

# **Why do we need business corporations? A functional analysis of the legal form**

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## **Introduction**

Usually a business is operated under a certain legal form, such as a business corporation (a limited company), a partnership, a LLC, or a sole proprietorship. Among those, a business corporation is one of the most common forms of business in most countries. Here a business corporation is defined as a legal form that has a legal personality and issue stocks to general public (public corporation) or to specific people (closed corporation). This specific kind of legal form exists and prevails in many countries, including the United States, the United Kingdom (a limited company), Germany (Aktiengesellschaft), Korea (Jusik Hoesa) and Japan (Kabushiki Kaisha).

Then the question is; why do we need this type of legal form? In other words, is a business corporation as a legal form useful in doing business? If yes, in what sense? The purpose of this paper is to try to answer these questions. Hansmann and Kraakman (2000), for example, raised questions such as “what more, if anything, these entities [legal forms] offer” and ”Do they [legal forms] (...) play essentially the same role performed by privately supplied standard-form contracts.” If legal forms of business enterprises, such as a business corporation, are just standard forms of contracts between stakeholders, I can stop my analysis here. As Hansmann and Kraakman (2000) continued their analysis, however, it seems to us that those legal forms are not just standard forms of contracts. Moreover, some scholars, such as Blair and Stout (1999) or Iwai (1999), even opposed the view that business enterprises are basically a bundle of contracts between stakeholders, which is known as the “nexus of contract” theory (Alchian and Demsetz, 1972; Jensen and Meckling, 1976). Their papers suggest that there are many problems to be investigated.

In this paper, I tried to tackle the question above from the standpoint that is different from previous studies, i.e., the standpoint of organizational theory (Barnard, 1938; Simon, 1947; March and Simon, 1958). As Blair and Stout (1999) and Iwai (1999) indicated, we cannot disregard the role of human capital, especially firm-specific human capital. In a business enterprise, human capital is utilized by organizational coordination. In other words, a business organization plays an important role in utilizing human capital. Thus one way to answer the above question is to focus on the role of a business organization and investigate the relationship between functions of a business organization and a legal form.

The approach of this paper has not been taken in previous studies. Though Blair and Stout (1999) focused on the role of human capital, they did not analyze the function of a business organization. Iwai (1999) pointed out the importance of organization and organizational asset, but he did not investigate the inside of a business organization, that is, role of communication and coordination, for example. Teubner (1988) introduced organizations into his analysis of legal person, but his analysis focused on the self-defining or self-description of organizations. On the other hand, some scholars of business administration who investigated corporate social responsibility are interested in legal responsibility of corporations (e.g., Post, Lawrence and Weber, 2002). They did not investigate functions of legal forms, however.

First I focus on the functions of legal personality. I examine why we need legal personality even when we can conduct our business without that (as is seen in a sole proprietorship). Then I investigate the functions of shareholders from the perspective of business operation.

### **Legal personality and business organization**

Before going into analysis, let me clarify the meanings of legal person and business organization. Legal person is a legal concept which is made to give a group of individuals or an organization a right to conduct legal actions in its own name, i.e., a legal person can own properties, can sign contracts, and can sue and be sued by other persons. On the other hand, business organization is an organization consists of managers and employees doing a business. Please note that legal person itself is just a legal concept. A legal person should be distinguished from the business organization in the real world that is given the legal personality.

If a business is conducted by a small group of natural persons (individuals) who also contribute some money (in a business corporation, those people are called shareholders) to run their business, the distinction between legal person and organization is not a big problem. The business is owned and operated by the group, and legal personality is given to the group.

If a business is so big that more people have to be employed in addition to the shareholders, or there are some shareholders who do not want to engage in the business, separation of shareholders and business organization takes place. That is, there are shareholders who do not engage in the business and not included in the business organization. Even in this case, the legal personality is, from the legal point of view, given to the group of *shareholders*, including shareholders who do not included in the

business organization. Stakeholders – employees, suppliers, customers, lenders and others – contract with this legal person and make the business organization.

The problem here is functions of legal personality in doing business. In other words, why do we need legal personality to do a business? One simple answer is following; if a group of individuals (i.e., shareholders) does not have legal personality, it is inconvenient for them to own properties or sign contracts since all shareholders have to sign the contract. It might be true, but if so, a representative or an agent of shareholders can make a contract or own properties instead of a legal person.

That is, there are three ways to form a business organization and to conduct its business in a legal manner;

- (a) contracts with all shareholders
- (b) contracts with a representative or an agent (or small number of representatives or agents) of shareholders.
- (c) contracts with the legal person

In the case of (a), singing a contract or having a property registered may be very difficult, because of the reason mentioned above. In the cases of (b) and (c), however, doing such things is not so difficult, since one person or one legal person deals with all legal relationships related to the business of the organization. That is, the difficulty I just mentioned can be eliminated by using an agent or a representative of shareholders. Thus the question why we use the corporate form instead of an agent or a representative remains unsolved.

Another explanation is “asset partitioning,” that is, by using the legal personality the assets being used for business are separated from the personal assets of shareholders (the case of (a) ) or of an agent or a representative of shareholders (the case of (b) ). Though this function itself has been known for years or decades, the benefit of this function was recently investigated by Hansmann and Kraakman (2000). They insisted that asset partitioning reduces monitoring cost borne by creditors of a firm and also protect firm’s going concern value. Under the context of this paper, their explanation can be understood in a following way; without asset partitioning, potential creditors of the business organization have to monitor the creditworthiness of all shareholders or the agent (or the representative) of shareholders, since creditors of a shareholder or the agent (or the representative) of shareholders can make a claim against (the person’s share of) the assets being used for business in the case of the person’s insolvency. It requires a large amount of monitoring cost. Moreover, the petition of

bankruptcy may impair or destroy the business organization's value. Though this explains a function of legal personality quite well, they are silent about the problems related to firm-specific human capital that are suggested by Blair and Stout (1999) and Iwai (1999). I will try to provide a synthetic explanation from the standpoint of organization theory.

As I pointed out, human capitals are utilized by organizational coordination. In other words, production of goods and services can be achieved by organizational coordination. Here organizational coordination means a series of communication between employees, managers and other related stakeholders. In this series of communication, an employee communicates some kind of information which is needed for production to another employee, and the latter person behaves based on the information from the former person. Simon (1947) interpreted this series of communication as the chain of decision making. According to Simon (1947), decision making is a process in which draw out a conclusion from decision premises (i.e., factual premises, such as alternatives and the outcome results of these alternatives, and value premises, such as evaluation criteria). Within an organization, the result of decision making of a person is delivered to another person as a decision premise, and the latter person makes a decision based on the delivered information (a decision premise). The whole process of decision making is often called as an organizational decision making.

Decision making needs some time and effort. Especially in a situation that occurs repeatedly, people try to save their time and effort by developing and using a pattern of behavior to deal with the situation, instead of making a decision repeatedly. This patter of behavior is called as a "program" (March and Simon, 1958) and maintained in forms of manuals (standard operating procedures), instructions, or facilities.

In the situation where a business organization has developed a wide "repertoire" of programs and those programs are connected each other, these programs, as well as physical facilities, consists of a complex that can deal with the business efficiently. We can call this complex as the "technical core" as Thompson (1967) called.

Thompson (1967) pointed out influence from the outside of a technical core should be controlled so that the technical core can operate efficiently. Considering this point, we can understand the concept of legal person as a device to control influence from the outside and to ensure efficient operation of a technical core.

In order to investigate this possibility further, let me consider the situation in which an organization doing a complex business – thus it has its technical core – does not have legal personality. In other words, there is a natural person, hereafter Mr. A,

legally signs any contract and owns all the property regarding the business. In this situation, the relationship between a shareholder (except for Mr. A, if Mr. A is also a shareholder) and Mr. A can be a loan contract or another type of legal contract. We can understand this situation as if a sole proprietor runs a big business with many employees. In this situation, what kind of problems is there? At least, I can point out four problems.

- (1) Inseparability of the assets being used for business from Mr. A's personal assets
- (2) Unexpected influence comes from Mr. A's personal situation
- (3) Mr. A's legal power to exercise all contractual rights related to the business.
- (4) Mr. A's heavy burden of responsibility

Because of (1), Mr. A can use, sell or consume properties that are necessary for the operation of the technical core. For example, Mr. A can use or sell a truck which is needed to deliver the products of the business enterprise. This kind of behavior is harmful to the technical core of the business organization, since efficient operation of technical core requires stable environment. In addition, some assets for the business may be seized and contracts cannot be maintained when Mr. A goes bankrupt, as is noted above (Hansmann and Kraakman, 2000). Hansmann and Kraakman (2000) pointed out the monitoring cost and enterprise's going concern value, the latter is more important from my point of view. If some assets for business are seized because of the insolvency of Mr. A, the efficient operation of business and thus the value of business may be impaired or destroyed.

Let me go to the problem of (2). If Mr. A dies or decides to retire from the job, all contracts have to be reconstructed with another person, and all properties have to be transferred to that person. In the worst case, the technical core may collapse because of the difficulty of reconstruction of the legal relationships.

As for (3), Mr. A can exercise his power for his own sake, for example, to force some employees to do Mr. A's personal things. Needless to say, it may impair the efficient operation of the technical core. If Mr. A is a shareholder or an agent of shareholders, Mr. A may exercise his power only for shareholders. Even in this situation, there may be a bad influence for the operation of the technical core since shareholders may be myopic or cannot understand the needs for a new investment. Iwai (1999) pointed out that in the classical firm, where the shareholders directly contract with its employees, there is a disincentive to invest for firm-specific assets since those shareholders may exploit the benefit from the investment by threatening employees to dismiss (it's an example of hold-up problem). Only when Mr. A considers the benefit for

the technical core or the organization, this problem does not affect the operation of the technical core.

(4) is somewhat different from the problems above. From Mr. A's point of view, the situation is very burdensome, since Mr. A has to take the responsibility for all matters that are related to legal relationships. As Barnard (1938) pointed out, people usually do not want to take full responsibility for his own decision. Here, Mr. A has to take the responsibility for almost all matters.

If we utilize legal personality, we can solve all of these problems, since a legal person has no will, no personal matters, and no possibility to die. By utilizing legal personality, the properties for business are separated from those of other people. No one can freely exercise contractual rights related to business, since any shareholder, manager, employee or customer cannot decide the "will" of the legal person by herself. No one has to take responsibility of legal relationships regarding the business. Since legal person does not die and has no personal matters, there is no unexpected influence.

The discussion here can be summarized as follows. Function of legal personality is to separate shareholders or other natural persons from business organization, and thus ensure efficient operation of the technical core of that organization.

This may be also good for shareholders, especially those who do not engage in the business, because of two reasons. One reason is that by separating themselves from the business they do not have to worry about the business but can obtain the return from their investment (contribution). The other reason is by utilizing legal personality shareholders can formally secure the right to intervene in the business. If there is a natural person, Mr. A, instead of a legal person, he has his own will and thus it's difficult for shareholders to control Mr. A's decision. A legal person has no will and thus a decision of the legal person is made through a certain formal procedure, and shareholders can participate in the procedure.

## **Functions of shareholders**

We can thus conclude that legal personality is used to protect the technical core of a business organization from outside influence. The next question is how we can understand the power of shareholder.

In many countries, shareholders have a power to appoint and dismiss directors. Directors constitute the board of directors, which has a power to decide important matters of business. Shareholders usually do not have a power to make a decision

regarding the business directly.

In order to evaluate the power of shareholders, I should consider two kinds of problems. One problem is the efficient operation of a technical core. If shareholders have enough power to monitor and control the business completely, problems of (1) and (3) take place again and thus the efficient operation of the technical core may be impaired. That is, shareholders can use or sell assets required for the business at the expense of the efficient operation of the technical core<sup>2</sup>, or they may be so myopic that they do not approve new investment that is needed for the business. In this regard, powers of shareholders must be small.

The other problem is securing the possibility of change in the technical core. As I mentioned, influence from the outside should be controlled in order to secure efficient operation of a technical core (Thompson, 1967). In other words, the technical core should be kept stable. If people try to keep a technical core stable, however, it's very difficult to change the technical core, even when it becomes obsolete or it is not well-adapted to the environment. In the extreme case, it may produce negative value to the society. In these cases, executives cannot change the technical core since they are involved in it. So it is important to have some people who can change the technical core or force executives to change it. Those people have to have an incentive to do so. Giving shareholders the right to intervene the business is one resolution to solve this problem, since they want to increase returns from their investment, they have an incentive to monitor and intervene the business.

Considering those two problems, we can understand the power conferred to shareholders is the result of the attempt to solve these problems. Since shareholders cannot decide business matters directly, they cannot affect the operation of the technical core. On the other hand, they can force executives to change the technical core by appointing new directors when the technical core become obsolete or is not well-adapted. In short, shareholders can be understood as an “alarming device.”

## **Discussion and Conclusion**

In this paper, I examined the functions of a business corporation as a legal form, by focusing on legal personality and shareholders.

My conclusion is as follows; a function of legal personality is to protect the technical core of a business organization from the outside influence. A function of

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<sup>2</sup> This kind of problem can be seen in M&As. Some companies may acquire another company and then divide and sell out some divisions to obtain cash. This problem is basically the same as the problem of the “breach of trust” (Shleifer and Summers, 1988).

shareholders is to change the technical core when it is obsolete or not well-adapted, but powerful shareholders may impair the efficient operation of the technical core. Thus only restricted rights of governance are conferred to shareholders.

In summary, a business corporation provides a good environment for business, even though it imposes some restrictions on the discretion of shareholders. If we use a sole proprietorship, in which the sole contributor have a wide range of discretion, instead of a business corporation, for example, the smooth operation of the technical core would become more difficult. On the other hand, if we do not have shareholders, that is, people who have powers and incentives to monitor and intervene the operation of business, we cannot assure that the technical core of a business is not out of date nor harmful to the society. In my opinion, this situation was seen in state-owned companies at least to some extent.

The conclusion of this paper also indicates that we should be careful when we talk about the shareholders' "ownership" of a business corporation. Needless to say, shareholders' contributions are fundamental to a business corporation. Nevertheless, it seems to me that by using the term "ownership" we may misunderstand the nature of the rights of shareholders. More detailed analysis of the shareholders' rights remains to be solved in the future.

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