Catholic Social Thought and the Reality of the Corporation

Michael LP Lower, Chinese University of Hong Kong
The corporation: a reality or a fiction?

Introduction

Does the corporation, or any other human grouping or society, have a reality or existence that is independent of its members? If so, what are the theoretical and practical implications? What does this mean for the idea of the legal personality of the corporation? This article considers these questions. Catholic Social Thought ("CST") talks of the firm as a community of persons and it seems to follow from this that the corporation is a reality that has a being separate from that of its members; the view that the corporation is no more than a contract or nexus of contracts is, therefore, incompatible with CST. The idea that the corporation as something real is contrasted with the well-known notions that the corporation is a pure fiction and that the underlying reality is that of a contract or nexus of contracts. The idea that the corporation is a mere fiction does not account for the fact that corporations are capable of collective action and learning. It does not account for the perception that one “belongs” to a group, can be loyal to it and can see the intelligibility of making a contribution to the well-being of the group.

CST now explicitly speaks of the corporation as a community of persons. The corporation has a common good of its own and it cannot be understood as being simply a shorthand way of referring to its members. CST’s principle of subsidiarity suggests that social groupings (such as the corporation) have a reality that is independent both of the state and of their individual members. CST sees the firm as an intermediate association
with its own capacity for action that the state ought to promote, principally because it thereby helps to promote a personalist vision of society. That is to say, the idea that society, and communities such as the firm, seek to promote at least some aspects of human flourishing.

Some major theories of the firm promote, or rest on, the view that the corporation is a pure fiction. According to the nexus of contracts view, the firm is a pure fiction only the individuals and the contracts between them have any reality to them. The terms of the debate between those who think of human communities as really existing and those who deny that position have very deep roots. Fundamentally, it is possible to trace them to a revolution in moral theology that took place in the fourteenth century. Writing after St Thomas Aquinas, he proposed an approach that was radically at odds with that of Aquinas. Pinckaers explains:

“With Ockham we witness the first atomic explosion of the modern era. The atom he split was obviously not physical but psychic. It was the nadir of the human soul, with its faculties, broken apart by a new concept of freedom. This produced successive after-shocks which destroyed the unity of theology and Western thought. With Ockham, freedom, by means of the claim to radical autonomy that defined it, was separated from all that was foreign to it: reason, sensibility, natural inclinations and all external factors. Further separations followed: freedom was
separated from nature, law and grace; moral doctrine from mysticism; reason from faith; the individual from society.”

The consequences of nominalism for moral theology were enormous, as the above extract suggests. For present purposes, it should be noted that:

“According to nominalism, only individual realities exist. They are unique in their singular existence. Universals are simply convenient labels, having no reality in themselves and only nominal value. Within the moral domain, reality lies in the individual decision of the free will.”

Thus, the modern view that the corporation is a pure fiction has its roots in this revolution of centuries ago. The individual reality is the employee, the shareholder, the manager. The contracts between these individuals and the firm are similarly accessible to those of a nominalist cast of mind. The firm, however, according to this approach, seems to be nothing more than a mere word or something purely conceptual with no existence or reality outside of the mind. CST, by contrast, sees “the firm” as something that does, in some sense, have a reality of its own.

---

Then there is the question of the legal personality of the corporation. Those who believe that the corporation is a fiction presumably think that the legal personality of the corporation is a matter of administrative convenience, a kind of shorthand way of referring to the individual contracting parties. If, however, one believes that the corporation has a reality of its own then the idea of legal personality takes on greater interest and importance. According to Teubner, corporate personality helps to reinforce amongst the participants in a human community the sense that they are a group as well as facilitating attribution of actions to the group. Legal personality is not a necessary attribute of human groups but it is helpful. Legal personality can be thought of as an element of the firm’s common good.

What does all of this mean for employees? CST interprets social phenomena from the perspective of the integral self-realisation of the individual. When one thinks about the corporation from this perspective, the employee naturally takes centre stage. The corporation is intrinsically linked to human work; it organizes work, is built up through work and makes work more productive and fulfilling.

No-one could doubt that the corporation is brought into being by contract nor that relations within the firm are essentially governed by contract. The questions are, however, whether the corporation can be reduced to the sum of its parts (the individuals and the contracts between them) or is itself no more than a sophisticated form of contract. CST, it is contended, answers both of these questions in the negative. It attributes a reality to the corporation for reasons that are philosophically compelling, capture much more
satisfactorily the experience of those of us who work in organizations and provides a generally sounder basis for thinking about corporate governance.

Theories of the firm have to deal with the relationship between the individual and the groups to which he belongs. This philosophical question is very important for corporate governance since it helps us to understand what motivates the members of organisations and how it is that the corporation plays a positive role in the broader economy.

CST conceives of the corporation as being something with a reality and existence of its own. It has its own common good to which its members contribute and from which they benefit. It has an action and operation of its own which, while clearly dependent on its members, cannot simply be reduced to the sum of the actions of its individual members. The corporation exists to facilitate the effort of its members to meet a certain specialised range of human needs. But it would be too simplistic to say that the corporation exists for the sake of its members and to leave it at that. The human person is sociable and built for relationships for others. We rely on the communities to which we belong for survival and growth and playing a part in building up our communities is itself an element of our personal growth and well-being. As a result, there is a much more profound bond between the individual and the communities to which he belongs than contractual analyses of communities and organisations would allow.

CST focuses on the flourishing of the individual human person and this is approach is carried through into its approach to the firm. The firm is at the service of consumers and
of its employees, shareholders and managers in ways that are ultimately reducible to the pursuit of intelligible human goods. Contractual approaches, such as those discussed below, focus on the will of the individual. The natural law approach, by contrast, is to look at the firm in the context of the flourishing of the individual. Freedom is a part of the picture but not the whole for free choices ought to be directed towards the building up of the human personality. The idea that a community has a being of its own can be said much more convincingly of the state than of the corporation since the state exists to promote flourishing in an open-ended way whilst the firm is more specialised in what it seeks to achieve and in the range of goods that it seeks to promote. Nevertheless, and bearing in mind this important difference, this chapter takes the view that what is said about the reality of the state can be said, analogously, of the corporation.

Why does it matter?

Theories of the firm have been enormously significant in shaping our understanding of the legal nature of the corporation and corporate law and policy. Millon has charted the interplay between theory, social and economic context and legal policy. Though the relationship between theories of the firm and legal policy is complex and multi-directional, Millon shows clearly that changes in theory have accompanied (and to some extent caused) changes in how the law has regarded the corporation\(^4\). The basic idea is clear:

“[L]egal theories set forth a positive or descriptive assertion about the world – an assertion about what corporations are. Normative implications are then said to follow from the positive assertion. Thus, for example, because a corporation is an artificial entity, the state ought to be free to impose regulations on corporate activity deemed necessary to serve the public interest. Or, because the corporation is nothing but a nexus of contracts among private individuals, the state should not interfere with the parties’ autonomy by imposing restrictions on their freedom of contract.”

Millon’s contention is that the conclusions drawn from any given theory depend on a dynamic interplay between the theory itself, current law and practice and the prevailing orthodoxy as to the normative conclusions to be drawn from that theory.

Discussion about the theory of the firm is abstract but full of practical significance. The theory of the firm adopted by its participants, by markets and by governments shape the life of the organization and its people. Ghoshal and Moran point out that, “[a]ll positive theories of social sciences are also normative theories, whether intended or not.” One’s understanding of human nature and of social relations will have a profound impact on one’s opinions and behaviour. Further, the theories that have shaped the life of an organization will also influence both the external environment of its members and their inner selves. Ghoshal and Moran explain:

---

5 Millon, Theories of the corporation, p. 241.
6 Millon, Theories of the corporation”, p. 243.
“Social sciences carry a special responsibility because of the process of the double hermeneutic. The theories affect the agents who are its subject matter. By assuming the worst, [Williamson’s Transaction Cost Economics] can bring out the worst in economic behaviour.”

The bonus culture that has played such a significant part in our current economic woes can surely be attributed to a pessimistic view of human nature and (which may seem paradoxical) to a strongly negative approach to the role of organizations in the life of individuals and of society at large.

The nexus of contracts approach and Williamson’s transaction cost economics conception of the firm are each discussed later in this chapter. They have in common a pessimistic view of human behaviour. Jensen and Meckling’s point of departure is that:

“If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal.”

Taking this as one’s starting point means that the central question for corporate governance is the need to protect shareholders from managerial misconduct. It is assumed that, given the opportunity and the incentive, managers will readily renege on the

---

8 Ghoshal and Moran, Bad for practice, p. 39.
commitment that they gave to shareholders. Corporate governance is assigned the negative task of providing protection against the darker side of human nature.

One’s theory of the firm will shape one’s understanding of who belongs to the firm and of whose interests the firm exists to serve. Jacoby’s comparative study of the role and importance of HR directors in Japan and the US, for example, shows how the Japanese conception of the firm as a community has practical implications for board composition (the inclusion of the HR director on the main board of Japanese listed companies) and for employees (greater commitment to security of tenure and to the use of internal labor markets).\(^\text{10}\) Edwards’ study of the impact of national corporate governance and industrial relations styles on how employees are treated in corporate restructurings also provides evidence of a positive link between corporate governance and the way that employees are treated by the firm\(^\text{11}\).

**CST and the social sciences**

CST is usually taken to refer to a series of papal encyclicals beginning with, and in some way consciously developing, Leo XIII’s *Rerum Novarum* in 1891 and to include the Second Vatican Council’s Pastoral Constitution *Gaudium et Spes\(^\text{12}\)*. *Rerum Novarum* looked at the social question (the problems facing employees as a result of the industrial

---


revolution). It did so, “so that a proper evaluation may be made in the light of the
doctrinal principles founded on Revelation and on natural law and morality.”\textsuperscript{13} CST is a
branch of moral theology\textsuperscript{14} and so its primary data are the bible and Tradition\textsuperscript{15}. Thus, it
is from these sources, from revelation, that CST derives its anthropology (its
understanding of the human person). The Church is concerned about social issues
because of their impact on the all-round well-being (or integral self-realisation) of each
individual human person.

Philosophy, natural law theory in particular, plays a central role in understanding CST’s
central concepts such as the person, society, the common good, the state and
subsidiarity\textsuperscript{16}. CST’s ethical appraisal of the firm is supplemented by the specialist
contributions from a range of disciplines, notably economics and management. Each
discipline brings its own specialized perspective to bear in a multi-disciplinary effort that
CST expressly endorses\textsuperscript{17}. CST also seeks dialogue with the human and social sciences.
It seeks to learn from them but also challenges them to “open themselves to a broader
horizon aimed at serving the individual person who is acknowledged and loved in the
fullness of his or her vocation.”\textsuperscript{18} They offer “partial-yet true” insights into the human
person\textsuperscript{19}.

\begin{footnotes}
\item[13] Compendium, para. 89.
\item[15] Compendium, para. 74.
\item[16] Compendium, para. 77.
\item[19] Paul VI, \textit{Octagesima adveniens}, para. 40.
\end{footnotes}
CST’s broad ethical perspective and its concern with the most fundamental questions facing the human person allow it to help direct the efforts of the human sciences and to integrate them. CST, Catholic theology in general, is committed to the concept of the unity of knowledge. CST offers especially its knowledge of the human person and of the ultimate ends of human existence. It offers this broad focus as a counterbalance to the reductionism to which the social sciences are prone:

“methodological necessity and ideological presuppositions too often lead the human sciences to isolate, in the various situations, certain aspects of man, and yet to give these an explanation which claims to be complete or at least an interpretation which is meant to be all-embracing from a purely quantitative or phenomenological point of view. This scientific reduction betrays a dangerous presupposition. To give a privileged position in this way to such an aspect of analysis is to mutilate man and, under the pretext of a scientific procedure, to make it impossible to understand man in his totality.”

The contractual view of the corporation offers an example of this reductionism at work. Relations within the firm are, undoubtedly, contractual in nature but this does not mean that the firm is simply a collection of contracts. It is quite possible to think of the firm’s governance arrangements as being both contractual and as providing a process for the formation and administration of contracts. Again, however, this is a part of the picture but not the whole. It ignores the separate operation and being of the corporation and the subtle nature of the relationship between the individual and the communities of which he

20 Paul VI, Octogesima adveniens, para. 38.
or she forms part: the individual needs the community for self-realisation and building up one’s communities is a component of one’s self-realisation. An individual might see the sense, the intelligibility or rationality, of making sacrifices (even to the extreme of sacrificing one’s life) for the sake of a community to which he belongs. The contractual view is insufficiently alert to the full human context in which the contract is formed: it does not look at the human goods that are being pursued by the participants nor at the role that the organization plays in helping people to pursue integral self-realisation.

The problem, as *Octogesima Adveniens* points out, is that social science theories often have practical implications when they inform policy. The theories, grounded in simplifying assumptions (about human decision-making and the nature of human societies), have an air of scientific objectivity about them. It is all too easy to forget that social science theories have to be interpreted and understood in the light of the limitations imposed by their methodology and assumptions.

**CST and the corporation**

John XXIII introduced the idea that the corporation is a community into CST. He referred to the ideal enterprise as one which is “modeled on the basis of a community of persons working together for the advancement of their mutual interests in accordance with the principles of justice and Christian teaching.” In one short passage that is a powerful summary of CST’s position, John Paul II said:

---

“In fact, the purpose of the business firm is not simply to make a profit but is to be found in its very existence as a community of persons who in various ways are endeavouring to satisfy their basic needs, and who form a particular group at the service of the whole of society.”

This is a remarkable passage that conveys a number of crucial points: the firm has an existence; it is a community of persons; it facilitates the individual’s effort to meet basic needs and it is at the service of a broader society.

What does it mean to describe a corporation as a community of persons? The essence is that the members of a community have a shared purpose at least in the minimal sense that they need to consciously co-ordinate their activity if they are to attain the ends that brought each of them to the firm. According to Finnis, common action is the element that creates a group or community: one or more people can be said to be a “group” or “community” or “society” if they share some common purpose:

“a group, in the relevant sense, whether team, club, society, enterprise or community, is said to exist whenever there is, over an appreciable span of time, a co-ordination of activity by a number of persons in the form of interaction, and with a view to a shared objective.”

---

23 John Paul II, *Centesimus Annus*, para. 35.
The common good of the firm is intrinsically linked to the good of its individual members. Greenfield (although not writing from a CST perspective) captures some of the central elements of CST’s approach to the concept of the corporation well:

"Shareholders believe that buying shares is better than putting money in savings accounts, for example, because shareholders believe that managers can utilize the productive capacity of the firm to make a better, or safer, return than other possible investments. Workers show up to work because they believe that the managers can organize their labour and other resources so that they can be more productive than the sum of their productiveness as individuals, and that they will share in the gain."25

The **raison d’etre** of the firm is that it allows its shareholders and employees to get more out of their money or their work than would otherwise be possible.

**The common good**

Looked at in one way, the community can be said to be formed for the sake of its members. But the relationship is subtler than this would suggest since the human person is inherently social. There is a profound link between the good of the individual and the common good of the communities to which he belongs.

---

The term “common good” has several meanings. The well-being of the firm is a good for each of its members. First, if the firm does well it is more likely that its members will achieve the goals that brought them to the firm. Second, the members of the firm may well feel loyalty towards it and rejoice if it does well.

*Gaudium et Spes* proposed this definition of the common good:

> “the sum of those conditions of social life which allow social groups and their individual members relatively thorough and ready access to their own fulfilment.”

In this sense, the common good of the firm has a material aspect (the finance and physical resources of the firm) but the common good of the modern firm also includes its know-how, intellectual property, managerial prowess, governance structures and reputation. It includes the culture of the firm, its team spirit, its work ethic and its spirit of service. The common good in this final, central, sense clearly does not belong to any individual, although it is of the greatest importance to the individual members of the firm. It is what facilitates their pursuit of their own fulfilment in the social context of the firm.

It is important to note, too, that the common good of the firm is established, kept in being and developed by the firm’s members. The firm’s common good is an expression of the personality of its members as they work to achieve their own purposes and, in doing so, to build up the organisation for which they work. The idea of the common good, then,

---

emphasises the separate being of the firm; it has a common good which is not directly the
good of any individual member or even of all of its members at any one time. At the
same time, there is a real link between the common good of the firm and the good of its
individual members; the latter create the common good of the firm and benefit from it.
The most profound benefit that the common good offers to the individual is that it allows
the individual to express his social nature by making a contribution to the societies of
which he forms part. There is something self-interested in this, it is true but it is also a
realistic perspective and one that requires a certain generosity.

As an aside, it is worth considering the relationship between the common good of society
and the good (integral self-realisation) of the individual. Calvez and Perrin talk of a
“dialectic of the person and society”\textsuperscript{27}: society is personal since it is oriented to human
goods:

“[Society] is a living unity, rich in content, directed as is the person, of whom it is the
flowering, towards the highest purposes of human existence, towards the spiritual, even
the “eternal”.”\textsuperscript{28}

This is as true of the economy as it is of society in general. Even the economy should be
informed with something of the moral and spiritual life; the common good is a part of the
moral order\textsuperscript{29}.

\textsuperscript{27} Jean-Yves Calvez S.J. and Jacques Perrin S.J., \textit{The Social Teaching of the Popes from Leo XIII to Pius XII}, (Chicago, Henry Regenery Company, 1961), p. 119.
\textsuperscript{28} Calvez and Perrin, The Social Teaching of the Popes, p. 111.
\textsuperscript{29} Calvez and Perrin, The Social Teaching of the Popes, p. 115.
One might ask whether the individual is more important than society or the reverse. Fundamentally, society exists to promote the well-being of the person. Society has a certain pre-eminence because “not only does it express, realize in outward form, but also truly guarantee the fundamental right of the person to which therefore it remains interior.”  

Society is personal:

“Society contributes to the full development of the person, but it does so by drawing upon the springs of personal life and personal dignity.”

Society is personal since it comes from within the person, exists to serve human self-realisation and has to guarantee the fundamental rights of the person. One can err either by failing to give society its due or by failing to recognise that society is linked to the human rights of the individual.

The last few paragraphs have looked at the relationship between the individual and “society” in the broader sense. Still, it is argued that the discussion can cast some light on the relationship between the firm and its members. The firm’s common good, too, is personal in that it exists to promote certain specialised (though fundamental) aspects of human self-realisation. Clearly, the analogy between the firm and society in the broad sense should not be pushed too far; society is necessary to human self-realisation to a

---

30 Calvez and Perrin, The Social Teaching of the Popes, p. 119.
31 Calvez and Perrin, The Social Teaching of the Popes, p. 119.
degree that the firm is not. Nevertheless, what has been said about the personal character of society sheds some light on the “personalist” significance of the firm.

The principle of subsidiarity

The principle of subsidiarity requires the political authority, the state, to leave individuals, families and intermediate associations (such as the firm) to do as much as possible for themselves. The state is to refrain from “crowding out” the individual and intermediate associations. This self-restraint leaves space for individuals to make their own personal contributions to the common good; it makes it more likely that society will bear a personal imprint and less likely that it will be the product of a faceless bureaucracy. In the last analysis, the principle of subsidiarity respects the fact that only freely performed actions can build up the human personality. Freedom is a necessary pre-condition for integral self-realisation.

The principle of subsidiarity suggests that one should think in terms of clusters of mutually supportive communities. The cluster includes the family and other, more specialised, communities such as the firm. The state’s role in this cluster, is to co-ordinate the activities of the individuals and lesser communities within its jurisdiction with a view to creating the social conditions that make it as likely as possible that those individuals and communities can each achieve their fulfilment. This implies, of course, that the political community has a wider responsibility than do the lesser communities and that it

---

32 Nowadays it is unrealistic to think of political power as being vested in a single, all-embracing political unit since political power is now often shared (in a variety of ways) across supra-national institutions. It is, nevertheless, convenient to refer to “the state” for the purposes of this discussion.
has a certain ability to lay down the law for individuals and lesser communities. The principle of subsidiarity would make little or no sense if the firm did not have a reality of its own. The principle assumes that intermediate associations exist and act and have a reality of their own. They are neither emanations of the state nor a fiction. The principle assumes that there are really existing lesser associations that lie between the firm and the state.

The nexus of contracts view of the firm

CST, and the natural law concepts and approach on which it relies, see the firm as having a reality of its own. One can intelligibly say of some people that they are members of the firm and of others that they are not. It has to be admitted, however, that this is not the dominant view of how things are. It is common to find corporate governance scholars speaking of the firm as a nexus of contracts or as an especially sophisticated contract. The idea that the firm is a mere nexus of contracts is the foundation of many contemporary theories of the firm. According to this view:

"The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals. While this definition of the firm has little substantive content, emphasizing the essential contractual nature of firms and other
organizations focuses attention on a crucial set of questions - why particular sets of contractual relations arise for various types of organizations, what the consequences of these contractual relations are, and how they are affected by changes exogenous to the organization. Viewed in this way, it makes little or no sense to try to distinguish those things which are "inside" the firm (or any other organization) from those things which are "outside" of it. There is in a very real sense only a multitude of complex relationships (i.e. contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output."

In other words, the firm is no more than the fictitious counterparty to a collection of contracts. At its core is a set of financial claims on its assets and cash flows. There is no such “thing” as the firm and any suggestion that some people fall within its boundaries while others do not is a delusion.

Clearly, this is very different from CST’s vision of the firm. CST sees the firm as having a reality of its own, the nexus of contracts view sees it as a pure fiction; only the underlying contracts are real. CST thinks of communities such as the firm in terms of their contribution to meeting human needs while the nexus of contracts view takes no view as to what motivates individuals to contract with the firm. CST’s concept of the common good of the firm has no place in the nexus of contracts approach. if there is no firm, it cannot have its common good in the central sense identified earlier. Each

---

contracting party deals with the firm for his own purposes and, presumably, seeks to take from it as much as possible. There is no reason why the contracting party would want to build up the firm or feel any sense of loyalty towards it. The concept of the common good is replaced by the much thinner concept of welfare maximisation. The nexus of contracts view of the firm distorts our understanding of the nature of human organizations by depriving them of any ability to be and to operate that is separate from the individuals or groups who contract with the firm. The nexus of contracts view that the firm is a fiction is a poor starting point for any attempt to understand the firm as a community with its own common good. It seems to undermine the distinctive role that organizations play in economic life.

A further shortcoming of the nexus of contracts view is that it does not help to locate the firm in the broader social and economic context. CST sees the firm as being a part of a bigger social, political and economic picture. CST’s principle of subsidiarity, it is true, emphasizes the need to respect the relative autonomy of intermediate but, in so doing, implicitly accepts that the corporation is neither isolated from the broader social fabric nor beyond the legitimate reach of the political authority. The corporation has its own part to play in the societies of which it forms part. This is clearly incompatible with the essentially individualistic premises on which the nexus of contracts view rests.

Eisenberg points out that the nexus of contracts theory fails to capture the way in which rules and directions function in the lives of those who are members of hierarchical organizations, such as corporations, the way in which instructions issued by an
organizational hierarchy differ (psychologically and economically) from contractual exchange and the organization’s capacity for learning that means that it is more than the sum of its parts. He argues that the nexus of contracts approach is a theory as to why there are no firms rather than a theory of the firm. Eisenberg points out that the nexus of contracts approach provides no basis for understanding (or taking into account) employee loyalty to the corporation and that this would undermine one of the bases on which the corporation’s success rests.

Williamson’s Theory of the Firm

Williamson assumes that the firm and market-place contracting are alternative ways of organising economic activity; in essence the firm is just one type of contractual exchange. The need to economize is the decisive factor when deciding on whether to use the firm or some other type of contract to govern a particular exchange. Firms come into their own when the parties to an exchange are making a transaction-specific investment (one where the value of the asset in which one invests has a much greater value in the context of a given exchange than in any alternative context). When such an investment has been made, the fear of being cheated grows because of the loss that would follow from taking the investment and applying it to some other use. Thus, the fear that one’s commercial partner will behave opportunistically becomes the dominant factor in the decision to

---

35 Eisenberg, The conception that the corporation is a nexus of contracts.
associate in the context of the firm; the firm, and relations within it, are to be structured in such a way as to minimise the risk of loss from opportunism\(^\text{36}\).

Williamson’s approach to corporate governance is based on the premise that, “the relations between each constituency and the firm needs to be evaluated in contractual terms”\(^\text{37}\). The transaction is the basic unit of analysis and one of the principal purposes of economic organization is to economize on the costs of transacting over time\(^\text{38}\). Williamson uses this framework as the basis for his discussion as to which constituencies should have their interests protected by the corporate governance “contract”.

Ghoshal and Moran argue that markets and firms each have their own, distinctive “institutional logics”\(^\text{39}\). Markets allow for "autonomous adaptation" under two conditions: (1) prices must be known or be predictable (so that they can offer an effective signal to market participants; and (2) autonomous adaptation is biased towards static efficiency. The distinguishing feature of an organisation is shared purpose\(^\text{40}\). This allows for "purposive adaptation". Shared purpose induces co-ordination. This offers the following advantages vis-à-vis markets: (1) there is no need for a known price or an organised market; and (2) it allows organisations to pursue dynamic efficiency. Ghoshal and Moran continue:


\(^{37}\) Williamson, Corporate Governance, p. 1198.

\(^{38}\) Williamson, Corporate Governance, p. 1201.


\(^{40}\) Ghoshal and Moran, Bad for practice, p. 33.
"Because organizations' members and routines are repositories of knowledge and skills, they can have an edge over autonomous market participants in coordinated adaptation.

Shared purpose permits organizations to relax the binding constraint of current period efficiency and allows the organizations' members and subunits to ignore (ie not select) some allocations and select others, in ways that they could not outside the organization.\textsuperscript{41}

Ghoshal and Moran, with Williamson’s transaction cost economics approach in mind, point out the dangers of giving aberrant behaviour too central a place in corporate governance. They argue that corporate governance systems that take opportunism for granted and make it their central concern turn into self-fulfilling prophecies; they lead to systems of hierarchical controls that emphasize monitoring and extrinsic rewards. Evidence suggests that these hierarchical controls send a signal to employees that they are not trusted or trustworthy; they decrease their sense of personal autonomy and of intrinsic motivation\textsuperscript{42}. Ghoshal and Moran summarize their concerns thus:

"[M]anagers who pay heed to Williamson's version of TCE will be distracted from the business of generating the collective energy of their organizations and

\textsuperscript{41} Ghoshal and Moran, Bad for practice, p. 34.
\textsuperscript{42} Ghoshal and Moran, Bad for practice, p. 13.
focusing it on the task of running a business. Instead, they would oversee the
dissipation of their organizations' energy, or worse, they would witness it being
channeled into and consumed by the efforts of each individual to protect himself
or herself from colleagues. Because opportunism is difficult to distinguish \textit{ex ante}
from entrepreneurship and leadership, in an effort to control the former, they will
destroy the latter." \footnote{Ghoshal and Moran, Bad for practice, p. 27.}

Those who propose a theory of the firm need to bear in mind that if it is taken seriously it will affect governance and management generally; it will have an impact on the “moral ecology” of the organization. Ghoshal and Moran observe that by assuming the worst, Williamson’s theory of the firm can bring out the worst in economic behaviour\footnote{Ghoshal and Moran, Bad for practice, p. 39.}. The sort of environment that the theory helps to create will attract some types of people but may drive others away. It may well have an impact on the integrity of employees and on whether or not they are able to pursue their self-realisation through their membership of the firm.

Teubner, too, emphasizes that the contractual view of the firm does away with the specific advantages of corporations\footnote{Gunther Teubner, “Enterprise Corporatism: new industrial policy and the essence of the legal person”, (1988) 36 American Journal of Comparative Law 130 – 155, p.155.}:

“Certainly the advantages of contractual arrangements lies in the speed of reactions with which action systems can be built up and demolished in the short
term, in accordance with the fluctuations of environmental pressures. The drawback, however, is that contractual solutions cannot exhaust the “organizational surplus value.” “Organizational surplus value” arises through (1) the building up of long-term co-operative arrangements which would be continually destroyed by contractual flexibility; (2) through the diffuseness of “commitments” in the organization which by comparison with rigid, sharply defined contractual obligations produces more situational flexibility; and finally (3) in the orientation towards the organization’s interest which provides stronger orientation than mere linkage to a contractual purpose.”

Teubner, like Ghoshal and Moran, is pointing out the damage that is done when one thinks of the corporation in purely contractual terms. The commitment to the firm’s common good (“long-term co-operative arrangements”), the firm’s ability to respond flexibly to new environments (“situational flexibility”) and loyalty are all diminished. The theory of the firm, apparently abstract, turns out to have very great practical importance.

The Stakeholder Theory of the Firm

Stakeholder theories focus on the mutual interdependence of the firm and other groups and argue that this interdependence ought to be reflected in corporate governance; this could be achieved through a modification of the duty of loyalty, by giving stakeholders a

---

seat on the corporate board or through corporate reporting. Mallin’s list of stakeholders represents the usual view:

“Stakeholders include: employees, suppliers, customers, banks, and other creditors; the government; various ‘interest groups’, for example, environmental groups; indeed anyone on whom the activities of the company may have an impact.”

Stakeholder theory might be taken as a call for firms to deal justly with the various individuals and groups that it deals with or who are in some way affected by its decisions and behaviour. No-one could object to this. If, however, stakeholder theory implies an essentially contractual view of the firm then it is open to the same objections as are levelled at the nexus of contracts approach: it discards the reality of the firm and its common good and cannot accommodate the principle of subsidiarity. This type of stakeholder theory would lack an adequate understanding of what it means to say that a human group or community has come into existence.

Legal personality of the corporation

The UK confers separate personality on the corporation. Indeed, this seems to be a feature of the corporate law of very many jurisdictions. As a result, it can own property,
enter into contracts, be a party to legal proceedings and so on. Although British corporate
governance focuses on the needs of shareholders, British company law has expressly
rejected the proposition that a corporation is to be regarded as the property of its
shareholders:

“Between the investor, who participates as shareholder, and the undertaking
carried on, the law interposes another person, real though artificial, the company
itself, and the capital employed is its capital and not in either case the business or
the capital of the shareholders … the idea that [the company] is mere machinery
for effecting the purposes of the shareholders is a layman’s fallacy. It is a figure
of speech which cannot alter the legal aspect.”50

Although British company law makes directors accountable to shareholders and seeks to
make the board responsive to the interests of shareholders, it does not see the corporation
as being simply the property of shareholders.

Communities can be said, in some sense, to have a personality of their own. In some
cases, such as those of the state and the corporation, the community is endowed with
legal personality too. Thus, it can own property and enter into contracts. The legal
personality of the corporation can be thought of as an element of its common good since
it allows the corporation and its members “relatively thorough and ready access to their

49 Henry Hansmann and Reinier Kraakman, “The basic governance structure?” in The Anatomy of
University Press, 2004).
50 Gas Lighting Improvement Co. Ltd. v Commissioners of Inland Revenue [1923] AC 723 at 741 per Lord
Sumner.
own fulfilment.⁵¹ Teubner makes an interesting suggestion as to the role that legal personality plays in this regard. His argument is that legal personality reinforces the consciousness of the members of the corporation that they are a group (in his terms that they are “an internal dynamics system, with selections of its own, and with a capacity for self-organization and self-reproduction.”⁵²)

Legal personality is not, Teubner argues, a necessary attribute of the corporation as a social actor but it is a highly useful one that links “legal capacity to the social capacity for collective action”⁵³. Thus, legal personality and the underlying “collectivity” are mutually reinforcing so that Teubner asks: “May not the legal person's function indeed consist in making self-reference possible and in increasing self-reference still further in the interest of organizational autonomy?”⁵⁴ The corporation as a separate person cannot be reduced to its shareholders (nor to any other group within the corporation) rather, “the legal person is identical with the collectivity, as the personification of the enterprise.”⁵⁵.

Implications for employees

The theory of the firm has implications for how corporate governance and management should think of their responsibilities. Management is responsible for promoting the common good of the firm which is intimately connected to (though not identical with) the good of its individual participants. This common good has a moral and spiritual dimension even though we are talking about an organisation with an economic purpose.

⁵³ Teubner, Enterprise Corporatism, p. 145.
⁵⁵ Teubner, Enterprise Corporatism, p. 152.
The firm is especially concerned with the organisation of work with a view to enhancing its productive capacity and channelling it towards meeting some range of human needs. But work is not a commodity or impersonal resource; it is one of the core goods that shape a human life, it is profoundly personal. An appreciation that this is the case is bound to have an impact on how management think of their responsibilities and of the priority that they give to employee concerns.

Contractual views of the firm distance themselves from any consideration of the human values that are at stake in the running of the business organisation. The nexus of contracts view hollows out the whole concept of the human community or organisation. Thus, there is no room for it to accommodate CST’s concepts of the common good. Williamson’s contractual view of the organisation has been challenged on the basis that it makes dealing with opportunism, self-seeking with guile, the central concern of corporate governance. The focus is not on building up the firm’s common good but on something that is essentially negative. Ghoshal and Moran have pointed out the baleful consequences of this approach. Opportunism is, no doubt, a problem to be addressed but it is a question of getting the right balance, of looking for realistic ways of harnessing self-interest within a more positive framework.

On the face of it, stakeholder theory provides a basis for focusing management attention on the interests of employees by diluting the emphasis on shareholder interests promoted by the nexus of contracts view, for example. If, however, a version of stakeholder theory is adopted that sees the firm as essentially contractual then, again, the concept of the
common good is under threat and the idea of the firm’s common good includes much that is of vital concern to employees.

Contractual approaches to the firm deny that the firm is something that really exists, with a life and operation of its own; they reduce the firm to its individual members and the contracts that they enter into. In this way, they are impoverished accounts of the relationship between the person and the community. They make it difficult to explain how organisations “add value” and how it is that they are able to command loyalty. Implicitly or explicitly, they focus on the need to control dishonesty and laziness rather than on the positive value to be achieved through collaboration.