup> N Gregory Mankiw, *Principles of Economics*, 7th ed (Stamford, Conn: Cengage Learning, 2014).

<sup>50</sup> Douglas M MacDowell, “The *Oikos* in Athenian Law” (1989) 39:1 *Classical Q* 10 at 10-11.

<sup>51</sup> *Ibid* [citations omitted].



However, Aristotle, often cited for his references to the household, apparently causes some confusion. MacDowell asks: “By what criterion was it decided whether a person was a member of a particular *oikos*? If we judged by the word itself, we might suppose that an *oikos* consisted of all the people living in a particular house. That is indeed what Aristotle seems to mean when he discusses an *oikos* or an *oikia*. He defines an *oikos* as a ‘natural association for everyday purposes’, and he regards it as including not only a husband, wife, and children but also slaves. But it is not normal Attic usage to regard slaves as members of the *oikos* in this sense. Normally the term *oikos*, when it refers to persons, refers to the line of descent from father to son through successive generations.”<sup>52</sup>

The point of interest here is that a single word, *oikia*, except when used in a strictly legal context, may refer to house, family, and property, suggesting the close connection among the three referents, each one of which would relate to the household as part of a distinctly private sphere, as will be discussed below. When used in a legal context, however, separate words are used for “house” and for either “family” or “property”, with the result that the concepts of family and property are seen to be closely connected as a matter of law.

Lin Foxhall concluded that it is now widely accepted that the household was the fundamental building block of ancient Greek society<sup>53</sup> She argues that the household embodies a complex of relationships among its members relating to its property resources that suggested that the *kyrios*, or head of the household, who owned the property in the household, and was empowered to cross the boundary between household and community in dealing with such property, worked on behalf of, or in consensus with, the other members of his household, rather than as a tyrant.<sup>54</sup> This may have been a later development, some acknowledgement of natural justice as applied to the household.

Etymologically, then, the terms “economy” and the “family” are closely related.

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<sup>52</sup> *Ibid* at 15 [citations omitted].

<sup>53</sup> Lin Foxhall, “Household, Gender and Property in Classical Athens” (1989) 39:1 *Classical Q* 21 at 22.

<sup>54</sup> *Ibid* at 31-32. She cites Aristotle’s *Politics* (3.4.5) (without referencing the edition) as authority that the head of the household acted on behalf of the ruled or in pursuit of some interest common to both the *kyrios* and the household members.

### **The Embedding of the Ancient Economy in Social Institutions**

Why is the origin of this term of importance to the present discussion? The concept of the economy and of the economic sphere of activity arose in the context of the household, often considered as a unit of social action and as part of the social sphere of activity. In fact, according to classicist Bradley Ault, the ancient Greek household itself has been said to constitute a viable economic enterprise. He found that the ancient economy was “embedded” in social institutions (as discussed below in more general terms) to such a point that classicists have not often studied the ancient economy separately from their study of its society generally.<sup>55</sup>

Relying primarily on archaeological evidence, Professor Ault concludes, in effect, that the household economy of ancient Greece was the totality of its economy, finding that “even in the most humble circumstances in the Archaic and Classical periods, households engaged in a range of activities from textile production and other craftwork, to agricultural production and processing, which had the potential for going beyond mere subsistence.” He argues that the “time-honoured notions of domestic self-sufficiency” are inaccurate; instead, “the orientation of the household would tend, in stressed and favourable circumstances alike, towards market exchange, and hence local and regional economic involvement. The stigma against non-agrarian, banausic activities or mercantile involvement so often cited in the primary sources... similarly needs to be dismissed as elitist and moralising in tone rather than being reflective of reality. In short and in fact, the ancient Greek domestic economy was to a large extent co-terminous with the macroeconomy.”<sup>56</sup>

The historical and etymological origins of the word “economy” considered here have revealed significant evidence that the economy of classical Greece was situated in the family or household. While that situs may appear to be part of the “private sphere”, one can ask whether, and if so, in what sense the case may be otherwise. A discussion of the private and public distinction will follow in relation to the next assumption.

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<sup>55</sup> Bradley Ault, “Oikos and Oikonomia: Greek Houses, Households and the Domestic Economy” (2007) 15 *British School at Athens Studies* 259 at 259. Ault points out that Moses Finley’s reluctance to consider archaeological evidence, and his reputation as one of the greatest economic historians of the ancient world, contributed to this. See M. I. Finley, *The Ancient Economy*, updated ed (Berkeley: University of California Press, 1999).

<sup>56</sup> *Ibid.*

### **ASSUMPTION THREE - ACTUAL AND ANALYTICAL SEPARATION OF PRIVATE AND PUBLIC SPHERES**

We now consider the assumption that the private sphere and the public spheres are separate and distinct from each other and that each can be analyzed in a manner which is distinctive to it alone. Matters of public interest include the constitution of the political entity or state, and any subdivisions, the manner of its exercise of authority, and any limitations on it, elections, regulation of crime, and protection of certain human, political or social rights, including economic rights, welfare rights, and the authorization and exercise of distributive or redistributive functions, such as taxation and provision of public goods and services. It is conventionally assumed in classical liberal legal and political economy literature that the economy does not engage those matters sufficiently directly to be considered otherwise than as part of the private sphere. This section will establish that the separation in fact and in analysis of the private and public spheres is either fallacious, or is highly contestable or problematic.

#### **The Private/Public Distinction - Context and Characteristics**

The philosopher Hanna Pitkin considers how the private/public distinction may present itself, asking “When we talk of public and private, do we know what we are talking about? Wanting to theorize, we seize on or are seized by the first image that springs to mind: the private is “in here,” personal, intimate, closest to the self, secluded from unwanted others, where we have “privacy” and are free to be ourselves. The public, by contrast, is “out there,” impersonal, distant, formal; whatever goes “out in public” must be ready for “publication,” its “private parts” properly clothed. This is the view developed most recently by Richard Sennett, who speaks in spatial metaphors of a “geography” of public and private. It is a plausible view.”<sup>57</sup>

Pitkin says that “[t]he economist obviously distinguishes public from private in a different way... Here “public sector” is divided from private on the basis of ownership, and public means, roughly, government, the state.”<sup>58</sup> The description of private as “in here” and of public as “out there” likely resonates with some readers. Notably, however, Pitkin acknowledges that the distinction has different significance for economists than for others. Those others may include legal academics, theorists, and practitioners and others in the legal field, such as jurists. Pitkin’s observation itself

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<sup>57</sup> Hanna Fenichel Pitkin, “Justice: On Relating Private and Public” (1981) 9:3 *Political Theory* 327 at 328. Her reference to Sennett is footnoted as: Richard Sennett, *The Fall of Public Man* (New York: Knopf, 1977) at 16.

<sup>58</sup> *Ibid.*

leads to the suggestion that the significance of the distinction depends to some significant degree on the context in which it is used or applied.

Pitkin argues that in ordinary use words like "public" and "private" function mainly as adjectives; and that turning them into general categories, as Arendt does as "The Public" and "The Private," makes them seem mysterious entities, "seducing us into reification"; whereas attaching them as adjectives to some general noun, such as the public (or private) sector, sphere, domain, or realm subjects us to the unexamined connotations of our own metaphor. Instead, she concludes that "[p]rivate and public, it is important to realize, are relative terms. Things in the world are not generally classifiable exclusively as either public or private."<sup>59</sup> Instead, public and private should best be regarded as a continuum.

Pitkin explains the distinction which C. Wright Mills drew in *The Sociological Imagination*, between "the personal troubles of milieu", which "occur within the character of the individual and . . . his immediate relations with others" and "the public issues of social structure."<sup>60</sup> Personal troubles "occur within the character of the individual and . . . his immediate relations with others" and their "statement and resolution" properly lie with "the individual as a biographical entity and within the scope of his immediate milieu – the social setting that is directly open to his personal experience and to some extent his willful activity. A trouble is a private matter." She argues that for Mills, "[p]ublic issues of social structure, however, transcend "these local environments of the individual," and deal with "the organization of many such milieux into the institutions of an historical society as a whole, with the ways in which various milieux overlap and interpenetrate to form the larger structure of social and historical life. An issue is a public matter."<sup>61</sup> In effect, Pitkin says that for Mills the distinction is between individual-immediate group relations, or milieu, a "trouble", as private, and relations among various milieux, that is to say, as an "issue", as public.

Pitkin herself notes that not only are the terms private and public adjectival, in that they modify a noun, but they are also relative terms. That is to say, the terms modify some noun so that the sense of that adjective is affected by the nature of the nominative which it is used to describe. Further,

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<sup>59</sup> *Ibid* at 329.

<sup>60</sup> *Ibid*, citing C Wright Mills, *The Sociological Imagination* (New York: Oxford University Press, 1959) at 8.

<sup>61</sup> *Supra* note 57 at 329.

the terms are relative, rather than objective. Again, we might expect, then, that the terms and their referents may fall along some type of continuum.

Pitkin argues that our ways of distinguishing public and private, then, are heterogeneous, saying that the question of who gets to do the defining is itself part of the problem. She identifies three dimensions along which we distinguish public from private, which help to make up our concept of the public, calling them the dimension of access or attention, the dimension of impact or effect, and the dimension of governance or control:

First, something may be public in the sense that it is accessible to all, open to scrutiny by anyone, visible as a focus of attention. Here the term connects with publicity, public knowledge, public opinion, and going "out in public," and contrasts with reserved, closed, hidden.

Second, something may be public in the sense that it affects all or most of us, public in its consequences and significance. This objective publicness may go unrecognized by the people affected; thus the first and second sort of publicness really are distinct. The decisions of, say, a private corporation can have enormous public impact and importance. Here the opposite of public is not secluded or withdrawn, but personal, of limited impact, affecting only select individuals or groups. Mills's distinction between personal troubles and public issues, then, telescopes the first and second dimensions of the public: troublesome social conditions are public in their impact, but become public issues only when made the focus of public attention.

When they do, it is usually with a view toward the third dimension: public direction or control. This is the publicness of government, public administration, and collective action. It includes Arendt's main conception. But public direction or control is in itself difficult to define, particularly in times like ours, for a nation may be governed more by "private" aggregations of power than by its official government, and its government may be so dominated by special interests that it functions more as a private than a public agency?<sup>62</sup>

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<sup>62</sup> *Ibid* at 329-330.

This relatively modern view of the distinction in terms of access or attention, impact or effect, and governance or control focuses attention on ways in which the distinction is experienced. Can this focus apply equally in various historical epochs?

### **The Private/Public Distinction in Liberal Thought**

In a 1982 symposium on the distinction, Duncan Kennedy contended that: “The history of legal thought since the turn of the century is the history of the decline of a particular set of distinctions – those – those that, taken together, constitute the liberal way of thinking about the social world. Those distinctions are state/society, public/private, individual/group, right/power, property/sovereignty, contract/tort, law/policy, legislature/judiciary, objective/subjective, reason/fiat, freedom/coercion, and maybe some more I’m not thinking of.” He explains that, while not synonymous, these distinctions “are all in a sense "the same." By this I mean that it is hard to define any one of them without reference to all, or at least many of the others, and that if one understands the common usage of one of them, one understands, pretty much ipso facto (what a fudge!), all the others.”<sup>63</sup> Having thus described the distinctions that characterize such liberal thinking, Kennedy then purports to chronicle the stages of its decline.

Morton Horwitz, averting to Karl Polanyi, attempts to identify the liberal origins of the distinction, saying that it “arose out of a double movement in modern political and legal thought”.<sup>64</sup> One aspect of this double movement involved “ideas of a distinctly public realm that began to crystallize” with “the emergence of the nation-state and theories of sovereignty in the sixteenth and seventeenth centuries”. The other aspect of the double movement involved “a countervailing effort to stake out distinctively private spheres free from the encroaching power of the state.”<sup>65</sup> In part, these involved the development of “[n]atural rights theories ...for the purpose of setting limits on state power, both over property and religious conscience” and “were therefore not only efforts to incorporate into law what one writer has called a philosophy of "possessive individualism," but also to provide an important basis for arguing for religious toleration.”<sup>66</sup> The general tenor of Horwitz’s argument

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<sup>63</sup> Duncan Kennedy, “The Stages of the Decline of the Public/Private Distinction” (1982) 130:6 U Pa L Rev 1349 at 1349.

<sup>64</sup> Morton J Horwitz, “The History of the Public/Private Distinction” (1982) 130:6 U Pa L Rev 1423 at 1423. As to the emergence of the market, as his “double movement” language might suggest, at 1424 he cites Karl Polanyi’s *The Great Transformation* (New York: Farrar & Rinehart, 1944).

<sup>65</sup> Horwitz, *supra* note 64.

<sup>66</sup> *Ibid.*

will be outlined here in more detail, as one explication of the history of the private/public distinction.

Horwitz argues that by the late medieval period, English law distinguished between lands held by the King as feudal lord, which he could alienate as private property, and lands held by him in his role as the crown or embodiment of the public, which he could not alienate.<sup>67</sup> Later, other legal developments reinforced this distinction. Gradually, legal doctrines developed that separated a public realm on the one hand, and “a separate private realm free from public power”.<sup>68</sup>

According to Horwitz, “[a]lthough one can find the origins of the idea of a distinctively private realm in the natural-rights liberalism of Locke and his successors, only in the nineteenth century was the public/private distinction brought to the center of the stage in American legal and political theory. Before this could occur, it was necessary to undermine an earlier tradition of republican thought that had closely identified private virtue and public interest.”<sup>69</sup>

Horwitz claims that “[t]he emergence of the market as a central legitimating institution brought the public/private distinction into the core of legal discourse during the nineteenth century.... One of the central goals of nineteenth century legal thought was to create a clear separation between constitutional, criminal, and regulatory law – public law – and the law of private transactions – torts, contracts, property, and commercial law.”<sup>70</sup> We might observe that public law was often thought to be concerned either with the state alone, or with matters concerning the relationship between the state and citizens. These “private” transactions were paradigmatically thought to occur between or among private citizens, exclusively.

This separation was attacked by the legal realists, says Horwitz, “in reaction to the Supreme Court's 1905 decision in *Lochner v. New York*<sup>71</sup>, constitutionalizing freedom of contract.” Horwitz argued that “[t]he Legal Realist Movement of the 1920's and 1930's...[r]idiculed the invisible hand premise behind any assumption that private law could be neutral and apolitical. All law was coercive and had distributive consequences... must therefore be understood as a delegation of coercive public power to individuals, and could only be justified by public policies. Contract, that

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<sup>67</sup> *Ibid.*

<sup>68</sup> *Ibid* p. 1424.

<sup>69</sup> *Ibid.*

<sup>70</sup> *Ibid.*

<sup>71</sup> *Ibid*, citing *Lochner v New York*, 198 US 45 (1905).

most "private" of nineteenth-century legal categories, was reconceptualized as simply a delegation of public power that could be justified only by public purposes."<sup>72</sup>

Of course, the premises behind the public/private distinction, and the distinction itself, were not only under attack in the United States but also in Europe, as we have seen. Horwitz claims that progressivism in the period prior to World War II posited a sharp conflict between a substantive public interest and private self-interest, and recognized as a primary function of the state the creation of institutions that would promote a public interest, an observation that has some historical basis. He asserts that after the war, a substantive conception of the public interest was a first step towards totalitarianism. Then, the public interest became defined in procedural and pluralist terms as the outcome of interaction among pluralist interest groups. This means that private self-interest was the only legitimate political reality.<sup>73</sup>

In effect, according to Horwitz, interest-group pluralism nullified the public interest: "The recent revival of natural-rights individualism in legal and political theory is a symptom of the collapse of a belief in a distinctively public realm standing above private self-interest. It is not only a dangerous symptom of the unravelling of all sense of community, but also a relapse into a predatory and vicious conception of politics."<sup>74</sup> Horwitz, like the Greeks and Romans, and British and American republican thinkers of the seventeenth and eighteenth centuries, conceived of a public interest and a distinctive public realm quite apart from politics as "politicking" and negotiating the influence of competing private perspectives with others having similar objectives. Indeed, Horwitz argues that imbalances in power among pluralist interests had dire consequences: "Yet reality has a funny way of intruding upon theory. The public/private distinction could approximate the actual arrangement of legal and political institutions only in a society and economy of relatively small, decentralized, nongovernmental units. Private power began to become increasingly indistinguishable from public power precisely at the moment, late in the nineteenth century, when large-scale corporate concentration became the norm. The attack on the public/private distinction was the result of a widespread perception that so-called private institutions were acquiring coercive power that had formerly been reserved to governments."<sup>75</sup>

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<sup>72</sup> *Ibid* at 1426.

<sup>73</sup> *Ibid* at 1426-27.

<sup>74</sup> *Ibid* at 1427.

<sup>75</sup> *Ibid* at 1428.



Horwitz's attack on corporate power, whether or not sound, does not detract from his principal argument, which seems to be that the distinction made sense only where the state, and other legal and political institutions, social actors and economic actors were each at a relatively small and relatively comparable scale. The implication seems to be that larger economic actors and a larger state would erode the distinction.

Of course, the "liberal" conception of the distinction does not exhaust its logical dimensions and possible explanatory power, nor does its attack by Horwitz constitute the final chapter in the discussion of the distinction. With that, we now turn to the perspectives of Jürgen Habermas and Hannah Arendt. Both Habermas and Arendt develop philosophical perspectives which are both thoroughgoing and extensive in scope. Consequently, each of their arguments will require some exposition in order for them to be useful for our purposes. For that reason, these will be set out in much the same order as to that was adopted by their authors.

### **The "Public Sphere" and the "Private Sphere" of Habermas**

Perhaps the most famous observation made by Habermas in this connection is his "definition" of "the public sphere", at the beginning of his famous article on the subject, to mean "first of all a realm of our social life in which something approaching public opinion can be formed. Access is guaranteed to all citizens. A portion of the public sphere comes into being in every conversation in which private individuals assemble to form a public body. They then behave neither like business or professional people transacting private affairs, nor like members of a constitutional order subject to the legal constraints of a state bureaucracy. Citizens behave as a public body when they confer in an unrestricted fashion – that is, with the guarantee of freedom of assembly and association and the freedom to express and publish their opinions-about matters of general interest."<sup>76</sup>

For Habermas, then, as a philosopher of discourse, it is not surprising that the public sphere is a realm of social life in which, in effect, the body of public citizens, informally and in periodic elections, formally, engages in the tasks of criticizing and controlling the state as ruling structure. It would be difficult, if not impossible, to ignore the similarity between the public sphere of Habermas and that of the Greek polis.

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<sup>76</sup> Jürgen Habermas, "The Public Sphere: An Encyclopedia Article (1964)", translated by Sara Lennox & Frank Lennox (1974) 3 *New German Critique* 49 at 49.

Yet for Habermas, the state authority, while the executor of the political public sphere, is not a part of it. Instead, he says, it derives its “public” task of caring for the well-being of all citizens from the public discussion of matters concerning the activity of the state. In effect, the political public sphere legitimates the state and its governmental and bureaucratic structure. In this description, the society and the polity are part of the public sphere, and may be distinguished only by their differing objectives, whether social, in the sense of participating in a common life, or political, in the sense of state, governmental or bureaucratic activity concerned with caring for the well-being of citizens. Yet the state is not part of Habermas’s public sphere.<sup>77</sup>

### *The Effect of the Demise of Feudalism*

Habermas finds “no indication European society of the high middle ages possessed a public sphere as a unique realm distinct from the private sphere. Nevertheless, it was not coincidental that during that period symbols of sovereignty, for instance the princely seal, were deemed “public.” At that time there existed a public representation of power.”<sup>78</sup> Thus, “the holder of the position represented it publicly: he showed himself, presented himself as the embodiment of an ever present “higher” power. The concept of this representation has been maintained up to the most recent constitutional history. Regardless of the degree to which it has loosed itself from the old base, the authority of political power today still demands a representation at the highest level by a head of state.”<sup>79</sup> As will be argued further below, such representation is also effected in the case of non-state organizations, including corporations.

Habermas maintains, in effect, that the demise of feudalism de-linked its authoritative institutions from the representative public sphere. That demise and de-linkage caused a functional separation within those institutions, as between public functions, on the one hand, and private functions, on the other. He argues that “the feudal authorities (church, princes and nobility), to which the representative public sphere was first linked, disintegrated during a long process of polarization” such that “by the end of the eighteenth century they had broken apart into private elements on the one hand, and into public on the other.”<sup>80</sup>

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<sup>77</sup> *Ibid.*

<sup>78</sup> *Ibid* at 50.

<sup>79</sup> *Ibid.*

<sup>80</sup> *Ibid* at 51.

Habermas explains each element of this delinkage as follows: “The position of the church changed with the reformation: the link to divine authority which the church represented, that is, religion, became a private matter. So-called religious freedom came to insure what was historically the first area of private autonomy. The church itself continued its existence as one public and legal body among others. The corresponding polarization within princely authority was visibly manifested in the separation of the public budget from the private household expenses of a ruler. The institutions of public authority, along with the bureaucracy and the military, and in part also with the legal institutions, asserted their independence from the privatized sphere of the princely court. Finally, the feudal estates were transformed as well: the nobility became the organs of public authority, parliament and the legal institutions; while those occupied in trades and professions, insofar as they had already established urban corporations and territorial organizations, developed into a sphere of bourgeois society which would stand apart from the state as a genuine area of private autonomy.”<sup>81</sup>

In this excerpt, Habermas ignores the land ownership of the church, and its related economic activities, and assumes, without so stating, that the activities of the feudal lords in the post-feudal were significantly economic in nature, thereby ignoring their functions as law-givers in making local law, and as law-appliers, in applying that law in their own courts. Further, he erroneously assumes that the source of economic activity in the post-feudal era, and the origin of bourgeois society, was only the feudal lords, thereby ignoring the church and other participants in the feudal economy, such as smallholders, manufacturers, traders, and others.

Habermas also assumes that the church did not suffer a translation of some of its activities into those of a “public” nature, as well as those of a private nature, relating to religious observance (including the investiture of kings, princes, and nobles). While he separates “princely” activities of the prince and its expenses from the prince’s household, he fails to remark on the often significant landholdings of the prince in relation to which significant economic activity took place, not only with respect to agriculture, but also with respect to industry and commerce, as was the case also with respect to the aristocracy at that time, as in ancient Greece and Rome. Thus, the apparent appeal of his argument is diminished somewhat by its incompleteness.

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<sup>81</sup> *Ibid.*

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His explanation of the origin of the public sphere is likewise both engaging and incomplete: “The representative public sphere yielded to that new sphere of “public authority” which came into being with national and territorial states... “Public” no longer referred to the “representative” court of a prince endowed with authority, but rather to an institution regulated according to competence, to an apparatus endowed with a monopoly on the legal exertion of authority. Private individuals subsumed in the state at whom public authority was directed now made up the public body.”<sup>82</sup>

Habermas appears to argue that the creation of state apparatus based on bureaucratic principles, including expertise, divorced the state from the “re-presentative” princely court in which authority had to be re-presented and re-legitimized constantly and thereby opposed the state to the large swathe of non-state participants, who were without voice and without power, he says, but nevertheless subject to the power of the state. This is similar to the conception of the state as government discussed previously in this work. It is also consistent with Habermas’s conception of the “public sphere” that is said to exist not so much as a sphere or section of society or the polity but, instead, as an ethereal realm of discourse. In this regard, his concept harkens back to the Greek and Roman city states.

In fact, Habermas goes further than this, appearing to argue that the state de-linked itself from the society, and “[s]ociety, now a private realm occupying a position in opposition to the state, stood on the one hand as if in clear contrast to the state. On the other hand, that society had become a concern of public interest to the degree that the reproduction of life in the wake of the developing market economy had grown beyond the bounds of private domestic authority. *The bourgeois public sphere* could be understood as the sphere of private individuals assembled into a public body, which almost immediately laid claim to the officially regulated “intellectual newspapers” for use against the public authority itself.”<sup>83</sup>

Habermas thus characterizes the liberal model of the public sphere as one founded on private authority over property, and in which the claims of individuals vis-à-vis the state or public authority are based on the sharing of power, as well as opposing the publicity of proceedings (which he calls “supervision”, and considers as a means of transforming the nature of power). It

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<sup>82</sup> *Ibid* at 51-52.

<sup>83</sup> *Ibid* at 52 [emphasis in the original].

is, of course, possible to argue that the public sphere is divided by Habermas into various segments, only one of which is the bourgeois public sphere. That is to say, the bourgeois public sphere may not be the public sphere as a whole. That point, although interesting, cannot detain us here.

Habermas' exposition continues: "In the first modern constitutions the catalogues of fundamental rights were a perfect image of the liberal model of the public sphere: they guaranteed the society as a sphere of private autonomy and the restriction of public authority to a few functions."<sup>84</sup>

Habermas seems to suggest that the "liberal" private sphere was coeval with the society, and that the "liberal" public sphere was a sphere within which public authority, the state, conducted a limited range of activities. In the liberal model, the economy was part of society, but society, and presumably the polity, were, at least notionally, or arguably, outside the state.

The early liberal constitutions, says Habermas, provided for communication of the needs of society to the state, which would act accordingly: "Between these two spheres, the constitutions further insured the existence of a realm of private individuals assembled into a public body who as citizens transmit the needs of bourgeois society to the state, in order, ideally, to transform political into "rational" authority within the medium of this public sphere." He says that thereby, the "general interest, which was the measure of such a rationality, was then guaranteed, according to the presuppositions of a society of free commodity exchange, when the activities of private individuals in the marketplace were freed from social compulsion and from political pressure in the public sphere."<sup>85</sup>

For Habermas, then, liberal models of society posit a very small public sphere, in which public authority is exercised by the state rationally, considering the interests of citizens acting on an atomistic and pluralistic basis, and a very large private sphere, in which private and atomistic individuals could operate in a marketplace free from social or political pressures. In effect, he argues that the rationality of political authority was established in terms of its efficacy in relation to commodity exchange. As has been argued above, such a model could only be, at best, an ideal type incapable of instantiation in the real world. As discussed, markets are socially constructed and operated; consequently, they are not free from social or political pressures.

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<sup>84</sup> *Ibid* at 52-53.

<sup>85</sup> *Ibid* at 52-53.

*The Demise of the Liberal State and the Rise of the Social Welfare State*

Habermas argues that the liberal model of the public sphere, which assumed a coherence of attitudes and interests among the bourgeois participants in public matters, “cannot be applied to the actual conditions of an industrially advanced mass democracy organized in the form of the social welfare state.”<sup>86</sup> That is, it can only be an ideal type. Habermas claims that the diffusion of the press and propaganda which accompanied the Chartist movement in England and the February revolution in France created an expansion of the public body beyond the bounds of the bourgeoisie, as a result of which “[t]he public body lost not only its social exclusivity; it lost in addition the coherence created by bourgeois social institutions and a relatively high standard of education. Conflicts hitherto restricted to the private sphere now intrude into the public sphere.”<sup>87</sup>

Of course, on his account, the public body lost its social exclusivity and coherence as a result of extension of public discourse much more broadly. At the same time, this may be thought to have changed the nature of such discourse, at least in terms of expanding the role of the state. A broader public, of course, lessened “social activity and coherence”, which might be expected to be approved by Habermas. While it did introduce new opportunities for conflict, Habermas seems to have underestimated the degree of conflict extant in earlier periods in England and France.

Habermas argues that those “group needs which can expect no satisfaction from a self-regulating market now tend towards a regulation by the state. The public sphere, which must now mediate these demands, becomes a field for the competition of interests”.<sup>88</sup> As we have already noted, this competition of interests either predated or accompanied the extension of participation in public affairs and voting, but, in any case, arose well before the welfare state.

Instead of laws “arising from the consensus of private individuals engaged in public discussion”, the laws “correspond in a more or less unconcealed manner to the compromise of conflicting private interests. Social organizations which deal with the state act in the political public sphere...[and], [w]ith the interweaving of the public and private realm, political authorities assume

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<sup>86</sup> *Ibid* at 54.

<sup>87</sup> *Ibid*.

<sup>88</sup> *Ibid*.

certain functions in the sphere of commodity exchange and social labor, while social powers assume certain political functions. This leads to a kind of "refeudalization" of the public sphere."<sup>89</sup>

Here, Habermas treats the political public sphere as peopled, not by atomistic private individuals pursuing private interests, but by groups acting as social organizations pursuing their respective interests, in effect, a species of interest group pluralism. He suggests that where these large organizations cannot reach compromises among themselves, with or without the state and its political parties and bureaucracy, they may be forced to engage in the public sphere. He argues that the political public sphere of the social welfare state is characterized by a peculiar weakening of its critical functions yet, at the same time, by the extension of fundamental rights, including rights to information<sup>90</sup>, which would enable organizations to participate in dealings with the state and would legitimize the compromises reached.

Habermas concludes that the "idea of the public sphere, preserved in the social welfare state mass democracy, an idea which calls for a rationalization of power through the medium of public discussion among private individuals, threatens to disintegrate with the structural transformation of the public sphere itself. It could only be realized today, on an altered basis, as a rational reorganization of social and political power under the mutual control of rival organizations committed to the public sphere in their internal structure as well as in their relations with the state and each other."<sup>91</sup>

Amelioration requires, in his view, the introduction of the public sphere to the organizations internally, in relation to each other, and in relation to the state. Ignoring for the moment, the similarities of his model to the corporatist model popularly discredited by its association with totalitarian regimes of the past century, his model and his call for action engage a conception of the public sphere as embracing social and even economic domains, and arguably vastly exceeding the private sphere in its scope and scale.

On the whole, Habermas seems to maintain that the private sphere, in its economic and other aspects, has been drastically reduced in scope and scale, if not largely eliminated, by the modern welfare state. He thus juxtaposes individuals against, firstly, organizations competing for social

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<sup>89</sup> *Ibid.*

<sup>90</sup> *Ibid* at 55.

<sup>91</sup> *Ibid.*

and political power with each other and the state, on the one hand; and secondly, against the state. This is a recurring theme in the discourse of various social sciences and humanities. In the result, then, Habermas identifies the private sphere with the personal or the intimate sphere, as does Hanna Pitkin. With that, we turn next to Hannah Arendt.

### **The “Public Realm” and the “Private Realm” of Arendt**

Hannah Arendt devotes a chapter of her 1958 book *The Human Condition*<sup>92</sup> to The Public Realm and the Private Realm, as she calls it. It has been cogently analyzed by Hanna Fenichel Pitkin, whose observations on Pitkin’s work and otherwise will be employed extensively here.<sup>93</sup>

#### *Classical Origins*

Arendt finds the origins of the distinction in classical Greece, says Pitkin, in that the distinction between public and private, Arendt tells us, "corresponds to" the distinction between "the household and the political realm" that first emerged in ancient Greece and continued until the onset of the modern age, when it was blurred by the emergence of a third "realm" she calls the "social."<sup>94</sup> As is widely known, in the ancient Greek world, the public realm, characterized by the way of life of the *polis*, distinguished Greek from barbarian, and made possible a free and truly human life.

Indeed, the “rise of the city-state meant that man received “besides his private life a sort of second life, his *bios politikos*. Now every citizen belongs to two orders of existence; and there is a sharp distinction in his life between what is his own (*idion*) and what is communal (*koinon*).”<sup>95</sup> For the ancient Greeks, the life of the household enabling the bodily life (which she calls “private”) was vastly inferior to the citizen’s second life, his political life or the life of, and in, and what is yet you and me to let all know the polis. This can be compared with Cartesian and Christian concepts.

We have previously discussed the importance of the ancient Greek household in relation to the etymology of the word “economy” and the private/public distinction. Pitkin explains:

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<sup>92</sup> Hannah Arendt, *The Human Condition* (Chicago: University of Chicago Press, 1958).

<sup>93</sup> *Supra* note 57. She describes Arendt, at 327, as “the political theorist who wrote most powerfully on that theme in our time, and who tried hardest to renew our access to politics as a positive gratification, a ‘public happiness’”.

<sup>94</sup> *Ibid* at 330-331 [citations omitted]. Her quotes from Arendt are from Arendt, *supra* note 92 at 32, 32, 30, 29, 28, 30 and 62, 37, and 29 and 25, respectively.

<sup>95</sup> Arendt, *supra* note 92 at 24.



The household was a "pre-political realm," a necessary prerequisite for citizenship, but strictly a means to that higher end. First, that household was ruled by domination and force, by a *despotes*, while *polis* life was carried on through speech and reason. Second, by contrast with household inequality and despotic barbarian kingship, polis citizenship was a relationship of equality. The polis "knew only 'equals,'" though the Greek notion of equality was different from ours; it had nothing to do with universal natural rights, nor did it assume parity in wealth, talent, or ability. Rather, it was a special, artificially created equality of status as citizens. Thus, to be a citizen "meant neither to rule or be ruled."

Third, citizenship in the *polis* meant admission to a public "sphere of freedom," while the private sphere was governed by necessity – not just the domination of the master over the family and slaves, but the "necessities of life" that would rule even the master if he did not have others to provide for him. The household was considered the locus of economic life; it was the basic unit of production, as is suggested by the Greek word for household (*oikia*) which is the root of our word "economics." It was the proper place for labor, for activities "related to the maintenance of life," Arendt argues, just as the more direct necessities of bodily function and species reproduction are properly hidden away in privacy.

Accordingly, "no activity that served only the purpose of making a living, of sustaining only the life process, was permitted to enter the political realm." Anything "economic" was "non-political . . . by definition," for "everything merely necessary or useful" had to be "strictly excluded" from the *bios politikos*, the realm of freedom.<sup>96</sup>

For the Ancient Greeks, as mentioned previously, economic matters, in the earliest times, were conducted largely in, or in connection with, the household and its environs, as a place, and as an extended family or kinship unit, as a social entity. Once such economic matters were dealt with, the citizen (and only the citizen), freed from rule by the necessities of life, was free to participate in the life of the *polis*, free to live his second or political life, and free to achieve a free and truly human life, Arendt says.

Hence, economic matters were not proper subjects of political life, but were assumed by it, or treated as effective pre-conditions of political life. Economic concerns were also excluded on the

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<sup>96</sup> *Supra* note 57 at 331 [citations omitted]. Her quotes from Arendt are from Arendt, *supra* note 92 at 28 and 24, respectively.

grounds that the intrusion of “the social” would destroy true public life.<sup>97</sup> Pitkin explains that economics was “to be excluded because it serves the needs of the body, and the body is a threat to human greatness and freedom, an encumbrance that ties us to our animal nature, something shameful to be hidden in private darkness. Public life, by contrast, is the quest for secular immortality, the hope of being remembered after one's death so that one's name and fame live on.”<sup>98</sup>

It would be difficult to avoid noticing the similarity between this Greek view and the Greek-oriented Christian view espoused in the early Christian era. Yet, to the Greeks, it is civic, not religious, virtue that is attained by freeing oneself from the needs of the body. Arendt explains: “To be free meant both not to be subject to the necessity of life or to the command of another *and* not to be in command oneself. It meant neither to rule nor to be ruled. Thus within the realm of the household, freedom did not exist, for the household head, its ruler, was considered to be free only in so far as he had the power to leave the household and enter the political realm, where all were equals.”<sup>99</sup> The other members of the household were not “free” in this sense, either within or without the household.

The Greek notion of freedom obtained only in the realm of the polis and, consequently, only with respect to citizens, who were far from the majority of the population: “To be sure, this equality of the political realm has very little in common with our concept of equality: it meant to live among and to have to deal only with one's peers, and it presupposed the existence of “unequals” who, as a matter of fact, were always the majority of the population in a city-state. Equality, therefore, far from being connected with justice, as in modern times, was the very essence of freedom: to be free meant to be free from the inequality present in rulership and to move in a sphere where neither rule nor being ruled existed.”<sup>100</sup> Not only economic, but also legislative, matters were pre-political.<sup>101</sup> As Arendt notes, the work of the legislator, who did not need to be a citizen, was not political but pre-political, in that “political life, however, could begin only after he had finished his legislation.”<sup>102</sup>

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<sup>97</sup> Pitkin, *supra* note 57 at 337.

<sup>98</sup> *Ibid.*

<sup>99</sup> Arendt, *supra* note 92 at 32 [emphasis in the original].

<sup>100</sup> *Ibid* at 32-33.

<sup>101</sup> Pitkin, *supra* note 57 at 337 [citation omitted].

<sup>102</sup> *Supra* note 92 at 64 at n 65.

### *The Middle Ages*

How is it, then, that modernity aligns the economic, social, and political domains? Arendt argues that in the modern world, the social and the political realms are much less distinct, and, moreover, “that politics is nothing but a function of society”. In fact, she says, “[t]his functionalization makes it impossible to perceive any serious gulf between the two realms; and this is not a matter of a theory or an ideology, since with the rise of society, that is, the rise of the "household" (*oikia*) or of economic activities to the public realm, housekeeping and all matters pertaining formerly to the private sphere of the family have become a "collective" concern. In the modern world, the two realms indeed constantly flow into each other like waves in the never-resting stream of the life process itself.”<sup>103</sup> The argument, then, is that the translation of “household” or economic matters from the private into the public realm somehow created a “society” with respect to which those private and public realms constantly interacted.

Arendt explains that the gulf in the ancient world between the narrow realm of the household and the loftier realm of politics was continued in the Middle Ages, since “after the downfall of the Roman Empire, it was the Catholic Church that offered men a substitute for the citizenship which had formerly been the prerogative of municipal government. The medieval tension between the darkness of everyday life and the grandiose splendor attending everything sacred, with the concomitant rise from the secular to the religious, corresponds in many respects to the rise from the private to the public in antiquity. The difference is of course very marked, for no matter how "worldly" the Church became, it was always essentially an otherworldly concern which kept the community of believers together.”<sup>104</sup>

The religions of Greek and Roman city states, of course, provided some element of otherworldly cohesion. Allowing for that difference, “the secular realm under the rule of feudalism was indeed in its entirety what the private realm had been in antiquity. Its hallmark was the absorption of all activities into the household sphere, where they had only private significance, and consequently the very absence of a public realm.”<sup>105</sup> Arendt seems to locate the church in the political space, as

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<sup>103</sup> *Ibid* at 33.

<sup>104</sup> *Ibid* at 34.

<sup>105</sup> *Ibid* [citations omitted].

it assumed functions that were undertaken by municipal government in antiquity and in later Europe. She also fails to explicitly acknowledge its role in the feudal economy.

Unlike Habermas, Arendt attempts to deal with the application of the public/private distinction in relation to the Catholic Church, finding its religious aspects in the private sphere and its superintendence of the well-being of its citizen-members in the public sphere. However, she fails to note that the pursuit of the virtuous public life of the Greek philosopher or any other Greek citizen had a parallel, in the medieval period, namely, the pursuit of the virtuous Christian life. Arendt also fails to acknowledge the similarity between the economic support provided by coreligionists of those in Holy Orders to the priests, friars, nuns, and others in Holy Orders, on the one hand, and by the non-citizen members of the household to the Greek citizen of the polis, on the other hand.

The highest pursuit of virtue, for the Greeks, in the life of the polis, and for medieval Christians, in the truly Christian life, was available only to a fortunate few, many of whose “economic” or “requisite for (higher) living” needs were supplied by others, as in many other religiously dominated societies. Consequently, while Arendt’s comparison between the private realm or household sphere of antiquity and that of the feudal era is striking and innately appealing, she claims too much when she alleges that all activities were absorbed into the household sphere and that the private realm and feudalism were devoid of any public realm.

The next step in Arendt’s analysis of the public/private distinction is to extend feudal or household models into medieval economic pursuits:

It is characteristic of this growth of the private realm, and incidentally of the difference between the ancient household head and the feudal lord, that the feudal lord could render justice within the limits of his rule, whereas the ancient household head, while he might exert a milder or harsher rule, knew neither of laws nor justice outside the political realm. The bringing of all human activities into the private realm and the modeling of all human relationships upon the example of the household reached far into the specifically medieval professional organizations in the cities themselves, the guilds, *confreries*, and *compagnons*, and even into the early business companies, where "the original joint household would seem to be indicated by the very word 'company' (*icmnpans*). . . [and] such phrases as 'men who eat one bread,' 'men who have one bread and one wine.' ” The medieval concept of the

"common good," far from indicating the existence of a political realm, recognizes only that private individuals have interests in common, material and spiritual, and that they can retain their privacy and attend to their own business only if one of them takes it upon himself to look out for this common interest. What distinguishes this essentially Christian attitude toward politics from the modern reality is not so much the recognition of a "common good" as the exclusivity of the private sphere and the absence of that curiously hybrid realm where private interests assume public significance that we call "society."<sup>106</sup>

Arendt assigns the feudal lord a role, in dispensing justice within the limits of his rule (which actually were quite extensive at various points in time), which she considers to be political. Perhaps Arendt was not bearing in mind the extent to which enforcing order within the household was a prerogative of the heads of ancient household heads, who admittedly would not have thought that they were exercising a political function. While later feudal lords may have considered that they were exercising a political function, the characterization of the power by the person exercising it does not seem to be a valid basis for its functional characterization (although it might indicate something about the historical discourse surrounding it).

Arendt fails to see that the feudal lord enforcing order within his estates was acting as household head, just like an ancient household head, but, because the latter characterized such action otherwise than as exercising a political function, she infers that the former, whose characterization of the same activity is not disclosed to us, must be exercising a political function. In fact, one suspects that the reason for her inference is that she considers the feudal order and feudal estates as political in nature, particularly in reference to the subsequent roles of the feudal lords and later landed nobility in reaching accords with the Crown, a form of undertaking she would be expected to consider to be within the political realm.

More importantly, Arendt fails to sufficiently acknowledge the kinship nature of the ancient household when she says that the household model was applied to the medieval professional organizations in the cities, municipalities and early business companies which organizations acknowledged as members those who share the same bread and wine. She ignores the possibility that the extension of such household models beyond the kinship-based household might involve,

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<sup>106</sup> *Ibid* at 34-35 [citations omitted; emphasis in the original].

implicitly or explicitly, some acknowledgement of kin-like or affiliative relationship. An argument which is mentioned throughout the present book is that the need for social intercourse, sometimes extending to such a relationship, is an originative element in the creation of many organizations, including the modern business corporation.

Similarly, Arendt's comments go astray when she says that the medieval conception of the common good expresses only that private individuals have interests in common the achievement of which depends on some person or entity looking out for this common interest, namely the ability to maintain one's own privacy and to pursue one's own private interests. Her argument fails to acknowledge that extending the kin-like or affiliative aspect of the household model to the extended community or society may involve similar kin-like or affiliative feelings and motivations.

Instead, she "breaks out" individuals, considered atomistically, from their household groups and attributes to them a pursuit of exclusively personal interests. If not Hobbesian, such analysis assumes at least a liberal orientation, which, however, Arendt proceeds to criticize. However, having built such "straw man" unverified assumptions into her description of the transition from feudal to early modern European history, attacking the straw man may facilitate an attack on liberalism and neoliberalism.

### ***Modernity***

Arendt claims that modernity assigns all activities to the household or private sphere and thereby eliminates the social sphere, or society, "that curiously hybrid realm where private interests assume public significance". She argues, further that "[w]e no longer think primarily of deprivation when we use the word "privacy," and this is partly due to the enormous enrichment of the private sphere through modern individualism. However, it seems even more important that modern privacy is at least as sharply opposed to the social realm—unknown to the ancients who considered its content a private matter – as it is to the political, properly speaking. The decisive historical fact is that modern privacy in its most relevant function, to shelter the intimate, was discovered as the opposite not of the political sphere but of the social, to which it is therefore more closely and authentically related."<sup>107</sup>

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<sup>107</sup> *Ibid* at 38.

Arendt seems to consider society as existing beyond the household. She argues that the rise of society coincided with the decline and disintegration of the family, which “indicates clearly that what actually took place was the absorption of the family unit into corresponding social groups. The equality of the members of these groups, far from being an equality among peers, resembles nothing so much as the equality of household members before the despotic power of the household head, except that in society, where the natural strength of one common interest and one unanimous opinion is tremendously enforced by sheer number, actual rule exerted by one man, representing the common interest and the right opinion, could eventually be dispensed with. The phenomenon of conformism is characteristic of the last stage of this modern development.”<sup>108</sup>

Arendt analogizes the household to modern society, with the household members replaced by social groups and the head of the family by the state, eventually not represented only by a monarch. Arendt’s analysis conflates the decline of the family with its “disintegration”, and ignores the complexity of the medieval household and its economic as well as social functions. In addition, she assumes that the complex membership of the household in medieval and later times is divided up into new social groups, within the social sphere, the members of all of which groups are all and only atomistic individuals.

Arendt’s analysis of the discontinuity is such that she assumes that there were no social groups in medieval times and, consequently, that there was no continuity of social groups from medieval times to modernity. Thus, according to Arendt, these “abandoned” atomistic individuals, divorced from their household and extended kin-like origins, as well as from pre-existing social groups whose existence she does not recognize, now must enter into new affiliative groupings, which requires eliminating their own interests and opinions in favour of the new common interest and opinion.

Consequently, Arendt argues that following the decline of the family, the rise of society, and the admission of “household and housekeeping activities to the public realm”, society has exhibited “an irresistible tendency to grow, to devour the older realms of the political and private”.<sup>109</sup> She argues that the constant and constantly accelerating growth “derives its strength from the fact that through society it is the life process itself which in one form or another has been channeled into

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<sup>108</sup> *Ibid* at 40.

<sup>109</sup> *Ibid* at 45.

the public realm”.<sup>110</sup> This was because the necessities of life, of individual survival as well as of continuity of the species, were taken care of and guaranteed in the private realm of the household. In effect, she maintains that the demands of “the life process” itself accelerates in some unexplained manner once the household dissolves and individuals are cast into a vast panoply of atomistic individuals that she maintains constitute society.

Arendt relates that antiquity held tremendous contempt for the private sphere because “man existed in this sphere not as a truly human being but only as a specimen of the animal species man-kind” and the emergence of the private into society “has hardly transformed its nature. The monolithic character of every type of society, its conformism which allows for only one interest and one opinion, is ultimately rooted in the one-ness of man-kind.”<sup>111</sup> That one-ness is the pursuit of life itself.

For Arendt, “society constitutes the public organization of the life process itself” and the new social realm is one of jobholders, in effect, “centered around the one activity necessary to sustain life.”<sup>112</sup> Society, then, is “the form in which the fact of mutual dependence for the sake of life and nothing else assumes public significance and where the activities connected with sheer survival are permitted to appear in public.”<sup>113</sup> In a sense, Arendt might consider that the assertion “man is a social animal” is either completely vacuous or tautologous, because for her, society, the social realm, is that of man as animal.

Arendt considers that the extension of the domain of the household, or private, so as to devour the older domains of the political and the private, and to create the domain of the social, or society, has rendered supreme man as a social animal, and has rendered the once private needs of life public. For Arendt, the word “public” has come to signify, first, “everything that can be seen and heard by everybody and has the widest possible publicity”<sup>114</sup> and, second, “the world itself in so far as it is common to all of us and distinguished from our privately owned place in it.”<sup>115</sup> In the first sense, appearance to others, as well as ourselves, Arendt says, “constitutes reality”, perhaps in the sense that it “institutes reality” or that it “institutes that reality which is common to all”.

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<sup>110</sup> *Ibid.*

<sup>111</sup> *Ibid* at 46.

<sup>112</sup> *Ibid.*

<sup>113</sup> *Ibid.*

<sup>114</sup> *Ibid* at 50.

<sup>115</sup> *Ibid* at 52.



The common world is related “to the human artifact, the fabrication of human hands, as well as to affairs which go on among those who inhabit the man-made world together. To live together in the world means essentially that a world of things is between those who have it in common, as a table is located between those who sit around it; the world, like every in-between, relates and separates men at the same time.”<sup>116</sup> For her, that which was formerly private, the means of life, has become both public and celebrated and “[t]he public realm, as the common world, gathers us together and yet prevents our falling over each other, so to speak. What makes mass society so difficult to bear is not the number of people involved, or at least not primarily, but the fact that the world between them has lost its power to gather them together, to relate and to separate them.”<sup>117</sup>

Arendt thinks that the public realm, the common world, the world between (*inter-esse*) people has become dominated by a common objective measurement, money, as a common denominator for all needs. For her, such “objectivity” entails the failure of public life, the significance of which derives from being the common meeting ground of those present, each of whom has a different position from which they observe the common world, a world in which everybody is always concerned with the same object.<sup>118</sup>

In mass society, as in isolation, “men have become entirely private, that is, they have been deprived of seeing and hearing others, of being seen and being heard by them. They are all imprisoned in the subjectivity of their own singular experience, which does not cease to be singular if the same experience is multiplied innumerable times. The end of the common world has come when it is seen only under one aspect and is permitted to present itself in only one perspective.”<sup>119</sup>

## Conclusion

Thus, for Arendt, the public realm or common world has been destroyed when the universal perspective is economic, or, as we may say, when the only perspective is that of the household, that is to say, when the public and the private can no longer be distinguished, and when the economic, social and political domains have disappeared or have merged into a single economic domain. It is not necessary, of course, to adopt Arendt’s arguments or conclusions; however, it is necessary to admit that she presents with some cogency an argument concerning the devolution

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<sup>116</sup> *Ibid.*

<sup>117</sup> *Ibid* at 52-53.

<sup>118</sup> *Ibid* at 56.

<sup>119</sup> *Ibid* at 56-57.

and disappearance of the distinction between the public and private spheres, on the one hand, and the distinction between the economic, social and political spheres on the other.

It will be recalled that Habermas criticizes liberal models of society in which states consider the interests of individuals who act atomistically and pluralistically, and in which the public sphere is very small and the private sphere very large. Recognizing that this model no longer obtains, he calls, instead, for the restoration of the public sphere as a place for rationalization of power through discussion among competing organizations each of which is committed to the public sphere in terms of their relationships to their own constituents, to those other organizations, and to the state.

Habermas and Arendt argue cogently that the private and public spheres are not completely discrete, either actually or analytically. In conclusion, the assumption of orthodox economics, which is often expressed in legal theory and legal discourse, that the private sphere is fundamentally separate and distinct from the public sphere, and the related assumption that the each can be analyzed in a manner which is distinctive to it are both contrary to historical and archaeological evidence, and to logical analysis, and are highly contestable.

**CHAPTER B2:  
ASSUMPTIONS ABOUT THE ECONOMY, AND SOCIETY, THE POLITY, AND THE  
STATE AS SPHERES OF ACTION**

**ASSUMPTION FOUR - THE DISTINCTIVE MODE OF ANALYSIS OF THE  
ECONOMY**

The fourth assumption concerning the economy, and society, the polity and the state is that the economy must be analyzed in a distinctive manner from society and the polity. It is most frequently unarticulated, but, instead, assumed by economists and others. We have already seen that certain assumptions, such as the atomistic behavior of individuals, are common in various social sciences, not only in economics. However, this fact that some assumptions are common does not touch the issue of the distinctiveness of the mode of analysis, to which we now turn.

In these investigations, alternative modes of analysis will be explicated, critiqued, and evaluated. This will entail significant exposition of perspectives taken by influential academic and other analysts and commentators. The objective of this chapter is to demonstrate that the assumption considered in this chapter, viz., that the economy must be analyzed in a manner that is distinctive from that in which society and the economy may be analyzed, is either unsupported (in the strong form of the hypothesis), or, (in the weaker form of the hypothesis) is highly contestable and problematic.

**Markets, The Economy, and Society**

One of the most powerful explications of the relationships among the social, economic, and political realms is that of embeddedness, a perspective that speaks to the relationship of those realms, and to the relationships among individuals, groups, and institutions. This perspective, therefore, provides a suitable focus for issues relating to the analytical uniqueness of the economy which are discussed in this chapter. That perspective will also be employed in the following chapter, which concerns the independence and distinctness of the economy from society and the polity. The focus in the present chapter will be on classical and neoclassical analysis of the economy.

In his influential 1985 article “Economic Action and Social Structure: The Problem of Embeddedness”,<sup>1</sup> Mark Granovetter accepts that “[i]t has long been the majority view among

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<sup>1</sup> Mark Granovetter, “Economic Action and Social Structure: The Problem of Embeddedness” (1985) 91:3 *American J Sociology* 481.

sociologists, anthropologists, political scientists, and historians that [economic] behavior was heavily embedded in social relations in premarket societies but became much more autonomous with modernization. This view sees the economy as an increasingly separate, differentiated sphere in modern society, with economic transactions defined no longer by the social or kinship obligations of those transacting but by rational calculations of individual gain. It is sometimes further argued that the traditional situation is reversed: instead of economic life being submerged in social relations, these relations become an epiphenomenon of the market.”<sup>2</sup>

While Granovetter admits that “most [economists] assert instead that embeddedness in earlier societies was not substantially greater than the low level found in modern markets”,<sup>3</sup> he argues that historians and social scientists see the economy “as an increasingly separate, differentiated place in modern society” with economic transactions determined by rational calculations of individual gain.<sup>4</sup> He also argues that how the absence of social relations (which he asserts are always present) might affect behaviour and institutions can only be imagined by a thought experiment like Thomas Hobbes’s “state of nature” or John Rawls’s “original position”.

Granovetter maintains that “[m]uch of the utilitarian tradition, including classical and neoclassical economics, assumes rational self-interested behavior affected minimally by social relations, thus invoking an idealized state not far from that of these thought experiments.”<sup>5</sup> The inference is that economic activity cannot be separated from social relations, except in some idealized or purely conceptual state, or in some thought experiment. The assumption of classical and neoclassical economics concerning rational self-interested behaviour largely unaffected by social relations invokes a particular understanding of the nature of man. As this chapter proceeds to consider the question whether the economy may or must be analyzed in a distinct and separate manner from the society and the polity, partly by means of applying a lens of “embeddedness”, it will also consider that question by way of a perspective or lens concerning different assumptions or generalizations with respect to the nature of man.

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<sup>2</sup> *Ibid* at 482. It is not necessary to accept the first, Polanyian type observation, in order to reach the conclusion in the next sentence.

<sup>3</sup> *Ibid*.

<sup>4</sup> *Ibid* at 481.

<sup>5</sup> *Ibid*.

## The Conception of Man in Neoclassical Economics

The assumption that economic transactions proceed “by rational calculations” is characteristic of neoclassical economics. John Lie, a leading proponent of sociological analysis of markets, argues that “the problem with neoclassical economics is that it demarcates the economy as an arena within which social relations do not matter.... Hirschman writes that in the neoclassical vision "there is no room for bargaining, negotiation, remonstrance or mutual adjustment and the various operators that contract together need not enter into recurrent or continuing relationships as a result of which they would get to know each other well." Unfortunately, these insights have been lost by neoclassical economics, which relies on the notion of atomized individuals who maximize subjective utility.”<sup>6</sup>

Neoclassical economics, says John Lie, ignores the social relations that underlie economic activity. As already mentioned, its “notion of atomized individuals” is not, unique to classical and neoclassical economics, but is also shared by much classical and neoclassical liberal political theory, and by much sociological theory. The explication of neoclassical economics in any significant detail is beyond the scope of the present work, although some of its principal assumptions and generalizations will be discussed in Chapters A4 and A5.

However, as a rough working summary, for present purposes, we will adopt the usage of Roy Weintraub, a leading writer in the history of economics, that neoclassical economics is a metatheory, “a set of implicit rules or understandings for constructing satisfactory economic theories. It is a scientific research program that generates economic theories the fundamental assumptions of which are not open to discussion in that they define the shared understandings of those who call themselves neoclassical economists, or economists without any adjective.” In the case of neoclassical economics, indicates that the “fundamental assumptions include the following: 1. People have rational preferences among outcomes. 2. Individuals maximize utility and firms maximize profits. 3. People act independently on the basis of full and relevant information.”<sup>7</sup>

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<sup>6</sup> John Lie, “Embedding Polanyi’s Market Society” (1991) 34:2 *Sociological Perspectives* 219 at 226 [citations omitted].

<sup>7</sup> E Roy Weintraub, “Neoclassical Economics” in *The Concise Encyclopedia of Economics*, by David R Henderson, online: *Library of Economics and Liberty* <<http://www.econlib.org/library/Enc1/NeoclassicalEconomics.html>>.

These fundamental assumptions involve what we may characterize as an even more fundamental meta-assumption, the atomism of economic actors. The economic actors posited by neoclassical economics are individuals, and they seek outcomes for themselves, which are based on preferences that are their own, and in a sense, unique to them. Their economic behaviour is instrumentalist, as it is directed towards attainment of preferences that are rationally determined and which they expect to be satisfactory to them. This atomistic meta-assumption and these assumptions of metatheory are operationalized in more detailed theory, as explained by Weintraub here:

The framework of classical economics is easily summarized. Buyers attempt to maximize their gains from getting goods, and they do this by increasing their purchases of a good until what they gain from an extra unit is just balanced by what they have to give up to obtain it. In this way they maximize “utility” – the satisfaction associated with the consumption of goods and services. Likewise, individuals provide labor to firms that wish to employ them, by balancing the gains from offering the marginal unit of their services (the wage they would receive) with the disutility of labor itself – the loss of leisure. Individuals make choices at the margin. This results in a theory of demand for goods, and supply of productive factors.

Similarly, producers attempt to produce units of a good so that the cost of producing the incremental or marginal unit is just balanced by the revenue it generates. In this way they maximize profits. Firms also hire employees up to the point that the cost of the additional hire is just balanced by the value of output that the additional employee would produce.

The neoclassical vision thus involves economic “agents”, be they households or firms, optimizing (doing as well as they can), subject to all relevant constraints. Value is linked to unlimited desires and wants colliding with constraints, or scarcity. The tensions, the decision problems, are worked out in markets. Prices are the signals that tell households and firms whether their conflicting desires can be reconciled.<sup>8</sup>

This description evokes what we may characterize as another meta-assumption, namely, that the actions of individual monadic agents take the form of transactions (etymologically, and substantially, actions between, across, or through actors) that are dyadic in nature, in that there are two parties to each such transaction.

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<sup>8</sup> *Ibid.*

These transactions are monadic or unique as transactions in the sense that each is separate and distinct from every other transaction. That is not, of course, to say that transactions are not linked to other transactions. For example, an actor pursuing and seeking to maximize his or her utility may engage in functionally intermediate transactions that are of an instrumental nature, but aimed at securing his or her preferences and overall utility. We might choose to characterize this as a meta-assumption of discreteness. Such meta-assumptions (atomism, dyadism, and discreteness) may be said to underlie the fundamental assumptions Weintraub identifies and to be operationalized in the framework that he describes.

Another leading economic historian, David Colander, summarizes the primary attributes of neoclassical economics, in effect, as follows: 1. It focuses on allocation of resources at a given moment in time. 2. It accepts some variation of utilitarianism as playing a central role in understanding the economy. 3. It focuses on marginal tradeoffs. 4. It assumes farsighted rationality. 5. It accepts methodological individualism. The individual is “doing the maximizing” and the market translates that individual rationality into social rationality. 6. It is structured around a general equilibrium conception of the economy.<sup>9</sup> In effect, the market of neoclassical economics, as described by Colander, is the aggregation of individual rationality, utility, and marginalism (secondary or marginal, utility, additional satisfaction derived from each additional unit of the product or service considered).

Another leading economist, Sherwin Rosen, elucidates upon the rationality assumption, saying that “[i]n neoclassical economics, individual behavior is described as the outcome of rational choices – doing the best one can under the circumstances, and pursuing those specific actions from available alternatives that maximize the difference between personal benefits and costs. The choice set is fully specified, technology of sellers and tastes of buyers are given, as are the number and varieties of goods. There is a well-defined solution to the resource allocation problem. General conditions can be found for which a market equilibrium “exists” in the sense that all individual agents can independently fulfill the plans that best serve their self-interests, given the model

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<sup>9</sup> David Colander, “The Death of Neoclassical Economics” (2000) 22:2 *J History Economic Thought* 127 at 134-35. Weintraub and Colander both identify Thorstein Veblen as the first user of the term. Colander says this was in Veblen’s “Preconceptions of Economic Science” (1899) 13:4 *QJ Economics* 396. His citations for discussions of this are: Tony Aspromourgos, “On the Origin of the Term “Neoclassical” (1986) 19:30 *Cambridge J Economics* 265; and Susan Fayazmanesh, “On Veblen’s Coining of the Term ‘Neoclassical’” in Susan Fayazmanesh & Marc R Tool, eds, *Institutionalist Method and Value: Essays in Honor of Paul Dale Bush*, vol 1 (Aldershot: Edward Elgar, 1998) 1.

assumptions.”<sup>10</sup> Indeed, for neoclassical economics the existence of an equilibrium is a logical necessity, “[f]or if the individual plans chosen to fulfill self-interest turn out to be infeasible, the problem must have been incorrectly specified in the first instance”, which make it important that the conditions under which an equilibrium exists are fairly minimal.<sup>11</sup>

In effect, neoclassical economics posits an aggregation of the result of the behaviours of individual atomistic actors that can be independently derived from the assumptions of a given model, such that a failure of such aggregation to derive the result hypothesized must result from an under-specification of the problem. Neoclassical economics assumes that the characterization of an economic problem can be adequately specified, and that once set in motion, the calculations required are somewhat mechanical.

Weintraub emphasizes the rationalism assumption of neoclassical economics, saying that it “conceptualized the agents, households and firms, as rational actors. Agents were modeled as optimizers who were led to “better” outcomes. The resulting equilibrium was “best” in the sense that any other allocation of goods and services would leave someone worse off. Thus, the “social system” in the neoclassical vision was free of unresolvable conflict.”<sup>12</sup>

Weintraub explains that the atomistic conception of individual action employed was quite deliberate, indeed that “[t]he very term “social system” is a measure of the success of neoclassical economics, for the idea of a system, with its interacting components, its variables and parameters and constraints, is the language of mid-nineteenth-century physics. This field of rational mechanics was the model for the neoclassical framework. Agents were like atoms; utility was like energy; utility maximization was like the minimization of potential energy, and so forth.”<sup>13</sup> Linking the “rhetoric of successful science” to neoclassical theory linked the two disciplines, and treated

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<sup>10</sup> Sherwin Rosen, “Austrian and Neoclassical Economics: Any Gains From Trade?” (1997) 11:4 J Economic Perspectives 139 at 140.

<sup>11</sup> *Ibid.*

<sup>12</sup> Weintraub, *supra* note 7. This use of the term “best” refers to Pareto optimality or Pareto efficiency. Of course, Pareto optimality or Pareto efficiency was not part of the original neoclassical formulation but was incorporated into neoclassical orthodoxy after its appearance in 1906, including by such Nobel economists as Kenneth Arrow, Gerard Debreu, Joseph Stiglitz (all of whom worked on its mathematical proofs), and Amartya Sen. It is interesting, in view of Weintraub’s comments on modelling economics on physics and mechanics, that Vilfredo Pareto’s doctorate (on the equilibrium of solid bodies) and early career were in engineering.

<sup>13</sup> *Ibid.*



neoclassical theory as “scientific economics” with the result that “to challenge the neoclassical approach was to seem to challenge science and progress and modernity.”<sup>14</sup>

### **Conceptions of Economic Man Abstracted from Social and Political Contexts**

It may be somewhat more accurate to say that neoclassical economics, in its meta-assumptions and assumptions, “assumed away” social and political influences, consequences, and spheres of human existence, and so did not concern itself with them as matters of primary importance. As Mark Granovetter said, some interpreters consider those social relations to be “an epiphenomenon of the market”.<sup>15</sup>

It is said by some commentators that it was a reaction to this signal fact that led to the development of sociology and, in particular, to the sociological critique of economic behaviour and of markets. For example, the sociologist Dennis Wrong in his highly influential 1962 article “The Oversocialized Conception of Man in Modern Sociology”<sup>16</sup> says: “Modern sociology, after all, originated as a protest against the partial views of man contained in such doctrines as utilitarianism, classical economics, social Darwinism, and vulgar Marxism. All of the great nineteenth and early twentieth century sociologists saw it as one of their major tasks to expose the unreality of such abstractions as economic man, the gain-seeker of the classical economists; political man, the power-seeker of the Machiavellian tradition in political science; self-preserving man, the security-seeker of Hobbes and Darwin; sexual or libidinal man, the pleasure-seeker of doctrinaire Freudianism; and even religious man, the God-seeker of the theologians.”<sup>17</sup> For Dennis Wrong, as the title of his article suggests, even the social or socialized conception of man can be in error, either as oversocialized or as undersocialized.

These assumptions and mechanistic models of man and his activities abstracted of social context may be expected to be deficient, as the political scientist Terry M. Moe observed, with respect to economic man, in a 1984 article entitled “The New Economics of Organization”: “The neoclassical theory of the firm is not in any meaningful sense a theory of economic organization.

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<sup>14</sup> *Ibid.*

<sup>15</sup> *Supra* note 1 at 482.

<sup>16</sup> Dennis Wrong, “The Oversocialized Conception of Man in Modern Sociology” (1961) 26:2 *American Sociological Rev* 183.

<sup>17</sup> *Ibid* at 190. His article criticizes as the oversocialized conception of man a sociological view that, put all too simply, sees human behaviour as determined and predictable by roles adopted by individuals in connection with their socialization.

It centers around the entrepreneur, a hypothetical individual who, by assumption, makes all decisions for the firm and is endowed with a range of idealized properties defining his knowledge, goals, computational skills, and transaction costs.” As we will argue, this single individual entrepreneur “firm” thus excludes, by hypothesis, consideration of the firm as an organization. Instead, Moe says: “Virtually all aspects of business enterprise that organization theorists find interesting and consequential –from formal structure to social context and worker psychology to bounded rationality, adaptive search, and goal conflict – are thereby assumed away. The model firm is simply a black box that produces optimal choices automatically as a function of any given environment.”<sup>18</sup>

He argues that neoclassical economists dismiss criticism of this nature “since the theory was never intended to be realistic in its assumptions nor to be accurate in its micro-level implications for individuals and organizations.” As a result, “assumptions about the firm and perfect competition are simply vehicles” used to derive “formal implications for market prices and outputs, resource allocation, equilibria, and other aggregate properties of economic systems.”<sup>19</sup>

While Moe’s argument that neoclassical economic theory of the firm was not intended to be realistic or accurate at the micro-level may be true with respect to later neoclassical economists, we may reserve some doubt on this point, at least with respect to earlier neoclassical economists, based on their own descriptions of their own micro-economic theories. We will defer until later a discussion of the theory of the firm, especially as a “black box”, and of perfect competition as involving “atomized decisional units” operating without any system of central coordination. We will also discuss the rationality assumption in more detail in Chapters B4 and B5.

Moe maintains that many of the weaknesses and omissions attributed to neoclassical models can often be answered within the broader neoclassical framework, which he characterizes as “less a unified neoclassical theory than a large family of diverse theories related by shared analytical foundations, chief among them: a focus on the individual as the unit of analysis; the assumption of rational, utility-maximizing behavior; a concern for efficiency, optimality, and equilibrium; and a preference for mathematical modeling over other approaches to theory construction.”<sup>20</sup>

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<sup>18</sup> Terry M Moe, “The New Economics of Organization” (1984) 28:4 *American J Political Science* 739, citing Harold Demsetz, *Economic, Legal, and Political Dimensions of Competition* (Amsterdam: North Holland, 1982).

<sup>19</sup> Moe, *supra note* 18 at 740-741.

<sup>20</sup> *Ibid* at 741.

Rationality, as practiced by atomistic profit-seeking individuals, is (at least, formally) considered by neoclassical economists (but no longer by all modern economists, for example, with respect to bounded rationality and other behavioural limitations) to exclude behaviours that are other than strictly profit-seeking. Granovetter claims: "That such behavior is rational or instrumental is more readily seen, moreover, if we note that it aims not only at economic goals but also at sociability, approval, status, and power" which, he says, are rarely seen by economists as rational goals, "in part on account of the arbitrary separation that arose historically, as Albert Hirschman (1977) points out, in the 17th and 18th centuries, between the "passions" and the "interests," the latter connoting economic motives only." Accordingly, economists came to analyze human behaviour as "motivated only by "interest" and to assume that other motives occur in separate and nonrationally organized spheres; hence Samuelson's much-quoted comment that "many economists would separate economics from sociology upon the basis of rational or irrational behavior".<sup>21</sup>

According to Granovetter, following one's passions is considered intrinsically irrational by economists; however, it is scarcely open to doubt that the motivations he identifies, (*viz.*, sociability, approval, status, power) are powerful drivers of individual behavior in their own right, and not just as instrumental to economic or utilitarian goals.

### **Socialization and Models of Man**

That motivations to behaviour are more complex than suggested by utilitarian theory is maintained by Dennis Wrong in his influential article, which was elucidated and expanded upon by Granovetter in his famous discussion of embeddedness. Wrong raises what he calls the Hobbesian question: "The question may be variously phrased as, "What are the sources of social cohesion?"; or, "How is social order possible?"; or, stated in social-psychological terms, "How is it that man becomes tractable to social discipline?" I shall call this question in its social-psychological aspect the "Hobbesian question" and in its more strictly sociological aspect the "Marxist question."" Wrong then continues by explicating the distinctions between these two questions as follows: "The Hobbesian question asks how men are capable of the guidance by social norms and goals that makes possible an enduring society, while the Marxist question asks how, assuming this capability,

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<sup>21</sup> Granovetter, *supra* note 1 at 506, citing Albert Hirschman, *The Passions and the Interests* (Princeton, NJ: Princeton University Press, 1977).

complex societies manage to regulate and restrain destructive conflicts between groups. Much of our current theory offers an oversocialized view of man in answering the Hobbesian question and an over-integrated view of society in answering the Marxist question.”<sup>22</sup>

***Oversocialized and Undersocialized Models of Atomistic Man***

Wrong asks, in turn, “What is the answer of contemporary sociological theory to the Hobbesian question? There are two main answers, each of which has come to be understood in a way that denies the reality and meaningfulness of the question. Together they constitute a model of human nature, sometimes clearly stated, more often implicit in accepted concepts, that pervades modern sociology. The first answer is summed up in the notion of the "internalization of social norms." The second, more commonly employed or assumed in empirical research, is the view that man is essentially motivated by the desire to achieve a positive image of self by winning acceptance or status in the eyes of others.”<sup>23</sup> Wrong concedes, then, that not only economists, but also sociologists, make use of implicit assumptions.

In Wrong’s judgment, modern sociologists believe “that they have understood these [non-instinctive social processes] and that they have not merely answered but disposed of the Hobbesian question”.<sup>24</sup> In effect, the social norms that are internalized and the approbation of others become goals of the individuals concerned. This model of human nature, while still atomistic, models the way in which atomistic individuals are affected by the behaviour of others, which is conducive to maintaining social order.

Wrong discusses Durkheim’s interpretation of constraint as explained by Parsons: “Parsons argues that Durkheim originally conceived of society as controlling the individual from the outside by imposing constraints on him through sanctions, best illustrated by codes of law. But in Durkheim's later work he began to see that social rules do not "merely regulate 'externally' . . . they enter directly into the constitution of the actors' ends themselves." Constraint, therefore, is more than an environmental obstacle which the actor must take into account in pursuit of his goals in the

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<sup>22</sup> Wrong, *supra* note 16 at 184.

<sup>23</sup> *Ibid* at 185.

<sup>24</sup> *Ibid*.

same way that he takes into account physical laws: it becomes internal, psychological, and self-imposed as well."<sup>25</sup>

This sort of internalization (characteristic, according to Wrong, of modern sociology generally), is equated by Durkheim and Parsons with learning or habit formation, such that, according to Wrong, "when a norm is said to have been 'internalized' by an individual, what is frequently meant is that he habitually both affirms it and conforms to it in his conduct"<sup>26</sup>. Wrong notes that from a psychoanalytic perspective, this eliminates an individual's inner conflict between Freud's id and the superego, or between impulses and controls over desires. For Freud, the internalization of the norm means that it has become part of the individual's superego.<sup>27</sup>

Dennis Wrong argues that the sociological perspective on human motivation still characterizes it in individualistic or atomistic terms, saying that "Parsons' model of the 'complementarity of expectations,' the view that in social interaction men mutually seek approval from one another by conforming to shared norms, is a formalized version of what has tended to become a distinctive sociological perspective on human motivation."<sup>28</sup> It certainly generalizes, at the group level, a characteristic said to pertain to the individual. Presumably, however, each individual is aware of the fact that each other individual in the group is seeking approval, if not necessarily of the first individual, then certainly of individuals in the group generally, however, this is not remarked in the passage just discussed. Wrong says that Ralph Linton states the same view, but in explicit psychological terms, when he says: "The need for eliciting favorable responses from others is an almost constant component of [personality]. Indeed, it is not too much to say that there is very little organized human behavior which is not directed toward its satisfaction in at least some degree."<sup>29</sup>

In Wrong's view the importance of "social factors" to sociologists easily leads them to stress the priority of such socialized or socializing motives in human behavior. However, in psychological terms, due to socialization motives, approbation becomes a distinct attribute of personality. Dennis Wrong claims that this perceived need for the approbation of others is applied mechanistically in

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<sup>25</sup> *Ibid* at 186, 191, citing Talcott Parsons, *The Structure of Social Action* (New York: McGraw-Hill Book, 1937) at 378-390; Emile Durkheim, *The Rules of Sociological Method* (Chicago: University of Chicago Press, 1938) at 71.

<sup>26</sup> *Supra* note 16 at 187.

<sup>27</sup> *Ibid*.

<sup>28</sup> *Ibid* at 188

<sup>29</sup> *Ibid*.

sociology in respect of behaviour but not in psycho-analysis, which “is primarily concerned with the inner life, not with overt behavior” (as with sociologists), noting that even for sociologists, “[s]o long as most individuals are “socialized,” that is, internalize the norms and conform to them in conduct, the Hobbesian problem is not even perceived as a latent reality.”<sup>30</sup>

This is what Wrong describes as the “overocialized conception of man”, which he describes as “yet another reified abstraction in socialized man, the status-seeker of our contemporary sociologists”.<sup>31</sup> Interestingly, Wrong appears to think that the Freudian psychoanalytic concept of man avoids this tendency, since “[t]he drives or “instincts” of psychoanalysis, far from being fixed dispositions to behave in a particular way, are utterly subject to social channelling and transformation and could not even reveal themselves in behavior without social molding...To psychoanalysis man is indeed a social animal”.<sup>32</sup>

Wrong distinguishes between the Freudian view, on the one hand, and both sociological and neo-Freudian conceptions of man, on the other:

To Freud man is a *social* animal without being entirely a *socialized* animal. His very social nature is the source of conflicts and antagonisms that create resistance to socialization by the norms of any of the societies which have existed in the course of human history. “Socialization” may mean two quite distinct things; when they are confused an over-socialized view of man is the result. On the one hand socialization means the “transmission of the culture,” the particular culture of the society an individual enters at birth; on the other hand the term is used to mean the “process of becoming human,” of acquiring uniquely human attributes from interaction with others. All men are socialized in the latter sense, but this does not mean that they have been completely molded by the particular norms and values of their culture. All cultures, as Freud contended, do violence to man's socialized bodily drives, but this in no sense means that men could possibly exist without culture or independently of society.<sup>33</sup>

In effect, Wrong claims that Freud’s man is a social animal in the sense that he engages in social interaction and so acquires uniquely human attributes as a result of such interaction, but is only

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<sup>30</sup> *Ibid* at 187.

<sup>31</sup> *Ibid* at 190.

<sup>32</sup> *Ibid* at 192.

<sup>33</sup> *Ibid* [emphasis in the original].

partly socialized in the sense of adopting the norms and values of their culture, which he may resist where they conflict with his bodily and other drives. In Wrong's terms, this means that Freud's conception of man is certainly not overly-socialized, and may even be under-socialized, although in a different sense from the conceptions of man in neoclassical economics and politics.

In Wrong's analysis, an "overly socialized conception of man" sees men as having "been completely molded by the particular norms and value of their culture" such that they behave in ways that are largely or even entirely predictable in concrete instances given knowledge of the norms and values of that culture, and the roles the individual plays in that culture. In such a view, the behaviour of individuals is not only atomistic (in any concrete instantiation), in the sense of derivable without interaction with other individuals (or groups), but is derivable in a mechanistic, scientific and regular way. Such a conception, we may say, commits an "atomistic" fallacy.

### *The Atomistic Homo Economicus*

As argued here, the atomistic conception of man in neoclassical economics, which Wrong and Granovetter maintain is undersocialized, likewise lacks efficacy and predictive capacity as a guide to human behaviour. Granovetter maintains that this results from its abstraction of the individual and of interpersonal interactions among individuals from their individuated and social contexts. He argues that "even when economists do take social relationships seriously...they invariably abstract away from the history of relations and their position with respect to other relations – what might be called the historical and structural embeddedness of relations. The interpersonal ties described in their arguments are extremely stylized, average, "typical" – devoid of specific content, history, or structural location. Actors' behavior results from their named role positions and role sets; thus, we have arguments on how workers and supervisors, husbands and wives, or criminals and law enforcers will interact with one another, but these relations are not assumed to have individualized content beyond that given by the named roles."<sup>34</sup>

Granovetter asserts that such treatment relegates "the specifics of individual relations to a minor role in the overall conceptual scheme, epiphenomenal in comparison with enduring structures of normative role prescriptions deriving from ultimate value orientations. In economic models, this treatment of social relations has the paradoxical effect of preserving atomized decision making

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<sup>34</sup> Granovetter, *supra* note 1 at 486.

even when decisions are seen to involve more than one individual. Because the analyzed set of individuals - usually dyads, occasionally larger groups - is abstracted out of social context, it is atomized in its behavior from that of other groups and from the history of its own relations. Atomization has not been eliminated, merely transferred to the dyadic or higher level of analysis.”<sup>35</sup> Thus, according to Granovetter, such analysts employ an oversocialized conception – that of actors behaving exclusively in accord with their prescribed roles – to implement an atomized, undersocialized view.

Granovetter’s argument here is that economists who pay any attention to social relationships abstract such social relationships away from their history and structural position, generating a description of interpersonal ties that is highly stylized and role-based, without any individualized content or surrounding historical and structural circumstances. Behaviour is predicted by ideal type, without any individuation. Specific intra-dyadic characteristics, history and circumstances, are ignored in favour of systemic typology. Individual relations are not distinctive, and hold no interest, as they are completely typified. This excessive orientation to typology may be said to characterize certain perspectives not only in economics, but also in sociology, as Granovetter admits, and also in political science.

Indeed, Granovetter’s description of such individual relations as “epiphenomenal” seems to be inadequate: instead, they are minor, unexplained, aberrant instantiations of a typology that is assumed to be all but invariably accurate. The “epiphenomenal” aberrations may even be hypothesized as statistical variances or anomalies. Thus, attempts by economics at “socializing” economic man (or generating an economic sociology) may become oversocialized, while still atomized, like such efforts by the Parsonian sociologists Granovetter criticizes. The key point which Granovetter makes, of course, is that relations are embedded in history and structure. Both economists and sociologists who “oversocialize” man excessively typologize, or, as Granovetter calls it, “oversocialize” the relations they seek to describe, whether economic or social. They overlook any possibility of atypicality or differentiation of the individual actor. Put another way, they generalize or abstract away individuation and the individual as such.

Of course, as noted earlier, the original atomized characterization of the Hobbesian problem might be expected to lead to no different conclusion. As argued here, the dyadic interaction of atomized

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<sup>35</sup> *Ibid* at 486-87.



individuals leaves no “space” for the “social”, except a binary one, between one atomized individual and another atomized individual. As Granovetter says, when even groups of individuals are abstracted out of social context, the group remains atomistic in its behaviour vis-à-vis other groups, just as do its component individuals in terms of one another. The atomization continues at the group level, and regardless of the elevation to a higher level of analysis.

Granovetter rightly concludes that “[a] fruitful analysis of human action requires us to avoid the atomization implicit in the theoretical extremes of under- and oversocialized conceptions. Actors do not behave or decide as atoms outside a social context, nor do they adhere slavishly to a script written for them by the particular intersection of social categories that they happen to occupy. Their attempts at purposive action are instead embedded in concrete, ongoing systems of social relations.”<sup>36</sup>

### *Actors as Members of Social Groups*

Actors also act as members of groups, not just as atomistic individuals. And each such group does not just engage with a single other group in a series of dyadic encounters. Groups, like individuals, often engage simultaneously or closely with more than one other. Similarly, at the group level, groups may interact with other groups at the same time or within a short space of time, just as individuals do not engage only in serial monadic interactions with only one other individual at a time. Social relations are also causal.

In a highly influential 2003 article to which we will refer in more detail below,<sup>37</sup> the network theorists James W. Moody and Douglas R. White comment on the ways in which social groups are maintained and how they relate to each other:

Here, we identify an important feature of the relational dimension of social solidarity that is applicable to groups of any size. Following Simmel, that feature is the extent to which a group depends on particular individuals to retain its character as a group. The relevant quantitative measure is the minimum number of individuals whose continued presence is required to retain the group's connectedness. For clarity and theoretical consistency, we refer to this relational aspect of social solidarity as *structural cohesion*. Structural cohesion

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<sup>36</sup> *Ibid* at 487.

<sup>37</sup> James W Moody & Douglass R White, “Structural Cohesion and Embeddedness - A Hierarchical Concept of Social Groups” (2003) 68:1 *American Sociological Rev* 103. This work cannot explore network theory more thoroughly.

simultaneously defines a *group* property characterizing the collectivity, a *positional* property that situates subgroups relative to each other in a population, and *individual* membership properties. Although we do not claim to capture the full range of either "solidarity" or "embeddedness," structural cohesion provides an exact analytic operationalization of a dimension of each.<sup>38</sup>

Structural cohesion, as they use the term, recognizes properties of the group, sub-groups within that group, and individuals as members. It is not clear whether they hypothesize that individuals may simultaneously be members of more than one sub-group or more than one group. We assume that this is the case. Indeed, we would submit that structural cohesion is one aspect or measure of individual-group loyalty, salience, identification, and identity, subjects which are discussed below.

Thus, for Moody and White, "structural cohesion necessarily entails a positional analysis of the resulting groups with respect to their nesting within the population at large. Theoretically, the resulting concept of nestedness captures one dimension of Granovetter's concept of social embeddedness. Like "solidarity," "embeddedness" is a multidimensional construct relating generally to the importance of social networks for action."<sup>39</sup>

Moody and White's concept of "nestedness" thus describes the relationships among sub-groups in relation to higher order groups and in relation to the population at large. This does not eliminate the possibility that groups, like sub-groups, may not overlap and thereby capture individuals who are simultaneously members of one or more other sub-groups or groups. This view of "nestedness" does not necessarily entail that nestings or groups or sub-groups are, like Faberge eggs, always contained within the higher order entity in which they are nested. Like embeddedness, the concept of nestedness indicates that the extreme atomism posited by classical and neoclassical economists is not maintainable except as a theoretical construct. Even in that employment, it presents difficulties as to how social order might be attained. Groups are part of the social fabric of a population.

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<sup>38</sup> *Ibid* at 105 [emphasis in the original].

<sup>39</sup> *Ibid*.

*The Hobbesian Problem of Order in Political and Economic Contexts*

We next examine the Hobbesian problem of order in political and economic contexts. In a useful discussion of embeddedness to which we will refer further in due course,<sup>40</sup> the sociologists Greta Krippner and Anthony Alvarez discuss the problems of atomism and embeddedness from Granovetter's and from Polanyi's perspectives, noting that "the Granovetterian formulation of embeddedness deals fundamentally with the problem of atomism, whereas the Polanyian tradition deals most centrally with the problem of the analytically autonomous economy. These two problems are indistinguishable within the neoclassical paradigm."<sup>41</sup>

Yet atomism is fundamental to neoclassical economics, and, accordingly, Krippner and Alvarez find it applied in the criticisms of neoclassicism by both embeddedness perspectives, saying: "An atomistic perspective, that is, a perspective that assumes isolated, self-interested actors who arrive on the scene already equipped with an inborn tendency to "truck, barter, and exchange," requires essentially no governance structure to police exchange. In such a world, there is no opportunity for fraud, collusion, corruption, or vice of any kind, hence no need for government meddling in the economy. With the assumption of atomism, we are therefore in the world of the self-regulating market—a world in which politics and culture enter into the market only as an interference and in which the economy can legitimately be described as an analytically autonomous sphere. As critique, Granovetterian and Polanyian perspectives provide a unified and compelling assault on the neoclassical perspective."<sup>42</sup>

The human tendency to "truck, barter, and exchange" was, of course, noted by Adam Smith in his classic work, *The Wealth of Nations*.<sup>43</sup> As we will discuss below, it is not clear that Adam Smith's treatment of economic man was as thoroughlygoingly atomistic as was that of some other economists considered to be neoclassical in orientation. Krippner and Alvarez find that both Granovetter and Polanyi are hostile to the atomistic assumptions of the neoclassical perspective, but their approaches to the relationship between economic and social action differ:

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<sup>40</sup> Greta Krippner & Anthony S Alvarez, "Embeddedness and the Intellectual Projects of Economic Sociology" (2007) 33 *Annual Rev Sociology* 219.

<sup>41</sup> *Ibid* at 222.

<sup>42</sup> *Ibid*.

<sup>43</sup> Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, vol 2 ed by RH Campbell & AS Skinner (Indianapolis: Liberty Fund, 1981).

Granovetter's concept of embeddedness involves identifying relational bases of social action in economic contexts; [that of] Polanyi, in contrast, concerns the integration of the economy into broader social systems. These are not the same problem. They invite different strategies of analysis and involve different assumptions about the nature of the underlying reality that these analytical strategies purport to describe. In particular, we argue that Granovetter's conception of embeddedness puts forward what we call an exterior relationship between the economic and the social, whereas Polanyi's elaboration of the concept posits an interior view of this relationship. In the former case, social relations shape economic outcomes from the outside; in the latter case, the social and the economic are seen as mutually constituting.<sup>44</sup>

In terms of the present, fourth, assumption, it can be seen that these are two different perspectives concerning the extent of separation of the economic and the social sphere and the interaction between the two. Indeed, as we will argue below, the present writer would maintain that Granovetter adheres rather too closely to the economic conception of social action. Perhaps this is affected by his concern to avoid an oversocialized account.

Krippner and Alvarez maintain that "Granovetter argued that a conception of social action as embedded in social networks could avoid the twin perils represented by undersocialized and oversocialized accounts. He noted, "Actors do not decide as atoms outside a social context, nor do they adhere slavishly to a script written for them by the particular intersection of social categories that they happen to occupy." Rather, examination of individuals' patterns of insertion into social relations affords a more compelling explanatory account of behavior in economic contexts."<sup>45</sup>

Krippner and Alvarez mention Granovetter's example of economic wrongdoing. Granovetter maintains that this is reduced not by efficient institutions, which they describe as an undersocialized account, or by generalized morality, which they maintain is an oversocialized account, but because "economic transactions are enmeshed in a thick net of personal relationships that explains order in economic life. These relationships both provide information on the

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<sup>44</sup> *Supra* note 40 at 223.

<sup>45</sup> *Ibid* [citation omitted].

motivations of one's exchange partner—is this person likely to fleece me? – and transform those motivations by infusing personal trust into exchange.”<sup>46</sup>

Whether one adopts the Granovetterian or the Polanyian perspective, embeddedness treats economic transactions as “enmeshed in a thick net of personal relationships” that explains order in economic life. Both dispute the neoclassical atomistic account of “self-interested actors who carry full formed preference rankings in their heads and make maximization decisions in isolation from other social actors”.<sup>47</sup>

Krippner and Alvarez say that: “Implicitly or explicitly, purveyors of the Granovetterian view of embeddedness reject the existence of *Homo Economicus*: The self-interested, maximizing agent who makes decisions in isolation from other agents is little more than a fiction. This is not to say that self-interest is not a motivator in economic life, nor that individuals do not attempt to maximize utility, narrowly or broadly conceived. Far from it – many Granovetterians are comfortable with rational choice theory, if not necessarily card-carrying adherents; similarly, many rational choice theorists have warmly embraced Granovetter's concept of embeddedness.”<sup>48</sup>

Instead, rational motivation is not thought to be the exclusive motivation of economic behaviour. According to them, “[w]hat this perspective rejects is the notion that there is some pure, invariant motive driving human behavior: Because motivations inhere in social relations, and because relations are by their very nature multipurpose, motivations are likely to be mixed. More to the point, it is appropriate to think of social relations, rather than the set of motivations (mixed or otherwise) produced by these relations, as causal. Primacy is given to the context of social action.”<sup>49</sup>

Although developments in psychology, psychiatry and psychoanalysis, sociology and political science have made it difficult to maintain the exclusivity of economic gain, self-interest, or utility as the sole motivating force behind the actions of individuals, it might behoove us to briefly examine the some of the background of those notions. As is well known, Hobbes describes a state of nature in which he conceptualizes man as a solitary individual.<sup>50</sup> He asked what Dennis Wrong

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<sup>46</sup> *Ibid* at 223-224 [citations omitted], citing Granovetter, *supra* note 1 at 487.

<sup>47</sup> Krippner & Alvarez, *supra* note 40 at 223.

<sup>48</sup> *Ibid* at 227 [citations omitted; emphasis in the original].

<sup>49</sup> *Ibid* [citations omitted].

<sup>50</sup> Thomas Hobbes, *Leviathan: Or the Matters, Form and Power of a Commonwealth, Ecclesiastical and Civil* (London: George Routledge & Sons, 1907), c XIII.

describes as the “Hobbesian question”, which as noted above,” may be variously phrased as, "What are the sources of social cohesion?"; or, "How is social order possible?"; or, stated in social-psychological terms, "How is it that man becomes tractable to social discipline?" ...The Hobbesian question asks how men are capable of the guidance by social norms and goals that makes possible an enduring society... Much of our current theory offers an oversocialized view of man in answering the Hobbesian question”.<sup>51</sup> With that, attention turns to some consideration of that question.

### **Thomas Hobbes’s Conception of Man**

Hobbes posits a “state of nature” and says that it is “manifest that during the time men live without a common power to keep them in awe, they are in that condition which is called war: and such a war is of every man against every man”<sup>52</sup>. He observes that the natural equality of mankind in body and mind is such that none can without all have the hope of attaining their ends, but when two men desire the same thing which both cannot enjoy, they become enemies and everyone tries to master the persons of others, even more so than security requires, so long as he is not endangered by a greater power. He assumes that “men have no pleasure (but on the contrary a great deal of grief) in keeping company where there is no power able to overawe them all”<sup>53</sup>, for every man wants others to value him as highly as he values himself. His state of nature is one in which men quarrel by reason of, firstly, competition, or gain; secondly, for diffidence, or safety; and, thirdly, for glory, or reputation over others.

In a famous passage, Hobbes delineates the consequences of such state:

Whatsoever therefore is consequent to a time of war, where every man is enemy to every man, the same consequent to the time wherein men live without other security than what their own strength and their own invention shall furnish them withal. In such condition there is no place for industry, because the fruit thereof is uncertain: and consequently no culture of the earth; no navigation, nor use of the commodities that may be imported by sea; no commodious building; no instruments of moving and removing such things as require much force; no knowledge of the face of the earth; no account of time; no arts; no

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<sup>51</sup> *Supra* note 16 at 184.

<sup>52</sup> *Supra* note 50, c XIII.

<sup>53</sup> *Ibid.*

letters; no society; and which is worst of all, continual fear, and danger of violent death; and the life of man, solitary, poor, nasty, brutish, and short.<sup>54</sup>

The solitary man in a state of nature pursues his passions, which do not include social or moral impulses, by using force and fraud, unrestrained by law or justice:

To this war of every man against every man, this also is consequent; that nothing can be unjust. The notions of right and wrong, justice and injustice, have there no place. Where there is no common power, there is no law; where no law, no injustice. Force and fraud are in war the two cardinal virtues. Justice and injustice are none of the faculties neither of the body nor mind. If they were, they might be in a man that were alone in the world, as well as his senses and passions. They are qualities that relate to men in society, not in solitude. It is consequent also to the same condition that there be no propriety, no dominion, no mine and thine distinct; but only that to be every man's that he can get, and for so long as he can keep it. And thus much for the ill condition which man by mere nature is actually placed in; though with a possibility to come out of it, consisting partly in the passions, partly in his reason.<sup>55</sup>

It is, of course, reason, according to Hobbes, that inclines men to agree on “convenient articles of peace”, which Hobbes describes as the laws of nature, and which result in the constitution of the Commonwealth.

The fundamental law of nature, laid down in Chapter XIV, is that each man has the liberty to use his own power as he wishes to preserve his own life and to do anything which is, in his judgment, apt for that purpose. From this, Hobbes derives a second law of nature that, in order to obtain peace and to defend himself, a man should be willing to lay down this right to all things insofar as do others, and to but to retain only so much liberty as he would allow others against himself. The third law of nature, laid down in Chapter XV, is that men perform their covenants, without which a state of war would prevail. Performance of these covenants is ensured by a Commonwealth.

Other laws of nature are, respectively: fourth, that the recipient of a benefit given freely not give any reasonable cause for the donor to regret his good will; fifth, that every man strive to accommodate the rest; sixth that a man ought to pardon offences past of them that repent; seventh,

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<sup>54</sup> *Ibid.*

<sup>55</sup> *Ibid.*

that men look not at the greatness of the evil past but the greatness of the good to follow; eighth, that men show no hatred or contempt for others; ninth, that every man acknowledge another for his equal by nature; tenth, that no man reserve at the time of entry into conditions of peace rights that he is not content to be reserved by every other; eleventh, that a man deal equally between men; twelfth, that things that cannot be divided or enjoyed in common be distributed by lot or by first possession; and thirteenth, that men who mediate peace be allowed safe conduct. Hobbes says that “[t]hese are the laws of nature, dictating peace, for a means of the conservation of men in multitudes; and which only concern the doctrine of civil society.”<sup>56</sup>

Of course, Hobbes is not prescribing any laws of nature in the sense of laws that obtain in a state of nature; instead, he is stipulating certain rules, norms, conventions, or laws of civil society that are necessary, in his judgment, to permit man to depart from the state of nature and to commence construction of a civil society. Many of these may be thought to have religious, even Biblical, origins. Certainly, his “laws of nature” are consistent with Biblical injunctions. What cannot be doubted, however, is that most, if not all, of these “laws of nature” are effectively prescriptions for accommodating atomistic individuals to society. This is true even of the first or fundamental law, to seek peace and follow it, though it is bound up with man’s right in a state of war to everything that is conducive, in his judgment, to maintaining his person and liberty.

It is clear, then, that the state of nature, of atomized individuals engaged in war against every other, is hypothesized only for the purpose of contrasting it to a social or societal environment adopted figuratively to end that state of war. However, what cannot be ignored is that the “laws of nature” posited to accomplish that purpose recognize, quite clearly and cogently, man’s social, sociable, or societal needs, desires, or impulses, or “passions”. Despite Hobbes’s claim that in a state of nature man gains no pleasure in keeping company with others, this claim is strictly predicated on the dangers that others present. That is not to say, however, that even the rational atomist asserts that in that state of nature man does not have social “passions”. In their guise as “laws of nature”, these social “passions” influence the construction of a social domain.

In fact, even in the state of nature, combinations of men are possible. In his discussion of the rough equality of men in body and mind, Hobbes admits that “the weakest has strength enough to kill the strongest, either by secret machination or by confederacy with others that are in the same danger

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<sup>56</sup> This is the present author’s summary of the laws of nature set forth by Hobbes *supra* note 50, cc XIV and XV.



with himself.”<sup>57</sup> He recognizes that atomistic individuals might gather together to take action against a common danger. This involves social action. However, a purely dyadic war of every man against every man would not likely result in perennial war, although Hobbes admits that he considers war to include “a tract of time, wherein the will to contend by battle is sufficiently known: and therefore the notion of time is to be considered in the nature of war”.

In any event, as Mark Granovetter observed, the “extent of disorder resulting from force and fraud depends very much on how the network of social relations is structured. Hobbes exaggerated the extent of disorder likely in his atomized state of nature where, in the absence of sustained social relations, one could expect only desultory dyadic conflicts. More extended and large-scale disorder results from coalitions of combatants, impossible without prior relations. We not generally speak of “war” unless actors have arranged themselves into two sides, as the end result of various coalitions. This occurs only if there are insufficient crosscutting ties, held by actors with enough links to both main potential combatants to have a strong interest in forestalling conflict”.<sup>58</sup>

Granovetter allows that “disorder and malfeasance also occur in the absence of social relations. “But the *level* of malfeasance available in a truly atomized social situation is fairly low; instances can only be episodic, unconnected, small scale. The Hobbesian problem is truly a problem, but in transcending it by the smoothing effect of social structure, we also introduce the possibility of disruptions on a larger scale than those available in the “state of nature.””<sup>59</sup>

In conclusion, then, the Hobbesian state of nature and laws of nature cannot be said to portray individuals as atomistic actors, possessed of both reason and passion, seeking only satisfaction of wants. The wants which he ascribes to men in a state of nature embrace not only security and satisfaction of other physical needs and desires, but also needs and desires for approbation and regard, and other social and affiliative impulses. One might speculate concerning whether the serial dyadic conflicts posited in the Hobbesian state of nature would be sufficient to motivate the aggregation of atomistic actors then present to engage in social relations, including, of course, those social relations necessary in order to adopt the articles of peace terminating the state of war

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<sup>57</sup> *Supra* note 50, c XIII.

<sup>58</sup> Granovetter, *supra* note 1 at 492-93.

<sup>59</sup> *Ibid* at 493 [emphasis in the original].

prevailing in that state of nature. A series of dyadic relationships between various series of individuals in a given environment may not be sufficient.

The question also arises how negotiations for exiting the state of nature could be conducted in safety and in time to benefit the individuals concerned. Of course, while a given individual bargained with each of the others, others that he or she had not bargained (yet) with might seek to impose their will by force or otherwise. The recursive feature of dyadic negotiations being conducted by multiple parties with multiple parties might itself constrain, and even make impossible, reaching agreement, even without considering such matters as the Prisoner's Dilemma and other more arcane learning from game theory. Fortunately, for present purposes, it is not necessary to solve these problems: a mere acknowledgement that they arise from atomistic assumptions is sufficient.

If doubt is cast on the Hobbesian model of atomized individuals as a basis for the economic man of later neoclassical economists, perhaps we can consider Adam Smith's economic man as a more suitable model. Adam Smith's 1776 book *The Wealth of Nations*<sup>60</sup> is frequently considered to be the origin of classical economics. Marx is said to have originated the term "classical economics" to identify the work of David Ricardo, James Mill, and their predecessors, but the term later came to include followers of Ricardo, including John Stuart Mill, Alfred Marshall, Francis Edgeworth, and Arthur C. Pigou.<sup>61</sup>

### **Adam Smith's Conception of Man**

In this regard, Adam Smith argued that free competition and free trade were conducive to the wealth of a nation. Individual pursuit of needs and desires would by some invisible hand attain aggregate welfare. He pretended not to start from a hypothesized state of nature as did Hobbes, but from "an early and rude state of society" in which there were minimal inequalities of wealth, power and income. The economist John Elliott explains that Smith "imagines (one surmises more as a hypothetical mental experiment than a definitive historical observation) an "early and rude state of society which precedes both the accumulation of stock and the appropriation of land". In such a society, ownership of land and capital, and hence wealth power based on ownership, is

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<sup>60</sup> *Supra note 43.*

<sup>61</sup> John Maynard Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan, 2007), c 1 n 1.

nonexistent. Consequently, "the whole produce of labour belongs to the labourer", and workers do not share income with capitalists or landlords."<sup>62</sup>

Smith allowed that the produce of labour, and hence income, and thence power, from labour, might vary as a result of differences in effort, or "dexterity and ingenuity, which he considered likely to be relatively small. Elliott summarizes his argument: "First, the talents characterizing diverse occupations "can seldom be acquired but in consequence of long application and the superior value of their produce may frequently be no more than a reasonable compensation for the time and labour which must be spent in acquiring them." Second, Smith tells his readers early in *Wealth* that the "difference of natural talents in different men is, in reality, much less than we are aware of." "The difference between the most dissimilar characters, between a philosopher and a common street porter, for example, seems to arise not so much from nature as from habit, custom and education". Consequently, a social order in which the worker "has neither landlord nor master to share with him" is likely to be highly egalitarian and free from substantial income differences based on differential wealth power."<sup>63</sup>

Accordingly, Smith assumed that political powers and duties would be relatively equally dispersed among the labourer members of this society, who were expected to be either self-employed or communally employed with the result that there would be no separate employer with "employer power". As Elliott maintains, Smith, paraphrasing Hobbes, says that "wealth is power", as wealth conveys the power of purchasing; a certain command over labour or products available in the market,<sup>64</sup> but is only one of several different sources of power which Smith identifies: namely, wealth power, monopoly power, employer power, and political power.<sup>65</sup> Wealth power can be obtained either through ownership of capital or through ownership of land.<sup>66</sup>

Monopoly power does not exist in early societies with free competition. Smith, says Elliott, argues that "under a regime of "perfect liberty" or "free competition", market prices, wages, and profits tend to approximate their "natural" levels, resources are allocated efficiently, income inequalities

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<sup>62</sup> John E Elliott, "Adam Smith's Conceptualization of Power, Markets and Politics" (2000) 58:4 Rev Political Economy 429 at 430 [citations omitted], citing Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Chicago: University of Chicago Press, 1976) at 53-54 [citations omitted].

<sup>63</sup> *Ibid* at 431 [citations omitted].

<sup>64</sup> *Ibid* at 430.

<sup>65</sup> *Ibid* at 429.

<sup>66</sup> *Ibid* at 431-32.

are minimized, labor markets tend toward full employment, capital is accumulated vigorously, and the economy grows robustly. Under these (freely competitive) circumstances, according to Smith, private self-interest, notably in the pursuit of profit and acquisition of wealth, is not necessarily anti-social. Indeed, self-interest often fosters the social good. In his discussion of foreign trade, for example, Smith states that individuals employ their capital and direct their industry so that "its produce may be of the greatest possible value." But in maximizing his own income, he also renders the "annual revenue of the society as great as he can." Thus, the individual is "led by an invisible hand to promote an end which was no part of his intention." And "by pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it", says Smith.<sup>67</sup>

This alignment of self-interest and public interest by means of the invisible hand disappears with monopoly power: "Smith makes painstakingly clear that, in practice, monopoly and monopoloid behavior is widespread in both economic conduct and public policy. Consequently, things are not left "at perfect liberty," free competition does not actually prevail in practice, and substantial inequalities, considerably larger than compensating differences (for example, differences in wages to compensate for differences in the time and expense of education), emanate from the exercise of monopoly power."<sup>68</sup> Elliott cites Smith's famous quote about monopoly power: "The interests of merchants and manufacturers Smith avers, are promoted by collusion. "People of the same trade seldom meet together," Smith observes in an often quoted passage, "even for merriment and diversion, but the conversation ends in a conspiracy against the public or some contrivance to raise prices"."<sup>69</sup>

Self-interested behaviour of merchants and manufacturers and merchants, according to Smith, conflicts with the public interest in cases of monopoly, aligns with it in foreign trade, and its possibly pernicious effects are countervailed by means of free competition.<sup>70</sup> However, for Smith, free competition does conduce to the attainment of aggregate social welfare. As such, he maintains

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<sup>67</sup> *Ibid* at 434 [citations omitted].

<sup>68</sup> *Ibid*.

<sup>69</sup> *Ibid* at 435 [citation omitted].

<sup>70</sup> *Ibid*.

that government policy which departs from perfect liberty of competition generates substantial inequalities.<sup>71</sup> Thus, it attracts his criticism.

Smith's analysis of economic phenomena incorporates a theory of power; and if Elliott's arguments convince, theories of (at least four) sources of power. Elliott argues that this explication of power is absent from neoclassical models, to their detriment. He asserts that in standard models of market relationships, perfect competition assumes that the number of individual suppliers or purchasers is such that each individual exercises no appreciable power and influence over any individual competitor, aggregate supply and demand, or the ambient society or polity. "Hence, power is conceived as external to or beyond the scope of economy as thus defined, a proper topic, perhaps, for politics or sociology, but not economics."<sup>72</sup>

The argument Elliott asserts here is that standard neoclassical assumptions eliminate the consideration of power as a factor in economic activity. "By contrast, Smith's argumentarium incorporates, indeed features, causes and consequences of the pursuit and exercise of social power by individuals, organizations, classes, and governments. Thus, the scope of Smith's social or political economy is broader than twentieth century orthodoxy in economics, and expressly includes within its corpus the "visible hand" of power and politics as well as the "invisible hand" of market exchange relationships."<sup>73</sup>

Elliott argues that from "a Smithian perspective, neoclassical economics (or at least the version thereof which has dominated the economics discipline in the last 50 years or so) contains a logical or internal flaw. Market exchange and power, Smith believed, are not merely related but are interdependent, not separate, topics. On the one hand, the "obvious and simple system of natural liberty establishes itself of its own accord." On the other, "every man, *as long as he does not violate the laws of justice*, is left perfectly free to pursue his own interest his own way. . .".<sup>74</sup> Since power is an integral component of market exchange, certain exercises of power may "violate the laws of justice" and thus require to be restrained; whether such power constitutes monopoly power, wealth power, employer power, or political power.

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<sup>71</sup> *Ibid.*

<sup>72</sup> *Ibid* at 453.

<sup>73</sup> *Ibid.*

<sup>74</sup> *Ibid* at 453-4 [citations omitted; emphasis in the original, but not in the underlying quotation itself].

Elliott concludes that “Adam Smith's analysis was broader and richer than the neoclassical theories, which followed a century later. But "even within the realm of pure neoclassical economic theory, in the absence of a perfectly and costlessly functioning legal system, one cannot rule out" differential power and its impact on economic relationships. "The notion that markets spontaneously solve these [economic] problems by themselves, so widely believed and propagated, is simply logically incorrect". ...Smith understood the relationships between power and market processes to be interdependent, not separate... ”.<sup>75</sup>As remarked previously, markets are socially constructed. While power may be instrumental in their construction, substantial inequalities of power in their operation may impair their free functioning and attainment of aggregate welfare. Adam Smith apparently understood this.

### **Markets and Social Order**

Smith's concept of the interdependence of markets and power concerns not only what Dennis Wrong calls the “Hobbesian question”, namely, how man becomes tractable to social discipline, but also what he calls the “Marxist question”, namely, how social cohesion arises or how social order becomes possible.<sup>76</sup> This is discussed above under the heading “Socialization and Models of Man”. As discussed in the section next following that heading, the Hobbesian state of nature in which each man opposes his power to that of every other man in order to preserve his person and liberty ends, according to Hobbes, when use of reason inclines men to agree on “convenient articles of peace”, which Hobbes describes as the laws of nature, and which result in the constitution of the Commonwealth. The resulting Leviathan is able to ensure the imposition and continuance of social order.

Mark Granovetter argues that classical and neoclassical economics substitute markets for Hobbes's autocratic authority and provide the social relations and institutional context which, like Leviathan, end the state of disorder prevailing in the Hobbesian state of nature. Instead: “The solution of classical liberalism, and correspondingly of classical economics, is antithetical: repressive political structures are rendered unnecessary by competitive markets that make force or fraud unavailing. Competition determines the terms of trade in a way that individual traders cannot manipulate. If traders encounter complex or difficult relationships, characterized by mistrust or malfeasance, they

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<sup>75</sup> *Ibid* at 454, citing Ronald Wintrobe, *The Political Economy of Dictatorship* (New York: Cambridge University Press, 1998) at 33n.

<sup>76</sup> Wrong, *supra* note 16.

can simply move on to the legion of other traders willing to do business on market terms; social relations and their details thus become frictional matters.”<sup>77</sup>

Granovetter’s comparison invites the question whether he really means to assert that, like Leviathan for Hobbes, competitive markets, for classical liberalism and classical economics, solve not only the Hobbesian question of how man becomes subject to social discipline, but also the Marxist question of how social cohesion and social order becomes possible. It may be that Granovetter asserting that social and political acceptance of competitive markets in which all personal and social goods and services are commoditized ends all manner of personal, social, and political contention. This is obviously problematic.

Instead of considering directly how the market equates with Leviathan in terms of its acquisition and exercise of power, Granovetter pursues the social aspects of the operation of power with his famous claim that in “classical and neoclassical economics, therefore, the fact that actors may have social relations with one another has been treated, if at all, as a frictional drag that impedes competitive markets.”<sup>78</sup> He cites Adam Smith’s suggestion that public trade registers be eliminated as evidence of their “recognition that *social atomization is prerequisite to perfect competition*.”<sup>79</sup> It may be suspected, however, that Adam Smith’s proposal related to facilitating formation of monopolies.

As demonstrated in the immediately preceding section, Adam Smith appealed to natural justice with respect to both of Dennis Wrong’s foundational social questions, the Hobbesian question and the Marxist question. Importantly, Smith also took those questions into account from the perspective of continuum: namely, how man’s tractability to social discipline, once established, is maintained on an ongoing basis; and how social cohesion and social order, once established, is maintained on an ongoing basis. The Hobbesian solution to both questions seems to relate to the external overarching authority of the Leviathan.

Granovetter maintains that such later economic and transaction cost theorists as Oliver Williamson<sup>80</sup> “appeal to authority relations in order to tame opportunism”, a development which

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<sup>77</sup> Granovetter, *supra* note 1 at 484.

<sup>78</sup> *Ibid*.

<sup>79</sup> *Ibid* [emphasis in the original], citing Adam Smith, *The Wealth of Nations*, ed by Andrew Skinner (Baltimore: Penguin, 1979) at 223-33.

<sup>80</sup> *Ibid* at 493, citing Oliver Williamson, *Markets and Hierarchies* (New York: Free Press, 1975) [Williamson, *Markets*]; Oliver Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations" (1979) 22:2

constitutes a rediscovery of Hobbesian analysis, though confined here to the economic sphere.”<sup>81</sup> Such authority relations appear in the firm, which efficiently employs internal organization of relationships and hierarchical authority to mitigate the limitations of bounded rationality and opportunistic behaviour otherwise prevalent in the market.<sup>82</sup> For reasons discussed in the next paragraphs, we would maintain that the “rediscovery of Hobbesian analysis argument” made by Granovetter might be (better) sustained by envisioning “the market” as some kind of superordinate authority over economic relations.

For the moment, however, this argument has to be left to one side while we consider Granovetter’s observation of Williamson: “This analysis entails the same mixture of under- and oversocialized assumptions found in *Leviathan*. The efficacy of hierarchical power within the firm is overplayed, as with Hobbes’s oversocialized foreign state. The “market” resembles Hobbes’s state of nature. It is the atomized and anonymous market of classical political economy, minus the discipline brought by fully competitive conditions – an under-socialized conception that neglects the role of social relations among individuals in different firms in bringing order to economic life.”<sup>83</sup>

Granovetter fails to explain, as he does with the firm, the oversocialized assumption that Williamson makes in relation to the market. In that regard, it would be open to them to argue that the market itself functions as a latter-day Leviathan with respect to individual consumers and producers whose behaviour is constrained by their aggregation. In effect, aggregate supply and demand may be said to “rule” individual consumers and producers in the economic sphere, just as Leviathan itself rules members of the society and the polity in those spheres.

As we have suggested previously, continued social relations must be considered as important with respect to the Hobbesian and Marxist questions, not only in terms of the origins, but also in terms of the continuance, of man’s tractability to social influence, and of social order in general. However, on a less esoteric level, openness to social influence and the continuance of social order may be effected by various means, in the economic sphere, as in other spheres of human activity.

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JL & Econ 233; Oliver Williamson, "The Economics of Organization: The Transaction Cost Approach" (1981) 87:3 *American J Sociology* 548; Oliver Williamson & William Ouchi, "The Markets and Hierarchies and Visible Hand Perspectives" in Andrew Van de Ven & William Joyce, eds, *Perspectives on Organizational Design and Behavior* (New York: Wiley, 1981) 347.

<sup>81</sup> *Ibid* at 494.

<sup>82</sup> *Ibid*.

<sup>83</sup> *Ibid* at 494-495.



In this regard, Granovetter cites examples of cases in which Williamson acknowledges some social influence on the market, saying: "Norms of trustworthy behavior sometimes extend to markets and are enforced, in some degree, by group pressures.... Repeated personal contacts across organizational boundaries support some minimum level of courtesy and consideration between the parties.... In addition, expectations of repeat business discourage efforts to seek a narrow advantage in any particular transaction.... Individual aggressiveness is curbed by the prospect of ostracism among peers, in both trade and social circumstances. The reputation of a firm for fairness is also a business asset not to be dissipated".<sup>84</sup>

As seen above, even Hobbes conceded the existence and operation of some associative motivations. Granovetter argues in the following famous passage that Williamson's concept of the market as a powerful controlling influence over human economic actors, which fails to accord real weight to the influence of social relations, supports his argument that, in choosing to establish firms, economic actors are choosing hierarchy over market. He says: "A wedge is opened here for analysis of social structural influences on market behavior. But Williamson treats these examples as exceptions and also fails to appreciate the extent to which the dyadic relations he describes are themselves embedded in broader systems of social relations. I argue that the anonymous market of neoclassical models is virtually nonexistent in economic life and that transactions of all kinds are rife with the social connections described."<sup>85</sup>

While Granovetter concedes that the network of intrafirm social relations may be more dense and long-lasting than those between firms, "all I need show here is that there is sufficient social overlay in economic transactions across firms (in the "market," to use the term as in Williamson's dichotomy) to render dubious the assertion that complex market transactions approximate a Hobbesian state of nature that can only be resolved by internalization within a hierarchical structure."<sup>86</sup>

Finding that "the anonymous market of neoclassical models is virtually nonexistent in economic life", Granovetter maintains that even dyadic one-off trades in a discrete market "are themselves embedded in broader systems of social relations".

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<sup>84</sup> *Ibid* at 494, citing Williamson, *Markets*, *supra* note 80.

<sup>85</sup> *Ibid* at 495.

<sup>86</sup> *Ibid*, citing Williamson, *Markets*, *supra* note 80 at 106-108.

## Markets in Economic Theory

With that, we now turn to a summary exploration of the nature of markets in economic theory. A review article on this subject is “What is a Market? On the Methodology of a Contested Concept” by the economist Eckehard F. Rosenbaum published in 2000.<sup>87</sup> Contrary to expectations, perhaps, discussions of this subject are relatively uncommon, and thus Rosenbaum’s discussion presents itself as both learned and relatively comprehensive; and hence useful for present purposes.

Rosenbaum says that many economists find markets at almost any place and time, and assume that they emerge spontaneously once a set of necessary conditions, including well defined property rights and liberalized prices obtain, and citing Oliver Williamson’s dictum that “in the beginning, there were markets”.<sup>88</sup> He contrasts that ubiquity view with Herbert Simon’s view that the institutional structure of economic life on Earth is divided among organizations (which dominate, except for rural areas in India, Africa or China perhaps), market relationships, and contractual relations, with a combination of market relationships and contractual relations prevailing in the Western hemisphere and large parts of Asia, and prior to 1989 contractual relations prevailing in the North Eastern hemisphere.<sup>89</sup>

Rosenbaum notes that “No less an authority than Ronald Coase has observed that the role of markets in modern economic theory is even more opaque than that of enterprises.” He argues that, even though its frequent use in economic discourse might suggest otherwise, “closer inspection immediately reveals a wide range of meanings and contents”, reflecting the fact that “the market concept itself is hardly if ever analyzed in a systematic fashion with a view to identifying the constituting or essential elements of a market.”<sup>90</sup> A non-economist observing the use made of the term by some economists might conclude that the market is some sort of *deus ex machina*, as it seems often to be “pulled out”, as if from a hat, in order to explain higher order conclusions for which no further proof is offered.

One explanation for this lack of formal definition might be that the term is used in different contexts with somewhat different meanings, which meanings are, at least in part, referable to the

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<sup>87</sup> Eckehard F Rosenbaum, “What is a Market? On the Methodology of a Contested Concept” (2000) 58:4 Rev Social Economy 455.

<sup>88</sup> *Ibid* at 455, citing Oliver Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: Macmillan, 1983).

<sup>89</sup> *Ibid* at 455-456.

<sup>90</sup> *Ibid* at 456.

purpose and context of their use. This is not to say that the term means what one wants it to mean. Rosenbaum emphasizes that: “Hypotheses about the functions and the properties of markets (e.g. establishment of prices, allocation of resources, efficiency) which claim to have empirical validity presuppose that the researcher outlines the characteristics of the social object “market” for which the hypothesised relationship or property is to hold.” This is only infrequently the case. “Arrow and Hahn’s (1971) *General Competitive Analysis*, for example, provides no explicit definition of what a market is and only a highly abstract account of how markets function. Indeed, it is not until page 348 that they acknowledge that they have taken the “existence of markets... for granted.”<sup>91</sup>

Rosenbaum analyzes definitions of markets into three categories: firstly, observational, which describe some empirical phenomenon;<sup>92</sup> secondly, functional, which “focus on what the market *does* rather than on what, from an empirical perspective, the market *is*”<sup>93</sup>; and, thirdly, structural, which “draw attention to the underlying and thus not immediately observable structure of a market, emphasizing the putative mechanisms and structure that give rise to market phenomena.”<sup>94</sup> He finds two types of functional definitions branch: firstly, those (generally neoclassical views) which consider the market as an allocation mechanism (or as an “invisible hand” in the Smithian tradition), or a mechanism “for the *determination of relative prices* by supply and demand” (culminating in a general equilibrium as pioneered by Walras); and, secondly, those in which the function of the market is to provide “a *natural order* or equilibrium of social activities” (in some resonance, he says, with Hayek’s notion of spontaneous order).<sup>95</sup> In the former, “the market is synonymous with the intersection of unobservable and merely hypothesized demand curves devoid of any institutional, spatial or social features, and each individual market is interrelated with others and aggregated into the economy as a whole, which jointly determines relative prices and the allocation of commodities.”<sup>96</sup> Of course, many uses of the term by economists and others fit into more than one category.

As has already been suggested, how one uses the term may be affected by the purpose and context of a particular research program. Rosenbaum notes that: “observational definitions... single out

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<sup>91</sup> *Ibid* at 457, citing KJ Arrow & RH Hahn, *General Competitive Analysis* (San Francisco: Holden-Day, 1971).

<sup>92</sup> *Supra* note 87 at 458. He says that Adam Smith, Hayek, Walras, and Debreu use observational definitions.

<sup>93</sup> *Ibid* at 459 [emphasis in the original]. He says Cournot, Jevons, and Marshall, and Lipsey employ functional definitions.

<sup>94</sup> *Ibid* at 460. He says that Hodgson, North and the later Marshall use structural definitions.

<sup>95</sup> *Ibid* at 459 [emphasis in the original].

<sup>96</sup> *Ibid* at 457-462, especially at 459.

for further investigation some empirical phenomenon”; functionalist definitions, which are based on a great deal of analysis which supports ascribing specific function to the market which, in turn, “provides a guiding line for further research”; while structural definitions, represent “an intermediate position in that, accepting as they do the function of markets in principle, their concern is to open the black box of the disembodied and deinstitutionalized market of neoclassical theory, and to provide a better understanding of the working of the market by highlighting some central structural features of markets.”<sup>97</sup>

Rosenbaum concludes that because “each definition belongs to a specific part of economic discourse, it has first of all to be judged in its own terms, with the result that it would be “nonsensical to criticize structural definitions for being empirically ambiguous, as it would be problematic to look for rich empirical content in functional definitions.”<sup>98</sup> Taking this perspective on board, it may be maintained that neoclassical views of the market generally are, or, at least, purport to be, empirical or functional, and, as such, abstract the market from its institutional, spatial or social context and environment. While later neoclassical economists purport to take account of certain institutional and social features, as noted above, even such features are often abstracted from their social and institutional contexts. Rosenbaum argues that even such traditional economists as Marshall who focus (in his later work) on the social organization of a market, describe it as “a group or groups of people, some of whom desire to obtain certain things, and some of whom are in a position to supply what the others want”.<sup>99</sup>

Rosenbaum contrasts the market with five “alternative social forms”, namely, firms and organizations, central planning, bargaining, casual exchange, and the exchange of gifts, eventually evaluating them in terms of voluntariness and specificity, regularity and typification, and competition. This description of “alternative social forms” seems to owe much to Polanyi, whose classification is largely ignored by Rosenbaum, who allows for more (and different) categories.<sup>100</sup> Rosenbaum concludes that the characteristics which are unique in markets are: firstly, voluntary and specified exchange; secondly, typification and regularity of exchange; and thirdly,

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<sup>97</sup> *Ibid* 461.

<sup>98</sup> *Ibid*.

<sup>99</sup> *Ibid* at 459, citing Alfred Marshall, *Industry and Trade* (London: Macmillan, 1919) at 182.

<sup>100</sup> *Supra* note 87 at 466.

competition. Following the economic and political sociologist Fred Block,<sup>101</sup> he maintains that exchange situations exhibit different degrees of “marketness” according to the degree to which these criteria are realized and that market economies do not necessarily exhibit the same degree of “marketness” across time and space.<sup>102</sup>

Of course, if regularity and typification is an essential formal criterion of markets, it is clear that some social context must be presumed. To the vacation and regularity are also “the most basic elements of the institutional character of markets” considering institutions, in the most fundamental sense, as routines.<sup>103</sup> Consequently, “markets constitute institutions because they involve certain routines (typical exchanges) that are repeated over time (regularity)”. While institutionalists like Douglas North, limited use of the term “institutions” to “sets of rules with or without enforcement mechanisms” which involves “investigating the institutional *framework* of exchange, the present account thus emphasises the institutionalized *form* of exchange.”<sup>104</sup>

Again, such routines and repetition would be unlikely to arise without social context. Rosenbaum indicates that “many markets can also be regarded as institutions in a more specific sense in that market clearing and the determination of prices follow (procedural) rules or in that there is a number of auxiliary institutions and/organizations which facilitate certain types of exchange” as argued by Hodgson, thereby requiring consideration of “the social and cultural embeddedness of economic interaction”.<sup>105</sup> Rosenbaum posits that “Hodgson's auxiliary institutions or organizations, which serve to overcome problems relating to moral hazard, trust and asymmetric information, are likely to be shaped by the social and cultural setting. There are no reasons to suggest after all that similar problems are always solved by using the same set of institutions.”<sup>106</sup>

Considering only modern capitalist societies “there is not only a wide range of institutional forms in use...but when it comes to addressing specific problems within the economic sphere, there is

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<sup>101</sup> Fred L Block, *Postindustrial Possibilities: A Critique of Economic Discourse* (Chicago: University of Chicago Press, 1990). Of course, Fred Block is also a follower, editor, and interpreter of the work of Karl Polanyi.

<sup>102</sup> *Supra* note 87 at 475.

<sup>103</sup> *Ibid* at 476, citing Tony Lawson, *Economics and Reality* (London: Routledge, 1997).

<sup>104</sup> *Supra* note 87, citing DC North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990) [emphasis in the original].

<sup>105</sup> *Supra* note 87 at 477, citing Geoffrey M Hodgson, *Economics and Institutions? A Manifesto for a Modern Institutional Economics* (Cambridge: Polity Press, 1988).

<sup>106</sup> *Supra* note 87 at 477. For examples, he references: Irena Grosfeld, “Financial Systems in Transition: Is there a Case for a Bank Based System?” (1994) CEPR Discussion Paper No 1062; and John Zysman, *Governments, Markets, and Growth* (Ithaca: Cornell University Press, 1983).

also a tendency to adopt institutional or organizational forms which originate outside the economic system and which have to do with the culturally impregnated "Wirtschaftsstil" [economic styles] of a society." Economic institutions, forms and practices can vary significantly across societies. "At one extreme, certain forms of exchange are tabooed or so heavily overshadowed by cultural influences that economic factors can hardly be detected, at the other extreme culture provides little more than the background of transactions in the form of general norms of behavior."<sup>107</sup> These observations accord with the position taken in this book with respect to the interrelatedness of the economy, the society, the polity, and the state;<sup>108</sup> the consequential situation of the modern business corporation within that interrelated economy-society-polity-state environment;<sup>109</sup> and its status as a rights-and-duty-bearing entity as a matter of law situate, and whose legal counterparties are situate within that environment, and the firm as an organization situate, like its organizational participants, within that interrelated economy-society-polity-state environment.

That the institutional response to specific economic and other problems is affected by social and cultural factors involved in a given society and its "economic style" may seem, in some senses, trite or self-evident, however, as has been shown, the characterization of the economic sphere as one that is separate and apart from the social, cultural, political, and other spheres of a society, is one explicitly or implicitly accepted by the neoclassical economic tradition that is broadly reflected in modern law, regulation, and governance, not only with respect to business organizations, but even more generally. Before proceeding to consider this "embeddedness" further, we will briefly examine the social construction of markets.

### **Social Construction of Markets**

In an important review article from 2007, the sociologists Neil Fligstein and Luke Dauter discuss contributions from political economy, sociology and organizational theory that led to the new field of "sociology of markets"<sup>110</sup>, remarking: "Scholars in all these fields doubted that economics could sufficiently make sense of what happens in markets. In essence, they discovered that the atomized,

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<sup>107</sup> *Supra* note 87 at 477, citing, for "Wirtschaftsstil", Bertram Schefold, *Wirtschaftsstile? Band 1: Studien zum Verhältnis von Ökonomie und Kultur* (Frankfurt: Fischer, 1994).

<sup>108</sup> See the discussion in Chapters B1 through B3 inclusive concerning the situation of the corporation within such interrelated economy-society-polity-state environment.

<sup>109</sup> See the discussion in Chapters Five and Six concerning the corporation as an actor in such environment and in Chapter Seven and following concerning interrelationships between the corporation as a legal entity and the corporation as an organization.

<sup>110</sup> Neil Fligstein & Luke Dauter, "The Sociology of Markets" (2007) 33 *Annual Rev Sociology* 6.1 at 6.5.

price-taking actors, with perfect and symmetrical information assumed by neoclassical theory, did not seem to exist empirically. Social relations seemed to be crucial to the functioning of markets and market actors in a myriad of ways.”<sup>111</sup> We use Fligstein and Dauter to guide this discussion.

As indicated above, Rosenbaum’s examination of the market of neoclassical economics showed that markets were distinguished from other “alternative social forms” of distribution of goods in that only markets exhibit the three characteristics of voluntariness, typification and regularity of exchange, and competition.<sup>112</sup> These characteristics relate to actors and the form of exchange. As noted in the present work, each of those characteristics presupposes some underlying social relations among market participants. Fligstein and Dauter remark:

For neoclassical theory, markets simply imply exchange between actors for goods or services. These exchanges are usually thought to be fleeting, with price (i.e., the amount of a commodity that is exchanged for another using a generalized medium of exchange, i.e., money) determined by the supply and demand for the commodity. From the point of view of the sociology of markets, the problem is that this type of exchange already shows a great deal of social structure. Market actors have to find one another. Money has to exist to allow market actors to get beyond bartering nonequivalent goods. Actors have to know what the price is. Underlying all exchange is that both buyers and sellers have faith that they will not be cheated. Such faith often implies informal (i.e., personal knowledge of the buyer or seller) and formal mechanisms (i.e., law) that govern exchange. Furthermore, market actors are often organizations, implying that organizational dynamics influence market structures. For sociologists, market exchange implies a whole backdrop of social arrangements that economics does not even begin to hint at.<sup>113</sup>

As Fligstein and Dauter say, these market actors have to find each other, must have a desire to exchange, must have a medium of exchange (such as money), must exchange something that has determinable characteristics, with some frequency or regularity, must be able to generate a price for the exchange on some reasonable basis, and must have some basis (such as experience, reputation, and rules) to justify having some trust or confidence in the completion and effectiveness of the exchange. These characteristics of a market envision a complex set of social relationships

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<sup>111</sup> *Ibid* at 6.5-6.6.

<sup>112</sup> Rosenbaum, *supra* note 87 at 477.

<sup>113</sup> *Supra* note 108 at 6.9.

necessarily affecting the actors who are the immediate parties to the exchange and others. The social nature of these characteristics and related relationships in real instantiations, not hypothesized circumstances, is apparent.

Markets, say Fligstein and Dauter, involve “day-to-day social relationships” among market actors which are “based on trust, friendship, power, and dependence”. Thus, “unstructured, haphazard, one-shot, anonymous social exchange is not a market. Instead, markets imply social spaces where repeated exchanges occur between buyers and sellers under a set of formal and informal rules governing relations between competitors, suppliers, and customers.”<sup>114</sup> Local understandings, formal and informal rules, and conventions “guide interaction, facilitate trade, define what products are produced, indeed are constitutive of products, and provide stability for buyers, sellers, and producers. These marketplaces are dependent on governments, laws, and larger cultural understandings supporting market activity.”<sup>115</sup> Market actors develop social practices, processes, and structures to mediate the problems they encounter in exchange, competition, and production.<sup>116</sup>

Of course, the market actors in actual cases are not the atomistic individuals specified in the hypothesis of neoclassical economics, but are often themselves social groups or organizations. Firms are often not composed of a single entrepreneur hiring a manager to produce and sell at a product with the objective of generating a profit. More often, firms, as they are experienced in real instantiations, are socially constructed, as groups or organizations, of people.

Thus, each element of production and exchange engages social activity. While buyers and sellers may sometimes be known to each other, in many cases they are not. Confidence in the completion of the exchange, in the quality and quantum of the goods exchanged, and in other aspects of its “fairness” may involve the reputation of the parties concerned, the mechanics of verification of quality, quantity and method of exchange, and on the relative market power of the actors concerned.<sup>117</sup> Fligstein and Dauter emphasize the importance of trust in linking buyers and sellers, indicating that the “experimental literature shown that trust matters most in situations in which there is a great deal of uncertainty about the qualities of the product being exchanged;” noting “Granovetter’s main argument about embeddedness is that if one has close ties to others over long

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<sup>114</sup> *Ibid.*

<sup>115</sup> *Ibid.*

<sup>116</sup> *Ibid.*, citing Emile Durkheim, *The Division of Labor in Society* (New York: Free Press, 1964).

<sup>117</sup> Fligstein and Dauter discuss some of the literature bearing on these matters. *Supra* note 108 at 6.9-6.10.



periods of time, one can trust that in any particular transaction, people are less likely to try to cheat one another.”

Such close ties can arise from a course of dealing or from knowledge of the reputation of the other party through one’s network ties. However, “[j]udging the trustworthiness of another actor is not just a matter of having a long-term network tie to them. Trust is also about power and resource dependence. Firms work to reduce uncertainty and resource dependence by choosing partners who they either know to be reliable or others think are reliable.”<sup>118</sup>

Resource dependence concerns the dependence of an organization on its environment, economic social and political, for resources upon which its existence, operations and profitability depend and which therefore affect its organization, strategy, and structure. These resources include labour, capital, and raw materials, and may include access to customers and markets. As such, resource dependence affects the production and distribution of an organization’s products, including its competitive strategy and its implementation. Power is related to access to resources, and the ability to employ them effectively. Trust can increase the power of the economic actor by reducing uncertainty and by reducing resource dependence.

Resource dependence theory became prominent with the publication of Pfeffer and Salancik’s book, *The External Control of Organizations: A Resource Dependence Perspective*, in 1978.<sup>119</sup> The ability to access resources required for an organization, of course, necessarily implicates it in engagement to procure those resources, to manage them, and to ensure their continuity. All such activities require social activity.

The environment upon which an organization is dependent, therefore, necessarily includes social elements. As Fligstein and Dauter mention, “institutional theory posited that the environment was at least partially a social construction. Scott & Meyer (1982) called such environments “sectors” and described the socially constructed environment of firms as a function of all the other

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<sup>118</sup> *Supra* note 108 at 6.10 [citations omitted]. Power will be discussed below in relation to the neoclassical economic model of the firm.

<sup>119</sup> Jeffrey Pfeffer & Gerald R Salancik, *The External Control of Organizations: A Resource Dependence Perspective* (New York: Harper & Row, 1978). See also Tiziana Cascario & Mikolaj Jan Piskorski, “Power Imbalance, Mutual Dependence and Constraint Absorption: A Closer Look at Resource Dependence Theory Revisited” (2005) 50:2 *Administrative Science Q* 167; Amy J Hillman, Michael C Withers & Brian J Collins, “Resource Dependence Theory: A Review” (2009) 35:6 *J Management* 1404; and Gerald F Davis & J Adam Cobb, “Resource Dependence Theory: Past and Future” (2010) 28 *Research in the Sociology of Organizations* 21.

organizations that might impinge on a particular organization. They included governments, suppliers, workers, and customers as part of such a social construction.”

Fligstein and Dauter go on to explain that DiMaggio & Powell, instead of “sectors”, called these environments “organizational fields,” and state that this “metaphor implies that firms watch one another, engage in strategic behavior vis-à-vis one another, and look to one another for clues as to what constitutes successful behavior. DiMaggio & Powell’s main focus was how firms in organizational fields came to resemble one another through processes of mimetic, coercive, and normative isomorphism.”<sup>120</sup> Harrison White applied these insights, even more specifically, to intra-industry competition, as will be discussed next.

In an important and much-cited contribution to discussion of the origin of markets, Harrison C. White’s 1981 article asked “Where do markets come from?”<sup>121</sup> He sought to answer this question by “embedding economists’ neoclassical theory of the firm within a sociological view of markets”.<sup>122</sup>

White posited that production markets involve a producer side and a buyer side, each of which operate as cliques and constantly monitor the other side by means of terms of trade, a joint social construction including, but not limited to price, which may, however, be the most readily available such term. Each producer is a separate firm with a distinctive product who determines production volumes in part by observing the volumes of other producers. “Each producer acts purely on self-interest based on observed actions of all others, summarized through a feedback process. The summary is the terms-of-trade schedule, which reduces to constant price only limiting cases. The market emerges as a structure of firms with a defined niche for each firm.”<sup>123</sup> The market is thus built by “self-reproducing cliques of firms” engaging in “a conflict-written and erratic process with quite a range of outcomes possible in the form of market schedules”.<sup>124</sup>

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<sup>120</sup> *Supra* note 108 at 6.7, citing WR Scott & JW Meyer, *The Organization of Institutional Sectors* (Stanford, CA: Inst Res Educ Finance Gov Sch Educ, 1982); and Paul J DiMaggio & Walter W Powell, “The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields” (1983) 48:2 *American Sociological Rev* 147. In the latter article, which has been extensively cited, the authors developed the concept of “institutional isomorphism”, a similarity of institutional structure or process developed mimetically or independently. As noted previously, John Meyer, who was a co-author with Richard Scott of the first work cited, has been credited with applying the concept to nation-states and to the world order or what he calls “world society” or “world polity”.

<sup>121</sup> Harrison C White, “Where Do Markets Come From?” (1981) 87:3 *American J Sociology* 517.

<sup>122</sup> *Ibid* at 518.

<sup>123</sup> *Ibid* at 517.

<sup>124</sup> *Ibid* at 520.

Fligstein and Dauter argue that such a “sociological view of relations among producers begs the question of who these producers are and how they make production decisions. From the point of view of neoclassical economics, whether producers are individuals or organizations matters little; what is important is the production function and the combination of capital and labor used in the productive process.”<sup>125</sup> Conversely, they say, sociologists have long examined organizations as social structures with “complex internal dynamics that are important for organizational form and for the strategies they use to solve the problems of competition and exchange. They have pointed to competition within the firm, culture, and power struggles, in addition to environmental influence, as important to understanding a firm’s strategy and thus the structure of markets.”<sup>126</sup>

An examination of the firm will appear later in this work; however, for present purposes, we may take note that the sociology of markets literature and resource dependence literature both consider the internal dynamics of organizations, that is to say, they go “inside the black box” of the firm to consider its internal structure and processes.

## Conclusion

It goes without saying that the sociological study of markets or of business organizations is merely one of the lenses through which a business organization can be examined. In respect of some of these issues, as Fligstein noted, economists, political scientists, sociologists, anthropologists, social and other psychologists, and academics in business disciplines, including management, strategy, organizational behaviour, marketing, and finance, have influenced the development of more fulsome approaches to the study of business organizations.

As we have seen in our short discussion of the first assumption, anthropologists such as Henry Wright, nineteenth century social and cultural anthropologist, social theorist and lawyer Lewis Henry Morgan (author of *Ancient Society*, which influenced Karl Marx and Friedrich Engels, among others), and cultural anthropologist Elman R. Service contributed to our understanding of the importance of leadership and the state to economic development. We have also averted to

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<sup>125</sup> *Supra* note 108 at 6.12, citing Ronald Shepard, *Theory of Cost and Production Functions* (Princeton, NJ: Princeton University Press, 1970).

<sup>126</sup> *Ibid.* Fligstein and Dauter mention: Neil Fligstein, *The Transformation of Corporate Control* (Cambridge, Mass: Harvard University Press, 1990); William Ocasio & Hyosun Kim, “The Circulation of Corporate Control: Selection of Functional Backgrounds of New CEOs in Large US. Manufacturing Firms 1981–1992” (1999) 44:3 *Administrative Science Q* 532; Jeffrey Pfeffer, *Power in Organizations* (Marshfield, Mass: Pitman, 1981); Jeffrey Pfeffer & Gerald R Salancik. *The External Control of Organizations: A Resource Dependence Perspective* (New York: Harper & Row, 1978).

contributions made by political scientists such as Stephen D. Krasner, Terry M. Moe, and by organizational, institutional and political sociologist John W. Meyer.

As Fligstein observes: “The production of market institutions is a cultural project in several ways. Property rights, governance structures, conceptions of control, and rules of exchange define the social institutions necessary to make markets. Economic worlds are social worlds; therefore, they operate according to principles like other social worlds. Actors engage in political actions vis-a-vis one another and construct local cultures to guide that interaction.”<sup>127</sup>

In conclusion, the assumption that not only markets, but the economy as a whole, can be analyzed in a manner that is distinctive to it and to the private sphere within which the economy is constituted was not assiduously maintained even by early liberal political and economic theorists, such as Hobbes and Smith, who nevertheless perceived a relationship among the economic, social, and political spheres that is generally eliminated in modern economic and mathematical models of the economy.

The assumptions of classical and neoclassical economic theory that individuals are atomistic rational individuals each of whom seeks only to maximize his own welfare ignore social and affiliative needs, as even Hobbes and Smith recognized. This presents an “undersocialized” model of man. However, the continuance of assumptions of atomistic rational individuals by Parsonian and other modern sociological and political theorists, which is often implicit and subtle, often contributes to modelling individual human beings in a way that is excessively determined by roles and social positions, without considering the context, and personal history, and choices of the operative individual. This may be considered to constitute an “oversocialized” model.

Modeling group behaviour on such an atomistic rational individual seeking only his or her own welfare is not conducive to comprehension and prediction of such behaviour. Simple aggregation of individual behaviour to predict group behaviour ignores the personal attributes and history of the individual and the way in which his or her negotiation of personal identity constantly proceeds, as our experience demonstrates. It also ignores, necessarily, inter-subjective (individual-to-individual) and individual-to-group influences. Instead, economic activity is socially constructed.

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<sup>127</sup> Neil Fligstein, “Markets as Politics: A Political-Cultural Approach to Market Institutions” (1996) 61:4 *American Sociological Rev* 656 at 657, citing Clifford Geertz, *Local Knowledge* (New York: Basic Books, 1983).

Its advancement is dependent upon creation of necessary institutional supports, including, as we have seen, the state, even in the earliest societies of which we have detailed archaeological evidence, such as in Uruk. As has been noted here, those institutions make it possible, in many ways, for exchange to take place.

If the argument presented in this section have at least raised significant doubts as to propriety of analyzing the economy and the private sphere in a manner distinctive to it and distinctive from the social and political spheres, the related question of whether the operation of the economy can be distinctive from and even intrinsically independent of the social and political spheres may seem, to some extent, already decided. It may still be possible, however, that the operation of the economy proceeds as if it were distinct and intrinsically dependent of the ambient society and polity or even that it does so proceed as a matter of fact. It is to these matters that we now turn.

**CHAPTER B3:  
ASSUMPTIONS ABOUT THE ECONOMY, AND SOCIETY, THE POLITY, AND THE  
STATE**

**ASSUMPTION FIVE - THE ECONOMY AND ITS FUNCTION AS DISTINCT AND  
INDEPENDENT FROM THE SOCIETY AND THE POLITY**

The previous chapter explores the question whether the economy must be analyzed in a manner distinctive to it alone and distinctive from the mode of analysis applicable to the society and the polity. That question was considered by applying, in part, two different analytical perspectives, the one being embeddedness, and the other, although involved in the foregoing, being the analytically distinct perspective of the nature of man. Of course, the embeddedness perspective speaks directly to the question raised about analytical methodology, while the perspective that considers the nature of man proceeds from the particular viewpoints of classical and neoclassical economics, political economy, political and social theory, and the modern disciplines of political science and sociology may be said to reflect some blend of ideology and analytical methodology.

In any event, that chapter demonstrates the effectiveness of those methodological lenses, in the course of demonstrating that analysis of the economy is not a uniquely distinctive pursuit, and does not require a uniquely distinctive methodology; or, at the very least, that such a proposition is highly doubtful. It is also shown that assumptions or generalizations concerning the nature of man, which may be consistent or varied as among different disciplines, can have significant explanatory and operational consequences.

If it is accepted that the economy is related to its ambient society and to its ambient polity, as the present work has shown, the question may be asked whether the economy is distinct from and operates intrinsically independently from such society and from such polity, as is generally assumed, albeit tacitly and implicitly, by classical and neoclassical economic theory. This is the fifth assumption that will be considered here. As in the case of the previous assumptions and generalizations, this chapter does not set out to prove conclusively that the present assumption or generalization is completely and irrevocably erroneous but, instead, endeavours to cast doubt on its explanatory and predictive capacity, and on its efficacy, for the purposes of understanding, and regulating, the behaviour of modern business corporations.

## KARL POLANYI'S EMBEDDEDNESS

One method of investigation that may be used to test these assumptions, and, in particular, the fifth assumption which we now consider, is to evaluate that assumption against the theory of embeddedness, which originated in Karl Polanyi's signal work *The Great Transformation: The Political and Economic Origins of Our Time*.<sup>1</sup> The sweeping scope of that book is indicated by the Nobel laureate Joseph E. Stiglitz, who summarizes it in the Foreword as "describing the great transformation of European civilization from the preindustrial world to the world of industrialization, and the shifts in ideas, ideologies, and social and economic policies accompanying it."<sup>2</sup>

In particular, at the outset of *The Great Transformation*, which was written during the Second World War, Polanyi claimed that the book was concerned with the political and economic origins of the collapse of nineteenth century civilization, based on four institutions: the balance-of-power system, the international gold standard, the self-regulating market, and the liberal state.<sup>3</sup> He maintained that the proximate cause of the collapse was the collapse of the gold standard, an effort to save which had caused the sacrifice of most of the other institutions. He described the self-regulating market as "the fount and matrix of the system" as it gave rise to the other institutions and so to the ambient civilization concerned, so that "[t]he key to the institutional system of the nineteenth century lay in the laws governing the market economy".<sup>4</sup>

The market economy, then, was the primary institution of the growth and collapse of nineteenth century civilization:

Our thesis is that the idea of a self-adjusting market implied a stark utopia. Such an institution could not exist for any length of time without annihilating the human and natural substance of society; it would have physically destroyed man and transformed his surroundings into a wilderness. Inevitably, society took measures to protect itself, but whatever measures it took impaired the self-regulation of the market, disorganized industrial life, and thus endangered society in yet another way. It was this dilemma which

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<sup>1</sup> Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Press, 2001).

<sup>2</sup> Joseph E Stiglitz, "Foreword" in Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Press, 2001) vii at vii.

<sup>3</sup> Polanyi, *supra* note 1 at 3.

<sup>4</sup> *Ibid.*

forced the development of the system into a definite groove and finally disrupted the social organization based upon it.<sup>5</sup>

### **The Great Transformation and the Double Movement**

Polanyi's argues, then, that the expansion of the self-adjusting market disembedded the economy from society, in effect, "crowding out" the non-market aspects of society, thereby making it necessary for society to take protective measures, in effect, to reembed the economy in society. These two developments constitute what Polanyi refers to as the "double movement". Of course, Polanyi's description of nineteenth century civilization necessarily involves institutions, including the foundational "self-regulating market", and he credits laws governing the market economy as the key to this institutional system. In effect, he seems to assume that the market economy of the nineteenth century, as what he describes as an "institution", involved other institutions or institutional mechanisms, such as laws and the state.

If the "stark utopia of the self-adjusting market", governed by laws and the state, could not obtain "for any length of time without annihilating the human and natural substance of society", the liberal amelioration of the effects of the "great transformation" into modern industrialized civilization, like that transformation itself, may have been a gradual escalation of measures to protect society, rather than a single event or even series of events. This interpretation is fortified by his admission that the market economy of that time was governed by laws, promulgated by the state, and perhaps otherwise, with the result that it was not entirely self-adjusting at all: at most, its self-adjustment was affected, and perhaps even significantly affected, by external laws, putting the extent, and even existence, of its self-adjustment into question.

In making these claims, Polanyi claimed that "the role played by markets in the internal economy of various countries, it will appear, was insignificant up to recent times"<sup>6</sup>. As noted previously, this seems to significantly overstate the claim. We have considered above the position that the concept of "market" engages a continuum of "marketness".<sup>7</sup> Further, the extent of market type activity in economic activity in different historical epochs and locations is subject to some

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<sup>5</sup> *Ibid* at 3-4.

<sup>6</sup> *Ibid* at 46.

<sup>7</sup> See Eckehard F Rosenbaum, "What is a Market? On the Methodology of a Contested Concept" (2000) 58:4 *Rev Social Economy* 455. See also the discussion of the definition of the term "market" in Chapter B2 under the heading "Markets in Economic Theory".



contestation and, it is argued below, according to recent scholarship, may have been much greater, even in ancient times, than recognized previously, including the time at which Polanyi was writing.<sup>8</sup>

Perhaps more defensibly, in his seminal article, “The Economy as Instituted Process”,<sup>9</sup> Polanyi argued that markets have dominated economic behaviour in the nineteenth and twentieth centuries to a much greater extent than at any time previously, and that before that time, other allocative systems not grounded in economizing behaviour were much more prevalent.<sup>10</sup> This is a more empirically defensible claim.

Further, as mentioned below, that claim appears grounded on Polanyi’s description of the “commodification” of “noncommodities”, meaning by that term, “artificial commodities” or “fictitious commodities”, which he identifies as land, labour, and capital, during the period from the mid-eighteenth century to the mid-nineteenth century. That claim, that the fictitious commodities became the subject of market transactions to which they were not previously subject at all (strong form thesis), or to a much greater extent than previously (weak form), may be invoked in aid of his claim that the nineteenth century saw the dominance of the market institutions over other institutions in society.

### **Substantive Economics, Formal Economics, and Their Relation to Society**

In that article, Polanyi distinguishes between two different senses of the term “economic”, saying that “the substantive meaning of economic derives from man’s dependence for his living upon nature and his fellows. It refers to the interchange with his natural environment in so far as this relates in supplying him with the means of material want satisfaction.”<sup>11</sup> What Polanyi describes as the “substantive meaning” hearkens back to Aristotle and the discussion of the private/public distinction that appears above, referencing, in particular, Hannah Arendt and Jürgen Habermas. The concept of “householding” discussed there involves the difference between production for use and production for sale or exchange (although the two are not exclusive and may be engaged in by

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<sup>8</sup> *Ibid.* See also the discussion of markets in Ancient Greece in Chapter B1 in relation to each assumption mentioned there.

<sup>9</sup> Karl Polanyi, “The Economy as Instituted Process” in Karl Polanyi, Conrad M Arensberg & Harry W Pearson, eds, *Trade and Market in the Early Empires* (Glencoe, Ill: Free Press, 1957) 243.

<sup>10</sup> *Ibid* at 245.

<sup>11</sup> *Ibid* at 243.

a party at the same time). By engaging in householding, man may provide for many, but perhaps not all, of his material wants.

Because Polanyi acknowledges that man depends for his living not only upon nature but also upon his fellows, all “substantial” economic issues must involve a social, as well as a “natural” element. His economic man is an innately social being. The logical consequences of this social description of man, as opposed to the liberal atomistic concept of man, as expected, are highly significant. The satisfaction of an individual’s material wants not only include, but is highly dependent upon, joint or social action. It is not only upon nature, but also upon his fellows, that man depends for his “living”, for the means of “living” or, more simply, “to live”.

We may say that, for Polanyi, the consequent interchange by man with his “natural environment” is not only an interchange with “nature” but also with “his fellows”. In fact, it could be argued that the society of others is part of man’s “natural environment”. Polanyi’s man has associative or affiliative impulses and is not a purely atomistic individual seeking his own livelihood. Instead, each individual is dependent, in part at least, upon other individuals for the satisfaction of material wants. He also seeks to satisfy his non-material wants, which may be taken to include the favour, affection, regard, or respect of others. This recalls the natural condition of man posited by Thomas Hobbes and Adam Smith, as discussed above, which acknowledges these social impulses, contrary to popular conceptions of their work. As noted previously, such social impulses are perceived by Freudian psychiatry to be a dominant influence on behaviour.

Polanyi differentiates between the “substantive” and “formal” meanings” of economic, saying that the “formal meaning of economic derives from the logical character of the means-ends relationship, as apparent in such words as “economical” or “economizing”. It refers to a definite situation of choice, namely, that between the different uses of means induced by an insufficiency of those means. If we call the rules governing choice of means the logic of rational action, then we may denote this variant of logic, with an improvised term, as formal economics.”<sup>12</sup> Indeed, he maintains that the “two root meanings of “economic”, the substantive and the formal, have nothing in common. The latter derives from logic, the former from fact. The formal meaning implies a set

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<sup>12</sup> *Ibid.*

of rules referring to choice between the alternative uses of insufficient means. The substantive meaning implies neither choice nor insufficiency of means”.<sup>13</sup>

Polanyi claims that the substantive meaning of economics engages the laws of nature and the physical and social conditions of livelihood, while the formal meaning, involving, as it does, constructing relationships of means to ends, engages the laws of the mind, so that the two meanings could not be further apart.<sup>14</sup> Polanyi asserts that “only the substantive meaning of “economic” is capable of yielding the concepts that are required by the social sciences for an investigation of all the empirical economies of the past and present. The general frame of reference that we endeavor to construct require, therefore, treatment of the subject matter in substantive terms.”<sup>15</sup> In particular, he says that “the current concept of economic fuses the “subsistence” and the “scarcity” meanings of economic without a sufficient awareness of the dangers to clear thinking inherent in that merger.”<sup>16</sup>

Polanyi’s use of language may be unhelpful here. If the word “satisfactional” is substituted for “subsistence” and the word “teleological” for “scarcity” in this quotation, a different, arguably better, sense of its meaning appears. In those senses, satisfactional (i.e. substantive) economics describes the identification, concatenation and hierarchical organization of one’s materials wants, while teleological, or technical (in a non-pejorative sense, as in the sense of art, the Greek root word, *techne*) describes the process of attainment of those wants. Perhaps a better solution is to confine the use of the word “economic” to the substantive one, and to use the word “economizing”, as Polanyi does in the quotations above, for the technical aspect, even if this may have some assumedly “market” historical intentment.

### **Historical Investigation of the Place of the Economy in Society**

Polanyi argues that the task of economic history, is to conduct “an investigation of all the empirical economies of the past and present”. This task is in itself an empirical one, considering evidence, generating hypotheses and testing them. It is also one of considerable breadth and scope. Further comment on this point appears below, however, for the present, it may be noted that this sort of empirical investigation is methodologically discrete from one which consists primarily of

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<sup>13</sup> *Ibid* at 243-244.

<sup>14</sup> *Ibid* at 244.

<sup>15</sup> *Ibid*.

<sup>16</sup> *Ibid*.

intellectual ratiocination conducted by logical inference, considering assumptions which may or may not have factual relevance. For Polanyi, formal economics employs formal logic to seek a rational solution where the means are insufficient, without choice, to accomplish the desired ends. It seeks to construct a programme of rational action given those assumptions.

Polanyi says, in effect, that the organization of man's livelihood in price-making markets, which involved man in choices induced by an insufficiency of means, eliminated in practice the distinction between substantive and formal economics. He finds that this had adverse consequences in the social sciences (other than economics), since "the anthropologist, the sociologist or the historian, each in his study of the place occupied by the economy in human society, was faced with a great variety of institutions other than markets, in which man's livelihood was embedded."<sup>17</sup> Yet, he says, the problem of the economy in society required use of analytical method devised for a specific form of the economy involving specific market elements.

Polanyi seems to be arguing that the specificity or particularity of the means of analysis required to examine markets, in effect, precluded the application of other means of analysis to markets, and the dominance of markets in human society thereby also precluded analyzing institutions other than the market except by use of market-focused means of analysis. Polanyi, however, tends to focus attention on what he considers to be the market-dominated economy of the late eighteenth and the nineteenth centuries. Accordingly, his arguments concerning institutional analysis may be considerably influenced by that perspective.

One may observe that a "study of the place occupied by the economy in human society", if not intrinsically empirical, leans in that direction in a way that a consideration of means-ends relationships in conditions of scarcity does not (but, instead, leans in a logical, or, as Polanyi calls it, an "analytical", direction). However, the study of Polanyi's "substantive economy", of the ways in which man gains his living from interaction with nature and his fellows, necessarily places that economy in human society unequivocally and directly in a way in which logical analysis of how to choose among scarce means to achieve ends does not.

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<sup>17</sup> *Ibid* at 245.

## The Economy and Market Society

As discussed below, although Polanyi sought to explain empirical economies prevailing in different historical epochs in terms of patterns or “forms of integration”, namely, reciprocity, redistribution and exchange (the latter of which requires price-making markets),<sup>18</sup> he found that his contemporary economic and social theorists ignored empirical economies other than that prevailing at that point in time, which was a market economy. Polanyi calls the artificial identification of the economy with its market form, the “economistic fallacy”.<sup>19</sup>

As such, Polanyi claims that what he describes as “economic analysis” embraces this fallacy, as this “discipline results from the application of formal economics to an economy of a definite type, namely, a market system. The economy is here embodied in institutions that cause individual choices to give rise to interdependent movements that constitute the economic process. This is achieved by generalizing the use of price-making markets. All goods and services, including the use of labor, land and capital are available for purchase in markets and have, therefore, a price; all forms of income derive from the sale of goods and services – wages, rent, and interest, respectively, appearing only as different instances of price according to the items sold.”<sup>20</sup>

Although Polanyi does not expressly say this, price-making markets facilitate the comparison of goods and services that may be employed in vastly different ways. It enables consideration of the relative “utility” expected to be derived from a sale by both parties to the transaction. The buyer can compare the desirability to him, or, as we may say, the “desiredness” by him of various items, while the seller can compare the desirability or desiredness of continued ownership of the item in question with the acquisition and continued ownership of other items, which may be purchased by application of the sale price of the first item to the purchase of the second.

Price-making markets also facilitate a relative or ordinal ranking of preferences by potential market participants; it does this in a context in which not all preferences can be satisfied. As Polanyi comments: “The general introduction of purchasing power as the means of acquisition converts the process of meeting requirements into an allocation of insufficient means with alternative uses, namely, money. It follows that both the conditions of choice and its consequences are quantifiable

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<sup>18</sup> *Ibid* at 250ff.

<sup>19</sup> *Ibid* at 270 (this comment appears in the only footnote to the chapter, which follows the quotation here).

<sup>20</sup> *Ibid* at 247.

in the form of prices. It can be asserted that by concentrating on price as the economic fact *par excellence*, the formal method of approach offers a total description of the economy as determined by choices induced by an insufficiency of means. The conceptual tools by which this is performed make up the discipline of economic analysis.”<sup>21</sup>

### **Market Society, Commodification, and Prices**

As will be further explained below, Polanyi regarded as commodities “objects produced for sale on the market”.<sup>22</sup> As such, he says: “Labor, land, and money are obviously *not* commodities; the postulate that anything that is bought and sold must have been produced for sale is emphatically untrue in regard to them. In other words, according to the empirical definition of a commodity they are not commodities ... The commodity descriptions of labor, land, and money are entirely fictitious.”<sup>23</sup> Of course, Polanyi’s argument that a commodity is anything that is bought and sold entails that it must have been produced for sale is obviously erroneous: at a minimum, it plainly ignores production that exceeds the “use” requirements of the producer. However, it is also clear that labour, land, and money are not “produced for sale” and, accordingly, are not commodities (as defined) for that reason.

In the result, for Polanyi, the “commodification of non-commodities” results in their being denominated in a market system by a price expressed in a medium of exchange (money) which facilitates comparison with that of other commodities, which results in a prioritization of preference by allocation of a scarce resource with alternative uses, namely, money. Polanyi explains that “[o]utside of a system of price-making markets economic analysis loses most of its relevance as a method of inquiry into the working of the economy”.<sup>24</sup>

On the other hand, “[t]he fount of the substantive concept is the empirical economy. It can be briefly (if not engagingly) defined as an instituted process of interaction between man and his environment, which results in a continuous supply of want-satisfying material means. Want satisfaction is “material” if it involves the use of material means to satisfy ends; in the case of a

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<sup>21</sup> *Ibid* [emphasis in the original].

<sup>22</sup> Polanyi, *The Great Transformation*, *supra* note 1 at 75-76.

<sup>23</sup> *Ibid* [emphasis in the original].

<sup>24</sup> Polanyi, “Instituted Process”, *supra* note 9 at 247.

definite type of physiological wants, such as food or shelter, this includes the use of so-called services only.”<sup>25</sup>

### **Substantive Economics and Satisfaction**

To summarize the gist of Polanyi’s distinction between formal economics and substantive economics, we can say that his substantive economics considers man’s means of satisfying his wants, whether material or otherwise, provided that such wants require material means to their satisfaction; but if their satisfaction does not involve those material means, those wants do not engage substantive economics. Those wants, however, may engage the other social sciences, not in their “study of the place occupied by the economy in human society”<sup>26</sup>, but in their study, among other things, of human non-material wants and their satisfaction and, presumably, the place of such human non-materials wants and their satisfaction in human society.

Formal economics, though, according to Polanyi, involves choosing between means that are themselves insufficient to accomplish all man’s desired ends. This insufficiency or scarcity is seen most clearly in a market economy in which non-commodities, such as labour, are commodified, and are thus treated as if they were commodities, and priced as such. This presents some inconsistency with substantive economics, in which man’s gaining the means of satisfying his material wants from an interchange with his physical and social environment is an end in itself, and perhaps the most basic or most natural end.

Saying that each human depends for his or her living upon nature and his or her fellows, and that this trait is universally shared, should not be understood as implying that the abnegation of the wants, or even lives, of certain individuals effectuates commonly desired ends. Depletion of land, labor or capital does not avail others of the means to attain their material ends, but, instead, deprives them of certain of these means. This is seen most clearly in the foreshortening and diminution of quality of life that Polanyi saw as attending the lives of many industrial workers.

The substantive economy, however, as we have noted, involves interaction among humans. Polanyi says that social activities that form part of the process, may be called economic; institutions whose activities concentrate on such activities may be called economic; and any components of the economic process may be regarded as economic elements. He states that elements belonging

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<sup>25</sup> *Ibid* at 248.

<sup>26</sup> *Ibid* at 245.

to certain settings “can be conveniently grouped as ecological, technological or societal according to whether they belong primarily to the natural environment, the mechanical equipment, or the human setting.”<sup>27</sup>

### **Instituting the Economic Process**

The empirical economy, then, involves social activities and elements of the human setting, in a process of interaction, social and otherwise, that must be instituted in some manner. Polanyi explains that “reduced to a mechanical, biological and psychological interaction of elements that economic process would possess no all-round reality”, as the unity and stability of the economic process depends upon the interdependence and recurrence of movements in the process which, in turn, is affected by individual motives arising from societal conditions. He argues that it is those motives and social conditions which cause “[t]he interacting elements of nature and humanity” to form a coherent unit, a “structural entity that could be said to have a function in society or to possess a history.”<sup>28</sup>

As we have noted previously, Polanyi argues here that humans institute a process of interaction among themselves and with nature in order to achieve their motives in that environment, or in that place and time. Hence, the institutional aspect of the substantive economy becomes critical, because “[t]he instituting of the economic process vests that process with unity and stability; it produces a structure with a definite function in society; it shifts the place of the process in society, thus adding significance to its history; it centers interest on values, motives and policy. Unity and stability, structure and function, history and policy spell out operationally the content of our assertion that the human economy is an instituted process.”<sup>29</sup>

It is the instituting of the economic process that, according to Polanyi, accounts for its function and importance within society. Economic activity is embedded in society and in social values, motives and policy. As we have seen, such a conclusion is unsurprising, since, for Polanyi, economic activity, in the substantive sense, implicitly includes social, political, and ideological activity. He holds, therefore, that “[t]he human economy, then, is embedded and enmeshed in institutions, economic and noneconomic. The inclusion of the noneconomic is vital. For religion

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<sup>27</sup> *Ibid* at 249.

<sup>28</sup> *Ibid*.

<sup>29</sup> *Ibid* at 249-250.



or government may be as important for the structure and functioning of the economy as monetary institutions or the availability of tools and machines themselves that lighten the toil of labor.”

Polanyi then explains that “[t]he studying of the shifting place occupied by the economy in society is therefore no other than the study of the manner in which the economic process is instituted at different times and places.”<sup>30</sup> It may be inferred that this is the task of economic history for Polanyi, or, perhaps, for economic sociology or, in a market economy, for sociology of markets. For him, the study of the “manner in which the economic process is instituted” and the study of the “place occupied by the economy in society” are profoundly interrelated, if not actually non-fungible, activities. Needless to say, this represents a rejection of the fifth assumption or generalization of classical and neoclassical economics discussed in the present chapter.

### **Patterns of Integration**

For Polanyi, there are only a limited number of ways in which an economy acquires unity and stability, which he calls patterns or forms of integration, and which may occur side by side, on different levels, and in different sectors of the economy: “Empirically, we find the main patterns to be reciprocity, redistribution and exchange. Reciprocity denotes movements between correlative points of symmetrical groupings; redistribution designates appropriational movements toward a center and out of it again; exchange refers here to vice-versa movements taking place as between “hands” under a market system. Reciprocity, then, assumes for a background symmetrically arranged groupings; redistribution is dependent upon the presence of some measure of centrality in the group; exchange in order to produce integration requires a system of price-making markets. It is apparent that the different patterns of integration assume definite institutional supports.”<sup>31</sup>

Noting that these same words are often employed to denote personal interrelations, Polanyi observes that while it might seem that these forms of integration merely reflect aggregates of the respective forms of individual behaviour, individual behaviour, even aggregated, does not produce structures. Instead, individual behaviours can be integrated, he says, only by symmetrically organized structures. In effect, Polanyi’s different “patterns of integration” require definite institutional supports.<sup>32</sup> For example, Polanyi says that “[o]nly in a symmetrically organized

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<sup>30</sup> *Ibid* at 250.

<sup>31</sup> *Ibid* at 250-251.

<sup>32</sup> *Ibid* at 252.

environment will reciprocal behavior result in economic institutions of any importance; only when allocative centers have been set up can individual acts of sharing produce a redistributive economy; and only in the presence of system-making markets will exchange acts of individuals result in fluctuating prices that integrate the economy.”<sup>33</sup>

As noted previously in this work, research of early economies not then available to Polanyi has demonstrated that a redistributive economy is connected with the rise of the state and its establishment of regional and local centres for collection, allocation, and redistribution of various products, facilitating emergence of a more highly developed economy.

### ***Material and Non-Material Wants***

In *The Great Transformation*, Polanyi suggests that satisfying non-material or social wants, which does not involve the formal economy, is equally or even more important than satisfying material wants, which do implicate the formal economy: “The outstanding discovery of recent historical and anthropological research is that man's economy, as a rule, is submerged in relationships. He does not act so as to safeguard his individual interest in the possession of material goods; he acts so as to safeguard his social standing, his social claims, his social assets.”<sup>34</sup>

Consequently, Polanyi rejects the assumption or generalization of classical and neoclassical economics concerning the rational pursuit of self-interest by the atomistic individual. For him, the value of material goods is purely instrumental, in terms of this end: “Neither the process of production nor that of distribution is linked to specific economic interests attached to the possession of goods; but every single step in that process is geared to a number of social interests which eventually ensure that the required step be taken. These interests will be very different in a small hunting or fishing community from those in a vast despotic society, but in either case the economic system will be run on noneconomic motives.”<sup>35</sup>

Consequently, man's social interests may include, but are not limited to, securing one's livelihood, the means of doing which may vary with Polanyi's patterns or forms of integration. His explanation of how a tribal society ensures survival recalls Thomas Hobbes and Adam Smith. In the tribal society, the “individual's economic interest is rarely paramount, for the community keeps all its

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<sup>33</sup> *Ibid.*

<sup>34</sup> *Supra* note 1 at 48.

<sup>35</sup> *Ibid.*

members from starving unless it is itself borne down by catastrophe, in which case interests are again threatened collectively, not individually. The maintenance of social ties, on the other hand, is crucial. First, because by disregarding the accepted code of honor, or generosity, the individual cuts himself off from the community and becomes an outcast; second, because, in the long run, all social obligations are reciprocal, and their fulfillment serves also the individual's give-and-take interests best.”<sup>36</sup>

In such a tribal society, in which, as one might say, Polanyian man depends not only on nature, but also upon his fellows for his survival and well-being, motivations of a “give-and-take” nature coalesce with motivations of a social nature, with the result that “[s]uch a situation must exert a continuous pressure on the individual to eliminate economic self-interest from his consciousness to the point of making him unable, in many cases (but by no means in all), even to comprehend the implications of his own actions in terms of such an interest.”<sup>37</sup>

Regularly sharing food from the tribe’s catch, from its food cultivation, and from other activities reinforces the priority of communal interest, as opposed to self-interest, encourages industriousness, and the application of high levels of skill in pursuit of common objectives, creates a perception of fairness, reduces or eliminates jealousy, and encourages prestige-generating generosity, including the “performance of acts of exchange by way of free gifts that are expected to be reciprocated though not necessarily by the same individuals”. Polanyi says this makes “any other behaviour than that of utter self-forgetfulness simply not pay. Personal character has little to do with the matter. Man can be as good or evil, as social or asocial, jealous or generous, in respect to one set of values as in respect to another... The human passions, good or bad, are merely directed toward noneconomic ends.”<sup>38</sup>

Of course, the categorization of such goals as “noneconomic” may be criticized, in view of Polanyi’s own terminology, which would seem to characterize such behaviour, instead, as being “substantively economic”, since it relates to the satisfaction of material and non-material wants. Yet surely he is correct when he says that such a situation does not involve the economic motives of individuals; instead “the economic system is, in effect, a mere function of social organization.”<sup>39</sup>

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<sup>36</sup> *Ibid.*

<sup>37</sup> *Ibid* at 49.

<sup>38</sup> *Ibid.*

<sup>39</sup> *Ibid* at 52.

### *Social Interests, Social Influences, and Patterns of Integration*

Considering some of the earliest societies of which we are aware, then, social interests, as well as personal interests, underpinned reciprocity as a pattern of integration. Clearly, in such societies, individual behaviour cannot be described cogently as atomistic, but, instead, must be considered to exhibit significant social and collective motivations. Reciprocity often involves family and kinship. Polanyi cites the example of the Trobriand Islanders of Western Melanesia, where the sustenance of the family, other than its male head, is the responsibility of their matrilineal relatives, and where the male head of the family is motivated to deliver the finest part of his crop, not for immediate material benefit, but to preserve his own reputation.<sup>40</sup> He indicates that this was one of the most elaborate exchange networks known to man.

Polanyi says that case provides an example of redistribution, in which the chief receives and stores a substantial share of all the island's produce. "But as all communal activity centers around the feasts, dances, and other occasions when the islanders entertain one another as well as their neighbors from other islands (at which the results of long distance trading are handed out, gifts are given and reciprocated according to the rules of etiquette, and the chief distributes the customary presents to all), the overwhelming importance of the storage system becomes apparent. Economically, it is an essential part of the existing system of division of labor, of foreign trading, of taxation for public purposes, of defense provisions."<sup>41</sup>

As this example indicates, Polanyi considered that reciprocity, redistribution and exchange were not historical developments in which economic behaviour ascended to higher levels, but, instead, that a society could display each of these patterns of integration simultaneously, even in modernity.

### **The Market Economy, Commodification, Prices, and the Model of Man**

The social elements of reciprocity and redistribution are largely absent, however, from Polanyi's characterization in *The Great Transformation* of the market economy as instantiated from and after the Industrial Revolution, although he observes that such patterns of integration became more prevalent as society sought to curtail the most extreme adverse effects of that system:

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<sup>40</sup> *Ibid* at 50.

<sup>41</sup> *Ibid*.

A market economy is an economic system controlled, regulated, and directed by market prices; order in the production and distribution of goods is entrusted to this self-regulating mechanism. An economy of this kind derives from the expectation that human beings behave in such a way as to achieve maximum money gains. It assumes markets in which the supply of goods (including services) available at a definite price will equal the demand at that price. It assumes the presence of money, which functions as purchasing power in the hands of its owners. Production will then be controlled by prices, for the profits of those who direct production will depend upon them; the distribution of the goods also will depend upon prices, for prices form incomes, and it is with the help of these incomes that the goods produced are distributed amongst the members of society. Under these assumptions order in the production and distribution of goods is ensured by prices alone.<sup>42</sup>

Unlike reciprocity and redistribution, which assumed that individuals would have material and non-material wants and would want to satisfy some or all of them, acting individually or collectively, but in a manner that acknowledged others, group dependence, and social norms, values, objectives, and institutions, the self-regulating market form of exchange of classical and neoclassical economists posits a different view of human nature. In it, individuals function atomistically and rationally with the objective of achieving maximum monetary gains.

### ***Self-Regulating Markets***

Accordingly, says Polanyi, “there are markets for all elements of industry, not only for goods (always including services) but also for labor, land, and money, their prices being called respectively commodity prices, wages, rent, and interest.” He means to suggest that thereby all factors of input are priced in the market and he indicates that in such a case “all incomes derive from sales on the market, and incomes will be just sufficient to buy all the goods produced.”<sup>43</sup>

This commodification of non-commodities has been discussed above. Polanyi argues that the state is assumed not to have any role with respect to all such commodities, not interfering with the formation of markets; or with “the adjustment of prices to changed market conditions-whether the prices are those of goods, labor, land, or money.” Although markets must exist for all elements of industry, “no measure or policy must be countenanced that would influence the action of these

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<sup>42</sup> *Ibid* at 71-72.

<sup>43</sup> *Ibid* at 72.

markets. Neither price, nor supply, nor demand must be fixed or regulated; only such policies and measures are in order which help to ensure the self-regulation of the market by creating conditions which make the market the only organizing power in the economic sphere.”<sup>44</sup>

### *Self-Regulating Markets in History*

In these passages, Polanyi summarizes many of the assumptions of classical and neoclassical economics, as a prolegomenon to showing that such a market has never obtained historically. Polanyi argues that the very concept of a self-regulating market divorces its economy from the social and political spheres, saying that a “self-regulating market demands nothing less than the institutional separation of society into an economic and a political sphere. Such a dichotomy is, in effect, merely the restatement, from of view of society as a whole, of the existence of a self-regulating market.”<sup>45</sup> Thus, for Polanyi, “self-regulating” means that society and the polity “leaves the economy to itself” or “leaves the economy alone”, as we might say.

While any society requires “a system of some kind which ensures order in the production and distribution of goods”, Polanyi says that this does not require the existence of economic institutions separated from social institutions; instead, “normally, the economic order is merely a function of the social order. Neither under tribal nor under feudal nor under mercantile conditions was there, as we saw, a separate economic system in society. Nineteenth-century society, in which economic activity was isolated and imputed to a distinct economic motive, was a singular departure.”<sup>46</sup>

Polanyi overstates the point, in our view, as we have noted previously. While the extent of the dominance of markets was probably more extensive in the nineteenth century than in previous times, there is now considerable evidence (admittedly, not all of it available to Polanyi) that market economies or economies in which the operation of markets were economically significant obtained even in ancient times.

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<sup>44</sup> *Ibid.*

<sup>45</sup> *Ibid* at 74.

<sup>46</sup> *Ibid* at 74.

## Markets, Embeddedness, and the Double Movement

In a famous passage, and one worth quoting in its entirety, Polanyi argued that the extent of market dominance as a pattern of integration and the commodification of non-commodities presented difficulties that were almost insuperable:

Social history in the nineteenth century was thus the result of a double movement: the extension of the market organization in respect to genuine commodities was accompanied by its restriction in respect to fictitious ones. While on the one hand markets spread all over the face of the globe and the amount of goods involved grew to unbelievable dimensions, on the other hand a network of measures and policies was integrated into powerful institutions designed to check the action of the market relative to labor, land, and money. While the organization of world commodity markets, world capital markets, and world currency markets under the aegis of the gold standard gave an unparalleled momentum to the mechanism of markets, a deep-seated movement sprang into being to resist the pernicious effects of a market-controlled economy. Society protected itself against the perils inherent in a self-regulating market system – this was the one comprehensive feature in the history of the age.<sup>47</sup>

Polanyi maintains that such regulation, by society and the polity through the state, countered the power of markets and protected society from the adverse effects of a self-regulating market system, while operating as part of the double movement. He asserts that “[t]he road to the free market was opened and kept open by an enormous increase in continuous, centrally organized and controlled interventionism. To make Adam Smith's "simple and natural liberty" compatible with the needs of a human society was a most complicated affair.”<sup>48</sup>

Polanyi differentiates the two elements of the double movement in terms of intentionality, maintaining that “[w]hile laissez-faire economy was the product of deliberate State action, subsequent restrictions on laissez-faire started in a spontaneous way. Laissez-faire was planned; planning was not.”<sup>49</sup> Polanyi obviously intends his choice of words to emphasize his point. He argues that “[l]iberal writers like Spencer and Sumner, Mises and Lippmann offer an account of

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<sup>47</sup> *Ibid* at 79-80.

<sup>48</sup> *Ibid* at 146.

<sup>49</sup> *Ibid* at 147.

the double movement substantially similar to our own, but they put an entirely different interpretation on it”, seeing the self-regulating market as utopian and its cessation by way of protectionism as “a mistake due to impatience, greed, and shortsightedness, but for which the market would have resolved its difficulties.”<sup>50</sup> Polanyi’s analysis of the double movement led him to conclude that “[u]ndoubtedly, our age will be credited with having seen the end of the self-regulating market”, as well as the demise of liberalism as the “basic organizing principle in society”.

Of course, the non-commodity affected most adversely by the attempt to allow markets to regulate themselves, was labour, and the market most adversely affected was the labour market. Polanyi concluded that “[t]o separate labor from other activities of life and to subject it to the laws of the market was to annihilate all organic forms of existence and to replace them by a different type of organization, an atomistic and individualistic one.”<sup>51</sup> As discussed extensively, the concept of man as atomistic and individualistic accords with classical and neoclassical economic theory. Polanyi is critical of both that theory, its application, and the implications of both.

### **Commodification, and Fungibility, of Labour, Land, and Capital**

Polanyi asserts, in effect, that in order to commoditize labour, it was necessary to create a labor “product” that was homogeneous, and fungible, and, in consequence, exchangeable. That labour “product” had to be discrete and separate from other competing products. Some of these objectives were achieved, he says, by creating (or attempting to create) an atomized and individualistic person as product.

While classical liberal theorists often started their deliberations with the solitary, atomistic individual, Polanyi argues, instead, that such perspective was the result of liberal economics, whose principle of freedom of contract facilitated such scheme of destruction. “In practice this meant that the noncontractual organizations of kinship, neighborhood, profession, and creed were to be liquidated since they claimed the allegiance of the individual and thus restrained his freedom [of contract].”<sup>52</sup> Instead of not interfering with freedom of contract, he asserts that economic

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<sup>50</sup> *Ibid* at 148.

<sup>51</sup> *Ibid* at 171.

<sup>52</sup> *Ibid*.



liberals interfered, not with contract as such, but to “destroy noncontractual relations between individuals and prevent their spontaneous reformation.”<sup>53</sup>

Without taking issue with this description or characterization of the process of organizing labour for mass industrial production, we may admit that there is at least this element of truth in his description of the result: whether as a result of industrialization or otherwise, family and community ties and obligations were subordinated as rural workers moved to urban environments to work in factories and other industrial and commercial undertakings, thereby reducing the familial and community supports available during relocation and employment disruption or cessation.

Polanyi is, of course, critical of the consequences of the commodification of labour, as he is with the commodification of capital and land. “Traditionally, land and labor are not separated; labor forms part of life, land remains part of nature, life and nature form an articulate whole. And is thus tied up with the organizations of kinship, neighborhood, craft, and creed – with tribe and temple, village, guild, and church.”<sup>54</sup> This Elysian and antiquated relationship ended with what he describes as “One Big Market”, in which markets exist for all the factors of production. Because those factors are “indistinguishable from the elements of human institutions, man and nature, it can readily be seen that market economy involves a society the institutions of which are subordinated to the requirements of the market mechanism.”

This perspective may be considered to be just as utopian in respect of land as in respect of labour. One might argue with some cogency that the impairment of organizations of rural life was a consequence, not of the commodification of labour, but of the movement of agricultural and other rural workers to the cities as increased mechanization of agricultural production reduced the labour force required to work the land.

Equally well, however, there is some truth to the assertion that the increased mobility of the labour force and the alternative to agricultural work provided by the prospect of employment in factories and other work places in the cities reduced the prominence of rural organizations, sometimes, as Polanyi observed in other situations, without providing suitable means for the amelioration of the adverse effect of such shifts, such as establishing industrial guilds and unions, and religious and

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<sup>53</sup> *Ibid.*

<sup>54</sup> *Ibid* at 187.

community organizations. In effect, the means of ameliorating the social disruptions occasioned by the self-regulating market required societal responses that were often not put in place for some time after the disruption transpired.

### **Significance of Markets in the Modern Era**

In an important article, “Markets and Other Allocation Systems in History: The Challenge of Karl Polanyi,”<sup>55</sup> Douglass North concluded: “The stubborn fact of the matter is that Polanyi was correct in his major contention that the nineteenth century was a unique era in which markets played a more important role than at any other time in history. Polanyi, not only argued convincingly that economic historians have overplayed the role of markets in ancient economies, but argued with equal force that the market was a declining ‘transactional mode’ of the twentieth century as well.”<sup>56</sup> The present work has suggested that recent research, in economic history and otherwise, has demonstrated that markets were more significant in ancient economies than was thought when Polanyi and even North were writing.

Nonetheless, Polanyi’s argument that the importance of markets declined in the twentieth century is, at the present time, relatively non-contentious. This decline of the significance of markets concomitantly reduces the importance of the analysis of such markets. North argues: “To the extent that economic theory was confined to the analysis of markets, the tools of the economist were not only irrelevant to an understanding of the ancient world, but were increasingly less useful to explain the evolving economies of the twentieth century as well. Moreover, Polanyi’s concepts of reciprocity and redistribution, however imprecisely specified, clearly have characterized and continue to characterize a great deal of resource allocation. Economic historians have not even begun to account for such non-market allocative systems, and until they do, they can say very little about societies in which markets had very limited allocative effects.”<sup>57</sup>

North draws attention to the presence of reciprocity and redistribution in modern societies providing welfare and other social benefits to their members. This is consistent with Polanyi’s argument that his “transactional modes” may obtain simultaneously in a society. North points out, further, that “[w]hat gives Karl Polanyi’s challenge a force not found in other scholar’s criticism

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<sup>55</sup> Douglass C North, “Markets and Other Allocation Systems in History: The Challenge of Karl Polanyi” (1977) 6:3 *J European Economic History* 703.

<sup>56</sup> *Ibid* at 706.

<sup>57</sup> *Ibid*.

of the economist's tools is that he offers an alternative analytical framework to account for past and present institutional organization. Polanyi maintains that reciprocity and redistribution were the dominant "transactional modes" in past societies, and, increasingly, characterize economics in this century as well. These allocative systems were not based on economizing behavior, but can only be understood in terms of in-depth studies which are cultural, social, and psychological."<sup>58</sup>

Polanyi might say that reciprocity and redistribution, as patterns of integration, are characteristic of "substantive", although not necessarily "formal", economics. They are also, of course, inextricably linked to underlying social relations. As noted above, Polanyi maintained that "man's economy, as a rule, is submerged in his social relationships"<sup>59</sup> and, when considered in connection with reciprocity and redistribution, the "economic system, is, in effect, a mere function of social organization".<sup>60</sup> Reciprocity involves family and kinship, while redistribution generally involves an authority figure and is, therefore, territorial.<sup>61</sup> Polanyi explains that "reciprocity helps to safeguard both production and family sustenance."<sup>62</sup> He also provides numerous examples (some mentioned above) which demonstrate that "redistribution also tends to enmesh the economic system proper in social relationships."<sup>63</sup>

North maintains that reciprocity and redistribution, like markets, were important elements not only of all previous, but also of all modern, societies, as maintained by Polanyi. "But the point goes much deeper than even Polanyi realized, and poses a fundamental problem to the economist and economic historian. How do we account for substitutes for price-making markets of which families, firms, guilds, manors, trade unions, cooperatives, etc. are *organizing* institutions which allocate resources in place of markets. Most fundamental of all, how do we explain government?"<sup>64</sup>

From North's perspective, the task of economic history is not only explaining the rise of economic institutions and activities, but also explaining the origins of institutions generally, or, at least, those which are organizing institutions of alternative economic activity, which he seems to agree includes reciprocity and redistribution. North says: "These substitutes for markets not only have

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<sup>58</sup> *Ibid* at 704.

<sup>59</sup> *Supra* note 1 at 48.

<sup>60</sup> *Ibid* at 52.

<sup>61</sup> *Ibid* at 50.

<sup>62</sup> *Ibid*.

<sup>63</sup> *Ibid* at 55.

<sup>64</sup> *Ibid* at 709 [emphasis in the original].

dominated exchange in past societies, but do so today as well. Without a theoretical explanation for these allocative institutions, the new economic historian has little to contribute to an understanding of the past, and contemporary economists can explain less and less about the contemporary economic scene.”<sup>65</sup>

Although North faults Polanyi as failing to account for changes in, and in the mix of, these allocation systems over time, he allows that it “was Karl Polanyi’s intuitive genius that he saw the issues”.<sup>66</sup> Much more than that, however, he provided a cogent argument for the inseparability of economic and social life.

### **Conclusion**

Polanyi’s analysis has often been summarized as critical of an analysis of economic institutions that is disembedded from society as a whole.<sup>67</sup> However, the position maintained here is that Polanyi’s criticism is more properly directed to analysis that disembeds economic activity from its overall social, political, ideological and otherwise broader context. This has implications for the analysis of economic institutions, including business entities, customs and laws.

Leaving to one side whether Polanyi’s analysis of the pervasiveness of markets in the late eighteenth century and in the nineteenth century presents excessive claims, Polanyi makes a highly persuasive argument that economic, social, and political life do not occupy distinct and independent spheres but, instead, each should be considered to be co-present in an undifferentiated sphere of human life generally.

At least, his arguments cogently support the proposition that a model of the economy which does not include the social and political life of the society in which the economy is situated, including the institutions relating to such life, seems to lack explanatory and predictive power and capacity and, accordingly, that such model is inadequate as a model for regulation of the economy, the modern business corporation, and other business entities.

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<sup>65</sup> *Ibid.*

<sup>66</sup> *Ibid* at 715.

<sup>67</sup> Fred Block, “Introduction” in Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Press, 2001) xviii at xxiv.

## MARK GRANOVETTER'S EMBEDDEDNESS

### The Importance of Social Relations

Mark Granovetter's seminal 1985 article "Economic Action and Social Structure: The Problem of Embeddedness"<sup>68</sup> drew heavily on the work of Karl Polanyi and on Dennis Wrong's influential 1961 article "The Oversocialized Conception of Man in Modern Sociology".<sup>69</sup> Granovetter says that "[m]uch of the utilitarian tradition, including classical and neoclassical economics, assumes rational, self-interested behavior affected minimally by social relations, thus invoking an idealized state not far from that of these thought experiments. At the other extreme lies what I call the argument of "embeddedness": the argument that the behavior and institutions to be analyzed are so constrained by ongoing social relations that to construe them as independent is a grievous misunderstanding."<sup>70</sup>

The immediately preceding chapter concentrated on the subject of analysis and methodology; and this chapter concentrates on the subject of the independence of the economy as posited by classical and neoclassical economics, as compared with the interdependence of the economy and society, as maintained by others. As was the case in the previous section of this chapter, two lenses, being embeddedness, and the nature of man, will focus the discussion below.

This section will illustrate both the similarities and the differences between Polanyi's and Granovetter's concepts of embeddedness. As will be seen, both engage a perspective on the nature of man which differs, as Granovetter noted in the preceding paragraph, from that of classical and neoclassical economics. Both conceptions of embeddedness assume that economic and other social behaviours are integrated, rather than completely differentiated.

As noted previously, Granovetter maintains that most social scientists and historians considered that economic behaviour was "heavily embedded in social relations in premarket societies but became much more autonomous with modernization", thereby seeing the economy "as an increasingly separate, differentiated sphere in modern society, with economic transactions defined no longer by the social or kinship obligations of those transacting but by rational calculations of

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<sup>68</sup> Mark Granovetter, "Economic Action and Social Structure: The Problem of Embeddedness" (1985) 91:3 *American J Sociology* 481.

<sup>69</sup> Dennis Wrong, "The Oversocialized Conception of Man in Modern Sociology" (1961) 26:2 *American Sociological Rev* 183.

<sup>70</sup> *Supra* note 68 at 481.

individual gain” to such an extent that, “instead of economic life being submerged in social relations, these relations become an epiphenomenon of the market”<sup>71</sup>

Thus, as a matter of first impression, it can be seen that Granovetter’s view has considerable affinity with Polanyi’s perspective. Certainly, both contrast their perspectives with of classical and neoclassical economics. Granovetter opines that the level of embeddedness of economic behaviour has always been and continues to be more substantial than is allowed for by economists but lower in nonmarket societies than claimed by some “substantivists and development theorists” in anthropology and sociology.<sup>72</sup>

### **The Undersocialized Man of Economics and the Oversocialized Man of Sociology**

Granovetter commences his discussion “by recalling Dennis Wrong's 1961 complaint about an "oversocialized conception of man in modern sociology" – a conception of people as overwhelmingly sensitive to the opinions of others and hence obedient to the dictates of consensually developed systems of norms and values, internalized through socialization, so that obedience is not perceived as a burden...a conception...[that] resulted in large part from Talcott Parsons's recognition of the problem of order as posed by Hobbes and his own attempt to resolve it by transcending the atomized, *undersocialized* conception of man in the utilitarian tradition of which Hobbes was part.”<sup>73</sup>

As previously discussed, the Hobbesian problem of order is, of course, the question of how men become tractable to social order or, as Dennis Wrong says, become “capable of the guidance by social norms and goals that makes possible an enduring society”.<sup>74</sup> According to Granovetter, Parsons’s recognition of the embeddedness of actors in social context supplied “the crucial factor absent from Hobbes's thinking”, but Wrong “warned of exaggerating the degree of this embeddedness and the extent to which it might eliminate conflict”, in effect, warning against adopting an oversocialized conception of man.<sup>75</sup>

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<sup>71</sup> *Ibid* at 482-483.

<sup>72</sup> *Ibid* at 483.

<sup>73</sup> *Ibid* [emphasis in the original], citing Talcott Parsons, *The Structure of Social Action* (New York: McMillan, 1937) at 89-94.

<sup>74</sup> *Supra* note 69 at 184.

<sup>75</sup> *Supra* note 68 at 483.

As to economics, Granovetter argues that “[c]lassical and neoclassical economics operates, in contrast, with an atomized, *undersocialized* conception of human action, continuing in the utilitarian tradition,.... [whose] theoretical arguments disallow by hypothesis any impact of social structure and social relations on production, distribution, or consumption...[i]n competitive markets [in which] no producer or consumer noticeably influences aggregate supply or demand or, therefore, prices or other terms of trade.”<sup>76</sup>

Granovetter considered such hypotheses and arguments as inadequate. Instead, he adopted Albert Hirschman’s characterization of such markets as “idealized...., involving as they do "large numbers of price-taking anonymous buyers and sellers supplied with perfect information...[who] function without any prolonged human or social contact between the parties” with the result that “[u]nder [such] perfect competition there is no room for bargaining, negotiation, remonstrance or mutual adjustment and the various operators that contract together need not enter into recurrent or continuing relationships as a result of which they would get to know each other well .”<sup>77</sup>

We have previously criticized the atomized conception of human nature of classical and neoclassical economics in our discussion of the fourth, immediately preceding, assumption. Granovetter takes a somewhat similar position. He argues that in classical and neoclassical economics social relations between economic actors have been treated, even by Adam Smith, as a fictional drag that impedes competitive markets<sup>78</sup> and that it is assumed “that *social atomization is prerequisite to perfect competition*”.<sup>79</sup>

### **Undersocialized and Oversocialized Concepts of Atomistic Man**

Granovetter notes, as we have done, that both undersocialized and oversocialized views of human nature conceive of man as atomized, in respect of both action and decision. “In the undersocialized account, atomization results from narrow utilitarian pursuit of self-interest; in the oversocialized one, from the fact that behavioral patterns have been internalized and ongoing social relations thus have only peripheral effects on behavior. That the internalized rules of behavior are social in origin

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<sup>76</sup> *Ibid* at 483-4 [emphasis in the original].

<sup>77</sup> *Ibid* at 484, citing Albert Hirschman, “Rival Interpretations of Market Society: Civilizing, Destructive or Feeble?” (1982) 20:4 *J Economic Literature* 1463 at 1473.

<sup>78</sup> Granovetter, *supra note* 68 at 484. His example is Adam Smith’s famous complaint that “people of the same trade seldom meet together, even for merriment, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices”.

<sup>79</sup> *Ibid* [emphasis in the original].

does not differentiate this argument decisively from a utilitarian one, in which the source of utility functions is left open, leaving room for behavior guided entirely by consensually determined norms and values – as in the oversocialized view.”<sup>80</sup>

Although the cause of the atomization differs, both undersocialized and oversocialized accounts atomize and abstract actors from the immediate social context, for example, “in Hobbes's *Leviathan*, in which the unfortunate denizens of the state of nature, overwhelmed by the disorder consequent to their atomization, cheerfully surrender all their rights to an authoritarian power and subsequently behave in a docile and honorable manner; by the artifice of a social contract, they lurch directly from an undersocialized to an oversocialized state.”<sup>81</sup>

According to Granovetter, modern economists who attempt to take account of social influences generally adopt an oversocialized view, in which the influences of society on individual behavior “are rather mechanical: once we know the individual's social class or labor market sector, everything else in behavior is automatic, since they are so well socialized. Social influence here is an external force that, like the deists' God, sets things in motion and has no further effects – a force that insinuates itself into the minds and bodies of individuals... altering their way of making decisions.”<sup>82</sup>

Granovetter emphasizes that social influence is not considered to operate subsequently; instead, social influences are assumed to be pre-set attitudinally *ab initio*, as it were, and do not arise otherwise. As such, course, it is assumed that social influences are not subject to change. Consequently, “in actual decision situations, [the individual] can be atomized as any *Homo economicus*, though perhaps with different rules for decisions. More sophisticated (and thus less oversocialized) analyses of cultural influences... make it clear that culture is not a once-for-all influence but an ongoing process, continuously constructed and reconstructed during interaction. It not only shapes its members but also is shaped by them, in part for their own strategic reasons.”<sup>83</sup>

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<sup>80</sup> *Ibid* at 485.

<sup>81</sup> *Ibid*.

<sup>82</sup> *Ibid* at 486.

<sup>83</sup> *Ibid* [citations omitted]. As examples of more sophisticated accounts, he cites: Gary Fine & Sherryl Kleinman, “Rethinking Subculture: An Interactionist Analysis” (1979) 85:1 *American J Sociology* 1; and Robert Cole, *Work, Mobility and Participation: A Comparative Study of American and Japanese Industry* (Berkeley: University of California Press, 1979), c 1.



Curiously, this argument maintains, in effect, that society influences individual behaviour by socializing the individual so as to behave in accordance with a certain role or certain roles; and that once that role and related behaviour are assigned to the individual, other possible types of individuation, whether in terms of past, present, or future circumstances, can safely be ignored for practical purposes. In this way, subsequent to role assignment and inculcation, the individual, and the behaviour of the individual is just as monadic and atomized as is assumed in classical and neoclassical economics.

### **The Atomism of Role-Determined Behaviour**

One may say, as does Roy Weintraub with respect to economics,<sup>84</sup> that this oversocialized conception posits a mechanistic view of human behaviour as entirely determined by role and position, seeking rules as in the “hard” sciences, such as mechanics and physics. Such a mechanistic view may be considered to be contrary to experience. Further, as we have argued previously, an atomistic and deterministic analysis of economic and other social behaviour cannot be expected to involve or adequately take into account associative or affiliative motives and behaviour.

In that sense, Dennis Wrong’s “oversocialized” conception of man is rather less “oversocialized” than “over-ruled” (not “overruled”) in the sense that it involves less a social conception of man than a conception of man as an enactor of social “roles”. Yet, as soon as one recalls that “roles” are merely “ideal types” derived from empirical observations of real world behaviour, one can see the weakness in the reasoning. Summarized simplistically: the characterization of the general is derived from observations of the particular to derive roles that are seen as enacted in behaviour, and then the general, the role, is considered to be determinative of the behaviour of individuals seen as enacting or performing the particular role. All of the history, historicity, and individuality of the individual is eliminated in the process of abstracting the behaviour of particular individuals to “role” behaviour, and then the decontextualized behaviour assigned to the generalized “role” is expected to determine instantiations of particular behaviour of human individuals in the real world.

As we know, though, individuals are constantly negotiating their individual identities: firstly, in particular contexts; secondly, against the background of competing roles and functions; and,

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<sup>84</sup> E Roy Weintraub, “Neoclassical Economics” in *The Concise Encyclopedia of Economics*, by David R Henderson, online: *Library of Economics and Liberty* <<http://www.econlib.org/library/Enc1/NeoclassicalEconomics.html>>.

thirdly, in accordance with the salience they accord to particular claims on their personal identity (which we may call their “social identities” as such may obtain from time to time.<sup>85</sup> Without investigating those matters further here, as we do in Chapter Four, we may agree with Granovetter when he says that “[a] fruitful analysis of human action requires us to avoid the atomization implicit in the theoretical extremes of under- and oversocialized conceptions. Actors do not behave or decide as atoms outside a social context, nor do they adhere slavishly to a script written for them by the particular intersection of social categories that they happen to occupy. Their attempts at purposive action are instead embedded in concrete, ongoing systems of social relations.”<sup>86</sup>

As indicated by the names assigned by Wrong and Granovetter, we may agree that neither of these conceptions of man assigned the proper weight to man’s social relations nor, we would suggest, to the psychology, personality, and values of individual purposive actors.

### **The Oversocialized Concept of Man in New Institutional Economics**

Granovetter also criticizes as undersocialized the account of new institutional economics (NIE), which he describes as “a loosely defined confederation of economists with an interest in explaining social institutions from a neoclassical viewpoint,”<sup>87</sup> who adhere to the “general story...that social institutions and arrangements previously thought to be the adventitious result of legal, historical, social or political forces are better viewed as the efficient solution to certain economic problems.”<sup>88</sup> He gives the example of clever institutional arrangements that make it too costly to engage in malfeasance and which are considered to have arisen to discourage that practice, such as elaborate implicit and explicit contracts which do not produce trust, but are a functional substitute for it.

On the other hand, NIE may be considered to be assigning an economic “role” to social institutions which “role” is then seen as being enacted and instantiated subsequently. It might be argued that, as is the case with respect to human behaviour (in which excessive role orientation is considered to be “oversocialized” in its account), treating institutional behaviour solely as a function of its economic role might also be considered as “over-rolled” or “over-institutionalized”. In that sense, the account of new institutional economics may be considered as excessively prioritizing the

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<sup>85</sup> Phillip G Bevens, *Identity and Directors: A Preliminary Inquiry* (2008) [unpublished, on file with the author].

<sup>86</sup> Granovetter, *supra* note 68 at 487.

<sup>87</sup> *Ibid* at 488.

<sup>88</sup> *Ibid*.

economic “roles” or functions of institutions, just as oversocialized conceptions of man excessively prioritize role behaviour with respect to individuals.

Granovetter criticizes the conceptions of NIE theorists as undersocialized “in that they do not allow for the extent to which concrete personal relations and the obligations inherent in them discourage malfeasance, quite apart from institutional arrangements.”<sup>89</sup> He asserts that “[t]he embeddedness argument stresses instead the role of concrete personal relations and structures (or “networks”) of such relations in generating trust and discouraging malfeasance. The widespread preference for transacting with individuals of known reputation implies that few are actually content to rely on either generalized morality or institutional arrangements to guard against trouble.”<sup>90</sup>

As we noted in relation to the fourth assumption, Granovetter also considers whether “generalized morality”, an implicit agreement to certain kinds of regard for others,<sup>91</sup> prevents malfeasance, distrust, and disorder. He concludes that “[d]isorder and malfeasance do of course occur also when social relations are absent... [although] the presence of such relations inhibits malfeasance. But the level of malfeasance available in a truly atomized social situation is fairly low; instances can only be episodic, unconnected, small scale. The Hobbesian problem is truly a problem, but in transcending it by the smoothing effect of social structure, we also introduce the possibility of disruptions on a larger scale than those available in the “state of nature.”<sup>92</sup> The latter observation claims that the low level of social interaction in a “truly atomized social structure” contains negative interactions: in effect, as we have argued previously, atomized individuals may engage in “fights” but lack the social capacity to conduct “wars”.

Granovetter claims that “[t]he embeddedness approach to the problem of trust and order in economic life, then, threads its way between the oversocialized approach of generalized morality and the undersocialized one of impersonal, institutional arrangements by following and analyzing concrete patterns of social relations. Unlike either alternative, or the Hobbesian position, it makes

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<sup>89</sup> *Ibid* at 489.

<sup>90</sup> *Ibid* at 490.

<sup>91</sup> *Ibid* at 489, citing Ken Arrow, *The Limits of Organization* (New York: Norton, 1974) at 26; and George Akerlof, “Loyalty Filters” (1983) 73:1 *American Economic Rev* 54.

<sup>92</sup> Granovetter, *supra* note 68 at 493.

no sweeping (and thus unlikely) predictions of universal order or disorder but rather assumes that the details of social structure will determine which is found.”<sup>93</sup>

The other example with which Granovetter deals at length is the matter of hierarchy and markets, when, in effect, economic activity is organized within a firm or hierarchical structure, rather than in markets, as explicated by Oliver Williamson in his 1975 book *Markets and Hierarchies* and in his later articles.<sup>94</sup> Discussion of this matter will await our consideration of assumptions of corporate law and corporate governance concerning the nature of the firm.

Granovetter summarizes the approach of the new institutional economists by saying that “the main thrust of the “new institutional economists” is to deflect the analysis of institutions from sociological, historical, and legal argumentation and show instead that they arise as the efficient solution to economic problems. This mission and the pervasive functionalism it implies discourage the detailed analysis of social structure that I argue here is the key to understanding how existing institutions arrived at their present state.”<sup>95</sup>

Granovetter argues, instead, that the analysis of economic institutions should focus on the social relations in which economic life is embedded<sup>96</sup> and on economic action “as a special, if important, category of social action.”<sup>97</sup> It can be seen that such an argument is, at least on its face, broadly consistent with Polanyi’s concept of embeddedness.

## **POLANYI AND GRANOVETTER COMPARED**

Polanyi and Granovetter initiated separate intellectual trajectories with respect to embeddedness.<sup>98</sup> They are compared and contrasted in two useful articles to which reference will be made here, one

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<sup>93</sup> He cites, in particular, Oliver Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: Free Press, 1975); Oliver Williamson, “Transaction-Cost Economics: The Governance of Contractual Relations” (1979) 22:2 *JL & Econ* 233; Oliver Williamson, “The Economics of Organization: The Transaction Cost Approach” (1981) 87:3 *American J Sociology* 548; Oliver Williamson & William Ouchi, “The Markets and Hierarchies and Visible Hand Perspectives” in Andrew Van de Ven & William Joyce, eds, *Perspectives on Organizational Design and Behavior* (New York: Wiley, 1981) 347.

<sup>94</sup> *Ibid.*

<sup>95</sup> Granovetter, *supra* note 68 at 505.

<sup>96</sup> *Ibid* at 507.

<sup>97</sup> *Ibid.*

<sup>98</sup> Greta Krippner & Anthony S Alvarez, “Embeddedness and the Intellectual Projects of Economic Sociology” (2007) 33 *Annual Rev Sociology* 219 at 219.

by John Lie from 1991,<sup>99</sup> and the other by Greta Krippner and Anthony Alvarez from 2007.<sup>100</sup> It will be convenient to consider them in reverse order.

### **Granovetter's Atomism and Polanyi's Non-Autonomous Economy**

Krippner and Alvarez argue that “embeddedness takes on two aspects of the neoclassical paradigm – atomism and the analytically autonomous economy – that are logically joined when viewed through the prism of neoclassical economics but become not only distinct but actually incommensurable problems within the context of sociology”.<sup>101</sup> As noted in our discussion of analytical methodology in relation to the fourth assumption, they argue that Polanyi and Granovetter each concentrate primarily on only one aspect of embeddedness: Granovetter on the role of atomism, and Polanyi on the problem of the analytically autonomous economy, although these are “indistinguishable within the neoclassical paradigm.”

According to them: “An atomistic perspective, that is, a perspective that assumes isolated, self-interested actors who arrive on the scene already equipped with an inborn tendency to “truck, barter, and exchange,” requires essentially no governance structure to police exchange. In such a world, there is no opportunity for fraud, collusion, corruption, or vice of any kind, hence no need for government meddling in the economy. With the assumption of atomism, we are therefore in the world of the self-regulating market—a world in which politics and culture enter into the market only as an interference and in which the economy can legitimately be described as an analytically autonomous sphere.”<sup>102</sup> These are, of course, the subjects considered in this and in the preceding chapter.

Naturally, this distinction is a matter of emphasis only, and is arguably considerably less pronounced than Krippner and Alvarez suggest. As we have discussed, both authors engage with both concepts, however, they place greater weight on one or the other, just as Krippner and Alvarez indicate. Indeed, the present author would maintain that Granovetter concedes the separation of the two spheres, the economic, and the social-political-cultural, whereas Polanyi maintains that it is the market that has forced a “formal”, but not a “substantive”, separation between the two

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<sup>99</sup> John Lie, “Embedding Polanyi’s Market Society” (1991) 34:2 *Sociological Perspectives* 219.

<sup>100</sup> Krippner & Alvarez, *supra* note 98 at 221.

<sup>101</sup> *Ibid* [citation omitted], citing Fred L Block, *Postindustrial Possibilities: A Critique of Economic Discourse* (Chicago: University of Chicago Press, 1990), c 2.

<sup>102</sup> Krippner & Alvarez, *supra* note 98 at 222.

spheres. For Polanyi, such a separation is logically impossible, and hence unsustainable, even theoretically.

### **Interior and Exterior Relationships Between the Economic and the Social**

Krippner and Alvarez maintain, instead, that Granovetter's concept of embeddedness "involves identifying relational bases of social action in economic contexts... [while that of] Polanyi, in contrast, concerns the integration of the economy into broader social systems. These are not the same problem. They invite different strategies of analysis and involve different assumptions about the nature of the underlying reality that these analytical strategies purport to describe. In particular, we argue that Granovetter's conception of embeddedness puts forward what we call an exterior relationship between the economic and the social, whereas Polanyi's elaboration of the concept posits an interior view of this relationship. In the former case, social relations shape economic outcomes from the outside; in the latter case, the social and the economic are seen as mutually constituting."<sup>103</sup>

The posited exteriority of Granovetter's relationship of the economic and social spheres and the posited interiority of Polanyi's characterization of the relationship of those spheres has the logical results described in the previous sentence; alternatively, these relationships and results may be seen as endogenous, if not actually tautologous. It is significant, however, that, according to these commentators, at least, the "embeddedness" of both Granovetter and Polanyi deny the categorical distinctiveness of the existence and identity of the social and economic spheres.

As we have observed previously, and as previously explicated by Dennis Wrong, the atomistic perspective on man pervades classical and neoclassical economics, as well as certain schools of sociology. Krippner and Alvarez explained that:

Granovetter noted an ironic convergence between neoclassical economics and many sociological accounts of economic behavior: Both traditions share in common an atomistic perspective on social life. For neoclassical economics, atomism inheres in the assumption that economists' models are peopled by self-interested, rational actors who carry fully formed preference rankings in their heads and make maximization decisions in isolation from other social actors. With respect to sociology, Granovetter discerned an analogous

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<sup>103</sup> *Ibid.*

kind of atomism in the tendency lingering from the discipline's Parsonian past to rely on internalized norms or values to explain behavior. As Granovetter noted, because social behavior is essentially prescribed by norms or values in these accounts, the details of social structure are irrelevant in explaining any given outcome. Thus, neoclassical economics and sociology represent undersocialized and oversocialized conceptions of social action, respectively.<sup>104</sup>

We have previously remarked on the atomistic perspective shared by neoclassical economics and Parsonian sociology. That subject is reviewed in more detail in the next chapter. In effect, Granovetter uses the language and approach of neoclassical economics and new institutional economics to frame and debate the issues, for example, in relation to trust, and to markets and hierarchies. He may thereby be disabling himself from challenging the atomistic perspective at its most basic level, that of motivation and gratification of non-material needs.

Krippner and Alvarez, on the other hand, argue, to the contrary that “[i]mplicitly or explicitly, purveyors of the Granovetterian view of embeddedness reject the existence of *Homo Economicus*: The self-interested, maximizing agent who makes decisions in isolation from other agents is little more than a fiction. This is not to say that self-interest is not a motivator in economic life, nor that individuals do not attempt to maximize utility, narrowly or broadly conceived...What this perspective rejects is the notion that there is some pure, invariant motive driving human behavior: Because motivations inhere in social relations, and because relations are by their very nature multipurpose, motivations are likely to be mixed. More to the point, it is appropriate to think of social relations, rather than the set of motivations (mixed or otherwise) produced by these relations, as causal. Primacy is given to the context of social action.”<sup>105</sup>

### **Polanyi's Historicization of the Market Economy in Modernity**

Krippner and Alvarez emphasize that Polanyi's analysis is historical, rather than methodological. Rather than attacking the utilitarian assumptions, including the atomistic or methodological individualism, discussed in the next chapter, Polanyi sees economic man in an almost evolutionary sense, as acquiring those attributes in response to historical and institutional developments. As

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<sup>104</sup> *Supra* note 98 at 223.

<sup>105</sup> *Ibid* at 227 [emphasis in the original], citing Mark Granovetter, “Problems of Explanation in Economic Sociology” in Nitin Nohria & Robert G Eccles, eds, *Networks and Organizations: Structure, Form, and Action* (Boston: Harvard Business School Press, 1993) 25.

indicated in this work, the characterization of man assumes great importance in social and economic thought.

Krippner and Alvarez comment on this only indirectly, saying that “Polanyi did not so much reject as attempt to historicize the self-interested, maximizing agent. For Polanyi, this emanation of classic liberalism was realized at least in part during the nineteenth century in Western, especially British, society. As such, Polanyi’s critique of neoclassical economics was not that neoclassical theory offers a decontextualized account of economic behavior; it was rather that economists falsely generalize conditions that are approximately true in the nineteenth century (and to a lesser extent, the twentieth century, although Polanyi observed the grip of liberalism loosening through the New Deal reforms of mid-century) to periods in which they do not apply. Economists are able to commit this logical fallacy because they naturalize the type of economy that they observe in their own society; the (historically specific) institutional bases of *Homo Economicus* are obscured.”<sup>106</sup>

Krippner and Alvarez thus may be understood to suggest that economic man, the self-interested maximizing agent, was a creature of historical circumstance; in effect, that this characterization of human nature was referable to particular circumstances and points in time. They may be understood as arguing that such characterization described human nature as then and there instantiated. Alternatively, it may be that economic man represented an ideal type consonant with circumstances then prevailing.

We have suggested, however, that the historicization by Polanyi posited by Krippner and Alvarez related to Polanyi’s “formal” and not his “substantive” economy. While Polanyi himself argued that the differences between the two were obscured in late nineteenth century society, he certainly argued that the real or substantive economy could not, for very long, be disembedded from society.

Polanyi’s focus on that particular period of history should not be allowed to obscure his larger argument, which, to the present author, is that real or complete disembedding is a logical, but not a realistic or empirical, possibility. As Krippner and Alvarez acknowledge, Polanyi attempted to point out that in premodern economies, there was no economy in the sense that there was no separate institutional sphere in which the substantive task of securing a living was accomplished,

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<sup>106</sup> Krippner & Alvarez, *supra* note 98 at 227 [emphasis in the original].



as there was, albeit, he thought, temporarily, in more modern societies in the nineteenth century.<sup>107</sup> This prompted Polanyi to say that “[i]nstead of the economy being embedded in social relations, social relations are embedded in the economic system.”<sup>108</sup> This, in turn, may have affected his characterization of human nature in terms of the economic man.

### **Economic Action and Social Relations**

Again, with respect, Polanyi’s epigrammatic observation seems to unnecessarily overstate the position that he wants to maintain. He seems to be constructing an ideal typology that would not and could not obtain in reality. Surely, his comment is meant to suggest that in the modern self-regulating market economy, social relations are, to a significant degree, subordinate to, and governed by the economy, rather than the reverse.

Krippner and Alvarez reference Fred Block’s argument that, because it is only an ideal type, “Polanyi’s disembedded economy never really comes into existence; it is a utopian fantasy on the part of market liberals. To be sure, strenuous efforts are made on behalf of this vision, and society does pitch toward the market pole. But the automaticity (and necessity) of the response means that social protections, typically safeguarded by the state, are built into the very foundation of market society. As Block argues, the economy is always embedded; the self-regulating market is a theoretical impossibility.”<sup>109</sup> They also observe that “in an important sense, the whole notion of fictitious commodities—which require continuous state action to function as commodities—places the state inside the market”.

On the other hand, Krippner and Alvarez maintain that Granovetter insists that all economic action is intrinsically related to social action, which approach leaves intact the notion of an analytically autonomous economy, a notion which is so much criticized by Polanyi.<sup>110</sup> We have suggested that Granovetter himself sees economic activity as embedded in dense social relationships but as notionally distinct from that social sphere, which makes his critique of what Polanyi calls “economic analysis” less potent than it might otherwise have been.

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<sup>107</sup> *Ibid.*

<sup>108</sup> *Supra* note 1 at 60.

<sup>109</sup> *Supra* note 98 at 229, citing Block, “Introduction”, *supra* note 67; Fred Block, “Karl Polanyi and the Writing of The Great Transformation” (2003) 32:3 *Theory & Society* 275; and Fred Block & Peter Evans, “State and Economy” in Neil J Smelser & Richard Swedberg, eds, *The Handbook of Economic Sociology*, 2d ed (Princeton, NJ: Princeton University Press, 2005) 505.

<sup>110</sup> *Supra* note 98, at 231.

Krippner and Alvarez argue that “[s]cholars working in the Granovetterian tradition document the myriad ways in which social relations leave their imprint on business relations, shaping economic outcomes in ways that run counter to the expectations of economic theory...But perhaps most notable here is what is shared with the neoclassical perspective: Social relations affect the economy from the outside. To be sure, these social relations are ubiquitous rather than marginal, and their effects are seen as generally positive rather than as generating inefficiencies, but in both cases an exterior relationship is posed between the economic and the social. In this sense, it is not surprising that theorists writing in the Granovetterian tradition often seek to complement or extend neoclassical models rather than overthrow them.”<sup>111</sup>

They say that this is not the case with Polanyi, says Lie, since “[f]or Polanyians, the notion that markets could exist outside of state action is simply inconceivable. This is not a matter of some markets being more or less social than others...nor is it a matter of the state simply setting the context for market transactions. Rather, as Block argues, the state’s management of fictitious commodities places the state inside the market. This is an interior relationship of the economic and the social, and the metaphor of embeddedness here references the internal articulation of extraeconomic forms (e.g., a system of labor regulation) to market exchange.”<sup>112</sup>

### **Historical Construction of Markets**

As we have indicated here, the social construction of markets can readily be observed, at least from the present historical perspective. As noted in the present work, Polanyi did not have available to him certain information concerning the operation of markets in ancient societies, and was, accordingly, unable to identify and trace the development of market type activity over millennia, as is much more possible at the present time. Accordingly, he could not compare the situation which he describes in the century between 1750 and 1850, the period of the “great transformation”,

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<sup>111</sup> *Ibid*, citing Mark Granovetter, “The Sociological and Economic Approaches to Labor Market Analysis: A Social Structural View” in George Farkas & Paula England, eds, *Industries, Firms, and Jobs: Sociological and Economic Approaches* (New York: Plenum Press, 1988) 187; Mark Granovetter, “A Theoretical Agenda for Economic Sociology” in Mauro F Guillen Randall Collins, Paula England, and Marshall Meyer, eds, *The New Economic Sociology: Developments in an Emerging Field* (New York: Russell Sage Foundation, 2002) 35; Brian Uzzi, “Embeddedness in the Making of Financial Capital: How Social Relations and Networks Benefit Firms Seeking Financing” (1999) 64:4 *American Sociological Rev* 481.

<sup>112</sup> Krippner & Alvarez, *supra* note 98 at 233, citing Block, “Introduction”, *supra* note 67; Neil Fligstein, *The Architecture of Markets: An Economic Sociology of Twenty-First Century Capitalist Societies* (Princeton, NJ: Princeton University Press, 2001); and Bob Jessop, “Regulationist and Autopoieticist Reflections on Polanyi’s Account of Market Economies and the Market Society” (2001) 6:2 *New Political Economy* 213.

as involving the dominance of the self-regulating price-making market, against previous instantiations of market activity in previous periods, extending back as far as some thousands of years. Such an examination might have resulted in a greater rigour in his consideration of markets and, in particular, their social construction or embeddedness.

This view is supported by the analysis of John Lie in his 1991 article “Embedding Polanyi's Market Society”<sup>113</sup> in which he argues that Polanyi “leaves the core concept of the market unchallenged”, such that “[d]espite his embeddedness thesis, market exchange remains a disembedded concept.”<sup>114</sup> Lie proposes, and said, that “all economic activities and institutions are embedded in social relations” including markets, which are “historically variable social organizations constituted by traders”.<sup>115</sup>

As we have suggested, part of the problem in undertaking this analysis is that it necessarily depends upon an examination of historical data, some of which was not available to Polanyi. That, in turn, becomes highly significant for his theory of embeddedness, due to the parameters of his methodology. As Lie says, his “goal is to study the place of substantive, or empirical, economy in society, to investigate how economic actions and institutions are embedded in matrices of noneconomic movies and institutions”.<sup>116</sup> This meant that he did not proceed from prevalent assumptions, as did classical economists, including that of the rationalist atomistic individual.

### **Empirical Methodology, Investigation, and Analysis**

Instead, Lie says “Polanyi implicitly adopts a realist epistemology, in contrast to the positivism of neoclassical economic theory [which] seeks to uncover relationships among variables, such as supply and demand, which are given as universal categories [and whose]... "scientific" model is classical mechanics, which is deductive and anticontextual.”<sup>117</sup> Thus, “neoclassical economics postulates the universality of utility-maximizing action” as an “overarching theory of human behaviour applicable to all times and places”, independent of context, such as motives and

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<sup>113</sup> *Supra* note 99.

<sup>114</sup> *Ibid* at 219.

<sup>115</sup> *Ibid*.

<sup>116</sup> *Ibid* at 220.

<sup>117</sup> *Ibid* [citation omitted], citing Philip Mirowski, *More Heat Than Light* (Cambridge: Cambridge University Press, 1990).

institutions, which are, instead, “dismissed as frictional variables” and, like other non-economic variables, are banished “to the dustbin of the other social sciences.”<sup>118</sup>

Polanyi apparently considered that the construction of theories or hypotheticals in advance of observation was unlikely to have significant explanatory power. Instead, Polanyi’s methodology accorded primacy, of time and of importance, to observation. As John Lie indicates, “Polanyi eschews abstract models in favor of institutional analysis. This strategy stems from his belief that no logic of means-ends schema exists independent of context. Because ends are bound up in preexisting institutional arrangements, it is necessary to explicate institutions involved in economic activities. In short, he favors an inductive (or empirical) over a deductive approach, and institutional analysis over methodological individualism.”<sup>119</sup>

In support of this observation, Lie cites Polanyi, Arensberg, and Pearson, to the effect that “[t]o employ a metaphor, the facts of the economy were originally embedded in situations that were not in themselves of an economic nature, neither the ends nor the means being primarily material. The crystallization of the concept of the economy was a matter of time and history. But neither time nor history have provided us with those conceptual tools required to penetrate the maze of social relationships in which the economy was embedded. This is the task of what we will here call institutional analysis.”<sup>120</sup>

Indeed, as noted above, Polanyi did investigate non-market economies, employing a comparative and historical approach, finding that “the particular combination of variables assumed to be universal for classical for neoclassical economists rarely occurs”.<sup>121</sup> Lie argues that “Polanyi castigates attempts to use categories derived from the particular institutional context of market economy to study nonmarket economies”, quoting Polanyi’s dictum that “[t]he economic fallacy...consists in a tendency to equate human economy with its market form”.<sup>122</sup> However, Lie

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<sup>118</sup> Lie, *supra* note 99 at 220 [citations omitted], citing Lionel Robbins, *An Essay on the Nature and Significance of Economic Science*, 3rd ed (New York: New York University Press, 1984); Milton Friedman, “The Methodology of Positive Economics” in Milton Friedman, *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953) 3; and TEC Leslie, “The Known and the Unknown in the Economic World” in TEC Leslie, *Essays in Political Economy*, 2nd ed, (Dublin: Hodges, Friggs, 1888) 231. The reference to “empty economic boxes” is from John Clapham, “Of Empty Economic Boxes” (1922) 32:127 *Economic J* 305.

<sup>119</sup> Lie, *supra* note 99 at 220. The present work examines methodological individualism in Chapter B4 below.

<sup>120</sup> *Ibid* at 220-21, citing Karl Polanyi, Conrad M Arensberg & Harry W Pearson, “The Place of Economies in Societies” in Karl Polanyi, Conrad M Arensberg & Harry W Pearson, eds, *Trade and Market in the Early Empires* (Chicago: Henry Regnery, 1971) 239.

<sup>121</sup> Lie, *supra* note 99 at 221, quoting Karl Polanyi, *The Livelihood of Man* (New York: Academic Press, 1977) at 20.

<sup>122</sup> *Supra* note 99 at 221.

maintains that Polanyi underscores the uniqueness of the contemporary market economy, quoting him as saying: "While history and ethnography know of various kinds of economies, most of them comprising the institution of markets, they know of no economy prior to our own, even approximately controlled and regulated by markets".<sup>123</sup>

We should observe, in passing, that Polanyi admits here that most known economies involved the institution of markets, as well as other forms of integration, namely, reciprocity and redistribution. That leads to the logical conclusion that markets, at least in such economies, must have been socially constituted or embedded. In turn, that suggests, as does this quotation, that it is the extent of the dominance of markets, rather than their presence, that is distinctive of the "disembedded" economy of the nineteenth century. However, as Lie also argues, Polanyi does not himself investigate the nature of non-dominant markets to any significant extent but concentrates his discussion, instead, on the period of dominant markets.

### **Non-Market Patterns of Integration and the Market**

As previously discussed, Polanyi develops his own nonmarket categories of economies, which he calls "patterns of integration". Lie describes these as empirical, rather than logical categories, saying: "The crux of Polanyi's argument is that the first two of these forms of integration, reciprocity and redistribution, are inextricably related to underlying social relations. Reciprocity is bound up in friendship, kinship, and other social ties. It therefore refers to horizontal ties of exchange, primarily among individual or group actors. A gift relation, for instance, denotes "reciprocity"."<sup>124</sup>

Lie explains of the second form of integration, "[r]edistribution, on the other hand, is underlaid by political and religious factors and, therefore, denotes vertical ties of exchange. Administered trade, for example, involves "redistribution" since it is often undertaken by the state for political or military reasons."<sup>125</sup> Lie quotes Polanyi's explanation of how one or the other might arise, saying: "Reciprocity, then, assumes for a background symmetrically arranged groupings; redistribution is dependent upon the presence of some measure of centrality in the group; exchange in order to

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<sup>123</sup> *Ibid.*, quoting Polanyi, *The Great Transformation*, *supra* note 1 at 44.

<sup>124</sup> Lie, *supra* note 99 at 222.

<sup>125</sup> *Ibid.*

produce integration requires a system of price-making markets. It is apparent that the different patterns of integration assume definite institutional supports.”<sup>126</sup>

All of these patterns of integration, including market exchange, are socially instituted. As Polanyi says in the above quotation, the pattern of exchange requires a system of price making markets in order to produce integration, and that system of price-making markets must be socially constructed. Perhaps because, as Lie suggests, Polanyi saw the market as a “place” or, as posited by neoclassical economists, as a “supply-demand-price mechanism” in a “market society”, Lie concludes that “Polanyi's commitment to analyze "economy as instituted process" does not extend to the large set of contemporary "market" economies. This seems to stem from his acceptance of the neoclassical concept, which posits the market as an asocial and noncontextual entity and market exchange as an asocial and noncontextual activity. He does not challenge the market concept itself. Its implications are seen most strikingly in his influential argument on the rise of market society.”<sup>127</sup>

Instead of explicating the concept of the market generally, as derived from an examination of its instantiations in different places and times, Polanyi seeks to explain the origins of the market society prevailing in his own place and time. Presumably, this is because he considered that market society to be the one most dominated by markets, and, hence, concentrated his attention there. His orientation, that is to say, is historical, but not historically comparative.

Polanyi found that the organizing principle of society in England was transformed during the period from 1750-1850 from one in which the operation of the economy was subordinate to the satisfaction of human needs to one in which “the organizing principle of a society” is one in which “industry is based on the institution of a self-regulating market”.<sup>128</sup> That transformation, however, was not effected by means of the market alone, or even at all, for, as Lie says, “Polanyi views the creation of the free market as a utopian experiment in social engineering. The effort to construct a laissez-faire economy required active state intervention. He notes: "The road to the free market was opened and kept open by an enormous increase in continuous, centrally organized and controlled interventionism.”<sup>129</sup>

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<sup>126</sup> *Ibid.*

<sup>127</sup> *Ibid* at 222-23.

<sup>128</sup> *Ibid* at 223, citing Polanyi, *Great Transformations*, *supra* note 1 at 149.

<sup>129</sup> Lie, *supra* note 99 at 223-224, quoting Polanyi, *Great Transformations*, *supra* note 1 at 139-140.

### **Market Society and the Role of the State**

For Polanyi, says Lie, the market society of economic liberals was “a chimera, belief in which has had catastrophic consequences”, making it all but inevitable that society would adopt protective legislation “in order not to be, in its turn, annihilated by the self-regulating market”<sup>130</sup>, because “[n]o society can withstand the dehumanizing effects of treating noncommodities as if they were commodities.”<sup>131</sup> One aspect of that dual movement, the protective reaction, was what John Ruggie describes as a “social reaction against market reality”, in which as a result of the great transformation, “land, labor and capital had all seized upon the state in the attempt to reimpose broader and more direct social control over market forces.”<sup>132</sup>

It was, then, the interests of land, labour, and capital, all three of Polanyi’s “noncommodities” who clamoured for protection, according to Ruggie. Ruggie claims that “this shift in what we might call the balance between “authority” and “market” fundamentally transformed state-society relations, by redefining the legitimate social purposes in pursuit of which state power was expected to be employed in the domestic economy. The role of the state became to institute and safeguard the self-regulating market.”<sup>133</sup> This is the classic liberal perspective.

A contradiction is immediately apparent: if the role of the state in society is to institute and safeguard the self-regulating market, how can that market be described cogently as self-regulating, and not, at least partially, regulated by the state? Even if one concedes that the societal reaction of state regulation somehow reimbeds or corrects the disembeddedness of the self-regulating market, then it is the state, as a socially constructed institution, which causes the reimbedding or reverses such disembedding. In effect, the possibility of such action alone may be seen as an admission that the economy is never really entirely disembedded from its ambient society and polity.

### **Market Dominance and the Role of Society**

While Polanyi seeks to explain this dominance of society by the market, and the reactions to it, including Marxist and fascist reactions, this may have led him to neglect, to some extent, analysis of the embedded nature of the market, in terms of institutions and processes, even in a situation of

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<sup>130</sup> *Supra* note 99 at 224, citing Polanyi, *Great Transformations*, *supra* note 1 at 249.

<sup>131</sup> *Supra* note 99 at 224.

<sup>132</sup> John Gerard Ruggie, “International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order” (1982) 36:2 *International Organization* 379 at 387.

<sup>133</sup> *Ibid* at 386.

market dominance, which, in turn, might have led him to conclude that it was, in fact, the embeddedness of the market, in that situation of market dominance, that led to societal reaction to reduce that dominance and restrain its effects.

John Lie, who argues that Polanyi also erred in assigning the commodification of land, labour and capital, and the rise of market society in England, to the period from 1750 to 1850, reaches a similar conclusion. He states that “[b]y equating market with commodification, underlying forms of organizing commodity exchange are rendered invisible. Polanyi's analysis neglects the historical transformations and institutional diversity within which the commodification process occurred. In short, qualitative changes appear as quantitative changes.”<sup>134</sup>

Polanyi, says Lie, focuses on the process of commodification, instead of the process of institutionalization of the market, explaining which process would be useful with respect to commodities, as well as with respect to what Polanyi considers to be noncommodities. “Thus, Polanyi analyzes the rise of market society in terms of the process of commodification of noncommodities, rather than as an instituted process among networks of individuals and institutions. He provides little to guide investigators in distinguishing market exchange as a social practice embedded in particular sites, with concrete actors, institutions, and technological and other constraints.”<sup>135</sup>

Lie asserts that by treating the market as disembodied, Polanyi overestimated the significance of market exchange in modern society and underestimated its importance in societies that were not dominated by the market and which might be considered to be nonmarket societies. Lie alleges that “because of his treatment of the market as a disembodied structure, Polanyi overemphasizes the autonomous role of the state in explaining the rise of market society. The state exists as a social organization, but the economy does not. Because the market is employed as a purely economic category, its institutional effects are neglected and rendered as a part of the mysterious force of the laissez-faire economy.”<sup>136</sup> Lie says that Polanyi ignores the “social actors or social forces behind the expansion of the market. Had he adopted his program for embeddedness and applied it to the

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<sup>134</sup> Lie, *supra* note 99 at 225.

<sup>135</sup> *Ibid.*

<sup>136</sup> *Ibid* at 226.



market economy, he would have recognized social organizations and forces behind the construction of the market economy as well as within the state.”<sup>137</sup>

When Polanyi concedes the social construction of the state, and assigns it a role in the rise in market society and later in restricting the dominance of that market in society, an implication seems to arise that market society is not or, even, is not ever entirely disembedded from society. However, Polanyi does not quite adopt that perspective. It is almost as if Polanyi, who is prepared to consider the development of economies at diverse places and times throughout history, somehow has conceded entirely to neoclassical economics the analysis of economies dominated, as he thinks, by markets in the modern era. Such an analysis by Polanyi would likely have been most interesting.

## CONCLUSION

We have observed that contemporary economic theory generally assumes, albeit often tacitly and implicitly, that the economy is distinct and operates separately from its ambient society and polity, although somehow related to them. We have considered that assumption at length and have found compelling reasons to reject it, on logical, methodological, and epistemological grounds.

More generally, we have found reason to substantially doubt and perhaps even to actually reject the assumptions made by contemporary economic theory (“Contemporary Assumptions”) concerning: (1) the separation of economic roles and functions from other functions in a given society and polity; (2) the assignment of the economy to a “private” sphere of activity; (3) the separateness and distinctiveness of that “private” sphere from separate and distinct from the “public” sphere; (4) the distinctiveness of any appropriate analysis of the economy from the public sphere, from society and from the polity; and (5) as stated in the preceding paragraph, the distinctiveness and separate operation of the economy from the ambient society and polity.

Part 1 of this book considered the instantiations of legal theory and, in particular, corporate legal theory, in certain leading modern corporate law jurisdictions. It also investigated whether, and if so, to what extent, those corporate law instantiations could be demonstrated to be based upon, or underlain by, certain assumptions and generalizations of classical, neoclassical, and other modern economic theory. It was determined that the corporate law statutes examined did not appear, at

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<sup>137</sup> *Ibid.*

least explicitly, and perhaps implicitly, to adopt any particular assumptions, including, for the purposes of the present discussion, the Contemporary Assumptions.

Thus, notwithstanding the scope and scale of the discourse with respect to economic assumptions and generalizations which might be applicable in the field of legal discourse, the applicability of such economic assumptions and generalizations to the legal field, by way of statutes, regulations, decisions, theorizing and otherwise, must be regarded as problematic. To restate, this is the case inasmuch as such assumptions and generalizations are in many ways regarded by economists and others as being somewhat problematic.

It is the contention of this work that an investigation of the Contemporary Assumptions insofar as they concern the role of the modern business corporation as an economic, social and political actor are likewise subject to substantial doubt and even perhaps ultimately, rejection. It is to those assumptions that we now turn.

**SECTION B: ASSUMPTIONS OF CLASSICAL AND NEOCLASSICAL ECONOMICS****CHAPTER B4:****ASSUMPTIONS OF CLASSICAL AND NEOCLASSICAL ECONOMICS PART A****PURPOSE AND SCOPE OF THIS CHAPTER AND CHAPTER B5**

In accordance with the plan laid out in Chapter One, Part 1 and Appendix A of this book proceeded by examining the essential attributes of the modern business corporation and investigating the ways in which they were instantiated in modern corporate statutes; in effect “what” the modern business corporation “is” today, as a matter of law. As such, it examined the ways in which the corporation, as a single legal entity, could act extraneously, that is, “outside” or “in the real world”, namely, by means of human actors who animate, vivify, enliven, or represent such legal entity.

Further, it considered means by which such animation, vivification, enlivening, or representation of the legal entity could be effected by such human actors in terms of engaging structures, processes and personnel suitable to such requirements; and the rights, duties, and responsibilities appurtenant to the human actors “within” the corporate legal entity or, in effect, within its organization, and by whom its actions are instantiated, as a matter of law and otherwise.

As indicated, Part 2 of this book, including Appendix A, considers the questions: Why this? How did this come about? What significant influences can be identified that may have contributed to the present stage of legal development and theorization of the modern business corporation? In effect, these questions relate to the discourse and theorization of, and relating to, the firm, in general, and the modern business corporation, in particular, and the situation of such entity or entities in relation to the economy, the society, the polity, and the state in which such entity appears.

Expressed, perhaps, more concretely, such discourse, theorization, and situation of the firm and the modern business corporation addresses how the firm and the modern business corporation, as a matter of law and otherwise, “fits” into the discourse and theorization of, and relating to, the economy, the society, the polity, and the state; and, more particularly, what assumptions, common understandings, perceptions, or methods of proceeding are imported from those discourses and theorizations to those of the firm and the modern business corporation.

The preceding chapters in this Appendix B have examined these matters and have established the salience of the economy and of economic activity generally to the activities of the firm and to the modern business corporation. They have also demonstrated that the notional separation of the economy in the economic sphere of activity from the social, political, and statal spheres of activity problematizes, but does not at all resolve, issues concerning the nature of such relationships. The location of business actors solely within the economy and the economic sphere of activity, as distinct from the social, political, and statal spheres of activity, has a similar problematical effect. Nevertheless, discourse concerning the firm and, latterly, the corporation, has been significantly influenced by economic discourse; and discourse concerning the firm and the corporation has also been significantly influenced by assumptions (in the “everyday” or “common” sense not only of premises or hypotheses, but also of beliefs, presumptions, and suppositions) proceeding from economic discourse. Before considering the ways in which the firm or the corporation, as a legal entity, may engage as an economic actor, this chapter will review what might be described as conventional “assumptions” (in the broad colloquial sense just mentioned) of classical and neoclassical economics.

## **PURPOSE AND METHODOLOGY OF ECONOMICS**

In this connection, it may be useful to interrogate the purpose and methodology of economics and, in particular, of economic theory. The discussion here is guided by Milton Friedman’s extremely important article, “The Methodology of Positive Economics”,<sup>1</sup> in which he sought to distinguish between economics, considered as a positive science, and economics, considered as a normative science.

### **Purpose of Economic Theory**

In that regard, Friedman adopted the usage of John Neville Keynes in his book *The Scope and Method of Political Economy*,<sup>2</sup> describing economics as a positive science as “a body of systematized knowledge concerning what is”, and describing economics as a normative or regulatory science as “a body of systematized discussing criteria of what ought to be... an *art*... a

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<sup>1</sup> Milton Friedman, “The Methodology of Positive Economics”, in *Essays In Positive Economics* (Chicago: University of Chicago Press 1966) at 3.

<sup>2</sup> John Neville Keynes, *The Scope and Method of Political Economy*. (London: McMillan & Co. 1891).

system of rules for the attainment of a given end”; and commenting that “confusion between them is common and has been the source of many mischievous errors”.<sup>3</sup>

Friedman, like Keynes, thus maintains that positive economics is, in principle, independent of any ethical position or normative judgments; further, that its “task is to provide a system of generalizations that can be used to make correct predictions about the consequences of any change in circumstance”; and that its “performance is to be judged by the precision, scope, and conformity with experience of the predictions it yields.”<sup>4</sup> He argues that “[e]conomics as a positive science is a body of tentatively accepted generalizations about economic phenomena that can be used to predict the consequences of changes in circumstances.”<sup>5</sup>

The present chapter and the immediately following chapter investigate the “tentatively accepted generalizations” of classical and neoclassical economics and considers the “precision, scope, and conformity with experience” of their predictions. Such chapters thus treat social science generally, and economics, in particular, in the manner advocated by Friedman with respect to positive economics as a positive science.

Friedman’s earlier article concerning Alfred Marshall’s theory of demand, “The Marshallian Demand Curve”,<sup>6</sup> averted to Marshall’s statements that economic theory is “an engine for the discovery of concrete truth”;<sup>7</sup> that the “economic organon” introduces “systematic and organized methods of reasoning”;<sup>8</sup> and that the economist must pursue a “plan of interrogating facts in order to in the manner of action of causes singly and in combination, applying this knowledge to build up the organon of economic theory, and then making use of the aid of the organon in dealing with the economic side of social problems”.<sup>9</sup>

Friedman says that Marshall’s conception of the purpose of economic theory differs from more purely mathematical perspectives such as that of Leon Walras<sup>10</sup>. Averting to Marshall, Friedman

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<sup>3</sup> *Ibid* at 3 [emphasis in the original].

<sup>4</sup> *Ibid* at 4.

<sup>5</sup> *Ibid* at 39.

<sup>6</sup> Milton Friedman, "The Marshallian Demand Curve" (1949) 57:6 *Journal of Political Economy* 463.

<sup>7</sup> *Ibid* at 469. Friedman’s citation is to: Alfred Marshall, "The Present Position of Economics" (1885), reprinted in *Memorials of Alfred Marshall*, ed. A. C. Pigou (London: Macmillan & Co., Ltd., 1925) 159.

<sup>8</sup> *Supra* note 6 at 490, citing Marshall, at 161.

<sup>9</sup> *Supra* note 6 at 490, citing Marshall, at 171.

<sup>10</sup> Interestingly, although Friedman cited Walras throughout both of these articles, he apparently felt that his work was so well known that he did *not* cite a specific work, as he did with Keynes and Marshall, to mention but two examples.

says: "Economic theory, in this view, has two intermingled roles: to provide "systematic and organized methods of reasoning" about economic problems; to provide a body of substantive hypotheses, based on factual evidence, about the "manner of action of causes." In both roles the test of the theory is its value in explaining facts, in predicting the consequences of changes in the economic environment. Abstractness, generality, mathematical elegance - these are all secondary, themselves to be judged by the test of application. The counting of equations and unknowns is a check on the completeness of reasoning, the beginning of analysis, not an end in itself."<sup>11</sup>

The present work examines the "body of substantive hypotheses" presented by classical and neoclassical economic theory, in an attempt to assess the extent to which they employ "systematic and organized methods of reasoning"; and to determine the extent to which such theory explains facts and predicts "the consequences of changes in the economic environment". In this regard, we will follow Marshall, Keynes, and Friedman, rather than Walras.

Friedman criticizes Walras, saying: "Abstractness, generality, and mathematical elegance have in some measure become ends in themselves, criteria by which to judge economic theory. Facts are to be described, not explained. Theory is to be tested by the accuracy of its "assumptions" as photographic descriptions of reality, not by the correctness of the predictions that can be derived from it."<sup>12</sup> Friedman clearly considers such characterizations to be indicate some aberration of the purpose of economic theorizing.

It should be emphasized that the present work does not adopt a Walrasian treatment of the "assumptions" that are used in generating economic theory; instead, it considers the premises adopted by, and common to, classical and neoclassical economics over time. In this sense, we are examining more the content and results of economic theory over time, rather than the process of its development. We are, in fact, examining what Friedman, describes as "economics as a positive science", as also identified by Keynes, meaning "a body of tentatively accepted generalizations

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However, Friedman did publish a review article on Walras' work in 1955: Milton Friedman, "Leon Walras and His Economic System" (1955) 45:5 *American Economic Rev* 900. That article celebrates the translation of Walras' principal work into English, cited by Friedman as Leon Walras, *Elements of Pure Economics*, (Homewood, Ill.: Richard Irwin, 1954.)

<sup>11</sup> *Supra* note 6 at 490.

<sup>12</sup> *Ibid.*

about economic phenomena that can be used to predict the consequences of changes in circumstances”.<sup>13</sup>

### **Methodology of Economic Theory**

The performance of positive economics is, according to Friedman, “to be judged by the precision, scope, and conformity with experience of the predictions it yields”<sup>14</sup> Further: “Viewed as a body of substantive hypotheses, theory is to be judged by its predictive power for the class of phenomena which it is intended to “explain.” Only factual evidence can show whether it is “right” or “wrong” or, better, tentatively “accepted” as valid or “rejected.” As I shall argue at greater length below, the only relevant test of the *validity* of a hypothesis is comparison of its predictions with experience. The hypothesis is rejected if its predictions are contradicted (“frequently” or more often than predictions from an alternative hypothesis); it is accepted if its predictions are not contradicted; great confidence is attached to it if it has survived many opportunities for contradiction.”<sup>15</sup>

The evaluation of economic theory conducted in the present work adopts such perspectives. That is to say, this work attempts to evaluate assumptions and generalizations of classical and neoclassical economic theory by means of the “precision, scope, and conformity with experience” of the predictions they yield or, in Friedman’s alternative formulation, by means of “its predictive power for the class of phenomena which it is intended to ‘explain.’” To recapitulate, the “assumptions” examined in the present work are not those attendant upon, or of, any particular hypothesis in the course of scientific examination of the same; but are, instead, the generalized or generalizable propositions to which assent is given by a significant proportion of those engaged in discourse on the subject.

That is to say, it is acknowledged in this work that the procedure sought to be adopted in economic theory or in economic research must often necessarily simplify propositions or facts by eliminating certain propositions or facts that are not to be subjected to theoretical analysis or empirical investigation. This is the case in other areas of research seeking to apply scientific methodology. Friedman takes pains to point out that this may result in a lack of correspondence between the assumed “facts” as posited by the investigator and the “facts” as observed by others; in part,

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<sup>13</sup> *Supra* note 1 at 39. Similar observations appear at 4 and 7.

<sup>14</sup> *Ibid* at 4.

<sup>15</sup> *Ibid* at 8-9.

because the investigator attempts to isolate the hypothesis and its relevant considerations from others in the environment.

Friedman says: “One confusion that has been particularly rife and has done much damage is confusion about the role of “assumptions” in economic analysis. A meaningful scientific hypothesis or theory typically asserts that certain forces are, and other forces are not, important in understanding a particular class of phenomena. It is frequently convenient to present such a hypothesis by stating that the phenomena it is desired to predict behave in the world of observation *as if* they occurred in a hypothetical and highly simplified world containing only the forces that the hypothesis asserts to be important.”<sup>16</sup> The elimination of circumstances considered irrelevant to the hypothesis simplify it, and its testing, but, as Friedman suggests, this lessens the correspondence with reality.

In this regard, Friedman stresses that there is no meaningful way in which a theory can be tested by comparing its “assumptions” directly with reality. Complete “realism”, he says, “is clearly unattainable, and the question whether a theory is realistic “enough” can be settled only by seeing whether it yields predictions that are good enough for the purpose in hand or that are better than predictions from alternative theories. Yet the belief that a theory can be tested by the realism of its assumptions independently of the accuracy of its predictions is widespread and the source of much of the perennial criticism of economic theory as unrealistic.”<sup>17</sup> Indeed, it is often the case that assumptions, some or all of which may be counterfactual, are combined in order to determine whether the particular combination posited might produce generalizable results, which may arise not from the realism of the individual assumptions but, instead, from their combination.

Indeed, as Friedman says, generally “there is more than one way to formulate such a description – more than one set of “assumptions” in terms of which the theory can be presented. The choice among such alternative assumptions is made on the grounds of the resulting economy, clarity, and precision in presenting the hypothesis; their capacity to bring indirect evidence to bear on the validity of the hypothesis by suggesting some of its implications that can be readily checked with

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<sup>16</sup> *Ibid* at 40 [emphasis in the original].

<sup>17</sup> *Ibid* at 30.



observation or by bringing out its connection with other hypotheses dealing with related phenomena; and similar considerations.”<sup>18</sup>

### **The Example of Equilibrium Theory**

One example of the assumptions or accepted generalizations of classical and neoclassical economics is the general equilibrium model or theory. In an article provocatively entitled “The Intrinsic Limits of Modern Economic Theory: The Emperor has No Clothes”, Alan Kirman evaluates its broad acceptance in relation to broadly accepted scientific methodology. In this regard, he states: “General Equilibrium Theory regarded by many as the summum of the 'grand neo-classical synthesis' has throughout its development been systematically attacked by a wide variety of critics from many different angles. Yet, curiously, these criticisms have been largely ineffective and it would not be unfair to say that this theory still furnishes the basic foundations of what many are pleased to call 'mainstream economics'. Indeed such theory as is used by practical men to justify their economic recommendations is derived from this underlying framework, albeit with unwarranted appendages.”<sup>19</sup>

Despite attacks on general equilibrium theory and other principles of classical and neoclassical economics, Kirman says that there “seems to be a quiet confidence in the profession that we are moving, if only slowly, towards a more scientific basis for economics. Indeed, many economists seem persuaded that we are arriving at the point where the simplest criterion for a scientific theory, that it generate empirically testable and falsifiable propositions is met.”<sup>20</sup> He argues, then, that economics at the end of the twentieth century was only on the cusp of developing a scientific methodology.

As with the other assumptions or accepted generalizations that are reviewed here, such as utilitarianism, general equilibrium theory may be considered as an elemental constituent of classical and neoclassical economics. Kirman claims that “the fundamental underpinnings of modern economic work and indeed of quantitative work is the general equilibrium model”.<sup>21</sup> So widely accepted is the general equilibrium model that Nobel laureate Robert M. Solow, in a review

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<sup>18</sup> *Ibid* at 40-41.

<sup>19</sup> Alan Kirman, "The Intrinsic Limits of Modern Economic Theory: The Emperor has No Clothes" (1989) 99 *Economic J* 126 at 126.

<sup>20</sup> *Ibid*.

<sup>21</sup> *Ibid* at 137.

of the state of macroeconomics provocatively entitled “What Is a Nice Girl like You Doing in a Place like This? Macroeconomics after Fifty Years”, concluded that “[t]he only complete economics that was available to serve as a foundation for macroeconomics was Walrasian general equilibrium theory. In practice, the demand for microfoundations was a demand that macroeconomics should be built on Walrasian foundations.”<sup>22</sup> He expressed the opinion that this may ultimately be “an exercise in futility” as it continues to be “an exercise in straining credulity”.<sup>23</sup>

Solow says that, although “[m]uch of our understanding of the operation of multiple-market systems comes from the study of Walrasian economics... [t]here is no good reason to believe that our world is Walrasian, or that it behaves from quarter to quarter or year to year like a Walrasian economy, or that aggregating it somehow makes everything OK.”<sup>24</sup> He maintains, however, that the commitment to Walrasian general equilibrium theory has been so widely shared that “[t]he most amazingly far-fetched assumptions have been invoked to induce a Walrasian economy to exhibit behavior a little like the real world. Even so there is been no major empirical success.”<sup>25</sup>

As indicated, in order to provide a context for discussion of the firm and of the corporation, respectively, as an economic actor, it is necessary to review certain major assumptions, generalizations or common understandings of economics. The merits of this approach are confirmed by the observations of Kirman and Solow just mentioned, and by identifying inadequacies in certain of these assumptions, when assessed from the standpoint of scientific methodology.

This review does not pretend to be, in any sense, definitive or exhaustive, either as to the subject matter selected or as to the treatment of such subjects. However, an attempt has been made to select for discussion, and to orient discussion towards, subject matters bearing on the modern business corporation. This will include the subject matters of earlier chapters in Part 2 of this work relating to relationships among the economy, the society, the polity, and the state. It will also include the subject matters discussed later in Part 2, namely, the corporation as an economic actor.

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<sup>22</sup> Robert M Solow, "What Is a Nice Girl like You Doing in a Place like This? Macroeconomics after Fifty Years" (1986) 12:3 *Eastern Economic J* 191 at 196.

<sup>23</sup> *Ibid* at 196-7.

<sup>24</sup> *Ibid* at 196.

<sup>25</sup> *Ibid* at 197.

In each case, the relevant assumptions, generalizations, or common understandings will be identified, briefly explained, some of the relevant criticisms identified, and some discussion, and even some tentative conclusions, presented.

## **ASSUMPTION ONE – ATOMISTIC UTILITARIANISM**

### **1. Statement**

Mainstream, that is, classical or neoclassical, economics considers that atomistic individuals who are motivated to seek their own good, satisfaction, or utility engage in economic activity to maximize (or, in some later writing, optimize) their own good, satisfaction, or utility. This is said to be true of all economic actors, whether they are consumers or producers. This view, or a variant of the same, is fundamental to classical and neoclassical economics.

### **2. Explanation**

Terry Moe suggests that the “textbook components of neoclassical theory”, such as the theory of the firm and the theory of perfect competition, “have given rise over several decades to an enormous, richly diverse body of economic theory that does address many of the obvious gaps in the simple models themselves.”<sup>26</sup> In effect, he argues that because the weaknesses and omissions of many of the simple economic models “can often be handled within the broader neoclassical framework”<sup>27</sup>, these cannot be regarded as criticisms of neoclassical theory more broadly.

In fact, Moe maintains that “the simple models of the core of neoclassical economics are ultimately not so simple after all – and not so easily criticized – having been generalized to yield a complex, highly varied body of theory.”<sup>28</sup> This body of theory, he says, “is less a unified neoclassical theory than a large family of diverse theories related by shared analytical foundations, chief among them: a focus on an individual as the unit of analysis; the assumption of rational, utility-maximizing behavior; a concern for efficiency, optimality and equilibrium; and a preference for constructing theory by mathematical modeling over other approaches to theory construction.”<sup>29</sup>

It must be admitted, of course, that the finding that neoclassical theory is less a unified theory “than a large family of diverse theories” presents challenges to constructing a statement, and later

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<sup>26</sup> Terry Moe, "The New Economics of Organization" (1984) 28:4 *American J Political Science* 739 at 741.

<sup>27</sup> *Ibid* at 742.

<sup>28</sup> *Ibid* at 741.

<sup>29</sup> *Ibid*.

a critique, of neoclassical theory, in the present work, as well as otherwise. Moe's observation indicates that the analytical foundations mentioned are ones that may be regarded as commonly accepted elements of neoclassical theory. This supports the merits of the present work in proceeding to examine exactly those issues.

Of course, the elements identified by Moe are among the ingredients of the economic approach outlined in the first paragraph of this section. We will consider some objections to this approach in the next section. However, Moe claims that "[t]he most unsettling criticisms – from behaviouralists, institutionalists, or Marxists, for instance – are those that challenge the foundations that neoclassical theories generally share, for these point to deficiencies that may call for shifts to new and perhaps markedly different theoretical approaches. Given the magnitude of the edifice they threaten, it is little wonder that these alternative views have had a difficult time attracting mainstream support or even serious attention."<sup>30</sup> Again, it is those "foundations that neoclassical theories generally share" which are examined in the present work.

John Lie notes that "neoclassical economics... relies on the notion of atomized individuals who maximize subjective utility".<sup>31</sup> He quotes Hirschman to the effect that in the neoclassical vision "there is no room for bargaining, negotiation, remonstrance or mutual adjustment and the various operators that contract together need not enter into recurrent or continuous relationships as a result of which they would get to know each other well."<sup>32</sup> Accordingly, "[t]he problem with neoclassical economics is that it demarcates the economy as an arena within which social relations do not matter."<sup>33</sup>

The assumption that atomistic individuals seek to maximize their utility and the assumption that perfect competition prevails, together permit a simple aggregation of supply and demand at various price points and resulting in equilibrium. In their famous article "Existence of an Equilibrium for a Competitive Economy", Kenneth Arrow and Gerard Debreu credited Leon Walras with having "first formulated the state of the economic system at any point of time as the solution of a system

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<sup>30</sup> *Ibid* at 742.

<sup>31</sup> John Lie, "Embedding Polanyi's Market Society" (1991) 34:2 *Sociological Perspectives* 219 at 227. He cites Nicholas Kaldor, *Economics without Equilibrium*. (Cardiff: University College Cardiff Press, 1985).

<sup>32</sup> *Ibid* at 227, citing: Albert O Hirschman, "Rival Views of Market Society" [1982] in *Rival Views of Market Society and Other Essays*, AO Hirschman, (New York: Viking, 1986) 105 at 123.

<sup>33</sup> *Ibid* at 226.

of simultaneous equations representing the demand for goods by consumers, the supply of goods by producers, and the equilibrium condition that supply equal demand on every market. It was assumed that each consumer acts so as to maximize his utility, each producer acts so as to maximize his profit, and perfect competition prevails, in the sense that each producer and consumer regards the prices paid and received as independent of his own choices.”<sup>34</sup> These assumptions are reminiscent of those identified by Terry Moe. However, Arrow and Debreu maintain that Walras failed to demonstrate that such equations could be solved.

In effect, the simplicity of these assumptions rendered the theory readily amenable to aggregation and quantification, and generation of an equilibrium. Arrow and Debreu explain that “[t]he basic economic motivation in the choice of a consumption vector is that of maximizing utility among all consumption vectors which satisfy the budget restraint, i.e., whose cost at market prices does not exceed the individual's income...This economic principle must certainly hold for equilibrium values of prices and of the profits of the production units.”<sup>35</sup> The result, they say is that the supply and demand for all commodities is determined as a function of price if as the price varies, the producers and consumers behave as if the announced value the price were the equilibrium value. Thus, “[t]he market for any commodity is usually considered to be in equilibrium when the supply for that commodity equals the demand”.<sup>36</sup>

This classical and neoclassical relationship among supply, demand, and equilibrium does rely, of course, on the assumption that rational atomistic individuals seek to maximize their own subjective utility. Krippner and Alvarez comment that an “atomistic perspective, that is, a perspective that assumes isolated, self-interested actors who arrive on the scene already equipped with an inborn tendency to “truck, barter, and exchange,” effectively requires essentially no governance structure to police exchange. In such a world, there is no opportunity for fraud, collusion, corruption, or vice of any kind, hence no need for government meddling in the economy. With the assumption of atomism, we are therefore in the world of the self-regulating market — a world in which politics

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<sup>34</sup> Kenneth J Arrow and Gerard Debreu, "Existence of an Equilibrium for a Competitive Economy" (1954) 22:3 *Econometrica* 265 at 265.

<sup>35</sup> *Ibid* at 270-271.

<sup>36</sup> *Ibid* at 271.

and culture enter into the market only as an interference and in which the economy can legitimately be described as an analytically autonomous sphere.”<sup>37</sup>

These classical and neoclassical assumptions have already been demonstrated in the preceding chapters of this work to be, at best, highly problematic and, at worst, entirely fallacious. This work has already examined the perspectives of Granovetter and Polanyi, which “provide a unified and compelling assault on the neoclassical perspective” according to Krippner and Alvarez.<sup>38</sup> We trust that readers will agree with this.

The reference to the inborn tendency to “truck, barter, and exchange” is, of course, to Adam Smith’s *The Wealth of Nations*.<sup>39</sup> Smith ascribes the division of labour to the “necessary, though very slow and gradual consequence of a certain propensity in human nature which has in view no such extensive utility”; namely, “the propensity to truck, barter, and exchange one thing for another.”<sup>40</sup> This propensity, we would argue, might be motivated, at least in part, by associative or affiliative, rather than simply economic, impulses. Such impulses, along with “other propensities of human nature” are, except for rational utility seeking, ignored by the conventional economic model.

This relatively simple exposition must suffice for the present; the individual components of this generalization will be considered in more detail later in the chapter and in Part 3 of this work.

### 3. Criticism

#### *a. Self-Interest as Motive to Action*

The statement that individuals engage in economic action from a motive of self-interest in order to attain their own utility or satisfaction is often considered tantamount to the assertion that all action by individuals is motivated by self-interest. Indeed, when it is considered that some commentators seek to characterize marital, family, and friendly relations and interactions as

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<sup>37</sup> Greta R Krippner and Anthony S Alvarez. “Embeddedness and the Intellectual Projects of Economic Sociology” (2007) 33 Annual Rev Sociology 219 at 222.

<sup>38</sup> *Ibid.*

<sup>39</sup> Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*. 1776. Vol 2, ed by RH Campbell & AS Skinner (Indianapolis: Liberty Fund, 1981).

<sup>40</sup> *Ibid* at Book 1, Chapter 2.

motivated by self-interest, such an interpretation of the statement cannot be ignored. However, as we have seen, even Adam Smith conceded that there were other non-economic motives for action. Charles Perrow maintains that most economists assume that individuals maximize their own self-interest.<sup>41</sup> He criticizes the assumption that human nature is ruled only or primarily by self-interest on the grounds that human nature “signifies primarily a lack of instinctual responses” which “means humans are highly adaptive (as well as inventive and variable and so on).”<sup>42</sup> He says that if this is the case, “the setting in which interactions or contracts occur is the most important thing to consider in explaining behavior” and that “[s]ome settings, or organizational structures...will promote self-interested behavior, others will promote other-regarding behavior, and still others will be neutral.”<sup>43</sup> Perrow’s characterization of man as adaptive presents a different model of man from that of classical and neoclassical economics, which model, may be expected to have quite different consequences from the model of economic man.

Perrow concludes that the settings, or organizational structures, in which self-interested behaviour is favoured are those in which: 1. continuing interactions are minimized; 2. storage of rewards and surpluses by individuals is encouraged; 3. the measurement of individual effort or contribution is encouraged; 4. interdependent effort through design of work flow and equipment is minimized; 5. there is a preference for leadership stability and generalized authority; and 6. there are tall hierarchies [by which he means hierarchies with many levels, based upon unequal rewards and notions that coordination must be imperatively achieved].<sup>44</sup> An adaptation towards behaviour which is other than self-interested may, therefore, be expected in other settings or in other organizational structures.

Of course, these are only exemplary of the criticisms advanced.

### ***b. Desire and Satisfaction/Utility Distinguished***

In a major study of the theory of demand and its realism and relevance, the eminent economist Frank Knight observed that “[i]n scientific economics, of course, we are concerned only with the quality of desiredness, without regard to any basis it may have in valuation in the higher sense or

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<sup>41</sup> Charles Perrow, "Economic Theories of Organization" (1986) 15:1/2 Theory and Society 11 at 12.

<sup>42</sup> *Ibid* at 3.

<sup>43</sup> *Ibid* at 13-14.

<sup>44</sup> *Ibid* at 16-17.

even to the "satisfaction" which may actually follow upon choice and action."<sup>45</sup> We also assume, according to him, "that freedom in choice involves more than mere contingency or chance or caprice, and ordinarily more than "arbitrary" thought and action."<sup>46</sup> The absence of such chance, caprice, or arbitrariness does not, however, entail that the satisfaction of desire sought may follow upon choice and action.

There may be many reasons for this, as a matter of logic and otherwise, including, we submit, the following: the actor may mistake actual desire for something else, erroneously believing that he or she desires something when this is not, in fact, the case; the individual may erroneously expect satisfaction to ensue from satisfaction of desire; the individual may make a mistake as to the extent or quantum of desire; the individual may make a mistake as to the extent or quantum of satisfaction to be derived; because of timing differences, the pursuit of the desired object and its attainment may entail that the elements expected to satisfy the individual's desire are no longer present at the time of attainment; the individual's desires may change over time such that the attainment of the relevant desire does not produce any satisfaction, or does not produce the expected quantum of satisfaction; the individual's prioritization of desires may change over time such that the attainment of the desire produces less (or, alternatively, more) satisfaction, either on its own or in comparison to other desires, than was originally anticipated; or, in the case of an instrumental desire, other means have made it unnecessary or less necessary or appropriate, either on its own or in comparison to other instrumental desires, than was originally the case, or may make it ineffective in order to accomplish the higher order desire.

These are but some examples of possible causes of discrepancies between desire and satisfaction.

### *c. Determination of Desires*

A useful criticism of the relationship between desire and utility is presented by Knight, who considers the methodological problems with respect to the treatment of demand as the most important and most difficult, "because it is here that behavior facts are most inseparably bound up

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<sup>45</sup> Frank A Knight, "Realism and Relevance in the Theory of Demand" (1944) 52:4 J Political Economy 289 at 308 (in footnote).

<sup>46</sup> *Ibid* at 308.



with motivation and that objective data most imperatively call for interpretation by subjective facts and meanings.”<sup>47</sup>

Knight discusses a treatment of demand and utility adopted by John R. Hicks, Evgeny Slutsky, Henry Schultz, and others, which employs “a new psychology of consumption and a distinctive treatment of the demand curve” based upon it<sup>48</sup>. He argues that this “new interpretation of consumption is more relativistic than the conventional view, specifically that of Marshall, and is adopted for the sake of greater objectivity. It has two aspects. The first is replacement of the conception of “absolute” diminishing incremental utility (of a single good) with a diminishing “coefficient of substitution” of one good for another, assumed to be a purely behavioristic principle, or at least purely relative. The second aspect is a distinctive view of the relation between change in income and change in the psychic state of the subject – his economic well-being.”<sup>49</sup>

Knight’s conviction is that these thinkers seem to compare the utility (which is taken as equivalent to satisfaction), at least by way of diminishing marginal utility (roughly speaking, the principle that more of a good at some point generates less satisfaction per unit than previously), of various goods. This will be discussed further below. As to the second aspect of such theory, this posits a relationship between income and actual satisfaction of desire, rather than simple desire itself. Of course, taken in combination with the first point, it may be inferred that the marginal utility of the purchase of more of the same good depends, at least in part, upon the total income available for the purchase of that good and other goods.

Knight criticizes this, saying that such thinkers “have not been willing to follow through with a behavioristic complete rejection of subjective magnitudes - or their reduction to the role of a “force” impelling men to buy and consume and to compare and choose” and that such thinkers “still think of the individual as controlling his consumption with a view to securing more rather than less of something called “utility” - a subjective magnitude which is maximized when the consumer’s behavior conforms to the economic ideal. They merely insist that this something-maximized need not, and therefore should not, be treated as a quantity in the ordinary “cardinal” meaning, but as only “ordinal,” that is, utilities are subject to ranking but not to real quantification,

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<sup>47</sup> *Ibid* at 289.

<sup>48</sup> *Ibid*.

<sup>49</sup> *Ibid*.

which is identified with measurement.”<sup>50</sup> It may be said, more generally, that the treatment of demand in terms of desire and utility, whether by Marshall or by Hicks et al., is not adequately explicated either in positive economics or in economic theory.

*d. Desire or Utility and Choice or Substitution*

Determining desire for a good or service is natural but intrinsically difficult, as Knight demonstrates in his criticism of the theory of demand, since “[o]ur thinking about conduct must conform to common-sense introspection and intelligible intercommunication, which always run in terms of "reasons" for action or choice, meaning ends or motives. In the discussion of conduct we cannot separate description from teleological interpretation - the "what" from the "why" in this sense - what is done from what is achieved or expected to be achieved.”<sup>51</sup> In effect, rationality is assumed, not only in economics, but generally; as such, desires must often be justified by being characterized as instrumental.

Appealing to common experience, Knight says that ruling out motive, which he considers to be desire for things or their services or for experiences of “satisfaction”,<sup>52</sup> from our conception of human conduct “where everyone is directly aware of it in his own experience and has the most certain knowledge of its reality and others”<sup>53</sup> would be extremely arbitrary. However, “[t]here is a special reason (motive!) against admitting motive into the interpretation of economic choice, in that choices do not seem to correspond accurately with motives. This is true with respect to other persons, and also of one's own choices, viewed with detachment or from a later point in time. This discrepancy is partly a matter of error in choice itself and partly one of error in the assignment of motives, including one's own.”<sup>54</sup>

Desire does not always meet satisfaction. Ratiocination is not always or invariably successful. Even one's own motives may be imperfectly understood by oneself. Moreover, the phenomenon of “economic choice” may admit of influences that are not entirely “economic” in nature. In addition, as we have seen in connection with our previous discussion of desires, more than one object or good can be the subject of desire by the same individual. As Knight says, “[i]t is also

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<sup>50</sup> *Ibid* at 289-290.

<sup>51</sup> *Ibid* at 307.

<sup>52</sup> *Ibid*.

<sup>53</sup> *Ibid*.

<sup>54</sup> *Ibid* at 308.

evident that the idea of economic value, or utility, always arises out of the necessity of choosing between alternative "goods," more or less different in kind. The giving-up of an alternative good is the meaning of cost."<sup>55</sup>

Yet, according to Knight, economics deals with desires independently, such that "any one desire or attraction is a distinct factor and the associated satisfaction an independent variable under any actual conditions of choice. (However, discussion of the psychological effect of variation in the consumption of a single good, under the condition that it is the only one consumed by the individual, in place of reasonable *ceteris paribus* conditions, is one of the "classical errors" from which theory needs to free itself.)"<sup>56</sup> In this sense, the economic model of choice and substitution lacks explanatory power."<sup>57</sup>

#### e. *Rationality*

The rational choice paradigm of neoclassical economics was challenged by Herbert Simon, who sought to model "how people think" and to "replace the conventional model of rational economic man with an empirically adequate theory of individual choice", as Terry Moe explains.<sup>58</sup> He continues: "At the heart of Simon's contribution is his model of bounded rationality... This model recognizes that people are limited both in the information and knowledge they possess and in the computational skills they bring to bear in making choices. Thus, they cannot engage in the kind of informed optimization attributed to economic man, nor can they engage in the kind of decision making under uncertainty that information economists and game theorists have subsequently developed. Instead, boundedly rational individuals "satisfice." This mode of choice, in turn, leads them to behave in a routine, myopic, but reasonably adaptive manner."<sup>59</sup>

While these concepts will be discussed in more detail below, it is noted here that the "bounding" or "limiting" of rationality has consequences. As Perrow explains, "even where self-interest is encouraged by the context of behavior, humans (1) do not have clear utilities to maximize, (2) do

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<sup>55</sup> *Ibid.*

<sup>56</sup> *Ibid.*

<sup>57</sup> *Ibid.*

<sup>58</sup> *Supra*, note 26 at 743.

<sup>59</sup> *Ibid* at 743-744 [citations omitted]. He refers (in the portion omitted) to Herbert A Simon, *Administrative Behavior*. (New York: Macmillan, 1947). He refers at the end of the last sentence to: James G March and Herbert Simon. *Organizations*. (New York: Free Press, 1958).

not have much of the information needed to maximize utilities, and (3) do not know of cause-effect relations regarding maximization.”<sup>60</sup> Bounded rationality, in effect, relates to making choices based on the best available information and expectations, including the relationships between one’s desires and the means of achieving the same, the likelihood of attaining such desires, expectations of the satisfaction or utility to be achieved from achievement of those desires, and comparable information with respect to other desires and their prioritization by the individual as such and when compared with alternative desires in respect of the matters just mentioned.

Knight says that we “know too much” about motives and behaviour, since “we have direct knowledge, not only that motives are present but that they do not correspond with hypothetical forces connecting behavior with its antecedent conditions. Their operation disrupts the uniformity of sequence. In the first place, action rarely leads to exactly the intended result, because it is always affected by error, which also is of several kinds. And, beyond this fact, ends are never really given. Actual desires are partly a matter of curiosity - the urge to explore giving rise to the paradox of expected surprise as an important element in motivation.”<sup>61</sup>

We would maintain that the import of this argument is that desire is not necessarily, or only, for the thing thought to be desired, but also involves a desire to determine if the thing thought to be desired really is desired. This is separate, according to Knight, from “the problem-solving interest, the quest of the "right" answer to some question, which it is a sheer contradiction to treat as an end given in advance. Well-being is largely of this nature, the answer to an unsolved problem, to be sought through "intelligent" experiment.”<sup>62</sup>

When Knight says that “ends are never really given” and contrasts curiosity-seeking behaviour and problem-solving behaviour, he draws attention to the fact that expectations of the satisfaction or utility sought from the particular course of action may be quite different from that which actually eventuates. This is not only because of inadequate information, limited rationality, variances between expected profitability and the occurrence of events, and the prospect of error arising from these and other sources, but because the satisfaction or utility derived cannot be estimated with

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<sup>60</sup> *Supra* note 41 at 14.

<sup>61</sup> *Supra* note 45 at 310.

<sup>62</sup> *Ibid.*

any real certainty in advance. In consequence, the paradigmatic assumption or generalization of economics cannot be sustained as a description of experience.

*f. Atomism or Methodological Individualism*

The assumption that atomistic individuals seek to satisfy their own desires or to maximize their own utility, and do so completely independently and without any interaction with other such individuals, has been challenged in the modern era by economists such as Coase and Simon, both of whom develop quite different theories of economic organizations. Terry Moe characterizes this difference by saying that “[f]or Coase, transaction costs lead optimizing individuals to prefer hierarchy to markets. For Simon, uncertainty and limited cognitive capacity lead human decision-makers to satisfice and thus to engage in highly structured behavior. Both approaches are individualistic, anchored in economic models of choice, and characterized by the incorporation of new elements whose value is suggested by empirical observation.”<sup>63</sup> Moe says that “both argue that the relative efficiency of hierarchy - and the explanation of organization - is due at base to limitations, imperfections, and frictions that shape individual choice in consequential ways but are omitted from the core neoclassical models.”<sup>64</sup>

Of course, Simon argued that individuals, who are, unlike economic man, only boundedly rational instead of fully rational, express this by behaving “in a routine, myopic, but reasonably adaptive manner”<sup>65</sup>. Routine behaviour and adaptive behaviour, Simon argued, counteract some of the limitations of bounded rationality. It will be recalled that Perrow characterized man as highly adaptive. That characteristic was not part of the model of “economic man”.

Another model which seeks to respond to the difficulties of atomistic individualism is the organizational evolution or natural selection model set forth by Armen Alchian in his seminal 1950 article “Uncertainty, Evolution, and Economic Theory”. In effect, Alchian treats individuals and organizations as similarly adaptive in respect of their learning behaviour; that is to say, individuals make choices about the structures, processes and behaviours of organizations that are expected to be conducive to success.

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<sup>63</sup> *Supra* note 26 at 745.

<sup>64</sup> *Ibid.*

<sup>65</sup> *Ibid* 744. His cite is to Herbert A Simon, *Administrative Behavior* (New York: Macmillan, 1947).

Terry Moe explains that in “a fundamental sense, Alchian's theory of economic organizations is different from those of Coase or Simon. He disavows an explicit model of individual choice (although it is clear he favors some sort of adaptive model), and he offers a system-level explanation of organizational emergence, structure, and survival that is largely independent of decision making at the micro level. His theory is not individualistic. Yet it is precisely this independence of a distinct model of choice that ultimately renders it compatible with the individualistic theories of both Coase and Simon, however different they might be from one another, and that provides each of them with a new dimension of explanatory power.”<sup>66</sup>

Moe says that under Alchian’s logic of natural selection, “[w]hether individuals optimize under uncertainty or satisfice under the more limiting conditions of bounded rationality, they make choices about organizational structures, processes, and behaviors that may be far from objectively efficient and that may vary widely across individuals and organizations”. Hence, “Alchian's logic of natural selection, when grafted onto either approach, provides a powerful means of deriving and integrating expectations about individuals, organizations, and systems.”<sup>67</sup> This absence of isomorphism with respect to organizations is considered to reflect differences in individual choice-making.

Needless to say, quite apart from any theory of natural selection at the individual or group level, even the atomistic individual may have to employ other instruments, whether animate or inanimate, to attain satisfaction. As Frank Knight says, treating the human being “as either simple or constant involves heroic abstraction, even if we could think of our Robinson Crusoe as using only his own "person" in the satisfaction of his economic wants, ignoring all other instrumentalities.”<sup>68</sup> In other words, a strict application of complete atomism to economic theory would necessitate ignoring externally-sourced capital and labour in determining the cost of producing a particular item.

#### ***g. The Problem of Aggregation***

As has been seen, Kirman’s criticism of general equilibrium theory proceeds from his finding that the assumptions of uniqueness and stability it makes have no theoretical justification. The source

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<sup>66</sup> *Supra* note 26 at 746-747.

<sup>67</sup> *Ibid* at 747.

<sup>68</sup> *Supra* note 45 at 309

of this problem, in turn, he says “seems to be embodied in what is an essential feature of a centuries-long tradition in economics, that of treating individuals as acting independently of each other.”<sup>69</sup> This is the problem which we have been discussing and which is described in the preceding heading as “atomism” or “methodical individualism”.

Kirman argues that this tradition does not necessarily entail that there is no interaction among individuals. Instead, following Paul Samuelson<sup>70</sup>, he suggests that “once the appropriate signals are given, individuals behave in isolation and the result of their behaviour may simply be added together. Then the equilibrium signals can be determined.”<sup>71</sup> He says that it is the assumption that individuals “*demand behaviour is completely independent of the others*” that is essential to the construction of economies generating arbitrary excess demand functions.<sup>72</sup> This does not entail the absence of any interaction. Instead, “[i]t is not mere chance that one assumption that leads to strong results as to uniqueness and stability is that society should behave as an individual. Yet we know that to obtain such behaviour individuals' behaviour must be very similar. If we are to progress further we may well be forced to theorise in terms of groups who have collectively coherent behaviour. Thus demand and expenditure functions if they are to be set against reality must be defined at some reasonably high level of aggregation. The idea that we should start at the level of the isolated individual is one which we may well have to abandon.”<sup>73</sup>

Kirman's argument, then, is that a model which describes demand or consumption by the behaviour of one individual and then aggregates over more than one individual, while it may be attractive as conducive to a unique and stable equilibrium, is unjustified, and can only be seen as a pure assumption or postulate. On the other hand, theorizing in terms of group behaviour makes it necessary, he says, “to explain how and why a sector of society or society itself organizes itself in such a way as to behave like an individual, if indeed it does”<sup>74</sup>. He concludes that, in effect, “making assumptions on the distribution of agents' characteristics amounts, in some sense, to making assumptions about the organisation of society.”<sup>75</sup>

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<sup>69</sup> *Supra* note 19 at 137.

<sup>70</sup> *Ibid.* He cites PA Samuelson, "Problems of Methodology: Discussion" (1963) 54 *American Economic Rev* 231.

<sup>71</sup> *Supra* note 19 at 137.

<sup>72</sup> *Ibid* at 138 [emphasis in the original]

<sup>73</sup> *Ibid.* The similarity of the behaviour of individuals is discussed in Chapter A5 under the heading "Assumption Three – Individual Determination of Utility".

<sup>74</sup> *Ibid.*

<sup>75</sup> *Ibid.*

We would argue that theorizing, “in terms of groups who have collectively coherent behaviour” would generate a demand curve at a group level of aggregation, which, presumably, would intersect separately with the supply or production sector of the economy. The supply or production side may itself, and for similar reasons, be modelled at a higher level of aggregation than an individual supplier or producer, in effect, generating a group level supply or production curve. Each group of consumers and each group of producers might then be said to behave “independently”. Logically, then, such an approach would seem to require a level of aggregation above that of groups with collectively coherent behaviour, if it is to provide a model of supply and demand for the economy as a whole.

Kirman’s argument suggests that if the complete independence of individuals in terms of demand behaviour is not to be considered purely as a postulate or assumption, it becomes necessary to make a number of assumptions about the organization of society. These may be necessarily more complex than the assumption of aggregation of demand.

#### ***h. Profit Maximization as Primary Goal***

Kirman refers to the argument that the underlying hypothesis of individual maximization is inappropriate and unnecessarily restrictive and considers Simon’s work as an alternative. He says that Simon’s model, like that of Arrow and Debreu,<sup>76</sup> relies on individuals reacting to signals in the form of prices. He concludes that “unless it could be proved that individual behaviour of the type invoked by Simon imposes restrictions on the collective behaviour *because* it leads people to behave similarly, we are no further advanced.”<sup>77</sup> Such proof has so far been absent.

Armen Alchian rejects utility maximization at both the individual and firm level, following the criticism of Gerhard Tintner. Alchian maintains that: “Uncertainty arises from at least two sources: imperfect foresight and human inability to solve complex problems containing a host of variables even when an optimum is definable. Tintner's proof is simple. Under uncertainty, by definition, each action that may be chosen is identified with a *distribution* of potential outcomes, not with a unique outcome. Implicit in uncertainty is the consequence that these distributions of potential outcomes are overlapping. It is worth emphasis that each possible action has a *distribution* of potential outcomes, only one of which will materialize if the action is taken, and that one outcome

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<sup>76</sup> *Supra* note 34.

<sup>77</sup> *Supra*, note 18 at 127 [emphasis in the original].



cannot be foreseen. Essentially, the task is converted into making a decision (selecting an action) whose potential outcome *distribution* is preferable, that is, choosing the action with the *optimum distribution*, since there is no such thing as a *maximizing* distribution.”<sup>78</sup>

Accordingly, Alchian argues that realized positive profits, rather than profit maximization, “is the sine qua non of survival and success”.<sup>79</sup> It is the “relevant objective whose *fulfilment* is rewarded with survival.” However, because of uncertainty, “[n]either perfect knowledge of the past nor complete awareness of the current state of the arts give sufficient foresight to indicate profitable action”.<sup>80</sup> As a result, he says, two modes of behavior replace optimum equilibrium conditions as guiding rules of action: mimesis, and innovation or “trial and error”.

As to mimesis, “wherever successful enterprises are observed, the elements common to these observable successes will be associated with success and copied by others in their pursuit of profits or success.”<sup>81</sup> He explains that “[m]any factors cause this motive to imitate patterns of action observable in past successes. Among these are: (1) the absence of an identifiable criterion for decision-making, (2) the variability of the environment, (3) the multiplicity of factors that call for attention and choice, (4) the uncertainty attaching to all these factors and outcomes, (5) the awareness that superiority relative to one's competitors is crucial, and (6) the nonavailability of a trial-and-error process converging to an optimum position.”<sup>82</sup>

Alchian explains that the “second type of conscious adaptive behavior, in addition to imitation, is “trial and error.” This has been used with “profit maximization,” wherein, by trial and ensuing success or failure, more appropriate actions are selected in a process presumed to converge to a limit of “profit maximization” equilibrium. Unfortunately, at least two conditions are necessary for convergence via a trial-and-error process, even if one admits an equilibrium situation as an admissible limit. First, a trial must be classifiable as a success or failure. The position achieved must be comparable with results of other potential actions. ... The second condition, then, for the

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<sup>78</sup> *Supra* note 66 at 212 [emphasis in the original]. His cite of Tintner is to “The Theory of Choice under Subjective Risk and Uncertainty”, (1940) IX *Econometrica* 298; “The Pure Theory of Production under Technological Risk and Uncertainty” (1940) IX *Econometrica* 305; and *A Contribution to the Nonstatic Theory of Production*, Studies in Mathematical Economics and Econometrics (Chicago: University of Chicago Press, 1942) 92.

<sup>79</sup> *Supra* note 66 at 217.

<sup>80</sup> *Ibid* at 218 [emphasis in the original].

<sup>81</sup> *Ibid*.

<sup>82</sup> *Ibid*.

convergence via trial and error is the continual rising toward some *optimum optimorum* without intervening descents.”<sup>83</sup>

Of course, in a changing environment, as Alchian says, “there can be no observable comparison of the result of an action with any other” and “the possibility of an individual’s converging to the optimum activity via a trial-and-error process disappears. Trial and error become survival or death. It cannot serve as the basis of the *individual’s* method of convergence to a “maximum” or optimum position.”<sup>84</sup>

It may be conjectured from this that a combination of mimesis and trial-and-error might enable competitors within a particular industry or sector to copy only practices which are “successful” in the sense of being co-present with organizational continuity, and not those which are “unsuccessful” in a sense of being co-present with organizational decline and termination. Apart from obvious questions of whether the practices observed and the survival or death of the individual competitor have a relationship of simple collinearity or one of causation, the myriad of attendant and differing circumstances with respect to organizations that survive and those that die make comparisons and causative inferences extremely difficult.

Unless conditions in the environment are invariant, which is not the normal case, profit maximization or even profit optimization is not possible for Alchian, and profit sufficiency must be sought instead. It may, therefore, be concluded that the assumption of profit maximization as the primary goal of economic activity is no longer maintained even by all mainstream economists.

### *i. Time Lag*

Assumed invariance of conditions is likewise discussed by Frank Knight, who says that “it is actually quite unrealistic to think of the functional (cause-and-effect) relations between economic variables as remaining unchanged through a real change in any independent variable.”<sup>85</sup> In particular, “[t]here is always a significant ‘lag’ in time; and in the meantime other things will not remain ‘equal’.”<sup>86</sup> As previously noted, this may also result in the utility expected not accruing in actuality.

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<sup>83</sup> *Ibid* at 219.

<sup>84</sup> *Ibid* [emphasis in the original].

<sup>85</sup> *Supra* note 45 at 310.

<sup>86</sup> *Ibid*.

### *j. Organizations*

As discussed above under the subheading “Rationality”, Herbert Simon argued that the information, knowledge, and computational skills of human beings are limited, result in them being only bountifully rational, promote satisficing rather than maximization of utility, and leads them to behave in a routine, myopic, but reasonably adaptive manner.<sup>87</sup> Terry Moe relates this bounded rationality of individuals to Simon’s theory of organizations, explaining that the “key insight is that, just as individuals will routinize behavior if left to their own devices, so routines can also be imposed by organizational superiors, who can take steps to shape the decisional premises (information, beliefs, aspiration levels) of subordinates and provide them with the programmed responses deemed suitable for efficient pursuit of the organization's objectives. It is this combination of bounded rationality and managerial efforts to program subordinate behavior that largely explains organizational structure.”<sup>88</sup>

In effect, self-routinization can be seen as an adaptation made necessary by the boundedness of one’s own rationality. Accordingly, routinization by external pressure may be considered as imposing, and accelerating the imposition of, routinization that the individual may have concluded, eventually, was a necessary adaptation. Terry Moe explains how this is effected: “Individuals throughout the organization, precisely because they are boundedly rational, will behave in the routine, patterned ways characteristic of structured behavior; and (boundedly rational) managers, in seeking to shape and coordinate individual programs into an organized, efficient structure, impose behavioral routines via hierarchy, division of labor, communications flows, and training programs. Thus emerge the basic structural aspects of organization, all of them anchored in the inherent limitations on human decision-makers.”<sup>89</sup>

Of course, organizations are not advantageous only because they improve routines which assist in overcoming the limitations of the bounded rationality of individuals with respect to their individual decisions but, among other things, are also advantageous because they provide for some aggregation of bounded rationality, which might be expected to result in increased rationality of decisions made at the organizational level. More fundamentally, however, organizations exist to

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<sup>87</sup> See Moe, *supra* note 26 at 744. He cites: James G March and Herbert Simon. *Organizations*. (New York: Free Press, 1958).

<sup>88</sup> *Ibid.*

<sup>89</sup> *Ibid.*

accomplish certain goals and objectives or to pursue certain stated purposes and may be expected to adopt, and later to adapt and improve, structures and processes suitable to those ends. Routinization may be useful in some organizations, and at some levels and in some functions within organizations, but may not be (as) useful, with height any good news other organizations, levels and functions.

#### **4. Discussion**

As indicated above under the heading “Purpose and Methodology of Economics”, in order to provide a context for discussion of the firm and of the corporation, respectively, as an economic actor, it is necessary to review certain major assumptions, generalizations or common understandings of economics. As noted there, the use of the word “assumption” is used in this work generally and in this chapter, in particular, in the sense of generalizations or common understandings, rather than an unproven proposition on the basis of which a scientific hypothesis is advanced for the purpose of discussing or testing the same. In effect, the assumptions investigated here are generalized or common understandings which are considered to be fundamental to mainstream, classical, and neoclassical, economics.

This section has examined a proposition generally accepted in, and fundamental, to mainstream, that is, classical or neoclassical, economics, namely, that atomistic individuals who are motivated to seek their own good, satisfaction, or utility engage in economic activity to maximize (or, in some later writing, optimize) their own good, satisfaction, or utility. The elements of this assumption are separately identified and analyzed further below. As noted previously, the focus of discussion here is on assumptions that, and the ways in which such assumptions, may be employed, on the one hand, in economic discussions concerning the nature of the firm and the corporation and, on the other hand, in legal discussions concerning the nature of the firm and the corporation.

The review in this section establishes as problematic, or even inaccurate, the assumptions that individuals act completely atomistically, that they exclusively seek their own good, satisfaction or utility, and that they engage in economic activity solely to maximize or optimize their own good, satisfaction, or utility.

## ASSUMPTION TWO – ATOMISM AND METHODOLOGICAL INDIVIDUALISM

### 1. Statement

As discussed in relation to Assumption One, mainstream, that is, classical or neoclassical, economics considers that atomistic individuals who are motivated to seek their own good, satisfaction, or utility engage in economic activity to maximize (or, in some later writing, optimize) their own good, satisfaction, or utility. As such, the individual is the irreducible entity or monad from which higher-order units are constructed. As Steven Lukes says in his oft-cited study “Methodological Individualism Reconsidered”,<sup>90</sup> the doctrine of methodological individualism asserts that “facts about society and social phenomena are to be explained solely in terms of facts about individuals.”<sup>91</sup> Thus, it is reductionist at, and to, the level of the individual.

According to Geoffrey Hodgson in his important article “Meanings of Methodological Individualism”<sup>92</sup>, the term *methodische Individualismus* was originally used by Max Weber’s student, Joseph Schumpeter, in an eponymous chapter of a book published in 1908.<sup>93</sup> The equivalent English term “methodological individualism” was first used by Schumpeter in his 1909 paper, “On the Concept of Social Value”,<sup>94</sup> but was introduced as a methodological precept into the social sciences by Max Weber, specifically in the first chapter of *Economy and Society*.<sup>95</sup>

Stephen Lukes compares the similar definitions of methodological individualism by Hayek, Popper, and Popper’s student, J. W. N. Watkins. Hayek says that “...there is no other way toward an understanding of social phenomena but through our understanding of individual actions directed toward other people and guided by their expected behaviour.”<sup>96</sup> Hayek’s definition is discussed further below in connection with our discussion of the nature of aggregation. Lukes’ further remarks make frequent descriptions of Hayek as an advocate of methodological individualism

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<sup>90</sup> Steven Lukes, “Methodological Individualism Reconsidered” (1968) 19:2 *British J Sociology* 119.

<sup>91</sup> *Ibid*, at 120.

<sup>92</sup> Geoffrey M Hodgson, “Meanings of Methodological Individualism” (2007) 14:2. *J Economic Methodology* 211 at 211.

<sup>93</sup> *Das Wesen und der Hauptinhalt der theoretischen Nationalökonomie*. Cited by the *Stanford Encyclopedia of Philosophy*, online at: <https://stanford.library.sydney.edu.au/archives/spr2012/entries/methodological-individualism/#3>.

<sup>94</sup> Joseph Schumpeter, “On the Concept of Social Value” (1908-9) 23. *Quarterly J Economics* 213.

<sup>95</sup> *The Stanford Encyclopedia of Philosophy*, citing Max Weber, *Economy and Society*. Ed. Guenther Roth and Claus Wittich, (Berkeley: University of California Press, 1968).

<sup>96</sup> *Supra* note 91 at 120, citing Friedrich von Hayek, *Individualism and Economic Order*, (London, Routledge, 1949) at 6.

questionable, as Hodgson observes.<sup>97</sup> For example, in his important review of the subject, Udehn describes Hayek as “probably the most well-known Austrian methodological individualist”, saying that “his methodology is a synthesis of elements taken from Menger, Weber, and Mises.”<sup>98</sup> Udehn calls the Weber – Mises – Hayek perspective the “intersubjectivist theory of society”.<sup>99</sup>

Karl Popper adds a reference to social institutions, thereby holding that “... all social phenomena, and especially the functioning of all social institutions, should always be understood as resulting from the decisions, actions, attitudes, etc., of human individuals, and . . . we should never be satisfied by an explanation in terms of so-called 'collectives'...”, such as states or social groups, “whose behaviour must be reduced to the behaviour and to the actions of human individuals”.<sup>100</sup>

Hodgson maintains that Popper’s statement of methodological individualism “omits the requirement of complete explanatory reduction to individuals, and does not imply that explanation should be in terms of individual alone. Instead, he claims that explanations (exclusively or otherwise) in terms of collectives are unsatisfactory.”<sup>101</sup> Popper does not deny the existence of collectives, such as states or social groups, and does not seem to deny that the function or act as such, but insists that their behaviour must be reduced to the level of the individual. Accordingly, Popper’s version of methodological individualism may be considered to be psychological in orientation is often referred to as “psychological” individualism or “psychologist” individualism.

Watkins says, to similar effect, that “large-scale *social* phenomena must be accounted for by the situations, dispositions and beliefs of *individuals*. This I call methodological individualism.”<sup>102</sup>

Watkins goes on to say that “[t]here may be unfinished or half way explanations of large-scale social phenomena (say, inflation) in terms of other large-scale phenomena (say, full employment); but we shall not have arrived at rock-bottom explanations of such large-scale phenomena until we have deduced an account of them from statements about the dispositions, beliefs, resources and inter-relations of individuals.”<sup>103</sup>

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<sup>97</sup> *Supra* note 84, at 215.

<sup>98</sup> Lars Udehn, "The Changing Face of Methodological Individualism" (2002) 28 Annual Rev Sociology 479 at 486.

<sup>99</sup> *Ibid* at 487.

<sup>100</sup> *Supra* note 91 at 120, citing Karl Popper, *The Open Society*, 4th ed., Vol. II, p. 98.

<sup>101</sup> *Supra* note 93 at 216.

<sup>102</sup> JWN Watkins, "Methodological Individualism: A Reply" (1955) 22 Philosophy of Science (see note 12) 58 at 58 [emphasis in the original].

<sup>103</sup> *Ibid*.

As Hodgson argues, Watkins' definition "is broad in that it does not reduce explanations of social phenomena to individuals alone, but also includes 'resources and inter-relations of individuals'". The latter term admits a huge class of phenomena, including social relations.<sup>104</sup> This work makes a similar observation below. It should also be noted that Watkins' phrase "rock-bottom explanations" anticipates a criticism related to such regression that will be discussed further below.

Lukes explains that it is to be contrasted with sociological holism or organicism, which treats social systems as "wholes" and explains the behaviour of individuals partly by macro-laws that are not explicable as mere regularities or tendencies resulting from the behaviour of individuals and partly by the function of institutions within the whole social system.<sup>105</sup>

## 2. Explanation

In his much-cited article, "The Changing Face of Methodological Individualism",<sup>106</sup> the sociologist Lars Udehn reviewed the subject from historical and methodological perspectives. That article is used as a guide to those perspectives in this section.

Udehn described Thomas Hobbes, with his theory of the state of nature,<sup>107</sup> as adhering to "methodological individualism-in-use" by which he means that Hobbes conformed to the principle without expressly stating it.<sup>108</sup> The theory of the social contract, positing that individuals living in a state of nature originate social order, may be considered to express a strong form of methodological individualism. Udehn notes, as we have done here, that we should not assume that "individuals in the state of nature are also isolated. They are not, but instead they interact with one another in their own sort of way, that is by means of fraud and violence. The main characteristic of individuals in the state of nature is not that there they are *asocial*, but that they lack culture."<sup>109</sup>

Udehn describes the philosophers of the Scottish Enlightenment, especially David Hume, Adam Ferguson, and Adam Smith, as adopting a species of individualism, which he calls "institutional individualism", that was very different from that of the theory of social contract. He says that it

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<sup>104</sup> *Supra* note 93 at 216. He cites: JWN Watkins, "Historical Explanation in the Social Sciences" (1957) 8:2 *British J Philosophy of Science* 104 at 106.

<sup>105</sup> *Supra* note 91, at 121.

<sup>106</sup> *Supra* note 99.

<sup>107</sup> The version of the text cited by Udehn is Thomas Hobbes, [1651] *Leviathan*. (Harmondsworth: Penguin, 1968).

<sup>108</sup> *Supra* note 99 at 481.

<sup>109</sup> *Loc. cit.* [emphasis in the original].

knew nothing of “asocial individuals in a state of nature”, but considered individuals “as socio-cultural beings shaped by social institutions and by the history of society”.<sup>110</sup> Udehn says that even though Adam Smith is considered to be the founder of classical economics, other classical economists, particularly John Stuart Mill, were more individualistic than was Smith.<sup>111</sup> This observation supports the view expressed with respect to Adam Smith in the present text.

Udehn advances the following position concerning Mill. He points out that, in *A System of Logic*,<sup>112</sup> Mill argues that all social sciences are based on laws of mind, or on human nature; and that finding causal explanations for empirical laws or generalizations describing large-scale social phenomena requires psychological laws.<sup>113</sup> Consequently, Udehn says, Mill is generally considered, including by such authorities as Karl Popper,<sup>114</sup> to be a psychological reductionist and a methodological individualist whose version of such approaches is sometimes called “psychologistic individualism”.<sup>115</sup>

Udehn argues that the marginalist revolution in the 1870s which introduced neoclassical economics established economics as an individualistic science, explaining economic phenomena in terms of the subjective evaluations of individual human beings.<sup>116</sup> While he describes the Austrian School of Economics and the English utilitarian tradition, starting with Stanley Jevons, as explicitly individualistic, Udehn considers the theory of general equilibrium, originating with Leon Walras, to be the most individualistic.<sup>117</sup> The latter has already been discussed in this chapter.

Udehn agrees with others, such as Hausman and Arrow,<sup>118</sup> that neoclassical economics is generally considered as the most individualistic of the social sciences.<sup>119</sup> He also considers contemporary

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<sup>110</sup> *Ibid* at 481-2 [emphasis in the original].

<sup>111</sup> *Ibid* at 482.

<sup>112</sup> *Ibid*. Udehn’s cite is to: JS Mill, [1843–1872] *A System of Logic. Ratiocinative and Inductive. Collected Works*, Vols. VII-VIII. (Toronto: Univ. Toronto Press, 1974).

<sup>113</sup> *Supra*, note 99 at 482.

<sup>114</sup> *Ibid*. The edition of Popper to which Udehn refers is: KR Popper. [1945] *The Open Society and Its Enemies*, Vol. 1: *Plato*, Vol. 2: *Hegel and Marx*. (London: Routledge & Kegan Paul, 1966).

<sup>115</sup> *Supra* note 99 at 482. For the last point, Udehn cites J Agassi, 1975. "Institutional Individualism" (1975) 26 *British J Sociology* 144.

<sup>116</sup> *Supra* note 99, at 482.

<sup>117</sup> *Ibid*.

<sup>118</sup> *Ibid* at 483. His cites are to: DM Hausman, *The Inexact and Separate Science of Economics*. (Cambridge, UK: Cambridge University Press, 1992) at 97ff. and to KJ Arrow, "Methodological Individualism and Social Knowledge" (1994) 84 *Am Econ Rev Pap Proc* 1 at 2.

<sup>119</sup> *Supra* note 99 at 483.



general equilibrium theory, whose main architects he considers to be Kenneth Arrow and Gerard Debreu<sup>120</sup>, to be a second paradigm of methodological individualism.<sup>121</sup> Such commentators as Lawrence Boland, says Udehn,<sup>122</sup> claim that neoclassical economics as a whole manifests psychologistic individualism, in the sense that no economic explanation can be considered successful until all exogenous variables have been reduced to psychological states of individuals and natural constraints; and that social institutions appear in the models of neoclassical economics only as endogenous variables.<sup>123</sup>

Hodgson argues that it was “through the Austrian Trinity of Schumpeter, Hayek and von Mises” that the term “methodological individualism” was exported from economics into other disciplines.<sup>124</sup> This transpired, of course, most obviously in political science and sociology.

In their signally important article, “The New Institutionalism: Organizational Factors in Political Life”, March and Olsen opine that theories of politics since about 1950 have been, among other things: contextual, inclined to see politics or the polity as an integral part of society (as discussed in Part 1 of the present text); reductionist, inclined to see political phenomena as the aggregate consequences of individual behaviour; and utilitarian, inclined to see action as the product of calculated separate self-interest.<sup>125</sup> Thus, while “[d]iscovering, or deducing, the collective consequences may be difficult, even impossible”; nevertheless, “outcomes at the collective level depend only on the intricacies of the interactions among the individual actors”, such that “concepts suggesting autonomous behaviour at the aggregate level are certainly superfluous and probably deleterious.”<sup>126</sup>

Methodological individualism requires explanations of economic, social, political phenomena in terms of the human individual. Social contract theories and many modern theories of politics, similarly, according to March and Olsen, are reductionist at the level of the individual. Thus, the state must be explained in terms of aggregation from the individual. Similarly, other institutions of and social phenomena must be explained in this manner.

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<sup>120</sup> *Supra* note 34.

<sup>121</sup> *Supra* note 99 at 483.

<sup>122</sup> *Ibid.* He cites LW Boland, *The Foundations of Economic Method* (1982) London: Allen & Unwin, 1982) at 13.

<sup>123</sup> *Supra* note 99 at 483.

<sup>124</sup> *Supra* note 93 at 212.

<sup>125</sup> James G March and Johan P Olsen, "The New Institutionalism: Organizational Factors in Political Life" (1984) 78:3 *American Political Science Rev* 734 at 735.

<sup>126</sup> *Op. cit.*, at pp. 735-6.

A recent article in the area of comparative law and development theory by Teemu Ruskola maintains that “[t]he paradigmatic subject in the political and economic spheres is the individual. Even as the state stands in a relationship of authority over us, we retain certain rights against it as individuals. Likewise, in the marketplace we enter into contracts as individuals. The family, in contrast, is the one place where we are expected to shed our self-interested individual motivations to come together with others.”<sup>127</sup> He argues that “[t]he corporation has no natural resting place in this order. On the one hand, as an economic entity it would seem to be the quintessential actor in the market. On the other hand, the corporation is also evidently a *collective* entity while the marketplace is paradigmatically an arena of interaction among self-interested individuals.”<sup>128</sup>

Of course, just because the paradigmatic subject of economic and political interactions is the individual does not entail that social organizations, groups, or other collectivities must lack ontological, epistemological, methodological, or legal status. However, methodological individualism requires that all explanations be reduced to the level of the individual. As distinct from ontological individualism, it does not require that society be made up only of individuals, thereby denying the reality of social institutions and organizations. Instead, it requires only that explanations of social organization, groups of individuals be reduced, ultimately, to the level of the individual.<sup>129</sup>

On the other hand, ontological individualism, as applied to legal theory, might be considered to require that only individuals be recognized as rights-and-duty-bearing parties. In turn, if only “persons” are considered to bear rights and duties, then ontological individualism might be considered to require that in order to bear rights and duties, the bearer must be a person, or, at least, that the “rights-and-duty-bearing” status of the bearer be reduced to the level of the human individual.

In that case, Ruskola might be justified in saying that this might motivate “the legal fiction of the corporation as a person in its own right, as if it were a human being.”<sup>130</sup> As has been argued in this work previously, however, equating rights-and-duty bearing status with legal personhood is neither

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<sup>127</sup> Teemu Ruskola, “What Is a Corporation? Liberal, Confucian, and Socialist Theories of Enterprise Organization (and State, Family, and Personhood)” (2013-2014) 37 *Seattle U L Rev* 639 at 644.

<sup>128</sup> *Ibid* [emphasis in the original].

<sup>129</sup> Udehn discusses these distinctions at some length. *Supra* note 99 at 501. He also discusses strong and weak versions of methodological individualism at 502ff.

<sup>130</sup> *Supra* note 128 at 645.

required nor, if required, would it require further analogizing the corporation or other “legal entity” or “legal person” with the individual person.

### 3. Criticism

Much relevant and useful criticism of methodological individualism has been assembled, distilled, reviewed, and weighed in a number of excellent articles on the subject, notably by Arrow, Hodgson, Lukes, and Udehn, as mentioned above. These can be mentioned only briefly here.

#### *a. Nature of Aggregation*

In an important and widely-cited paper on the subject, Kenneth Arrow argues that while it is “a touchstone of accepted economics that all explanations must run in terms of the actions and reactions of individuals”, social categories are, in fact, used, “all the time” and as “absolute necessities of the analysis.”<sup>131</sup>

Hodgson maintains that “it is crucial whether it is claimed that the social world simply consist of individuals, or of individuals and *interactive relations between them*. The social world, by virtue of the fact that it is social, must involve such interactive relations.”<sup>132</sup> In effect, adopting some species of ontological individualism need not be entailed simply as a consequence of adopting methodological individualism.

Hodgson quotes Hayek that “[t]he overall order of actions in a group is in two respects more than the totality of regularities observable in the actions of the individuals and cannot be wholly reduced to them.”<sup>133</sup> Hayek says that this “is so not only in the trivial sense in which the whole is more than the mere *sum* of its parts but presupposes also that these elements are related to each other in a particular manner. It is more also because the existence of those relations which are essential for the existence of the whole cannot be accounted for wholly by the interaction of the parts but only by their interaction with an outside world both of the individual parts and the whole.”<sup>134</sup>

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<sup>131</sup> KJ Arrow, “Methodological Individualism and Social Knowledge” (1994) 84:2 *American Economic Rev* (Papers and Proceedings) 1 at 1.

<sup>132</sup> *Supra* note 93 at 215 [emphasis in the original].

<sup>133</sup> *Ibid*, citing FA Hayek, *Studies in Philosophy, Politics and Economics*, (London: Routledge and Kegan Paul, 1967) at 70-71.

<sup>134</sup> *Supra* note 93 at 215 [emphasis in the original].

Hodgson seeks to explain Hayek's remark by saying that "society consists not merely of individuals, but also of interactions between individuals, plus interactions between individuals and other aspects of their environment including, presumably, both the natural world and other socio-economic systems."<sup>135</sup> It is suggested here, however, that the "particular manner" in which "these elements are related to each other" includes not only the relationship of each individual to each other individual, but also the relationship of each individual to the group composed of all other individuals; that is, to each individual separately, and to each individual *qua* group member. This position has been advanced elsewhere in the present work.

### ***b. Behaviour of Organizations***

March and Olsen point out that a reductionist perspective in economics and in the other social sciences explains the behaviour of the organization as "the consequence of the interlocking choices by individuals and sub-units, each acting in terms of expectations and preferences manifested at those levels."<sup>136</sup> For example, "[t]he behavior of a market is the consequence of the interlocking choices by individuals and firms, each acting in terms of a set of expectations and preferences manifested at those levels."<sup>137</sup> However, they assert that "[i]t is not necessary that the micro processes involve choice, of course", since aggregate behavior of a group can be seen as the consequence of the interlocking trial-and-error learning at the level of individuals<sup>138</sup> and aggregate behaviour of an industry can be explained as "the consequence of the interlocking of standard operating procedures and accounting rules followed at the level of the individual firm."<sup>139</sup>

However, it is suggested here that the expectations and preferences of individuals and their "interlocking choices" and, at the next higher level of aggregation, the expectations and preferences of groups and their "interlocking choices" do, in fact, consider, as inputs for such expectations, preferences and choices, the actual and expected behaviours of other individuals as part of the framework of choice. Similarly, with respect to non-choice models, the nature of "interlocking trial-and-error learning" at the individual level, and the adoption of industry standard

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<sup>135</sup> *Ibid.*

<sup>136</sup> *Supra* note 126 at 736, citing WA Niskanen, *Bureaucracy and Representative Government*. (Chicago: Rand McNally, 1971).

<sup>137</sup> *Supra* note 126 at 736, citing GJ Stigler, *The Theory of Price* (Rev. ed.) (New York: Macmillan, 1952).

<sup>138</sup> *Supra* note 126 at 736, citing CA Lave & JG March, *An Introduction to Models in the Social Sciences*. (New York: Harper and Row, 1975).

<sup>139</sup> *Supra* note 126 at 736, citing RR Nelson & SG Winter, *An Evolutionary Theory of Economic Change*. (Cambridge, Mass.: Harvard University Press, 1982).

operating procedures and accounting roles at the level of individual firm may each be expected to consider the actual and expected behaviours of other units. In this sense, actions taken by the lowest level unit are not the only factors determinative of group or industry behaviour, as the case may be.

*c. Reduction to Level of Individuals*

A theory which is essentially reductionist is not thereby necessarily constrained to adopt, as its basic unit, the individual. March and Olsen note that “[t]here is nothing intrinsic to a perspective that emphasizes the macro consequences of micro actions which requires that the elementary units be individuals. All that is required is that the behavior of a more comprehensive system be decomposable to elementary behaviors explicable at a less comprehensive level.”<sup>140</sup>

The basic unit of behaviour in a macro system or at a system level, as March and Olsen call it, need not be that of the individual: “In practice, however, in most of the social sciences, the actions of individual human beings are considered to determine the flow of events in a larger social system. Outcomes at the system level are thought to be determined by the interactions of individuals acting consistently in terms of the axioms of individual behavior, whatever they may be. Thus, we make assumptions about individual consumers to understand markets, about voters to understand politics, and about bureaucrats to understand bureaucracies.”<sup>141</sup> Accordingly, any reductionist account, in economics or otherwise, is subject to criticism as to whether it decomposes the phenomena concerned to a basic or elementary unit that is appropriate to the instant case.

A further criticism of any reductionist account which might be made concerns the necessity of maintaining the same basic or elementary unit throughout successive levels of aggregation. In turn, this is related to the criticism that at a higher level of aggregation a new higher level of basic or elementary unit may interact with a lower level of basic or elementary unit. For example, the argument that group behaviour is largely determined by interaction among group members, who are individuals, need not necessarily entail, as a matter of theoretical construction or as a matter of logic, that the group, so composed, does not interact with individuals, or that the group in respect

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<sup>140</sup> *Supra* note 126 at 736.

<sup>141</sup> *Ibid.*

of its interaction with other groups, does not interact with individuals either in the acting group or in the group with which it interacts.

The relationship between an individual and a non-immediate group, namely, a group of which the individual's immediate group is a part or which is otherwise beyond the immediate focal group, presents particular difficulties in conducting research with respect to conflict resolution, choice, and decision-making. As James March indicates, in many studies of conflict systems small groups are treated both as systems involving individuals as basic units and as groups within organizations (or larger groups) within which the focal small group is an elementary unit. "Since the first postulate of conflict is essentially that the basic units themselves not be conflict systems, it seems awkward to be able to view a single system as either an elementary unit or a conflict system depending on the level of aggregation involved. In fact, most systems studied in the social sciences are apparently conflict systems of conflict systems."<sup>142</sup>

Consequently, the relationship between the individual and groups other than the immediate or focal group to which the individual is most closely connected, including the organization itself, may be less amenable to direct research than the more immediate relationship between individual and the immediate focal group. We submit that at least one reason for this is that the immediate focal group exercises some intermediating effect with respect to the individual/less immediate group, or individual/organization, relationship. These research difficulties, however, should not result in either in ready acceptance of reductionism, or its automatic reduction to the level of the individual.

#### ***d. Explanatory Power of Reductionist Theories***

In response to the inquiry whether there are any successful explanations of social phenomena in terms of individuals alone, without social relations and institutions, Hodgson points to Udehn's affirmative answers with respect to both social contract theory and general equilibrium theory.<sup>143</sup> Hodgson refers to Kenneth Arrow's counterargument to reductionism, which proceeds "by pointing out that price mechanisms involve social interactions and structures, and social phenomena that cannot be reduced entirely to individuals alone."<sup>144</sup> He quotes Arrow's rejoinder

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<sup>142</sup> James G March, "The Business Firm as a Political Coalition" (1962) 24:4 J Politics.662 at 664.

<sup>143</sup> *Supra* note 93 at 217, citing Udehn's 2001 article, *supra* note 99.

<sup>144</sup> *Supra* note 93 at 217. His cite is to KJ Arrow, "Methodological Individualism and Social Knowledge", (1994) 84:2 American Economic Rev (Papers and Proceedings) 84(2) 1.

that “economic theories require social elements as well even under the strictest acceptance of standard economic assumptions ... individual behavior is always mediated by social relations. These are as much part of the description of reality as in individual behavior.”<sup>145</sup> Accordingly, Udehn’s examples are put into question.

Hodgson provides examples of these interactions, saying: “All versions of social contract theory and general equilibrium theory involve individuals communicating with others or, at least, adopting tacit presumptions of the intentions and stances of others. All such interactions presume rules of interaction or interpretation. Trading in models of market interaction presumes some form of communication over prices or quantities. Communication involves some form of language, and languages by their nature are systems of rules. Furthermore, exchange involves the transfer of property rights, with rules established through prior social interactions. Similarly, all contracts rely on social structures of enforcement.”<sup>146</sup>

Accordingly, says Hodgson, “social contract theory and general equilibrium theory both presume structured relations between individuals, rather than individuals in isolation. They also presume relations between individuals and social institutions. For example, property rights require some system of enforcement. These things may not be stated explicitly in the models, but they are presupposed.”<sup>147</sup> Social relations are obviously implicitly assumed by such theories.

Arrow himself mentions that “[I]mitations on individualistic methodology appear very strongly when considering the role of information”<sup>148</sup>, especially new knowledge, which he says can be acquired either by observing nature or by learning from other individuals.<sup>149</sup> One can learn from others either intentionally (by communication or education) or by inferring the knowledge of others by observation of their behaviour. He indicates that both types of learning from others present “clear empirical problems with maintaining the individualist orientation.”<sup>150</sup>

Indeed, learning itself involves not only the reception of information but also, as Hodgson says, a conceptual framework to process and make sense of that information, the acquisition of which

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<sup>145</sup> *Supra* note 93 at 217.

<sup>146</sup> *Ibid* at 217-8.

<sup>147</sup> *Ibid* at 218.

<sup>148</sup> *Supra* note 132, at 2.

<sup>149</sup> *Ibid* at 7.

<sup>150</sup> *Ibid*.

framework involves processes of socialization and education by means of extensive interaction with others.<sup>151</sup> Consequently, “[t]he means of our understanding of the world are necessarily acquired through social relationships and interactions. Cognition is a social as well as an individual process.”<sup>152</sup> Because individual rational choice presumes cognition, “[i]ndividual choice is impossible without these institutions and interactions.”<sup>153</sup>

Even the development of social institutions presupposes social interaction. Hodgson credits Alexander Field with having “shown that key attempts by economists to explain the origin of social institutions presume individuals acting in a particular context, with rules of behaviour governing their interaction. In the presumed “state of nature” from which institutions are said to have emerged, a number of weighty roles, structures and cultural and social norms have already been (implicitly or explicitly) assumed.”<sup>154</sup>

#### *e. Social Intermediation*

As has been seen, even such neoclassical economists and general equilibrium theorists as Kenneth Arrow concede that it is “a touchstone of accepted economics that all explanations must run in terms of the actions and reactions of individuals”, a consequence of which is that “judging economic research... includes the criterion that in principle the behaviour and the policies we propose are explicable in terms of individuals, not of other social categories”<sup>155</sup> However, some, like Arrow, nevertheless argue that “even the most standard economic analysis shows that social categories are in fact use in economic analysis all the time and that they appear to be absolute necessities of the analysis, not just figures of speech that can be eliminated if need be.”<sup>156</sup>

In effect, it is acknowledged by Arrow and other mainstream economists that social intermediation of individual economic behaviour is implicit in such behaviour itself. As noted above, Arrow himself remarked that “economic theories require social elements as well even under the strictest

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<sup>151</sup> *Supra* note 93 at 218.

<sup>152</sup> *Ibid.*

<sup>153</sup> *Ibid.*

<sup>154</sup> *Ibid.*, citing AJ Field, "On the Explanation of Rules Using Rational Choice Models", (1979) 13:1 J Economic Issues 49; AJ Field, "The Problem with Neoclassical Institutional Economics: A Critique with Special Reference to the North/Thomas Model of Pre-1500 Europe" (1981) 18:2 Explorations in Economic History 174; and AJ Field, "Microeconomics, Norms and Rationality" (1984) 32:4 Economic Development and Cultural Change 683.

<sup>155</sup> *Supra* note 132 at 1.

<sup>156</sup> *Ibid.*



acceptance of standard economic assumptions... Individual behaviour is always mediated by social relations. These are as much part of the description of reality as in individual behaviour.”<sup>157</sup>

#### *f. Regression*

As suggested previously in relation to Watkins’ demand that “rock-bottom explanations” be expressed in terms of individuals, a strict form of reductionism at the level of the individual seems to present what Hodgson calls “an apparently infinite regress” in which “attempts to explain each emergent level of institutions always rely on previous institutions and rules” with the result that in this infinite regress “neither individual nor institutional factors have legitimate explanatory primacy.”<sup>158</sup>

Hodgson succinctly explains this regress: “If institutional influences on individuals are admitted, then these too are worthy of explanation. In turn, the explanation of those may be partly in terms of other purposeful individuals. But where should the analysis stop? The purposes of an individual could be partly explained by relevant institutions, culture and so on. These, in their turn, would be partly explained in terms of other individuals. But these individual purposes and actions could then be partly explained by cultural and institutional factors, and so on, indefinitely. As long as we are addressing social phenomena, we never reach an end point where there are isolated individuals, and nothing more.”<sup>159</sup>

One may speculate that social phenomena are intrinsically inter-subjective and, consequently, presuppose some kind of connectivity between subjects. Logically, it may be considered unlikely that this kind of inter-subjective connectivity could be explained in terms of “isolated individuals”. Social phenomena, by definition, presuppose no such isolation.

As a result, some methodological individualists attempt to assert some kind of “half-way” position. For example, Udehn explains that Watkins’ recognizes empirical generalizations about large-scale social phenomena, but claims that they were “in principle” reducible to psychological laws.<sup>160</sup> Udehn says that this eventually leads Watkins to “recognize the existence of half-way explanations

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<sup>157</sup> *Ibid* at 4-5.

<sup>158</sup> *Supra* note 93 at 219.

<sup>159</sup> *Ibid*.

<sup>160</sup> *Supra* note 99 at 489.

of large-scale social phenomena in terms of other large-scale social phenomena as distinguished from rock-bottom explanations in terms of individuals and their interrelations.”<sup>161</sup>

Others, such as Popper’s student, Joseph Agassi, have sought to explicate Popper’s reference to the “decisions, actions, attitudes, etc., of human individuals” and, in particular, the “etc.” as embracing all aspects of the situation or circumstances of the individual. Udehn characterizes this, as does Watkins, as “psychologicistic individualism”, a species of individualism which includes only material conditions, and not social institutions, in the relevant circumstances.<sup>162</sup> As such, it excludes social institutions from the description of the situations of individuals except insofar as those social institutions are reflected in or reduced to the attitudes of individuals towards things and other people.<sup>163</sup> Consequently, since those social institutions are not considered as involving a separate dynamic, this perspective is still considered as “psychologicistic individualism”.

The version of methodological individualism advanced by Joseph Agassi, which is described by Udehn as “institutional individualism”, explicitly “includes social institutions in the situation of individuals.”<sup>164</sup> Agassi argues that “institutions constitute a part of the individual’s circumstances which together with his aims determine his behaviour”.<sup>165</sup> Institutional individualism thus rejects the claim of psychologicistic individualism that only material conditions should be included in the description of the individual’s relevant circumstances.

Udehn also refers to the development of Agassi’s perspective by the economist Lawrence A Boland<sup>166</sup> who differentiated psychologicistic individualism from institutional individualism on the basis that in the former the only exogenous variables were psychological states and natural constraints, with the result that social institutions appear, if at all, and such model only as endogenous variables; whereas in institutional individualism, social institutions were permitted among the exogenous variables as well.<sup>167</sup> Udehn characterizes new institutional economics as frequently representing an amalgam of psychologicistic and institutional individualism.<sup>168</sup>

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<sup>161</sup> *Ibid.*

<sup>162</sup> *Supra* note 99, at 490.

<sup>163</sup> *Ibid* at 488.

<sup>164</sup> *Ibid* at 489.

<sup>165</sup> Joseph Agassi, "Methodological Individualism" (1960) 11 *British J Sociology* 244 at 247.

<sup>166</sup> Udehn’s cite is to Lawrence A Boland, *The Foundations of Economic Method* (London: Allen & Unwin, 1982). Ch. 2.

<sup>167</sup> *Supra* note 99, at 489.

<sup>168</sup> *Ibid* at 490.

Accordingly, there is a wide range of perspectives within methodological individualism, adherents of some of which criticize other perspectives. As the foregoing examination indicates, the perspective adopted may have very significant consequences in terms of theory and explanatory capacity.

***g. Emergence of Institutions***

Hodgson concludes that problems of this nature “undermine any claim that the explanation of the emergence of institutions can start from some kind of institution-free and ensemble of (rational) individuals in which there is supposedly no rule or institution to be explained.”<sup>169</sup> He concludes that “[c]onsequently, the project to explain the emergence of institutions on the basis of given individuals runs into difficulties, particularly with regard to the conceptualization of the initial state of nature from which institutions are supposed to emerge.”<sup>170</sup> The review of the various arguments discussed here supports that conclusion.

Institutions, according to Hodgson, are “a special case of social structure, involving systems of widely observed rules.”<sup>171</sup> In effect, he argues that social phenomena cannot be explained in terms of individual only; and that social structures are equivalent to relations between individuals; with the result that social phenomena should be explained in terms of individuals and social structures.<sup>172</sup> In the result, “[w]e *always* have to start from structures *and* individuals. There is no other viable explanatory strategy.”<sup>173</sup>

A strict form of methodological individualism must, as has been demonstrated, present an infinite regress in argumentation which is intractable. In addition, as we have argued above, the very concept of “social phenomena” presupposes a lack of isolation as between individuals. The “social” can be seen as a kind of “inter esse” or “inter-esse”, that which lies between, and both separates and connects, individuals. As will be recalled, for Hannah Arendt, this characterizes all reality, which is characterized by its common recognition as such.<sup>174</sup>

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<sup>169</sup> *Supra* note 93 at 219.

<sup>170</sup> *Ibid.*

<sup>171</sup> *Ibid* at 220. He cites as authority his own article: GM Hodgson, “What are Institutions?” (2006) 40:1 J Economic Issues 1. It reviews literature, and, as Hodgson himself says there at p.1, “draws on insights from several academic disciplines”.

<sup>172</sup> *Supra* note 93 at 220.

<sup>173</sup> *Ibid* at p. 221 [emphasis in the original].

<sup>174</sup> See the discussion in Chapter B1 under the heading “The “Public Realm” and the “Private Realm” of Arendt”.

Hodgson argues that is a mistake to conclude that social structures involve more than relations between individuals (where such relations also include social positions), saying that: “A danger here is to reify social structure as something other than an interacting pattern of individuals, which would exist even if the individuals all disappeared. Social structures are essentially groups of interacting social individuals, possibly including social positions, and with emergent properties resulting from this interaction.”<sup>175</sup>

At the same time, rejection of such reification does not entail admitting the isolation or atomism of individual human beings. Instead, it is obvious that “[s]tructures and isolated individuals are different things because interacting and isolated individuals are different things. By definition, isolated individuals have no causal interaction with other individuals. Structures depend on interacting individuals and would cease to exist if all the individuals or all their interactions disappeared.”<sup>176</sup>

Unlike isolated individuals, “every human individual is born into a world where structures already exist. Then individuals engage with this world, and play their part in supporting or changing these structures, while interacting with others.”<sup>177</sup> Individuals interact with others through social structure. Accordingly, a model, economic or otherwise, that rests on the proposition that there is no interaction among individuals is not likely to facilitate an understanding of the social construction of reality, the importance of social structures or, more generally, the construction of hypotheses that are consistent with experience.

#### **4. Discussion**

The project of methodological individualism has been demonstrated to present difficulties of such a high order as to make it difficult, if not impossible, to maintain seriously. Hodgson argues that even “[s]ophisticated advocates of methodological individualism are aware that the individual is a social being, enmeshed in relations with others. They are aware of the importance of culture, and that communication and language are deeply involved in constituting individuality.”<sup>178</sup> Indeed, “the idea of a genuinely isolated individual, free of all social relations, is untenable”; however,

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<sup>175</sup> *Supra* note 93 at 221. He cites D Weissman, *A Social Ontology*, (New Haven, CT: Yale University Press, 2000).

<sup>176</sup> *Supra* note 93 at 221.

<sup>177</sup> *Ibid.*

<sup>178</sup> *Ibid.*

“[w]hat many methodological individualists seem reluctant to do is to use this awareness to rule out such isolated individuals in the *explanantia*.”<sup>179</sup>

At this point, a question may be raised concerning the relevance of the assumption of methodological individualism in classical and neoclassical economics to the theory of the firm and the theory of the corporation and, in particular, to the legal theory of the firm and the legal theory of the corporation. Certainly, the theory of methodological individualism itself must be considered to be problematic, and perhaps even completely inefficacious. Indeed, adding somewhat to Hodgson’s observation, the very idea of an individual so isolated that he or she has been, is, and will continue for the foreseeable future to be, completely free of social relations does seem to be completely untenable, both logically and with respect to explanatory capacity “in the real world”.

As will be discussed below, the economic model of the firm which, in its simplest and, in economic theory, arguably the most prevalent, form essentially involves an entrepreneur, as sole proprietor, either acting as a manager or engaging a manager, to direct the activities of employees towards production of a product (most often) or service offered for sale on a market and eventually sold at a price reflecting, to some extent, the cost of input factors, and the price which consumers are willing to pay for such product. It is clear that an assumption of methodological individualism can only go so far in terms of explanatory capacity with respect to such phenomena. As argued above, the “purity” of such an assumption cannot coherently be maintained.

Accordingly, to the extent that such an assumption is employed in the economic theory of the firm or otherwise, it can be expected to result in generating explanations which are deficient. As in the case of other assumptions discussed in this chapter, the “real world” in which the “real corporate law”, including “real statutory law” is extant is bereft of what Hodgson calls the “genuinely isolated individual, free of all social relations”. Instead, the constitution and operation of corporation necessarily involves the actions of individuals who are not genuinely isolated and were not free of all social relations. Consequently, the application to corporate law and legal theory of the assumptions or propositions which are generally accepted in economics, including methodological individualism and other assumptions are or propositions relying upon it, you must be regarded as highly problematic, if not inappropriate or specious.

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<sup>179</sup> *Ibid.* For the “untenable” observation, he cites JB Davis. *The Theory of the Individual in Economics: Identity and Value* (London and New York: Routledge, 2003).

Time does not permit an excursion into the complexities of new institutional economics; however, it is apparent that post-Walrasian economics may contribute to the solution of some of the difficulties of Marshallian and Walrasian economics.

The remaining assumptions identified at the beginning of this chapter will be discussed in Chapter B5, following next.

**CHAPTER B5:  
ASSUMPTIONS OF CLASSICAL AND NEOCLASSICAL ECONOMICS  
PART B**

**ASSUMPTION THREE – INDIVIDUAL DETERMINATION OF UTILITY**

**1. Statement**

As discussed previously, mainstream, that is, classical or neoclassical, economics considers that atomistic individuals are motivated to seek their own good, satisfaction, or utility; and that they engage, independently, in economic activity to maximize (or, in some later writing, optimize) their own good, satisfaction, or utility. There, we quoted John Lie's comment that "neoclassical economics... relies on the notion of atomized individuals who maximize subjective utility".<sup>1</sup>

Lie's comment draws attention to the assumption implicit in the view that individuals, acting independently, seek, and maximize, subjective utility; or satisfaction of their own individual desires. That assumption involves in turn, the assumption that individuals are capable of determining, acting independently, what will afford them satisfaction and what will maximize their satisfaction. To this point we now turn, setting aside for later discussion in connection with assumption seven, the subject of rationality, the means by which they pursue such satisfaction.

**2. Explanation**

As discussed previously, Terry Moe's description of neoclassical economic theory describes it as a family of theories sharing, among other things, a focus on the individual as a unit of behaviour and an assumption of rational utility maximizing behaviour.<sup>2</sup> As discussed above, the distinguished economist Alan Kirman criticizes the reductionist perspective in his attack on "the citadel" of neoclassical economic theory, saying that "if one maintains a fundamentally individualistic approach to constructing economic models no amount of attention to the walls will prevent the citadel [of general equilibrium theory] from being empty. Empty in the sense that one cannot

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<sup>1</sup> John Lie, "Embedding Polanyi's Market Society" (1991) 34:2 Sociological Perspectives, 219 at 227. See the discussion in Chapter B4 in the section entitled "Atomistic Utilitarianism".

<sup>2</sup> Terry Moe, "The New Economics of Organization" (1984) 28:4 American J Political Science 739-77 at 741. See the discussion in Chapter B4 in the section entitled "Atomistic Utilitarianism".

expect it to house the elements of a scientific theory, one capable of producing empirically falsifiable propositions.”<sup>3</sup> This chapter will devote “attention to the walls”.

As seen previously, attacks on the rational choice paradigm have proceeded from many quarters. For example, as Moe says, Simon “sought to replace the conventional model of rational economic man with an empirically adequate theory of individual choice”<sup>4</sup> which resulted in his model of “bounded rationality”. Of course, that model has had a profound effect in management, as well as economic circles. However, the rational choice paradigm has continued to be maintained in much modern economic theory. Moe says that most economists in the economics of organization, at least, are not willing to reject the optimization model of choice; however, he credits Simon with demonstrating that aspects of social and human psychology are relevant to economics and organizations.<sup>5</sup> On the other hand, Moe describes Alchian’s “natural selection” or “evolutionary” theory of organizations as “disavowing an explicit model of individual choice (although it is clear he favors some sort of adaptive model)”.<sup>6</sup>

As shown in the previous chapter, Granovetter maintains that “[c]lassical and neoclassical economics operates...with an atomized, undersocialized conception of human action, continuing in the utilitarian tradition. The theoretical arguments disallow by hypothesis any impact of social structure and social relations on production, distribution, or consumption.”<sup>7</sup> For example, in relation to markets Granovetter cites Hirschman’s observation that in the idealized markets supposed, “large numbers of price-taking anonymous buyers and sellers supplied with perfect information...function without any prolonged human or social contact between the parties.”<sup>8</sup>

Among other things, the very idea of “perfect information” being available to an atomized individual actor without any social intervention is highly problematic as an assumption or generalization. Information generation, assembly transmission, and interpretation seem to

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<sup>3</sup> Alan Kirman, "The Intrinsic Limits of Modern Economic Theory: The Emperor has No Clothes" (1989) 99:395 *Economic J* 126. There, "the citadel" of neoclassical economic theory is ascribed by him to F Hahn, (1981) *General Equilibrium Theory* in D Bell and I Kristol, eds, *The Crisis in Economic Theory* (New York: Basic Books 1981).

<sup>4</sup> *Supra* note 2 at 743.

<sup>5</sup> *Ibid* at p. 744.

<sup>6</sup> *Ibid* at p. 746.

<sup>7</sup> Mark Granovetter, "Economic Action and Social Structure: The Problem of Embeddedness" (1985) 91:3 *American J Sociology* 481 at 483.

<sup>8</sup> Albert Hirschman, "Rival Interpretations of Market Society: Civilizing, Destructive, or Feeble?" (1982) 20:4 *J Economic Literature* 1463 at 1473.



presuppose some social intermediation, as is emphasized by Kenneth Arrow and as discussed in the preceding chapter.<sup>9</sup> Further, the assumption of “perfect information” itself presents substantial difficulties. Nevertheless, Granovetter maintains, perhaps generously, that the narrow utilitarian pursuit of self-interest is not admitted in this perspective to exclude social roles, even when internalized, because in the utilitarian model “the source of utility functions is left open, leaving room for behaviour guided entirely by consensually determined norms and values”.<sup>10</sup>

In an extensively cited article concerning the place of the market in economic theory,<sup>11</sup> Michel Callon starts his discussion with the general definition of market proposed by Robert Guesnerie as “a coordination device in which (a) the agents pursue their own interests and to this end perform economic calculations which can be seen as an operation of optimization and/or maximization; b) the agents generally have divergent interests, which lead them to engage in c) transactions which resolve the conflict”<sup>12</sup> (without, as Callon says, resorting to physical violence, in effect by reaching an acceptable compromise), by defining a price.

For Guesnerie, “a market opposes buyers and sellers, and the prices which resolve this conflict are the input but also, in a sense, the outcome of the agents’ economic calculation”.<sup>13</sup> Among other things, Callon says this presupposes an organization that takes into account the variety of calculative agencies and their distribution. He also says that it is assumed that the agents enter and leave the exchange like strangers, although they are obviously in touch with each other during the transaction.<sup>14</sup> In effect, such an explanation fails to account for how parties who are willing to transact make contact with each other, bargain, and leave, and then later return, to a “market” which only exists when transacting parties are present, and are willing, and able, to transact. Characterizing the market as a “coordination device” requires explication of how such coordination is effected, which seems to require human, and, moreover, coordinated, agency.

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<sup>9</sup> KJ Arrow, "Methodological Individualism and Social Knowledge" (1994) 84:2 American Economic Rev (Papers and Proceedings) 1 at 1.

<sup>10</sup> *Supra* note 7 at 486.

<sup>11</sup> Michel Callon, "The Embeddedness of Economic Markets in Economics" (1998) 46: Sociological Rev 1.

<sup>12</sup> *Supra* note 11 at 3; citing R Guesnerie, *L'economie de marche*. Dominos (Paris: Flammarion, 1996).

<sup>13</sup> Callon, *supra* note 11 at 3.

<sup>14</sup> *Supra* note 12 at 3.

As observed previously in the present work, it is difficult to avoid the observation, even conclusion, that markets are socially constructed. However, the third assumption, individual determination of utility, speaks to the motives of consumers and producers, or of construction of the supply side and of the demand side, in respect of such market. We now turn to criticisms of this assumption.

### 3. Criticism

It goes without saying that in a work of this nature a consideration of such criticisms must necessarily be partial and summary in nature.

#### *a. Knowledge of Desires and Goals*

In his important work, previously discussed here, concerning oversocialized and undersocialized conceptions of man,<sup>15</sup> Dennis Wrong argues that, while “material interests, sexual drives and the quest for power have often been over-estimated as human motives”, this is no reason to deny their reality.<sup>16</sup> His observation calls attention to the multiplicity of human motives.

A discussion of whether, and the extent to which, the goals of individual human beings can be said to be “innate” on the one hand, or fully or partially socially constructed, on the other, exceeds our present objectives. Dennis Wrong says that modern sociology presents a model of human nature in which human motivations or desires are affected firstly, by the “internalization of social norms” and, secondly, “by the desire to achieve a positive image of self by winning acceptance or status in the eyes of others”.<sup>17</sup> Internalization of social norms may be related to learning and habit formation.

Dennis Wrong, following Talcott Parsons, concludes that Durkheim’s later work acknowledged that social rules do not merely “regulate externally” but actually “enter directly into the constitution of the actors’ ends themselves”.<sup>18</sup> As a result, Durkheim maintained that constraint is not only an external environmental obstacle to be taken into account by an actor in pursuit of his goals, but also “becomes internal, psychological, and self-imposed as well.”<sup>19</sup> Internalization of norms by an

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<sup>15</sup> Dennis Wrong, “The Oversocialized Conception of Man in Modern Sociology” (1961) 26:2 *American Sociological Review* 183. See the discussion in Chapter B3, including in the section entitled “Mark Granovetter’s Embeddedness”.

<sup>16</sup> *Supra* note 15 at 191.

<sup>17</sup> *Ibid* note at 185.

<sup>18</sup> *Ibid* at 186; citing Talcott Parsons, *The Structure of Social Action*, (New York: McGraw-Hill, 1937) at 382.

<sup>19</sup> *Supra* note 15 at 186.

individual is normally intended to signify that the individual habitually both affirms the norm and conforms to it in his conduct.<sup>20</sup>

Wrong explains that in Freudian or psychoanalytic terms, the norm has been interjected to become part of the superego, which indicates that a person will suffer guilt-feelings if he fails to live up to it, not that he will live up to it in his actual behaviour.<sup>21</sup> He says that “the main explanatory function” of the concept of the superego “is to show how people repress themselves, imposing checks on their own desires and thus turning the inner life to a battlefield of conflicting motives, no matter which side “wins” by successfully dictating overt action.” He also observes that for psychoanalysis “the wish, the emotion, and the fantasy are as important as the act in man’s experience”;<sup>22</sup> whereas sociologists minimize or even deny the importance of “motivational forces bucking against the hold social discipline has over him”.<sup>23</sup>

Indeed, says Wrong: “When Freud defined psychoanalysis as the study of the “vicissitudes of the instincts,” he was confirming, not denying, the “plasticity” of human nature insisted on by social scientists. The drives or “instincts” of psychoanalysis, far from being fixed dispositions to behave in a particular way, are utterly subject to social channelling and transformation... To psychoanalysis man is indeed a social animal.”<sup>24</sup>

Accordingly, the existence, and recognition, of desires or motives in the atomistic individual which are completely independent of, and not intermediated by, others must be admitted to be, at the very least, problematic, and subject to significant contestation.

### ***b. Ranking of Desires and Goals and Calculation***

The rational pursuit of a desire or goal by an actor, acting completely independently, requires that the actor not only recognize the existence of the focal desire or goal, but also the existence of other desires or goals, and in each case, the circumstances attending the satisfaction of the same, in each case acting completely independently.

Callon unpacks this by saying that “for calculative agents to be able to make decisions they need at least to be able to: (i) establish a list of the possible states of the world (each state of the world

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<sup>20</sup> *Ibid* at 187.

<sup>21</sup> *Ibid*.

<sup>22</sup> *Ibid*.

<sup>23</sup> *Ibid* at 188.

<sup>24</sup> *Ibid* at 192.

being defined by a certain list of actors and goods, and by a certain distribution of these goods amongst the actors); (ii) rank these states of the world (which gives a content and an object to the agent's preferences); (iii) identify and describe the actions which allow for the production of each of the possible states of the world.”<sup>25</sup> Obviously, such decision-making is an extremely information-intensive activity. Indeed, even these three essential tasks, which are by no means exhaustive as to the information required, are massively complex. One might conclude that securing complete information, even as to just those three subject-matters, is virtually impossible.

In addition, of course, to ranking possible states of the world, the individual actor must also rank his or her preferences in accordance, among other things, with such possible states of the world. According to Callon, “[f]or an agent to be able to calculate – ie to rank – her decisions, she must at least be able to draw up a list of actions that she can undertake, and describe the effects of these actions on the world in which she is situated. This presupposes the existence in organized form of all the relevant information on the different states of the world and on the consequences of all conceivable courses of action and the access of all this information to the agent. Thus she will not only be able to get an idea of possible goals and rank them, but also mobilize the resources required to attain them.”<sup>26</sup>

Needless to say, what Callon is describing also involves calculation of instrumental actions conducive to the attainment of higher order of actions which are, in turn, conducive to the attainment of higher order actions still, and so on, until eventually the preference sought is achieved. Each of those calculations of instrumental actions requires identification, assessment, and weighting, and weighting the likelihood of eventuation, of various influences which may possibly affect the attainment of the particular instrumental action at hand. It is clear that the assumption of complete rationality, including acting on a rational basis with respect to complete information, is, accordingly, highly contestable.

As noted previously, learning and acquiring information presuppose certain social interaction. Callon argues accordingly, that the presumption of cognitive psychology that individual economic agents are capable of mental calculation fails to reflect the nature of calculating as a complex collective practice; and, further, that calculative competence is culturally or socially constructed,

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<sup>25</sup> *Supra* note 11 at 4.

<sup>26</sup> *Ibid.*

such that some social structures and cultural forms favouring calculation and pursuit of selfish interest, while others induce agents to be altruistic, disinterested, generous and even to give freely.<sup>27</sup>

These considerations, and others, indicate that the classical and neoclassical assumption of complete rationality is so highly problematic as to be considered unrealistic.

### ***c. Expectation of Satisfaction***

The discussion above, in the section entitled “Individual Determination of Utility”, of the relationship between desire and satisfaction mentions a number of reasons why the level or quantum of satisfaction actually experienced may differ from the level or quantum anticipated; and also why there may be other discrepancies between desiredness and satisfaction, both actual and anticipated. The same observations are relevant in this context. It is submitted that these considerations also make it impractical to maintain the utilitarian assumption of classical and neoclassical economics.

### ***d. Seeking of Personal Utility***

As discussed in Chapter B4, many social scientists, including Charles Perrow, criticize the assumption that individuals mainly or exclusively seek satisfaction of their own self-interest.<sup>28</sup> As discussed there, Perrow considers self-interest as a situationally dependent motivation and describes a number of variables which are thought to affect behavioural orientation as between self-interest, other-regarding, and neutral behaviour.

For example, Perrow finds that self-interested behaviour is favoured when: continuing interactions are minimized; accumulation of rewards and surpluses by individuals is encouraged; measurement of individual effort or contribution is encouraged; and interdependent effort is minimized through design of work flow and equipment. He maintains that it is generally conceded that not all behaviour is motivated by one’s own utility and, in fact, that some organizations appear able to

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<sup>27</sup> *Ibid* at 4-5.

<sup>28</sup> Charles Perrow, "Economic Theories of Organization" (1986) 15:1/2 *Theory and Society* 11 at 12-14. See the discussion in Chapter B4 in the section entitled "Atomistic Utilitarianism" and therein under the subheading "Self-Interest as Motive to Action".

minimize self-interested behaviour.<sup>29</sup> The present work has presented a variety of perspectives critical of this assumption.

#### *e. Independent Formation of Goals and Desires*

As has been argued in this section, human beings normally internalize social norms, often to such an extent that such norms are implicit in, or imprinted upon, an individual's personal goals and desires. Dennis Wrong mentions that human beings engaged in social interaction mutually seek approval from one another by conforming to shared norms. Wrong refers to this phenomenon as Parsons' model of the "complementarity of expectations".<sup>30</sup>

Wrong also refers to Ralph Linton's assessment of this phenomenon, in explicit psychological terms, saying that "[t]he need for eliciting favourable responses from others is an almost constant component of [personality]. Indeed, it is not too much to say that there is very little organized human behaviour which is not directed towards its satisfaction in at least some degree."<sup>31</sup>

These two phenomena, the internalization of social norms, and the need for the approval of others, provide some evidence that desires and goals are not formulated exclusively and independently by the individual concerned, as posited in classical and neoclassical economic theory.

#### *f. Independent Determination of Utility*

These and other similar factors also suggest that utility is not determined exclusively and independently by the individual concerned, as posited by classical and neoclassical economics. As indicated above, Hodgson argued that while social structure should not be reified to the point where it is considered to exist "even if the individuals all disappeared",<sup>32</sup> it is clear that social structure is a key explanatory ingredient with respect to the behaviour of individuals. As discussed previously, this applies to the construction of desires and utility by individuals.

### **4. Discussion**

In conclusion, for reasons including those advanced with respect to our discussion of methodological individualism, the assumption that individuals are capable of determining, acting

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<sup>29</sup> *Supra* note 28 at 16-17.

<sup>30</sup> *Supra* note 15 at 188.

<sup>31</sup> *Ibid.*

<sup>32</sup> Geoffrey M Hodgson, "Meanings of Methodological Individualism" (2007) 14:2 J Economic Methodology 211 at 221.

independently, what will afford them satisfaction and what will maximize their satisfaction, and in a proceeding to attain such satisfaction must be rejected or, at the very least, regarded as highly problematic and contested.

#### **ASSUMPTION FOUR – SIMILARITY OF DESIRES AND UTILITY**

##### **1. Statement**

As discussed in relation to Individual Determination of Utility, mainstream, that is, classical or neoclassical, economics considers that atomistic individuals are motivated to seek their own good, satisfaction, or utility; and they engage, independently, in economic activity to maximize (or, in some later writing, optimize) their own good, satisfaction, or utility.

As noted above, the assumption implicit in such view is that individuals, acting independently, seek, and maximize, subjective utility; or satisfaction of their own individual desires. That assumption involves in turn, ascertaining what those desires are and, in turn, whether or not the desires sought by individuals are homogeneous or heterogeneous. A related issue is whether the answers to these questions matter to the economist. To the extent possible, these questions will be considered separately in separate subsections combining explanation, criticism, and discussion.

##### **2. Identity or Similarity of Desires and Utility**

One possibility is that is the desires and goals of atomistic individuals acting independently are identical or, failing that, similar, as between one individual and another. This may be maintained by its proponents as an assumption not subject to contestation. Otherwise, a difficulty arises in seeking to explain how this complete or relative homogeneity arises.

Since individuals are assumed to act independently, a mimetic explanation would not seem to be available: they are assumed not to observe the conduct of others, the desires or goals sought, and the utility or satisfaction derived by those other individuals from such desires or goals. While certain needs or goals, expressed broadly, may be invariant, usual, or common, these would likely be at a very high level: for example, food, clothing, or shelter. It would seem to be difficult to attain higher levels of specificity or granularity on this basis; for example, a need for a Savile Row suit. Another explanation for such identity or similarity might be that such uniformity arises from human instinct. Such a suggestion, however, would also require some evidentiary support.

In our discussion of Individual Determination of Utility, it was noted that Alan Kirman, following Paul Samuelson, conceded that methodological individualism, in assuming the independence of action of individuals, did not require that there be no interaction among individuals at all; saying, instead, that individuals may react in isolation to the appropriate signals, thereby producing an aggregate demand function, and then generating equilibrium signals.<sup>33</sup> In effect, the argument is that similarity in behaviour might result from interaction through signalling, at least by price, and perhaps otherwise.

As indicated there, Kirman argues that the assumption that individuals' demand behaviour is completely independent of others is essential to constructing economies that generate arbitrary excess demand functions; however, generating a unique and stable equilibrium requires that one assumes that society behaves as an individual which, in turn, requires that individuals' behaviour must be very similar.<sup>34</sup> This suggests one justification for maintaining as an assumption the independence of individuals' demand behaviour: namely, that it facilitates generating a unique and stable equilibrium. As indicated, while this might provide a motive for such assumption, it certainly does not supply justification for it.

Kirman argues that "demand and expenditure functions if they are to be set against reality must be defined at some reasonably high level of aggregation. The idea that we should start at the level of the isolated individual is one which we may well have to abandon."<sup>35</sup> We might posit that it is this starting point which, to a large extent, may motivate the assumption of complete or relative homogeneity of individual demand. Otherwise, a significant dispersion of demand among individuals, although perhaps more likely to obtain, might be difficult to manage theoretically.

For example, a broad dispersion that was relatively consistent might generate a "band" that might be said to approximate aggregate demand, at least ignoring outliers, but it would not reduce to a single point forming a demand curve, which could be said to intersect with the supply curve. That supply curve, moreover, might be similarly constituted, that is to say, as a "band" rather than as a single point. While it might then be possible to generate a supply and demand "band" representing the areas of intersection of the supply and demand "bands", just as it was not possible to generate a single point representing either supply or demand at a particular price point, it would not be

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<sup>33</sup> *Supra* note 3 at 137. See the discussion under the subheading "The Problem of Aggregation".

<sup>34</sup> *Supra* note 3 at 138.

<sup>35</sup> *Ibid.*



possible to generate a single point of intersection of the supply and demand “bands”. Indeed, the “band” of intersection might involve a very wide swath indeed.

It is possible, therefore, that the motivation for greater precision accounts, to some degree, for the assumption of complete or relative homogeneity of demand. In this way, it could be said that the assumption of complete or relative homogeneity of demand is, in itself, “reductionist”, that is to say, quite separately, from being “reductionist” in the sense of reductionism to the level of the individual. One might speculate that aggregations of “reductionist” methodologies might be expected to generate conclusions which are less dependable than a single “reductionist” methodology alone might produce. Of course, this is beyond the scope of the present discussion.

Kirman does not, of course, raise the matters mentioned here in the discussion to which we avert. He does conclude, however, that “[t]here is no more misleading description in modern economics” than describing “the consumption or production sector by the behaviour of one individual or firm.”<sup>36</sup> Such a model based on aggregation at the individual level is, he says, unjustified, yet the alternative is to “be honest from the outset and assert simply that *by assumption* we postulate that each sector of the economy behaves as one individual and not claim spurious microjustification.”<sup>37</sup>

Consequently, the aggregation problem, for him, requires an explanation of “how and why a sector of society or society itself organizes itself in such a way as to behave like an individual, if indeed it does. Whatever the answer, this seems to be a question which economists have singularly failed to address.”<sup>38</sup> Kirman concludes that making assumptions about the distribution of agents’ characteristics amounts, he says, to making assumptions about the organization of society, which, accordingly, must then be separately justified.

Accordingly, the identity or similarity of goals and desires from one agent to another is an assumption which is conceded by a number of prominent economists, such as Kirman, to require justification, which has hitherto been absent.

### **3. Dispersion of Desires and Utility**

An assumption or generalization to this effect accords with methodological individualism. In turn, it affects the interpretation of the general equilibrium model. The economist Frank Ackerman, in

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<sup>36</sup> *Ibid.*

<sup>37</sup> *Ibid* [emphasis in the original].

<sup>38</sup> *Ibid.*

a review of such model, concluded that the “mathematical dead end reached by general equilibrium analysis... arises from intentional design features, present in neoclassical theory since its beginnings.”<sup>39</sup> He says that these are variously ascribed to two principal features of neoclassical theory: aggregation, and the individualistic model of consumer behaviour. Both of these have been discussed above.

In neoclassical economic theory, he says, “a different utility function motivates each individual, giving a group of people a structureless, unpredictable pattern of change. No common forces move them all in parallel; no interactions with each other, save through market exchange, coordinate their motions.”<sup>40</sup> Accordingly, the modelling of individual and firm behaviour by the behaviour of a single individual or firm, criticized by Kirman under the immediately preceding heading, would be subject to similar objections.

Because the microeconomic model of neoclassical economics “concentrates on one aspect of human activity and assumes away everything else”, namely, the utility function, Ackerman says that it fails to interpret human behaviour as involving “a complex combination of relatively predictable responses to social forces on the one hand, and unpredictable individual preferences and choices on the other hand.”<sup>41</sup> Because utility cannot be directly observed, it cannot be compared from one person to another, leading to the consequence, according to Ackerman, that “Walrasian general equilibrium was devoid of empirical content.”<sup>42</sup> However, some economists, such as Alfred Marshall and Arthur Pigou, “maintained that interpersonal comparison of utility was at least sometimes possible, for group averages if not for individuals.”<sup>43</sup>

The later substitution of revealed preference relations (of preferences) for utility functions, involved ranking preferences rather than absolute measures of utility. However, this still maintained “the asocial individualism of the model, the feature which subverts structure and prediction of group behaviour. Each individual still marches to a different drummer, even if the

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<sup>39</sup> Frank Ackerman, "Still Dead After All These Years: Interpreting the Failure of General Equilibrium Theory" (2002) 9:2 J Economic Methodology 119 at 119.

<sup>40</sup> *Ibid* at 131.

<sup>41</sup> *Ibid* at 132.

<sup>42</sup> *Ibid*.

<sup>43</sup> *Ibid*.

drums are now labeled ‘revealed preference relation’ instead of ‘utility function’. Naturally, this leaves no way of telling where the parade is headed.”<sup>44</sup>

This exposition of the difficulties of what Ackerman calls “asocial individualism” recalls the argument of Alan Kirman in the immediately preceding section. In Kirman’s view, “the standard assumptions on the endowments, production possibilities and preferences of individuals” do not generate a satisfactory general equilibrium model.<sup>45</sup> In support, Kirman cites Morishima’s statement to the effect that even if such assumptions could be employed to devise a correct general equilibrium model, without some social connection among individuals, “that equilibrium solution will amount to no more than a utopian state of affairs which bears no relation whatsoever to the real economy.”<sup>46</sup>

Kirman’s review of literature concerning general equilibrium theory also sought, among other things, to determine whether greater or lesser dispersion of individual preferences could result in equilibrium conditions that are stable and unique. He concluded that it could not;<sup>47</sup> but that a sufficiently wide dispersion of preferences in a large enough market could generate a continuous aggregate demand function, which, he argued, would not satisfy the requisite conditions of uniqueness and stability.<sup>48</sup> As discussed under the immediately preceding heading, Kirman concluded that methodological individualism may have to be abandoned; and that describing the behaviour of the consumer or production sector of the economy by the behaviour of one individual or firm is as misleading as any description in modern economics.

Accordingly, it is clear that substantial difficulties attend maintaining this position.

#### **4. Relevance to Economic Inquiry**

Of course, the third possible position in relation to desire and utility is that its investigation is not a proper subject of economic inquiry. In his extremely widely cited article “Rational Fools: A

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<sup>44</sup> *Ibid.*

<sup>45</sup> *Supra* note 3 at 127.

<sup>46</sup> *Ibid.* He cites M Morishima, “The Good and Bad Uses of Mathematics” in P Wiles and G North, eds, *Economies in Disarray* (Oxford: Basil Blackwell, 1984).

<sup>47</sup> *Ibid* at 128-133.

<sup>48</sup> *Ibid* at 128-129.

Critique of the Behavioral Foundations of Economic Theory”,<sup>49</sup> Nobel economics laureate Amartya Sen discussed economic models based on egoistic behaviour, concluding that “[t]he nature of man in these current economic models continues, then, to reflect the particular formulation of certain general philosophical questions posed in the past. The realism of the chosen conception of man is simply not a part of this inquiry.”<sup>50</sup>

The political scientist Stephen Krasner agrees. He describes the Chicago School’s work as exemplifying the “most pristine and imperialistic form of this argument”, in that it “applies microeconomic analysis to all aspects of human behaviour. It assumes that preferences are universal.”<sup>51</sup> This may be, at least in part, because economists do not consider the formation of preferences as an appropriate or interesting subject for economic inquiry, as Sen maintains. For support, Krasner cites Gary Becker, who argues that since “economists generally have had little to contribute, especially in recent times, to the understanding of how preferences are formed, preferences are assumed not to change substantially over time, nor to be very different between wealthy and poor persons, or even missions in different societies and cultures”.<sup>52</sup> It can be conceded immediately that such assumptions are, in general, at variance with ordinary experience.

In an extremely widely cited article, provocatively entitled “De Gustibus Non Est Disputandum”,<sup>53</sup> Nobel economic laureates George Stigler and Gary Becker explicate this further, discussing two possible interpretations of the “venerable admonition not to quarrel over tastes”.<sup>54</sup> They note that this admonition “is commonly interpreted as advice to terminate a dispute when it has been resolved into a difference of tastes, presumably because there is no further room for rational persuasion. Tastes are the unchallengeable axioms of a man’s behavior: he may properly (usefully) be criticized for inefficiency in satisfying his desires, but the desires themselves are *data*.”<sup>55</sup>

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<sup>49</sup> Amartya K Sen, "Rational Fools: A Critique of the Behavioral Foundations of Economic Theory" (1977) 6:4 *Philosophy & Public Affairs* 317.

<sup>50</sup> *Ibid* at 322. To similar effect, as previously cited, see Moe, *supra* note 2 at 741.

<sup>51</sup> Stephen D Krasner, "Sovereignty: An Institutional Perspective" (1988) 21:1 *Comparative Political Studies* 66 at 68.

<sup>52</sup> Gary S Becker, *The Economic Approach to Human Behavior*. (Chicago: University of Chicago Press, 1976) at 5.

<sup>53</sup> George J Stigler and Gary S Becker, "De Gustibus Non Est Disputandum" (1977) 67:2 *American Economic Review* 76.

<sup>54</sup> *Ibid* at 76.

<sup>55</sup> *Ibid* [emphasis in the original].

It may be noted, in passing, that this admonition and related observations assume that tastes and, accordingly, individual demand, vary among individuals. The admonition adopts the perspective that “an explanation of economic phenomena that reaches a difference in taste between people or times is the terminus of the argument: the problem is abandoned *at this point* to whoever studies and explains tastes (psychologist? anthropologist? phrenologists? sociobiologists?).”<sup>56</sup> The suggestion made here appears to be that the economist should assume complete or relative homogeneity of individuals’ tastes and preferences.

Stigler and Becker also advance “another and preferable interpretation [of the admonition]: that tastes neither change capriciously nor differ importantly between people”, on which interpretation, they say, “one never reaches this impasse: the economist continues to search for differences in prices or incomes to explain any differences or changes in behavior.”<sup>57</sup> They submit that, in consequence, “[t]he choice between these two views of the role of tastes in economic theory must ultimately be made on the basis of their comparative analytical productivities”.<sup>58</sup>

In that regard, they propose (ambitiously, they say) “the hypothesis that widespread and/or persistent human behaviour can be explained by a generalized calculus of utility-maximizing behaviour, without introducing the qualification “tastes remain the same”... [a] thesis that does not permit a direct proof because it is an assertion about the world, not a proposition in logic.”<sup>59</sup> They also claim that “no significant behavior has been illuminated by assumptions of differences in tastes”, whether by wealth or other classifications.<sup>60</sup>

Of course, the hypothesis, assumption, or generalization which remains subject to contestation, even without the qualification concerning “tastes remaining the same”, is the larger one concerning the universality of utility-maximizing behaviour. Consideration of that subject in the present work has suggested that such a hypothesis, assumption, or generalization is either highly contentious, at best, or is unsupported.

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<sup>56</sup> *Ibid* [emphasis in the original].

<sup>57</sup> *Ibid*.

<sup>58</sup> *Ibid*.

<sup>59</sup> *Ibid*.

<sup>60</sup> *Ibid* at 89.

## 5. Conclusion

Accordingly, it may simply be the case that the preferences of individuals are not of significant concern to economists. In his 1992 Nobel lecture, Gary Becker explains that “[w]hile the economic approach to behavior builds on the theory of individual choice, it is not mainly concerned with individuals. It uses theory at the micro level as a powerful tool to derive implications at the group or macro level.”<sup>61</sup> This suggests that individual choice theory is only of interest insofar as it concerns aggregate demand (or supply). In that case, Becker’s observations may be tantamount to asserting that the theory of individual choice and individual demand is not seriously maintained; and that, instead, what is important is the aggregation. As demonstrated in the discussion here, aggregation of individual behaviour presupposes the existence of both inter-subjective behaviour and group-subject oriented behaviour.

Even if it is maintained that individual choice and individual demand are not relevant to economic theory, the considerations advanced in the present work suggest that some conclusions may be drawn, at least preliminarily, about the relevance of economics to behaviour. One such conclusion is that for the purposes of analyzing behaviour within groups, including a variety of organizations, and, in particular, business corporations, it may be expected that “the economic approach to behaviour” may have but little to contribute to understanding how individuals behave, and how their behaviour and choices relate to the behaviour and choices of groups. These matters will be investigated in the immediately following chapters of Part 2 of the present work.

### **ASSUMPTION FIVE – DESIRE AND AVAILABILITY MISMATCH**

#### **1. Statement**

Mainstream economics assumes that the desires and goals of individuals are effectively unlimited: that is to say, individuals seek an unlimited quantum of utility, however it may be acquired. Alternatively, it can be said that there may be some limitation on the utility sought by individuals, although such limitation would be at a relatively high order. In turn, the possibility arises that an individual may not be able to completely satisfy or attain the utility that he or she seeks. This may occur because the individual lacks the resources to acquire the utility satisfying item; or because the availability of that item is limited, and perhaps even scarce; or both.

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<sup>61</sup> Gary S Becker, "The Economic Way of Looking at Life" (1992) *Economic Sciences* 38 at 52.

Notwithstanding this, mainstream economics also assumes that the supply and demand for a product at a particular price are matched, that is to say, that supply and demand are in equilibrium. That assumption, in turn, maintains that demand does not exceed supply at the relevant price, which is to say that there is no excess demand. In part, this is because both “demand” and “supply” are always modified by a price assumption: “demand” is demand at a particular price; while “supply” is supply at a particular price. As a result, the goals and desires of consumers may be effectively be limited by the availability of their resources to pay for additional commodities they seek; and the goals and desires of producers may be effectively limited by their ability to produce additional commodities at the prices which purchasers are willing to pay.

## 2. Explanation

In their important article “Existence of An Equilibrium for A Competitive Economy”, Kenneth Arrow and Gerard Debreu sought to prove the existence of an equilibrium for an integrated model of production, exchange and competition, employing what they maintain are, in effect, “more realistic” assumptions than in some other cases.<sup>62</sup> However, many of these assumptions are broadly consistent with mainstream economic assumptions.

Among other things, they assume that there are a finite number of distinct commodities, including services, including spatial and temporal specifications, that is to say, such that the same commodity at two different locations would be regarded as two different commodities. Similarly, the same commodity at two different points in time may be regarded as two separate commodities. Thus, the same commodity instantiated at two different places and at two different times may be considered to be not one, but four separate commodities.

They assume that the commodities are produced in “production units” or firms, each of which has a set of possible production plans involving, among other things, input and output schedules.<sup>63</sup> As they say, “[u]nder the usual assumptions of perfect competition, the *economic* motivation for production is the maximization of profits taking prices as given.”<sup>64</sup>

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<sup>62</sup> Kenneth J Arrow and Gerard Debreu, "Existence of an Equilibrium for a Competitive Economy" (1954) 22:3 *Econometrica* 265 at 266.

<sup>63</sup> *Ibid* at 267.

<sup>64</sup> *Ibid* at 268 [emphasis in the original].

Arrow and Debreu also assume the existence of a number of “consumption units”, typically families or individuals, but also including institutional consumers;<sup>65</sup> and, further, assume that the consumer is not subject to any budgetary restraints. They also assume that “[a]s is standard in economic theory, the choice by the consumer from a given set of alternative consumption vectors is... made in accordance with a preference scale” which reflects the consumer’s utility.<sup>66</sup>

These assumptions may give rise to situations of unsatisfied demand. Even in the situation of one producer and one consumer, the possibility can be envisioned that the producer might maximize profits at a level of production lower than that at which the consumer is able to satisfy his or her entire demand. This may be the case even where the consumer’s resources are unrestricted, such as by income or alternative resource deployment. Moreover, because the specified assumptions include the existence of a finite number of specified commodities, it may be that the availability of an unlimited number of the specified commodities or the specification of an unlimited number of commodities may also result in unsatisfied demand. In all those cases, of course, there is a limit on the availability of commodities which may be sought.

In Arrow and Debreu’s model, “[t]he basic economic motivation in the choice of a consumption vector is that of maximizing utility among all consumption vectors which satisfy the budget restraint, i.e., whose cost at market prices does not exceed the individual’s income.”<sup>67</sup> This is an assumption commonly made in such models. They explain that “the supply and demand for all commodities is determined as a function of [price] (not necessarily single-valued) if we vary [price] and at the same time instruct each production and consumption unit to behave as if the announced value of [price] were the equilibrium value. The market for any commodity is usually considered to be in equilibrium when the supply for that commodity equals the demand”.<sup>68</sup>

They explain that their model generates “the dynamic picture of the classical “law of supply and demand” ... [t]hat is, the price of a commodity rises if demand exceeds supply, falls if supply exceeds demand. Equilibrium is therefore incompatible with excess demand on any market.”<sup>69</sup> The “law of supply and demand”, that is, maintains that supply and demand are equal at each price

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<sup>65</sup> *Ibid.*

<sup>66</sup> *Ibid* at 269.

<sup>67</sup> *Ibid* at 270.

<sup>68</sup> *Ibid* at 271.

<sup>69</sup> *Ibid.*



point. Consequently, according to this “law”, demand is exhausted when prospective purchasers are unwilling to pay more in order to secure additional supply of the relevant commodity; and, similarly, supply is exhausted when prospective suppliers are not willing to supply additional quantities of the relevant commodity at the price for the question.

However, once again, it can be seen that the budget restraint alone may entail the consequence that the individual concerned, acting independently and rationally, is not able to maximize his or her utility. The assumptions of consumer or demand side independence and rationality of action have already been shown to be problematic. The inability to maximize utility as a consequence of the budget restraint assumption introduces the possibility that the individual will be required to reprioritize his or her preferences; and that such required reprioritization may reduce the individual’s aggregate utility. Similarly, on the supply side, the price required to generate additional supply may exceed the limit that prospective purchasers are willing to pay for the commodity. Indeed, they may be willing to pay more for the commodity than the highest point of intersection of the supply and demand curves but not as much they would be required to pay in order for the supplier to make additional quantities of the commodity available.

### **3. Criticism**

These mechanical or mathematical explanations of supply and demand or of production and consumption do not seem to assist us much in our quest to situate the corporation “in the real world” and in legal theory. The assertion that individuals seek only to maximize their own utility has been demonstrated to be highly problematic and, even more, likely inaccurate. Treatment of producers as taking into account only maximizing profits has been suggested to be somewhat misleading. Among other things, these perspectives on consumers and producers of products do not take into account factors underlying demand. The argument that consumers seek to maximize utility does not assist in explaining how it is that certain products or services are expected to maximize utility, which seems to require something in the way of a behavioural explanation.

Indeed, generating supply and demand curves for a “product” seems to depend upon reaching a conclusion as to what a product is and how the particular product concerned differs from other products with respect to certain prescribed indicia (for example, substitutability) such that those other products are not included in the supply and demand curves under consideration. As previously noted, in their discussion of the sociology of markets, Fligstein and Dauter observed

that determining what products are produced and even determining what constitutes a product are both matters that are socially determined.<sup>70</sup>

Likewise, they argue that nation states may influence the types of products which may be exchanged and rules supporting and surrounding exchange; and that specific exchange relations may be deeply affected by cultural meanings behind specific products that are bought and sold.<sup>71</sup> In these ways, demand seems to be affected by aspects of utility that are socially and not individually determined; such that the construction of demand is more complex than methodological individualism would suggest. The supposition that similar social dynamics, with appropriate changes, apply to the supply side may be considered to be not unreasonable.

The assumption of rationality has been closely linked with supply and demand; however, this has not always been the case, at least on the demand side. In his important article “Rationality of Self and Others in an Economic System”,<sup>72</sup> Kenneth Arrow, says that “[a]mong the classical economists, such as Smith and Ricardo, rationality had the limited meaning of preferring more to less” (which seems, at least, anecdotally appealing), and “their rationality hypothesis was the maximization of profits by the firm”.<sup>73</sup> However, “[t]here is no hypothesis of rationality on the side of consumers among the classicists. Not until John Stuart Mill did any of the English classical economists even recognize the idea that demand might depend on price”; or notice that “the demand for any commodity must depend on the prices of all commodities”.<sup>74</sup>

The latter insight was one that Jevons, Walras, and Menger, the “great pioneers of the marginalist revolution” later developed into “their rationality hypothesis for the consumer [which] was the maximization of utility under a budget constraint. With this formulation, the definition of demand as a function of all prices was an immediate implication, and it became possible to formulate the general equilibrium of the economy.”<sup>75</sup>

Our observation above that certain economists assume a homogeneity of utility and in its demand, while others assume the opposite, echoes here in connection with the assumption of rational

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<sup>70</sup> Neil Fligstein and Luke Dauter, "The Sociology of Markets" (2007) 33:6 Annual Rev Sociology 6.1 at 6.9. See the previous discussion in Chapter B2 in the section entitled "Social Construction of Markets".

<sup>71</sup> *Supra* note 70 at 6.9.

<sup>72</sup> Kenneth J Arrow, "Rationality of Self and Others in an Economic System" (1986) 59:4 J Business S385.

<sup>73</sup> *Ibid* at S388.

<sup>74</sup> *Ibid*.

<sup>75</sup> *Ibid*.

behaviour. Arrow explains that in connection with what he describes as “new classical” or “rational expectations” models, strong supplementary assumptions are added to the general model of rationality, of which the “[m]ost prevalent of all is the assumption that all individuals have the same utility function (or at least that they differ only in broad categories based on observable magnitudes, such as family size). But this postulate leads to curious and, to my mind, serious difficulties in the interpretation of evidence.” He asks why, if all individuals are alike, a dispersion is observed in the evidence as to choices actually made. This was discussed previously.<sup>76</sup>

Arrow concludes that “[t]his dilemma is intrinsic. If agents are all alike, there is really no room for trade. The very basis of economic analysis, from Smith on, is the existence of differences in agents.”<sup>77</sup> Arrow argues that the apparent force of the rationality hypothesis “only comes from the addition of supplementary hypotheses”,<sup>78</sup> the deepest of which is homogeneity across individual agents. Without that assumption, he adjudges the rationality hypothesis as weak, but he maintains that this assumption is especially dangerous because “[i]t denies the fundamental assumption of the economy, that it is built on gains from trading arising from individual differences. Further, it takes attention away from a very important aspect of the economy, namely the effects of the distribution of income and of other individual characteristics on the workings of the economy.”<sup>79</sup> Again, this recalls the discussion above in relation to the previous assumption.

While the classical view “emphasized how a complete price system would require individuals to know very little about the economy other than their own private domain of production and consumption”,<sup>80</sup> once it was recognized that demand was a function of all prices, “the individual agent has to know all (or at least a great many) prices and then perform an optimization based on that knowledge. All knowledge is costly, even the knowledge of prices”<sup>81</sup> The dependence of the demand for any commodity upon the prices of all commodities, it may be recalled from Arrow’s discussion of the classical economists, was first observed by “the great pioneers of the marginalist revolution, Jevons, Walras, and Menger” and, as later discovered, by Herman Heinrich Gossen.<sup>82</sup>

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<sup>76</sup> *Ibid* at S389. See the discussion in the present chapter in the section entitled “Similarity of Desires and Utility”.

<sup>77</sup> *Supra* note 72 at S389.

<sup>78</sup> *Ibid* at S390.

<sup>79</sup> *Ibid*.

<sup>80</sup> *Ibid* at S391.

<sup>81</sup> *Ibid*.

<sup>82</sup> *Ibid* at S388. See the discussion in the present work earlier under the present heading at note 72.

On the supply side, “[t]he firm has to know not only prices but a demand curve. Whatever definition is given to complexity of knowledge, a demand curve is more complex than a price. It involves knowing about the behavior of others” and imputes scientific behaviour to them, which “does seem to lead to an infinite regress.”<sup>83</sup> However, it is not only the demand curve that requires knowledge about the behaviour of others. As a minimum, it would seem that construction of the supply curve would also require similar knowledge. Knowledge of other modes of behaviour may also be required.

Significantly, Arrow says that to construct a rationality-based theory of economic behaviour, “the rationality of all agents must be *common knowledge*”.<sup>84</sup> Such rationality has an iterative aspect, since “[e]ach agent must not only know that the other agents (at least those with significant power) are rational but know that each other agent knows every other agent is rational, know that every other agent knows that every other agent is rational, and so forth. It is in this sense that rationality and the knowledge of rationality is a social and not only an individual phenomenon.”<sup>85</sup>

On the demand side, of course, Arrow suggests that an individual, in order to act rationally, is required to perform an optimization based on his or her knowledge of all, or, at least, a great number of, prices attributable, if not to all, then, at least, to a great number of, the products available. Yet logically, as well as in the real world, this may involve, if not an infinite number of products, then at least a very large finite number of such products. This presents a highly complex problem.

#### **4. Discussion**

Accordingly, assumptions concerning the homogeneity of goals and desires, and the one hand, or their heterogeneity, on the other, both lead to substantial logical difficulties. This is also the case with respect to assumptions of rational and independent behaviour. As in the case of other disciplines and fields, lawyers and legal theorists must be aware of these consequences and limitations on the applicability of these generalized assumptions or statements of knowledge.

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<sup>83</sup> *Supra* note 72 at S391.

<sup>84</sup> *Ibid* at S392 [emphasis in the original].

<sup>85</sup> *Ibid* [citation omitted].

## ASSUMPTION SIX – INDEPENDENT RATIONAL INFORMED ACTORS

### 1. Statement

As stated in Chapter B4 in relation to “Atomistic Utilitarianism”, mainstream, that is, classical or neoclassical, economics considers that atomistic individuals who are motivated to seek their own good, satisfaction, or utility engage in economic activity to maximize (or, in some later writing, optimize) their own good, satisfaction, or utility. In discussion of the previous assumptions, particularly in relation to “Atomistic Utilitarianism” under the heading “Desire or Utility and Choice of Substitution”, it has been noted that these individuals are assumed to make choices independently and rationally based on relevant and complete information.

### 2. Explanation

According to the sociologist James A. Coleman, most economists consider an actor “as having goals independently arrived at, as acting independently, and as wholly self-interested”, the “principal virtue [of which view] lies in having a principle of action, that of maximizing utility.”<sup>86</sup> Maximizing utility equates to economic rationality, however, Kenneth Arrow observes that “the everyday usage of the term “rationality” does not correspond to the economist’s definition as transitivity and completeness, that is, maximization of something. The common understanding is instead the complete exploitation of information, sound reasoning, and so forth.”<sup>87</sup> Thus, Arrow claims that economic rationality consists in maximizing utility. Obviously, such a definition of economic rationality excludes certain normal “rational” considerations. Such definition also does not comport with many of the uses of the term “rationality” to which that term is put by economists of a variety of persuasions and in a variety of contexts.

Rationality, considered more generally, is assumed to be the basis on which choices are made. March and Olsen say that not only in modern political science “but throughout modern theoretical work in the social sciences, the pre-eminent vision of human behavior as a vision of choice. Life is characterized as deliberate decisionmaking.”<sup>88</sup> Among other things, rational decision-making is considered to be deliberate and thoughtful.

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<sup>86</sup> James S Coleman, “Social Capital in the Creation of Human Capital” (1988) 94, Supplement, *American J Sociology* S95 at S95.

<sup>87</sup> *Supra* note 72 at S390.

<sup>88</sup> James G March and Johan P Olsen, “The New Institutionalism: Organizational Factors in Political Life” (1984) 78:3 *American Political Science Rev* 734 at 736.

### 3. Criticism

As noted previously, the rational choice assumption of economic decision-making relies on individuals who have complete information relevant to the decision engaging in rational action, in identifying what would be conducive to their utility ordering their preferences accordingly, and taking “rational” steps towards their attainment. Herbert Simon maintains that models of rational choice rely upon specific assumptions as to the “givens” or “constraints within which rational adaptations take place”, including “(1) the set of alternatives open to choice, (2) the relationships to determine the pay-offs (“satisfactions,” “goal attainment”) as a function of the alternative that is chosen, and (3) the preference-orderings among pay-offs.”<sup>89</sup>

As to the achievement of these “pay-offs”, March and Olsen say that the “details of the choice metaphor varied from one treatment to another,” however, “the characteristic form is one that assumes choices stem from two guesses about the future. The first is a guess about the uncertain future consequences of possible current action.”<sup>90</sup> Such a guess requires information about probable consequences, a measure which is subject to the human limitations of precision and bias, as well as limitations as to cost.<sup>91</sup>

March and Olsen explain that “[t]he second guess on which intentional, anticipatory choice is based is a guess about a decision maker's uncertain future preferences for possible future outcomes. In any theory of deliberate choice, action depends on the decision maker's values. Since the consequences of interest are to be realized in the future, it is necessary to anticipate not only what will happen but how the decision maker will feel about those outcomes when they are experienced.”<sup>92</sup> This has been noted in our discussion above.

Further, we have also drawn attention to the fact that the effluxion of time and intrusion of other events, changes in preferences, as well as mispredictions as to how the decision maker will feel about the outcomes sought, and any other factors, may result in the decision maker not attaining the utility or satisfaction sought. March and Olsen make a similar specification, namely, that “[t]he complexities of the second guess are largely ignored by theories of choice. In their standard forms,

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<sup>89</sup> Herbert A Simon, "A Behavioral Model of Rational Choice" (1955) 69:1 Quarterly J Economics 99 at 100.

<sup>90</sup> *Supra* note 88 at 736.

<sup>91</sup> *Ibid.*

<sup>92</sup> *Supra* note 88 at 736-7; citing: JG March, "Bounded Rationality, Ambiguity, and the Engineering of Choice" (1978) 9 Bell J Economics 587.

the theories assume that preferences are stable, thus that current preferences are good predictors of future preferences; that preferences are unambiguous and consistent, thus that a choice will be clearly indicated, given the first guess; and that preferences are exogenous, thus that whatever process generates preferences, it precedes choice and is independent of the choice process.”<sup>93</sup> It has been argued here that these assumptions are problematic and even highly doubtful, factors which contributed, in some degree, to the replacement of “utility” by “revealed preferences”.

Knight argues that “action rarely leads to exactly the intended result, because it is always affected by error”, and also because “ends are never really given”. For example, he says that actual desires are partly a matter of curiosity and that expected surprise is an important element in motivation.<sup>94</sup> Well-being, according to him, is not a matter of seeking the “right” answer to some question but is, instead, to be sought through “intelligent” experiment.<sup>95</sup>

March and Olsen described “revealed preference” theory as “one of the best-developed forms of choice theories” in which “these assumptions about preferences are taken as axioms, and preferences are discovered not by asking decision makers to report them but by defining a “revealed preference” function that satisfies the axioms and is consistent with choices made by a decision maker”.<sup>96</sup> In effect, the axioms plus the actual choices of the decision-maker are assumed to reveal the preferences of such decision maker. It can readily be seen that this is a relationship founded on logical, not empirical, construction. It also accords with Knight’s observations concerning well-being.

The development of revealed preference theory was originally credited to Paul Samuelson in his 1938 article “A Note on the Pure Theory of Consumers’ Behaviour”.<sup>97</sup> However, as indicated in the short description by March and Olsen quoted in the preceding paragraph, the theory also assumes that values held by the individual decision maker do not change over time, an assumption which we have identified as problematic. Further, according to Ackerman, revealed preference theory itself assumes not only that a consumer knows about all of the commodities on the market

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<sup>93</sup> *Supra* note 88 at 737.

<sup>94</sup> Frank A Knight, “Realism and Relevance in the Theory of Demand (1944) 52:4 J Political Economy 289 at 310-311.

<sup>95</sup> *Ibid* at 311.

<sup>96</sup> *Supra* note 88 at 737. For this formulation, they cite: R D Luce & H Raiffa, *Games and Decisions* (New York: Wiley, 1957).

<sup>97</sup> Paul Samuelson, “A Note on the Pure Theory of Consumer’s Behaviour” (1938) 5:17 *Economica*. 61.

and is able to preference order them, but also that the consumer learns of the availability of all new commodities on the market when they become available, and is able to revise their initial preference ordering at once in order to reflect the change.<sup>98</sup>

In order to depict this, Ackerman invokes “a commodity space that, in a modern industrial economy, may have hundreds of thousands of dimensions”;<sup>99</sup> and describes a consumer in such environment as being “lost in commodity space”.<sup>100</sup> Consequently, he admits that “[c]learly, no real person come close to fulfilling this role.”<sup>101</sup> Thus, revealed preference theory is subject to challenge on this ground, and on a number of other grounds.

As noted previously, commentators such as Herbert Simon have indicated that an individual cannot have perfect information as to a matter requiring decision, but must proceed, instead, based on information actually known, and in a manner as closely approximating rational process as possible, that is to say, by employing procedures devised in an attempt to make the best use of the information.<sup>102</sup> Simon’s concept of “bounded rationality” takes into account both limitations of information available to the individual and limitations of cognitive capacity.

In this respect, Simon’s theory differs from “traditional economic theory” which, as described by Simon, “postulates an "economic man," who, in the course of being "economic" is also "rational." This man is assumed to have knowledge of the relevant aspects of his environment which, if not absolutely complete, is at least impressively clear and voluminous. He is assumed also to have a well-organized and stable system of preferences, and a skill in computation that enables him to calculate, for the alternative courses of action that are available to him, which of these will permit him to reach the highest attainable point on his preference scale.”<sup>103</sup> These characteristics of “economic man”, their implications, and criticisms in that behalf have been discussed above.

Instead, Simon sought to “replace the global rationality of economic man with a kind of rational behaviour that is compatible with the access to information and the computational capacities that are actually possessed by organisms, including man, in the kinds of environments in which such

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<sup>98</sup> *Supra* note 39 at p. 131.

<sup>99</sup> *Ibid.*

<sup>100</sup> *Ibid* at 131.

<sup>101</sup> *Ibid.*

<sup>102</sup> *Supra* note 89 at 99.

<sup>103</sup> *Ibid.*



organisms exist.”<sup>104</sup> He indicates that “[l]acking the kinds of empirical knowledge of the decisional process that will be required for a definitive theory, the hard facts of the actual world can, at the present stage, enter the theory only in a relative unsystematic and unrigorous way”<sup>105</sup>, in effect, by “common experience” of such matters. In these respects, we would propose that, instead of the “global rationality” of “economic man”, something approaching “practical rationality” may be considered to be characteristic of “practical economic man”, “real economic man”, or “economic man in the world”.

In this connection, Simon argued that “there is a complete lack of evidence that, in actual human choice situations of any complexity, it [the classically required] computations can be, or are in fact, performed” referring to the “classical” concepts of rationality, including the ability to specify the exact nature of the outcomes (free of “unanticipated consequences”); a complete ordering of pay-offs; and the certainty or definable probability of outcomes of particular alternatives.<sup>106</sup> We have made a similar argument previously in this work. We would also repeat, in passing, the observation that this description of rationality approximates that in use in fields other than economics, contrary to Arrow’s description of “economic rationality” as congruent with utility.<sup>107</sup> Simon posited that, instead of making the classically required computations, a decision maker would formulate “some *aspiration* as to how good an alternative he should find” and that once an alternative was discovered which met this level of aspiration, the decision-maker would terminate that search and choose that alternative, a selection process which he referred to as “satisficing”.<sup>108</sup> Simon himself referred to the existence of a large mass of descriptive data concerning “how human problem solving and decision-making actually take place in a wide variety of situations”<sup>109</sup>, and which were incorporated in a variety of theories which “do not yet constitute a single coherent whole” but which commonly, in one way or another, “incorporate the notions of bounded rationality: the need to search for decision alternatives, the replacement of optimization by targets

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<sup>104</sup> *Ibid.*

<sup>105</sup> *Ibid* at 100.

<sup>106</sup> *Ibid* at 103-104.

<sup>107</sup> See the discussion earlier in this chapter in the section entitled "Desire and Availability Mismatch" and therein under the heading "Criticism", and see the quotation there, *supra* note 73.

<sup>108</sup> Herbert A Simon, "Rational Decision Making in Business Organizations" (1979) 69:4 *American Economic Review* 493 at 503 [emphasis in the original].

<sup>109</sup> *Ibid* at 510.

and satisfy some goals, and mechanisms of learning and adaptation.”<sup>110</sup> Simon counselled against the uncritical use of counterfactual assumptions of classical and neoclassical economics on the grounds that “we have seen, on the contrary, that neoclassical theory does not always lead to the same conclusions at the level of aggregate phenomena and policy as are implied by the postulate of bounded rationality, in any of its variants.”<sup>111</sup>

When Simon asserts that the assumptions of perfect or “classical” rationality may lead to different conclusions from assumptions of bounded rationality, the “difference” may consist in greater correspondence with real world phenomena. Accordingly, this assertion may be seen as an implicit recognition that the assumption of bounded rationality is preferable to that of perfect or “classical” rationality because the assumption of bounded rationality has greater explanatory power with respect to phenomena in the real world. Rejecting an assumption of perfection seems to lead to superior results, hence, Simon applies this perspective to assumptions other than rationality.

Accordingly, he rejects the assumption that rational human behaviour can be accounted for by a handful of invariants, such as perfect adaptation to the environment, arguing that each of these principles “operates in interaction with extremely complex boundary conditions imposed by the environment and by the very facts of human long-term memory and of the capacity of human beings, individually and collectively, to learn.”<sup>112</sup> In this way, he rejects the perfect rationality assumptions of decision making of mainstream economics, preferring, instead assumptions of bounded rationality.

The influences determined to attend upon decision-making were extended and further specified by other behavioural scientists, including economists, and included the very significant contributions of Nobel laureate Daniel Kahneman and of Amos Tversky. For example, “framing effects” describe the effects of “the passive acceptance of the formulation given”.<sup>113</sup> Prospect theory recognizes that perception is reference dependent, such that preferences appear to be defined in

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<sup>110</sup> *Ibid.*

<sup>111</sup> *Ibid.*

<sup>112</sup> *Ibid.*

<sup>113</sup> Daniel A Kahneman, "A Perspective on Judgment and Choice: Mapping Bounded Rationality" (2003) 58:9 *American Psychologist* 697 at 703.

relation to a reference point. Consequently, for example, changes in wealth might affect attitudes to risk more than would the quantum of wealth itself.<sup>114</sup>

Similarly, loss aversion explains the “familiar observation that out-of-pocket losses are much more distressing than foregone gains”.<sup>115</sup> Richard Thaler identified a particular example of loss aversion which he called the “*endowment effect*: the finding that the “maximum amount that people pay to acquire a good is commonly much less than the minimal amount they demand to part from it once they own it.”<sup>116</sup> Kahneman concluded that “[t]he interpretation is straightforward: A good is worth more when it is considered as something that could be lost or given up than when it is evaluated as a potential gain.”<sup>117</sup>

Kahneman and Tversky also determined that “people rely on a limited number of heuristic principles which reduce the complex tasks of assessing probabilities in predicting values to simpler judgemental operations”<sup>118</sup>, which heuristics can be quite useful sometimes but can sometimes lead, instead, to severe and systematic errors<sup>119</sup>, including heuristically induced bias. Their 1974 review article described “three heuristics of judgment, labelled representativeness, availability, and anchoring,... along with a dozen systematic biases, including non-regressive prediction, neglect of base-rate information, overconfidence, and overestimates of the frequency of events that are easy to recall.”<sup>120</sup> Kahneman and other collaborators also “propose that an automatic affective evaluation – the emotional core of an attitude – is the main determinant of many judgments and behaviours”<sup>121</sup>, which is to say that judgments and behaviours are often determined emotively,

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<sup>114</sup> *Ibid* at 704.

<sup>115</sup> *Ibid* at 705.

<sup>116</sup> *Ibid* [emphasis in the original]. Kahneman cites: RH Thaler, "Toward a Positive Theory of Consumer Choice" (1980) 1 J Economic Behavior and Organization 39. In support of this finding, Kahneman cites: D Kahneman, JL Knetsch, J & RH Thaler, "Experimental Tests of the Endowment Effect and the Coase Theorem" (1990) 98 J Political Economy 1325; D Kahneman, JL Knetsch, & RH Thaler, "The Endowment Effect, Loss Aversion, and Status Quo Bias" (1991). 5 J Economic Perspectives 193; and A Tversky & D Kahneman, "Loss Aversion in Riskless Choice: A Reference-Dependent Model" (1991) 106 Quarterly J 1039.

<sup>117</sup> *Supra* note 113 at 705.

<sup>118</sup> *Ibid* at 707, citing Amos Tversky and Daniel Kahneman, "Judgment Under Uncertainty: Heuristics and Biases" (1974) 185 Science 1124 at 1174.

<sup>119</sup> *Supra*, note 113 at 707.

<sup>120</sup> *Ibid*.

<sup>121</sup> *Ibid* at 710, citing: D Kahneman & I Ritov, (1994) "Determinants of Stated Willingness to Pay for Public Goods: A Study in the Headline Method" (1994) 9 J Risk and Uncertainty 5; and D Kahneman, I Ritov, & D Schkade, Economic Preferences or Attitude Expressions? An Analysis of Dollar Responses to Public Issues (1999). *Economic preferences or attitude expressions? An analysis of dollar responses to public issues*. 19 J Risk and Uncertainty 220.

rather than rationally. Unfortunately, in spite of their intrinsic interest, time does not permit a further excursion into these issues.

#### **4. Discussion**

As demonstrated in this section and previously, social scientists, including economists, have criticized the “rational choice” assumptions of classical and neoclassical economics and have, instead, adopted principles concerning “bounded rationality” and advances of “behavioural economics”. Accordingly, to the extent that the perspectives of mainstream economics concerning decision-making are sought to be applied in analyzing and regulating participants in the economy, such as the economic “firm” or the legal “corporation”, such an approach must be rejected or amended to conform work closely with “bounded rationality” and “behavioural economics” approaches to decision-making.

### **ASSUMPTION SEVEN – UTILITARIAN INDEPENDENT MARKET TRANSACTIONS**

#### **1. Statement**

As stated in Chapter B4 in the section entitled “Atomistic Utilitarianism”, mainstream, that is, classical or neoclassical, economics considers that atomistic individuals who are motivated to seek their own good, satisfaction, or utility engage in economic activity to maximize (or, in some later writing, optimize) their own good, satisfaction, or utility. Mainstream economics also assumes that these individuals make choices rationally based on relevant and complete information, an assumption demonstrated here to be highly problematic. It has also been demonstrated here that the quest for subjective utility may be ephemeral and unsustainable. It is also assumed by mainstream economics that these atomistic individuals pursue their own utilitarian goals and objectives independently through market transactions. This last point will be taken up in this section.

#### **2. Explanation**

As noted above, according to Coleman, most economists consider an actor “as having goals independently arrived at, as acting independently, and as wholly self-interested” the “principal virtues [of which view] lie in having a principle of action, that of maximizing utility.”<sup>122</sup> Maximizing utility equates to economic rationality, as to which Kenneth Arrow observes that “the

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<sup>122</sup> *Supra* note 86 at S95.

everyday usage of the term "rationality" does not correspond to the economist's definition as transitivity and completeness, that is, maximization of something. The common understanding is instead the complete exploitation of information, sound reasoning, and so forth."<sup>123</sup> This point has been discussed above in the section entitled "Independent Rational Informed Actors".

Rationality is assumed to be the basis on which choices are made. We restate here March and Olsen's observation that not only in modern political science "but throughout modern theoretical work in the social sciences, the pre-eminent vision of human behavior as a vision of choice. Life is characterized as deliberate decisionmaking."<sup>124</sup> Simon and others purport to accept the choice paradigm, but reject the assumption of complete rationality in favour of "bounded" rationality.

For present purposes, what is important is that these choices are exercised by decision makers in the context of a market. We have previously argued that the market is socially constructed, with the result that the decision maker who acts in the market does not do so in an atomistic or methodologically individualistic capacity, or completely "independently", but acts, instead, in a socially constructed sphere of action and in accordance with his or her expectations of the behaviour of others.

Kenneth Arrow allows that "the possibility of rational expectations cannot be denied. But they require not only extensive first-order knowledge but also common knowledge, since predictions of the future depend on other individuals' predictions of the future."<sup>125</sup> This has been discussed here previously. Indeed, Arrow argues that "rationality is not a property of the individual alone, although it is usually presented that way. Rather, it gathers not only its force but also its meaning from the social context in which it is embedded."<sup>126</sup> This recalls our discussion of Arendt's characterization of "reality" as the product of common recognition among individuals.<sup>127</sup>

Arrow takes pains to ensure that his observation of the social nature of reality is not limited only to theory. He goes on to say that "rationality in application is not merely a property of the

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<sup>123</sup> *Supra* note 72 at S390.

<sup>124</sup> *Supra* note 88 at 736.

<sup>125</sup> *Supra* note 72 at S394.

<sup>126</sup> *Ibid* at S385.

<sup>127</sup> See the discussion in Chapter B4 in the section entitled "Assumption Two – Atomism and Methodological Individualism" under the heading "Criticism" and therein under the subheading "Emergence of Institutions"; referring, in turn, to the discussion in Chapter B1 in the section entitled "Actual and Analytical Separation of Private and Public Spheres", particularly under the heading "The" Public Realm" and Private Realm" of Arendt".

individual” but, instead, “[i]ts useful and powerful implications derived from the conjunction of individual rationality and the other basic concepts of neoclassical theory – equilibrium, competition, and completeness of markets.”<sup>128</sup> Of course, the notions of equilibrium and competition, as well as completeness of markets, all relate in some way to markets, which are often considered to be a paradigmatic example of the social construction of reality.

At the same time, a definite substratum of Arrow’s analysis is the notion that markets are rational. This is, of course, consistent with his observation that rationality in application relates to the other basic concepts of neoclassical theory which he mentions. These include, importantly, matters relating to markets. Having said that, Arrow also admits, that “[r]ationality also seems capable of leading to conclusions flatly contrary to observation.”<sup>129</sup> He may be distinguishing between “rationality in application” as being at least partly socially derived and “rationality in theory” and expressing the view that rationality and theory may lead to results not borne out by observation. On the other hand, he may be returning to his treatment of neoclassical “rationality”, in theory, as signifying only utility. Although interesting, resolution of this issue need not detain us.

### 3. Criticism

As indicated at the beginning of this discussion under the heading “Statement”, this chapter has considered the proposition that atomistic individuals motivated to seek their own utility engage in market transactions, acting independently and rationally, based on complete relevant information, for that purpose. Each of the elements of this proposition have been discussed in the immediately preceding chapter and in this chapter. The nature of human individuals positive by economics as exclusively self-interested in their pursuit of their desires, own good, and satisfaction was discussed in B4.<sup>130</sup> The atomism of human individuals and the related subjects of methodological individualism, reductionism, and aggregation were also discussed in that chapter.<sup>131</sup>

Accordingly, the present chapter up to this point has examined various matters relating to how the posited atomistic individual independently acquires knowledge of, formulates, or determines his or her desires and goals and expectations of their satisfaction.<sup>132</sup> This chapter has discussed the

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<sup>128</sup> *Supra* note 72 at S387. He cites Frank Knight as having first made these assumptions explicit.

<sup>129</sup> *Ibid* at S398.

<sup>130</sup> See the discussion in the section entitled “Atomistic Utilitarianism”.

<sup>131</sup> See the discussion in the section entitled “Atomism and Methodological Individualism”.

<sup>132</sup> See the discussion in the section entitled “Individual Determination of Utility”.

independence, identity, similarity and dispersion of desires and utility,<sup>133</sup> and constraints on achievement of desires, goals, or utility.<sup>134</sup> The behaviour of human individuals independently from one another and acting completely “rationally” and with full and complete information was also the subject of discussion in the present chapter.<sup>135</sup> Finally, the pursuit of such desires, goals, or utility by means of independent market transactions is the subject of discussion in the present section.

The subject of utilitarian independent market transactions involves questions concerning whether individuals determine their utility completely independently, which has been discussed earlier in this chapter,<sup>136</sup> and the question whether market actions or market transactions can be effected by human individuals completely independently, which is discussed in the present section. As noted in Chapter B4,<sup>137</sup> Kirman argues that the independence of individual action posited by economics for centuries does not deny the existence of any interaction among individuals.<sup>138</sup> It is apparent that there is such interaction.

Kirman quotes Samuelson, who analogized such interaction to “individualistic atoms of the rare gas in my balloon”, and said that they “are not isolated from the other atoms”, eventually claiming that even Adam Smith “would have stressed... that the contacts between the atoms [individuals] were *organized* by the use of markets and prices.”<sup>139</sup> Kirman says that Samuelson is objecting here to the argument that “once the appropriate signals are given, individuals behave in isolation and the result of their behaviour may simply be added together”,<sup>140</sup> in effect to produce aggregate supply or demand curves, as the case may be. As noted in the immediately preceding paragraph, the problem of aggregation is the subject of discussion in B4.<sup>141</sup>

Rosenbaum objects that such unobservable and merely hypothesized demand curves intersect at a transactional point or Walrasian market which is “devoid of any institutional, spatial or social

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<sup>133</sup> See the discussion in the section entitled “Similarity Desires and Utility”.

<sup>134</sup> See the discussion in the section entitled “Desire and Availability Mismatch”.

<sup>135</sup> See the discussion in the section entitled “Independent Rational Informed Actors”.

<sup>136</sup> See the discussion in the section entitled under the heading “Individual Determination of Utility”.

<sup>137</sup> See the discussion in the section of Chapter B4 entitled “Atomism and Methodological Individualism” under the heading “Criticism” and therein under the subheading “The Nature of Aggregation”,

<sup>138</sup> *Supra* note 3 at 137.

<sup>139</sup> *Ibid* [emphasis in the original].

<sup>140</sup> *Ibid*.

<sup>141</sup> *Supra* note 137.

features".<sup>142</sup> Walrasian markets and market equilibrium are discussed below.<sup>143</sup> Kirman maintains, of course, that the classical assumption of independence of action of individuals does not conflict with the existence of some degree of interaction between or among them. As argued above, organization of contacts, whether conscious or otherwise, constitutes a form of social action. Markets are socially constructed.

In this regard, the nature and role of markets in economic theory is investigated in Chapter B2,<sup>144</sup> guided by a review article by Rosenbaum.<sup>145</sup> The social construction of markets is likewise investigated in Chapter B2,<sup>146</sup> guided on this subject by a review article by Fligstein and Dauter.<sup>147</sup>

#### 4. Discussion

In conclusion, as demonstrated in B2, the assumption of neoclassical economics that market transactions take place between or among atomized individuals acting independently and rationally seeking to maximize their own utility must be rejected as an empirical description of reality. As such, that assumption and others based upon it should be rejected as a principle which may be used empirically by legal theorists, commentators, legislators, regulators, and judges, whether in relation to the corporation or otherwise ("legal readers").

As previously noted, legal readers of economically oriented academic and other materials, particularly those who lack a background in economics, should exercise due care in relying upon economic discourse and other discourse seeking to apply or involve economic terms, principles, assumptions, and practices. Special heed should be paid to unstated or underlying terms, principles, assumptions, and practices that are not specifically identified to readers.

Those who seek to engage in legal discourse and seek assistance in economic discourse should be particularly attuned to the differences in the use of terms, principles, assumptions, and practices as between law, on the one hand, and economics and other social sciences, on the other. The present work has sought to juxtapose terms, principles, assumptions, and practices applied in economic

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<sup>142</sup> Eckehard F Rosenbaum, "What is a Market? On the Methodology of a Contested Concept" (2000) 58:4 Rev Social Economy 455 at 459.

<sup>143</sup> See the discussion in the section entitled "Market Prices Tend Towards An Equilibrium".

<sup>144</sup> See the discussion in in the section entitled "Markets in Economic Theory".

<sup>145</sup> *Supra* note 142.

<sup>146</sup> See the discussion in the section entitled "Social Construction of Markets".

<sup>147</sup> *Supra* note 70.



discourse, particularly in classical and neoclassical theory, with those extant in other social sciences, and in the legal field. This practice will continue throughout the present work.

## **ASSUMPTION EIGHT – MARKET PRICES TEND TOWARDS AN EQUILBRIUM**

### **1. Statement**

Alan Kirman, in his review of General Equilibrium Theory, indicates that it is “regarded by many as the summum of the ‘grand neo-classical synthesis’” and, although subjected to varied and systematic criticism, “still furnishes the basic foundations of what many are pleased to call ‘mainstream economics’.”<sup>148</sup>

### **2. Explanation**

As noted in our discussion in the section entitled “Desire and Availability Mismatch”, Arrow and Debreu credited the origination of General Equilibrium Theory to Leon Walras, who described the economy at any point in time “as the solution of a system of simultaneous equations representing the demand for goods by consumers, the supply of goods by producers, and the equilibrium condition that supply equal demand on every market.” In turn, this involved assuming “that each consumer acts so as to maximize his utility, each producer acts so as to maximize his profit, and perfect competition prevails, in the sense that each producer and consumer regards the prices paid and received as independent of his own choices.”<sup>149</sup> Consequently, it may be said that the “market price” of any commodity is determined invariantly by supply and demand. These issues have been reviewed and their analysis by orthodox economics found at least problematic and, more properly, erroneous, in the text above.

Rosenbaum indicates that “the market is synonymous with (the intersection of) unobservable and merely hypothesized demand and supply (curves) and devoid of any institutional, spatial or social features, and where each individual market is part of a set of interrelated markets that make up the economy as a whole and that is seen is jointly determining a vector of relative prices and an associate allocation of commodities.”<sup>150</sup>

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<sup>148</sup> *Supra* note 3 at 126.

<sup>149</sup> *Supra* note 62 at 265. Their cite is: L Walras, *Elements d'economie politique pure*, 4eme Edition, (Lausanne, Paris, 1900) at 20 and 491.

<sup>150</sup> *Supra* note 142 at 459. His cite is to G Debreu, *Theory of Value? An Axiomatic Analysis of Economic Equilibrium* (New York: Yale, 1959).

Samuel Hollander, an economist well known for his work in the history of classical economics, writes that Adam Smith's "cost of production theory whereby competition, through the operation of supply and demand, assures that market prices gravitate towards their "natural" prices defined as the sum of the unit wage, profit and rent cost, the factors paid at their "natural" rates."<sup>151</sup> In effect, this "natural" state is general equilibrium. Hollander describes this as "the *true* classical tradition" as taken up by John Stuart Mill and later by W. Stanley Jevons and Alfred Marshall. Hollander takes issue with Schumpeter's finding that "Ricardo's procedures were diametrically opposed to the spirit of general equilibrium."<sup>152</sup> The details of this history need not concern us.

### 3. Criticism

General Equilibrium Theory and criticisms of the same have been discussed previously in this chapter, most particularly in the discussion in the section entitled "Atomistic Utilitarianism" in Chapter B4 and in the sections entitled "Similarity of Desires and Utility" and the immediately preceding "Utilitarian Independent Market Transactions" in the present chapter. Consequently, the present section will mention only a few additional criticisms.

In their discussions of Walrasian equilibrium, as just noted under the heading "Explanation", Arrow and Debreu indicate that Walras did not provide "any conclusive arguments to show that the equations, as given, have a solution."<sup>153</sup> Thus, Walras left proof of the theory to others. Such proof appears from the commentary cited below to have been elusive.

The elements of the theory of general equilibrium have been variously challenged, including by Milton Friedman. Friedman criticized the Marshallian demand curve, among other things, on the ground that that "[d]emand and supply are to him concepts for organizing materials, labels in an "analytical filing box." The "commodity" for which a demand curve is drawn is another label, not a word for a physical or technical entity to be defined once and for all independently of the problem at hand."<sup>154</sup> Friedman maintains that Marshall treats commodities other than the one which is the

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<sup>151</sup> Samuel Hollander, "Smith and Ricardo: Aspects of the Nineteenth-Century Legacy" (1977) 67:1 *American Economic Rev* 37 at 41.

<sup>152</sup> *Ibid.* His cite is: Joseph A. Schumpeter, *History of Economic Analysis* (New York: 1954) at 568ff. [emphasis in the original].

<sup>153</sup> *Supra* note 62 at 266.

<sup>154</sup> Milton Friedman, "The Marshallian Demand Curve" (1949) 57:6 *J Political Economy* 463 at 469.

focus of immediate attention at the particular time only in groups and treats only their average price as relevant.<sup>155</sup>

Clearly, the specifications of the commodity in question, closely related commodities, and all other commodities are highly significant. Philip Mirowski argues that neoclassical theory, contrary to its claims to be based on individual behavior and the coordination activities of a market, has had little to say about the “dual coincidence of wants” [A wants “commodity” one and B has and wants to sell commodity one and buy commodity two] and the problems of getting the trading activities of numerous individual actors to mesh.<sup>156</sup>

Mirowski’s point is that markets are based on the complementary objectives of a willing buyer and a willing seller of a specified commodity. How their interaction arises requires explanation, and, as argued in this work, this is difficult to imagine without some form of social interaction. Moreover, standardizing commodity identities is another important aspect of the function of the market.<sup>157</sup> Mirowski assumes that both the specification of the identity of commodities and the institution of a connected trading market are, necessarily, social activities.<sup>158</sup> The present work has noted frequently that commodification, like other aspects of the market, is a social phenomenon.

Friedman also criticizes Marshall’s stasis or *ceteris paribus* assumption concerning the derivation of the demand curve arguing, among other things, that when it is said that a demand curve shows the quantity of the commodity that will be purchased by the group per unit of time at each price, “all other things being the same”, the word “same” does not mean “same over time”, nor does it or can it, without emasculating the concept, mean that literally “all” other things remain the same.<sup>159</sup> Friedman maintains that different specifications of the “other things” will yield different demand curves.

As to equilibrium, Kirman points out that a frequent criticism of general equilibrium theory is “that the underlying hypothesis of individual maximization is inappropriate and that such an assumption

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<sup>155</sup> *Ibid* at 464.

<sup>156</sup> Philip Mirowski, "Postmodernism and the Social Theory of Value" (1991) 13:4. *J Post Keynesian Economics* 565 at 569. He cites: Robert Clower, *Money and Markets*. (New York: Cambridge University Press, 1984); J Ostroy and R Starr, "Money and Decentralization of Exchange" (1974) 42 *Econometrica* 1093; and John Eckalbar, "Money, Barter and Convergence to Competitive Allocation" (1984) 32 *J Economic Theory* at 201.

<sup>157</sup> *Supra* note 156 at 570-571.

<sup>158</sup> *Ibid* at 571.

<sup>159</sup> *Supra* note 154 at 464.

is unnecessarily restrictive.”<sup>160</sup> This aligns with the discussion and conclusions presented in Chapter B4 in relation to “Atomistic Utilitarianism”.

As noted previously, the second common criticism Kirman mentions is that “general equilibrium lacks any results as to the stability or uniqueness of equilibrium that can be derived from the standard assumptions on the endowments, production possibilities and preferences of individuals.”<sup>161</sup>

Thirdly, Kirman adopts the argument of Michio Morishima that a general equilibrium solution, even if proven, could not be realized without the necessary institutional backing. Accordingly, any such equilibrium solution “will amount to no more than a utopian state of affairs which bears no relation whatsoever to the real economy.”<sup>162</sup> This third criticism seems to be consistent with more general criticisms, such as by Granovetter<sup>163</sup> and by Hirschman,<sup>164</sup> concerning the idealized markets, devoid of influence from social structure, social contact, or other social interaction, which are posited by classical and neoclassical economics. These were discussed in more detail in relation to the assumption “Individual Determination of Utility” at the beginning of the present chapter.

Ackerman, like Kirman, draws attention to the fact that a general equilibrium solution cannot be proven either to be unique or to be stable.<sup>165</sup> Instead, he says that the Sonnenschein-Mantel-Debreu (SMD) theorem<sup>166</sup> shows that “almost any continuous pattern of price movements can occur in a general equilibrium model, so long as the number of consumers is at least as great as the number of commodities. Cycles of any length, chaos or anything else you can describe, will arise in a general equilibrium model for some set of consumer preferences and initial endowments. Not only does the general equilibrium fail to be reliably stable; its dynamics can be as bad as you want them

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<sup>160</sup> *Supra* note 3 at 127.

<sup>161</sup> *Ibid.* See the discussion in the section entitled “Similarity of Desires and Utility” under the heading “Dispersion of Desires and Utility”.

<sup>162</sup> *Ibid.* His cite to Morishima is to: M Morishima, “The Good and Bad Uses of Mathematics” in P Wiles and G North, eds, *Economies in Disarray* (Oxford: Basil Blackwell, 1984). See the discussion in this chapter in the section entitled “Similarity of Desires and Utility” under the heading “Dispersion of Desires and Utility”.

<sup>163</sup> *Supra* note 7, at 483.

<sup>164</sup> *Supra* note 8 at 1473.

<sup>165</sup> *Supra* note 39, at 121-122. See the discussion in the section entitled “Similarity of Desires and Utility” under the heading “Dispersion of Desires and Utility”.

<sup>166</sup> Ackerman refers by this means to the basic finding about instability initially presented by Sonnenschein, as generalized by Mantel and by Debreu. His cites are: H Sonnenschein, “Market Excess Demand Functions” (1972) 40 *Econometrica* 549; R Mantel, “On the Characterization of Aggregate Excess Demand” (1974) 7 *J Economic Theory* 348; and Gerard Debreu, “Excess Demand Functions” (1974) 1 *J Mathematical Economics* 15.

to be.”<sup>167</sup> Ackerman maintains, to the contrary, that “the SMD theory proved that there is no hope of showing that stability is a generic property of market systems,”<sup>168</sup> which “should challenge the foundations of economic theory.”<sup>169</sup> If correct, these criticisms seem to the non-economist, at least, to be critical, highly problematic, and possibly even fatal, objections to equilibrium theory and, possibly, as Ackerman maintains, to orthodox economic theory generally.

Ackerman asserts that “[r]ecent accounts identify two causes of the finding of instability: the inherent difficulties of aggregation, and the individualistic model of consumer behaviour... [both] present in neoclassical theory since its beginnings.<sup>170</sup> Both of these matters have been discussed and criticized in the present work previously.<sup>171</sup> It has been noted, as well, that Kirman also criticizes the assumption of individual maximization of utility.

It is interesting that Ackerman concludes that “[m]odification of economic theory to overcome these underlying problems will require a new model of consumer choice, nonlinear analyses of social interactions, and recognition of the central role of institutional and social constraints.”<sup>172</sup> Such a modification of economic theory would, of course, represent a substantial abnegation of classical and neoclassical economic theory. What Ackerman proposes is that the assumptions of aggregation and individualistic behaviour associated with the neoclassical model must be discarded, he says, in order to “make economics more realistic”.<sup>173</sup> He concludes, then, that classical and neoclassical economics are not, and should be, more relevant to the real world.

Kirman likewise concludes that “recent theoretical work is shown how little the Walrasian model has to say about aggregate behaviour. Economists therefore should not continue to make strong assertions about this behaviour based on so-called general equilibrium models which are, in reality,

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<sup>167</sup> *Supra* note 39 at 122.

<sup>168</sup> *Ibid* at 133.

<sup>169</sup> *Ibid*.

<sup>170</sup> *Ibid* at 119.

<sup>171</sup> With respect to aggregation, see the discussion in Chapter B4 in the section entitled "Atomistic Utilitarianism", in particular, under the heading "Criticism" and under the subheading "The Problem of Aggregation"; and in the section entitled "Atomism and Methodological Individualism" under the heading "Criticism". With respect to the individualistic model of consumer behaviour, see the discussion in Chapter B4 in the sections entitled "Atomistic Utilitarianism" and "Atomism and Methodological Individualism"; and in the present chapter in all the preceding sections.

<sup>172</sup> *Ibid*.

<sup>173</sup> *Ibid* at 136.

no more than special examples with no basis in economic theory as it stands.”<sup>174</sup> Kirman, then, finds that the Walrasian model does not adequately model actual human economic behaviour.

From this review, it can be concluded that the problem of aggregation and the individualist model of consumer behaviour are the subject of considerable comment and criticism by modern economists, not only in relation to the general equilibrium model, but also more generally, and, moreover, to such an extent as to call for the rejection of such assumptions. Since those assumptions are at the heart of classical and neoclassical economic theory, such a reassessment and rejection would seriously affect their continuing relevance.

Ackerman argues that “it is more obvious in practice than in theory that large, complicated market economies are usually stable. If it is so difficult to demonstrate that stability is endogenous to a market economy, perhaps it is exogenous.”<sup>175</sup> He suggests that such “exogenous factors such as institutional contexts, cultural habits and political constraints may provide the basis for stability, usually damping the erratic endogenous fluctuations that could otherwise arise in a *laissez-faire* economy.”<sup>176</sup> Of course, these exogenous factors are contrary to the neoclassical assumptions of atomistic rational actors acting independently and seeking to maximize their own personal utility.

Ackerman indicates that there are other approaches closer to conventional theory that also make institutions central to economic analysis, including what David Colander calls “post-Walrasian macroeconomics”. As described by Ackerman, “Colander...identifies three distinguishing characteristics of the post-Walrasian perspective. First, the equations necessary to describe the economy have multiple equilibria and complex dynamics. Second, individuals act on the basis of local, bounded rationality, since global rationality is beyond anyone’s information processing capabilities. Finally, institutions and non-price coordinating mechanisms are the source of systemic stability in a market economy. Colander refers to the last of these characteristics as establishing the macrofoundations of microeconomics.”<sup>177</sup>

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<sup>174</sup> *Supra* note 3, at 138.

<sup>175</sup> *Supra*, note 39 at 135.

<sup>176</sup> *Ibid* [emphasis in the original].

<sup>177</sup> *Ibid*. He cites David Colander, ed, *Beyond Microfoundations: Post-Walrasian Macroeconomics*, (New York: Cambridge University Press, 1996).

Time does not permit an excursion into the complexities of new institutional economics; however, it is possible that post-Walrasian economics and institutional economics, in particular, may contribute to solving some of the difficulties of Marshallian and Walrasian economics.

#### **4. Discussion**

The present review has demonstrated some of the difficulties of general equilibrium theory, some of the reasons giving rise to those difficulties, inhibiting its acceptance, and, moreover, supporting its rejection.

#### **CONCLUSION**

It is submitted that the present review has demonstrated that the assumptions or generalizations of classical and neoclassical economics have been criticized by modern mainstream economists of differing theoretical perspectives, and have been established to be, at best, highly problematic. The extent to which this is true is illustrated, somewhat comically, by Alan Kirman in giving his paper “The Intrinsic Limits of Modern Economic Theory” the subtitle “The Emperor has No Clothes”.

In view of the highly problematic nature of the assumptions and generalizations of classical and neoclassical economics, the application of such assumptions and generalizations to, and their use in, legal theorizing, including theorizing about the nature of the corporation, should be carefully considered, and should be regarded as highly problematic.

Further, chapters in the main text of this book argue that the characterization of the firm or of the corporation by classical and neoclassical economics as an agent or actor in economic activity “in the real world” is similarly highly problematic. This discussion begins in Chapter Two.

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