Do shareholders really own the firm?

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Title: Do shareholders really own the firm?

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Abstract: The object of this contribution is to address the question of the ownership of the firm. Both law and economics shape representations of the world: law focuses on rules and justice; economics focuses on efficiency and allocation. They describe common situations and "objects" such as firms and their functioning, both with positive (analytical) and normative perspectives. However, their descriptions and remedies for the issues which they tackle are very different due to the differences in their philosophical and sociological goals. The Law & Economics perspective can be described as the use of the economics theoretical framework upon issues of law. In this perspective, law issues are addressed as any other economic phenomenon through the prism of efficiency. From this perspective, law is contingent upon normative conditions of economic theory and the best solution arises after a standard process of optimisation. This paper will set out a reversal of that epistemological position: instead of using economic representations to improve the state of law, representations of law will be aimed at testing and improving the economic analytical framework. Since corporate governance issues are structured by domestic laws as well as by economic regulations, legal representations will be discussed in light of economic corporate governance analysis.

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Do shareholders really own the firm?

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1 Introduction

The object of this contribution is to address the question of the ownership of the firm. Both law and economics shape representations of the world: law focuses on rules and justice; economics focuses on efficiency and allocation. They describe common situations and “objects” such as firms and their functioning, both with positive (analytical) and normative perspectives. However, their descriptions and remedies for the issues which they tackle are very different due to the differences in their philosophical and sociological goals.

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Corporate governance is a subject upon which economists and lawyers seem to share the same object (the firm) and to have a common perspective. Most of the literature defines corporate governance as the answer to “what means are open to assist shareholder in controlling the managers?”. This perspective can be considered as a narrow one (still it is the most widespread perspective among economists and lawyers), but it can be extended with a “stakeholder” approach that relies on a broaden definition of corporation. In this extended perspective, the question of corporate governance can still be put in terms of control: “what are the possible ways that would enable stakeholders (including shareholders, employees, creditors and sometimes also customers, suppliers, local communities, environment...) to take part in the corporation’s decisions?”

The narrow (but dominant) economic perspective about corporate governance carries out its reflexions within the framework of agency theory that considers the firm as a nexus of contracts where shareholders try to align the board of directors’ members interests with their own. The parallel jurists’ perspective on corporate governance focuses on the same issues: both American and European practices are focused on the same set of legal mechanisms described by

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national legal frameworks (and sometimes also by international bodies as the OECD (OECD, 2004) or institutional investors as CalPERS (CalPERS, 2007)) about control and transparency in the corporations.

Despite an unquestionable relevance in their questioning (information and disclosure are linked to the objective of enhancing the financial market’s efficiency), the relevance of their normative responses is questionable from both the theoretical and the practical points of view. The aporia of the agency theory lies in its incapacity to conceive the firm as anything else than an nexus of contracts: this definition excludes everything except bilateral bargaining and consequently neglects the existence of social constraints and of any form of collective action (Lenoble, 2003).

The solutions to the issue of reliability of information, which is the paradigmatic issue of agency theory, are only described and conceived in terms of incentives meant for the agent to act solely in the interest of the principal. According to this theoretical framework, decisions are taken through the mechanical framework of an optimisation program. This perspective denies the existence of any social and/or collective phenomenon. This is the reason why we reject the agency theory theoretical framework as an adequate framework for solving corporate governance issues: in our opinion, it is too much disconnected from the concrete reality of the firm’s situation.

2 Firm’s Representations in Economics and in Law: a Cross Fertilization

The search for a more accurate theoretical and practical framework for corporate governance issues than that of the agency theory requires an understanding of the nature of the firm and of its interest. The nature of the firm is a subject upon which the lawyers’ representations about economy cross those of economists and managers about law. In order to reconstruct a theory of corporate governance, we will first consider these representations separately and then cross them.

From an epistemological point of view, our approach distinguishes itself from the posnerian approach of “law and economies” issues. This approach is a typically economist approach: it focuses on law with a normative objective. The main question of posnerian law and economics is the question of efficient allocation: judges (as law makers) are not supposed to make their judgements with an objective of justice but with the only objective of efficient allocation (Kirat, 1999). In this normative theory, judges have to respect only one rule, derived from the paradigmatic economic “law” of optimization.

Our approach is different in its foundations and is closer to Williamson’s. His heuristic perspective develops the idea that the law is one of the foundations of any economic action (Williamson, 1985). Then the objective is not to define what kind of rule must be applied to optimize the well being of the economic agents, but how law, via its representations in economic agent’s minds, influences the economic actions of people. We must emphasize that this is not the same as looking, as most economists do, at the legal framework as an exogenous constraint because it allows to endogeneise the influences of laws and rules and by extension, to consider the possibility of improving the set of rules implemented.
Aligning managers’ interests with the shareholders’ interests is pertinent only when the analysis is focused on contractual relations and excludes any other relation: because contracts are considered as complying with the rule of equivalence and would not be accepted by one of the parties if it was not so, they are also supposed to protect both of the contracting parties. Workers, managers, consumers, suppliers have one or more contract(s) with the firm. For this reason, they are considered as protected by their contract and also subject to asymmetrical information problems, while the shareholder, whose stakes are not protected by a contract, appears then as the weakest stakeholder of the firm and also the one who the best embodies its interests. This analytical perspective\(^1\), which is the mainstream one, considers the firm as the shareholders’ property. Thus, the interest of the shareholders and the interest of the firm are the same.

The confusion of the shareholders’ and the firm’s interests is not a scientific assertion: it is the common representation of a majority of researchers in corporate governance. This point can be addressed by the civil law analysis of the firm in a way that can reveal the weak points of this standard perspective and overcome its aporia. Crossing the representations of law with the economic ones, in this case where lawyers and economists share the same “object”, contributes to the emergence of a new framework in corporate governance analysis. By revealing the underlying beliefs of the mainstream corporate governance theory, both lawyers and economists can improve the efficiency of their normative propositions.

The first point with this crossing of representations of law and economics is that, historically, the enterprise does not exist in either of these disciplines (Boyer, 2002). The closest concept in economics is the concept of entrepreneur whose aim is to optimise (as a price taker) the production\(^2\). From the juridical point of view, the firm is reduced to the concept of company which is considered as an autonomous person (Robé, 1995). In both cases, the question of governance cannot be considered as a question solved by those perspectives: the firm is represented as an autonomous person, with a personal and clearly defined interest.

If we assume that these descriptions are the accurate framework for analyzing corporate governance issues, we must agree with Kreps’ foreword (Kreps, 1990) on his seminal article about corporate culture: we don’t have anything to say, nor as an economist nor as a lawyer upon this subject. As provocative as it may seem, this point is to state that these representations lead to an impossibility of conceiving the firm as a place governed by people with different interests which must be considered in order to succeed. As a consequence, corporate governance cannot be an issue within this theoretical framework.

However, if the crossing of representations between classical standard economics and standard positive theory of law does not open any fruitful perspective, this crossing is much more promising when we look at the ways lawyers and economists cope with this aporia. In order to analyse questions of governance within the firm, both economists and lawyers have to pass through the representation of the firm as a black box. The first way we will explore is linked to the question of property rights.

\(^1\)For further development and precisions see Grossman & Hart (1986).

\(^2\)This neo-classical description of the firm is based on Walras (1874).
dation of any corporate governance issue with the question of “ownership and control” over the firm (Berle & Means, 1932). It is the basis upon which mainstream analysis is built. As the subject of this work is to analyse the value of considering the representations of law in order to improve our understanding of corporate governance, the property rights theory can be interestingly re-interpreted in accordance with the juridical perspective. Actually, property rights are a well-known legal category and we will question the accuracy of applying this category to the firm and the shareholders.

3 The Legal Representation of Property

In the ancient roman law (and also in civil law), the bundle of rights that together constitutes full ownership of property comprises three separate sub-bundles: (1) the usus is the right to use or possess, i.e., hold, occupy, and utilize the property; (2) the abusus is the right to abuse or alienate, i.e., transfer, or even destroy the property, and (3) the fructus is the right to the fruits, i.e., to receive and enjoy the earnings, profits, rents, and revenues produced by or derived from the property. Ownership may be allocated in various combinations among different persons, with each having less than full ownership. For example, the owner of a legal usufruct (“usufructuary”) has the right to use the property burdened with the usufruct (usus) and to enjoy the fruits of that property (fructus), but does not have the right to alienate the property (abusus); that right belongs to the naked owner, albeit subject to the usufruct. The owner of the abusus cannot sell the property: he or she can only sell its part of the property (the abusus) and this cannot deter the usufructuary from his or her prerogatives.

The notion of incomplete ownership is particularly accurate for this critic, because in our opinion, shareholders cannot be described as the sole owners (/having full ownership) of the firm. The property rights theory assumes that because shareholders are the residual claimants of the firm, they are the owners of it. Our aim is to show that their ownership is incomplete and depends of their situation. As a consequence, other stakeholders must be considered also as incomplete owners of the firm and should then be able to exercise the associated rights.

What could be the ownership of a firm? From a juridical point of view, this question would be considered as a non-sense: the company⁷ is a legal person and the shareholders do own shares, they do not own the company because it is a person (nobody can own a person, even if it is a legal person). But in our critical perspective, the legal representation of property will still be applied in order to challenge the property rights approach.

What could be the usus, the fructus and the abusus of a firm? As the usus is about the control of the use, we can assume that the control of the firm by the manager is the closest approximation. The fructus should be considered as the allocation of profit of the firm (in technical terms: Net Operating Profits

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⁷The question of the status of the company (e.g. is the company the same thing as the firm?) is particularly discussed among the lawyers community (see Despax (1957), Paillusseau (1984) or Teubner (1987)), but won’t be taken into account in this development at this moment: we will consider, in the first instance that “company” and “firm” are synonyms. The translation of an economic category to a juridical category is tricky and causes difficulties that go far beyond the scope of this reasoning.
After Taxes a.k.a. NOPAT) and not only as the dividend which is the share’s fructus. The abusus can obviously be defined as the right to end or sell the firm. With this framework we can now test the accuracy of the property right theory.

Individually, a minority shareholder cannot make use of his right of abusus: the decision of ending a company can only be made by a majority of the shareholders or, in some countries by a majority of \( \frac{2}{3} \) of the shareholders. Shall we then consider that a minority shareholder is an usufructuary of the firm? Actually, as the usus must be shared with the other shareholders (co-ownership) and delegated to a director (shareholders elect among themselves the board whose mission is to control the management of the company), we can assume that a minority shareholder cannot be considered as having the complete usus of the firm. For the same reason, he or she will not be considered as having the fructus of the company.

Collectively, the property of the firm must be differently considered. Even if the usus and the fructus are delegated, the community of shareholders owns these rights. The abusus is also owned by the community of shareholders. For these reasons, the shareholders as a community can be considered, at first sight, as owners of the firm as they seem to have the full set of rights that characterised ownership.

From this point of view, the property rights theory can be considered as solidly confirmed in its construction of “the shareholders as the owners of the firm”. Meanwhile, does the property of the firm belong only to the shareholders? As creditors can demand (only in some cases of financial distress) the liquidation of the company, which is the prerogative of the owner’s abusus, we must recognise that shareholders do not have the complete abusus of the firm. Moreover, in some cases of severe fraud or misconduct, the State can require, in some countries, the winding-up of a company. In certain countries, a part of the profit is compulsorily dedicated to employees by a legal mechanism of “participation”, which lessens the usus of the shareholders.

As we have demonstrated that shareholders do not completely have the full set of property rights, we must then consider that shareholders are not at all times the only residual claimants of the firm. Thus we have now to find out in what circumstances other stakeholders are involved because of their part of the property rights. The answer is found through an analysis of the firm’s interest.

4 The Question of Firm’s Interest

In capitalist countries, free entrepreneurship has been the key element of development during the industrial revolution of the 19th century. The industrial development tended to increase the need for big companies, big enough to be able to raise enormous amounts of capital (e.g. railroads). At this time, the general rule for firms was unlimited liability: the associates were liable on their own patrimony for all the obligations of the firm and the consequences in case of bankruptcy were financially disastrous for the associate(s) sued by the creditor(s) (in addition to the penal sanctions) (Szramkiewicz, 1989). Financing such projects needed huge amounts of finance capital that consequently needed large numbers of small savings in addition to the other significant blocks of capital. In order to attract these small savings, the status of these companies should be a status of limited liability.
In the first half of the 19th century in Europe and in USA, that kind of company (with limited liability) had to be founded by a State Charter (royal or from a national body) because limited liability was derogatory. This process was cumbersome and too heavy in a period of fast economic development. If, at the beginning of the industrial revolution, the involvement of the public interest was the only acceptable justification for allowing the limited liability of a firm, limited liability became, in a few years during this period of history, the common status of entrepreneurial activities.

As from this time (mid and late 19th century), the promotion of the public interest was no longer a requirement for a company to formed. Still, the possible impact of bankruptcy on the economy was a matter of concern for the legislators who decided that the State and the creditors (e.g. suppliers, bankers, employees...) should be able to ask for the dissolution of a company in case of unpaid debt. This shows that, from a legal point of view, the firm’s stakeholders are not only the shareholders. As a consequence, the firm’s interest, even if it is no longer directly bounded by the public interest, is still linked, for example, to the creditors interest when the existence of the company is at risk (especially through insolvency, but also when public order is jeopardized).

In civil law, the interest of the firm is considered different from the shareholder’s interest and is described as the interest of all its co-contractants. This means that the firm’s interest is the superior interest of its stakeholders: an interest common to the shareholders, the employees, the providers of finance, services or goods, the customers, and the State.

Despite the fact that shareholders (mostly pension funds) tend to stay for shorter periods in companies’ capital, it has been argued that all these stakeholders have the same interest in the long run and that shareholders, as they are less protected than other stakeholders (as they are not “protected” by a contract, they have the fewest incentives to act in a different interest from the company’s one), are the best representatives of the firm’s interest. As obvious as it may seem (the survival and, if possible, the development of the firm is the common goal), the civil law recognises that a decision taken in the sole interest of a shareholder and different from the company’s interest can legally be cancelled.

These arguments show that shareholders cannot, in any situation, be considered as the only residual claimants of the firm. The fiduciary duties of the managers do not go to the shareholders: they must also take into account other stakeholders’ interests because they are part of the company’s interest. However, these arguments about the company’s property do not lead to the conclusion that shareholders are not legitimate owners of the firm: they only state that they are not the only owners of the firm and that in certain cases, legitimate owners of the firm can also be other stakeholders. Depending on such cases, the stakeholders that should be involved are not always the same: this has to be defined by a contextualised approach.

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1The idea of a single and homogeneous interest is flawed: shareholders have individually different time horizons and different risk structure.

2For further developments on this point see Lenoble & Maesschalck (2003).


5 Conclusion

In conclusion, we consider that the theoretical mainstream framework of corporate governance (the agency theory and the property rights approach) must take into account that shareholders are not the only residual claimants of the firm and that the other residual claimants must be defined after an analysis of the situation. In this perspective, employees are not always residual claimants of the firm, but may be considered so, for example, in case of financial distress. Moreover, one must point that stakeholders do not have equivalent stakes in the firm and that this should also be taken into account. Our aim was not to destroy the foundations of the theory of corporate governance but to point out its limitations in order to improve the incentives it can produce.

The use of law’s representations in order to test the assumption of the economic property rights approach can be regarded as successful. Applying the legal framework leads to an enhancement of the basis of the property rights theory. Instead of using philosophical and political objectives of law or economics to evaluate respectively economics or law, theoretical representations of both economics and law are crossed with respect to corporate governance. Within the framework of the introduction of law’s representations in an economic theory (the property rights theory), perspective regarding governance issues (especially in this matter of corporate governance) has changed from a comprehensive approach based on aligning interests toward a new coherent framework relying on ethics and contextualisation.

References


