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THE NATURE OF THE BUSINESS CORPORATION: ITS LEGAL STRUCTURE AND ECONOMIC FUNCTIONS*

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Between a classical firm and a business corporation lies a fundamental difference in legal structure. While the first consists of a single ownership relation between owners and assets, the second consists of two overlapping ownership relations—between shareholders and the corporation, and between the corporation and corporate assets. The latter legal relation is indirect and exists only through the intermediary of the corporation that performs the dual role of a thing and a person. This paper shows how such two-tier ownership structure of the business corporation fundamentally affects the form of its organization, the ways and means of its governance and the efficiency of its performances.
JEL Classification Numbers: D23, G30, K00, K22, L20.

1. Introduction: the legal structure of the business corporation

Suppose you are an owner of a mom and pop grocery shop around the 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 the only thing you have to worry about is the wrath of your spouse—your co-owner. Now suppose you are a shareholder of a big supermarket chain. If you feel hungry, can you go into one of its stores and grab an apple from the shelf, claiming that that apple is your property? The answer is no. There is a real possibility that you will be arrested as a thief! To be sure, if you are prudent enough to carry a share-certificate with you, the supermarket manager may let you off so as not to tarnish the public image of the chain as a shareholder-friendly corporation. But if you are known to be an activist shareholder, fighting against the chain's inhuman treatment of animals in its slaughterhouse, the chance is high that you will be put into jail.

Why? Because corporate shareholders are not owners of corporate assets. Who, then, owns corporate assets? The answer, of course, is the corporation as a "legal person". The law treats a corporation as a subject of property rights capable of owning real property, entering into contracts, suing and being sued, all in its own name, separate and distinct from its overlooking shareholders.[1] After all, the corporate assets are literally the corporation's assets. It is the corporation as a legal person that is the owner of the corporate assets. Who, then, are corporate shareholders? The answer, of course, is the owners of the

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1 For instance, s. 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; . . .."

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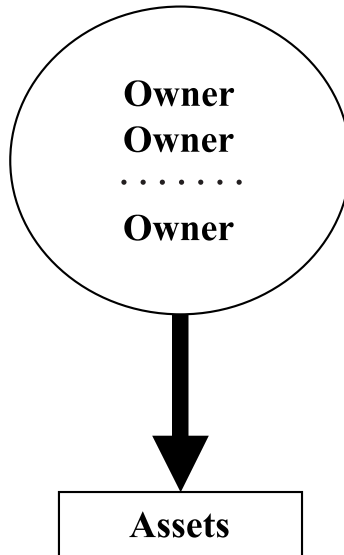

FIGURE 1. Single ownership structure of a classical firm

corporation. Literally as well as legally, corporate shareholders are the holders of corporate shares—a bundle of the financial 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 *thing*, i.e. as an asset separate and distinct from the underlying corporate assets. It is the corporation as a "legal thing" that the corporate shareholders own.

A classical firm like our small grocery shop has a very simple ownership structure. You and your spouse (your co-owner) jointly own the apples and other grocery goods on the shelf. As is shown in Figure 1, a classical firm consists of a single ownership relation between a group of owners (or a single owner, in the case of a sole proprietorship) and a collection of assets. In stark contrast, once a firm is incorporated and becomes a business corporation, its ownership structure undergoes a fundamental change. As is depicted in Figure 2, a business corporation like our supermarket chain now consists of not one but *two* ownership relations. The corporate shareholders own the corporation as a legal thing, and the corporation as a legal person in turn owns corporate assets. You, as a shareholder, have a legal relation with the apples and other assets of the supermarket chain only indirectly, through the intermediary of the corporation as both a person and a thing.

There is thus a fundamental difference in legal structure between a firm that is incorporated and one that is not. And yet, there is little evidence of economists—or even of legal scholars—taking heed of this difference in their analysis of business corporations. This is all the more surprising as there has been a tremendous upsurge of interest in the so-called "corporate" governance over the last two decades.[2] In fact, most of the recent works on corporate governance do not even bother to make a distinction between classical firms and business corporations; they discuss the issues of governing an unincorporated

2 See Shleifer and Vishny (1997), Zingales (1998) and Tirole (2001) for recent surveys on the theory of corporate governance.

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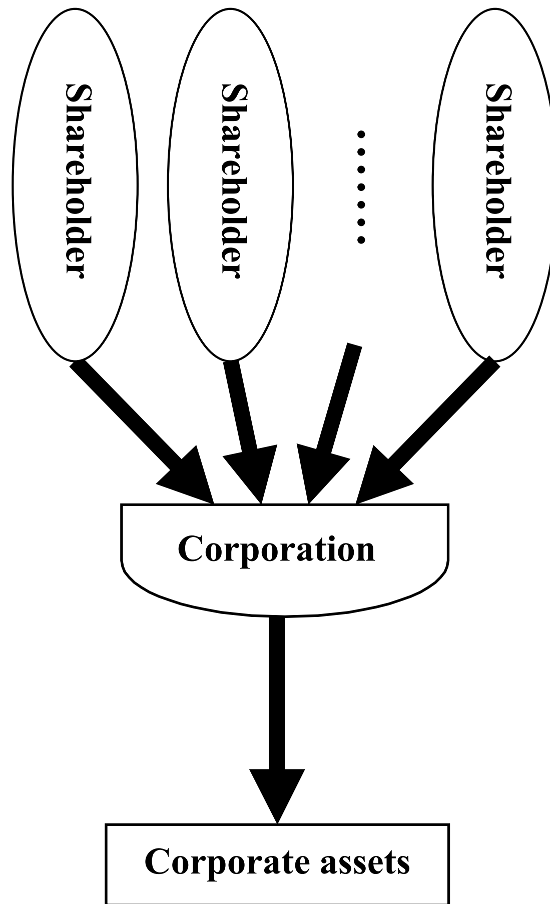

FIGURE 2. Two-tier ownership structure of a business corporation

firm and governing an incorporated firm as if they were the same. At best, these works regard the latter as mere extensions of the former, with some complications arising from the dispersal of ownership among small shareholders with limited liability. To be sure, if the firm's incorporation does not change any of its underlying economic activities, such a conceptual laxity would not cause any serious problems. The corporation, however, is not "just an empty legal shell". Indeed, the main purpose of this paper is to show how the legal institution of corporation has fundamentally changed the organizational structure of the firm, the ways and means of its governance, and its overall efficiency.

The paper is organized as follows. Section 2 reviews the textbook account of the *raison d'être* of the corporation, and Section 3 deduces from the business corporation's basic characterization its two-tier ownership structure. For many centuries there has been a heated controversy on the "essence" of the corporation—between corporate nominalism on one hand and corporate realism on the other. The former approach views the corporation as a mere contractual association of shareholders, and the latter views it as a fully fledged organizational entity. Sections 4 and 5 attempt to resolve this controversy once and for all by demonstrating that the two-tier ownership structure of the corporation is

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capable of generating two seemingly contradictory corporate forms, one approximating "corporate nominalism" and the other, "corporate realism". These two sections also show that the legal institution of corporation supports a wide variety of organizational structures, ranging from a closely held private corporation with active shareholders to a large managerial corporation with passive shareholders, from a pyramidal system of vertically connected corporations to a horizontal network of mutually holding corporations.

Section 7 proposes an indeterminacy principle in law—that corporate law, instead of determining the nature of the corporation, provides each business enterprise with a legal menu of corporate forms from which to choose. Section 7 introduces corporate managers, i.e. directors and officers, into our picture of the business corporation. Indeed, each corporation has a team of managers not by contractual arrangement with shareholders but as required by law. This implies that the legal status of corporate managers is not as the agents of shareholders, but as the fiduciaries of the corporation, and that the problems of governing business corporations cannot be reduced to the problems of controlling agency relations. Section 8 then maintains that every corporate governance system should have at its core the managers' fiduciary duties to the corporation, and should make the rules stipulating these duties to be essentially mandatory. Section 9 turns to the characterization of business corporations as economic organizations. 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. Not unexpectedly, our "nominalistic"/"realistic" opposition of corporate forms corresponds more or less to these competing views of organizations.

Furthermore, the paper relates the autonomous character of "realistic" corporations to the accumulation of human assets that are specific to each organization, and argues that it is both rational and legitimate to suppose that the "realistic" corporation has a "purpose" other than to maximize shareholders' returns. Section 10 then compares the economic efficiency of classical firms and "nominalistic" corporations on the one hand with that of "realistic" corporations on the other. It suggests that the separation of ownership and control, which has been regarded as "the central weakness of the public corporation" in the traditional corporate governance literature, may also contribute to its economic efficiency by mitigating the "hold-up" problems and encouraging managers and workers to create, maintain and expand organization-specific human assets, even if they have little or no ownership stake. Section 11 concludes the paper by discussing the future of the corporate system, albeit briefly.

2. Persons, things and corporations

In the basic model of the market economy, expounded in any introductory textbook of economics, the relation between persons and things is simple and clear. Persons are *subjects* of property rights, and things are *objects* of property rights. Persons own things, and things are owned by persons. There is an absolute divide between persons and things. If persons owned persons, we would be back in a slave economy. If things owned persons, we would be trapped in the world of science fiction. Classical firms are founded on this simple relation between persons and things. A group of persons (or one person, in the case of a sole proprietorship) invests its capital in assets in order to earn profits. The individual capitalists are the subjects of property rights, whereas the assets, both tangible and

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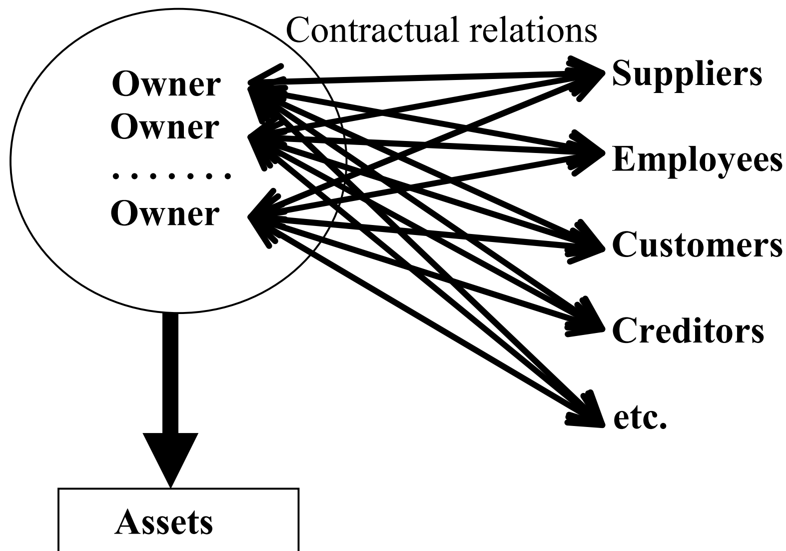

FIGURE 3. Contractual relations between a classical firm and outside parties

intangible, are the objects of property rights. They are directly opposed as persons and things. Indeed, such relation was already depicted in Figure 1 above.

In a capitalistic society, every business undertaking must enter into numerous contractual relations with outside parties such as employees, suppliers, customers, creditors, governments and even tort plaintiffs in order to generate profits. In the case of a classical firm, every owner has an equal right and an equal duty to any contract it maintains, as is illustrated in Figure 3. This means that whenever there is a departure of one of the co-owners because of internal dispute, illness, death or an admission of a new co-owner, each contract has to be rewritten or at least the signatures of the remaining owners have to be updated. To rewrite a contract *ex post* involves various kinds of transaction costs. Of course, if owners are few and outside relations are limited and short term, it may be possible to save these transaction costs by writing up detailed provisions for such contingencies in each contract *ex ante*. As the owners become numerous or outside relations become widespread and long term, these transaction costs will quickly become prohibitively large. The contracts will then become necessarily incomplete, and outside parties will be easily discouraged from entering into contractual relations with the classical firm.

The corporation is a legal solution to this problem. Law endows a corporation with "the same power as an individual to do things necessary or convenient to carry its business and affairs".[3] If a group of N investors sets up a corporation and becomes its shareholders, this is equivalent to creating the $(N + 1)$st person, who has the same legal capacity to own real assets as they themselves have. Outside parties are then able to form a contract with this $(N + 1)$st person, independently of its N shareholders, in exactly the same manner as they form a contract with the owner of a sole proprietorship. As is illustrated in Figure 4, the complex network of contractual relations is greatly simplified, leading to a large reduction

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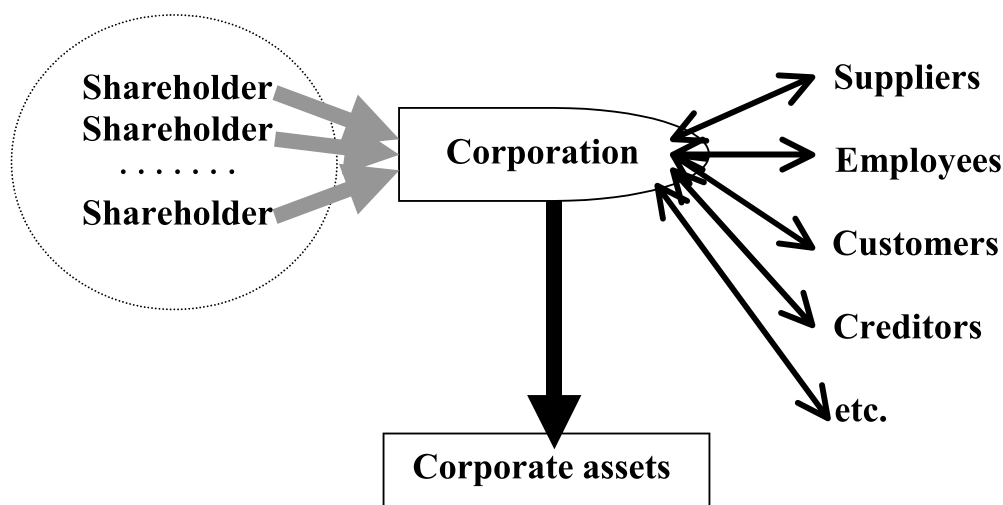

FIGURE 4. A corporation as a legal device to simplify outside relations

of transaction costs for all participants.[4] This then shields the contracting outside parties from the vagaries of internal disputes, illness, death or the entry of new shareholders, thereby encouraging them to enter into long-term contractual relations with the firm.

I have dwelled upon a textbook account of the 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 device to economize on the transaction costs of arranging the internal organization among shareholders, but as a device to economize on the transaction costs of arranging the external relations that the shareholders must have with outside parties. As has been repeatedly pointed out by the advocates of the contractual theory of the firm, any innovation in the firm's organizational structure can in principle be arranged internally by a well-crafted contractual agreement among shareholders (see e.g. Easterbrook and Fischel, 1991, p. 1445, and Posner, 1992, pp. 392–3). To do so may incur transaction costs, but those costs could easily be reduced by an extensive use of standard form contracts. In contrast, the corporation's legal capacity to coordinate complex contractual relations between inside shareholders and outside parties is essentially a "social" or "intersubjective" one. It cannot be asserted by an internal contract among shareholders alone, no matter how skilfully 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 holder of property rights, and to form contractual relations with others, not because 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 for a corporation, and what the law does is to formalize and reinforce this social recognition in the form of a legal personality.

It should be noted that the corporation is described here not as a "nexus of contracts" (Jenson and Meckling, 1976, pp. 310–11), but as a fully fledged subject of property

4 When there are N co-owners and M outsiders, the formation of a corporation reduces the number of necessary relations (contractual and other) from $N \times M$ to $N + M$. If both N and M are large, $N \times M - (N + M) = (N - 1) \times (M - 1) - 1$ can easily become a huge number.

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rights. In order for a corporation to serve as one of the parties in 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 a contractual relation even as a figment of legal fiction, simply because it cannot locate the ultimate subject of rights and duties when an event not specified in contracts takes place.[5]

3. The corporation as a person/thing duality

We have now seen that the legal institution of corporation has been introduced into the legal system as a non-contractual device that simplifies the external relations of a group of investors. But we all know that there is no "free lunch"—not 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 the business corporation. For this purpose, the only thing we have to do is to go back to Figure 4 and rotate the horizontal arrows (representing ownership relations) drawn from the shareholders to the corporation clockwise around the latter until they all become vertical. Then what we get is Figure 2, which illustrates the two-tier ownership structure of the business corporation. The legal institution of corporation thus doubles the ownership relations within a firm: shareholders own a share of the corporation as a tradable thing, and the corporation as a legal person in turn owns corporate assets. In fact, in this two-tier ownership structure, the corporation *per se* plays a dual role: that of a "person" and that of a "thing". It owns corporate assets, and it is owned by shareholders. In other words, with regard to things, a corporation acts legally as a person, as a *subject* of property rights; and with regard to persons, a corporation is acted on legally as a thing, as an *object* of property rights. Of course, in reality a corporation is neither a person nor a thing. Legally, however, it is endowed with both personality and thingness.

For many centuries, philosophers, political scientists, sociologists, economists and legal scholars have debated heatedly as to what constitutes the "essence" of a corporation's legal personality. In this so-called "corporate personality controversy", one of the most celebrated in legal theory and philosophy, two competing legal theories have emerged, each advancing a diametrically opposed view on the nature of the corporation: "corporate nominalism" and "corporate realism."[6]

The advocates of corporate nominalism assert 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 contrast, the supporters of corporate realism claim that the corporation is a fully fledged organizational entity whose legal personality is an external expression of its real personality in the society. And both claim to

5 Grossman and Hart (1986) and Hart and Moore (1990), in their property rights 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. I will come back to their theory in Section 10.

6 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); Hart (1954); Hessen (1979); Dan-Cohen (1986) and 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.

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have superseded the "fiction theory", the traditional doctrine since medieval times, which maintained that the corporation is a separate and distinct social entity but that 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 a transaction-cost economics version or an agency theory version, is a direct descendant of corporate nominalism,[7] whereas the evolutionary theory of the firm or the knowledge-based view of the firm can be interpreted as a modern reincarnation of corporate realism.[8] The former regards corporations as "simply legal fiction that serve as a nexus for a set of contracting relations among individuals" (Jenson and Jeckling, 1976, p. 310), whereas the latter posits corporations as "organizations that know how to do things, . . . while individual members come and go" (Winter, 1988, p. 176). The corporate personality controversy is far from being a relic of the past.

I believe it is now possible to "end" this age-old controversy once and for all—not, however, by declaring defeat for one of them, but by declaring victory for both. I submit that it is the person/thing duality of the corporation I have just elucidated that has caused the heretofore endless controversy. If we look only at the first-tier ownership relation in Figure 2, the corporation appears merely as a thing owned and controlled by shareholders, and we draw near to the position of corporate nominalism. On the other hand, if we look only at the second-tier ownership relation in Figure 2, the corporation appears fully as a person, owning and managing corporate assets, and we draw near to the position of corporate realism. Needless to say, these observations alone are not enough to resolve the continuing opposition between nominalism and realism. That a corporation can be owned by other persons makes it less than a person even in legal sense, and that a corporation can own other things makes it more than a thing even in legal sense. The corporation still appears to fall short of being either a full person or a mere thing. In the following two sections I will endeavour to show that there are ways to entirely eliminate either personality or thingness from the person-cum-thing corporation, thereby turning it into a mere "thing" or a full "person". The corporate personality controversy will then "end", because there will no longer be any contradiction between corporate nominalism and corporate realism.

4. How to make a "nominalistic" corporation

The way to eliminate personality from a corporation is trivial: have some tightly knit group of individuals (or a single individual) own more than 50% of its shares and become the dominant shareholders. That group (or individual) then commands a majority block of votes in shareholder meetings and acquires absolute control over the corporation. If it so wishes, it can close off the corporation from the stock market. 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 group of shareholders who can exercise the ultimate control over corporate

7 See e.g. Coase (1937); Alchian and Demsetz (1972); Jensen and Meckling (1976); Easterbrook and Fischel (1991) and Williamson (1985).

8 See e.g. Penrose (1959); Nelson and Winter (1982); Teece (1982); Wernerfelt (1984); Pelikan (1989) and Chandler (1990).

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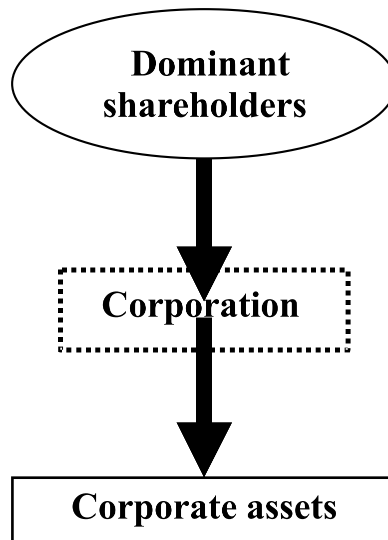

FIGURE 5. A "nominalistic" corporation

assets. As is illustrated in Figure 5, such a closed corporation is reduced *de facto* to a single ownership relation between the dominant group of shareholders and the corporate assets. We are certainly in the world of corporate nominalism here.

In *Modern Corporation and Private Property*, published in 1932, Adolphe Berle and Gardner Means reported that share ownership of public corporations in the United States was so dispersed among small and fragmented shareholders that, by the end of 1920s, about a half of the largest industrial corporations were effectively controlled by professional managers who had little or no ownership stake in them. Dispersion of share ownership has shown a steady increase since then, and, by the end of the 1970s more than 80% of the 200 largest non-financial corporations in the United States were considered to be under management control (Harman, 1981). Because the lifetime careers of these professional managers hinge critically on the continued existence of business corporations as organizational entities, many viewed this as a triumph of corporate realism.

Such view was challenged, however, by the advocates of the "market for corporate control" hypothesis (see Manne, 1965). They argued that threats of outside takeovers in the stock market discipline managers who fail to promote shareholder interests and force the corporation to conform to the paradigm of corporate nominalism. In fact, as we shall now see, the key to this hypothesis is the very two-tier ownership structure of the business corporation.

That any business corporation consists of two-tier ownership relations implies that it contains two kinds of "things": the corporate assets, and the corporation itself. This then means that two kinds of values reside in a corporation. 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 with the total share price of the corporation in the stock market. Can these two values be different from each other? The answer is yes.

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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. More importantly, some managers are incompetent or opportunistic, and their management may fail fully to realize the fundamental value of the corporate assets.

Now the job of the so-called "corporate raiders" is to buy corporations cheap and sell them dear. If there actually exists a corporation whose stock market value is substantially lower than the fundamental value of the underlying assets, there is room for a team of corporate raiders to enter. As soon as such a firm is spotted, the raiders start negotiating a leveraged buyout (LBO) plan with their financers. By an LBO, I mean a form of financing that allows the corporate raiders to borrow the funds for acquiring a corporation by pledging the very assets of the target corporation as collateral. No sooner is the LBO plan approved than our corporate raiders begin a takeover bid (TOB), offering publicly to buy the shares of the target corporation at a price higher than the current market price.

A TOB, especially a hostile one, seldom succeeds without challenges, and soon a bidding war is likely to break out. Let us, however, skip all the details of such a bidding war, and simply suppose that our team of corporate raiders has emerged as the ultimate winner.[9] They then gain absolute control over the use of corporate assets and are able to close off the corporation from the stock market. If they want quick money, they as the *de facto* owners can sell off part or all of the corporate assets in second-hand asset markets. If they are prepared to be patient, they can replace the incumbent managers with better ones, and closely monitor the new management. If the corporate restructuring goes well, the team of corporate raiders will 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, they can make the corporation public again and resell all their shares at an improved price. In any case, it is the difference between the values of corporate assets and corporate shares, minus the price premium for TOB and the interest payment for LBO, that constitutes the profit from this TOB operation. It could be a huge prize if the raiders' original estimate of the "fundamental" value of the corporate assets was not off the mark. And the important thing to note is that, if successful, this whole operation can be self-financing. At least in theory, our team of corporate raiders would not have to invest any of their own capital to carry it out.

We all know that money and hubris motivate corporate raiders. Whatever their subjective motives, their day-to-day business in effect results in an attempt to realize the idea of corporate nominalism in this world. In fact, it is claimed that, even if they are not raiding corporations every day, 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 fail to realize the fundamental value of corporate assets. If this is indeed the case, stock market functions efficiently as the "market for corporate control".

Does this mean that by the mere existence of corporate raiders the corporate personality controversy has finally been settled in favour of corporate nominalism? The answer is no. In the first place, the incumbent managers of the targeted corporation can take various measures to block takeover attempts, such as employee stock ownership plans (ESOP), super-majority amendments, fair price amendments, reductions in cumulative voting rights, greenmails and poison pills.[10] Sometimes they even pressure central or local

9 We also ignore all the informational difficulties associated with TOB operation discussed by Grossman and Hart (1980).

10 For a useful discussion on various anti-takeover strategies, see Jarrell *et al.* (1988).

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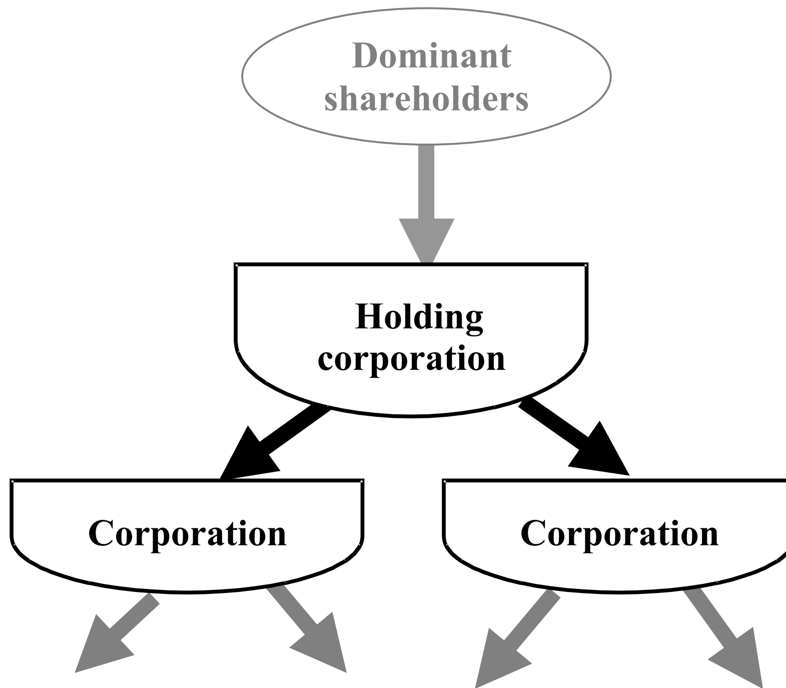

FIGURE 6. A holding corporation and a pyramidal system of ownership and control

governments to pass legislations that protect the interests of the corporate constituencies rather than shareholders. These anti-takeover measures are not foolproof, however, and corporate raiders are constantly devising ever newer strategies to overcome these defence tactics. Yet, I will now describe a legal mechanism by which the thingness of the person-cum-thing corporation is almost entirely eliminated.

5. How to make a "realistic" 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. What this suggests is that a corporation as a person can in principle own another corporation as a thing. (Needless to say, antislavery law prohibits a real human being from owning another real human being.) In fact, since the state of New Jersey in the United States legalized "holding corporations" in 1889, business corporations all over the world have been buying and holding the shares of other corporations. As is shown in Figure 6, a holding corporation is a business corporation created solely for the purpose of owning other corporations. It acts as a person in regard to the corporations it owns.

The legalization of holding corporation has opened the way to an important organizational innovation: the pyramidal system of corporate ownership and control. At the top is a group of individuals who own a corporation as a thing. But a corporation, being a legal person too, can own another corporation as a thing, which, also being a legal person, can

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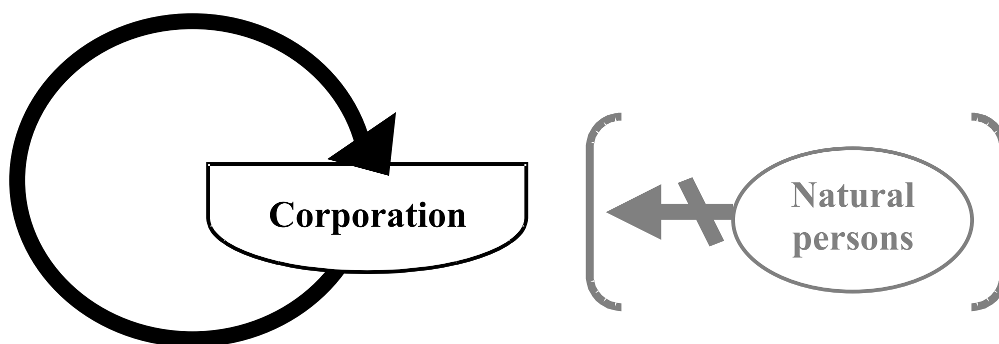

FIGURE 7. A (hypothetical) self-owning corporation

own another corporation as a thing, and so on. Such ownership hierarchy can extend *ad infinitum*.

This, however, is not the whole picture, because you need not own all the shares to control a public corporation. As long as minority shares are diffused among passive investors, a share only slightly greater than 50% suffices for a full control of the corporation. 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 corporate shares with a capital close to one unit. It then follows that, as more layers are added to the ownership hierarchy, capitalists at the top can multiply the controlling power of their capital by an order close to 2^n, where n is the number of hierarchical layers beneath.[11] This was shown in Figure 6. The prewar Japanese *zaibatsu* and present-day Italian family empires and Korean *chaebols* come to mind as typical examples of this pyramidal system of corporate ownership and control.[12]

Nevertheless, a holding corporation still falls short of shedding its thingness entirely, because it has its own dominant shareholders who are 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 that becomes its own controlling shareholder by holding a majority block of its own shares under its own name, as is illustrated in Figure 7. If this were possible, that corporation would be free from any control by real human beings and would become a self-determining subject. It would remove the thingness from itself and acquire a full personality, at least in the province of law.

One might dismiss all this as idle speculation. Many countries prohibit a corporation from repurchasing its own outstanding shares.[13] In countries that allow share repurchases, the repurchased shares lose their voting rights in shareholder meetings. (They are called "treasury stocks" because they are kept in the corporate treasury's safety box during

11 Moreover, if this hierarchical structure is combined with cross-shareholdings at each hierarchical layer, the capitalists at the top can further enhance the leverage of their own capital.

12 See Barca *et al.* (1999) for an extensive discussion on prewar Japanese *zaibatsu* and Italian family empires.

13 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 repurchase has been allowed under certain conditions. Japan also used to prohibit share buybacks, but the ban was partially lifted in 1995 and wholly removed in 2000.

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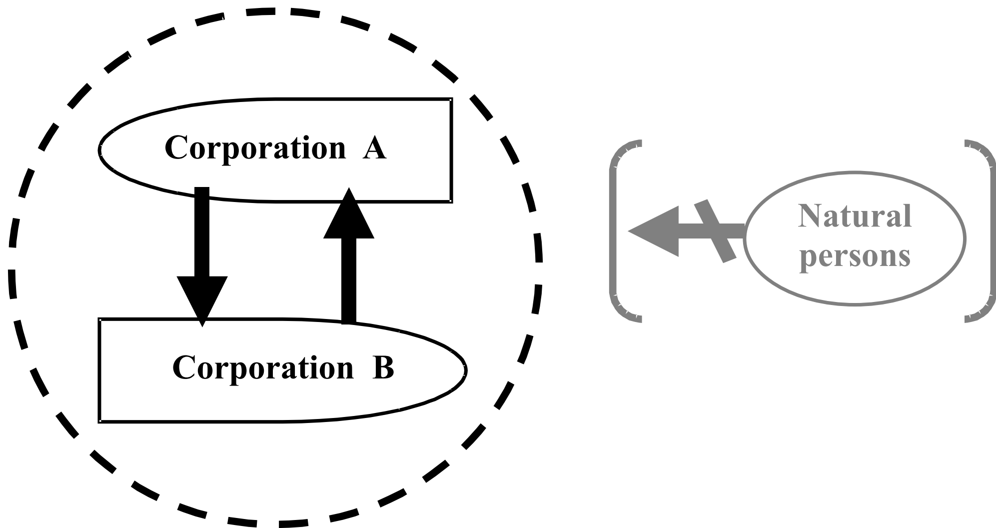

FIGURE 8. Mutually holding corporations

shareholder meetings.) In a real economy, therefore, it appears impossible for a 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 Figure 8 shows, corporation A as a person owns corporation B as a thing, and corporation B as a person in turn owns corporation A as a thing. Even though neither corporation owns itself directly, it does so indirectly, through the intermediacy of the other corporation. Though in a much more attenuated manner than in the case of a 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.[14] 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% of the shares of any domestic corporation.[15] Yet, it is possible to circumvent even these limits. Suppose that 12 corporations get together and that each holds 5% 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 Figure 9, these 12 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.

14 In many countries, including the USA, the UK, Germany, Sweden, Japan and France, a subsidiary is generally prohibited from holding the shares of its parent corporation.

15 In the USA banks can own up to 5% of the voting stock of any non-banking corporation stocks only indirectly through bank holding companies.

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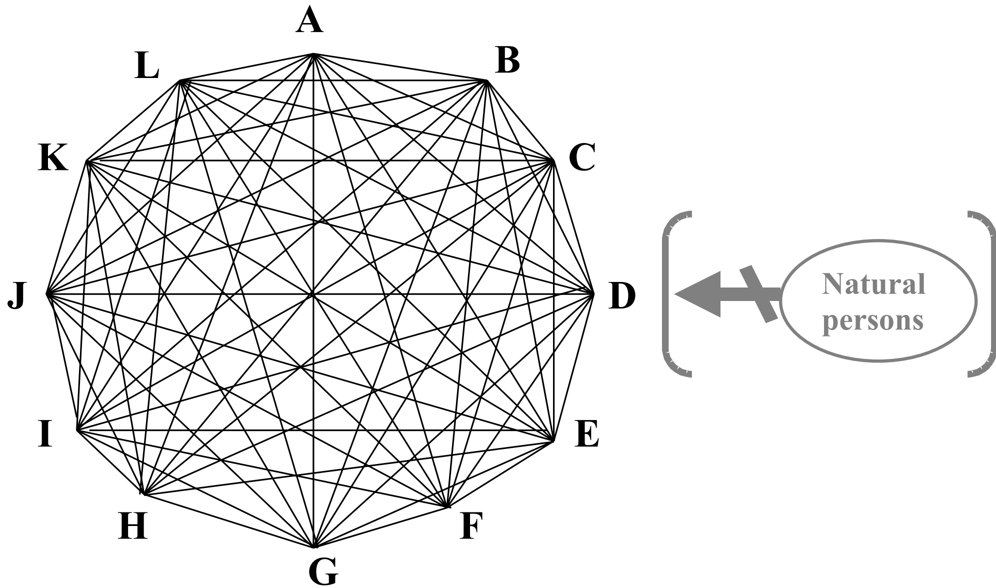

FIGURE 9. Cross-shareholdings among 12 corporations

We have now reached the paradigm of corporate realism. What we have seen is that, by extensive cross-shareholdings, a group of corporations can rid themselves of their thingness and become an association of self-determining subjects, that is full persons, in the system of law.

6. The indeterminacy principle and a variety of capitalism

I have 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. More important is the fact that the two-tier ownership structure enables business corporations to have a wide variety of organizational forms, ranging from a closely held private corporation fully controlled by a group of dominant shareholders to a Berle–Means type of managerial corporation with dispersed shareholders, from a pyramidal system of vertically connected corporations to a horizontal network of mutually holding corporations. No doubt, other organizational forms are also possible for business corporations. In stark contrast, a classical firm can increase the number of co-owners, enlarge the size of its assets and expand the extent of its contractual relations, but it can never be other than a single ownership relation.

What I have established is a sort of the indeterminacy principle in law, that the law is incomplete and is unable to determine the nature of the corporation even within its own system. Instead, the supposedly universal law of corporation has provided each business enterprise with a long “menu” of corporate structures from which it can choose. 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 organizational form of corporations varies widely from country to country—the USA and the UK with dispersed share ownership but active takeover activities, Italy and Korea with solid pyramidal

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structures of corporate groups, and Japan and Germany with extensive cross-shareholdings within corporate groups.[16]

7. Corporate managers as fiduciaries of the corporation

Our picture of the corporation would never be complete without including "managers", i.e. directors and officers, in it.[17] This is not a mere rhetorical statement, because a corporation without managers ceases to exist as a corporation. The reason is straightforward. Even if the corporation has a fully fledged personality in the system of law, it is in reality a mere abstract entity, incapable of performing any act except through flesh-and-blood human beings. As a result, corporate law requires of a corporation to have a board of directors as the ultimate holder of power to act in the name of the corporation.[18] The principle of division of labour generally dictates that directors delegate part of their power to corporate officers for actually managing corporate assets. Any act that managers perform *qua* managers legally binds the corporation to it as a corporate act. This is once again an elementary fact in corporate law, but I have reiterated it so as to highlight the fundamental difference between managers in a classical firm and managers in a business corporation. The recent upsurge in the naive 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. I will now proceed to argue that this is mistaken.

"Agency", according to its leading definition, is "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 (or her) behalf and subject to his (or her) control, and consent by the other so to act".[19] The control need not be total and continuous, but there must be some sense that the principal is "in charge".[20] Needless to say, the relation between owners and managers in a classical firm is a paradigmatic agency relation, with the owners acting as the principals and the managers as their agents, as is illustrated in Figure 10. It is the owners who unilaterally define the objective of the relation and maintain the power to control and direct the managers who have consented to act solely on their behalf. In fact, it is important to note that the owners need not hire any managers at all: at any time, they can terminate the agency relation and manage their own assets by themselves.

If there are any problems pertaining to the governance of a classical firm, they all arise from informational asymmetry between owners and managers in the form of adverse

16 See Prowse (1994) for a very informative survey of corporate structures among large firms in the USA, the UK, Japan and Germany.

17 I use the term "managers" to designate both directors and officers in the case of incorporated business firms. I therefore ignore in this paper the problems pertaining to the often difficult relationship between directors and officers.

18 Section 8.01 (6) of the 1984 *RMBCA*, for instance, states: "All corporate powers shall be exercised by or under authority of, and the business and affairs of a corporation shall be managed, under the direction of its board of directors . . ..

19 The America Law Institute's *Restatement (Second) of Agency* 1958, s. 1(1).

20 "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, p. 8).

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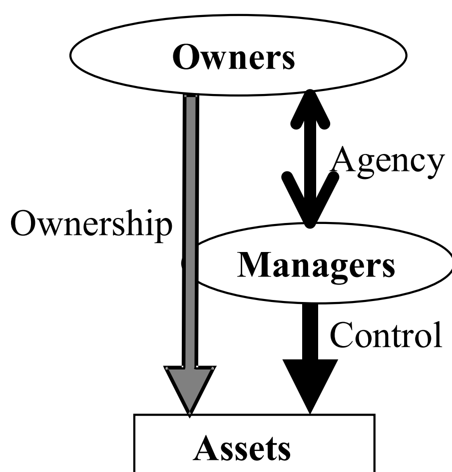

FIGURE 10. Managers as owners' agents in a classical firm

selection and moral hazard. The owners may try to discipline the managers by a closer monitoring of their activities. The managers may try to guarantee their trustworthiness by setting up a bond for the owners to sever should they find any evidence of substandard management. But both require effort and expenses, and the task of the owners of a classical firm is to find an optimal balance between the monitoring and bonding costs on the one hand and the residual managerial slack that is too costly to eliminate on the other, so as to minimize their total sum (agency cost). 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.[21]

However, once 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 (i.e. directors and officers) can no longer be identified with an agency relation. To be sure, shareholders can dismiss individual directors, or even replace the entire team of incumbent directors at shareholder meetings; but they cannot dismiss the very legal institution of the board of directors, if the corporation is to remain a corporation. To be sure, shareholders can approve or veto major policy decisions of directors at shareholder meetings; but they cannot deny the very legal power of the directors to act in the name of corporation, if the corporation is to remain a corporation. As Clark (1985) remarks, "[s]tockholders cannot withdraw the authority they delegated to the board of directors, because they never delegated any authority to the directors" (p. 57). Shareholders are not "in charge" of their corporation's managers.

Corporate managers are not shareholders' agents. So who are they? What is the legal status of the corporate managers? They are the corporation's "fiduciaries". A fiduciary is a person who is entrusted to act as a substitute for another person for the sole purpose of serving that person.[22] (See Figure 11 for an attempted illustration of this relation.)

21 The classic paper on agency approach to "corporate" governance is Jensen and Meckling (1976).

22 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).

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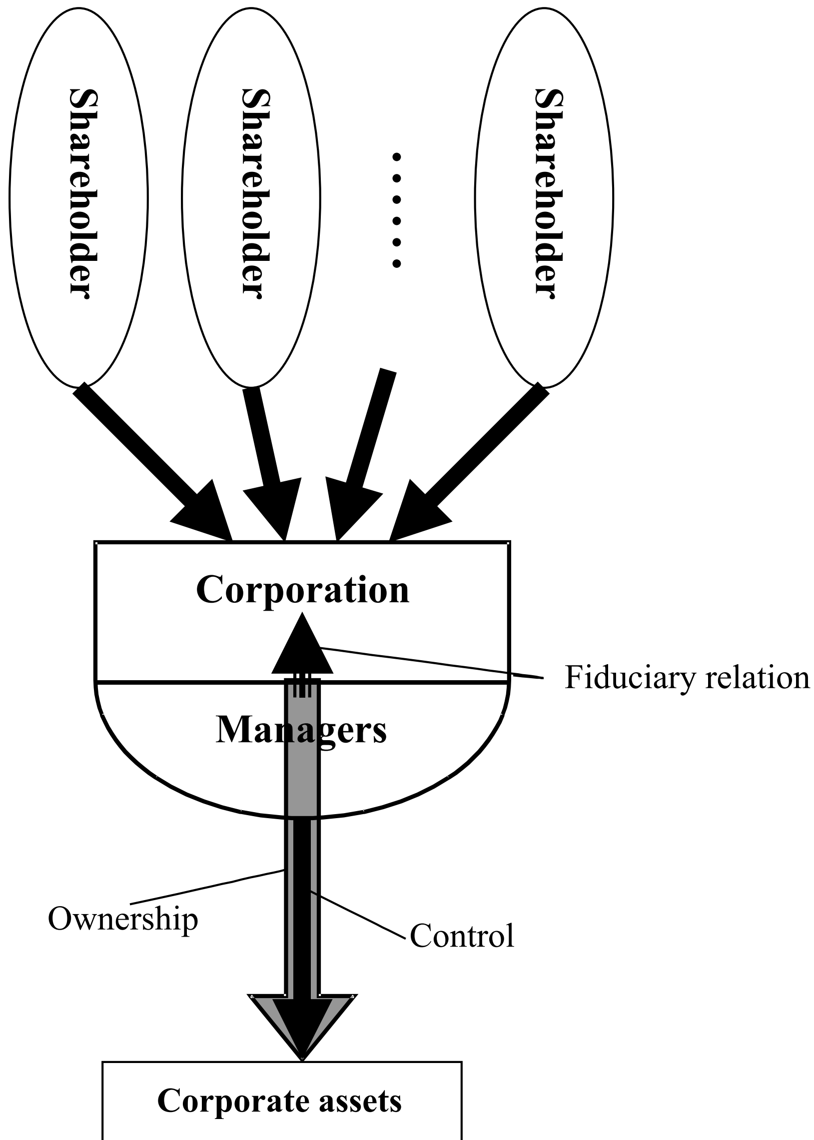

FIGURE 11. Corporate managers as fiduciaries of the corporation

Examples include guardians, conservators, trustees, administrators, attorneys, physicians, psychiatrists, fund managers, 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 an agent is merely a special type of fiduciary, and many fiduciary relations are by their very nature non-contractual. In the case of corporate directors, for example, it is the corporate law, and not any contract with shareholders, that endows them with the fiduciary power to act in the name of the corporation.

This at once leads us to the central problem of corporate governance: the managers' abuse of fiduciary power. The risk that corporate managers may not use their fiduciary

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power in the best interest of the corporation stems not from opportunism or the incompetence of managers, but from the very nature of the corporation as a legal person.[23] 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. There inevitably emerges the danger of *quid pro quo*: the danger that the managers unconsciously mistake their fiduciary power for their own power which can be employed at their own discretion. They may not exercise this power with the care and prudence that the best interests of the corporation would demand. Worse, they may consciously appropriate this power for the purpose of conferring benefit on themselves, or even of injuring a particular party.

8. Fiduciary principles in corporate governance

How can we prevent corporate managers from abusing their fiduciary power? The answer is by no means simple. I would maintain that at the foundation of any corporate governance system should lie in the corporate managers' "fiduciary duties" to the corporation, and that the rules regulating these fiduciary duties should be made mandatory. Indeed, it is impossible to control the behaviour of corporate managers by contractual arrangements alone, because any act performed by the corporation is in reality an act performed by its managers. Hence the corporation 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 is unable to work out an incentive system (such as performance-dependent bonuses and stock options) with the managers, except through the very managers to whom it is supposed to give incentive. Any attempt to control corporate managers by means of contractual arrangements, whether explicit or implicit, would necessarily degenerate into self-dealing by managers and create the very problem it meant to solve. One may appeal to the morality of corporate managers to behave themselves, but we all know that moral sentiments are the most scarce resources in the universe. The only way to protect the interests of the corporation from managerial self-dealing is to have fiduciary rules directly regulating the behaviour of managers.

The law governing fiduciary rules imposes on the fiduciaries "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".[24] The duty of loyalty obliges corporate managers to control the assets of the corporation in the best interests of the corporation and not in a conflict of interest. It forbids them to self-deal with corporate assets, to trade corporate opportunity or to trade on inside information; it imposes strict rules on the disclosure of information; and it restrains managers from taking "excessive" compensations. The duty of care then demands corporate managers to administer corporate assets with reasonable skill and care.

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23 "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, p. 810).

24 The American Law Institute's *Restatement* (*Second*) *of Trusts* [1959], for instance, lists 17 (!) such duties in §§169–85.

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It is the essence of the fiduciary law that it imposes these duties, not as a mere rhetorical device, but as the real content of the law (see Frankel, 1983, pp. 829–32; Clark, 1985, pp. 75–9). The advocates of the contractual theory of the firm, however, identify the fiduciary rules with "a standard-form penalty clause in every agency contract" and characterize them as the rules that "approximate the bargain that investors and agents would strike if they were able to dicker at no cost" (Easterbrook and Fischel, 1982, p. 737). 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 rules can never be a substitute for the private order. They are 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 to permit its fiduciary rules to be bargained around by insiders, is the surest way to destroy the corporate governance system.

It is fortunate that the entire tradition of fiduciary law (at least in the Anglo-American legal system) has so far resisted viewing the fiduciary rules as implicit contracts.[25] The courts hold corporate managers liable for a breach of the 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 they choose to become corporate managers, they owe the fiduciary duties to the corporation and cannot waive the courts' supervision at will.

I should, however, hasten to add that implementation of fiduciary rules 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 rules demands a large amount of human and non-human resources—all the more so since the so-called "business judgement rule" very often works as a barrier to their application unless courts are presented with very strong cases. It is neither wise nor practical to rely exclusively on the fiduciary law for the governance of business corporations.

For the efficient as well as effective governance of business corporations, therefore, it is 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, above all, shareholders find their roles to play in the system of corporate governance. Indeed, a wide variation in costs and benefits of these supplementary mechanisms exists across countries, depending more or less on whether their dominant corporate form is "realistic" or "nominalistic". I believe that this variation should constitute a starting point of the comprehensive theory of comparative corporate governance. However, I leave the details of such theory to other papers.[26]

25 Clark (1985) is a very insightful exposition of the orthodox principles before the appearance of the contractual theory of the firm; see also Clark (1986, pp. 114–89) and Eisenberg (1989). Recently, Margaret Blair has made a vigorous effort to revive these old orthodox principles (Blair, 1995; Blair and Stout, 1999). I share most of her critical concerns, but dissent from her claim that the faults of the post-contractual theory orthodoxy arise from their mistaken view of shareholders as the owners of the corporation. The whole point of this paper is that shareholders are indeed the owners of the corporation, but not the owners of its corporate assets.

26 For some useful accounts of comparative corporate governance, see Mayer (1988), Aoki (1988, 2000), Franks and Mayer (1990), Coffee (1991), Baums (1992), Aoki and Dore (1992), Prowse (1994). See s. 9 of Iwai (1999) for an attempt to develop a unified theory of comparative corporate governance.

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9. The business corporation as an economic organization

What is the "purpose" of the business corporation? In the case of a "nominalistic" corporation, the answer is straightforward. It is, as in the textbook model of the firm, to maximize the return to its shareholders. None the less, the logic behind this answer is not as straightforward as in the textbook model of the firm, because the legal owner of corporate assets is not the shareholders, but the corporation itself as a legal person. The corporate profit is literally the profit of the corporation, and the legal claimant to the profits from corporate assets is the corporation itself, not the shareholders. 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 as a thing that the shareholders lay legal claim to the corporate profit. And if a corporation is turned purely "nominalistic"—through actual control of dominant shareholders or through potential takeover threats in the stock market—it becomes perfectly legitimate to assume, as the traditional theory has been assuming, that the sole purpose of the business corporation is to maximize the return to its shareholders.

But, as we have already seen, the "nominalistic" corporation constitutes only one end in the extensive 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 cannot, of course, 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 power solely for the purpose of their corporation. (That corporate managers are prone to abuse their fiduciary powers is a different matter—a matter already dealt with in the previous two sections on corporate governance.) 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 the corporation. But what is this social entity? In order to answer this question, we now have to look at the business corporation as an organization of real individuals who participate either directly or indirectly in the production and distribution of goods and services in the society.

"An organization", according to Max Weber (1947), is "a system of continuous purposive activity of a specified kind". The classical conception of an organization 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.[27] An organization is said to "come into existence when explicit procedures are established to coordinate the activities of a group in the interest of achieving specified objectives" (Blau, 1968).

This instrumental conception of organizations is broadly consistent with the nominalistic view of the corporation. True to that view, a purely "nominalistic" corporation is a mere

27 "Formal organization is that kind of cooperation among men that is conscious, deliberate, purposeful" (Barnard, 1938); "Organizations are social units (or human groupings) deliberately constructed and reconstructed to seek specific goals" (Etzioni, 1964); "Organizations are collectivities orientated to the pursuit of relatively specific goals and exhibiting relatively highly formalized social structures" (Scott, 1998). What I have called the "classical conception of organizations" above corresponds to what Richard Scott (1998) has called "a rational system definition of organizations". My account of the theory of organizations owes much to Scott's textbook.

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means for its dominant shareholders. In fact, a business corporation typically begins its life as a purely "nominalistic" one. It is founded by a group of entrepreneurs who invest their money and manage the enterprise for the sole purpose of maximizing their returns. Nevertheless, it is commonplace in the history of social institutions that a means to an end becomes an end in itself.[28]

The best account of such a process remains the famous study by Robert Michels, a contemporary of Max Weber, on the transformation of the Social Democratic Party in Germany before the First World War. Michels claims that the party was originally created as a means to implement radical causes for workers. In the process of political struggle and economic bargaining, power was gradually consolidated in the hands of a small number of full-time officers who became indispensable for carrying out complex administrative tasks for the party. As the organization expanded in size and scope, these officers became 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. From this observation, Michels drew a conclusion that it is "a universally applicable law" that "every organ of the collectivity, brought into existence through the need for the division of labour, creates for itself, as soon as it becomes consolidated, interests peculiar to itself" (Michels, 1959, p. 389). 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".[29]

We have before us two different conceptions of an organization, one emphasizing its instrumental nature and the other its autonomous nature. I believe that these two opposing conceptions are not mutually incompatible characterizations of their ideal-type, but equally valid representations of their two polar empirical types. Some organizations are merely instrumental while others are fully autonomous, though most of the organizations we observe in actual society occupy positions in between.

What do we find when we lift the legal veil of a business corporation? I have already suggested that the type of organization that is consistent with the "nominalistic" corporation is an instrumental one. What we find at 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 organization that is associated with the "realistic" corporation is an autonomous one. What we find at its social substratum is 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 other than 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, I do not mean to conjure up the spectre of that notorious "physico-spiritual unity" of "real corporate personality" *à la* Otto Gierke (see Maitland, 1900). A corporate organization is never a superhuman being or metaphysical organism,

28 Such process is called "goal displacement" in organization theory; see e.g. Merton (1957) and Etzioni (1964).

29 Scott (1998). 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.

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mysteriously endowed with a will of its own. Its autonomy, if it has any, emerges out of the social actions of—or rather, social interactions among—individuals both inside and outside the corporate organization. Directors, top officers, middle managers, regular workers, 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, temporary workers, 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 a corporate personality is a mere legal artefact. But it can serve as a sort of catalyst for the social construction of reality. To the extent that organizational members' internal actions, and their recognition by contracting external partners, help cultivate a corporate personality, the corporate organization maintains its autonomy and takes on a social reality.[30]

It should be noted that the autonomous character of corporate organization is tied closely to the existence of human assets specific to each organization. Various authors have called these human assets "firm-specific human assets" (Klein *et al.*, 1978), "managerial resources" (Penrose, 1959), "organizational capabilities" (Chandler, 1990), "organizational routines" (Nelson and Winter, 1982), "core competences" (Prahalad and Hamel, 1990), "resources" (Wernerfelt, 1984), "good-will of a going concern" (Commons, 1924), "corporate cultures", etc. In spite of the wide variation of labels, they all refer to "the collective learning in the organization" (Prahalad and Hamel, 1990) especially regarding how to coordinate diverse production skills, integrate multiple streams of technology, maintain a reliable network of suppliers and cultivate the goodwill of customers.

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, plants and equipment, materials and inventories, cash and bank accounts and the stocks and bonds of other corporations. They can also seize computer software, technology licences, patent rights, copyrights, trademarks and even brand names. All of these assets 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, in parcels or as a whole unit. In contrast to these more or less familiar assets, the organization-specific human assets can be neither 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 the organization or repeated transactions with outside parties, because they are not available ready-made in the market. And they 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 organization-specific human assets. They can function as assets only within the organization to which they have been specialized. 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 I 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

30 See Teubner (1988) 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" (p. 57).

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of skills and know-how. No one inside the corporate organization—and by this I mean managers and regular workers—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 regarding the organizational self-reproduction and self-expansion as the "purpose" of a "realistic" corporation. Since the profits accruing from organization-specific human 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 these human 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. In other words, the corporation as a legal person may assume the role of a *de facto* owner of the human assets that are specific to its organization.

10. Costs and benefits of the separation of ownership and control

Since the work of Berle and Means, the traditional literature on corporate governance (based mostly on the perspective of the agency theory of the firm) has deemed "the separation of ownership and control" as "the central weakness of the public corporation" (Jensen, 1988, p. 61). Its main concern is on the managers' autonomous pursuit of goals that fail to conform to the shareholders' interests.[31] Corporate managers may over-invest on growth opportunities in order to enhance their own compensations, social prominence and political power, all of which are correlated with their firm size; they may retain excess cash balances in order to increase their autonomy against capital markets; they may forgo profitable projects in order to stay in the lines of business operations with which they are familiar; they may encourage the corporate organization to multiply its hierarchical layers in order to generate new positions for middle managers who are motivated more by internal promotions than by performance bonuses; they may hesitate to fire unproductive workers in order to maintain their standing as conscientious managers, etc. And it is these "managerial discretions" that are said to cause large inefficiencies in the public corporations in advanced capitalistic societies.

From such a perspective, the "realistic" corporation with autonomous organization is nothing but a formula for disaster. As has already been seen, in the case of a purely "realistic" corporation, its managers have no human shareholders whose interests they must serve. Even in its less pure form, managers of a "realistic" corporation may still pursue, together with other members of the corporate organization, a "purpose" that does not conform to the interests of its human shareholders. If the central weakness of the public corporation were the separation of ownership and control, the "realistic" corporation would be the weakest of all corporations.

Yet, "realistic" corporations are not a mere academic curiosity. Not only have they survived the competition with classical firms and "nominalistic" corporations, both of which are managed or controlled by owners; they even dominated the industrial sectors of the advanced capitalist economies at least during a good part of the twentieth century. One of their variants—the Berle–Means type managerial corporations—played the central role

31 Shleifer and Vishny (1997) wrote in their survey on corporate governance: "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting return on their investment. How do suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers?"

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in creating the industrial capitalism of the USA and some of the European countries since the last quarter of the nineteenth century at least until very recently, and another variant—corporate groups (*keiretsu*) with extensive cross-shareholdings—formed the core of the Japanese-style corporate system since the end of the Second World War, at least until very recently. Why?

The first explanation would be the financial advantage of the "realistic" corporation. The public corporation is often regarded as "a method of solving problems encountered in raising substantial amounts of capital" (Posner, 1992, p. 428). In contrast to classical firms and "nominalistic" corporations, both of which had to rely upon a closed circle of people for the source of capital, the "realistic" corporations invariably took the form of public corporations and were able to raise large sums of capital from thousands of small investors through stock markets or from tens of thousands of small savers through financial intermediaries. Capital thus amassed from the public then allowed the "realistic" corporations to invest in production facilities and distribution networks large enough to exploit the potential economies of scale and scope made possible by modern industrial technologies.

However, as has been repeatedly emphasized by Alfred Chandler and other business historians, "the potential economies of scale and scope, as measured by capital invested, are characteristics of a technology", whereas "the actual economies of scale or of scope, as measured by throughput, are organizational" (Chandler, 1992, p. 81).[32] The huge cost advantages of industrial technologies could not be fully realized unless continuing flows of inputs and outputs, or what Chandler has called "throughputs", were maintained to assure effective utilization of invested capital. Such continuing throughputs could not be maintained consistently unless procedures to operate production facilities and distribution networks were effectively routinized, and unless production and distribution among different operating units and between current and future operations were carefully coordinated. Of course, such routinization and coordination could not come about automatically; they demanded the constant participation of a large corps of regular workers and a large team of professional managers who were equipped with skills and know-how specialized to these tasks. And such skills and know-how were, as Chandler points out, "developed by learning through trial and error, feedback and evaluation; thus, the skills (and know-how) of individuals depended on the organizational setting in which they were developed and used" (Chandler, 1992, p. 84). In other words, it is the existence of organization-specific human assets that have played a critical role in realizing the potential scale and scope economies of highly capital-intensive technologies of industrial capitalism.

I now maintain that the primary advantage of the "realistic" corporation over the classical firm and the "nominalistic" corporation lies in the capacity of the former to create, maintain, and expand these human assets that are unique to its organization. Indeed, the "property rights theory of the firm" recently developed by Grossman and Hart (1986), and Hart and Moore (1990) has (inadvertently) revealed the fundamental limitation of the classical firm and "nominalistic" corporation as economic organizations.[33] It defines a firm as a collection of physical assets under joint ownership and investigates the factors that determine its boundary. Ownership matters because it confers the owners "residual control rights"—"the rights to decide all usages of assets in any way not inconsistent with

32 See also Chandler (1990). For the role of professional managers in Japanese corporations, see Morikawa (1992).

33 Hart (1989, 1995) and Moore (1992) provide the more accessible expositions.

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a prior contract, custom, or law" (Hart, 1995, p. 30). In particular, the owners can deny their partners in relational contracts further access to their assets when events not specified in the original contracts occur. "In a world of transactions costs and incomplete contract," Hart notes, "*ex post* residual rights of control will be important because, through their influence on asset usage, they will affect *ex post* bargaining power and the division of *ex post* surplus in a relationship. This division in turn will affect the incentives of actors to invest in that relationship" (Hart, 1989, p. 1767). Where the firm draws its boundary against markets thus has a direct bearing on its efficiency.

Unlike the contractual theory of the firm, the property rights theory has the merit of distinguishing a firm from a mere contractual relationship. Nevertheless, it applies only to the classical firm, and even if it is extended to the corporation it applies at most to the "nominalistic" corporation, because what it calls a firm is still a single ownership relation between owners and assets.[34] Furthermore, its very logic points to the intrinsic difficulty of the classical firm and "nominalistic" corporation toward inducing investments in organization-specific human assets.

To see this difficulty, consider a contractual relation between employers and employees in a classical firm. (Similar argument may apply to a relationship between dominant shareholders and corporate employees in a "nominalistic" corporation.) Employers by definition own physical assets in the firm, whereas employees, including both managers and workers, have no ownership stakes in the firm. If the employees invest in human assets that are specialized to the physical assets of the firm, the value of the firm will be much enhanced. But human assets are neither visible nor tangible. It is in general very difficult to measure their marginal contributions to the firm, and almost impossible to verify their values in courts. Given such a situation, do employees have the incentives to invest in firm-specific human assets? The property rights approach says no. The employees have every reason to worry about being "held up" by the employers; that is, they fear that their access to the firm's physical assets will be denied after their firm-specific investments are sunk and that they will then be forced to accept a smaller division of surplus than was initially agreed. Anticipating this, they are likely to refrain from specializing their human assets to the firm at the time of the contract. Inefficiency thus ensues.[35]

Of course, the above "hold-up" problem could be solved if the firm's physical assets and the firm-specific human assets were merged under common ownership. Since human assets are inalienable from the persons embodying them and cannot be owned by others, the only possible solution is to have the employees (managers and workers) own the physical assets and become owners of the firm.[36] But this is precisely what most employees cannot or will not do.[37] Employees are employees primarily because they are

34 For instance, Hart (1989) identifies a firm with "all the non-human assets that belong to it (i.e. that the firm's owners possess by virtue of being the owners of the firm)", and Moore (1992) with "a collection of assets over which certain agents have property rights".

35 In the traditional corporate governance literature, this is known as "the costs of large investors". See Shleifer and Vishny (1997, s. V) for its concise summary.

36 As is pointed out by Milgrom and Roberts (1992), "human capital is not easily tradable, and if the residual returns on that capital belong to the humans embodying them, then the usual arguments about ownership rights suggest that the residual control should be assigned to them too" (p. 523). Indeed, most of the literature on the property rights theory simply equates owners and managers.

37 The following discussion is very much related to the general question of why capital usually hires labor and not *vice versa*. See Hansman (1996) and Dow and Putterman (1999) for informative surveys on this issue.

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poor—they simply do not have enough wealth to own a firm. Can they not finance necessary funds from banks or some other investors? The inalienability of human assets again plays a crucial role here. The time of debt-prisons is long past, and human assets cannot be used as collaterals for debt. If borrowers default, the most banks can seize is the alienable physical assets they own. Knowing this, borrowers with little or no physical assets have a strong temptation to invest borrowed funds on excessively risky projects, or even secretly to divert borrowed funds to their pockets and simply declare default. Banks therefore find little reason to lend them substantial sums of money. Furthermore, even if employees had large enough wealth of their own or could borrow enough funds from banks, they might still choose not to become owners of the firm. As long as they are risk-averse, employees may prefer to diversify their portfolios, rather than to devote a heavy share of their assets to the firm they work for (Fama and Jensen, 1983).

A classical firm is an ownership relation between a group of persons and a set of assets. True that "ownership is a source of power" (Hart, 1995, p. 29). It gives owners not only power to hire employees (and not the other way around), but also power to "hold up" the hired employees. But this power is double-edged. In a world of incomplete contracts, the owners cannot commit themselves *not* to "hold up" their employees, and the mere possibility that the owners may exercise that power in the future will discourage employees from committing themselves to those human assets that have little value outside the firm. The resulting employment relationship tends to be at arm's length, and anything worthy of the name of "organization" is hard to develop around a classical firm.[38] The same can be said about a "nominalistic" corporation, which is in practice a single-ownership relationship between a group of dominant shareholders and a set of corporate assets.

It should be evident by now that the advantage of the "realistic" corporation over the classical firm and the "nominalistic" corporation lies in its very separation of ownership and control. The corporation as a *de facto* owner of organization-specific human assets can serve as an effective shield to inside employees against possible "hold-up" by outside shareholders. It thus encourages managers and workers to create, maintain and expand human assets that are critical for the corporation to realize the potential scale and scope economies of modern industrial technologies, even if they have little or no equities.

I have no intention of insisting, however, that the separation of ownership and control is totally costless. On the contrary, the autonomy of managers and workers that it fosters may cause a substantial loss in efficiency. I merely want to call attention to the fact that the same autonomy may also come with a substantial gain in efficiency.[39] There is a real trade-off, and the choice of the firm's legal form—whether or not it should be incorporated, and, once incorporated, whether it should remain "nominalistic" or become "realistic"—

38 This is, of course, an overstatement. Classical firms may be able to build up organizations if their owners have established a good reputation as committed employers. As Kreps (1990) has shown in his model of "corporate culture", a good reputation can even be carried over from one generation of owners to another. Nevertheless, the reputation is a fragile commodity, and the intrinsic uncertainty of human lives would make such a generational transaction very difficult to repeat many times, unless it is aided by the legal institution of corporation.

39 Burkart *et al.* (1997) developed a model of corporate governance on the basis of a theory of incomplete contracts that distinguishes real authority from formal authority in Aghion and Tirole (1997). The present comparison between "nominalistic" and "realistic" corporations is analogous to their comparison between corporations with large shareholders and corporations with dispersed shareholders. The main point of this paper is, however, that shareholders, especially those of "realistic" corporations, do not even have a formal authority in corporations because of the very legal structure of the corporation.

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depends very much on these costs and benefits of the separation of ownership and control. The corporation is a legal shell, but by no means an empty one.

11. Conclusion: the future of the corporate system

The eclipse of Berle–Means type managerial corporations has been reported in the United States and the United Kingdom.[40] A massive wave of hostile corporate takeovers in the 1980s brought significant changes in the ways corporations are financed and controlled in these economies. A paradigmatic example is a firm that has gone through a leveraged buyout (LBO) (see Jensen, 1988). Such firm is still corporate in form but is closed off to the stock markets. Its sole shareholders are LBO partners, comprising professional raiders who have executed the LBO and the institutional investors who have financed the LBO. They monitor the performance of managers closely. They give managers a substantial equity stake in order to align the interests of the managers with those of the shareholders. They keep the firm highly leveraged in order to leave the managers little cash flow to divert towards their empire building. They sell off many of the former businesses and spin off some of the former divisions in order to force the managers to concentrate on a well-defined range of businesses. Indeed, it is the same idea that lies behind many of the recent changes in Anglo-American corporate system—to improve the firm's performance by tightening the shareholders' control over managers.

On the other side of the Pacific Ocean, a growing number of journalists, business leaders, public officials and academics have been claiming that the Japanese-style corporate system is in eclipse. The "origin" of the Japanese-style corporate system has been traced by various authorities to a range of historical sources, such as the heritage of traditional merchant houses during the Tokugawa period, the late-development effect before the Second World War, the legacy of control economy during the war, the one-shot effect of the *zaibatsu* breakup after the war, the bureaucratic guidance during the high-speed growth era and so on. But there is at least one consensus: Japan was able to develop a highly idiosyncratic corporate system chiefly because its relatively large domestic market was effectively shielded from the outside world during much of the postwar period. In this era of ever-intensive global competition, such a condition is quickly disappearing. 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 have weakened the traditional ties between major banks and industrial corporations and have begun to loosen the tight network of corporate cross-shareholdings that have allowed corporate managers and core workers to pursue policies congenial to the autonomy of the corporate organization.

There appears to be little doubt that the long-run tide of the corporate system in advanced capitalist economies is moving away from the "realistic" and towards the "nominalistic". And yet, I can discern another tide that is moving in the opposite direction. This is a tide brought about by the forces of "post-industrial" capitalism. There is now a strong shift in the major source of profits for the capitalistic system, from physical assets to organization-specific human assets. What is critical to the long-run competitiveness of business corporations is no longer the scale and scope economies of production facilities

40 According to Michael Jensen (1989), what is in decline is not merely the Berle–Means type managerial corporation but the entire institution of the public corporation.

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and distributional networks, but ideas, know-how, coordinating skills, forecasting capabilities, strategic prowess, strong leadership, etc., of managers, researchers, engineers and other knowledge-oriented employees working inside of their organizations.[41] There is indeed a growing body of literature suggesting that the capital values of human assets and other "intangibles" have shown a phenomenal rise in recent years (see e.g. Hall, 2000; Blair and Wallman, 2001).

The single most important characteristic of human assets is its inalienability. Money can buy factories, machines, offices, land and other physical assets. Money can also buy software, licences, patents, copyrights, trademarks, brand names and other non-physical but non-human assets. Money cannot, however, directly buy ideas, know-how, skills, capabilities, prowess, leadership and other human assets, because these are all forms of knowledge that are stored inside human brains. As long as there is free will, it is impossible to dictate from outside how such knowledge should be employed and accumulated. The only thing money can do is to provide a variety of incentive schemes to encourage employees to utilize their existing knowledge effectively, and to develop it willingly towards a new knowledge applicable within their organizations. Examples of such schemes are performance bonuses, promotion systems, stock options, pension plans, flexible working conditions, intellectual autonomy and comfortable and stimulating environments. In the era of modern industrial capitalism, shareholders had the upper hand in the balance of power within a business corporation, because of the large sum of money required to construct and maintain the production facilities and distribution networks critical to the firm's competitive advantage. Now, in the new era of post-industrial capitalism, the physical assets have surrendered their central position to the knowledge-based human assets that money can no longer buy and control. The balance of power within a business corporation is clearly tilting away from the suppliers of money and towards the suppliers of knowledge-based human assets, i.e. from shareholders to knowledge-orientated employees. The recent tide of the corporate system in the "nominalistic" direction certainly runs counter to this new development. Indeed, the tighter shareholders' control will breed the worries of "hold-ups" on the part of employees and impede their efforts to invest in organization-specific human assets that the business corporation badly needs for its survival and growth.

I am not advocating a return to the ancient regime of the Berle–Means type managerial corporations or the Japanese-style corporate groups. In all likelihood, the future corporate system will not be like that. But nor will it be "nominalistic". The growing need to

41 It is the exhaustion of the "industrial reserve army"—the surplus population deposited in rural areas and supported by communal networks—that is the ultimate cause of this massive phase-transition of capitalistic system from "industrial" to "post-industrial". The consequent rise in real wages has reduced the profit margins of the existing production facilities and distribution networks so that capitalist enterprises are able to reap profits only by undertaking what Schumpeter (1950) called "innovations". By "innovations", Schumpeter designated a broad range of events including "the introduction of new commodities . . ., the technological change in the production of commodities already in use, the opening-up of new markets or of new sources of supply, Taylorization of work, improved handling of material, the setting-up of new business organizations . . .—in short, any 'doing things differently' in the realm of economic life". Obviously, in order to do things differently, capitalist enterprises need the ideas, know-how, coordinating skills, forecasting capabilities, strategic prowess, strong leadership, etc., of real human beings. (See Iwai, 2001a, for an attempt to formulate Schumpeterian or post-industrial way of generating profits.) In an interesting recent paper, Rajan and Zingales (2001) have claimed that the financial revolution that has made finance (money) cheap is the major cause of the rise of the importance of specialized human assets. But the financial revolution is merely a result of the more fundamental structural changes taking place in capitalism.

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encourage knowledge-orientated employees to invest in human assets unique to their organization will make it resemble a "realistic" rather than "nominalistic" corporation in the extensive menu of possible corporate structures.

Amidst much uncertainty, the only certainty is that no single organizational form is likely to dominate the future of the corporate system. The legal institution of the corporation has shown a surprising versatility in the past. Its two-tier ownership structure will surely engender a wide variety of business organizations, even in this era of post-industrial capitalism.

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