This paper appeared in
American Journal of Comparative Law
Fall 1999, Vol. 47, No. 4, pp.583-632

CIRJE-F-24

PERSONS, THINGS AND CORPORATIONS: THE CORPORATE PERSONALITY CONTROVERSY AND COMPARATIVE CORPORATE GOVERNANCE*

by
Katsuhito Iwai
Graduate School of Economics
The University of Tokyo

June 1997

* **In writing this paper I benefited from numerous discussions I had with my colleagues at the University of Tokyo. I am also grateful to Gunther Teubner, Ugo Pagano, the late Bruno Miconi, Massimo diMatteo and Masahiko Aoki for their suggestions, to the participants in the seminars at Università di Siena, Banco d'Italia, Columbia University, University of Tokyo and Japan Development Bank for their comments, and to Jamie Lipson for his editorial assistance on the earlier versions of the paper. Part of this research was supported by the grant from Suntory Foundation.**

0. Introduction

The law speaks of a business corporation as a 'legal person,' as a subject of rights and duties capable of owning real property, entering into contracts, and suing and being sued in its own name.[2] For many centuries, philosophers, political scientists, sociologists, economists, and above all jurists and judges have debated heatedly as to what constitutes the 'essence' of this soulless and bodiless person.[3] At issue are two related questions concerning the social reality and legal status of the corporation. Is a corporation a real entity with its own will and purpose in society, or is it a mere association of real individuals forming a contract among themselves? Is its legal personality a truthful representation of the underlying social reality, or a fictitious or artificial being breathing only in the province of law?

As the questions themselves imply, two competing legal theories of the corporation have emerged, each advancing opposing answers: 'corporate realism' and 'corporate nominalism.' The corporate realists believe that the corporation is a full-fledged organizational entity whose

---

[2] Sec. 3.02 of the *Revised Model Business Corporation Act (RMBCA)* of the American Bar Association states that 'unless its articles of incorporation provide otherwise, every corporation ... has the same power as an individual to do things necessary or convenient to carry out its business and affairs, including without limitation power: (1) to sue and be sued, complain and defend in its corporate name;...(4) 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; (5) to sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of all or any part of its property;....'

[3] There is a huge body of writings on this controversy. Some of the best-known works available in English are: F. M. Maitland, 'Introduction' to Gierke's *Political Theories of the Middle Age,* (Cambridge University Press, 1900); Arthur Machen, Jr., 'Corporate Personality,' 24 *Harvard Law Review* 253 (1911); Harold J. Laski, 'The Personality of Associations,' 19 *Harvard Law Review* 404 (1916); Paul Vinogradoff, 'Juridical Persons,' 24 *Columbia Law Review* 594 (1924); John Dewey, 'The Historical Background of Corporate Legal Personality,' 35 *Yale Law Journal* 655 (1926); Max Radin, 'The Endless Problem of Corporate Personality,' 32 *Columbia Law Review,* 643 (1932); Martin Wolff, 'On the Nature of Legal Persons,' 54 *Law Quarterly Review* (1938) 494; H. L. A. Hart, 'Definition and Theory in Jurisprudence,' 70 *Law Quarterly Review* (1954) 37; David P. Derham, 'Theories of Legal Personality,' in Leicester C. Webb, ed., *Legal Personality and Political Pluralism,* (Melbourne University Press; 1958) 1; Robert Hessen, *In Defence of the Corporation* (Stanford University Press, 1979); Peter Stein, 'Nineteenth Century English Company Law and Theories of Legal Personality,' 1 *Quaderni Fiorentini* 503 (1982/83); Meir Dan-Cohen, *Rights, Persons, and Organizations: A Legal Theory for Bureaucratic Society,* (University of California Press; 1986); Sanford A. Schane, 'The Corporation is a Person: the Language of a Legal Fiction,' 61 *Tulane Law Review* 563 (1987); Gunther Teubner, 'Enterprise Corporatism: New Industrial Policy and the 'Essence' of the Legal Person,' 36 *American Journal of Comparative Law* 130 (1988). For a comprehensive review of various theories of corporate personality (before 1930), see Frederick Hallis, *Corporate Personality: A Study of Jurisprudence,* (Oxford University Press; 1930).

legal personality is no more than an external expression of its real personality in the society. The corporate nominalists, in opposition, assert that the corporation is a contractual association of individual shareholders whose legal personality is no more than an abbreviated way of writing their names together for legal transactions. And both claim to have superseded the 'fiction theory,' the traditional doctrine since the time of Pope Innocent IV, which maintained an apparently tortuous position: that the corporation is a separate and distinct social entity, but that its legal personality is a mere fiction conceded by the state or created by law.[4]

This debate, however, was declared 'dead' in the late 1920s.[5] Some have attributed this to the immense success of Berle-Means managerial corporations in the U. S. economy. With the controlling power over business corporations shifting from investing shareholders to professional managers whose lifetime careers depend on the continuing existence of the corporations as entities, corporate realism was said to have won the day. Others have suggested that what killed the debate was the publication of John Dewey's article in 1926, which forcefully advanced a thesis of the essential indeterminacy of legal concepts. According to Dewey, '"person" signifies what law makes it signify,' so that social contexts, political purposes and many other extra-legal factors have inevitably entered into the theoretical discussion of the nature of corporate personality.[6] He pointed out that 'each theory has been used to serve the same ends, and each has been used to serve opposing ends,' and then dismissed the entire debate as pointless, as a 'confusion' brought about by an unwarranted assumption that 'there is in existence some single and coherent theory of personality and will, singular or associated.'[7]

---

[4] Our 'corporate realism / corporate nominalism / fiction theory' triad is by no means standard, and various triads have been used by various authors. Examples are: (1) corporate realism or fellowship theory / bracket theory or expansible symbol theory / fiction theory (Maitland); (2) theory of reality of corporate personality / subjective rights theory / fiction theory (Hallis); (3) Gierke's realist theory / Jhering's symbolist theory with Brinz's purpose theory / Savigny's fiction theory (Derham); (4) person theory / group theory / creature theory or concession theory (Shane).
[5] For the rise and fall of the corporate personality debates, see William W. Bratton Jr. 'The New Economic Theory of the Firm: Critical Perspectives from History,' 1 *Stanford Law Review* 1471 (1989).
[6] Dewey, *supra* note 2, at 655.
[7] Ibid., at 669.

Nevertheless, the debate has proved 'endless,' as Max Radin termed it more than a half-century ago.[8] In recent years it was suddenly revived by the advocates of the so-called 'contractual theory of the firm.' According to this new vintage of corporate nominalism, an import from neoclassical economics, private corporations are 'simply legal fictions which serve as a nexus for a set of contracting relationships among individuals.'[9] 'More often than not,' claim proponents, 'a reference to the corporation as an entity will hide the essence of the transaction' that actually constitutes it.[10] There have of course been rebuttals, and even though the academic current is certainly flowing in a nominalist direction one still encounters many works that try to keep the realist tradition alive by searching for a new and better way to characterize the social reality of a legal person.[11]

The present article constitutes a fresh attempt to 'end' the debate by arguing once again that 'person' signifies what law makes it signify. This is, however, neither to dismiss the entire debate as pointless, nor to declare victory for one side or the other. It is rather to declare victory for both. The key to this claim is the observation that, in contrast to an individual proprietorship or a joint partnership, an incorporated business firm is composed legally of not one but *two* ownership relations: the shareholders own the corporation as a legal thing and the corporation as a legal person in turn owns the corporate assets. The corporation thus plays a *dual* role--of 'person' and 'thing'--in the legal system, and it is this person/thing duality that is, I believe, responsible for the 'endlessness' of the corporate personality controversy in the past. The first objective of the present article is thus to elucidate the legal mechanisms through which the eminently legal concept of the corporation is capable of generating two seemingly contradictory

---

8 Max Radin, *supra* note 2.

9 Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,' 3 *Journal of Financial Economics* 305, 310 (1976).

10 Frank H. Easterbrook and Daniel R. Fischel, 'The Corporate Contract,' 89 *Columbia Law Review* 1416, 1426 (1989).

11 'I would suggest that the *social reality* of a legal person is to be found in the '*collectivity*': the socially binding self-description of an organized action system as cyclical linkage of identity and action,' Teubner, *supra* note 2, at 53 (italics original). See also Dan-Cohen and Shane, both *supra* note 2.

corporate structures--one approximating corporate realism and the other approximating corporate nominalism.

What goes under the name of capitalism differs widely from country to country, even among advanced industrial societies. Nowhere is this difference more marked than between America and Japan in regard to the 'purpose' of a corporation. The traditional assumption in America is that the whole aim of a business corporation is to maximize the returns to its shareholders; whereas in Japan, the main concern of corporate managers is to maintain and enlarge the corporation itself as a going concern. The second objective of the present article, therefore, is to show that these two seemingly contradictory capitalisms are but two variants of the genus Capitalism and are in fact not at all contradictory.

In fact, variation in the forms of capitalism is precisely what is implied by our new indeterminacy thesis. Law is unable to determine the internal nature of a corporation, but is at least able to supply a 'menu' of legally possible corporate structures, ranging from the purely 'nominalistic' to the purely 'realistic.' Each society can choose any item on this long legal menu, on the basis of (or at least under the influence of) economic efficiency, political interests, social ideology, and cultural tradition. Our hypothesis is that in their long history of capitalistic development America and Japan have respectively chosen, as their dominant corporate structures, one near the 'nominalist' pole and one near the 'realist' pole.

Indeed, not only each society but also each organization within such society can choose a form of corporate structure along its long legal menu. In organization theory there are two competing views of organizations – one as collectivities rationally constructed to attain exogenously given purposes and the other as collectivities autonomously striving to reproduce themselves as going concerns. The third objective of this article is to suggest how these two views of organizations correspond to our 'nominalistic'/'realistic' dichotomy of corporate structures. What we find as the social substratum of a 'nominalistic' corporation is a group of shareholders who control the managers for the sole purpose of maximizing their returns, and what we

find as the social substratum of a 'realistic' corporation is an autonomous organization whose internal members share a common interest in the survival and growth of the organization itself.

There is, then, no single corporate structure. That does not, however, imply the impossibility of a single principle unifying a variety of corporate governance systems that have evolved in different countries. The problems of corporate governance are literally the problems of governing the corporate form of business organization whose managers are not the agents of shareholders but the fiduciaries of the corporation. I shall demonstrate in what follows that at the foundation of every corporate governance system lie the managers' fiduciary duties to the corporation, and that the legal rules regulating these duties should be essentially mandatory. I shall then argue that a variety of corporate governance systems in different capitalistic countries is essentially due to the variety of governance mechanisms that supplement the fiduciary law. The third and last objective of the present article is to give a brief sketch of a unified theory of comparative corporate governance.

This article is divided into ten sections:

1. Persons, Things and Corporations

In the basic model of the market economy, expounded in any introductory textbook of economics, the relationship between persons and things is simple and clear. Persons are subjects of property right, and things are objects of property right. Persons own things, and things are owned by persons. There is an absolute divide between persons and things. If persons own persons, we are back to the slave economy of the ancient past. If things own persons, we are perhaps trapped in the world of a science-fiction story. Indeed, it is because persons and things are strictly opposed as subjects and objects of property right that it is possible for two persons to exchange the things they own in a market. A person and a person exchange a thing and a thing with one another -- this is the elementary form of market exchange.

Capitalistic firms are founded on this simple relationship between persons and things. In the case of the traditional single-proprietorship firm, a man of means invested his capital in production facilities, operated a production line, and sold products to markets in order to earn profits. (He usually employed workers and clerks and often hired managers. But that is another story and we will come back to the role of managers in Section 8.) The individual capitalist was the subject of property right, whereas the facilities, inventories, products and other tangible and intangible assets were all the objects of property right. They were directly opposed as a person and things.

Capitalism is for expansion. In order to meet the ever-expanding need for capital as well as to diversify the associated risks, capitalism has developed various forms of business partnership since time immemorial. For instance, excavations of private archives of a commercial settlement at Kaneš, a colonial town of the Old Assyrian state, brought to light the extensive use of long-term partnership contracts, known as *naruqqum*, in conducting the long-distance caravan trade as early as the 19th century BC.[12] The ancient Romans are also known to have set up a

[12] M. T. Larsen, 'Partnerships in the Old Assyrian Trade,' 39 *Iraq* 119 (1977). One excavated *naruqqu*-tablet had a list of the names of investors and the size of their investments, the name of the merchant who was entrusted with these investments to conduct overland trades, and the names of seven witnesses.

number of partnership firms for their maritime trade. In fact, partnership forms of business firms were all over the pre-modern commercial worlds -- in the East China Sea, along the Yellow River, along the Silk Roads, in the South Sea, in the Indian Ocean, along the Tigris-Euphrates Rivers, in the Mediterranean Sea....

Of course, the transition from the individual proprietorship to the partnership in itself changes nothing of the basic relationship between persons and things. Instead of a single person owning facilities, inventories, products and other assets, we now have a group of persons jointly owning these things.[13] Indeed, just as the compagnia, a form of partnership firms that dominated medieval Italian cities from the thirteenth to the sixteenth century, literally meant sharing bread (L. *panis*) together (L. *com*) the partners are sharing everything together, from the right to profits to the obligation of debts; from the voice in management to the authority to act as agent. An ownership is an ownership, be it a sole ownership or a joint ownership. And yet, as we shall see, mere quantitative differences may beyond a certain point pass into qualitative changes.

'Men are social beings,' said Vinogradoff (after Aristotle), 'in the sense that no undertaking can be carried out to any large extent without some kind of social cooperation.'[14] This is particularly so in capitalistic society. No business undertaking can be carried out to any large extent without entering into numerous contractual relations with outside parties such as employees, suppliers, customers, creditors, and even tort plaintiffs. In the case of a partnership firm, however, every partner has an equal right and an equal duty to any contract it maintains. Whenever there is a withdrawal or a death of an old partner or an admission of a new partner, each contract has to be rewritten or at least the signatures of the partners have to be updated. To write a contract and to sign and seal it require toil and labor. If the number of partners is

---

It also stated the purpose of the investment, the time limit, the division of profit, and the rules concerning premature withdrawal of investments.

[13] **Section 6(1) of the *Uniform Limited Partnership Act (UPA)* of the American Bar Association defines a partnership as 'an association of two or more persons to carry on as co-owners a business for profit.'**

small, it may be possible to save these transaction costs by including provisions for such contingencies in each contract. But, as the size of the partnership gets larger and the entering and leaving of partners is expected to be much more frequent, it would soon become impossible to prepare for all the possible contingencies in advance. This would render the contract necessarily incomplete and its future execution necessarily costly and uncertain. Outside parties would easily be discouraged from entering into contractual relations with the partnership firm.

The corporation is a legal solution to this problem. Its origin may be traced to Roman times, and in the Middle Ages of Western Europe it was used mostly to protect the long-established interests of guilds, municipalities, monasteries and universities. The notable forerunners of the modern business corporations were the Dutch and English trading companies of the 16th and 17th centuries, which were chartered by the government for the privilege to engage in long-distance trade and colonial management. But it was the unchartered joint-stock companies of late 17th-century England that finally assembled all the attributes of the modern business corporation in one form: legal personality, freedom of incorporation, free transferability of shareholders' interests, and centralization of management.

Of all these attributes it is the legal personality that holds the key to the problem. For it is the legal personality that enables a business corporation to own real assets under its own name, separate and distinct from those of the constituting shareholders. This allows outside parties to enter into contracts directly with a business corporation itself in exactly the same way as they enter into contracts with the owner of a single-proprietorship firm. Hence, the complex network of contractual relations is greatly simplified, leading to a large reduction of transaction costs for all participants.[15] Moreover, the independence of the legal personality enables a busi-

---

[14] Vinogradoff, *supra* note 2, at 594.

[15] 'It was in order to simplify the complex of legal relations which arise wherever there is a corporate pursuit of interests, that Ihering thought the conception of corporate personality indispensable. He considers it to be an economic device by which we simplify the task of co-ordinating legal relations, similar to the device of the parenthesis in algebra.' (Hallis, *supra* note 2, at 173.) More formally, when there are

ness corporation to outlast the lives of individual shareholders as long as the shares are handed from individuals to individuals without interruption. This shields the contracting third parties from the vagaries of the death, withdrawal or entry of its individual shareholders, and removes some of the third parties' hesitation in maintaining contractual relations with it.[16]

We have rehearsed at length some of the textbook account of the corporate *raison d'être,* but with a shift in emphasis. The corporation is understood here primarily as a legal device which simplifies and stabilizes the complicated web of contractual relationships that an association of shareholders has to have with a multitude of outside parties. Its legal personality endows the corporation with the legal capacity to interpose itself between shareholders and outside parties and to enter into contracts with the latter on behalf of the former. But I have tried not to make any reference to the possible advantages of the corporation over the partnership in regard to the way shareholders organize themselves internally.

It is true that the indefinite life of a corporation encourages shareholders to make long-term commitments to it by reducing the risk of its sudden dissolution due to the mere departure of a fellow shareholder; that the free transferability of its shares induces shareholders to make short-term as well as small-scale investments in it by increasing the liquidity of these investments in financial markets; that the centralization of its management induces shareholders to make large-scale contributions to it by increasing the efficiency of the use of its assets, and so on. However, as the corporate nominalists have never been tired of pointing out, these organizational advantages of the corporation could in principle be achieved internally by a well-crafted contractual agreement among shareholders.[17] To do so may incur transaction costs,

---

***N* members and *M* outsiders, the formation of a corporation reduces the number of necessary relations (contractual and other) from $N \times M$ to $N+M$.**

16 We only have to recall the following well-known statement of Blackstone: 'Corporations aggregate consist of many persons united together into one society, and are kept up by a perpetual succession of members so as to continue forever....' William Blackstone, *Commentaries on the Laws of England,* vol. 1 (1765), at 469.

17 See, for instance, Easterbrook and Fischel, *supra* note 9, at 1445; and Richard A. Posner, *Economic Analysis of Law,* 4th ed. (Little, Brown and Co., 1992), at 392-393.

but those costs could easily be reduced by the extensive use of a standard form contract or by other legal devices.

Yet, I would argue, there is still a place for the corporation in the province of law. And it can be found in its legal capacity to coordinate the complex contractual relations between inside shareholders and outside parties by directly entering into contracts with the latter on behalf of the former. Here, it should be pointed out that this capacity is essentially a 'social' or 'inter-subjective' one, in the sense that it cannot be asserted by the internal agreement among shareholders alone, no matter how cleverly they formulate the contract, unless it is acknowledged by employers, suppliers, customers, creditors and other outsiders. A business corporation is able to act as an independent owner of its own property capable of making a contractual relation directly with others, not because the inside shareholders will it to be so, but because, and in so far as, the outside parties recognize it to be so. Such social recognition is indispensable, and the law formalizes and reinforces this social recognition in the form of legal personality.

After all, the Latin *persona*, from which the English word 'person' is derived, meant originally an actor's mask.[18] Each *persona* incarnated a role in a drama, and the spectator recognized the role of each actor by the *persona* he wore. It is not to express his inner self through it but to act out the role incarnated by it that an actor wore a *persona* on his face.

It should be noted that the corporation is described here not as a 'nexus of contracts'[19] but as a full-fledged subject of property ownership. In order for a corporation to serve as one of the parties of a contractual relation, it has to be recognized by others as the holder of the ultimate rights over some real assets and as the bearer of the ultimate duties associated with their use, independently of its constituent members. A mere nexus of contracts can never enter into

---

[18] **See the entry for 'person' in the *Oxford English Dictionary*.**
[19] **Jensen and Meckling, *supra* note 9, at 310-311.**

a contractual relationship even as a legal fiction, simply because it cannot locate the ultimate subject of rights and duties when an event not specified in the contracts takes place.[20]

Now, our argument in this section recalls at several points the supposedly defunct 'fiction theory' of F. C. von Savigny, and we will consider this further in Section 5. For the time being, however, I should merely like to emphasize that the corporation has been introduced into the legal system as a device to simplify the external relations of a group of investors. Of course, there is no 'free lunch' even in the province of law, and what we will see in the succeeding section is that this simplifying device also has the effect of complicating the internal ownership structure of a business firm.

Before we move into the inside of a business corporation, I have to make one clarification that is overdue. As one might have noticed by now, no mention has been made thus far of the 'limited liability' of corporate shareholders – an attribute which has often been singled out as the most important of all the attributes ascribed to the corporation. This is not an oversight. I have refrained from referring it, because the shareholder's limited liability and the corporation's legal personality are merely the different sides of the same coin. If the assets owned by a corporation as a legal person are separate and distinct from the assets owned by its shareholders, then the assets owned by shareholders must also be separate and distinct from the assets owned by their corporation. It would indeed be illogical to reject the legal personality of corporation and at the same time embrace the limited liability of corporate shareholders. A corporation and its shareholder are two distinct subjects of property right, and each owes no legal obligation to any contract the other has independently formed with a third party.

---

[20] **Grossman and Hart, in their theory of the firm, 'define' the ownership as the residual control rights over assets. If a contract is incomplete, it is the ownership that determines who has the right to decide the uses of assets in the event of contingencies not specified in the contract. See Sanford Grossman and Oliver Hart, 'The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration,' 94 *Journal of Political Economy* 691 (1986); and Oliver Hart, *Firms, Contracts and Financial Structure,* (Oxford University Press, 1995).**

How, then, can we account for the wide presence of the so-called unlimited liability corporations? This puzzle, however, can be readily resolved by viewing an unlimited liability corporation as an admixture of a (limited liability) corporation and a standard-form pledge to use its shareholders' assets as collateral. It would help a corporation, in particular a financially insecure one, to enter into a contractual relation with an outside party, if it could routinely post the personal assets of some (or all) of its shareholders as its collateral. True that limited liability corporations appeared in history much later than unlimited liability corporations, but the history of human institutions abounds with examples of the impure and complex preceding the pure and simple in chronological order. We will come back to the issue of limited liability vs. unlimited liability once again in section 9, in conjunction with the so-called corporate veil piercing cases, albeit very briefly.

2. The Corporation as a Person/Thing Duality

A starting point for our analysis of the internal structure of the corporation is one of the most elementary facts in corporate law. If I take away a gadget from the factory of the corporation I am a shareholder of, I will be immediately subject to arrest as a thief. Why? Because a corporate shareholder is not the legal owner of the corporate assets. Who, then, owns those corporate assets? The corporation does, of course. It is the corporation itself as a 'person' that legally owns the corporate assets. Then, what does a corporate shareholder own? The corporation, of course. It is the corporation itself as a 'thing' that a corporate shareholder legally owns. A corporate shareholder is literally a holder of a corporate share, a bundle of participatory and pecuniary rights in the corporation. And to hold a share of the corporation is, unlike a partnership share, to own a fraction of the corporation as a 'thing' independent of the remaining fraction and separate and distinct from the underlying assets. This is so commonplace a fact that no corporate law textbook has ever failed to make note of it. But its implications, I believe, have not been fully worked out. What it is telling us is that, in contrast to a sole pro-

prietorship firm or a partnership firm, an incorporated firm is composed of not one but *two* ownership relations: the shareholders own the corporation, and the corporation in turn owns the corporate assets.

We have already seen that the corporation is a legal device which simplifies the external relations a business firm has to have with employers, suppliers, creditors and customers. We now see that the same legal device has the effect of complicating the internal structure of a business firm by, so to speak, *doubling* the ownership relations within it. In fact, in this two-tier ownership structure the corporation is playing the *dual* role of a 'person' and a 'thing'. It owns assets and it is owned by shareholders. In other words, in regard to things, a corporation acts legally as a person, as a subject of property right; and in regard to persons, a corporation is acted on legally as a thing, as an object of property right. Naturally, of course, a corporation is neither a person nor a thing. Legally, however, it is endowed with both personality and thingness. The corporation has thus trespassed across that great divide between persons and things at least in the province of law.

The past controversy on the nature of the corporation has focused exclusively on its legal personality. Yet, its being a 'legal thing', separate and distinct from underlying corporate assets, is no less important. Even the die-hard corporate nominalists would concede that the corporation has a 'thingness' independently of the underlying assets. Because of the limited liability, any person can own a fraction of the corporation in the form of a certain number of shares, just like any other 'things' in the economy. In capitalistic society every 'thing' can become a commodity, and the corporation as a thing is no exception. Indeed, the stock market is there for people to buy and sell a share of the corporation as a valuable thing; that is, as a commodity, separate and distinct from the underlying corporate assets. Note that the stock market is not directly trading the corporate assets, though its day-to-day valuation certainly influences the way they are managed and accumulated. And here lies perhaps the most important advantage of the corporation, especially of the publicly held corporation, over the partnership or sole

proprietorship. No matter how rapidly the corporate shares are changing hands in the stock market, the productive assets for business activities forever remain in the hands of the same corporation as a legal person. The dual ownership structure thus accomplishes a dual task: it simultaneously 'liquidifies' the shareholders' ownership of the corporation and 'solidifies' the corporation's ownership of productive assets. The former serves to attract a large amount of investments, while the latter works to maintain the stability of business operations. This, however, is only half of the story because we have not yet brought in the role of managers. We will discuss the problems of corporate governance in Sections 8 and 9.

It is my belief that it is not the personality *per se* but the person/thing duality of the corporation that is responsible for most of the confusion in the past debate on its 'essence.' In fact, if we for some reason ignore or suppress or forget its personality, the corporation appears merely as a thing owned and controlled by shareholders, and we draw near to the position of corporate nominalists. If for some other reason we ignore or suppress or forget its thingness, the corporation appears fully as a person owning and managing corporate assets, and we draw near to the position of corporate realists. The recent important theorization by Professor Meir Dan-Cohen, who pictured the corporation as 'a machine endowed with artificial intelligence,' might be interpreted as an attempt, indeed an ingenious attempt, to reconcile the inherently irreconcilable person/thing duality of the corporation by invoking an image which amalgamates persons and things.[21]

One must note, however, that even within the province of law a corporation appears to be neither fully a person nor merely a thing. The fact that it can be owned by other persons makes it less than a person even legally, and the fact that it can own other things makes it more than a thing even legally. The task of the following two sections is to demonstrate that there are ways to eliminate either personality or thingness from the person-cum thing corporation, thereby turning it into a mere 'legal thing' or a full 'legal person', respectively.

3. How to Make a 'Nominalistic' Corporation.

The way to eliminate the personality from a corporation is simple: it is to have someone own more than fifty percent of its shares. That someone then commands a majority block of votes in shareholders meetings and acquires an absolute control over the corporation.[22] The corporation is then deprived of its subjectivity and turned into a mere object of property right. Legally speaking, the corporation is still the sole owner of the corporate assets, but in practice it is the dominant shareholder who can exercise the ultimate control over them. She can direct the managerial policies at her will. She can even dissolve the corporation and sell off all the accumulated assets to second-hand markets. The business corporation is reduced *de facto* to a single ownership relation between the dominant shareholder and the productive assets. We are certainly in the world of the corporate nominalists here.

This is too familiar a fact to warrant any further elaboration. What I should like to do in this section is to suggest that the so-called corporate raiders are daily putting this legal mechanism into practice in the real economy.

That there are two kinds of 'things'--the corporate assets and the corporation itself -- in an incorporated business firm means that there are also two kinds of values residing in it. They are, respectively, the value of corporate assets and the value of the corporation as a thing. The latter is simply given by its total share price in the stock market. The former is slightly more complex; but for our immediate purposes let us simply define it as the present discounted value of the future profit stream that would accrue from the most efficient use of these assets, with a due consideration of the risk premium. It is often called the 'fundamental' value of the corporation. Can these two values be different from each other? Can the stock market value of the corporation be, for instance, smaller than the fundamental value of its assets? The answer is

---

[21] **Meir Dan-Cohen, *supra* note 2, at 49 and thereafter.**

yes. On the one hand, the stock market is notoriously myopic, and its day-to-day valuation may fail to reflect the long-run profitability of the underlying corporate assets. On the other hand, some managers are incompetent or opportunistic, and their management may fail to realize fully the potential value of corporate assets.

In any case, it is the business of a corporate raider to search for a corporation whose stock market value is substantially lower than the value of the underlying assets. As soon as she has identified such corporation, she starts negotiating a leveraged buyout (LBO) plan with her banks. By an LBO I mean a form of financing which allows the corporate raider to borrow the funds for acquiring a corporation by pledging the very assets of the target corporation as collateral. Such an acrobatic arrangement is possible only if the borrower can convince the lenders that the stock market value of the target corporation is substantially lower than the value of its assets to be used as the collateral. No sooner is the LBO plan approved, than our corporate raider begins a takeover bid (TOB), offering publicly to buy the shares of the target corporation at a price higher than the current market price. Most of the shareholders are only interested in higher prices and are willing to sell their holdings as long as the offered price premium is large enough.[23] A takeover bid, however, especially a hostile one, seldom goes without challenge. The current management team, fearful of losing their job, often deploy various defen-

---

[22] **With a proviso that many countries (as well as many states in the case of the United States) have various rules which protect the interests of minority shareholders.**

[23] **As was pointed out by Grossman and Hart, there is, however, a free-rider problem in making a successful tender offer for a corporation. The fact that the raider makes a tender offer means that she has a private information about the way to improve the share price much above the tender price. Current shareholders thus find it their advantage not to tender now but to hold on to their shares until after the raider takes over the corporation and boosts its share price sufficiently high, as long as their shares are small. Hence, the raider never succeeds in raiding the target corporation. Sanford Grossman and Oliver Hart, 'Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation,' 11 *Bell Journal of Economics* 42 (1980). It is to avoid this free rider problem that several devices have been designed. One of them is to write a corporate charter that allows the raider to exploit minority shareholders if she succeeds in a takeover. Such right of dilution would certainly induce the shareholders to tender. But it is by no means a costless device as least for current shareholders, because it tends to lower the tender price as well as the returns when the takeover succeeds. On this point, see Lucian Bebchuk, 'The Pressure to Tender: an Analysis and a Proposed Remedy,' in J. Coffee, L. Lowenstein, and S. Rose Ackerman, eds. *Knights, Raiders, and Targets: The Impact of Hostile Takeovers*, 371 (Oxford University Press, 1988).**

sive tactics to block it.[24] They may even launch a counterattack by announcing their own buy-out plan. And other corporate raiders may suddenly enter into contention.

Suppose, however, that it is our corporate raider who has finally managed to survive the bidding war and to emerge as its ultimate winner. She would immediately call a shareholders meeting with a majority of shares in hand. She now has an absolute power over the fate of the corporation and an absolute control over the use of the corporate assets. She then closes off the corporation from the stock market. If she wants quick money, then she as the *de facto* owner sells off part or all of the corporate assets in second-hand asset markets. If she is patient, she replaces the incumbent managers by new and (she hopes) better ones, and closely monitors their management. If the corporate restructuring goes well, she can enjoy the improved stream of profits in the long-run. And if the stock market eventually comes round to appreciate the fundamental value of the corporate assets, she can even make the corporation public again and resell all her shares at the improved price. In any of these cases, the profit for her undertaking is the difference between the values of corporate assets and corporate shares, minus the price premium for TOB and the interest payment for LBO. It could be a huge prize if her original estimate of the 'fundamental' value of the corporate assets was not wide of the mark. And the important thing to note is that this whole operation can be, if successful, self-financing. At least in theory, our corporate raider did not have to prepare any of her own capital to carry it out. Something has come out of nothing, indeed.

We all know that money and hubris are what motivate our corporate raiders. Whatever their subjective motives, their day-to-day business in effect consists of an attempt to eliminate the personality from person-cum-thing corporations and restore the simple person-owning-things relation of the classical firm. Whether they like it or not, corporate raiders appear to be

---

[24] **Such as super-majority amendments, fair price amendments, reduction in cumulative voting rights, greenmail, and poison pills. For a useful discussion on various anti-takeover strategies, see Gregg Jarrell, James Brickley and Jeffrey Netter, 'The Market for Corporate Control: the Empirical Evidence since 1980,' 2 *Journal of Economic Perspectives* 49 (1988).**

helping to realize the idea of corporate nominalism in this world. In fact, it is often claimed that even if they are not daily raiding corporations, the mere perception that they may at any time enter the scene works as an effective threat to the incumbent managers, steering them away from management policies that may fail to realize the fundamental value of corporate assets. If this is indeed the case, the stock market is said to function efficiently as the 'market for corporate control.'[25]

Does this mean that by the mere existence of corporate raiders the corporate personality controversy has finally been settled in favor of corporate nominalism? The answer is, 'No.' Corporate realism can be achieved in fact as well as in theory.

4. How to Make a 'Realistic' Corporation

'All human beings are born free and equal in dignity and rights': so declared the United Nations in 1948.[26] The fundamental premise of modern civil society is that every human being is free from any coercion or constraint imposed by another human being and is free to pursue the ends he or she sets for himself or herself. A human being is treated as a self-determining subject.

In the system of law a corporation is treated equally to a human being as a legal person, that is, as a subject of property right. It, however, is also an object of property right, a thing owned and controlled by other beings, human or otherwise. So long as it retains this thingness, a corporation can never be a self-determining subject even within the province of law. Yet, as I shall now demonstrate, there exists a legal mechanism able to eliminate this thingness from the person-cum-thing corporation.

---

[25] **For the notion of the market for corporate control, see Henry Manne, 'Mergers and the Market for Corporate Control,' 73 *Journal of Political Economy* 110 (1965); and Michael Jensen, 'Takeovers: Their Causes and Consequences,' 2 *Journal of Economic Perspectives* 21. See, however, *supra* note 22.**
[26] **Cf. Article One of the *Universal Declaration of Human Rights*, the United Nations (1948).**

We know that as a legal person a corporation can own things, and that as a legal thing a corporation can be owned by persons. This implies that a corporation as a person can in principle own another corporation as a thing. In fact, since the state legislature of New Jersey in the United States legalized holding companies in 1889, corporations all over the world have been buying and holding the shares of other corporations in order to combine horizontally or in order to integrate vertically.[27] A holding company is a corporation which is created solely for the purpose of owning other corporations. It thus acts as a person in regard to these corporations it owns. Indeed, the holding company has opened a way to an important organizational innovation: the pyramidal system of ownership and control. At the top is a natural person (or a group of natural persons) who owns a corporation as a thing, which as a legal person owns other corporations as things, each of which again as a legal person owns other corporations as things, and so on. Such ownership hierarchy can extend *ad infinitum*.[28] Nonetheless, the holding company still falls short of shedding its thingness entirely, because it has its own dominant shareholders watching over it.

One can go a step further at least in theory. A corporation as a person can own itself as a thing. Indeed, nothing prevents us from imagining a corporation which becomes its own controlling shareholder by holding a majority block of its own shares under its own name. If this were indeed possible, that corporation would be free from any control by real human beings and become a kind of self-determining subject. It would remove the thingness from itself and acquire a full personality in the province of law. (In order not to complicate the discussion here, we have for the time being set aside the fact that the incorporeal corporation can act only through flesh and blood human beings. We will take up this problem later in Sections 7 - 9.)

---

[27] **See for instance Alfred D. Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business*, (The Belknap Press, 1977), at 315-329.**

[28] **See section 2 of Fabrizio Barca, Katsuhito Iwai, Ugo Pagano and Sandro Trento, 'The Divergence of the Italian and Japanese Corporate Governance Models: The Role of Institutional Shocks,' 23 *Economic Systems* 35, 1999. It is this pyramidal system of ownership and control that allowed Japanese economy**

One might dismiss all this as idle speculation with no practical content. Many countries prohibit a corporation from repurchasing its own outstanding shares.[29] And even though share repurchase is allowed in several countries (as long as it does not impair capital), the repurchased shares generally lose their voting rights in shareholders meetings.[30] In the real economy, therefore, it appears impossible for the corporation to become its own owner.

There is, however, an important leeway to this. Imagine a situation where two corporations, A and B, hold a majority of each other's shares. The corporation A as a person owns the corporation B as a thing, and the corporation B as a person in turn owns the corporation A as a thing. Even though each corporation does not own itself directly, it does indirectly through the intermediacy of the other corporation. It is true that this involves a bewildering infinite regression of A owning B owning A owning B..., but it should be noted that even the seemingly simpler single self-ownership (including that of a modern human being) implicitly involves an infinite regression of A owning A owning A owning A.... In any case, we can at least say that the cross-shareholding between two corporations allows each of them to eliminate real human beings as their dominant owners. Though in a much more attenuated manner than in the case of single self-ownership, we have here a pair of corporations owning themselves and becoming free from the control of any human beings.

One might still object to the practical possibility of this leeway by pointing out that some countries impose legal limits on the extent of cross-shareholdings between corporations. For instance, French law prohibits a corporation from owning the shares of another corporation

---

to develop *Zaibatsu* groups before the WWII and Italian economy family empires both before and after the WWII.

[29] German law and French law in principle prohibit the repurchase of the outstanding shares. Great Britain had made it illegal to acquire its own shares until 1980, but since then the repurchase was allowed under certain conditions. (See the *Company Act* of 1985, Section 143 for these conditions.) Japan also used to prohibit share buybacks, but the ban was partially lifted in June 1995.

[30] *RMBCA* sec. 6.31 provides that reacquired shares automatically reverted to the status of authorized but unissued stock.

that holds more than 10 percent of its shares.[31] Equally important, many countries place ownership limits on the percentage of shares that banks and other financial institutions may own in an individual corporation. For instance, Japanese law forbids a bank from owning more than 5 percent of the shares of any domestic corporation.[32] American law is even more restrictive, and prohibits a bank from owning any shares directly. It does, however, allow a bank to control up to 5 percent of the voting shares of another corporation indirectly through its parent corporation (bank holding company).[33]

Yet, it is possible to circumvent even these limits. Suppose that twelve corporations (which may include a bank holding company) get together and that each holds 5 percent of each of the other's shares but none of its own. Then, simple arithmetic ((12 - 1) 5% = 55%) tells us that a majority block of each corporation's shares could be effectively sealed off from real human beings, without violating any of the above-mentioned legal restrictions on cross-shareholding. These twelve corporations would indeed become their own owners at least as a group. And if fifty-two corporations can get together, they only have to hold 1 percent of each other's shares to secure the majority block for each. It is therefore practically impossible to prevent corporations from becoming their own owners, if they so wish.

We are not the first to note the possibility of a corporation owning itself, either directly or indirectly through cross-shareholding. That possibility has been discussed from various angles by Martin Wolff, by Alfred Conard, and more recently by Professor Meir Dan-Cohen, among others.[34] It should be noted, however, that these authors have characterized the self-owning corporation as 'personless' or 'ownerless' (Dan Cohen) or 'holderless' (Conard) or 'something

---

[31] **In many countries including US, Great Britain, Germany, Sweden, Japan and France, a subsidiary is generally prohibited from holding the shares of its parent corporation.**

[32] **Section 11 of *Anti-Monopoly Act*, Revision of 1977.**

[33] **The *National Bank Act* does not authorize banks to own stocks directly (see 12 U.S.C. § 24, 1988), and the *Bank Holding Company Act* of 1956 (see 12 U.S.C. § 1843 (c) (6) - (7), 1988) authorizes bank holding companies to own up to 5% of the voting stock of any non-banking corporation.**

[34] **See Martin Wolff, *supra* note 2, at 505; Alfred Conard, *Corporations in Perspective* (Foundation Press, 1976), at 160; and Meir Dan-Cohen, *supra* note 2, at 46-49. See also Arthur Nusbaum, 'Acquisition by a Corporation of its Own Stock,' 35 *Columbia Law Review* 971 (1935).**

resembling a foundation' (Wolff). True, the self-owning corporation eliminates human beings as its owners, but this by no means implies that it has eliminated all its owners. The corporation is a legal thing, and being a legal thing makes it impossible for it to be 'personless' or 'ownerless' or 'holderless,' at least legally. And indeed, as the name implies, the self-owning corporation as a thing is owned by itself as a legal person. It thus takes the place of human beings, natural subjects of property right, and becomes a self-determining subject itself. What Professor DanCohen called a 'personless' corporation is in fact the most 'personified' corporation in the province of law.

We have now come very close to the paradigm of corporate realism. We have indeed seen that a self-owning corporation is a self-determining subject, just as a real human being is, in the eyes of the law. However, this is as close as we can come to the corporate realist paradigm, so long as we remain in the province of law. This is because the claim of corporate realism is not merely that the corporation has a full-fledged legal personality but also that this legal personality is only an outer expression of the underlying social reality. And we have so far refrained from saying anything about the social nature of the corporation. In order to go further into the corporate personality controversy, we now have to face that perennial problem of legal science--the relationship between law and society. But to gain perspective we must first make a detour *via* Savigny and his fiction theory.

5. The Fiction Theory and the New Indeterminacy Thesis

Nothing appears more diametrically opposed than corporate realism and corporate nominalism. Yet, these two competing legal theories, I believe, share at the most fundamental level the same stance with respect to the relationship between law and society. Corporate realism asserts that the corporate personality is a full-fledged legal entity simply because this theory views the corporation as an organizational being capable of having its own will and pursuing its own goals in society. Corporate nominalism dismisses corporate personality as a mere legal

symbol simply because it views the corporation as no more than an association of individual human beings forming a contractual agreement among themselves in the society. The former asserts and the latter dismisses the corporate personality as a legal entity simply because the former asserts and the latter dismisses the corporate personality as a social entity. In either theory the legal concept is subservient to the sociological or economic or political theory, and their opposition in regard to the corporation's legal status is nothing but the reflection of their opposition in regard to the corporation's social being.

In contradistinction to these two theories, the now defunct fiction theory separated the system of law from the actual world of society and tried to locate the concept of corporate personality strictly within the system of law. Or so we can interpret the work of F. C. von Savigny, the best-known German Romanist in the first half of the nineteenth century and the principal proponent of the fiction theory of corporate personality. 'Persons as the Subjects of Legal Relations' is the title of the second volume of his famous System of Roman Law,[35] and he made it clear at the outset that his object of inquiry was first and foremost the system of legal relations. 'Every legal relation consists in the relation of one person to another person,' he wrote. 'The first essential element of that relation,' he continued, 'is the nature of the persons whose reciprocal relation is capable of producing it.'[36] Here, by 'person' Savigny meant not an empirical human being but a legal entity that is capable of assuming the role of a subject by serving as one of the two elements that constitute a legal relation. It is this separation of the legal from the empirical that prompted Savigny to pose the following seemingly paradoxical question: 'who can be the bearer or subject of a legal relation?' or more concisely, who can be a person? Of course, every human being is naturally a person, though that legal capacity may wholly or

---

35 ***Jurial Relations: or, the Roman Law of Persons as Subjects of Jurial Relations: being a Translation of the Second Book of SAVIGNY's System of Modern Roman Law,*** **translated by W. H. Rattigan, (Wildy & Sons, 1884), at 181 and 204.**

36 ***Ibid*****., at 1. Here, I have substituted the word 'legal person' for 'juristical person' as an English translation of 'juristischen Personen'.**

partially be denied to minors and lunatics.[37] And, besides these natural persons, Savigny also found a wide variety of non-natural or artificial beings equally capable of functioning as persons in the system of law. He called them 'legal persons' in order to differentiate them from natural persons.[38] One species of this class of legal subjects is the corporation.

As regards the corporation, Savigny said that its essential quality consists in 'that the subject of the right does not exist in the individual members thereof, not even in all the members taken collectively, but in the ideal whole.'[39] Savigny was well aware that such characterization was in direct opposition to the nominalistic view that identifies 'the joint act of all the individual members of a corporation' with the 'act of the corporation itself', but he was firm in his assertion that 'the totality of the members is rather wholly distinct from the corporation itself, and even when all the individual members without exception act together, this is not to be regarded as if the ideal being, whom we call a legal person, had acted.'[40] This by no means implies that Savigny is any closer to the corporate realists. On the contrary, Savigny repeatedly referred to the legal person as an 'artificial subject admitted by means of a pure fiction' and went on to insist on 'the necessity of State sanction for the creation of every legal person.'[41] Because of this insistence, Savigny has sometimes been ridiculed for having littered the legal world with State-created Frankensteins, or worse, he has often been criticized for having reduced the legal person to 'a wheel in the State's machinery.'[42] He might indeed deserve ridicule or criticism if he actually depicted legal persons as fictitious creatures of the State. Savigny was, however, far more subtle in his handling of the concept of legal personality.

---

[37] *Ibid*., at 2.
[38] *Ibid*., at 176 and thereafter.
[39] *Ibid*., at 181.
[40] *Ibid*., at 210.
[41] *Ibid*., at 206.
[42] 'The Savignian corporation is no 'subject' for 'liberties and franchises' or 'rights of self-government'. Really and 'publicistically' it can hardly be other than a wheel in the State's machinery.' (Maitland, *supra* note 2, at xxi.)

In the first place, Savigny never characterized legal persons as creatures of the State in the literal sense. He was careful enough to assert only the necessity of the consenting will or sanction of the State for the creation of legal persons. In fact, Savigny readily admitted that some legal persons such as communities, towns and villages have a *raison d'être* as natural as that of natural persons and are often as old and sometimes older than the State.[43] More fundamentally, as for the other legal persons (such as corporations) which do not have any natural basis, Savigny claimed he was able to supply a 'perfect legal basis' for the necessity of State sanction for their creation.[44] This may sound paradoxical, because insofar as the formal system of law is concerned there should be no difference between natural persons and legal persons. They are equally capable of functioning as subjects of legal relations. And yet, a crucial difference still remains between natural persons and legal persons even in the confines of the system of law. It is, according to Savigny, the way they 'appear' to the other subjects of legal relations! The natural person naturally carries his claim to the subjective right in his corporeal appearance, because 'by this appearance everyone else knows that he has to respect the personal rights of such a being, and every judge that he has to preserve those rights for him.'[45] In contrast, the legal person completely lacks that natural recognition because of its purely abstract character. If its creation (as well as its extinction) were left entirely to the volition of private individuals, Savigny feared, 'the greatest uncertainty of legal conditions would unquestionably result.'[46] Hence the claim of Savigny that 'the character of a legal person cannot be asserted by the mere arbitrary association of several members, or by the will of an individual founder; but for this purpose the sanction of the sovereign power of the state is necessary.'[47]

To recapitulate, Savigny defined the person, both natural and legal, as the subject of a legal relation. But, as every relation requires at least two elements, every legal relation requires at

---

[43] **Savigny, *supra* note 352, at 180 and 204.**
[44] ***Ibid*., at 206.**
[45] ***Ibid*., at 206.**
[46] ***Ibid*., at 206.**

least two subjects. This means that the legal notion of the person is inherently an inter-subjective one. In order for a human being or a corporation or some other entity to serve as a subject of a legal relation, she or he or it has to be recognized as such by the other subject of the same legal relation. In fact, it is because of this inter-subjective nature of personality that Savigny had to make a distinction between natural persons and legal persons even within the province of law. A natural person can become a person not because she or he is a creature of Nature but because she or he can be recognized as a person naturally. A legal person can become a person only with the sanction of the State not because it is a fictitious creature of the State but because it can be recognized as a person only with the assistance of the State.

There is therefore a good deal of parallelism between the theory of corporate personality Savigny developed in his System of Roman Law and the one we have developed in this article. Both have treated the corporate personality as a mere legal construct, thereby contradicting corporate realism, and both have treated the corporate personality as a full-fledged legal entity, thereby contradicting corporate nominalism. Equally important, both have separated the formal system of law from the real system of actions and studied the concept of corporate personality strictly within the province of law. In this sense both appear to share the methodological orientation of legal positivism, in particular, of the pure theory of law *à la* Hans Kelsen, which contends that the positive analysis of legal concepts must be distinguished from sociological inquiries into the actual world (as well as from the normative analysis of transcendental justice).[48] **In fact, if we were to stay in the province of law, our analysis would surely be taken as an exercise of the Kelsenian pure theory of law.**

---

[47] ***Ibid*., at 204.**

[48] **Hans Kelsen, *Pure Theory of Law*, translated by Max Knight (University of California Press, 1967). See also Kelsen's 'The Pure Theory of Law and Analytical Jurisprudence,' *What is Justice? Justice, Law and Politics in the Mirror of Science; Collected Essays* (Berkeley & Los Angeles: University of California Press, 1957) 266. It should be mentioned here that Kelsen's theory of the notion of legal personality as presented in *Pure Theory of Law* was wholly nominalistic.**

But our having remained so far in the province of law is merely strategic. Indeed, one purpose of the present article is to demonstrate that it is logically impossible to separate the formal system of law from the actual world of society. And our starting point was the observation, shared with Savigny, that the corporate personality is an inter-subjective concept which has been introduced into the legal system as a legal device to simplify the web of contractual relations between a group of individuals and a multitude of outside parties. We, however, then went beyond this Savignian observation and found that such a simplification of external relations at the same time works to complicate the internal structure of the corporation. Indeed, we saw that the 'essence' of the concept of the corporation is its person/thing duality, and we then elucidated two legal mechanisms, one capable of turning the corporation into a mere thing and the other into a full person. What does all this mean? It amounts to saying that the concept of the corporation is essentially indeterminate even within the system of law. The corporation can signify whatever law makes it signify.

This sounds very much like what John Dewey said of the corporate personality in his 1926 article.[49] It should be emphasized, however, that Dewey's indeterminacy thesis was a direct application of his pragmatic philosophy that asserts that a thing is defined not by its essence, but by its consequences or by what it does.[50] The definition of a legal subject, he said, is only 'a matter of analysis of facts, not of search for an inhering essence,'[51] and the factual analysis of 'the history of western culture,' he claimed, 'shows a chameleon-like change' in the use of the concept of corporate personality. He thus criticized corporate nominalism and corporate realism alike not for their theoretical content but for their very attempt to 'introduce unity into a conception where the facts show utmost divergence.'[52]

---

49 **Recall our discussion in the Introduction.**
50 **Dewey, *supra* note 2, at 660-661.**
51 **Dewey, *supra* note 2, at 661.**
52 **Dewey, *supra* note 2, at 671.**

In contrast to this, our new indeterminacy thesis is a purely theoretical proposition, the validity of which is totally independent of whether the facts show utmost divergence or not. The 'essence' of the legal concept of corporation is its person/thing duality, and it is this very 'essence' that is responsible for the persistence of divergent views on the nature of corporate personality.

This by no means implies that the 'facts' do not matter. Far from it. Our new indeterminacy thesis has opened up a new way of linking the formal system of law with the actual world of society. Law is incomplete and is unable to determine the nature of the corporation within its own system. But at least it is able to provide a 'menu' of corporate structures from which a society can choose. Indeed, each society can choose any position along a long spectrum that runs from a purely 'nominalistic' to a purely 'realistic' structure, on the basis of or at least under the influence of economic efficiency, political interests, ideological forces, cultural traditions, historical evolution and other extra-legal factors. That the law has really served as an effective 'menu' is evidenced by the well-known fact that even among advanced industrial societies the dominant corporate form varies widely from country to country, with America (and Britain) standing the nearest to the 'nominalistic' pole, Japan the nearest to the 'realistic' pole, and most of continental European countries somewhere in between.

It is time to look at the real world.

6. Two Capitalisms.

What goes under the name of capitalism differs widely from country to country and even among advanced industrial societies. Nowhere is this difference more marked than in views about the 'purpose' of the public corporation in society.

The traditional assumption in America is that the whole purpose of the business corporation is to maximize the returns to its shareholders and that the task of its managers is to exercise

their powers solely for that purpose.[53] However, the following tables suggest that this assumption has no place in Japan and in some of the European countries.

<Table 1: Important Management Goals>

	America	Japan	Europe (%)
Sustenance & Improvement of ROI	78.1	35.6	64.2
Capital Gains of Shareholders	63	2.7	10.6
Maintenance & Expansion of Market Share	53.4	50.6	61.8
Improvement of Product Portfolio	28.8	11.5	26
Maximization of Sales Volume	15.1	27.9	17.9
Increase in Own Capital Ratio	13.7	21.8	18.7
Rationalization of Production & Distribution Systems	13.7	27	27.6
Reinforcement of Global Strategy	12.3	32.8	30.9
Expansion of New Products & New Operations Ratio	11	60.8	14.6
Improvement of Corporate Social Image	6.8	18.6	18.7
Retention of Employees	1.4	3.8	6.5
Improvement of Employees' Benefits	0	7.7	0.8

***Source*: Keizai Doyu Kai, *Showa 63 nendo Kigyou Hakusho* (*1988 White Paper on Corporations)*, (1988).**
***Note*: Number of corporations responding to questionnaire: 73 in America, 724 in Japan and 123 in Europe**
(58 in Italy, 33 in Germany, 18 in France and 14 in Great Britain).

<Table 2: Criteria considered Very Important for Entry Decision into a New Line of Business>

	America	Japan	Europe (%)
ROI	57.7	42.1	45.9
Competitive Advantage	56.3	25.7	38.3
Growth Potential of Market	56.3	69.4	48.8
Synergy Effects	49.3	20.0	38.8
Size of Market	45.1	32.2	38.5
Magnitude of Risk	40.8	28.0	25.8
Effective Use of Existing Managerial Resources	34.3	32.6	39.3

Source: Keizai Doyu Kai, Showa 63 nendo Kigyou Hakusho (1988 White Paper on Corporations), (Keizai Doyu Kai, 1988).

The first table reports the results of a 1988 survey that asked corporate managers in America, Japan and Europe to pick out the three most important goals of their management policies. Answers given by American corporate managers were entirely consistent with the traditional

[53] In the famous case of *Dodge v. Ford Motor Co.*, the Michigan Supreme Court ruled as follows: 'A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of

assumption of the primacy of shareholders' interests--they ranked ROI (the rate of return on investments) at the top and capital gains of shareholders second. In stark contrast, the Japanese corporate managers placed capital gains of shareholders at the very bottom of their ranking. They also did not rank ROI as high. Instead, they put the ratio of new products and new operations at the top and ranked market share second. These goals are more or less related to the survival and growth of the corporation as a business organization in the ever-changing market environment. The answers given by European corporate managers, however, were somewhat murky. This is probably due to the diversity of the countries in this category.

The same study also asked the corporation managers the importance of the listed criteria in their decision to enter into a new line of business. Table 2 reports the percentage of the managers in America, Japan and Europe who termed each listed criterion 'very important.' While the American managers emphasize the ROI calculation even in their decision to open up a new business operation, the first and foremost concern of the Japanese managers is the growth potential of the market their corporation is about to enter. (The answers of European managers again give us no clear-cut picture.)

Care is needed in interpreting the above two tables, which are taken from an unevenly sampled questionnaire study. But they appear to be more than sufficient to bring home the striking difference in attitudes towards the purpose of the public corporation among advanced industrial societies, especially between America and Japan.[54] While in America it is generally believed that the whole task of the corporate managers is to maximize the returns to the shareholders, in Japan it is generally believed that the job of the managers is to seek the survival and growth of the corporation itself as a going concern. The attitudes of the corporate managers in

---

profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes ....' ***204 Mich. 459, 170 N.W. 668*** **(Mich. 1919).**

[54] **There have been a number of studies which report very similar results. See, for instance, Kagono, Nonaka, Okumura, Sakakibara, Komatsu and Sakashita,** ***Strategic vs. Evolutionary Management: A US-Japan Comparison of Strategy and Organization*****, (North-Holland, 1985), Table 2-5.**

Europe seem to be an admixture of those of their American and Japanese counterparts with a tone somewhat closer to the latter.

The above dichotomy, popularly dubbed 'shareholder capitalism' versus 'corporate capitalism,' is certainly a simplification. There is a wide disparity as well as a wide fluctuation both in theory and in practice within each type of capitalism. For example, since the Michigan Supreme Court affirmed the traditional assumption of the supremacy of the shareholders' interests in Dodge v. Ford Motor Co. in 1912, America has experienced a swing away from it at least twice. The first swing took place after the famous debate between E. Merrick Dodd and Adolf Berle, Jr. in 1932.[55] In this debate Berle took exception to Dodd who argued that the corporation is an 'economic institution which has a social service as well as a profit-making function,'[56] but he soon converted himself to a view similar to Dodd's.[57] The second swing came in the 1990s. In the aftermath of the frenzied wave of hostile takeovers in the 1980s, more than forty states rushed to enact statutes instructing corporate directors to take account of the interests of constituencies other than shareholders in employing their powers.[58] In Japan (and in some of the continental European countries as well), on the other hand, we are currently witnessing a strong swing in the opposite direction. Disgusted with a series of corporate scandals, alarmed by the deep and prolonged recession, and fearful of the prospect of losing global competitiveness in the post-industrial era, a growing number of academics, public officials, business leaders, and journalists have begun to pressure their 'inflexible' and 'outmoded' corporate system to become more like the Americans'.

---

[55] **E. Merrick Dodd, 'For Whom Are Corporate Managers Trustees?' 45 *Harvard Law Review*, 1145 (1932); and Adolf Berle, 'For Whom Corporate Managers Are Trustees: A Note,' 45 *Harvard Law Review*, 1365 (1932).**

[56] **Dodd, *op. cit.*, at 1148.**

[57] **Already in Chapter 4, Part 4 of *Modern Corporation and Private Property*, (Macmillan Publishing Co., 1932) he co-authored with G. C. Means, Berle expressed a view which is similar to Dodd's. See also Adolph Berle, Jr., *The 20th Century Capitalist Revolution*, (Harcourt, Brace, 1954).**

[58] **See Mark Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance*, (Princeton University Press, 1994), at 151-168, for an informative account of this movement.**

The dichotomy between shareholder capitalism and corporate capitalism is thus a simplification. And yet, this is merely a simplification, not an oversimplification. Notwithstanding large variations within each type of capitalism, we still find it a useful working hypothesis to assume that American managers are generally expected to maximize the returns to shareholders and that Japanese managers are generally expected to emphasize the survival and growth of the corporation as an organizational entity.

It is not the intention of the present article to pass judgment on which type of capitalism is ethically more just or politically more democratic or economically more efficient. We shall merely take the coexistence of two capitalisms as a given 'fact' and proceed with our investigation on that factual foundation. My thesis here is that these two seemingly contradictory capitalisms are but two variants of the genus Capitalism and by no means contradictory. I have already established that the legal concept of the corporation is not determinate itself and that what law is able to do is to offer to each society a menu of possible corporate structures ranging from the purely 'nominalistic' to the purely 'realistic.' I would now argue that from this long legal menu the American economy and the Japanese economy have chosen as their dominant corporate structure one close to the 'nominalistic' end and one close to the 'realistic' end, respectively.

<Table 3: Average Annual Volume of Completed Domestic Mergers and Corporate Transactions with Disclosed Values 1985-89>

	America	Japan	U.K.	Germany
Total Volume (in billions of US$)	**1 ,070.0**	**61.3**	**107.6**	**4.2**
As a Percentage of Total Market Capitalization	**41.1**	**3.1**	**18.7**	**2.3**

***Source*: Stephen Prowse, 'Corporate Governance in an International Perspective: A Survey of Corporate. Control Mechanisms among Large Firms in the United States, the United Kingdom, Japan and Germany,' *BIS Economic Papers*, No. 41 (July 1994); Table 12. Original sources cited in the paper are Securities Data Corporation, Merger and Corporate Transactions database for the U. S., the UK. and Germany, and Yamau-chi Securities Corporation for Japan**

***Note*: The total value of market capitalization is for 1987.**

In Section 3 we saw how the day-to-day activities of corporate raiders in the stock market work to turn a person/thing corporation into a 'nominalistic' corporation with little or no personality of its own. I would now suggest that the American corporate system very much fits in with this picture. The first row of Table 3 compares the average annual value of completed mergers and acquisitions between America and Japan for the second half of the 1980s. It includes the figures for Great Britain and Germany as well. The second row normalizes this value by dividing it by the total value of market capitalization in 1987. Although both America and Japan are comparable in regard to the value of total market capitalization--about 2,600 billion dollars in America and 2,000 billion dollars in Japan in 1987--their difference in the volume of completed mergers and acquisitions is simply enormous in both absolute and relative magnitude.[59] (In Great Britain corporate mergers and acquisitions were much more active than in Japan but not so much as in America, whereas in Germany they were even less active than in Japan.) When we examine the frequency of hostile takeovers, the difference becomes even more conspicuous. Takeover bids (TOBs) are the most commonly used means for hostile takeovers in America, and they were legally instituted in Japan in 1971 when its Securities and Exchange Acts were revised along the lines of their American counterparts. Hence, the legal apparatus has since been at least formally neutral in terms of comparing the two countries.

[59] These figures are taken from Stephen Prowse, 'Corporate Governance in an International Perspective: A Survey of Corporate Control Mechanisms among Large Firms in the United States, the United Kingdom, Japan and Germany,' *BIS Economic Papers* (No. 41, July 1994).

And yet, from 1971 to 1990, only three (!) TOBs were ever reported in Japan, whereas the Securities and Exchange Commission (SEC) in America received 1,032 reports of TOBs for the much shorter period of 1985 to 1990.[60] In fact, it is said that almost 10% of American corporations included in the Fortune 500 in 1980 have since been acquired in a transaction that was hostile or started off as hostile.[61] The stock market in America serves as the 'market for corporate control' far more effectively than that in Japan.

<Table 4: Cross-Shareholdings among Core 20 Corporations of Sumitomo Group, 1993>

HOLDER % \ ISSUER	S. Bank	S. Trus Bank	S. Life	S. Mar Ins.	S. Corp	S. Coal Mini	S. Cons	S. Fore	S. Che	S. Bake	Jap Glas	S. Cem	S. Meta	S. Meta Mini	S. Ligh Meta	S. Elect	S. Heav Ind.	NEC	S. Real Esta	S. Stor	TO TAL
S. Bank	----	2.8	6.1	1.8	1.7	0.0	0.0	0.1	1.1	0.2	1.1	0.2	1.3	0.4	----	0.9	0.2	1.1	0.1	0.2	19.3
S. Trust Bank	3.3	----	4.2	1.5	2.5	0.0	0.0	0.2	1.2	0.5	1.4	0.5	2.3	1.2	0.0	1.7	0.4	2.8	----	1.5	25.3
S. Life	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
S. Marine Ins.	4.4	6.3	4.6	----	2.3	0.1	0.1	0.1	1.2	0.3	1.2	0.3	1.0	1.0	----	0.9	0.6	1.8	0.1	0.8	27.1
S. Corporation	4.8	5.8	5.1	2.9	----	0.1	0.0	0.3	1.6	0.3	1.0	0.4	2.7	1.7	----	1.0	0.8	3.7	0.1	0.4	32.8
S. Coal Mining	4.8	4.0	2.5	2.4	3.4	----	0.8	----	2.5	----	0.4	1.0	4.9	2.1	----	----	1.7	4.2	----	0.2	34.8
S. Construction	4.4	2.9	5.8	1.4	----	3.1	----	0.6	1.1	----	0.6	2.3	----	3.3	----	1.0	----	----	0.4	0.2	27.0
S. Forestry	4.3	7.0	7.2	----	2.6	0.1	0.4	----	----	0.4	----	0.3	----	7.3	----	----	0.2	1.4	----	----	31.1
S. Chemical	4.7	5.3	8.9	1.4	1.3	0.0	0.1	0.1	----	0.1	0.4	0.3	----	0.2	----	0.3	0.2	0.5	0.0	0.2	23.9
S. Bakelite	4.8	7.1	5.9	1.3	2.1	----	0.3	0.4	21.6	----	0.3	0.5	0.9	----	----	0.3	----	1.3	0.4	0.1	48.2
Japan Glass	5.0	6.8	5.5	2.3	1.6	----	0.1	0.1	1.2	0.5	----	0.8	----	0.3	----	----	0.6	----	0.5	0.2	25.6
S. Cement	4.6	5.4	8.5	1.0	2.3	1.9	0.6	0.4	1.1	0.4	0.8	----	1.0	1.1	----	0.3	2.2	0.8	0.2	----	32.8
S. Metals	4.0	6.2	5.5	----	1.6	0.1	0.0	----	----	0.1	0.1	0.1	----	0.5	----	0.3	0.2	0.6	0.0	0.1	19.2
S. Metal Mining	4.6	10.0	4.8	1.5	2.5	0.1	0.2	0.3	----	----	0.3	0.7	0.8	----	----	1.0	0.3	2.4	0.1	0.1	29.6
S. Light Metals	4.7	5.8	4.0	1.4	4.0	----	----	----	1.3	----	----	0.4	23.3	0.9	----	0.8	0.6	0.8	----	0.2	48.2
S. Electrics	3.8	5.4	7.0	----	0.8	0.0	0.0	----	----	----	----	0.1	----	0.8	----	----	0.1	2.4	----	0.1	20.6
S. Heavy Ind.	4.6	6.4	7.8	2.5	3.0	0.1	0.1	0.1	----	----	0.5	1.3	----	0.7	----	0.7	----	----	----	0.3	27.9
NEC	5.0	4.8	6.8	2.6	2.2	0.0	0.0	0.1	0.4	0.1	0.2	0.1	0.7	1.0	----	2.2	0.1	----	0.0	0.2	26.4
S. Real Estate	3.4	5.1	2.3	1.6	0.5	0.0	0.2	----	0.4	0.2	0.7	0.1	0.5	0.3	----	0.5	----	0.7	----	0.5	17.2
S. Storage	4.7	6.7	8.4	5.4	2.4	----	0.3	----	1.5	0.1	0.8		2.2	----	----	0.9	0.9	3.9	0.3	----	38.5

***Sources*: Toyo Keizai, *Kigyo Keiretsu Soran '95 (Survey on Corporate Groups, '95)*, (Toyo Keizai Shinpo Sha, 1995).**
***Note*: '0.0' means a very small percentage, and '----' means no holding.**

Why then have hostile takeovers been so rarely observed in Japan? To this question we can readily provide an answer: it is because there are extensive cross-shareholdings among large Japanese corporations.

[60] **Since the revision of the *Securities and Exchange Act* in 1990, there have been a few more cases. American data are taken from various issues of the *SEC Annual Report*.**
[61] **According to W. Carl Kester, *Japanese Takeovers: The Global Quest for Corporate Control*, (Harvard Buisiness School Press, 1991).**

That Japan has six major corporate groups--Mitsubishi, Mitsui, Sumitomo, Fuyo (Fuji), Sanwa, and Daiichi-Kangin (DK) is well-known.[62] Each group is clustered around a main bank, extended over the whole industry, and connected through intricate cross-shareholdings. To get a sense of this, Table 4 exhibits the matrix of shareholdings among 20 corporations which constitute the core members (that is, the member corporations of the prestigious Presidents' Club) of the Sumitomo group. What is remarkable is that their network of cross-shareholdings is so tight-knit that this matrix has few vacant cells except the row for Sumitomo Life Insurance, which is a mutual company issuing no shares, and the column for Sumitomo Light Metals which is essentially a subsidiary of Sumitomo Metals.[63] For instance, Sumitomo Bank holds shares of Sumitomo Marine Insurance, Sumitomo Corporation, NEC, Sumitomo Metals, etc.; Sumitomo Marine Insurance in turn holds shares of Sumitomo Bank, Sumitomo Corporation, NEC, Sumitomo Metals, etc.; and so on. (Sumitomo Life Insurance holds shares of almost all the other corporations in the group.) The average ratio of the mutually held shares within the Sumitomo group was 27.5% in 1989. The average of the averages of the six groups was 21.6%.[64] Since these ratios are calculated only among the core corporations, they would go up much higher if we include lesser group members and subsidiaries.

If we combine the core members of the six major corporate groups, they as a whole account for about 15% of total assets, total sales and total profits of the entire economy (excluding the finan-

---

[62] **It is Hiroshi Okumura who first noted the importance of the system of cross-shareholdings among corporations in understanding the structure and performance of post-war Japanese economy. See *Hojin Sihonshugi no Kozo (The Structure of Corporate Capitalism),* (Nihon Hyoron Sha, 1975; Revised Ed., Gendai Kyoyo Bunko, 1991); *Nihon no Rokudai Kigyou Shudan (SixGiant Corporate Groups in Japan),* (Daiamondo sha, 1976; Revised Ed., Asahi Bunko, 1993); *Hojin Sihonshugi (Corporate Capitalism),* (Ochanomizu Shobo, 1984; Revised Ed., Asahi Bunko, 1991). (English translation of *Corporate Capitalism* is forthcoming from Macmillan.) The term 'corporate capitalism' was due to him.**

[63] **Among 20 Japanese life insurance companies established before 1975, 16 are mutual companies while only four of them are incorporated. (In the case of the United States 27 out of 41 life insurance companies were mutual companies in 1985. The ratio has, however, been steadily declining since then.)**

[64] **Kosei Torihiki Iinkai (Fair Trade Commission), *Kigyo Shudan no Jittai ni tsuite (On the Reality of Corporate Groups)*, 1992.**

cial sector).[65] If we include lesser members and subsidiaries, their total share would certainly become much larger (perhaps as large as a quarter of the entire economy). Apart from them, there are several other corporate groups with much looser networks of cross-shareholdings; and there are many large independent corporations with little or no cross-shareholdings. Table 5 reproduces the results of a questionnaire sent to all the public corporations in Japan. Its first column shows that, while a third of the respondents have mutual shareholdings ratios of less than 10%, almost a half of them have more than 20% of their shares held mutually. The average ratio is 23%, which is, even taking account of the difference of data sets, a figure comparable to that of the six major corporate groups.[66] Note that the mutual shareholdings ratio may not fully capture the extent to which each corporation is protected from hostile takeovers. Some of the shares may be owned by friendly corporations which maintain long-term mutual relations by buying up a large block of each other's products, by sending directors to each other's board, by sharing important information in the meetings of group corporations, and so on. Those shareholders that are expected to resist the temptation of tender offers by outside raiders are called 'stable shareholders' in Japan. The second column of Table 5 indicates that as much as 84% (!) of Japanese public corporations have succeeded in securing more than half of their shares for what they believe to be their stable shareholders.[67] They of course consider themselves largely immune to the threat of corporate raiders.[67a]

---

[65] ***Ibid*. The average ratios of the Mitsubishi, Mitsui, Fuyo, Sanwa and DK groups are, respectively, 35.5%, 19.5%, 16.4%, 16.5% and 14.6%.**

[66] **By contrast, in the case of 397 closed corporations responding to the same questionnaire, the average ratio of mutual shareholdings is 16.3%. See Fuji Sogo Kenkyujo (Fuji Research Institute Corporation), *'Mein Banku Sisutemu oyobi Kabushiki Motchiai' ni tsuite no Chosa Hokoku (Reports on the Study of Main Bank System and Cross-Shareholdings),'* (April 30, 1993).**

[67] **According to Fuji Research Institute Corporation, *supra* note 62, of those stable shareholders 20% are banks, 8% life insurance companies, 4% liability insurance corporations, 35% other corporations (of those about 10% are parent corporations), 15% individuals, and 2% employees' holding cooperatives.**

[67a] **In August 1999, Daiichi-Kangyo Bank and Fuji bank, together with Japan Industrial Bank, announced plans to merge their operations through a bank-holding corporation by 2002, and in October of the same year Sumitomo Bank and Sakura Bank (the main bank of Mitsui group) also announced a plan to unite, forming a single bank, by 2002. These announcements heralded a major transformation in the Japanese financial sector, but it is still to early to see whether this will lead to the complete trans-**

<Table 5: Ratios of mutual shareholdings and stable shareholdings among public corporations in Japan[1]>

	Mutual shareholdings[2]	Stable shareholdings[3] (%)
Less than 10%	**31.3**	**2.2**
10-20%	**19.1**	**0.3**
20-30%	**17.5**	**1.0**
30-40%	**12.8**	**3.8**
40-50%	**10.9**	**8.7**
50-60%	**5.4**	**25.9**
60-70%	**3.0**	**34.3**
70-80%	**0.5**	**17.1**
More than 80%	**0.2**	**6.7**
Average	**23.4**	**61.0**

***Source*: Fuji Sogo Kenkyujo (Fuji Research Institute Corporation), *'Mein Banku Sisutemu oyobi Kabushiki Mochiai' ni tsuite no Chosa Hokokusho (Reports on the Study of 'Main Bank System and Cross-Shareholdings'),* April 30, 1993.**

***Notes*: 1. The figures are based on the answers given by 586 publicly-held corporations. 2. Percentage of the shares held by the corporations whose shares are also held by the corporation in question. 3. Percentage of the shares held by the corporations which are regarded as stable shareholders by the corporation in question.**

In Section 4 we saw how extensive cross-shareholding among a group of corporations works to turn each of the person-cum-thing corporations into a 'realistic' corporation with little or no trace of thingness in itself. The Japanese corporate system is now seen to fit in with this picture quite well. Thus, in spite of their seemingly irreconcilable differences, shareholder capitalism in America and corporate capitalism in Japan are but two extreme forms of the genus Capitalism. They assume their particular forms by selecting, respectively, the most 'nominalistic' position and the most 'realistic' position along a long continuum of possible corporate structures that the law has supplied each society as a menu to choose from.

7. Corporation vs. Organization

What is the 'purpose' of the corporation? In the case of the 'nominalistic' corporation, the answer is straightforward. It is, as in the textbook model of the business firm, to maximize the returns to its shareholders. And yet, the logic behind this answer is not as straightforward as it is in the textbook model of the firm, because the legal owner of corporate assets is not the

formation of the entire Japanese corporate system or to a mere consolidation of its corporate group structure.

shareholders but the corporation as a legal person. The legal claimant to the profits accruing from the use of corporate assets is the corporation itself, not the shareholders. The corporate profit is literally the profit of the corporation. Of course, this is only half of the story, because the corporation is also a thing owned by shareholders. Indeed, it is as the owners of the corporation that the shareholders lay legal claim to the corporate profit. And if a corporation is turned purely 'nominalistic' by the actual control of dominant shareholders or by the potential takeover threat in the stock market, it becomes perfectly legitimate to assume, as the traditional theory has been assuming, that the sole purpose of the corporation is to maximize the returns to its shareholders. This is the paradigm of shareholder capitalism.

But, as we have already seen, the 'nominalistic' corporation constitutes but one end of the long legal menu of possible corporate structures. In fact, if a corporation becomes purely 'realistic' through extensive cross-shareholdings with others, it can lay total claim to the corporate profit. What, then, is the purpose of this 'realistic' corporation? We of course cannot attribute this purpose to anything like the 'will' of the corporation itself, for its legal personality is a mere construct within the system of law. Nor can we attribute this purpose to the personal objectives of corporate managers, for the managers are mere fiduciaries of the corporation whose task is to exercise their fiduciary powers solely for the purpose of their corporation. (That corporate managers are prone to abuse their fiduciary powers is a different matter, and will be discussed in the next two sections.) If there is such a thing as a 'purpose' to this 'realistic' corporation, it should refer to the purpose of some social entity that lies beneath the legal personality of corporation. But what is this social entity? Suddenly, we find ourselves once again in the midst of the corporate personality controversy. For we now have to deal with the relationship between the legal personality of corporation and its social reality, that is, between law and society. This time, however, we do not have to start from scratch.

We all know that every corporation needs an organization in order to make use of its own assets in society. It is because the corporate personality is a mere legal construct that is inca-

pable of performing any acts except through the acts of flesh and blood human beings. In fact, it is a legal requirement that a corporation must have a board consisting of directors who hold the formal powers to act in the name of the corporation. And it is through the need for the division of labor that the board members delegate part of their powers to corporate officers for the actual management of corporate assets, and that these officers in turn appoint middle managers and hire employees for day-to-day operations of corporate assets. It is true that there are many corporations, even among publicly-held corporations, whose shareholders place themselves as directors and manage the corporate assets all by themselves.[68] But, then, these shareholders act as board members, not as shareholders. In any case, we all know that one of the most notable features of modern business corporations is their tendency to develop large-scale organizations as their structural supports in society. Then, what is this thing called organization?

'An organization,' according to Max Weber, is 'a system of continuous purposive activity of a specified kind'[69]; and according to Talcott Parsons, 'the defining characteristic of an organization which distinguishes it from other types of social systems' is 'primacy of orientation to the attainment of a specific goal.'[70] The classical conception of organization, given by these authorities, is that of an instrument. It is for the explicit purpose of attaining a specified goal that the activities of individuals participating in an organization are coordinated centrally and structured formally.[71] An organization is said to 'come into existence when explicit procedures

---

[68] **Notable examples are contemporary Italian family empires and pre-war Japanese Zaibatsu. See, Barca, Iwai, Pagano, and Trento, *supra* note 28, for related discussions on them.**

[69] **Max Weber, *The Theory of Social and Economic Organization,* edited by Talcott Parsons, (Oxford University Press, 1947), at 151. Here, 'organization' stands for Betriebe and 'corporate organization' Betriebsverband. In a revised translation given in *Economy and Society*, edited by Guenther Roth and Claus Wittich, (Bedminster Press, 1968) 'Betriebe' was re-translated as 'enterprise' and 'Betriebesverband' as 'formal organization'.**

[70] **Talcott Parsons, *Structure and Process in Modern Societies* (Free Press, 1960), at 17.**

[71] **'Formal organization is that kind of coöperation among men that is conscious, deliberate, purposeful,' Chester I. Barnard, *The Function of the Executive*, (Harvard University Press, 1938), at 4; 'The distinctive characteristic of .... organizations is that they have been formally established for the explicit purpose of achieving certain goals,' Peter Blau and W. Richard Scott, *Formal Organizations*, (Chandler, 1962), at 5; 'Organizations are social units (or human groupings) deliberately constructed and recon-**

are established to coordinate the activities of a group in the interest of achieving specified objectives.'[72]

This instrumental conception of organizations is broadly consistent with the nominalistic view of corporations. True to that view, a purely 'nominalistic' corporation is a mere means for its dominant shareholders. In fact, many a business corporation begins its life as a purely 'nominalistic' corporation.[73] It is founded by a group of shareholders who invest their money for the sole purpose of maximizing their returns from corporate assets. And yet, it is a commonplace in the history of social institutions that a means to an end becomes an end itself.

The field of organization theory abounds in studies of what is called 'goal displacement'--organizations' propensity to attend to the needs of their own survival and growth at the sacrifice of the goals for which they were originally established.[74] The best account of this process is still found in the justly famous study by Robert Michels, a contemporary of Max Weber, on the transformation of the Social Democratic Party in pre-World War I Germany. The party is originally created as a means to implement radical causes for workers. In the process of political struggle and economic bargaining, power is gradually consolidated in the hands of full-time officers who become indispensable for carrying out complex administrative tasks for the party. As the organization expands in size and scope, these officers become increasingly concerned with protecting the organization against attacks from outside forces and increasingly preoccupied with fortifying its formal structure for the sake of its own survival and growth. 'Thus,'

---

structed to seek specific goals,' Amitai Etzioni, *Modern Corporations,* (Prentice Hall, 1964), at 3; 'Organizations are collectivities orientated to the pursuit of relatively specific goals and exhibiting relatively highly formalized social structures,' W. Richard Scott, *Organizations: Rational, Natural and Open Systems,* Second ed., (Prentice Hall, 1987), at 22. What I called the 'instrumental conception of organizations' above corresponds to what Richard Scott called 'a rational system definition of organizations.' My account of the theory of organizations owes much to Scott's textbook.

[72] Peter Blau, 'Theories of Organizations,' in Vol. X of *Encyclopedia of Social Sciences,* edited by David L. Sills, (Macmillan, 1968), at 297-8.

[73] There are of course many corporations which do not begin their lives as 'nominalistic' corporations.

[74] On goal displacement, see, for instance, Robert K. Merton, 'Bureaucratic Structure and Personality,' in Robert K. Merton, *Social Theory and Social Structure,* (Free Press, 1957); and Amitai Etzioni, *Modern Organizations,* (Prentice-Hall, 1964).

Michels concludes, 'from a means, organization becomes an end.'[75] Though this thesis originates from observations on political organizations, it is applicable to every sort of organization, and Michels asserted that it is 'a universally applicable law' that 'every organ of the collectivity, brought into existence through the need for the division of labor, creates for itself, as soon as it becomes consolidated, interests peculiar to itself.'[76] This at once leads us to a second conception of organizations, according to which 'organizations are collectivities whose participants share a common interest in the survival of the system and who engage in collective activities...to secure this end.'[77]

Before us are two different conceptions of organizations, one emphasizing their instrumental nature and the other their autonomous nature. The former conceives of organizations as collectivities rationally constructed to attain exogenously given purposes, and the latter as collectivities autonomously striving to reproduce themselves as going concerns.[78] I believe that these two opposing conceptions of organizations are not mutually incompatible characterizations of their ideal-type but equally valid representations of their two polar empirical types. There are organizations that are merely instrumental and there are organizations that are fully autonomous, though most organizations we observe in actual society occupy positions more or less in-between.

What do we find when we lift the legal veil? I have already suggested that the type of organization that is consistent with the 'nominalistic' corporation is an instrumental one. What we find as its social substratum is a group of shareholders who control its managers for the sole purpose of maximizing their own returns. I now suggest, not unexpectedly, that the type of

---

75 ***Ibid*., at 373.**

76 **Robert Michels, *Political Parties: A Sociological Study of the Oligarchical Tendencies of Modern Democracy*, (Dover, 1959; the original German edition was published in 1911), at 389.**

77 **Scott, *supra* note 71, at 23. This is what Scott called a 'natural system definition of organizations.' I omit his reference to the informality of the structure, because I believe that self-perpetuating organizations are not necessarily informal.**

78 **Scott, *op. cit.*, has introduced what he calls an 'open system definition of organizations' as a third definition of organization. However, I believe that this third definition is of a different nature from the first two.**

organization that is associated with the 'realistic' corporation is an autonomous one. What we find as its social substratum is, this time, a corporate organization whose members share a common interest in the survival and growth of the organization itself. And it is this organizational self-reproduction and self-expansion that should constitute the 'purpose,' or at least one of the main purposes, of the 'realistic' corporation. In contradistinction to the instrumental type of organization which has no purpose of its own but the one imposed from outside, the autonomous type of organization has every claim to be taken as a social entity in its own right.

Having said that, however, we hasten to add that we have no intention to conjure up the specter of that notorious 'physico-spiritual unity' of Otto Gierke's 'real corporate personality.'[79] A corporate organization is never a superhuman being or metaphysical organism, mysteriously endowed with a will of its own. If it has any autonomy, that is an autonomy which emerges as an effect of social actions of--or rather, social interactions among--individual human beings both inside and outside the corporate organization. Directors, top officers, middle managers, long-term employees, and other 'insiders' all identify themselves as members of the corporate organization and attribute their actions *qua* members to those of the corporation. More importantly, creditors, suppliers, customers, short-term employees, and other 'outsiders' in turn recognize these individuals as members of the corporate organization and acknowledge their actions *qua* members as those of the corporation itself. It is true that corporate personality is a mere legal artifact. But it can serve as a sort of catalyst for the social construction of reality. To the extent that internal actions of organizational members and external recognition by contracting partners become routinely oriented around the corporate personality (instead of shareholders), the corporate organization maintains its autonomy and takes on social reality.[80]

---

[79] **See Maitland, *supra* note 2. A good summary of Gierke's views can be found in Hallis, also *supra* note 2, at 137-165.**
[80] **See Teubner, *supra* note 3, for an illuminating discussion on the 'social reality' of corporation. 'The corporate actor is "fictional" because it is not identical with the real organization but only with the semantics of its self-description. It is "real" because this fiction takes on structural effect and orients social actions by binding them collectively.' (Teubner at 57.)**

The autonomous character of corporate organization is tied closely to the existence of intangible assets that have been variously called 'managerial resources,' 'firm-specific human assets,' 'organizational capabilities,' 'organizational routines,' 'economic competence,' 'core competences,' 'good-will of a going concern,' 'corporate cultures,' etc.[81] They more or less refer to 'the collective learning in the organization,'[82] especially how to coordinate diverse production skills, integrate multiple streams of technology, maintain a reliable network of suppliers, and cultivate the goodwill of customers. In order to contain further terminological proliferation, we will simply call them 'organizational assets.' Such assets are, according to Alfred Chandler, 'created during the knowledge-acquiring processes that are always involved in commercializing a new product for national and international markets,' and 'resulted from solving problems of scaling up the processes of production, acquiring knowledge of customers' needs and altering products and process to services needs, coming to know the availabilities of supplies and the reliability of suppliers, and in becoming knowledgeable in the ways of recruiting and training workers and managers.'[83]

When a business corporation suddenly goes bankrupt, its unfortunate creditors can still get hold of a variety of tangible and intangible assets, such as land and buildings, plant and equipment, materials and inventories, cash and bank accounts, stocks and bonds of other corporations. They can also seize computer software, technology licenses, patent rights, copyrights,

---

[81] **Let me cite a few examples: 'managerial resources' -- Edith Penrose, *The Theory of the Growth of the Firm*, (Oxford University Press, 1959); 'firm-specific human assets' – Benjamin Klein, Robert Crawford, and Armen Alchian, 'Vertical Integration, Appropriable Rents, and the Competitive Contracting Process, 21 *Journal of Law and Economics* 297 (1978) and Oliver E. Williamson, *The Economic Institutions of Capitalism*, (The Free Press, 1985); 'organizational capabilities' -- Alfred R. Chandler Jr., 'Organizational Capabilities and the Economic History of the Industrial Enterprise,' 6 *Journal of Economic Perspectives* 79 (1992); 'organizational routines' -- Richard Nelson and Sidney G. Winter, *An Evolutionary Theory of Economic Change*, (Harvard University Press, 1982); 'economic competence' – Pavel Pelikan, "Evolution, Economic Competence and the Market for Corporate Control,' 12 *Journal of Economic Behavior and Organization* 279 (1989); 'core competences' -- Prahalad and Hamel, 'The Core Competence of the Corporation,' *Harvard Business Review* 79, 82 (May-June 1990); 'good-will of a going concern' -- John R. Commons, *Legal Foundations of Capitalism*, (Macmillan Company, 1924), etc. etc.**

[82] **Prahalad and Hammel, *op. cit*.**

[83] **Chandler, *supra* note 81, at 84.**

trademarks, and even brand names. Note that all of the assets we have just listed are things that were bought or leased from the market, or produced or in the process of being produced for the market. More importantly, they can be detached from the organization and sold or leased to the market, individually or in parcels or as a whole unit. In contrast to these more or less familiar assets, what we have called organizational assets can neither be bought nor leased from the market; nor can they be sold or leased to the market; because they consist of skills and know-how that are highly specialized to each organization. Such skills and know-how have to be developed and accumulated by organizational members themselves through repeated practices within an organization or repeated transactions with outside parties, because they are not available ready-made in the market. And such skills and know-how are not readily available in the market, because they were developed and accumulated within a very specific organizational context and are difficult to transfer to other organizations.

Hence, the peculiarity of organizational assets. On the one hand, organizational assets are assets, in the sense that they are expected to add values to the corporation, as all other assets do. In fact, it is the accumulation of these highly specialized and hard-to-transfer assets within its organization that endows each corporation with competitive advantages or secure niches, thereby contributing to the persistence of profits it can reap and sow in the long run.[84] On the other hand, organizational assets are organizational, in the sense that they can function as assets only within the organization they have been specialized to. They cease to be productive, as soon as the bankruptcy or hostile takeover dissolves the corporate organization containing them. Moreover, they belong to no one but the corporation! No one outside of the corporate organization, and by this we include not only creditors but also shareholders, can own them as their own property, because they are embodied in the organizational members in the form of skills and know-how. No one inside of the corporate organization, and by this we mean manag-

[84] This is, of course, the main theme of the so-called knowledge-base or competence theory of the corporation. See the references cited *supra* note 81.

ers and core employees, can own them as their own property either, because these skills and know-how become useless once they leave the organization.

Here emerges a rationale for our having set up the organizational self-reproduction and self-expansion as the 'purpose' of the 'realistic' corporation. Since the profits accruing from organizational assets are contingent upon the continuation of the corporate organization, and since no individual human beings, whether inside or outside of the corporate organization, can get hold of organizational assets as their property, it is both rational and legitimate for the corporation to retain at least part of its profits and use them for the maintenance and enlargement of its own organization. Indeed, it is this circular relationship between corporate organization and corporate profits, with organizational assets serving as a two-way link, that constitutes the 'material' foundation of the autonomy of corporate organization, especially of that of a 'realistic' corporation.

8. Fiduciary Principles in the System of Corporate Governance

Our picture of the business corporation could never be complete without having 'managers,' i.e., directors and officers, painted explicitly in it.[85] As was already remarked in the preceding section, the corporation is able to manifest its existence in society only through the acts of directors who hold the formal authority to exercise all the powers of the corporation or through the acts of corporate officers to whom the directors have delegated part of their powers.[86] This is of course an elementary fact in corporate law, but we have reiterated it so as to bring forward a fundamental difference in the role played by managers in a business corporation and by managers in an unincorporated firm. The recent upsurge of corporate nominalism, under the new guise of the contractual theory of the firm, has blurred this difference completely and reduced

[85] I use the term 'managers' to designate both directors and officers in the case of incorporated business firms.

[86] '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.' *RMBCA* §.01(b).

the theory of 'corporate governance' to a mere application of the theory of agency relationship.[87] I shall argue that this is a mistake.

'Agency' is, according to the Restatement, 'a fiduciary relation which results from the manifestation of consent by one person [the principal] to another [the agent] that the other shall act on his behalf and subject to his control, and consent by the other so to act.'[88] The control need not be total and continuous, but there must be some sense that the principal is 'in charge.'[89] Of course, in the case of an unincorporated business firm the relationship between an owner and a manager is a paradigmatic agency relationship, with the owner being the principal and the manager her agent. It is the owner who unilaterally defines the objective of the relationship and maintains the power to control and direct the manager who has consented to act solely on her behalf. In fact, the owner need not hire any manager at all. She can at any time terminate the agency relation and manage her own assets by herself. If there are any problems pertaining to the governance of an unincorporated business firm, they all arise from manager's all-too-human tendency to lead an easy life, or in a more treacherous case to seek personal gain at the expense of his boss. The owner may try to discipline the manager by monitoring his activities more diligently. The manager may try to guarantee his trustworthiness by setting up a bond that the owner could forfeit upon his substandard performance. But either attempt requires efforts and expenses, and the task of the owner of an unincorporated business firm is to find an optimal balance between the monitoring and bonding costs on the one hand and the residual managerial slack too costly to eliminate on the other.[90] Of course, this is all in the realm

[87] Jensen and Meckling, *supra* note 9; and Eugene Fama, 'Agency Problems and the Theory of the Firm,' 88 *Journal of Political Economy* 288 (1980); Easterbrook and Fischel, *supra* note 10.
[88] America Law Institute, *Restatement [Second] of Agency*, sec. 1 [1].
[89] 'The agency cannot exist unless the "acting for" party (the agent) consents to the will of the "acted for" party (the principal). The control need not be total or continuous and need not extend to the way the agent physically performs, but there must be some sense that the principal is "in charge." At minimum, the principal must have the right to control the goal of the relationship.' Daniel S. Kleinberger, *Agency and Partnership* (Little, Brown and Co., 1995), at 8.
[90] The sum of the monitoring costs, the bonding costs, and the residual loss that is too costly to eliminate constitutes what Jensen and Meckling, *supra* note 9, called the 'agency costs' in their well-known article on the agency theory of 'corporations.'

of contractual law or private ordering, and little room is left for mandatory legal rules or other forms of legal intervention.

Once, however, we turn to the problems of 'corporate' governance, or of governing the 'corporate' form of business firm with its characteristic two-tier ownership structure, we find ourselves on a totally different plane. The relation between shareholders and managers can no longer be identified with an agency relation. Whether shareholders consent it or not, the corporation is legally required to have a board of directors. Admittedly, shareholders can fire individual directors or even replace the entire team of incumbent directors at a shareholders meeting. But, they cannot dismiss the very legal institution of the board of directors, as long as a corporation remains a corporation. Admittedly, shareholders can approve or veto the directors' major policy decisions at a shareholders meeting. But they cannot deny the very legal powers of the directors to act in the name of corporation, as long as a corporation remains a corporation.[91] Shareholders are in no sense 'in charge' of the directors of their corporation.

Corporate directors are not the agents of the shareholders. If so, what are they? What are the legal status of corporate directors? The answer is: they are the 'fiduciaries' of the corporation. The fiduciary is a person who is entrusted to act as a substitute for another person for the sole purpose of serving that person.[92] Examples include guardians, conservators, trustees, administrators, bailees, union leaders, physicians, psychiatrists, etc. A fiduciary is called an agent if he is bound by a contract with the beneficiary (the principal) and is subject to her control. But the agent is merely a special type of fiduciary, and many of the fiduciary relations

---

[91] 'Stockholders cannot withdraw the authority they delegated to the board of directors, because they never delegated any authority to the directors.' Robert Clark, 'Agency Costs versus Fiduciary Duties,' in Pratt and Zeckhauser, *Principals and Agents: The Structure of Business*, (Harvard Business School Press, 1985), at 57.

[92] According to Tamar Frankel, the defining characteristics of fiduciary relations are: (a) that 'the fiduciary serves as a substitute for the entrustor' and (b) that 'the fiduciary obtains powers from the entrustor or from a third party for the sole purpose of enabling the fiduciary to act effectively.' Tamar Frankel, 'Fiduciary Law,' 71 *California Law Review* 795 (1983), at 808-9. By 'entrustor' Frankel means the other party for whose benefits a fiduciary relation is set up. See Deborah DeMott, *Fiduciary Obligation, Agency and Partnership: Duties in Ongoing Business Relationships* (West Publishing Co., 1991); Tamar Frankel, "Fiduciary Duties as Default Rules," 74 *Oregon Law Review* 1209 (1995).

are non-contractual relations. In fact, I would consider the paradigmatic fiduciary relation to be such as the one between a physician and an unconscious patient who was rushed to an emergency room for immediate operation. In the case of corporate directors, it is the law that endows them with the powers to act *as* the corporation rather than merely to represent the corporation as its agents under some superior authority.

This at once leads us to the central problem of corporate governance: the abuse of fiduciary powers. The risk that the corporate managers may not use their fiduciary powers in the best interest of the corporation stems, not from the mere psychological makeup of managers, but from the very nature of the corporation as a legal person.[93] Since the corporation is a mere legal construct, its managers are the ones who actually decide whether to buy or sell, lend or mortgage, use or maintain the corporate assets, all in the name of the corporation. Any act taken by the managers as managers legally binds the corporation as the act of the corporation itself. Of course, managers are endowed (or rather entrusted) with these powers only in their legal capacity as fiduciaries of the corporation. But as they continue to act *as* the corporation over and over again, there inevitably emerges the danger of *quid pro quo*: the danger that they unconsciously mistake their fiduciary powers for their own powers which can be employed at their own discretion. They may not exercise these powers with enough skill, diligence and care that the best interest of the corporation would demand. Worse, they may consciously appropriate these powers for the purposes of conferring a benefit on themselves, or even of injuring a particular party. The line between the use and abuse of fiduciary powers is extremely thin.

How can we prevent the corporate managers from transgressing this thin line? The answer to this question is by no means simple. But, I would now maintain that at the foundation of the

[93] 'It is important to emphasize that the entrustor's vulnerability to abuse of power does not result from an initial inequality of bargaining power between the entrustor and the fiduciary. ..... Rather, the entrustor's vulnerability stems from the structure and nature of the fiduciary relation. The delegated power that enables the fiduciary to benefit the entrustor also enables him to injure the entrustor, because the purpose for which the fiduciary is allowed to use his delegated power is narrower than the purposes for which he is capable of using that power.' Frankel, *op. cit.*, at 810.

corporate governance system lie the corporate managers' 'fiduciary duties' to the corporation, and that the legal rules regulating these duties should be essentially mandatory. These are no more than the orthodox principles of corporate governance before the onslaught of the contractual theory of the firm. They still are honored, at least among practical-minded corporate lawyers, even in the United States, the stronghold of the contractual theory.[94] What I should like to do in the rest of the present section is to supply a 'proof' of this orthodoxy by means of what one might call a 'legal thought-experiment.' In fact, the model of the purely 'realistic' corporation delineated in Section 4 provides us with an ideal setting for that experiment.

Accordingly, let us again imagine a corporation which is its own controlling shareholder by holding a majority block of its own shares. To remove any impurities from this hypothetical self-owning corporation, let us further suppose that it has no outstanding loans from banks and other financial institutions and that its relationships with workers, suppliers and customers are all at arm's length. Then, the only flesh and blood human beings we can find within the corporation are the directors and officers, that is, the managers.

What would be the principles of corporate governance for this hypothetical corporation? There is only one answer: by fiduciary law. Indeed, it is simply impossible to leave the matter to private ordering. The corporation itself is unable to arrange a monitoring mechanism or a bonding scheme with the managers, except through the very managers it is supposed to discipline. The corporation itself is unable to work out an incentive system (such as performance dependent bonuses and stock options) with the managers, except through the very managers it is supposed to give an incentive. Any attempt to control the corporate managers by means of contractual arrangements, whether explicit or implicit, would necessarily degenerate into self-dealing by managers themselves, and create the very problem it is attempting to solve. Moreover, since the sole controlling shareholder of this hypothetical corporation is the corporation

[94] **For a clear exposition of the orthodox principles, see Robert Clark, *supra* note 91; see also Robert Clark, *Corporate Law* (Little, Brown and Co., 1986) at 114 -189 and M. A. Eisenberg, 'The Structure of**

itself, there is no way to use takeover threats in the stock market to discipline its managers. Since neither financial institutions nor employees nor suppliers nor customers have any stake in our corporation, there is no way to use other stakeholders to watch over its managers. The only way to protect the interests of the corporation from such self-dealing is to have fiduciary law regulate directly the behaviors of managers.

The most conspicuous feature of fiduciary law is its highly moralistic tone.[95] Courts impose on the corporate managers the 'duties to the corporation,' not as a mere rhetorical device, but as the real content of the law. These duties specify the standards for judging the 'trustworthiness' and 'fairness' of the managers' decisions and transactions which may conflict with the best interests of the corporation. And these standards usually include the so-called 'duty of care', the restraint on 'excessive' managerial compensations, the strict rule on the disclosure of information, and the prohibition of self-dealing, trading corporate opportunity, trading on inside information, and outright theft.

The advocates of the contractual theory of the firm invoke fiduciary law with 'a standard-form penalty clause in every agency contract' and characterize its socially optimal form as the rules which 'approximate the bargain that investors and agents would strike if they were able to dicker at no cost.'[96] They thus argue that corporate law is essentially 'enabling' and that the participants of what they call 'the corporate contract' ought to be free to opt out of the existing rules if they all believe that they can strike a better bargain among themselves. This is totally untenable. Fiduciary law can never be a substitute for the private order. It is placed and ought to be placed at the foundation of the corporate governance system for no other reason than that any attempt to control managers by means of contract or other forms of voluntary agreement would necessarily involve an element of managerial self-dealing. To make corporate law ena-

---

Corporate Law,' 89 *Columbia Law Review* 1461 (1989).

95 **See Frankel, *op. cit.*, at 829-832; and Clark, *supra* note 91 at 75-79.**

96 **Frank Easterbrook and David Fischel, 'Corporate Control Transactions,' 92 *Yale Law Journal* 700, 737 (1982).**

bling and permit its fiduciary rules to be bargained around by insiders would be the surest way to destroy the corporate governance system.

Fortunately, the entire tradition of fiduciary law is consistently hostile to viewing the fiduciary rules as implicit contracts.[97] The courts impose on managers the duties of care and loyalty, even if some of these duties are expressly removed by corporate statutes, charter and bylaws, or by terms in contracts. They also refuse to delve into the subjective intentions of managers. Once the managers choose to enter into the fiduciary relation with the corporation, they owe the fiduciary duties to the corporation and cannot waive the courts' supervision at will.

One may take exception to this entire discussion, on the ground that it deals only with a hypothetical self-owning corporation without any stakeholders. However, we have conducted this thought-experiment, not so much for the sake of erecting a special corporate governance model applicable only to the purely 'realistic' corporation, as for the sake of reinstating the fiduciary law at the very foundation of every corporate governance system. As long as the business firm takes the form of a corporation with its characteristic two-tier ownership structure, it must have managers as its fiduciaries, thereby structurally giving rise to the possibility of fiduciary abuse of powers. Any attempt to control such abuse through contractual arrangement would necessarily involve an element of managerial self-dealing. And this is independent of whether the corporation occupies a position close to the 'realistic' end or the 'nominalistic' end of the legal menu of corporate forms we discussed in Section 5. It is in this sense that we claim that the corporate managers' fiduciary duties to the corporation should lie 'at the foundation' of any corporate governance system.

9. Supplementary Corporate Governance Mechanisms and Corporate Veil Piercing

---

[97] See, for instance, Frankel, *supra* note 92. In contrast, the Japanese courts have traditionally been rather lenient in applying fiduciary law, even though her *Commercial Code* (254-3) imposes strong duties of care and loyalty on the directors. This has had very unfortunate consequences for the performance of Japanese corporations.

It should be obvious that it is neither wise nor practical to rely exclusively on the fiduciary law for the governance of business corporations. Implementation of such law requires a well-organized legal system in general and active courts in particular. But not every country has a well-organized legal system, let alone active courts. And even if the courts were active, the full implementation of fiduciary law would demand a large amount of human and non-human resources. All the more so since the 'business judgment rule' very often works as a barrier to its applications unless courts are presented very strong cases. For the efficient as well as effective governance of business corporations, it is of vital importance to supplement fiduciary law with other governance mechanisms. And it is as the agents of these supplementary mechanisms that the shareholders as well as other stakeholders, such as banks, employees, suppliers, and customers, find their roles to play in the system of corporate governance. Indeed there is a wide variation in these supplementary mechanisms across countries, depending more or less on whether their dominant corporate form is 'nominalistic' or 'realistic.' We believe that the fact of this variation should constitute the very starting point of the theory of comparative corporate governance, but we can only give a rough sketch of it in what follows.[98]

To this end, let us now add 'impurities' to our hypothetical self-owning corporation little by little, and see how they will open up room for supplementary governance mechanisms.

---

[98] **For some useful accounts of comparative corporate governance, see Colin Mayer, 'New Issues in Corporate Finance,' 32 *European Economic Review* 116, (1988); Masahiko Aoki, *Information, Incentives and Barganing in the Japanese Economy,* (Cambridge University Press; 1988); Julian Franks and Colin Mayer, 'Capital Markets and Corporate Control: A Study of France, Germany and the UK,' 10 *Economic Policy* 191, (1990); John C. Coffee, 'Liquidity versus Control: The Institutional Investor as Corporate Monitor,' 91 *Columbia Law Review* 1277 (1991); Theodor Baums, 'Corporate Governance in Germany: The Role of the Banks,' 40 *American Journal of Comparative Law* 503 (1992); Ronald J. Gilson and Mark J. Roe, 'Understanding the Japanese Keiretsu: Overlaps Between Corporate Covernance and Industrial Organization,' 102 *Yale Law Journal* 871, (1993); Mark Roe, 'Some Differences in Corporate Structure in Germany, Japan, and the United States, 102 *Yale Law Journal* 1927, (1993); Masahiko Aoki and Ronald Dore, eds., *The Japanese Firm: Sources of Competitive Strength,* (Oxford University Press, 1994); Masahiko Aoki and Hugh Patrick, ed., *The Japanese Main Bank System,* (Oxford University Press; 1995); and Stephen Prowse, 'Corporate Governance in an International Perspective: A Survey of Corporate Control Mechanisms among Large Firms in the United States, the United Kingdom, Japan and Germany,' *BIS Economic Papers,* No. 41 (July 1994).**

Let us first recall that in actual society a corporation can become 'realistic' only as the result of extensive cross-shareholdings with other corporations. This implies that even the managers of a 'realistic' corporation are not completely free from peer pressure. If the managers of all the other corporations in the same group were to get together, they could muster enough shares to oust their fellow managers who have embarrassed the corporate group.[99] The effectiveness of this potential threat as a supplementary governance mechanism, however, has to be ascertained more systematically.

Second, let us remove the supposition that our 'realistic' corporation has no outstanding loans. Now, it can and may actually default on loans. And when on the brink of default, the residual rights over its assets are effectively transferred to the creditors, so that even a 'realistic' corporation becomes a mere thing in the hands of the banks and other financial institutions.[100] And once a corporation actually files for bankruptcy, the banks and other creditors, at least some of the major ones, are forced to assume an active role in monitoring the managers' restructuring activities. True, such a governance mechanism operates only in a state of emergency and *ex post facto*, but that possibility may legitimize the banks and creditors to acquire a *de facto* right to monitor the managerial performance *ex ante* as a sort of preventive measure.

As a matter of fact, many business corporations in Japan and in some of the continental European countries have (or used to have) a long-term relationship with one particular bank (or a small number of banks) whose role extends far beyond that of the major supplier of loans. We will call such a bank the 'main bank' of the corporation, though this designation seems to

---

[99] **Hiroshi Okumura has been emphasizing the importance of such peer pressure for the governance of large Japanese corporations in his numerous writings cited in *supra* note 62. In fact, the so-called Mitsukoshi affair in 1982 may be regarded as a good example of this mechanism. An autocratic and scandal-prone president of Mitsukoshi Department Store, a member corporation of the Mitsui group, was ousted in a board meeting at the initiative of an influential director who was a former president of the Mitsui Bank (hence, external to the corporation but internal to the group as a whole) so as to save the reputation of the Mitsui group as a whole.**

[100] **Because of the limited liability of shareholders, when the value of corporate assets cannot cover the value of debts, the rights over the disposal of the assets shift entirely to the hands of the creditors.**

be used only in Japan.[101] The main bank daily watches over the financial position of the client corporation and periodically reviews its long-term investment plans. If it holds a substantial equity position as well, the main bank may use that power to directly intervene in managerial decision-making and even go so far as to dispatch a rescue team when the client corporation is in financial distress. It is because of these *ex ante* monitoring and *ex post* restructuring activities that some regard the existence of the main bank as 'an important substitute mechanism for what in effect is a 'missing' takeover market.'[102] Indeed, there are several empirical studies, as well as a number of anecdotal stories, that suggest that the Japanese main bank system and an analogous financial arrangement in Germany have been truly effective in mitigating the moral hazard problems of the client corporation, especially when it is in financial distress.[103]

Many have, however, voiced skepticism toward such a view, and that skepticism arises from the too-obvious fact that the bank itself is a private business corporation that has a motive of its own. And even if the main bank also has an equity position in the corporation, there is often a legal limit (e.g., 5% in Japan) on the proportion of the corporate shares a financial institution is allowed to hold. It is therefore doubtful that the purpose of the main bank in monitoring and restructuring the client corporation coincides with or even approximates the best interests of the corporation, at least in normal times. Besides, who monitors the monitor? This suggests that the main bank system itself may turn out to be the paradigmatic corporate governance problem, not its cure.[104] Furthermore, we should also note that, even if the main bank system

---

[101] **For good accounts of the Japanese main bank system, see Paul Sheard, 'The Main Bank System and Corporate Monitoring and Control in Japan,' *Journal of Economic Behaviors and Organizations*, 11, 1989; Stephan Prowse, *supra* note 98; Masahiko Aoki, Paul Sheard, and Hugh Patrick, 'The Japanese Main Bank System: An Overview,' in M. Aoki and H. Patrick, ed., *op. cit.* For the roles of German banks in corporate governance, see J. Cable, 'Capital Market Information and Industrial Performance: The Role of West German Banks,' 95 *The Economic Journal* (1985); and T. Baums, *supra* note 98.**

[102] **Sheard, *op. cit.***

[103] **For the Japanese main bank system, see, for instance, Takeo Hoshi, Anil Kashyap, and David Scharfstein, 'Bank Monitoring and Investment,' in Glenn Hubbard ed., *Asymmetric Information, Corporate Finance, and Investment*, 105-126, (University of Chicago Press; 1991); for the German financial system, see Cable, *op. cit*.**

[104] **In fact, in Japan it is widely believed that it was the reckless speculative loans of the banks themselves, the supposed monitors of borrowers, that actually caused or at least fueled the so-called 'bubble**

really played an effectual role in the governance of corporations, it could only help those which have to maintain a close and closed relationship with one particular bank or few particular banks. If the corporations can have easy access to various forms of external finances (such as the corporate bonds market) apart from bank loans, the way to use this supplementary governance mechanism is simply closed off. In fact, the government-led deregulation of financial markets and the market-driven wave of financial innovations in recent years, which have generated a wide variety of new means of external financing, are said to have weakened much of the efficacy of the main bank system both in Japan and in Germany.

Third, let us introduce long-term employees into our picture of the 'realistic' corporation. In several European countries employees have legal rights to participate in corporate management.[105] German law requires a stock corporation (AG) of more than 2,000 employees to have the representatives of employees and trade unions occupy 50% of seats on the supervisory board which oversees the lower-tier management board.[106] No such law exists in Japan; but a majority and sometimes the entire membership of the board of directors and the board of inspectors of a large Japanese corporation are promoted through internal competition from the pool of core employees who enjoy long-term employment, a seniority wage system and company unionism. Behind these laws and practices is a fact that the long-term employees have throughout their long working careers in the same organization accumulated a large amount of organizational assets -- skills and know-how not easily transferable to outside uses. If such skills and know-how were to contribute to the profitability of the corporation, the employees who embody them in their corporeal existence should have a *de facto* right to the management of the corporation. Again, however, we have to note that, even if the employees' voices actually

---

economy' in the second half of the 1980s. The bubbles then burst, and the majority of Japanese banks were left with a huge burden of bad loans.

105 **See Klaus Hopt, 'New Ways in Corporate Governance: European Experiments with Labor Representation on Corporate Board,' 82 *Michigan Law Review* 1338 (1984).**

106 **See, for instance, Terence Blackburn, 'The Societas Europea: The Evolving European Corporate Structure,' 61 *Fordham Law Review* 695 (1993).**

played an important role in the management, they might not necessarily be the ones which would promote the best interests of the corporation as a whole.

Fourth, we have to let our 'realistic' corporation maintain relational contracts with suppliers and customers. But their implications for corporate governance are far from clear-cut. On the one hand, repeated interactions may promote cooperation from suppliers and customers, which may work to lessen competitive pressures on managers. On the other hand, long-lasting relationships may encourage suppliers and customers to voice their opinions openly on the matters related to their transactions, which may work to check some of the managerial decisions. The balance can go either way, and nothing definite can be said on the effectiveness of this governance mechanism.

Up until now, we have been concerned only with the governance of the 'realistic' corporation. It is time to move in the 'nominalistic' direction along the long legal menu of possible corporate structures. For this purpose, we now have to unwind the tight network of cross-shareholdings among group corporations and expose the managers of each one of them to the harshness of the stock market, that is, to the market for corporate control.

At least in Anglo-American countries, hostile takeovers are often regarded as the most effective disciplinary device against managers. Since there is huge literature on this subject and since we ourselves have already discussed the mechanisms in Section 3, we will touch on it very briefly here. The basic argument is that whenever the share price of any corporation fails to reach the fundamental value of corporate assets, and as long as a majority of its shares are openly traded in the stock market, a corporate raider can easily employ the technique of LBO to wrest control from managers. Fearful of such takeover, the story goes, incumbent managers have little choice but to maximize the share price of their corporation.[107] The bulk of empirical

[107] **Note, however, the free-rider problem discussed in note 23 *supra*.**

evidence indeed suggests that hostile takeovers generate substantial gains to the targeted shareholders.[108]

There are, however, heated disputes over the sources of these gains. The standard theory has attributed these gains to the increased efficiency of the raided corporation, due to such factors as the installment of better managers, realization of economies of scale and scope, improvement of incentive schemes, and tapping of free cash flow. 'The market for corporate control is creating,' claims one of its chief advocates, 'large benefits for shareholders and for the economy as a whole by loosening control over vast amounts of resources and enabling them to move more quickly to their highest-valued use.'[109] In opposition to this, however, many now argue that most of the gains of shareholders in hostile takeovers are no more than wealth transfers from other stakeholders. The raider may simply be expropriating long-term employees by effectively nullifying the implicit contracts they formed with ousted managers and forcing a substantial cut in their wages and pension funds.[110] The raider may simply be expropriating future shareholders and future stakeholders by slashing R&D and other future-orientated investments to finance current dividend payments.[111] The raider may, according to the so-called 'hubris hypothesis,' simply be expropriating herself by setting a bidding price much higher than is justified by the rational calculation of the fundamental value of corporate assets.[112] What these expropriation theories suggest is a possibility that even the stock market discipline of corporate managers may sometimes end up with simply substituting one governance problem for another, rather than solving it.

---

[108] **See Michael Jensen and Richard Ruback, 'The Market for Corporate Control: The Scientific Evidence,' 11 *Journal of Financial Economics* 5 (1983); Jarrell, Brickley and Netter, *supra* note 23; Sanjai Bhagat, Andrei Shleifer and Robert Vishny, 'Hostile Takeovers in the 1980s: The Return to Corporate Specialization,' *Brookings Papers on Economic Activity: Macroeconomics 1990* 1, 1 (1990).**
[109] **Jensen, *supra* note 25, at 23.**
[110] **Andrei Shleifer and Lawrence Summers, 'Breach of Trust in Hostile Takeovers,' in Auerbach, ed., *Corporate Takeovers: Causes and Consequences*, 33 (University of Chicago Press, 1988).**
[111] **Michael A. Hitt, Robert E. Hoskisson, Richard A. Johnson, and Douglas D. Moesel, 'The Market for Corporate Control and Firm Innovation,' 39 *Academy of Management Journal* 1084-1119 (October 1996).**
[112] **Richard Roll, 'The Hubris Hypothesis of Corporate Takeovers,' 59 *Journal of Business*, 197 (1986).**

Finally, let us go to the other pole of the legal menu of corporate forms and examine the problems of governing a purely 'nominalistic' corporation. By definition a purely 'nominalistic' corporation has a natural person (or a group of natural persons) who holds a majority block of its shares and effectively owns it as her property. Such a corporation is of course the closest to the unincorporated business firm among all possible forms of corporations. And yet, even in this case the relationship between dominant shareholder and corporate managers is not as simple as the relationship between the owner of an incorporated firm and a manager she has hired as her agent. As long as a business firm retains a corporate form, corporate managers remain managers of the corporation, and it is only through her domination of shareholders' meeting, in particular through her exclusive appointing power of directors, that the dominant shareholder can exercise control over corporate managers. Of course, she can install a monitoring or bonding contract to discipline corporate managers; she can set up an incentive contract to motivate corporate managers. But these contractual arrangements cannot override fiduciary law. They have to supplement the legal rules which directly regulate the performance of the managers as fiduciaries of the corporation.

I do not want to give the impression that even the dominant shareholder cannot control the managers of her 'nominalistic' corporation. Of course she can, if she is keen and active. I merely want to emphasize the importance of distinguishing *de facto* from *de jure* relationship between the dominant shareholder and the corporate managers. In fact, what I would now argue is that even if the dominant shareholder has succeeded in controlling corporate managers completely, it does not mark the end of corporate governance problems. It merely changes the form they take.

The most important governance problem for the purely 'nominalistic' corporation is no longer the corporate managers' abuse of fiduciary powers; it is now the dominant shareholder's abuse of corporate privileges, especially of their limited liability status, to the detriment of outside creditors, such as lenders, suppliers, employees, customers, and tort plaintiffs. As we have

already seen, a purely 'nominalistic' corporation is in reality a mere thing at the disposal of its dominant shareholder. Yet, legally, or rather nominally, it still has a personality, distinct from that of the dominant shareholder and capable of owning assets under its own name. What it is *really* is not what it is *nominally*. And it is not hard to see that this real/nominal discrepancy gives the dominant shareholder an easy opportunity for a variety of sham transactions. In particular, she can use her own corporation as her 'alter ego' and have its managers transfer its assets and incomes to herself, with the intent to delay or reduce or defraud the payment of the debts it owes to outside creditors. Indeed, it is to protect these unfortunate creditors from such fraudulent transfers that courts sometimes 'pierce the corporate veil' and subject the dominant shareholder to personal liability for the debts of the corporation. As we argued in section 1, since the corporation having a legal personality and the shareholder having limited liability are merely the two sides of the same coin, it makes a sense to revoke the latter whenever the former was abused.

It is true that the legal principles that underlie such piercing cases are but a subset of the so-called Uniform Fraudulent Transfer Act or its predecessor, the Uniform Fraudulent Conveyance Act, the gist of which consists in a few simple but potent moral principles governing the conduct of all debtors towards their creditors.[113] But the piercing cases distinguish themselves from others in that the fraudulent transfers involved in them are the transfers between two 'persons' within the same business firm, that is, between the corporation as a legal person and its dominant shareholder. Legally these two persons are independent of each other, but in the case of the purely 'nominalistic' corporation the former is actually, like a slave in ancient times, a mere thing owned and controlled by the latter. The corporate piercing cases are thus the product of the very two-tier ownership structure that distinguishes incorporated business firms from unincorporated ones. Hence, our inclusion of these cases in the category of corporate governance problems.

10. Concluding Remarks.

In recent years, a growing number of journalists, business leaders, public officials, and academics have been claiming that Japanese-style corporate system, which supported the half-century of remarkable economic growth following the second World War, is now in the decline.[114] The 'origin' of the Japanese corporate system has been traced by various authors to various historical sources, such as the heritage of traditional merchant houses during the Tokugawa period, the late-development effect before the WWII, the legacy of control economy during the WWII, the one-shot effect of the break-up of Zaibatsu after the WWII, the bureaucratic guidance during the high-speed growth era, and so on.[115] But there is at least one consensus - Japan was able to develop a highly 'realistic' corporate system chiefly because its relatively large domestic market was effectively shielded from the outside world during much of the postwar period. Now that its economy has overtaken most of the advanced Western economies both in size and in efficiency, Japan can no longer act as a 'small country' and has to expose itself to the harshness of global capitalism. In addition to this, the bursting of the stock market and property market bubbles in the late 1980s and the belated but rapid liberalization of financial markets in the 1990s are said to have weakened the traditional ties between major banks and industrial firms and to have begun to loosen the tight networks of corporate cross-shareholdings that have shaped up the very 'realistic' feature of the Japanese corporate system.[116]

It is of course quite unlikely that many of the Japanese corporations will soon expose themselves to the market for corporate control and start behaving like American corporations. Be-

---

[113] **See, for instance, Robert Clark, *Corporate Law*, already cited in note 94 *supra*, at 35-92.**

[114] **And a growing number of journalists, business leaders, public officials, and academics have also been claiming that the German-style corporate system, which supported the half-century of steady economic growth and stable social environment following the second World War, is now in the decline.**

[115] **See, for instance, Barca, Iwai, Pagano and Trento, supra 28.**

[116] **As the recent announcement of big bank mergers, noted in supra note 67a, have witnessed it.**

cause the 'realistic' feature of the Japanese corporate system is so firmly interlocked with its other characteristic features that only a very strong institutional shock that can undermine the interlocked features all at once will put an end to the whole system.[117] In spite of the impending changes in its environment, most of the Japanese corporations are likely to remain highly 'realistic' at least for the time being. But, in this post-industrial era of ever-advancing information technology and ever-expanding global markets the current tide is certainly in the 'nominalistic' direction. If the history did establish the Japanese corporate system, the history can overturn it.

And yet, even if the Japanese corporate system had indeed finished its 'historical mission' already, the fact would still remain that such a highly 'realistic' corporate system really existed on this globe and prospered at least for half a century. It has at least taught us the surprising versatility of the legal institution of publicly-held corporation, whose two-tier ownership structure is capable of supporting a wide variety of business organizations even among advanced capitalistic economies.[118] Besides, history has never been and will never be linear.

[117] In other words, there is what Aoki called 'institutional complementarity' or what Pagano and Rowthorn called 'institutional stability' between 'realistic' corporate forms and other features of the Japanese economy, such as long-term employment and the seniority wage system of core workers, internal promotion mechanism of managers, and relational contracts with suppliers and customers. See the works of Aoki quoted 98 in note *supra*, and Ugo Pagano and Robert Rowthorn, "Ownership, Technology and Institutional Stability," 5 *Structural Change and Economic Dynamics* 221, (1994).
[118] In spite of the announcement of its 'eclipse' by Michael Jensen, 'Eclipse of the Public Corporation,' *Harvard Business Review* 61 (September-October 1988).