



**UiO • Faculty of Law**  
University of Oslo

PhD seminar on Sustainability Law: Companies Markets  
and Circular Economy

# Why is law-and-economics important for PhD candidates?

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# Paradox

- Company law we know has been constructed for a much simpler world we have today
- Economics has tried to make it even simpler than it is in law
- The complexity of companies cannot be described only in terms of shareholder and the board, principal and agent, or other so simple terms

# In the crossroads: corporate purpose revisited

- After decades of being dormant, corporate purpose has become a hot topic of discussion again in company law and corporate governance
- In the Anglo-American world this discussion has been however around a presumed shareholder v stakeholder dichotomy
- Connected often to private interests as the [B Corp](#) 'movement' and [Business Roundtable](#)

# Lack of theoretical analysis

- The shareholder v stakeholder discussion has been both misleading and atheoretical
  - [Aneil Kovvali: 'Stark Choices for Corporate Law Reform' \(2022\)](#) (from US perspective)
- As in company law and corporate governance generally, this dichotomy has been spread all over the world, also, eg, to Europe
  - Eg, in Europe it has reflected European ideas of stakeholder governance as employees' codetermination rights and the most recent EU initiatives

# Legal tradition

- The rich history of company law theory has been forgotten
  - Friedrich von Savigny, *System des heutigen römischen Rechts* (Bei Deit und Comp, 1840), vol. II (fiction theory); Otto Gierke, *Die Genossenschaftstheorie und die deutsche Rechtsprechung* (Weidmann, 1887) (organic theory)

## Legal tradition

- and replaced by US economic theory of the firm
  - ➔ Michael J Jensen & William H, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305; Frank Easterbrook & Daniel Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1991)
- Let's look this a bit

# No dichotomy

- Typical for the shareholder v stakeholder discussion: regulation is a scarce resource: regulation of corporate governance prevents external regulation that should really protect the stakeholders
  - As labour law and environmental law
- Kovvali (2022): ‘There is no reason to believe that the choices are *mutually exclusive*: there is no clear constraint that forces a choice between the internal and external paths.’

# No dichotomy

- In the same vein: [Beate Sjøfjell & Jukka Mähönen: 'Corporate Purpose and the Misleading Shareholder vs Stakeholder Dichotomy' \(2022\)](#)
- Looks like that the proposed Sustainable Due Diligence proposal is a mix of internal and external action



## Dichotomy still – in the US

- Kovvali (2022): Stakeholder governance theorists have not pressed this case, perhaps because many are not eager to encourage governmental action. But once the stark choice hypothesis is identified and inverted to match reality, it becomes possible to evaluate opportunities to effect real change through internal corporate governance reforms.

# As an example: In Europe

- Background
  - European societal approach to companies v. US-originated efficiency-based approach
  - European approach b. US-originated shareholder v. stakeholder dichotomy

# Misleading dichotomy

- In our paper ([Sjåfjell & Mähönen 2022](#)) we reject the dichotomy as a meaningful framing of the debate
- We argue that corporate purpose instead should be taken seriously as a matter of company law and as an element in ensuring the contribution of business to sustainability

## **The danger of the shareholder vs stakeholder dichotomy**

- We see The Anglo-American shareholder v. stakeholder debate is misleading and even dangerous in the way it takes company law proper out of the discussion
- A forced 'choice' between shareholder primacy and what we call 'stakeholder primacy' creates a vacuum where is no room for the broad canvassing of other options that suit better the variety of company law regimes around the world

## Taking company law seriously

- We see - in line with Kovvali (2022) looking from US point of view: we cannot exclude the internal
- To get real about integrating sustainability, we need to go to company law, which is the regulatory infrastructure for decision-making in business
- Company law gives a broad discretion to corporate boards and by extension senior management in their corporate governance

# Taking company law seriously

- We do not need to abandon “agency”
- It is just agency to the company
- But why agency is important and what is its relationship to law – and what economics has to do with it?

# Why economics is important in understanding company law theory?

- Economics is the mainstream in mainstream:
  - Reinier Kraakman et al.: *The anatomy of corporate law : a comparative and functional approach* (3rd ed., Oxford University Press, 2017)
- See also
  - Ronald J Gilson, 'From Corporate Law to Corporate Governance' in Jeffrey Gordon and Wolf-Georg Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* 4 (Oxford University Press, 2018)

# Theoretical basis

- Mainstream corporate law paradigm
  - Armour et al, ‘What Is Corporate Law?’ in Kraakman et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3<sup>rd</sup> ed, Oxford University Press, 2017)
- End of history of corporate law
  - Henry Hansmann & Reinier Kraakman, ‘The end of history for corporate law’ (2001) *Georgetown Law Journal* 439



# Theoretical basis

- Critique against mainstream paradigm
  - Older: Adolf Berle & Gardiner Means: *The Modern Corporation and Private Property* (The Macmillan Company, 1932)
    - Available:  
<https://archive.org/details/in.ernet.dli.2015.216028/page/n5/mode/2up?view=theater>
  - Luh Luh Lan & Loizos Heracleous: Rethinking agency theory: The view from law. *Academy of Management Review*, 294–314 (2010)

# Mainstream paradigm

- Emphasis on contracting and self-regulation
- Basis on microeconomics: theory of the firm
  - Nexus of contracts theory
  - Principal agent theory
- ➔ Shareholder primacy
- But how we ended to this?

# Historical theories on company law

- Fiction theory
- Organic theory
- Aggregate theory

# Fiction theory

- Company a state-created legal fiction only, without substantial reality or own free will
  - Public good
- Basis: state concession
- German variant: Friedrich von Savigny, Karl Puchta
- U.S. variant: *Dartmouth College v. Woodward* (1819); David Millon, 'Frontiers of legal thought I: Theories of the corporation' (1990) *Duke Law Journal* 201

# Fiction theory

- Modern influence:
  - Stakeholder primacy

# Organic theory

- Company a real entity having a separate existence from its shareholders
- Company a naturally occurring being
- German variant (real entity): Georg Beseler, Otto von Gierke
- U.S. variant: Ernst Freund: *The legal nature of corporations* (1897)
- Modern influence:
  - Managerialism: Berle & Means (1932)

# Organic theory

- Eva Micheler, 'A Real Entity Theory of Company Law' in Eva Micheler, *Company Law: A Real Entity Theory* (Oxford University Press, 2021)

# Aggregate theory

- Company formed by voluntary private contracting
  - Basis: contract theory
- German variant: Rudolf von Ihering (interest theory)
- U.S. variant: Victor Morawetz: *Private corporations* (1886), Charles Beach: *The Law of Private Corporations* (1891)



# Aggregate theory

- Modern influence:
  - Shareholder primacy: Jensen & Meckling, 'Theory of the Firm' (1976); Hansmann & Kraakman, 'End of History' (2001)
  - Director primacy: Margaret Blair & Lynn Stout, 'A team production theory of corporate law' (1999) *Virginia Law Review* 247

# Shareholder primacy

- Main idea shareholder primacy: the shareholders have a special role among the corporate stakeholders
- emphasis on contracting and self-regulation
- theoretical basis: principal agent theory

# Theoretical basis

- Theory of the firm (Akerlof, Fama, Jensen, Meckling)
  - Agency theory
  - Principal-agent theory: problem of asymmetric information
  - Incomplete contracting theory: problem of transaction costs
- Origins in large profit-making firms
- How to govern the relationships between management and shareholders?

# Theoretical basis

- Armen A Alchian and Harold Demsetz, 'Production, Information Costs, and Economic Organization' (1972) 62(5) *The American Economic Review* 777
- Eugene F Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *Journal of Political Economy* 288
- Eugene F Fama and Michael C Jensen, 'Agency Problems and Residual Claims' (1983) 26 *Journal of Law and Economics* 327

# Principal agency theory

- Main features
- Agency
- Asymmetric information
- Incomplete contracting
- Transaction costs
- Moral hazard ("opportunism")
- Legal tools
  - Fiduciary duties
  - Transparency

# Transaction costs

- Ronald H Coase, 'The Theory of the Firm' (1937)  
4 *Economica* 385
- Oliver E Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (Free Press, 1975)
- Oliver E Williamson, *The Economic Institutions of Capitalism* (Free Press, 1985)
- Oliver Williamson, 'Transaction- Cost Economics: The Governance of Contractual Relations' (1979)  
22 *Journal of Law and Economics* 23

# Principal agent theory in a company

- A firm is nexus of contractual input and output relations between the firm's stakeholders
- From this point of view, a firm does not have "owners" in the traditional sense
- Shareholders input only one among other contractual parties, eg creditors

# Special role of shareholders

- Shareholders carry the residual risk on the firm
- The most vulnerable stakeholder group for management opportunism
- The most vulnerable of all: the minority shareholders
- Management opportunism
- Controlling shareholder opportunism
- How to prevent opportunism?



# Principal agent relationship

- The board of directors: agents of shareholders monitoring the management
- The board must be seen as the agent for all shareholders and shareholders only
- Directors's duties to and only to shareholders
- Fiduciary duties: duty of care and duty of loyalty
- Company interest = Shareholder interest

## Division of control rights

- In a company with no controlling shareholders: the directors "own" the company by controlling it without hearing the investors
  - "director primacy"
- New interest conflict between the directors and the shareholders: the directors have the control but not a residual risk → no incentives to maximize the residual

# Division of control rights

- Other two interest conflict relationships
  - Controlling shareholders v the minority shareholders
  - Shareholders v creditors

# Corporate governance

- How to solve the interest conflicts between shareholders v directors and controlling shareholders v minority shareholders
- How the shareholders ensure that the directors serve shareholders' without opportunism?
- How the minority can trust the controlling shareholders?

# Corporate governance

- Problems to be solved
  - Information asymmetry: Efficient monitoring?
  - Transparency
- Tools
  - Legal rules
  - Self-regulation
  - Shareholders' decisions
  - Information duties

# Main question: How to monitor?

- The essential role of intermediaries
  - Auditors
  - Analysts
  - Rating agencies
- Duty to verify agent information on behalf of principals
- Moral hazard
  - Enron
  - Financial crisis
  - Panama Papers

# Importance of information

- Transparency rules
- Balances information asymmetry between principals and agents
- Enables efficient markets for corporate governance

# Creditor protection?

- Primarily an insolvency law not company law problem
- Continental and Nordic company law: main focus in company law – efficient?
- Change of focus in company law reforms:
- Creditor protection ➔ shareholder protection



# But is agency theory and answer to modern company?

- Criticism:
  - If agency understood as shareholder primacy – problem of corporate sustainability and resilience
  - Nexus of contract theory is abstract – to create shareholder primacy, an additional piece was required – shareholders' residual claim
  - Stakeholderism is not an answer either – just multiplies private interests
- Could there be a possibility to combine agency and sustainability?

# More institutional economics

- Brute facts and social facts
  - Richard Adelstein, ‘Firms as Social Actors’ (2010) 6(3) *Journal of Institutional Economics* 329
  - A firm as social unit
    - ‘supraindividual being that acquires knowledge, makes decisions and acts in the market through the operation of routines’
    - firms are not ‘living’ organisms but nonetheless ‘autonomous’ even ‘lifelike beings’ existing apart from their temporal participants capable of intentionality and social action in their own right

# More institutional economics

- Real entity revisited (Micheler, 2021)
  - Organizations as companies are characterized by the habits, routines, processes, procedures, tacit knowledge, and culture that human social interaction brings about
  - These are not biological but social phenomena which can be and are researched and understood by the methods available to the social sciences - as economics
  - Social structures shaping human action and creating organisational action <> human agency capable of deviating from social structure
- A company is non-zero sum game, important to recognise the players
  - How to achieve Nash equilibrium?