

State Concessions to (Mostly) Real Entities: Separate Legal Personality and the Firm

Dr Jonny Hardman,
Lecturer in International Commercial
Law,
University of Edinburgh

Edinburgh Centre for
COMMERCIAL LAW



The Firm & Company Law

- Firm hidden in historic economic analysis
- Models often say 'very little about the firm' (Hölmström 1999)
- Machlup found 21 different usages of the firm (Machlup 1967)
- Hart: [m]ost formal models of the firm are extremely rudimentary, capable only of portraying hypothetical firms that bear little relation to the complex organizations we see in the world. Furthermore, theories that attempt to incorporate real world features of corporations, partnerships and the like often lack precision and rigor (Hart 1989)
- As such argued that there's no point defining it (Cheung 1983), or that any definition would be arbitrary (Alchian & Woodward 1987)
- No development on the theory of the firm in recent years (Hodgson 2019)....

The Firm & Company Law

- Until 2017. Deakin, Gindis, Hodgson, Huang and Pistor:

“These puzzles concerning the nature and identity of the firm are solved once we recognize it as a legal entity. The glue that holds the firm together consists of the legal provisions that bind the parties into one legal entity, and in turn draw on appropriate legislation”

- Defined a firm as ‘individuals or organizations with the legally recognised capacity to produce goods or services for sale.’
- Debate with Robé has resulted in DGH doubling down on this claim – “all corporations are firms, but not all firms are corporation”

The Firm & Company Law

- Corporate law cares about this debate:
 - Company and firm used interchangeably in corporate law literature. Often unreflexively
 - Where considered, “firm” used as jurisdiction-neutral term to refer to wider concept
 - Arguments about corporate law design often take from economics
 - Arguments about the limits of the company often draw from the nature of the firm.
- Corporate law has its own examination of its base unit of study – the nature of separate legal personality

Separate Legal Personality: Historic Debate

- Modern debate started in Germany – Savigny said a company was a mere fiction ‘[w]e now have to consider it (juristic personality) as extended to artificial subjects by means of pure fiction.’ (Savigny tr. Rattigan 1884). BUT this exposes that it wasn’t actually about legal fictions.
- Machen: ‘a corporation cannot possibly be both an artificial person and an imaginary or fictitious person. That which is artificial is real, and not imaginary: an artificial lake is not an imaginary lake, nor is an artificial waterfall a fictitious waterfall.’ (Machen 1910).

Separate Legal Personality: Historic Debate

- Fiction arguments skewed from “fiction” to “concession”
- Fiction only became a straw man – e.g. Gierke’s response to the ‘prevalent’ fiction theory (Gierke tr. Maitland 1913).
- Often misdescribed – Maitland’s translation goes on to state ‘is no fiction... no piece of the State’s machinery... but a living organism and a real person, with body and members and a will of its own.’ – concession argument is NOT that company is state’s machinery, just that it gets concessions.
- Maitland (e.g. 1905) and Pollock (e.g. 1911) strongly in favour of Gierke & “real entities”.

Separate Legal Personality: Historic Debate

- Can reconcile the two – that the state provides concessions to real entities
- Vinogradoff (1924) ‘There are two sides to be considered in the case of companies and corporations. There is the business side directed towards a material purpose, which is created, not by the law, but by the respective interests involved. On the other hand, there are the legal consequences attached to the association, which may amount to the appearance on the scene of a new ‘juridical person’.
- Thus two step process. Real things would find other ways to operationalise – transaction costs analysis.

Separate Legal Personality: Today

- Legal textbooks tend to emphasize separate legal personality, but academic corporate law work tends to minimize its role – having ‘modest impact on bargaining dynamics’ (Cheffins 2008), or merely being a ‘convenient heuristic formula’ (Kraakman et al 2017) which is ultimately trivial (Black 1990).

Separate Legal Personality: Today

- Corporate law analysis is wrong to do so:
 - Separate legal personality not only law's to minimise (Ripken 2019)
 - Even within law, not only corporate law's to minimise – places company on a spectrum of law's persons (Naffine 2003)
 - Even if it is just a transaction cost saving device – how good is it at doing that?
 - The rules allowing a company are concessions from the state – limited liability for pure third parties cannot be contractually achieved. Other entities, like unincorporated associations, do not attain it. We need to understand why these features are conceded to the business community, and how good they are at achieving those ends.

Separate Legal Personality: Today

- But not all encompassing – it is a quest to identify what runs through every company – from Berle/Means to shelf – i.e. law’s ‘lowest common denominator’ (Hardman 2022).
- Ultimately ‘[t]he only common factor may be that they [companies] are all, within some existing legal system, treated in accordance with the rules of that system as units for that system’s method.’ (Derham 1958).
- Thus is corporate law’s equivalent ‘base unit’, as the firm is economics’ ‘base unit’
- Corporate law, though, needs something else that exists behind this lowest common denominator – a real thing for which law has created this combination of features.
- Corporate law analysis assumes that this real thing is the firm.

Business Vehicles and Firms

- How do the firm and separate legal personality map?
- 2017 definition of firm ‘individuals or organizations with the legally recognised capacity to produce goods or services for sale.’
- Under this definition, clear perfect mapping – every company is a firm:
 - Either “individuals” transcend natural persons to included all persons, or assumption that each company is an organization.
 - Either way, each company is a firm as it has the legally recognised capacity to produce things for sale
 - Every human must also, then, be a firm under this definition for the same reason
 - Each ‘organization’ (also a firm) must consist of firms (as every person is a firm).

Business Vehicles and Firms

- Under this definition, clear perfect mapping – every company is a firm:
 - Organizations cannot be limited to separate legal persons (so must include, e.g., English partnerships)
 - How test for organizations?
 - Any combination of persons which *could* commence business activity? Matches requirements for an individual to be a firm, but creates an infinite number of firms; or
 - Requiring some actual organization in plan. Limits the number of firms, but how test this? Why different test here than for the other limb? Risk that this approach just means that corporate law needs to care about the theory of the organization rather than the theory of the firm.

Business Vehicles and Firms

- Can be resolved by borrowing a test from partnership law – a wide interpretation of a need to be carrying on business in common with a view to a profit. Not actually making a profit, or currently running a venture, just an intention – so a shop does not cease to be a partnership when it shuts for the evening.

Business Vehicles and Firms

- Current definition raises a number of conceptual issues.
 - Each firm uses a multiplicity of legal features normally taken from the market:
 - Within legal personality, companies need agency to work (Orts 1998). Despite firms being dichotomous to the market, they rely on market features (e.g. contracts in employment contracts) to operationalise. How tell what's a 'market' interaction and what's a 'firm' interaction if focus is purely on capacity?
 - Moving beyond separate legal personality raises big questions of the definition – e.g. partnerships are a combination of private law rights (mutual agency, joint and several liability, fiduciary duties, etc). These rights are each used in market interactions. How do we test which combination of rights are sufficient for a firm to be created?

The Ship of Theseus

- Aka “my grandfather’s shovel”, “George Washington’s axe”, “Trigger’s Broom”.
- Athenians preserved Theseus’ ship. Every time a plank rotted they replaced it. It became ‘became a standing illustration for the philosophers in the mooted question of growth, some declaring that it remained the same, others that it was not the same vessel’ (Plutarch tr Perrin 1941).
- Hobbes went further – what if someone had kept the rotten planks and reconstructed them into a new ship. Which was Theseus’?
- Question of “continuity of matter” v “continuity of form”.

The Ship of Theseus

- Different answers, e.g.:
 - Lowe – depends how important/identifiable the plank in question was
 - Wiggins – neither were, once you replace one plank, it ceases to be
 - Finding a right answer needs ‘sharply defined codes of sufficiency conditions and overruling hierarchies between these conditions’ (Scaltsas 1980).
- Parallels for business vehicles evident.

The Ship of Theseus

- Company's Separate Legal Personality:
 - Archetype of continuity of form. Even if every constituent changes immediately and suddenly, continues.
 - Remains the same even if the "real thing" changes
 - My example of Rangers "if OldCo sold Rangers to NewCo, but instead of being liquidated OldCo then bought the Italian football club SS Lazio, we would not believe that, in some way, SS Lazio had won any Scottish football titles even though the same legal person would technically have done so"
- Partnerships follow Wiggins. Lord Lindley: '[t]he law, ignoring the firm, looks to the partners composing it; any change amongst them destroys the identity of the firm'. Same for English (with no SLP) and Scottish (with SLP) partnerships.
- As such, different types of different legal entities answer this thought experiment differently, through different sufficiency conditions and overruling hierarchies.

Challenges for Defining the Firm

- Under the 2017 definition, the end of the life of the firm depends on the end of the life of the legal vehicle. Thus:
 - Have some companies which continue to be firms without any business activity
 - Have some partnerships which cease to be firms despite business activity continuing within mostly the same organisation structure. If the firm isn't the thing that continues– then what is?

Challenges for Defining the Firm

- Ship of Theseus shows us that if the economic theory of the firm follows legal rules and identity so strongly, then:
 - Need Partnership Theory of the Firm and Company Theory of the Firm
 - This will change in different jurisdictions
 - This will change if laws change (Butterfly effect)
 - Need both (a) theory of the firm for each type of potential firm, and also (b) new meta-theory of a firm that only covers firm-of-firms. Why should corporate law care about the former?
 - Risks circularity – deciding the boundaries of the firm by the boundaries of company set by law mean that we cannot use the theory of the firm normatively in company law – **if theory of the firm predicated upon legal analysis, it is less useful FOR legal analysis**
 - Needs law to provide horizontal coherence across these forms (HINT it doesn't)
- Whilst firm needs legal form to “hold it together “(Hart 1995) or act as its “glue” (Gindis 2009), the glue does not fundamentally alter what is glued.

Conclusions

- Economic theory of the firm is, of course, for economists to decide.
- Legal form clearly important – provides series of bargaining boosts and chills
- Over-reliance on legal form, though, risks:
 - Circularity
 - Wrong focus of legal analysis
 - Wrong focus of economic analysis
- It's up to the economists here whether or not they do so.
- Corporate law commentators must wait with baited breath.