CORPORATE THEORIES:
A BRIEF ANALYSIS AND DISCUSSION

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ABSTRACT

Understanding and applying corporate theories is becoming increasingly important in today's fast-paced business environment. This article provides a brief analysis and discussion of key corporate theories that impact the operational structure and strategic decision-making processes within a corporation. The theories discussed include Concession/Fiction Theory, Realist Theory and Aggregate/Nexus of Contracts Theory among others. We examine each theory in the context of current corporate settings, highlighting the implications for legal issues, organisational efficiency, ethical considerations, sustainability, and corporate social responsibility.

INTRODUCTION

Corporate theories are fundamental concepts or frameworks that aid in comprehending the nature, functioning, and societal significance of corporations. These theories play a critical role as they shape our perception of corporations and provide guidance in the development of regulations and legislation governing them.[1]

This article aims to outline the various theoretical approaches to company law and articulate the link between these theories and corporate law reforms.

As a blueprint for a building, corporate theories provide a plan or a map for how corporations are structured and how they should behave. These

theories answer important questions like: Are corporations just groups of people coming together for business, or are they separate entities entirely? Do they have the same rights and responsibilities as individuals? How should they interact with society and the global economy?[2]

Different eras in history have their unique features. Therefore, corporate theories also evolve, reflecting the social, economic, and political changes of the period. This means that our understanding of corporations and how they are managed can change too.[3]

There are six major milestones in the evolution of contemporary corporate theory:

(1) *The Mercantile Era (16th–18th centuries)*: In this period, corporations emerged as trading organisations with charters granted by governments. They were designed to facilitate trade and exploration in the expanding global economy.

(2) *The Industrial Revolution (18th–19th centuries)*: The Industrial Revolution saw a shift in company structures, with the emergence of new forms of corporate organisation, including the limited liability company. This period saw joint-stock companies develop, allowing for pooled capital and risk-sharing among larger investors.

(3) *The Separation of Ownership and Control (late 19th–early 20th centuries)*: This era saw the rise of the managerial class as companies grew larger and more complex. The separation of ownership from control led to the development of agency theory, which focuses on the relationship between shareholders and managers and the need for mechanisms to align their interests.

(4) *The Rise of Corporate Social Responsibility (CSR) (mid-20th century)*: This period saw the recognition of the social and

environmental impact of business activities, leading to the development of CSR theories that emphasise the importance of balancing profit-making with social and environmental responsibilities.[4]

(5) *The Shareholder Primacy Era (late 20th century)*: Theories such as the shareholder value maximisation theory gained prominence, arguing that the primary purpose of a company is to maximise shareholder wealth.[5]

(6) *The Stakeholder Theory Era (late 20th century–present)*: This period saw a shift towards a more inclusive understanding of corporate responsibilities, with stakeholder theory emphasising the importance of considering the interests of all stakeholders, not just shareholders.[6]

This article will explore three primary concepts related to corporate laws. Specifically, we will discuss the following:

(a) the concession theory, alternatively referred to as the fiction theory;

(b) the realist theory; and

(c) the aggregate theory or nexus of contract theory.

Numerous theories have emerged to elucidate the functions and characteristics of corporations, which have significantly enhanced our comprehension of corporate law and its practical implications. This article endeavours to offer a comprehensive overview of corporate governance and operations by examining these theories, facilitating an in-depth understanding of their intricate dynamics.[7]

CONCESSION THEORY/FICTION THEORY

The concession theory, also known as the fiction theory, is a traditional approach in corporate law that views a corporation as a legal entity created by charter or statute by the prerogative of the State.

According to this theory, the corporation is granted certain privileges and rights by the State in exchange for providing public goods or fulfilling public purposes. Under the concession theory, company law statutes regulate every aspect of the company's activities, as the State is considered central to the existence and running of the company.[8]

This theory legitimises the State's authority to regulate and control corporations, as they are viewed as extensions of the State's power and subject to its governance. A great example of a company established under concession theory or fiction theory is the East India Company, which was granted a royal charter by Queen Elizabeth I in 1600.[9]

The key characteristics of the concession/fiction theory company are as follows:

(1) *Artificial Entity*: In this view, a corporation is not a natural person or a group of persons but an artificial being created by the State. It exists only in the eyes of the law.[10]

(2) *State Creation*: The State, through its legal system, grants the corporation its status and endows it with certain rights and privileges. This concession from the State allows the corporation to exist and function.[11]

The concession theory profoundly influences the content of the object clause in corporate charters, as well as the distribution of rights and authorities within a corporation. Specifically, it has a significant bearing on the doctrine of *ultra vires*.[12]

For instance, *Re German Date Coffee Co* is a significant landmark law case that touched upon the doctrine of *ultra vires*.[13]

Background: The company had a specific goal to obtain a German patent for producing a coffee substitute made from dates. Unfortunately, the Germans denied the patent and minority shareholders requested a fair and reasonable winding up of the company since it could no longer pursue its main objective.[14]

Judgment: Although the company established a factory in Hamburg for coffee production and had successful trading, it still received a winding-up order from the court. This was because the company's primary purpose was to manufacture the coffee substitute using a specific German patent, which they could not obtain. Additionally, the company's foundation had weakened despite acquiring a similar Swedish patent. As a result, the company's substratum was no longer viable. Therefore, this act was *ultra vires*, meaning beyond the company's powers as per its company's Constitution.[15]

This case underscores the historical strictness of the *ultra vires* doctrine, which was intended to protect the interests of shareholders and creditors by ensuring that a company's assets were used for their proper purpose. This is also an important case for understanding the development and application of the *ultra vires* doctrine, although, in many jurisdictions, the doctrine's application has been significantly relaxed in the modern era.[16]

REALIST THEORY

The realist theory is the theory that probably seems the strangest to a 21st century reader. It originated from 19th century German theorists who considered the corporation a distinct, real entity, separate from its shareholders and independent of the State.

This theory acknowledges a corporation as a social institution with obligations to multiple stakeholders. In doing so, it extends the

corporation's existence beyond being a mere tool for profit for its shareholders. It provides the corporation with a sense of corporate social responsibility, underscoring its roles in promoting sustainable business practices, contributing positively to society, and reducing environmental harm.[17]

The key characteristics of the realist theory include:

(1) *Separate Legal Entity*: The realist theory contends that a corporation is its own legal entity with an existence separate from its shareholders and directors. This allows it to own property, sue and be sued, and have rights and liabilities of its own.[18]

Salomon v. A Salomon & Co Ltd is one of corporate law's most important and widely cited cases. This United Kingdom case established the principle of corporate personality, also known as the legal entity or separate legal personality, a cornerstone of corporate law globally.[19]

Background: Aron Salomon, a bootmaker and leather merchant, incorporated his business into a limited company, transferring his business assets in return for fully paid-up shares. The company also issued a debenture (a debt secured against the company's assets) to Mr Salomon. Shortly after, the company ran into financial trouble and was put into liquidation. Upon liquidation, the company's assets were insufficient to repay the debenture and the unsecured creditors.[20]

Judgment: The liquidator, on behalf of the unsecured creditors, argued that despite the incorporation, the company was essentially an agent or trustee for Mr Salomon (acting as an alter ego of the company), so he should be personally liable for its debts. However, the House of Lords ruled in favour of Mr Salomon, stating that the company had a separate legal personality and therefore, Mr Salomon was not personally liable for the company's debts. The

House of Lords held that a new and separate artificial entity came into existence upon incorporation. At law, the company is different from its shareholders, directors, and members.[21]

Salomon v. A Salomon & Co Ltd is significant because it firmly established the principle of the corporate veil, which means a company has a separate legal personality from its members. This case has influenced corporate law worldwide and has significant implications on the limited liability of shareholders and the treatment of corporate debts.[22]

(2) *Rights and Responsibilities:* Under the realist theory, a corporation has similar rights and responsibilities as an individual. This includes constitutional rights in some jurisdictions, such as the right to free speech.[23]

(3) *Corporate Social Responsibility*: The realist theory also promotes the concept of corporate social responsibility. This is the idea that corporations should act as good citizens accountable not just to their shareholders, but also to society at large. This could include making ethical, sustainable, and beneficial decisions for the community.[24]

The realist theory has a significant influence on corporate law and governance. Its principles are reflected in many modern legal systems and guide the way corporations are regulated and operate.

The shortcomings of the realist theory were not seriously contested until the Great Depression in the 1930s. The work of Berle and Means in 1932 was the initial significant challenge, with their primary focus being on unaccountable managers. However, while 'The Modern Corporation and Private Property' stands as a key landmark in the discourse on corporate governance, it was the exchange of debates between Adolf Berle (Berle) and Merrick Dodd (Dodd) in the Harvard Law Review that significantly guided the direction of the corporate governance dialogue.[25]

Via the aforementioned influential publication, *The Modern Corporation and Private Property*, Berle and Means put forth two significant insights regarding the functioning of American businesses during the 1930s, namely:[26]

(a) First, shareholders were so numerous (described as dispersed ownership, and subsequently as the *Berle and Means Corporation*) that no individual shareholder had an interest in attempting to exercise control over management. In their view, 65 per cent of the largest 200 US companies were controlled entirely by their managers.

(b) Second, they expressed concern that managers were not only unaccountable to shareholders but exercised enormous economic power, which had the potential to harm society. There was apprehension about the lack of accountability of managers towards shareholders and their ability to wield significant economic influence that could have detrimental effects on society.

In relation to this issue, Dodd published an article where he aimed to delve deeper into some of the unresolved inquiries raised by proponents of corporate realism. Dodd attempted to respond to the inquiry: What are the concerns of this actual individual if they are not identified with the investors? Dodd contended that similarly as other genuine people have citizenship obligations that require individual self-sacrifice, a corporation has social responsibilities which may, from time to time, be contrary to its economic goals. Consequently, managers of this citizen corporation are anticipated to utilise their authority in a manner that acknowledges the company's societal duty to stakeholders – specifically workers, consumers, and society at large.[27]

Until the 1960s, the discussion was largely influenced by these two different perspectives. However, after World War II, management-led corporations experienced noticeable and concrete success, which posed a

significant challenge to Berle's proposition. Despite the absence of any US legislative action advocating Dodd's pluralistic approach, these management-led firms were able to act as corporate citizens, balancing the interests of shareholders, employees, and the broader public. In 1959, evidence began to emerge supporting Berle's claims about a lack of managerial accountability in the pluralistic model, and surprisingly, Berle abandoned his stance and adopted the pluralist approach.[28]

During the 1970s and 80s, there was a change in the dominant theory of corporate governance from corporate realism to the nexus of contracts theory. This shift was driven by alterations in market dynamics and shareholder behaviours. Previously, corporate realism, which saw companies as corporate citizens benefiting society, was the prevailing theory due to the success of management-based companies. However, by the 1980s, changes in equity funds, insurance schemes, state pensions, and healthcare reforms began directing significant amounts of money into equity markets through institutional investors such as pension funds, investment funds, and insurance companies.[29]

Many countries removed barriers to capital inflows and outflows, enabling international investment funds to operate globally on exchanges like the London and New York Stock Exchange. As a result, institutional investors gained dominance and held a significant percentage of shares in these markets. Although they remained mostly passive, they preferred market mechanisms that promote shareholder wealth maximisation. This led to increased share options as part of management salaries, which motivated managers to focus on share price performance. Additionally, non-executive directors emerged to oversee management.[30]

AGGREGATE THEORY/NEXUS OF CONTRACTS THEORY

Corporate realism was questioned by economists who revealed that managers often acted in their own self-interest instead of serving the public good. This led to a renewed interest in the aggregate theory, also known as the nexus of contracts theory. This theory sees the firm as a collection of contracts and regards shareholders as a means of oversight. Unlike the realist theory, which views corporations as separate legal entities, the aggregate theory sees corporations as a combination of contracts between different parties - including shareholders, employees, creditors, suppliers, customers, and more. Each party enters these contracts to further their interests. The corporation is essentially the sum of these contractual relationships, facilitating the cooperation and coordination between these parties.[31]

The key characteristics of the aggregate theory are:[32]

(1) *Collection of Contracts*: The corporation is seen as a set of voluntary contracts between various individuals or parties. Each individual or party agrees to contribute capital, labour, or other resources in exchange for a return.

(2) *Focus on Individual Rights*: Since the corporation is viewed as a collection of individual contracts, the focus tends to be on the rights and responsibilities of the individual parties rather than on the corporation as a distinct entity.

(3) *Role of Management*: In this model, the managers are considered agents who are contractually obliged to act in the best interests of the shareholders, who are seen as the principals.

(4) *Limitation of State Intervention*: The aggregate theory or nexus of contracts theory tends to limit the role of State intervention in corporate affairs. It views the corporation as governed by the laws of contract and agency rather than by a specific set of corporate laws.

This concept of the firm as a “nexus of contracts,” as developed by Alchian and Demsetz, describes an organisation as a collection of explicit and implicit agreements without any hierarchical power differential. It emphasises a continuous process of renegotiation where all involved parties are content with the outcome. The role of the shareholder is seen as a crucial monitoring agent in this theory. Other members, such as employees and creditors, have a fixed return for their efforts (salaries and interest, respectively). In contrast, shareholders’ returns depend on the team’s performance, motivating them to monitor. If necessary, they can also change the team’s composition by removing directors. This places shareholders at the centre of the business model and critiques firms where managers operate without shareholder constraints.[33]

Jensen and Meckling further contributed to this perspective, conceptualising the relationship between shareholders and management as a principal-agent interaction. Having more detailed knowledge about the firm’s operations, the manager increases monitoring costs for shareholders. These “*agency costs*” represent the expense shareholders incur to ensure managers make efficient decisions. The costs are highest in large public companies where ownership is separate from control.[34]

However, market mechanisms can mitigate these agency costs. For instance, the threat of hostile takeovers can compel management to keep agency costs down. If a company’s share price falls, signalling high agency costs, it may attract a takeover bid, which could lead to a management switching exercise. Other mechanisms to align the interests of management with shareholders include share options, independent audits, non-executive directors, and allowing for a free takeover market.[35]

Debt levels and competition in the product market can also limit management’s discretion. High debt levels leave less room for management’s self-interest by restricting surplus cash. If a firm generates a surplus, it should distribute it to shareholders, mimicking the effect of

debt. Moreover, highly competitive markets increase the threat of insolvency, pressuring companies to stay lean and efficient.[36]

In conclusion, several different corporate theories have been developed over the years. These theories offer different perspectives on the nature of the corporation and its relationship with its stakeholders. While there is no one 'correct' theory, each of these theories can provide insights into the complex world of corporate governance.

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