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WHAT IS CORPORATION?
-- THE CORPORATE PERSONALITY CONTROVERSY AND THE FIDUCIARY PRINCIPLE IN CORPORATE GOVERNANCE[1]

by

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<Abstract>

The present article is an attempt to 'end' the age-old controversy over the nature of corporate personality. It is, however, not by declaring victory for one side or the other, but by declaring victory for both. The key to this claim is an observation that an incorporated firm is composed of not one but 'two' ownership relations: shareholders own the corporation and the corporation in turn owns corporate assets. The corporation thus plays the dual role of a 'person' and a 'thing' in the system of law. This article then shows how this person/thing duality of corporation is capable of generating two seemingly contradictory corporate structures -- one approximating 'corporate nominalism' and the other 'corporate realism.' Such absence of a single corporate structure does not, however, imply the absence of a single principle unifying a variety of corporate governance systems in different countries. The fact that a corporate firm is characterized by two-tier ownership structure implies that corporate managers cannot be regarded as agents of shareholders. They are instead 'fiduciaries' of the corporation. This article argues that at the foundation of every corporate governance system lie the managers' fiduciary duties to the corporation and that the law governing these duties should be essentially mandatory. It also argues that a variety of corporate governance systems across countries is due to the difference in governance mechanisms that supplement the costly implementation of fiduciary law by courts.

JEL Classification: D23, G30, K00, K22, L20

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[1] This article is based on a lecture delivered for ISER XIII Workshop on ECONOMICS AND LAW, held from 25 June to 6 July, 2000, at the Certosa di Pontignano, Siena, Italy. It is based chiefly on Iwai [1999]. (See also Iwai [2002].) It will appear in F. Cafaggi, A.Nicita and U. Pagano eds., *Legal Orderings and Economic Institutions*, (London: Routledge).

0. Introduction.

What is corporation? The law speaks of a 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 among all jurists and legal scholars have debated heatedly as to what constitutes the 'essence' of this soulless and bodiless person. In this so-called 'corporate personality controversy,' one of the most celebrated controversies in legal theory and legal philosophy, two competing legal theories have emerged, each advancing diametrically opposed view on the 'essence' of the corporation. They are 'corporate nominalism' and 'corporate realism.'[3] The corporate nominalism asserts that the corporation is merely a contractual association of shareholders, whose legal personality is no more than an abbreviated way of writing their names together. In opposition, the corporate realism claims that the corporation is a full-fledged organizational entity whose legal personality is no more than an external expression of its real personality in the society. And both claim to have superseded the 'fiction theory,' the traditional doctrine since the medieval times, which maintained that the corporation is a separate and distinct social entity but its legal personality is a mere fiction created by the state.

The rivalry between corporate nominalism and corporate realism has continued up until now. The contractual theory of the firm, be it an agency theory version or a transaction-cost economics version or an incomplete contract theory version, is a direct descendant of the corporate nominalism,[4] whereas the evolutionary theory of the firm or the knowledge-base view of the firm can be interpreted as a modern reincarnation of the corporate realism.[5] The former regards corporate firms

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[2] Sec. 3.02 of the American Bar Association's *Revised Model Business Corporation Act [RMBCA]* 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 Savigny [1884], Maitland [1900], Machen [1911], Dewey [1926], Radin [1932], Wolff [1938], A. Hart [1954], Dan-Cohen [1986], Teubner, [1988]. For a comprehensive review of various theories of corporate personality [before 1930], see Hallis, [1930]. In Iwai [1999] I have given a more extensive discussion on this controversy.

[4] See, for instance, Coase [1937], Alchian and Demsetz [1972], Jensen and Meckling [1976], Easterbrook and Fischel [1991], and Williamson [1985], Grossman and Hart [1986], Hart [1995].

[5] See, for instance, Penrose [1959], Nelson and Winter [1982], Teece [1982], Wernerfelt [1984], Prahalad and Hamel [1990], and Chandler [1992].

as "simply legal fiction which serve as a nexus for a set of contracting relations among individuals,"[6] whereas the latter posits corporate firms as "organizations that know how to do things, ... while individual members come and go."[7] The corporate personality controversy is far from a relic of the past.

The present article is an attempt to 'end' this age-old opposition between nominalism and realism once and for all. It is, however, not by declaring victory for one side or the other. It is by declaring victory for both. The key to this claim is an observation that, in contrast to an sole-proprietorship firm or a partnership firm, a 'corporate' form of business firm consists 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 a 'person' and a 'thing' in the system of law. It is, I believe, this person/thing duality that is responsible for the long persistence of the controversy on corporate personality. Indeed, the first objective of the present article is to demonstrate how this person/thing duality of the corporation is capable of generating two seemingly contradictory corporate structures -- one approximating corporate realism and the other approximating corporate nominalism.

The law is thus unable to determine the legal nature of the corporation even within its own system. This 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 firms, not of governing sole-proprietorship firms or partnership firms. Indeed, the fact that a corporate firm is characterized by two-tier ownership structure implies that corporate managers cannot be regarded as agents of shareholders; they are the 'fiduciaries' of the corporation. The second purpose of this article is to demonstrate 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. The article also argues that a variety of corporate governance systems across countries is due to the difference in governance mechanisms that supplement the costly implementation of fiduciary law by courts.

1. Persons, Things and Corporations

In the basic model of the market economy, expounded in any introductory textbook of economics,

[6] Jensen and Meckling [1976], p. 310.
[7] Winter [1988], p. 176.

the relationship between persons and things is simple and clear. As is illustrated in *Fig. 1*, 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 a world of science-fiction.

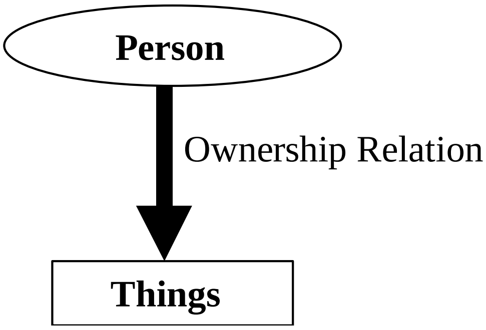

Fig. 1: A Person and Things.

Capitalistic firms are founded on this simple relationship between persons and things. In the case of the traditional sole-proprietorship firm, an individual invested his capital in productive assets in order to earn profits. As is shown in *Fig.* 2, the individual capitalist was the subject of property right, whereas the assets, both tangible and intangible, were the objects of property right. They were directly opposed as a person and things.

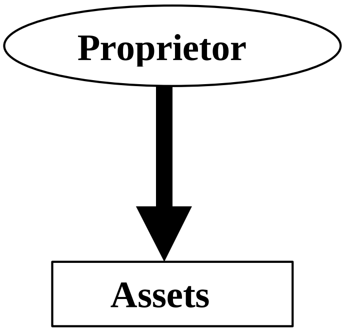

Fig. 2: The Basic Structure of a Sole-Proprietorship Firm.

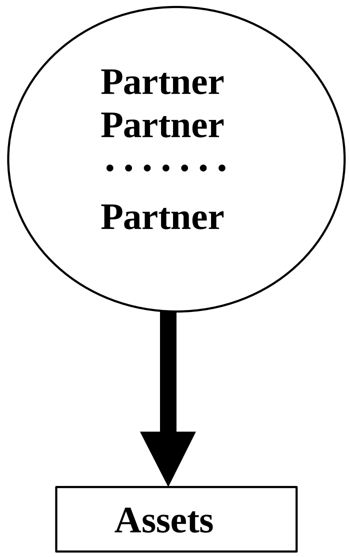

Fig. 3: The Basic Structure of a Partnership Firm.

We can draw essentially the same picture for the partnership firm. Instead of a single person owning assets, a group of individuals now own these assets jointly, as is depicted in *Fig. 3*. And yet, a transition from sole-proprietorship to partnership may engender a fundamental change in the nature of the firm. As is illustrated in *Fig.* 4, in capitalistic society every business undertaking must enter into numerous contractual relations with outside parties such as employees, suppliers, customers, and creditors. In the case of a partnership firm, every partner has an equal right and an equal duty to any contract it maintains. This means that 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 rewrite a contract *ex post* involves various kinds of transaction costs. Of course, if the number of partners is small or the scope of outside contracts is limited, it may be possible to save these transaction costs by including *ex ante* provisions for such contingencies in each contract. But, as the size of the partnership gets larger or outside relationships become numerous, these transaction costs would soon become prohibitively large, thereby rendering the contracts necessarily incomplete. Outside parties would then be easily discouraged to enter into contractual relations with the partnership firm.

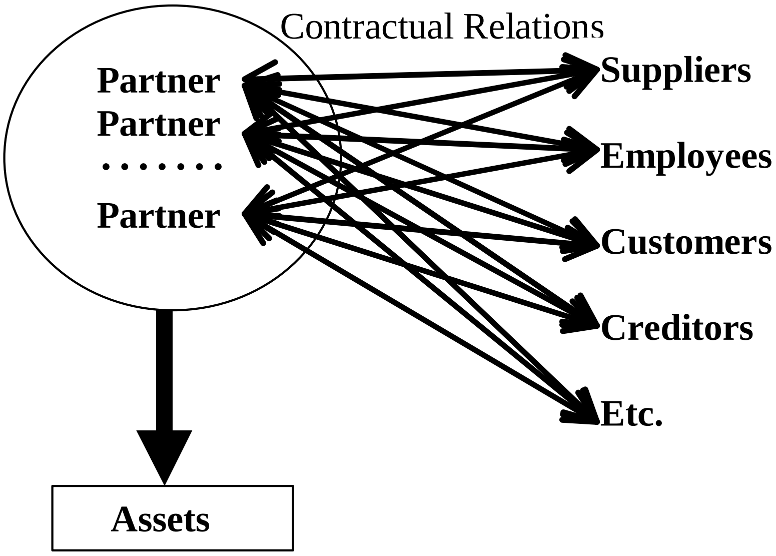

Fig. 4: Contractual Relations between a Partnership Firm and Outside Parties.

The corporation is a legal solution to this problem. How can it solve this problem? If a group of *N* individuals decide to set up a corporation and to become its shareholders, it is like creating beside themselves the $N+1^{st}$ person who has the same legal capacity to own real assets as they themselves have. As is illustrated in *Fig. 5,* outside parties then become able to enter into a contract with this $N+1^{st}$ person, independently of its *N* shareholders, in exactly the same manner as they enter into a contract with the owner of a sole-proprietorship firm. Hence, the complex network of contractual relations is greatly simplified, leading to a large reduction of transaction costs for all participants. This also shields the contracting outside parties from the vagaries of the death, withdrawal or entry of its individual shareholders, thereby encouraging them to form contractual relations with the firm.

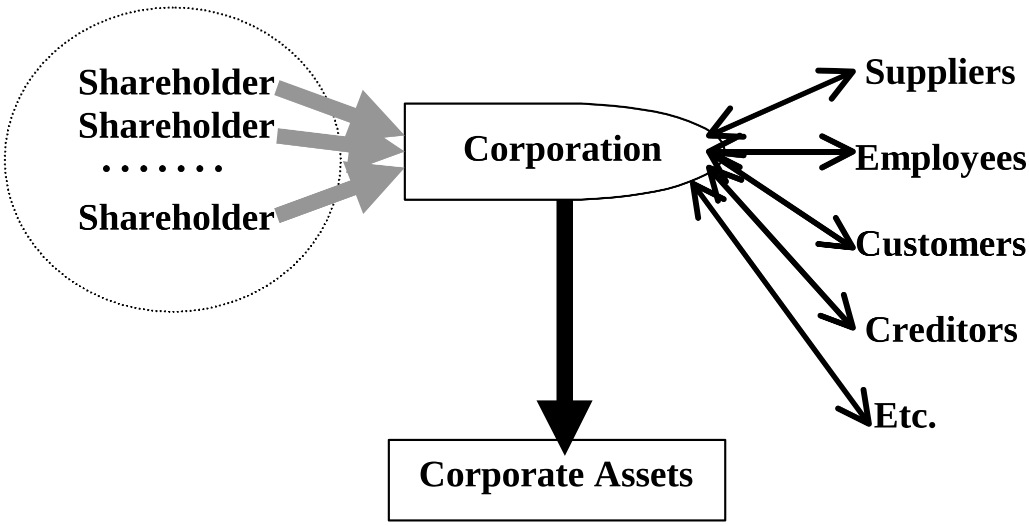

Fig. 5: Corporation as a Legal Device to Simplify Outside Relations.

I have dwelled upon a textbook account of corporate *raison d'être* in order to bring home the central fact about the legal institution of corporation: the corporation cannot be reduced to a mere 'standard form contract' among its constituting shareholders. The corporation is presented here, not as a devise to economize on the transaction costs of arranging internal organization among shareholders, but as a devise to economize on the transaction costs of arranging external relationships the shareholders have with outside parties. As the corporate nominalists have never been tired of pointing out, any innovation in the firm's organizational structure can in principle be arranged internally by a well-crafted contractual agreement among shareholders.[8] To do so may incur transaction costs, but those costs could easily be reduced by the extensive use of standard form contracts. In contrast, the corporation's legal capacity to coordinate the complex contractual relations between inside shareholders and outside parties is essentially a 'social' or 'inter-subjective' one. It cannot be asserted by the internal agreement among shareholders alone, no matter how skillfully they formulate the contract, unless it is acknowledged by employers, suppliers, customers, creditors, and other outsiders. A corporation is able to act as an independent owner of its own property capable of forming contractual relations 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 what the law does is to formalize and reinforce this social recognition in the form of legal personality. Indeed, the Latin word 'persona,' from which the English word 'person' is derived, meant originally an actor's mask. 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.

To recapitulate: the corporation is introduced into the legal system as a non-contractual legal device to simplify the external relationships of a group of individuals. But we all know that there is no 'free lunch' -- even in the province of law. What I would like to show now is that this simplifying device also has the effect of complicating the internal ownership structure of a corporate firm.

2. The Corporation as a Person/Thing duality.

Suppose you are an owner of a mom & pop grocery shop around a corner. Whenever you feel hungry, you can pick up an apple on the shelf and eat it right away. That apple is your property, and

[8] See, for instance, Easterbrook and Fischel [1991], at 1445, and Posner [1992], at 392-393.

the only thing you have to worry about is the wrath of your spouse -- your co-owner.

Suppose next you are a shareholder of a corporation, say, a big supermarket chain. Suppose further that you feel hungry. If you march into one of its stores and grab an apple from the shelf, claiming that that apple is your property. What will happen to you? You will be immediately arrested as a thief! Why? It is because corporate shareholders are *not* the owners of corporate assets. Who is, then, the owner of the corporate assets? The answer is, of course, the corporation itself as a 'legal person.' After all, the corporate assets are literally the corporation's assets. It is the corporation itself as a legal person that is the owner of the corporate assets. Then, what are the corporate shareholders? The answer is, of course, they are the owners of the corporation. Literally as well as legally, corporate shareholders are the holders of a corporate share – of a bundle of financial rights and participatory rights in the corporation that can be bought and sold freely as an object of property right. Indeed, to hold a corporate share is to own a fraction of the corporation as a 'legal thing,' independent of the remaining fraction and separate and distinct from the underlying corporate assets. It is the corporation itself as a legal thing that the corporate shareholders are the owners of.

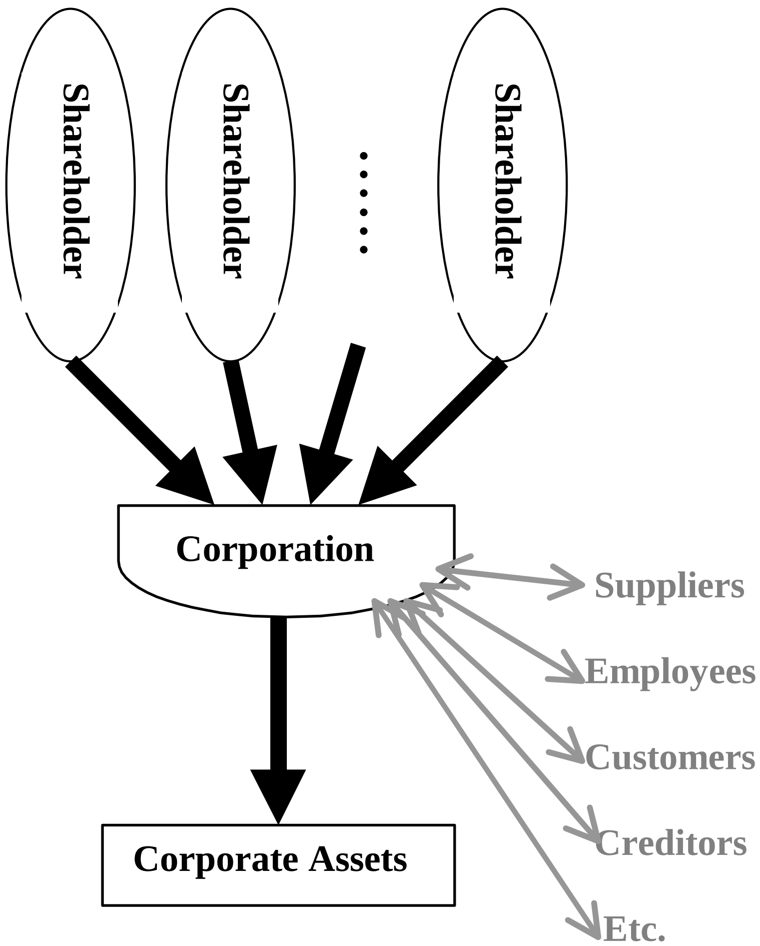

Fig. 6: The Two-Tier Ownership Structure of a Corporate Firm.

All this is the most elementary fact about the corporation no textbook of corporate law has ever failed to make note of. But its implications, I believe, have not been fully worked out even by legal scholars, let alone by economists, because this observation will lead us to the most crucial characterization of the internal structure of a corporate firm. In contrast to a sole-proprietorship firm depicted in *Fig. 2* and a partnership firm depicted in *Fig. 3*, a corporate firm is composed of not one but *two* ownership relations. As is shown in *Fig, 6*, the shareholders own the corporation as a legal thing, and the corporation as a legal person in turn owns the corporate assets.

I have argued in the preceding section that the corporation is a legal device that simplifies the external relations a business firm has to have with outsiders. We have now seen 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. Of course, a corporation is in reality neither a person nor a thing. Legally, however, it is endowed with both personality and thingness.

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 controversy on corporate personality. In fact, if we only look at the first tier, the corporation appears merely as a thing owned and controlled by shareholders, and we draw near to the position of corporate nominalists. If we only look at the second tier, the corporation appears fully as a person owning and managing corporate assets, and we draw near to the position of corporate realists.

However, one must note 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. But what I am going to demonstrate is that there are ways to eliminate either personality or thingness from the person/thing corporation, thereby turning it into a mere 'thing' or a full 'person', respectively.

3. How to Make a 'Nominalistic' Corporation.

The way to eliminate personality from a corporation is simple: it is to have someone own more than fifty percent of its shares. That someone then acquires an absolute control over the corporation. The corporation is 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. As is shown in *Fig. 7*, the corporate firm is reduced *de facto* to a single ownership relation between the dominant shareholder and the assets. We are certainly in the world of the corporate nominalism here.

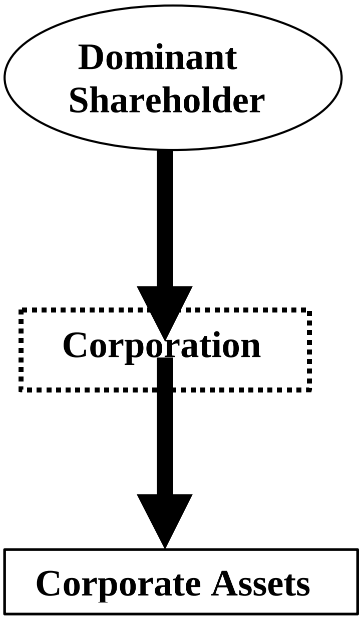

Fig. 7: A ‘Nominalistic’ Corporation.

This is of course a common sense. But I will now argue that the so-called corporate raiders are daily putting this legal mechanism into practice in the real economy.

That a corporate firm consists of two-tier ownership relations implies that it contains in it two kinds of 'things' — the corporate assets and the corporation itself. This fact immediately implies that there are also two kinds of values residing in a corporate firm. They are, respectively, the value of corporate assets and the value of the corporation as a thing. The former can be defined as the present discounted value of the future profit stream that would accrue from the most efficient use of these assets. This can also be called the 'fundamental' value of the corporation. The latter can be identified as the total share price of the corporation in the stock market.

And the business of a corporate raider is to search for a corporation whose stock market value is substantially lower than the value of the underlying assets. As soon as he has identified such corporation, he begins a takeover bid (TOB). Suppose that a TOB was successful, then our corporate raider would gain an absolute control over the use of the corporate assets.[9] He then closes

[9] We ignore all the informational difficulties associated with TOB operation discussed by Grossman and Hart

off the corporation from the stock market. If he wants quick money, then he as the *de facto* owner sells off part or all of the corporate assets in second-hand asset markets. If he is patient, he replaces the incumbent managers by new and better ones, closely monitors their management, and wait for the upward turn of the performance of the purchased corporation. In any case, it is the difference between the values of corporate assets and corporate shares that constitutes the profit from this TOB operation.

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 realize the idea of corporate nominalism in this world.

4. How to Make a 'Realistic' Corporation

I am now going to demonstrate that there exists a legal mechanism which is able to eliminate thingness from the person-cum-thing corporation.

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 at once suggests that a corporation as a person can in principle own another corporation as a thing. In fact, since the state of New Jersey in the United States legalized holding corporations in 1889, corporations all over the world have been buying and holding the shares of other corporations. A holding corporation is a corporation that is created solely for the purpose of owning other corporations, as is shown in Fig. 8. It thus acts as a person in regard to the corporations it owns.

[1980].

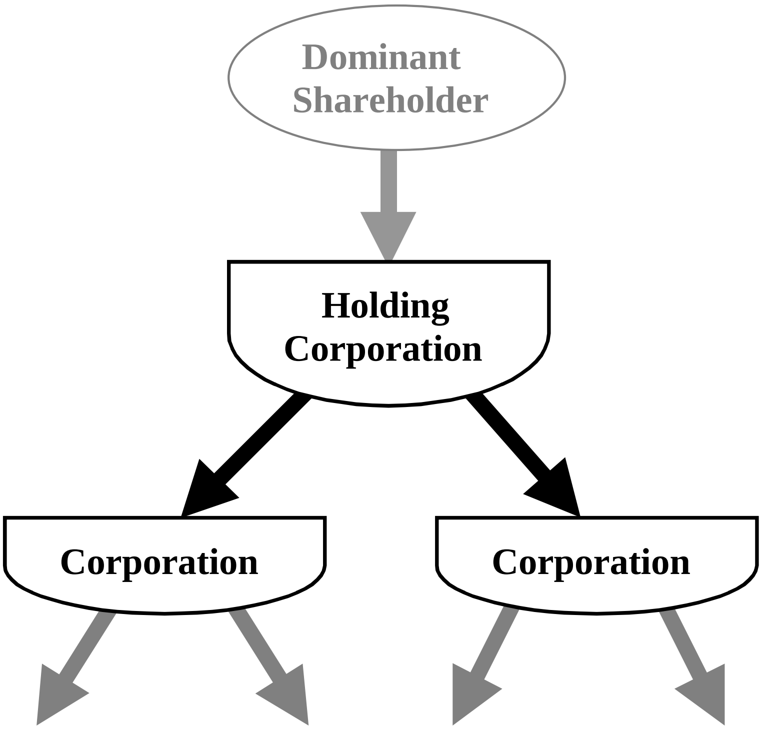

Fig. 8: A Holding Corporation and a Pyramidal Ownership Structure.

In fact, the holding corporation has opened a way to an important organizational innovation: the pyramidal system of ownership and control. At the top is a capitalist family who owns a corporation as a thing. But, being also a legal person, that corporation can own another corporation as a thing, which again as a legal person can own another corporation as a thing, and so on. Such ownership hierarchy can extend *ad infinitum*. This is, however, not the whole picture. Because you do not have to own all the shares to control a publicly-held corporation. As long as minority shares are sufficiently diffused among passive investors in the stock market, only a share slightly greater than *50%* is sufficient for the control. This implies that one unit of capital can in principle control almost two units of capital, if each half buys a bare majority of the shares of a corporation with a capital close to one unit. It then follows that, as more and more layers are added to the ownership hierarchy, a capitalist family at the top can multiply the controlling power of their capital by the order close to 2^n, where n is the number of hierarchical layers beneath.[10] One can regard the pre-war Japanese Zaibatsu and present-day Italian family empires and Korean Chaebols as typical examples of this pyramidal system of ownership and control.

Nevertheless, a holding corporation still falls short of shedding its thingness entirely, because it has its own dominant shareholders watching over it. One can, however, go a step further at least in

[10] Moreover, if this hierarchical structure is combined with cross-shareholdings at each hierarchical layer, the capitalist family at the top can further enhance the leverage of their own capital.

theory. A corporation as a person can own itself as a thing. Indeed, nothing prevents us from imagining a corporation that becomes its own dominant shareholder by holding a majority block of its own shares under its own name, as is illustrated in *Fig. 9*. If this were indeed possible, that corporation would be free from any control by real human beings and become a self-determining subject. It would remove the thingness from itself and acquire a full personality in the province of law.

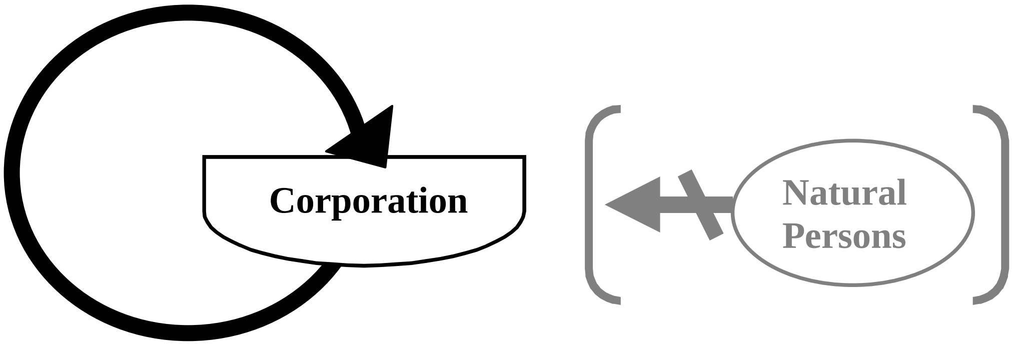

Fig. 9: A (Hypothetical) Self-Owning Corporation.

One might dismiss all this as idle speculation. Many countries prohibit a corporation from repurchasing its own outstanding shares. And in other countries which allow share repurchases, the repurchased shares always lose their voting rights in shareholders meetings. 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. As is illustrated in *Fig. 10*, 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. 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.

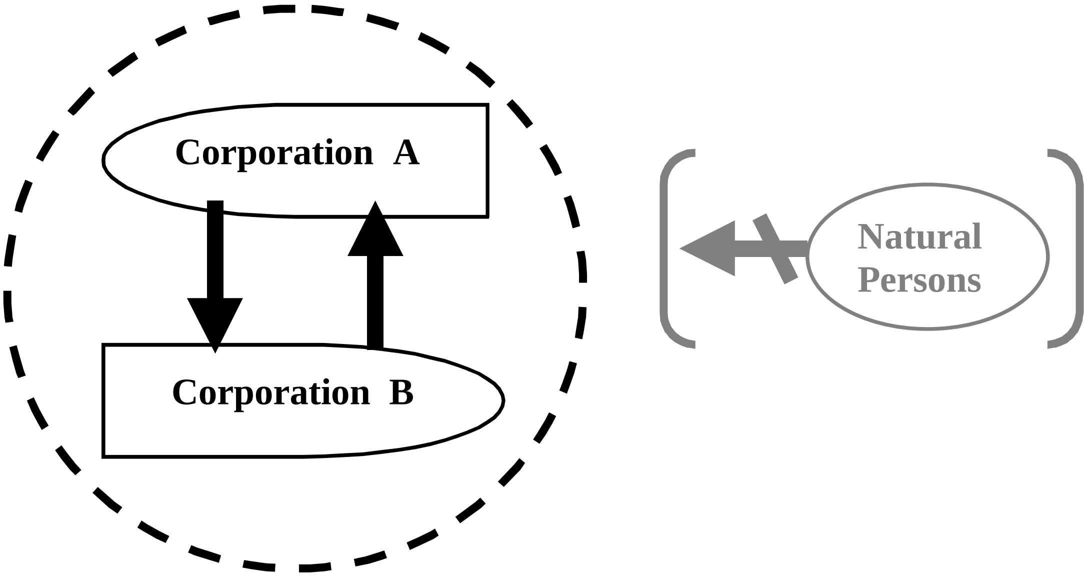

Fig. 10: Mutually Holding Corporations.

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. 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.

Yet, it is possible to circumvent even these limits. Suppose that twelve corporations get together and that each holds *5* percent of each of the other's shares. Then, simple arithmetic ($(12 - 1) \times 5\% = 55\% > 50\%$) 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. As is depicted in *Fig. 11*, these twelve corporations would indeed become their own owners at least as a group. It is therefore practically impossible to prevent corporations from becoming their own owners, if they so wish.

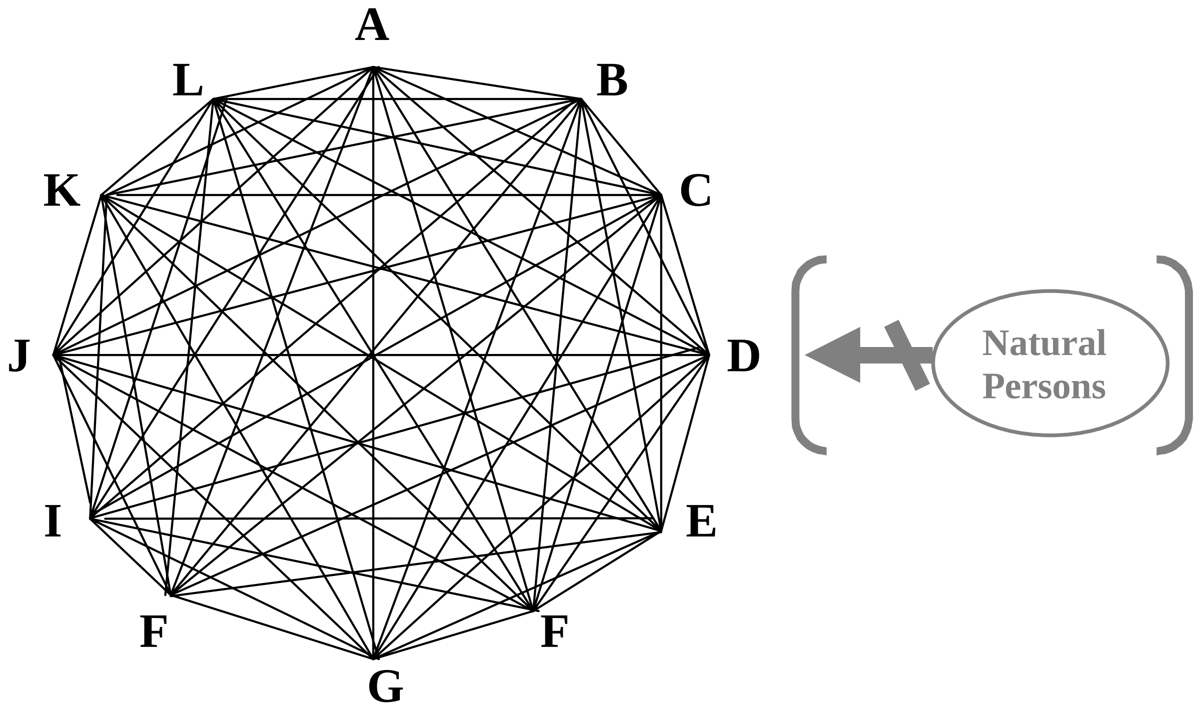

Fig. 11: Cross-Shareholdings Among 12 Corporations.

We have now reached the paradigm of corporate realism. We have indeed seen that by extensive cross-shareholdings a group of corporations can get rid of their thingness and become self-determining subjects in the system of law.

5. Indeterminacy Principle and Two Capitalisms.

I have thus elucidated two legal mechanisms – one turning a person-*cum*-thing corporation into a mere thing, and the other turning a person-*cum*-thing corporation into a full person.

What we have established is a sort of the indeterminacy principle in law, that law is incomplete and is unable to determine the very legal nature of the corporation within its own system. Instead, the supposedly universal corporate law has unknowingly provided each society with a 'menu' of corporate structures from which it 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 -- America (and Britain) with very active M&A activities in stock markets standing the nearest to the ‘nominalistic’ pole, Japan (and Germany) with extensive cross-shareholdings among large corporations the nearest to the ‘realistic’ pole, and most of continental European countries somewhere in between.[11]

6. Corporate Managers as Fiduciaries of the Corporation.

Our picture of the corporation could never be complete without having ‘managers,’ i.e., directors and officers, painted explicitly in it.[12] Even if the corporation has a full-fledged personality in the system of law, it is in reality a mere abstract entity that is incapable of performing any act except through the act of flesh and blood human beings. In fact, it is a legal requirement that the corporation must have a board of directors who hold the formal powers to act in the name of the corporation. And it is a common practice that these directors delegate part of their formal power to corporate officers for the actual management 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. But, then, these shareholders act as board members, not as shareholders. This is once again an elementary fact in corporate law, but I have reiterated it so as to highlight a fundamental difference between managers in a corporate firm and managers in an unincorporated firm. The recent upsurge of the naïve form of corporate nominalism, under the new guise of the contractual theory of the firm, has blurred this difference completely and reduced the theory of 'corporate governance' to a mere application of the theory of agency. This is a mistake.

‘Agency’ is, according to its leading definition, ‘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.’[13] The control need not be total and continuous, but there must be some sense that the principal is ‘in charge.’[14] Needless to

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[11] See Prowse [1994] for an informative survey of corporate structures among large firms in the U.S., U.K., Japan and Germany.
[12] I use the term 'managers' to designate both directors and officers in the case of incorporated business firms.
[13] America Law Institute, Restatement [Second] of Agency, sec. 1 [1].
[14] ‘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.’ Kleinberger [1995], at 8.

say, the relation between an owner and managers in a sole-proprietorship firm is a paradigmatic agency relation, with the owner being the principal and the managers her agents, as is illustrated in *Fig. 12*. It is the owner who unilaterally defines the objective of the relationship and maintains the power to control and direct the managers who have consented to act solely on her behalf. In fact, the owner needs not hire any managers 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 a partnership firm, they all arise from asymmetric information between the owner (principal) and managers (agents), in the form of adverse selection or moral hazard. And the task of governing an unincorporated firm can be reduced to that of designing an incentive system that would minimize the inefficiency (agency cost) arising from such asymmetric information. Of course, this is all in the realm of contractual law, and little room is left for mandatory legal rules or other forms of legal intervention.

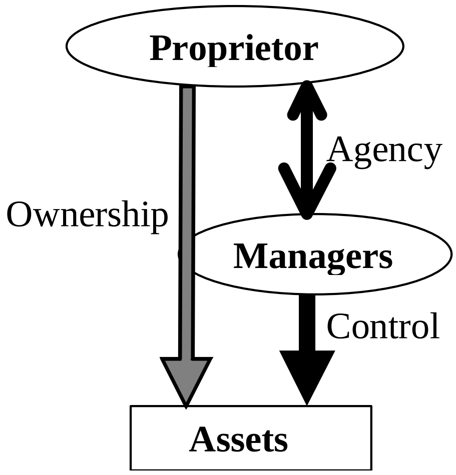

Fig. 12: Managers as Agents in a Sole-Proprietorship Firm.

Once, however, we turn to the problem 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. To be sure, shareholders can fire individual directors or even replace the entire team of incumbent directors at the shareholder meeting. But, they cannot dismiss the very legal institution of the board of directors, as long as a corporation remains a corporation. To be sure, shareholders can approve or veto the managers' major policy decisions at shareholders meetings. But they cannot deny the very legal power of the managers to act in the name of corporation, as long as a corporation remains a corporation.[15] Shareholders are in no sense 'in charge' of the managers

[15] 'Stockholders cannot withdraw the authority they delegated to the board of directors, because they never delegated any authority to the directors.' Clark [1985], at 57.

of their corporation.

Corporate managers are not the agents of the shareholders. If so, what are they? What are the legal status of the corporate managers? They are the "fiduciaries" of the corporation. (*Fig. 13* is an attempt to visualize this relationship.) The fiduciary is a person who is entrusted to act as a substitute for another person for the sole purpose of serving that person.[16] Examples include guardian, conservator, trustee, administrator, attorney, physician, psychiatrist, fund manager, etc. A fiduciary is called an agent if he is bound by a contract (often implicit) with the beneficiary and is subject to her control. But the agent is merely a special type of fiduciary, and many of the fiduciary relations are non-contractual. Indeed, in the case of corporate directors it is the law that endows them with the fiduciary powers to act in the name of the corporation.

[16] According to Tamar Frankel [1983], 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.' (pp. 808-9). See also Frankel [1995] and DeMott [1991].

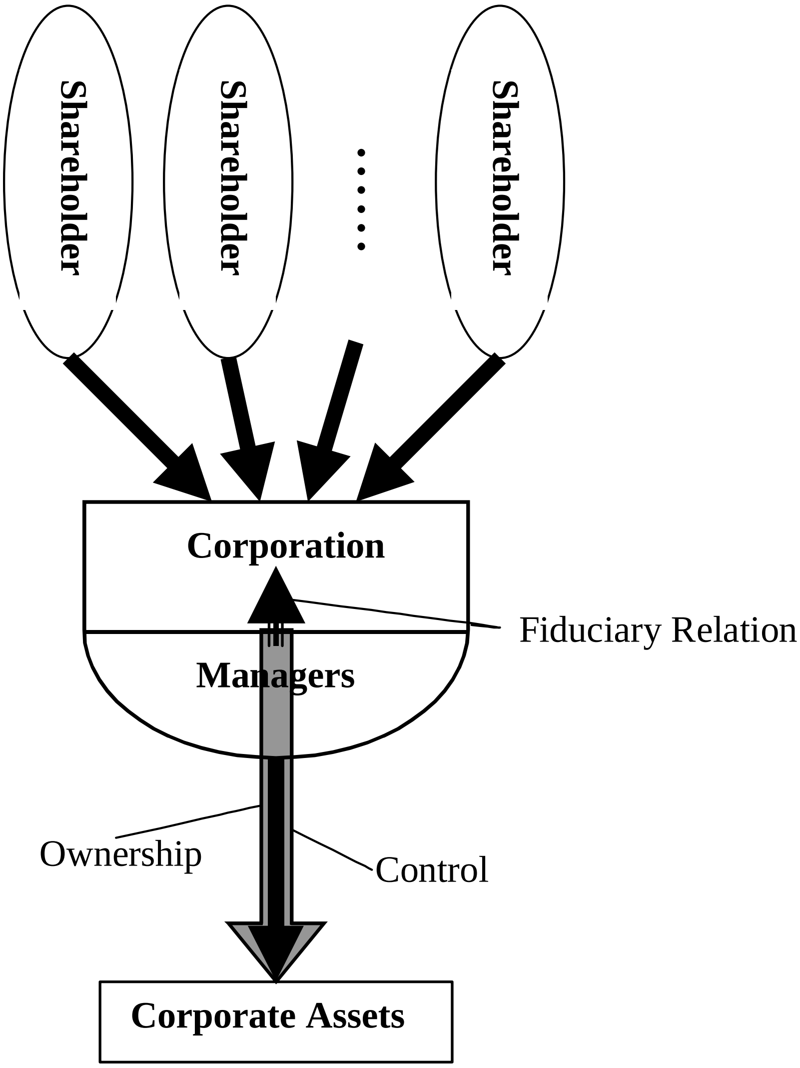

Fig. 13: Corporate Managers as Fiduciaries of the Corporation.

This at once leads us to the central problem of corporate governance: the managers' abuse of fiduciary powers. The risk that the corporate managers may not use their fiduciary powers in the best interest of the corporation stems from the very nature of the corporation as a legal person.[17] 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. Then, there inevitably emerges the danger of *quid pro quo*: the danger that

[17] '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 [1983] at 810.

the managers 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 care and prudence 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.

7. Fiduciary Principles in Corporate Governance

How can we prevent corporate managers from abusing their fiduciary powers? The answer to this question is by no means simple. But, I would maintain that at the foundation of the 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.[18] These orthodox principles are still honored among practical-minded corporate lawyers, but the current trend in legal thinking is certainly in the direction of eliminating any mandatory element from of the fiduciary duties.[19] What I would like to do now is to present a 'proof' of the validity of the 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.

For this purpose, let us again imagine a corporation that 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 corporate firm 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

[18] For a clear exposition of the orthodox principles, see Clark [1985]; see also Clark [1986] at 114 -189 and Eisenberg [1989].
[19] See Langbein [1995] as the representative of these recent attempts.

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. 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 the fiduciary law is its highly 'moralistic' tone. [20] It imposes on the fiduciaries the 'duties' to perform once they have consented to act as fiduciaries. The law lists many such duties, but the most fundamental ones are 'the duty of loyalty' and 'the duty of care'.[21] The duty of loyalty obliges the corporate managers to control the assets of the corporation in the best interest of the corporation and not in conflict of interest. It forbids them to self-deal with corporate assets, to trade corporate opportunity, and to trade on inside information; it imposes strict rules on the disclosure of information; it restrains managers from taking 'excessive' compensations. The duty of care then demands the corporate managers to manage the corporate assets with reasonable skill and care.

It is the essence of fiduciary law that it imposes these duties, not as a mere rhetorical device, but as the real content of the law. The advocates of the contractual theory of the firm, however, identify the fiduciary law with 'a standard-form penalty clause in every agency contract' and characterize it as the rules which 'approximate the bargain that investors and agents would strike if they were able to dicker at no cost.'[22] They thus argue that the fiduciary duties specified in corporate law are essentially 'enabling' and can be and must be waived if the participants of what they call 'the corporate contract' believe they can strike a better bargain among themselves. This is totally untenable. Fiduciary law can never be a substitute for private ordering. 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 corporate managers by means of contract or other forms of voluntary agreement would necessarily involve an element of managerial self-dealing. To make corporate law enabling and permit its fiduciary rules to be bargained around by insiders would be the surest way to destroy the corporate governance system.[23]

It is fortunate that the entire tradition of fiduciary law has so far been consistently hostile to

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[20] See Frankel [1983] at 829-832; and Clark [1985], at 75-79.
[21] *Restatement [Second] of Trusts* [1959], for instance, lists 17 (!) such duties in §§169 - 185.
[22] Frank Easterbrook and David Fischel [1982] at p. 737.
[23] As has been witnessed by Enron scandal in the year of 2001.

viewing the fiduciary rules as implicit contracts.[24] The courts hold corporate managers liable for a breach of fiduciary duties, 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 corporate managers choose to become corporate managers, 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, as long as the business firm takes the form of 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' pole or the 'nominalistic' pole of the legal menu of corporate forms we discussed in Section 5. It is in this sense that I claim that the corporate managers' fiduciary duties to the corporation should lie 'at the foundation' of any corporate governance system.

8. A Sketch of the Theory of Comparative Corporate Governance

It is, however, neither wise nor practical to rely exclusively on the fiduciary law for the governance of corporate firms. 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 corporate firms, it is thus of vital importance to supplement the fiduciary law with other governance mechanisms. And it is as the agents of these supplementary mechanisms that various stakeholders, such as banks, employees, suppliers, customers, and among others shareholders, find their roles to play in the system of corporate governance. Indeed, there is a wide variation in costs and benefits of these supplementary mechanisms across countries, depending more or less on whether their dominant corporate form is 'realistic' or 'nominalistic'. I believe this variation should constitute a starting point of the comprehensive

[24] See, for instance, Frankel [1985].

theory of comparative corporate governance.[25]

In order to present a brief sketch of such a theory, 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.

First, let us remove the supposition that our 'realistic' corporation has no outstanding loans. Then, 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.[26] 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 be used only in Japan.[27] 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."[28]

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. It is 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.

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[25] For the previous works on comparative corporate governance, see, for instance, Mayer [1988], Aoki [1988], Franks and Mayer [1990], Coffee [1991], Baums [1992], Roe [1993], Aoki and Dore [1994], and Prowse [1994].

[26] 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.

[27] For the comprehensive account of Japanese main bank system, see Aoki and Patrick [1995]. For the roles of German banks in corporate governance, see for instance Baums [1992].

[28] Sheard [1989].

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.[29] Furthermore, we should also note that, even if the main bank system really played an effectual role in the governance of corporate firms, if they can have easy access to various forms of external finances 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 some of the continental European countries.

Second, 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.[30] German law, for instance, 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. 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 organization-specific human 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 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.

Third, we have to let our 'realistic' corporation maintain relational contracts with suppliers and customers. But their implications for corporate governance are somewhat murky. On the one hand, repeated interactions may promote cooperation from suppliers and customers; on the other hand, long-lasting relationships may encourage suppliers and customers to voice their opinions

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[29] 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 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.

[30] See Hopt [1984].

openly on the matters related to their transactions. 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, and 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. 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 I have already discussed the mechanisms in Section 3, I will touch on it very briefly. 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, corporate raiders 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. The stock market thus becomes a 'market for corporate control'. The bulk of empirical evidence indeed suggests that hostile takeovers generate substantial gains to the targeted shareholders.[31]

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.[32] In opposition to this view, however, many 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 the ousted managers have formed with them and forcing a substantial cut in their wages and pension funds.[33] 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.[34] 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.[35] What these expropriation

[31] See Jensen and Ruback [1983], Jarrell, Brickley and Netter [1990], and Bhagat, Shleifer and Vishny [1990].
[32] '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,' Jensen [1988] at 23.
[33] Shleifer and Summers [1988].
[34] Hitt, Hoskisson, Johnson, and Moesel [1996].
[35] Roll [1986].

theories suggest is a possibility that even the stock market discipline of corporate managers may sometimes end up with substituting one governance problem for another, rather than solving it.

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. Such a corporate firm is of course the closest to the unincorporated business firm among all possible forms of corporate firms. And yet, even in this case the relationship between the dominant shareholder and corporate managers is not as simple as the relationship between the owner of a corporate firm and managers she has hired as her agents. 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 the 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 are merely supplements to the legal rules which directly regulate the performance of the managers as fiduciaries of the corporation.

Moreover, 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. Indeed, 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 her 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 shareholders 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 has its managers transfer corporate assets and corporate incomes to her purse, with the intent to delay or reduce or defraud the payment of the debts the corporation 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.[36]

9. A Concluding Remark

[36] For the so-called 'corporate piercing cases', see for instance Clark [1986], pp.35-92.

The present article has been devoted to the stipulation of the legal structure of the corporate firm. A corporation firm is, however, not merely a legal entity but also an organizational entity that pools human skills, physical facilities and financial instruments and produces goods and services to markets. Then, a question arises immediately. What is the relationship between the corporate firm as a legal institution and the corporate firm as an economic organization?

In organization theory there are two competing views of organization -- one viewing organizations as collectivities rationally constructed to attain exogenously given purposes and the other viewing organizations as collectivities autonomously striving to reproduce themselves as going concerns. My suggestion here is not an unexpected one. There is a strong correlation between these two views of organizations and our 'nominalistic'/'realistic' dichotomy of corporate structures. When we lift a legal veil from a nominalistic corporation, what we find as its social substratum is a group of shareholders who control the managers for the sole purpose of maximizing their own returns. On the other hand, when we lift a legal veil of a realistic corporation, what we find as its social substratum is an autonomous organization whose internal members share a common interest in the survival and growth of the organization itself. Moreover, I would also like to suggest that the autonomous character of the 'realistic' corporate organization is tied closely to the existence of intangible assets that have been variously called "firm-specific human assets," "organizational capabilities," "core competences," "managerial resources," etc. They more or less refer to 'the collective learning in the organization, 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 fact, these intangible assets have a very peculiar property -- they belong to nobody but the corporation! No one outside of the corporate organization, by which I include not only creditors but also shareholders, can own these assets as their properties. For these assets are inalienable human assets that are embodied in the members of the organization in the form of know-how and skills. No one inside of the corporate organization, by which I mean managers and core workers, can appropriate them as their own properties either. For these human assets are organization-specific and lose their economic values once they leave the organization. Here emerges a key insight into the role the corporation as a legal institution has played in the historical development of capitalistic economies -- the legal personality of corporation has been able to act as the *de facto* owner of these intangible assets, thereby encouraging their accumulation within corporate organizations. Indeed, as has been documented so painstakingly by Alfred Chandler and other business historians, it is the development and maintenance of these assets, especially that of organizational capabilities of managers, that enabled the modern firms to exploit the potential economies of scale and scope of their capital-intensive technologies and helped them to grow and continue to grow ever since the end of the 19^{th} century.[37]

I, however, leave the fuller discussions on this topic to other articles.[38]

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[37] Chandler [1977, 1990].

[38] See Iwai [2002] for such a discussion.

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