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Being Done With Milton Friedman

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In an article of just under 3,000 words, published on September 19, 1970 in The New York Times under the title *The Social Responsibility of Business is to Increase its Profits*,¹ Milton Friedman expressed strong views which quickly became canonical for a whole school of thought.² This article led to another one, more elaborated, by Michael Jensen and William Meckling.³ And from there flowed agency theory and the deduction that corporate executives and managers must be motivated by stock options to have their personal interest aligned with those of the shareholders so that their only concern in the management of the firm is the creation of “shareholder value”.

These notions now structure all reasoning about the firm, its responsibilities and government, opponents to agency theory arguing mostly from the camps of morality, justice, ethics or the negative effects induced by an analysis which wisdom is not really disputed.⁴ And for the proponents of Friedman’s “scientific” demonstration, at most should it be complemented, for example, to take into account certain “*altruistic concerns*” which manifest themselves.⁵ For Michael Jensen, these altruistic concerns derive from the fact that many are the victims of the “*deep emotional commitment of most individuals to the family and tribe.*”⁶ Shareholder value proponents seem to consider that there are, on the one hand, hard scientists who can keep up with their emotions and necessarily endorse agency theory and, on the other hand, people who, confronted with the negative consequences of agency theory, can’t keep up with their feelings and try to find a way out of science.⁷

¹ Available, for example, at:

<http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html>

² On the importance of this article, *see*, for example, Jean Tirole, *The Theory of Corporate Finance*, Princeton U. Press (2006), pp. 57-58.

³ Michael C. Jensen & William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, *J. Fin’l Econ.* 305 (1976).

⁴ On this point, *see also* Margaret M. Blair & Lynn A. Stout, “A Team Production Theory of Corporate Law”, *Virginia Law Review*, Vol. 85, No. 2 (1999), at 287.

⁵ *See* Roland Bénabou & Jean Tirole, “Individual and Corporate Social Responsibility”, *Economica*, vol 77, n°305, pp. 1-19 (2010), p. 21: “... *one needs to lever altruism and signaling concerns in the right way, and this requires a good understanding of the psychology of giving and how it interacts with markets and other general-equilibrium forces.*”

⁶ Michael C. Jensen, “Value Maximization, Stakeholder Theory and the Corporate Objective Function”, *12 Business Ethics Quarterly* 235-256 (2002), at 244.

⁷ For Jensen, those challenging shareholder value maximization are ignoring “*200 year’s worth of work in economics and finance*”. *Id.*, at 239.

Friedman's article has achieved the wonder of making appear as obviously true inferences about the role of the firm and its executives which, in fact, are based on erroneous assertions. One of Friedman's arguments, in particular, is based on the claim that shareholders own the firm. Although it appears as being nothing more than obvious "common sense", the notion that shareholders own the firm is totally false, as we will see.⁸ But based on this assertion, the argument has been built that corporate executives are the shareholders' agents, that they must maximize the shareholders' interests -equated with a maximization of "shareholders' value"- and that they should not pay attention to anything else and especially not to the impact the pursuit of this goal may have on other contributors to the firm or on its social and natural environments. In their 1976 article, Jensen & Meckling endorsed these erroneous assumptions and started their analysis by asserting that "*the relationship between the stockholders and the managers of a corporation fits the definition of a pure agency relationship.*"⁹

The devastating power of what is nothing more than the window-dressing of an ideology is extraordinary. So much so that these simplistic and fundamentally wrong ideas are a major source of the crises of our world: ecological crisis, financial crisis, economic crisis, debt crisis, political crisis. It is imperative to get rid of these ideas because they are still in the pantheon of the intellectual advocates of the firm as being an instrument of "shareholder value" maximization and prevent the development of the appropriate concepts which are much needed to think about proper principles to apply in the firm's management.

The purpose of the present paper is not to go through all the arguments of the proponents of the shareholder supremacy thesis versus those of the proponents of stakeholders and corporate social responsibility theories.¹⁰ What we would like to do here is go to the root of this misconceived school of thought to show how, with a total lack of rigor, Milton Friedman made a "demonstration" that has the appearance of science but is totally fanciful.

Friedman's piece was published in a newspaper. It does not have the classical, ordered structure of a scholarly article. But Friedman developed the

⁸ For earlier developments, *see* in particular Jean-Philippe Robé, « L'entreprise en droit », 29 *Droit et société* 117 (1995), "Multinational Enterprises: The constitution of a Pluralistic Legal Order", in *Global Law without a State*, pp.45-77, G. Teubner, ed., Dartmouth (1997) and *L'entreprise et le droit*, Presses Universitaires de France (1999).

⁹ *Supra*, note 3.

¹⁰ For a review of these arguments made in the context of an analysis making a clear distinction between the concepts of "firm" and "corporation", *see*, in this review, Jean-Philippe Robé, "The Legal Structure of the Firm", *Accounting, Economics, and Law*: Vol. 1: Iss. 1, Article 5, available at: <http://www.bepress.com/acl/vol1/iss1/5> (2011).

arguments supporting his article's title in two ways. The first is that since shareholders own the firm, says he, corporate executives must follow their masters' orders and maximize the owners' interest in the management of the firm. We will challenge this first thesis in Sections I to IV. Maybe more importantly, Friedman criticized the alternative CSR views as undermining the institutions of a free, market democratic society: an executive doing anything else but maximizing profits is acting as a "politician", raising taxes on various constituents without any mandate to do so. We will detail this criticism and reply to it in Sections V to VII. Section VIII contains our concluding remarks.

I. Introduction

From the very introduction of his article, Milton Friedman did not go around the bush: talking about the "social responsibility" of "business" amounts to nothing less than "*preaching pure and unadulterated socialism*". And "*businessmen who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of a free society these past decades*".¹¹ The warning is clear: those daring challenging the thesis are in advance treated as collectivists, even if they are unaware of their hidden tendencies...¹²

But Friedman did not remain at this level of language and took in the remainder of his article the position of the rigorous scientist. For Milton Friedman, "*The discussions of the 'social responsibilities of business' are notable*

¹¹ Friedman makes reference, later in the article, to the practice by certain businessmen to fake a pursuit of profits under the guise of "social responsibility": "*in practice the doctrine of social responsibility is frequently a cloak for actions that are justified on other grounds ... To illustrate, it may well be in the long run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill... In each of these—and many similar—cases, there is a strong temptation to rationalize these actions as an exercise of 'social responsibility.' ... this is one way for a corporation to generate goodwill as a by-product of expenditures that are entirely justified in its own self-interest. It would be inconsistent of me to call on corporate executives to refrain from this hypocritical window-dressing because it harms the foundations of a free society. That would be to call on them to exercise a 'social responsibility'! If our institutions, and the attitudes of the public make it in their self-interest to cloak their actions in this way, I cannot summon much indignation to denounce them. At the same time, I can express admiration for those ... who disdain such tactics as approaching fraud.*"

¹² And the debate goes on with the same tone. For Jensen, as a matter of example, alternative theories "*reduce social welfare ... just as in the failed communist and socialist experiments of the twentieth century*". See *supra*, note 6, at 244.

for their analytical looseness and lack of rigor.”¹³ Rigorously, in Friedman’s view, only individuals can have responsibilities. A corporation is an *artificial* person and in this sense may have “artificial responsibilities”; but that is not the case of “*business*”. For him, “*the first step toward clarity in examining the doctrine of the social responsibility of business is to ask precisely what it implies for whom.*”

Building (rightfully) on this distinction, he then notes that “*businessmen*” who are presumably responsible are either “*individual proprietors*” or “*corporate executives*”. And since discussions over corporate social responsibility “*are mainly directed at corporations*”, Friedman then indicates he will neglect “*individual proprietors*” and shall instead concentrate on “*corporate executives*”.

And that’s where Friedman commits his *tour de force*. While he himself insists that his analysis applies only to the firm organized using a corporation as a vehicle for its legal structuring, the analysis he makes is correct (although even this is questionable) in the case of a firm owned by an *individual proprietor*... It is entirely wrong for a firm legally structured using one or several corporations.

If one follows Friedman:

“In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, (...). The manager is the agent of the individuals who own the corporation.”
(Emphasis added)

Friedman indicates in his article that if he concentrates on the corporate firm only, it is for simplicity’s sake.¹⁴ In fact, had he conducted his analysis first on the individual proprietorship and then on the firm structured using one or several corporations, he would have been led to show what changes when corporations are being used. His analysis, if rigorous, would then have faltered in the face of contradictory facts. With the creation of a corporation to serve as the legal vehicle to structure an enterprise, the capital contributors retain their position of residual claimants. This is the origin of special prerogatives for them in the *corporation* and therefore within the *firm*. It strongly supports the fact that, as residual claimants, they should be entitled to vote in shareholders assembly

¹³ The word “*business*” is the only one used by Friedman in the beginning of his article.

¹⁴ “*I have, for simplicity, concentrated on the special case of the corporate executive...*”.

meetings, in particular on the issue of the nomination of the directors.¹⁵ But the use of a corporation to structure the firm -which has for consequence to limit their risk to the amount of their investment-, implies a strict separation between the assets and liabilities of the corporation, on the one hand, and those of the shareholders, on the other. The main reason for this is simple: corporate creditors have no recourse against the shareholders. As a consequence, it is necessary to protect the assets of the only legal entity against which creditors can act; i.e. the corporation having issued the securities which the shareholders own. After the process of incorporation, shareholders have *no right of access* to the assets of the corporation; they *do not enter into any contract* in its name. *No liability* can arise for them from the corporate activity. They *do not run* the corporation and *do not own it*. Only the corporate officers can dispose of the assets and conclude contracts on behalf of the corporation (not the shareholders), under the direction and supervision of the board of directors (who do not have, individually or collectively, such powers). But Friedman's analysis based on the shareholders' *ownership* of the corporation is untenable. This is so much the case that the integrity of the corporation's assets is protected by a set of criminal rules. If a corporate officer abuses these assets, he may be committing one or several criminal offences, such as embezzlement. If a shareholder does the same (assuming the shareholder finds a way to take possession of these assets on which the shareholder has *no right of access*), he commits theft or trespass. And it was far from impossible for Friedman in 1970 to find out what the law actually has to say on this. As early as 1897, Ernst Freund stated very clearly that:

“...a shareholder of a railroad company has no direct right of property in the rolling stock, the roadbed, the station houses, etc. of the road; he cannot use the cars at his pleasure, he can give no orders to the employees, and if he performs acts of ownerships, he is a trespasser.” (emphasis added)¹⁶

¹⁵ That the right to vote in corporations is linked to the residual claimant's position is demonstrated by the fact that the right to vote in corporations actually moves and it is not *per se* the shareholders' monopoly: owners of common stock have the right to vote most of the time; but if the firm is in trouble and, for example, omits dividends to preferred stockholders, these stockholders commonly acquire the right to cast controlling votes; and when the firm is insolvent, the bondholders and other creditors eventually acquire control through the operation of bankruptcy laws. Voting rights thus flow to whichever group holds the residual claim. *See*, for example, Roberta Romano, *Foundations of Corporate Law*, NY NY, Free Press (1993), pp. 188-189. For more details on this point, *see* Robé, *supra*, note 10.

¹⁶ Ernst Freund, *The Legal Nature of Corporations*, The U. of Chicago Press (1897) at 34.

It is a strange property right indeed which brings you to jail if you make use of it!

II.

In his analysis, Friedman begins by committing the classic confusion -but a serious one for someone claiming to exercise intellectual rigor- between “firm” and “corporation”.¹⁷ He uses two different expressions to designate the corporate executive, which demonstrate this mental confusion: the corporate executive is either “*an employee of the owners of the business*” (the “business” meaning the *firm* in this context) or “*the agent of the individuals who own the corporation*”. This confusion between “firm” and “corporation” (which are both “owned” in his view) is normal for him and his followers since anything that relates to law is usually treated by them as mere “fiction”. Jensen & Meckling made the same confusion between “firm” and “corporation” and shared the same disregard for “legal fictions” which, in their view, “*only serve as a nexus for a set of contracting relationships among individuals.*”¹⁸ But the neglect of the corporation’s “fiction”, i.e. the fact that the legal system treats the corporation as an autonomous legal person, and of its economic consequences is the biggest mistake Friedman and his followers make when they unanimously either ignore the law or reconstruct it in order to make it match their presuppositions.¹⁹ To restate the difference in simple terms, the *firm* (or enterprise) is an organization within which power is exercised to coordinate the production and/or distribution of goods and services. It is legally structured using a network of contracts connecting resource holders. In large firms, the key assets used by the firm are owned by a legal fiction having legal personality i.e. a corporation. The *corporation* has to be used to own the key assets and to be the counterparty to the

¹⁷ See Jean-Philippe Robé, « À qui appartiennent les entreprises ? » 155 *Le Débat* 32 (2009) and Robé, *supra*, note 10.

¹⁸ *Supra*, note 3.

¹⁹ As early as 1965, for example, Berle denied that the corporation’s managers are the shareholders agents; see Berle, *infra*, note 28 and accompanying citation. More recently, Robert C. Clark suggested that “*a closer focus on actual rather than presumed legal doctrines and concepts might do much to refine our current theory of the firm*” (in Robert C. Clark, “Agency Costs versus Fiduciary Duties”, in 55 *Principals and Agents: the Structure of Business*, at p. 55 (John W. Pratt & Richard J. Zeckhauser eds. 1985)); that “*stockholders cannot withdraw authority they delegated to the board of directors, for they never delegated any authority to the directors*” (at 57); and as a consequence, “*... an important but neglected job for agency cost theorists is to try to understand, in economic terms, the main features of the actual legal relationship between stockholders and managers*” (at 59). [All emphasis are mine]

other providers of resources to the firm for a wealth of reasons we will explain in Section IV of this article. But what is key at this stage of the analysis is to understand the fundamental difference between a *firm* and a *corporation*: the firm is an organization which has no existence at law (it is not a “fiction”) whereas the corporation is a legal person entitled to operate in the legal system by owning, contracting, suing and being sued; and it is subject to the laws and regulations of the legal system. The firm is none of this. It is neither a legal object nor a legal subject. It does not operate in the legal system and does not buy, sell, lease, rent, etc. anything. The firm, as an organization, can do this only through legal persons and, in the case of the large firm, through a corporation or a group of corporations.

Friedman’s description of the role of the “corporate executive” in a “free enterprise, private-property system” almost holds water when one considers what happens, for example, when the owner of a coffee-shop retires and entrusts the management of his coffee-shop to a manager. To paraphrase Friedman, the manager of the coffee-shop is an agent of the “individual proprietor” of the coffee-shop and is directly responsible to him. He must deal with the coffee-shop in accordance with the wishes of the owner of the coffee-shop, for whom he is a mere agent. And if the owner is not satisfied, he may terminate the contract with the manager and return behind the counter to manage his coffee-shop as he always did. Friedman’s analysis helps explaining -simplifying a little bit- what happens when an “*individual proprietor*” hires a manager.

But applied to the large firm structured using one or several corporations, Friedman’s description is wrong because it is based on a series of mistakes. Shareholders do not own *firms*; they own the *shares* issued by the corporations used to legally structure firms. The corporate officers are not the agents of *the shareholders*;²⁰ the officers are the agents of *the corporation itself*.²¹ Finally, there is no legal duty to maximize profits provided for by company law. The officers must manage in the “corporate interest” and it is nowhere written in the legislation or decided in case law (this is true in France but also in the U.S.²²) that such interest in the day-to-day management of the corporation’s business is profit

²⁰ See Blair & Stout, *supra*, note 4, at 291.

²¹ *Id.*, at 280-281, 288 and 293.

²² See Lynn A. Stout, “Why we should stop teaching Dodge v. Ford”, UCLA School of Law, Law & Econ. Research Paper Series, Research Paper No.07-11. See also the *Report of the Task Force of the ABA Section Of Business Law Corporate Governance Committee On Delineation Of Governance Roles & Responsibilities*, (the “ABA Report”) available at: <http://apps.americanbar.org/dch/committee.cfm?com=CL260000>.

maximization.²³ The myth that such a duty exists has probably been invented to maintain the idea that economic agents are all “maximizers”, that the firm is an “economic agent” like any other one and that the only issue which remains to deal with is to ensure that officers maximize “shareholder value” by the invention of a direct agency relationship between “owners” (“maximizing” shareholders) and officers. This allows returning to the classic economic treatment of the firm as a “black box”, which content is deemed to be irrelevant for economic analysis which can therefore remain confined to an analysis of market mechanisms using elegant mathematical formulas. Making the confusion between the firm and the corporation, and treating the firm as a legal fiction when it is not, Jensen & Meckling concluded that “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 input and the consumers of output ... the “behavior” of the firm is like the behavior of a market.”²⁴ Nothing could be further from the (legal) truth.

III.

But are we not guilty here of an excess of “legalism”? Isn’t the reality of things much simpler than the one suggested by these *quibbling*? The law indeed often appears to analysts of the economy as full of unnecessary and therefore negligible fictions. These legal fictions would mask a reality that they understand better and are able to present in a simpler manner. How could legal fictions have any importance since they are nothing but fictions after all? This attitude, however, leads to ignoring the vital role played by law in the *actual structuring* of the social system in general, and businesses in particular. No firm can operate without being structured using legal instruments made available by the legal system which are the only way for the firm as an organization having no legal existence as such to participate in economic exchange. Those creating or managing the firm as an organization need to use legal instruments to buy, sell, rent, etc., in short to contract to allow the firm to have access to the economic resources it needs for its operations as an organization. And if, like all human institutions, the law obviously contains flaws and is sometimes contradictory, many of its apparent

²³ Under Delaware law, it is only in cases where a change of control is anticipated through a sale or merger that the directors have a duty to maximize shareholders wealth. *E.g.* Revlon v. MacAndrews and Forbes Holding, 506 A.2nd 173 (Del. 1986). These “Revlon duties” do not apply in the day-to-day management of the corporation’s affairs.

²⁴ *Supra*, note 3.

complications, misunderstood and neglected, in fact fulfill functions which, if they are not immediately obvious, are no less real. Neglecting the role played by law leads to dramatic reasoning errors, for which we all bear the consequences. Given the key role played by law in the structuring of the firm, as remarked by Hodgson, “*the onus is on economists and others to provide concepts and criteria to discern the “true” reality “behind” the legal “forms”.*”²⁵

The challenge for those who want to dispense with a legal analysis of the firm will not be an easy one. An analysis of the function of the corporation in the structuring of the (large) firm²⁶ shows that, in fact, it is essential to its very existence that the shareholders are not “owners of the firm”. If all the corporate instruments used to structure large firms were removed and shareholders were made the co-owners of the assets and the joint-counterparties to the contracts with the participants in the firm, the operation of our complex and globalized economic system would instantly come to a halt. For (large) firms to become possible, there has been a progressive invention of legal arrangements under which shareholders are contributing capital (in the *primary market* for shares)²⁷ or are risk takers (in the *secondary market*)²⁸ but do not own the assets used to produce the goods or services produced or provided by the firm and are not the contracting parties with the various participants in the firm’s activity. And the interposition of a corporation between these assets and contracts, on the one hand, and the shareholders on the other, is not there for aesthetical reasons, as a sort of convenience or simplification decided by the shareholders which they could do without.²⁹ It is *essential* to the existence of (large) firms and it breaks any possibility of any ownership link between the shareholders and the “firm”; and there can therefore be *no* agency relationship between them and corporate officers. Referring to a property right that does not and cannot exist -and therefore to an agency relationship that does not and cannot exist- is a total incongruity, a fundamental flaw in Friedman’s reasoning.

²⁵ Geoffrey M. Hodgson, “The Legal Nature of the Firm and the Myth of the Firm-Market Hybrid”, *Int. J. of the Economics of Business*, Vol. 9, n°1, pp. 37-60 (2002), at p. 47.

²⁶ See Robé, *supra*, note 10.

²⁷ They contribute assets or funds to the corporation and in exchange they get title to shares.

²⁸ They pay a price to an existing shareholder and in exchange they get title to shares; in this case, no contribution is being made to the corporation.

²⁹ In her article entitled “Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century,” 51 *UCLA Law Review* 387 (2003), Margaret Blair gives a number of examples showing that without the existence of the corporation as a separate legal person, many businesses could never have been created.

Incidentally, the idea that corporate officers are not “agents” of the shareholders and that they have no obligation to follow their orders was available when Friedman wrote his 1970 article. Adolf Berle (the author of the famous *The Modern Corporation and Private Property*, published in 1932 with Gardiner Means), for example, wrote in 1965 that:

“The directors of the corporation are not ... the agents of the stockholders and are not obliged to follow their instructions.”³⁰

It was therefore easy to know, by simply reading the writings of one of the greatest jurists of his day, that Friedman’s assertions were wrong. It would be fascinating to find out why some thought they could do without checking what the law actually says on the issue and, without any doubt, build agency theory on the basis of totally erroneous statements.

The fact that a shareholder acting as an owner would be a criminal has unfortunately been ignored by many and did not prevent the wide spreading of the erroneous notion that shareholders own the firm. And this irrespective of the fact that, in 1980, Eugene Fama was already warning that “*ownership of the firm is an irrelevant concept. Dispelling the tenacious notion that a firm is owned by its security holders is important because it is a first step toward understanding that control over a firm’s decisions is not necessarily the province of security holders*”. Fama reached this conclusion on the basis of a faulty analysis –he also neglected the reality of the legal structure of the firm.³¹ But at least there was a

³⁰ Adolf A. Berle, “Property, Production and Revolution”, 65(1) *Columbia Law Review* pp. 120 (1965), p.1.

³¹ Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288, 290 (1980). Fama made this statement because he considered that “...ownership of capital should not be confused with ownership of the firm. Each factor in a firm is owned by somebody. The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs. In this “nexus of contracts” perspective, ownership of the firm is an irrelevant concept.” But this “nexus of contract” perspective misses the most important legal instrument in the structuring of a large firm: the *corporation* as a separate legal person, which is not a mere contract. It is a legal person. As a consequence of its interposition between the shareholders and the key assets used for the operation of the firm: (a) the “real” capital (plant, IP, e.) is owned by the corporation; (b) the shareholders only own the shares issued by the corporation and (c) the nexus of contract is centered on the corporation as an autonomous legal person. Isolated from its context, Fama’s statement that “*ownership of the firm is an irrelevant concept*” is true. But Fama reaches this conclusion after an analysis which is false: the firm is not a set of contracts. The set -or nexus- of contracts is just the legal structure used to connect in legally binding ways resource providers to the corporation (or the various corporations of the group of corporations in the largest firms) to allow the operation of the firm as an organization. See Robé, *supra*, note 6, pp. 6-8.

theory which tended to show that the common sense principles on which agency theory rests were untrue.

One possible explanation for the neglect of all these serious indications that shareholders do not own firms and that managers cannot be their agents may be that they are counterintuitive to many. Common sense was on Friedman's side. And the key role played by the corporation as a legal person isolating the shareholders from the "business" had not been conducted at the time.³²

Explaining why the shareholders are not and cannot be owners of the firm requires, first, understanding the difference between a "firm" and a "corporation". But it also requires going into a close analysis of the economic role played by the corporation, which has a strong form of legal personality, strongly partitioning assets between those of the corporation and those of the shareholders. It is due to the characteristics of the corporation that the large firm accesses legal life, and thus economic or financial exchange. And these features are mutually exclusive with the notion that shareholders own the firm.

IV.

We will now review some of the economic functions fulfilled by the corporation in more details.³³

(1) The interposition of the strong form of legal personality of a corporation between the "business" and the shareholders allows the accumulation of assets (factories, machinery, buildings, patents, trademarks, etc.) and contracts over time.³⁴ The use of an artificial legal person to serve as an anchor to the contracts and property rights used in the firm allows the development of the firm on a stronger legal basis than that offered by the legal personality of fallible and mortal individuals. Because the counterparty of the participants in the activity of the firm is a "legal fiction" (a corporation) with a potentially infinite duration, the network of contracts used as the legal conduits of the firm's activities continues its existence beyond the vagaries of human life. In case of death of a shareholder,

32 Coase's 1937 article (Ronald H. Coase, *The Nature of the Firm*, 1937 *Economica* N.S. 386) had by then been "*much cited and little used*". E.g. Ronald H. Coase, "Industrial Organization: A Proposal for Research", in V. R. Fuchs (Ed.), *Policy Issues and Research Opportunities in Industrial Organization*: 59-73. New York: National Bureau of Economic Research (1972).

33 For earlier and more detailed developments on some of the arguments in this Section IV, *see generally*, for French law, Robé, *supra*, note 8 and, for US law, Blair & Stout, *supra*, note 4 and Blair, *supra*, note 30. A more detailed discussion of the literature on these various topics with references to prior work by other various authors can be found in Robé, *supra*, note 10.

34 Blair, *supra*, note 30, p. 427.

the heirs inherit shares, but the ownership of the assets used by the firm and the contracts that serve as its support are unaffected. Assets and contracts remain in the company's ownership, unchanged, without the death of the shareholder creating any disturbance in their content or continuity. This allows the firm to continue despite the death of individual shareholders. While Friedman and his followers disregard the corporation as a mere "fiction", they do not realize that it is *precisely because it is a stable legal fiction* that it plays an essential role in the organization and long term existence of large firms. Generations of shareholders and managers can pass because of the continued existence of the legal personality of the corporation. The possibility to accumulate assets and contracts, and therefore to build large firms through time, requires the use of such a "legal fiction". Contrary to what most economists think, the fact that the corporation is a "legal fiction" cannot be neglected in economic analysis. The fact that it has a strong form of legal personality, potentially eternal, allows it to fulfill fundamental economizing properties which would otherwise be unattainable. It could not be done, in particular, by resolving to contracts only, contrary to Jensen & Meckling's belief.

(2) Further, creating a legal person to own or control key assets used in the business also avoids having to agree on detailed contracts among the shareholders to specify who will do what in what circumstances and get what in return. This is made possible by the fact that when a corporation is created to hold the assets of a business, the residual control rights in connection with the various assets contributed are owned by the "artificial" legal person, not by *any* of the contracting parties -who would have *ex post* bargaining advantage in the absence of a separate legal person to own the assets and operate the business- for as long as the corporation exists. Decisions in connection with the assets owned by the corporation will be made by the corporate officers, under the direction and supervision of the board of directors (who can't do it themselves) with shareholders having no direct involvement and being involved -rarely³⁵- only via votes. This complements Oliver D. Hart thesis that the incompleteness of contracts opens the door to a theory of ownership.³⁶ In our view, the incompleteness of contracts indeed opens the door to a theory of ownership: it leads to a very powerful explanation as to why certain assets key for the existence

³⁵ See the ABA Report, *supra*, note 22, at 6-8.

³⁶ See, "Incomplete Contracts and the Theory of the Firm", in 138, *The Nature of the Firm – Origins, Evolution, and Development* (Oliver E. Williamson and Sidney G. Winter eds., 1993).

of a large firm must be in the ownership of these legal fictions having legal personality we call corporations.³⁷

(3) The interposition of the strong form of legal personality of the corporation also protects the bundle of assets, rights and contracts used by the firm from potential misappropriation or dissipation by the shareholders. This protection benefits all and each shareholder. It also benefits other “stakeholders” who may thus enter into contractual relationships with a legal person which, *because it is a fiction*, has a more stable asset profile than an individual, a set of strict rules limiting what can be done with the corporation’s assets.³⁸ Again, Friedman and his followers completely miss the importance of this key point...

(4) These rules securing the property used by the corporation facilitate the financing of its activity:³⁹ the creditors have rights over a bundle of assets and contracts which is clearly separated from the assets and liabilities of both the shareholders and the corporate officers. Its integrity is protected by a set of legal provisions (the existence of an autonomous legal personality, the fact that certain agreements between the corporation and its officers or those who control it either must go through a specific authorization procedure or are even prohibited, the concept of abuse of corporate assets, the duty to manage in the “corporate interest”, independent from his own or the one of any individual shareholder, etc.). It is therefore possible to finance the firm independently of any consideration relating to the shareholders, their wealth, their commitments, their marital status, etc.. The problems which may affect them do not impact the corporation’s assets and contracts. Without recourse to a “legal fiction”, it is simply impossible to obtain the same result.⁴⁰

(5) The accounting of the firm’s activity is facilitated by the existence of a corporation which is the counterparty of the contracts that generate the financial flows reflecting the firm’s business.⁴¹ It is this legal entity which performs the sales, pays the expenses, records provisions, depreciates assets, etc... Separate accounts to acknowledge the firm’s activity, separate from other activities and

³⁷ For more detailed developments on this idea, *see generally* Robé, *supra*, note 10.

³⁸ Blair, *supra*, note 30, pp. 427-433.

³⁹ *Id.*, p. 393.

⁴⁰ On this assets partitioning effect of the corporation, seen from the point of view of the protection of the corporation’s assets and not from the traditional point of view of the shareholders’ wealth protection via limited liability, *see* Henry Hansmann & Reiner Kraakman, *The Essential Role of Organizational Law*, 110 Yale L. J. 387 (2000).

⁴¹ Yuri Biondi, *The Firm as an Entity: Management, Organization, Accounting* (August 2, 2005), Università degli Studi di Brescia Working Paper No. 46, available at SSRN: <http://ssrn.com/abstract=774764>.

income and expenses of the shareholders may be developed independently. Without recourse to a legal fiction, this could be done *analytically* only, *in a fictitious way*, since it would not correspond with *legal* reality.

(6) The structuring of the firm using corporations also facilitates litigation. Anyone having a claim against “the business” does not have to go against each and every partner/shareholder/manager, who can then countersue each other in all sorts of ways: the litigation is between the claimant and the corporation which is the sole defending party and bears the consequences of the lawsuit. Conversely, if “the business” has a claim against a third party, it is much easier to initiate and conduct the lawsuit via the corporation than if a myriad of partners/shareholders/managers had to be coordinated in the effort.

(7) In addition, the creation of a group of corporations (corporations having the ability to own the shares issued by other corporations) allows refining the ownership structure as well as corporate finance, structured finance, etc... These are all devices without which large firms simply could not survive through time in the present world.⁴² There are *no* contrary examples in the current economy. Even a firm controlled by a billionaire having created it relatively recently is held through a complex corporate structure.

(8) Legal personality further allows the internationalization of firms through the creation of groups of corporations with subsidiaries (autonomous legal entities incorporated under local company laws) located in various countries.⁴³ Of course, the internationalization of the firm can be done via the opening of branches, devoid of legal personality. But when local activities reach a certain size, the formation of a subsidiary with a separate legal personality is the rule. *All* major global firms have a group of companies as their corporate structure.

(9) The strict separation of the assets and liabilities between those of the shareholders and those of the corporation also provides protection to the shareholders themselves (because of limited liability), allowing passive investments, without participation in the management and without taking into account the other shareholders, their wealth, their qualities and defects, etc... Thus, a key feature of ownership gets displaced. An owner is responsible over the whole of his estate for the damages caused by his acts and things. Being the owner of securities carrying limitation of liability, the shareholder is only responsible in connection with the conduct of the business for what he owns:

42 Kurt A. Strasser and Philip Blumberg (2011) “Legal Form and Economic Substance of Enterprise Groups: Implications for Legal Policy,” *Accounting, Economics, and Law*: Vol. 1: Iss. 1, Article 4. Available at: <http://www.bepress.com/ael/vol1/iss1/4>.

43 Robé 1999, *supra*, note 8, pp. 31-37.

shares. And shares are financial assets which cannot generate damages. So there is no liability which can migrate from the firm's activities via the corporation to the shareholder. The shares may lose their value, but that's it. And the shareholder does not own the firm or corporation for this reason as well: he is *not responsible for it*, as he is for any of his properties. It is to the corporation serving as the legal person used to legally structure the firm's activity (or of part of this activity in the case of a firm structured using a group of corporations) that liabilities for damages caused by this activity will be allocated. Except in the rare cases where the doctrine of "piercing the corporate veil" applies, shareholders are protected by a watertight legal barrier even if the corporation's liabilities cannot be met by its assets. The irony here is that Friedman and his followers insist at length in their analyses on the benefits of a "free enterprise, private-property system" in which "owner-entrepreneurs" are responsible for their actions and their property.⁴⁴ But this is true only in individual firms which are not structured using corporations. Friedman's trick is to use principles applicable in the management of a firm owned by an "individual proprietor" to make deductions which he then uses in his analysis of large firms. He then draws lessons for their government, while these firms are structured in a radically different way, excluding any liability of the shareholders... Here is one of the main issues of our time: because of the development of agency theory, the firm is now being managed in the sole interest of the shareholders (thanks to an invented property right they would have over the firm) while -precisely because the shareholders have no responsibility stemming from the firm's activities- the firm must be managed in an interest (the "corporation's" or the "firm's" interest) separate from the shareholders' interests. Otherwise, as we will see in more details in Section VI, this leads to an excessive shifting of costs and risks on other parties, be they other stakeholders or the firm's environment, natural and social.

(10) The capital of the corporation being represented by marketable securities, the interposition of a corporation further allows investors to benefit from liquidity in their investments.⁴⁵ Not being "co-owners" of sets of assets, or joint-contractors to sets of contracts, in unmanageable co-ownerships, they can sell their shares with a minimum of formalities and constraints. They are the full owners of each and any of the tradable securities they own⁴⁶ and can easily assign, sale, give or otherwise dispose of, separately or together, each of the

⁴⁴ In his 1970 article, Friedman writes " ... *the great virtue of private competitive enterprise – it forces people to be responsible for their own actions.*"

⁴⁵ Robé 1999, *supra*, note 8, pp. 37-39.

⁴⁶ See Robé, *supra*, note 10.

shares on which bears the only title they have. “Financial markets” can then develop, including for equity securities representing assets for which the market would otherwise be almost nonexistent. Selling a small undivided property interest in a steel mill valued several billions of dollars would be quite a challenge, with huge transaction costs. Selling listed shares representing a portion of the capital stock of a corporation owning the *same* steel mill is an extremely simple operation with near-zero transaction costs.⁴⁷

(11) The interposition of the legal personality of a corporation further allows removing the shareholders from the firm’s management, which allows separating the function of providing capital from the management function. This allows the professionalization of management.⁴⁸ It is of particular importance in case of survival of the firm over the long term, the transmission of entrepreneurial talent not being necessarily connected with the transmission of the title to the securities representing the share capital. In short, a firm created by a talented founder can survive the fact that he gave birth to incompetent heirs. We can then enter the era of professional management.

(12) These characteristics of the share also allow the shareholder to have a strategy of diversification, investing in a “portfolio” of various securities, and a better allocation of risk. And since the share does not carry risks beyond that of its loss of value, it is possible to create a range of investment vehicles allowing for a great diversity in strategies. A variety of funds managed by investment professionals can be created to meet the wishes and strategies of their investors. Some may focus on one geographic area or an industry, others may be diversified, some can be conservative in their investment policies, some very aggressive, some can be focused on the short term, others on the longer term, etc... A substantial analysis would be required to identify the beneficial or harmful or even *toxic* effects of the various types of funds on firms and the real economy. And this analysis is urgently needed because of the perceived negative effects of some types of funds. Needless to say, this work is impossible under the mistaken analyses which are in line with that of Friedman, where the analysts start with the idea that what is bought and sold at the stock exchange are property rights over firms!

This list of the corporation’s economizing properties is not exhaustive. It suffices to show that without the interposition of a corporation (or a group of corporations for the largest firms) between the assets and contracts, on the one

⁴⁷ See generally Lynn A. Stout, “The Nature of Corporations”, *University of Illinois Law Review* 2005(1):253-267.

⁴⁸ Blair, *supra*, note 30, p. 433.

hand, and the shareholders on the other, no large firm could have developed in a private law setting.

The simplistic theories developed by Milton Friedman and his followers on corporate governance could, perhaps, hypothetically work in a universe of small businesses. But when it comes to discussing the governance of large firms, relying on an alleged property right of the shareholders masks an organizational reality in which the ownership of the shareholder is *totally antithetical* to large firms. It is thus absurd and deeply misleading to ground the analysis on a nonexistent shareholders' property right over firms.

Milton Friedman's thesis (that *The Social Responsibility of Business is to Increase its Profits*) is therefore false for this first reason: it is not possible to justify the pursuit of "shareholder value", i.e. the primacy of shareholders' interests in corporate governance, the sole pursuit of profits, by the existence of a property right of shareholders over firms.

V.

In his 1970 article, Milton Friedman developed a second line of arguments in favor of "shareholder value" maximization: a governance model giving the incentive to pursue this goal only is socially beneficial anyway because it maximizes the wealth created. Once this wealth is *maximized*, it is then up to political institutions to allocate its use. But neither firms nor their leaders have anything to do with the *allocation* of the value created. If the holders of interests present in "society" want the value created in enterprises and so "maximized" being used to promote their interests, there are political institutions for that. It is up to them to get the appropriate taxes levied and necessary standards being adopted after democratic debate and vote. Firm managers have no role to play in the allocation of the value created, and no legitimacy to do anything but maximize "value" creation. Any conduct by a firm manager other than the search for profit maximization amounts, in Friedman's analysis, to spending someone else's money for a "social interest" that this someone else has not chosen.⁴⁹ *"Insofar as his actions in accord with his "social responsibility" reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers' money. Insofar as his actions lower the*

⁴⁹ "... the corporate executive would be spending someone else's money for a general social interest".

wages of some employees, he is spending their money”.⁵⁰ Whereas for Friedman, it is up to the shareholders, customers or employees to decide for themselves how to spend their money. In fact, by behaving in such a manner, the corporate officer acts as a “politician”, raising “taxes” and deciding how to spend the proceeds of these taxes. If the corporate executive wants to have a social activity, he is entitled (after working hours, please) to spend his own money, or to act using the political institutions created to serve as a forum for debate on the legal standards to be adopted and on their content.

Milton Friedman’s simplistic theory on the division of labor between “private” and “public” governance is based on two implicit assumptions which have since then been clarified.⁵¹ The first is that the *contracts* linking the resource contributors to the firm via the business corporation are assumed to be perfect, i.e. they are assumed to perfectly represent the *informed* agreement of *equal* parties; and the second is that we live in a *perfect normative environment* that integrates “social” demands and, in particular, *internalizes* in the cost of producing goods and services (and thus, ultimately, in prices), via mandatory norms (laws, regulations, taxes, etc.) *all the “negative externalities”*.⁵²

The first assumption is certainly distant from reality but it is based on the underlying idea that individuals should be responsible for their own affairs. We will not discuss its wisdom here (although we generally agree with it). The second assumption could possibly be made if one analyzed the operation of a firm operating within a closed social and ecological system (i.e., existing on the territory of one single State with closed borders and therefore operating within one single isolated legal, political, economic and ecological system), with unified and effective democratic political institutions having jurisdiction over that territory. This assumption would be very bold because it implies political institutions operating perfectly in a totally closed system. It is hard to imagine this assumption to be correct in *any* social system. But in the present context of a global economy, where most large firms have a global footprint and operate in the

⁵⁰ Here also, Milton Friedman is cutting corners. If one neglects the legal structure of exchange relationships, everybody spends everybody’s money all the time. In Friedman’s logic, my baker who just bought a new oven this morning spent my money. Except that, legally speaking, in exchange for the baguette I bought yesterday evening and which immediately became my property, he became immediately the owner of the coin I gave him as payment. And he does what he wants with it: buy a new oven or paint the shop. Today, he is not spending *my* money, but *his* money.

⁵¹ See Tirole, *supra*, note 2, pp. 60-61.

⁵² See recently, Yuri Biondi, “The Problem of Social Income: Another View of the Cathedral”, 34 *Seattle University Law Review* 1025 (2011).

anarchic world of a post-Westphalian “State System” without a global State, this second assumption really makes no sense.⁵³ The management teams at the helm of large firms decide on the geographical allocation of the resources they control looking worldwide at the pros and cons of the various possible locations. Global firms “purchase” normative environments and individually and via their collective mode of operation make States compete to provide them with rules appropriate for the conduct of their activities. The contents of States’ laws must be adapted for States’ territories to remain as competitive places for the location of at least part of the production processes. In a globalized economy, it is the whole system of allocation of authority, of division of powers and of resources that is affected by the firms’ decisions. Public authorities, as well as the social and natural environments, bear to an unprecedented extent the consequences of choices made within firms because globalization is negatively affecting States’ internalizing capacities through laws and regulations. It is therefore impossible to assume in such an environment that all negative externalities are perfectly internalized by the political system of mandatory norm creation.

The consequence of such an institutional setting is that the accounting methods used to account for the firm’s activities and their consequences are unable to give indications as to the extent of the real value created by the firm’s operations. The accounting system through which profits are acknowledged does not take into account all the costs generated by the firm’s activity. Some “negative externalities” are inevitable and unintended consequences of economic activity. But because of the precepts of agency theory and its avatar of shareholder value maximization, other externalities are *intentionally* produced by firms: externalizing costs on the social or natural environments translates into profits. In many cases, an objective accounting of the value created by a firm’s activity, taking into account all the costs and benefits involved, would show that the profits made do not correspond to value creation. But the notion that firms should only seek to maximize shareholder value leads to an exploitation of the difference between an accounting of the creation of *shareholder value* and an accounting of the *value actually created* by the economic activity organized within the firm. In a world of State competition for the localization of firms’ activities, of political failure at the international level and of imperfect norms, there may be a difference between the costs and benefits generated by a decision and its accounting translation; i.e. there may be creation of “shareholder value” by simply

⁵³ For more details, see Jean-Philippe Robé, *l’entreprise et la constitutionnalisation du système-monde*, (2011) available at : <http://www.collegedesbernardins.fr/index.php/pole-de-recherche/economie-homme-societe/economie-homme-societe-seminaire.html>

“externalizing” costs. The spread of the ideology of shareholder value has led to the widespread exploitation of this possibility: it is not necessary to create value to create “shareholder value”.

VI.

From this possibility derive many of the serious problems of our time.

(1) Take for example the case of the relocation of a profitable activity to increase profits by taking advantage of the relocation of the activity in a legal environment with lower labor costs. The cost of closing the original production site will be partly supported by the corporation implementing it legally (cost of terminating the employees, etc.). But it will also be borne by the dismissed employees, by the local social security system (paying them income of substitution), by local authorities (affected by the decline in their tax base and the need to address the induced social problems), by sub-contractors (who see their business reduced), by other suppliers, by the local economic environment, etc... However, only the group of corporations used to legally structure the firm within which the decision was taken, and its shareholders, will benefit from the costs reduction induced by the relocation of the business in a low-cost environment. The positive externalities generated at the new location should also be taken into account. But it is only with an accounting of all the costs and benefits generated by such a decision that one could determine whether the relocation is socially beneficial. All relocation is not inherently evil; but with a more accurate accounting of the costs and benefits of the decision made, many decisions to relocate could turn out not be socially beneficial. The point is that with the accounting instruments we have today, no one knows.

(2) Take the case of the relocation of a polluting activity in a location with lower environmental standards. Before the relocation, the cost of the pollution is internalized in the costs of production and, ultimately, in the prices paid by the consumers of the production due to mandatory legal standards. After the relocation, prices are lower, since they do not include this cost, profits are higher (if some part of the cost reduction is not reflected in lower prices) but the pollution affects the environment. For some pollution with local effects which are not serious in the long term or for the surrounding communities (pollution with local effects only in a desert area, for example), there may be a case for such relocations which consist in a more balanced use of natural resources. For pollutions having global effects (CO₂ production, for example) wherever they occur, the profits may not match *any* value creation. They are simply the consequence of an externalization of costs on the natural environment. And we all bear the cost of this relocation in varying degrees by suffering the consequences of climate disruption.

(3) With the development of the structuring of the holding of economic activities through legal entities located in tax havens, the sums available for distribution to the shareholders are increased. But at the same time, firms are reducing the tax base of the States on whose territory the real economic activities of production and distribution take place. Hence one of the causes of the crisis of government debt, constantly presented as a crisis of public *spending* while it is perhaps above all a crisis of tax *collection* as a result of the internationalization of enterprises and of the tax evasion thus made possible. And this is no small matter as it is estimated that there are today 12.000 billion US dollars invested in the « real economy » via corporate vehicles established in tax and regulatory havens. It is also estimated that this stock is increasing at a rate of 1.200 billion US dollars a year and that about 340 billion US dollars' worth of taxes evaporate from regular States' budgets *every year* worldwide in this fashion.⁵⁴

(4) By dramatically increasing the proportion of the value creation compensating the equity to the detriment of wages, shareholder value maximization also leads to lingering issues deriving from weak demand, leading yet again to more public spending and private and public debt issues.

(5) Shareholder value maximization, combined with a form of abuse of the corporate legal personality, has also led to a generalized « securitization » of financial assets, packaged in legal vehicles which can then issue various tranches of securities with highly complex bundles of rights and security interests attached to them, which are usually repackaged in even more complex securitization vehicles issuing yet other securities in a chain which makes any valuation of the securities (which are derivatives of derivatives of derivatives in an almost never ending chain) based on the underlying assets and activities almost impossible to make. Values are then only dependent on the highly opaque and purely financial information available with a limited ability to make any sanity check by looking at the underlying economic activity. The outcome is, for example, the insane logic which has led to the issuance of mortgages to people who could not afford them, leading to the issuance of securities highly valued by “markets” on the basis of the short term returns they were providing. The loans were subprime but the derivative securities were highly remunerative; so where was the problem? We all know now where it was. And we are all still paying the price for this insanity (thanks for the negative externalities!). We all know also that not much has been done to prevent this from happening again.

⁵⁴ Ronen Palan, Richard Murphy & Christian Chavagneux, *Tax Havens – How Globalization Really Works*, Cornell University Press (2010), pp.4-5.

The examples are legion. Agency theory thus leads a number of firms to become organizations producing negative externalities not as an *ancillary* consequence of their economic activity, as is the case with any economic agent, but as *one of their main activities* -because that's one easy way to produce profits. There are, of course, firms producing value and most firms produce both value and negative externalities. But shareholder value theory has prevented the development of accounting systems selecting those firms creating "real value". And even for those aware of the fact that "... *the legal and regulatory framework is ... imperfect*",⁵⁵ the only consequence to be drawn for them is that "*shareholder-value maximization is ... very much a second-best mandate [and] in view of some imperfections in contracts and the laws, extremist views on shareholder value are distasteful.*"⁵⁶

Looking at the sub-prime and subsequent financial and economic crisis, environmental problems such as the extinction of many species of plants and animals, all sorts of instances of tax and legal dumping (the existence of tax and legal "havens"), the induced offshoring phenomenon (the use of corporate devices to locate the accounting acknowledgement of wealth creation in low tax jurisdictions)⁵⁷ and the debt crisis, it is hard to agree, however, that there are only "*some imperfections in contracts and the laws*" and that "*extremist views on shareholder value are [only] distasteful.*" The evidence is that negative externalities are large and pervasive and existing modes of corporate governance designed on the tenets of shareholder supremacy play their role in this state of affairs. And shareholder value proponents bear their fair share of *liability* for this situation. By oversimplifying the issues of corporate governance in a globalizing world, the proponents of shareholder value contribute to the sustenance of corporate governance systems which systematically convert externalities -costs imposed upon others and the environment, social and natural, via biased governance systems- into profits.

To correct this, one could imagine supplementing traditional accounting with an accounting of the social and environmental consequences of major decisions ("triple bottom line" accounting, for example). One could then develop incentive pay schemes based on this type of "true value" creation.⁵⁸ Compensation incentives -such as stock options- linked to the increase in "shareholder value" are a catastrophic substitute since only a portion of the costs

⁵⁵ Tirole, *supra* note 2, at 61, emphasis added.

⁵⁶ *Id.*

⁵⁷ See generally Ronen Palan, *The offshore world – sovereign markets, virtual places and nomad millionaires*, Cornell U. Press (2003, 2006).

⁵⁸ For more details, see Robé, *supra*, note 54.

is taken into account in determining “shareholder value”. This automatically results in an increase in negative externalities. Indeed, the combination of the fact that firms operate in an imperfect world with an ideology based on the opposite assumption -notwithstanding its obvious absurdity- creates an imbalance in the firm management. It is tilted in favor of one category of resources contributors only -who, in addition, are irresponsible- and is the source of the production of many important negative externalities. The ideology of shareholder value results in a lack of alignment between the play of private interests and public interest.

VII.

There is a point on which Milton Friedman is right: the head of a large firm who does not act in the sole interests of one category of stakeholders acts as a politician. But not in the sense that he imposes “taxes”; in the sense that, in an imperfect world, his role is to make decisions reconciling partially convergent and partially conflicting interests.⁵⁹ Large firms, which are not owned by anyone, have formed over time as part of the most important *political* institutions of our global society.⁶⁰ But because of agency theory, the businessman of today is a politician deprived of the means to properly fulfill his role. Agency theory makes of him the mere agent of the shareholders and a maximizer of “shareholder value” which can translate in reality into a destruction of real value, of social cohesion and of the natural environment. And even in cases where managers are not put on a short leash because of the shareholding structure of the firm they manage, some still like being qualified as agents and act as such because the theory that they are the shareholders’ servants allows them to capture a portion of the “shareholder value” created via stock-options or similar devices. The political coalition among shareholders and company managers, which in effect Friedman was advocating

⁵⁹ See Blair & Stout, *supra*, note 4, at 254.

⁶⁰ Here again, one could have preferred following Adolf Berle in his analyzes instead of Milton Friedman. As early as 1958, he wrote: “... control ... is no longer solely an attribute of stock ownership, though stock ownership plays a part. ... It is not a ‘thing’ but a function. It is essentially a variety of political process –non-statist and therefore, in our vocabulary, ‘private’, but with substantial public responsibilities. The holder of control is not so much the owner of a proprietary right as the occupier of a power-position.” Adolf A. Berle, “‘Control’ in Corporate Law”, 58 *Columbia Law Review* pp. 1212-1225 (1958), p. 1215. But, contrary to Friedman, Berle was not offering a simplistic theory and acknowledged the difficulty: “When control has been secured, its exercise must be ‘responsible’. We do not know yet the full import of this rule...”; *id.* p. 1224.

behind his “scientific” arguments, is thus quite effective -for them. But it entails, as a consequence, substantial social and environmental costs.

Milton Friedman’s simplistic and misleading arguments prevent the understanding of the complex political system of our time. Let’s remember: anyone trying to do it is a “collectivist”, even without being aware of it. As a result, the implementation of Friedman’s ideology in the real world has led to a diversion of corporate power, which is subservient to alleged “owners” of the firm. The result is a transfer to public institutions of the job of taking into account the negative externalities generated in this way, often *voluntarily*. States took on the role of adopting protective legal norms and creating redistribution schemes financed by mandatory contributions (taxes or social charges), especially after the Great Depression of the 30s and even more so in the first decades following World War II. But globalization is progressively depriving them of the means to play this role. In a world of competition among States for the localization of business activity, the level of protection of the interests negatively affected by this mode of firm governance is being reduced and the States’ tax base is being eroded.⁶¹ The *same bias* in corporate governance both requires more public intervention and reduces the resources available to do it...

With an analysis free of agency theory, the firm manager-politician (a “civil servant”, to quote Friedman) loses the present source of his or her legitimacy: if the firm manager is not the agent of some firm “owner”, who is he representing? What are the goals he must pursue in the firm’s management? Why should he be left alone to decide on the goals of the enterprise and to identify, evaluate and take into account -and to what extent- the interests affected by the decision-making process? From that point of view, Milton Friedman’s reasoning is well founded as well:

“On grounds of political principle, it is intolerable that such civil servants ... should be selected as they are now. If they are to be civil servants, then they must be elected through a political process. If they are to impose taxes and make expenditures to foster “social” objectives, then political machinery must be set up to make the assessment of taxes and to determine through a political process the objectives to be served.”

⁶¹ Via, for example, the use of tax havens in the structuring of the firm’s corporate structure and for the geographical location of the accounting recognition of income or capital gains, exerting a downward pressure on the tax burden bearing on firms, etc.) and a decrease of legislative and regulatory protection of the interests adversely affected.

Friedman saw in this conclusion -which he probably thought was provocative and revulsive- the fundamental reason why the doctrine of “corporate social responsibility” involves the acceptance of the “socialist” vision according to which it is political rather than contractual mechanisms which are suitable for determining the allocation of scarce resources between the various alternatives uses. His ultimate conclusion is clearly absurd, since “political” does not mean “socialist”; and with Friedman’s reasoning, all States would be “socialist” since all have laws influencing, at least in part, the allocation of resources, including those created by firms.⁶² But at the time of the Cold War, getting out the bogeyman of “socialism” was useful to support a flawed analysis.

The issue we face is not to decide whether firm managers “are to be civil servants”. No decision has to be made in this regard: firm managers *are* political decision makers. But that does not mean they should be elected or become “civil servants”. The issue is to develop proper institutions of *firm* (as opposed to *corporate*) governance. Corporate governance only involves the rules applicable to directors, executives and shareholders in the governance of the corporation. Firm governance goes well beyond this as it comprises in addition the rules of the governance of an organization having an impact on other stakeholders and on its social and natural environments. In an imperfect contractual, legislative and regulatory world, the function of the firm manager, and more generally of the management team, is partly a political function and this raises a problem of legitimacy and also, at the very least, an issue of favoring the appropriate incentive schemes in the management of the firm.

That the issue is political derives from the fact that it is a *legal fiction* which is the owner of the assets and the counterparty to the contracts serving as the legal structure of the firm. Equity investors in the firm are only owners of intangible securities (shares) or even, in most cases, the beneficiaries of derivative rights through their direct or indirect investment in various funds. *No one owns the corporation or the firm* and, as a consequence, no one is responsible for it. The corporation therefor cannot be thought about as an *homo economicus* to which a maximizing function can be assigned; and the firm’s manager is not the agent of such an *homo economicus*. Contractual freedom combined with property, and the ancillary principle of *un*limited liability for one’s acts, are no longer sufficient to ensure, even theoretically, the harmony of interests. We can no longer rely on the “individual proprietor” (a) who knows better than anyone else what his interests are and (b) whom we can expect to act cautiously in the pursuit

⁶² Friedman acknowledged himself: “*I do not see how one can avoid the use of the political mechanism altogether*”.

of his interests because of the responsibility that weighs on him. Forcing firms to act in the sole interest of irresponsible shareholders, which is the exact opposite of the principles of an economy based on liberal principles, is a recipe for disaster. And dinner is served.

VIII.

The globalization of firms and of the economy creates a global political problem of governance. It is simultaneously a problem of institutionalization of the institutions appropriate for firm governance, but also of State governance. We must draw the consequences of the way in which the complex structure of the power system on a global scale has developed both at the level of “public” and “private” institutions, with the actual meanings of these terms. In fact, one cannot separate the “economic” from the “political” in a globalized economy. Such a differentiation could theoretically be done if there were one single world State, with a single legal system and uniform rules for all economic actors. The global State would be the *public* institution in charge of adopting the necessary rules for a smooth functioning of the world economy, internalizing negative externalities in the cases where the world political process would determine that this is warranted. And firms would be operating in a *private* sphere without having to take into account the negative consequences of their activities, relying on appropriate political institutions to correct “market failures”. But we do not live in such a world; and we will not live in such a world. The global economic and political system is not a unified system with a “world State” which could isolate a public (political) sphere from a private (economic) sphere. The global economic and political system is merging the “public” and the “private” spheres of government into one global power-system which needs to be thought as one global, constitutional, pluralist system of government.⁶³

⁶³ For antecedents in this line of thought, see Adolf A. Berle, *Constitutional Limitations on Corporate Activity – Protection of Personal Rights from Invasion through Economic Power*, U. Pa. L. Rev. 933 (1952) and generally the writing of Arthur S. Miller, *Toward the “Techno-Corporate” State? - An Essay in American Constitutionalism*, 14 Vill. L. Rev. 1 (1968), *The Global Corporation and American Constitutionalism: Some Political Consequences of Economic Power*, J. of Int’l L. & Eco. 235 (1972), *The Modern Corporate State: Private Governments and the American Constitution*, Greenwood Press, Conn. (1976), and *Toward constitutionalizing the Corporation*, 80 W. Va. L. Rev. 187 (1978); see also Philip Selznick, *Law, Society and Industrial Justice*, New York, Russel Sage (1969, 1980, 1983). On the German tradition in these issues see, in Walter Rathenau’s continuity, the work of Peer Zumbansen and, recently, *Neither “Public” nor “Private”, “National” nor “International”*: *Transnational Corporate Governance from a Legal Pluralist Perspective*, 38(1) Journal of Law and Society, pp. 50-75 (2011) and *Carving out*

[Footnote continued on next page]

The challenges to understand this new reality and address its requirements are of course quite substantial. A necessary starting point is to free our mind from agency theory, and thus to be done with Milton Friedman.

IX. List of legal cases

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[Footnote continued from previous page]

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