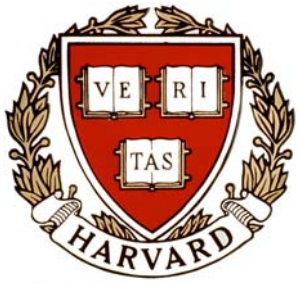

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Corporations

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CORPORATIONS

Randall Morck

Abstract

A corporation is an artificial person created for an economic purpose, as described in various aspects of the Theory of the Firm. Recent historical and comparative research shows that corporations in most countries come in groups, each controlled by a single principal. This has implications for various "theories of the firm". The perception that firms ought to be run to maximize shareholder value, though commonplace in financial economics, is also problematic in application.

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Corporations

Randall Morck

A *corporation* is an artificial person, with many of the legal rights of a biological one. This modern legal and economic usage arose in the 16th century from the term's now archaic meaning of 'a group acting as one body' – encompassing municipal governments, businesses, and other groups of individuals united towards a common goal. In that century and the next, trade with the Orient and New World promised immense returns, but only after vast capital outlays for fleets of ships, networks of forts, and private armies to defend them. The first business corporations, such as the Dutch East Indies Company, the British East India Company, and the Hudson's Bay Company, were formed to pool the savings of many individuals and permit ventures on a scale none could afford individually. Each owner of a *share* of the corporation was periodically entitled to a *dividend* – a *pro rata* division of the corporation's free cash flow.

Polling all a corporation's shareholders for each business decision was impractical in an age of sailing ships and horse-drawn carriages. Instead, the shareholders elected *boards of governors* (later *directors*) – reputable men trusted by the majority of shareholders to direct the corporation's affairs.

This did not prevent all dispute. The Dutch East Indies Company (*Vereenigde Oostindische Compagnie* in Dutch) was formed as a limited time venture. When that limit drew near, the board boldly announced that the corporation would persist indefinitely. The shareholders sued to force a liquidating dividend – and lost! Fortunately, they found they could sell their shares to other investors for the value of a liquidating dividend – or even more (Frentrop, 2002/3). Thus was born the first modern stock market, and the *alienability*, or unhindered sale, of shares became a defining characteristic of a corporation. Letting shareholders realize their investments by selling their shares, rather than liquidating the business, gave corporations a second defining characteristic: *indefinitely long lives*.

Boards occasionally betrayed their shareholders' trust and caused a corporation to contravene the law. Since individual shareholders were not consulted, holding them fully to account for the corporation's misdeeds seemed wrong. Since the corporation is a legal person, plaintiffs could sue it directly, and need not sue its shareholders personally. Thus, *limited liability* statutes came to shield individual shareholders from personal lawsuits for wrongs by corporations whose shares they own. Limited liability, a third defining characteristic of the modern business corporation, is an important innovation because it frees individuals to invest their savings in corporations run by strangers, undertaking risky ventures, or doing business in far off places. Vulnerability to personal lawsuits would otherwise make such investments seem indefensibly reckless to most savers.

Early corporations, like the Hudson's Bay Company, assigned one vote to each share in board elections. This essentially let the wealthiest shareholders appoint the board and, if they wished, run the corporation in their narrow interest, rather than in the interests of all shareholders equally. For example, a large shareholder might force the corporation to do business with another corporation she controlled on disadvantageous terms. This sort of self-dealing, which Johnson et al. (2000) dub *tunneling*, remains a widespread corporate governance concern where firms typically have dominant

shareholders. Or a dominant shareholder might simply relish the perks, power, and prestige of running the corporation, and refuse to make way for more qualified managers – a corporate governance problem called *entrenchment* (Morck, Shleifer, and Vishny, 1988). Entrenchment and tunneling provide controlling shareholders with *private benefits of control* – returns not shared with small shareholders (Dyck and Zingales, 2004). Distorted corporate governance associated with private benefits of control remains a first order governance concern wherever corporations typically have controlling shareholder. According to La Porta et al. (1999), this includes the large corporate sectors of virtually all countries except Germany, Japan, the United Kingdom, and the United States. Small and middle sized corporations everywhere tend to have controlling shareholders.

In the 19th century, *democratic* corporate governance became associated with *one vote per shareholder*, rather than one vote per share (Dunlavy, 2004). Echoes of this remain in the *voting caps* of modern Canadian and European corporations, which limit any single shareholder's voting power regardless of shares owned. However, large shareholders in many countries later turned deviations from one vote per share to their advantage by granting themselves special classes of common stock with many votes per share. In most countries, such *dual class shares* now virtually always magnify, rather than limit, the voting power of large shareholders, and so amplify, rather than dampen, problems associated with private benefits of control (Nenova, 2003).

In the United States and the United Kingdom, however, one vote per share is the norm in shareholder meetings. Disclosure rules, regulatory oversight, officer and director liability, and other restraints on private benefits of control also seem more effective in America and Britain than elsewhere in curtailing private benefits of control (LaPorta et al, 1999; Dyck and Zingales, 2004). This makes being a large shareholder less attractive, especially if holding a diversified portfolio of small stakes in many firms reduces risk (Burkart et al., 2003). Unsurprisingly, most large American and British corporations now lack controlling shareholders (LaPorta et al., 1999). They are run by professional managers who often own few shares (Morck et al., 1988).

A small shareholder who monitored and controlled these corporate top managers would bear all the investigative, legal, and administrative costs involved, but the benefits of better governance would be spread across all shareholders. The cost therefore typically exceeds the benefit for any small shareholder acting alone (Grossman and Hart, 1988). The consequent general lack of monitoring and control in corporations with no large shareholder gives rise to *other people's money* corporate governance problems. Adam Smith (1776) famously explains that since corporate managers who own few or no shares are more "the managers of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they ... consider attention to small matters as not for their master's honour and very easily give themselves a dispensation from having it." Unmonitored professional managers can thus enjoy the perks and privileges of running large corporations without any real concern for the returns they generate. Berle and Means (1932) argue that this sort of governance problem occurs in many large American corporations.

But in other countries, other people's money governance problems probably also afflict many corporations that, on first inspection, seem to have a controlling shareholder.

This is because large corporations in most countries are not freestanding entities, but belong to *corporate groups* (LaPorta et al., 1999). These are typically pyramidal structures, in which an apex shareholder, usually an extremely wealthy family, controls one or more listed corporations, which each control more listed corporations, which each control yet more listed corporations, *ad valorem et infinitum*. A family that controls 51% of a listed corporation that controls 51% of another that controls 51% of yet another and so on actually owns only 0.51^n of the corporation *n* tiers down the in pyramid, with the remained of each corporation financed by public or minority shareholders. Pyramids with a dozen or more layers are not uncommon, rendering the controlling shareholder's actual ownership of corporations at the pyramid's base negligible. Pyramidal business groups thus permit controlling shareholders to extract private benefits of control from corporate empires financed largely from other people's money. (Morck et al., 2000; Bebchuk et al., 2000) Pyramids were common in the United States until the 1930s (Berle and Means, 1932; Bonbright and Means, 1934), but were eliminated by various New Deal initiatives, including the double and multiple taxation of inter-corporate dividends (Morck, 2005). British pyramids apparently withered under sustained attacks from institutional investors (Franks et al., 2005). However, the relevant unit of economic analysis for many purposes elsewhere in the world should often be the *business group*, not the corporation.

Jensen and Meckling (1976) show that *agency costs*, the present value of the costs of expected future governance shortfalls of any sort, are born by the corporation's initial shareholders. A corporation's founders receive less per share when they first sell shares to outside investors if worse corporate governance problems seem likely.

This gives rise to a *time inconsistency* problem in securities and corporations law. Investors and entrepreneurs selling shares to the public benefit from credible guarantees of good governance because these limit agency costs and so raise share prices. But top corporate decision makers in firms that already issued shares, who foresee issuing no more, wish to maximize their utility (Baumol, 1959, 1962; and Williamson, 1964) and understandably value the freedom to spend public shareholders' money as they like and to capture such private benefits of control as they can. Actual public policy probably reflects these groups' relative political lobbying power, which can change over time (Morck et al., 2000; Morck et al., 2005).

The normative view that a corporation *should* be run to maximize shareholder value derives from economists' assumption that firms maximize profits. In neoclassical economic theory, a firm that maximizes the present value of all its expected future economic profits necessarily maximizes the market value of its shares. This follows from modeling the corporation as a *nexus* of contracts, with the shareholders the *residual claimants* to the firm's cash flows (Fama and Jensen, 1983, 1983a). Neoclassical theory further allows that profit maximization (value maximization in a multi-period setting) accords with economic efficiency under certain idealized conditions; see e.g. Varian (1992), Malliaris and Brock (1983).

This normative view conflicts with the actual legal duties of corporate officers, directors, and controlling shareholders in many countries. For example, many northern European countries and some US states impose a duty to balance shareholders' interests with those of *stakeholders*, especially employees. This is formalized in the German legal principle of *Mitbestimmung* (co-determination), which requires members of the *Aufsichtsrat* (supervisory board) of a large corporation to balance the interests of

shareholders, employees, and the State (Fohlin, 2005). Common Law legal systems assign officers and directors a duty to act *for the corporation*. In Britain and the United States, this is often interpreted as a duty to act for the corporation's owners, its shareholders. A duty to maximize share value seems implicit (Jensen and Meckling, 1976; Black and Coffee, 1997). However, the Canadian Supreme Court holds in *Peoples v. Wise* that the duty of the officers and directors of a corporation is not to shareholders, nor to any other stakeholders, but to the corporation *per se*. The social welfare implications of assigning different legal duties to corporate top decision makers are incompletely understood. Giving labor a voice in corporate decision making seems to impede risk taking and hamper growth (Falaye et al. 2005). Moreover, regardless of their assigned objective, if those entrusted to govern great corporations occasionally put their own interests ahead of their legal duties, agency costs must arise in some form.

The view that a corporation's top managers ought to maximize shareholder value also collides with evidence that stock prices are sometimes set by investors with incomplete information (Myers and Majluf, 1984) or behavioral biases (Shleifer, 2000). Coase (1937) argues that firms come about to alleviate information asymmetries and other market imperfections, collectively denoted *transactions costs*, and that the boundaries of the firm correspond to an efficient solution to these problems. Alchian and Demsetz (1972) argue that the critical market imperfections arise from people working in teams. Williamson (1975) argues that interdependent assets are more generally important. Jensen (2004) calls for more research on normative theories about the boundaries of the corporation and the objective function of its top decision makers if stock prices are set by *noise traders*, that is, investors with behavioral biases. One approach holds that corporations actually exist primarily to lock the economy's capital into productive uses by isolating capital allocation decisions from maniac or panicked investors (Stout, 2004). This view long dominated discussions of corporate management in Japan (e.g. Aoki and Dore, 1994) but appears to give rise to its own set of inefficiencies (see e.g. Morck and Nakamura, 1999).

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