

## A New Look at the Theory of the Firm

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Tamara Belinfanti & Lynn A. Stout, *Contested Visions: The Value of Systems Theory for Corporate Law*, **U. Pa. L. Rev.** (forthcoming 2017), available at [SSRN](#).

Tamara Belinfanti and Lynn Stout's *Contested Visions: The Value of Systems Theory for Corporate Law*, forthcoming in the *University of Pennsylvania Law Review*, brings systems theory to the theory of the firm. I picked the paper up expecting a cross-disciplinary reference to the work of Niklas Luhmann and other social theorists. But the reference here is to another branch of the systems inquiry, the cross-referents of which go to engineering, biology, and computer, environmental and management science. Belinfanti and Stout include a succinct and lucid primer of the basic points. They then deploy them against the most important point in the quadripartite case for shareholder value as the purpose of the firm.

A little law and economics background needs to be provided to show the importance of the intervention. Microeconomics does not yield shareholder value maximization as the purpose of the firm as a primary proposition. Indeed, in a frictionless world with complete markets, optimality would mean maximizing the yield to every actor connected to the firm rather than just the yield to the shareholders. Shareholder primacy emerges once frictions and incomplete markets are interpolated. It follows from four more particular assertions: first, an instruction to maximize for multiple constituents would be incoherent; second, the shareholder interest, as the residual interest, points management in the most productive direction; third, the shareholders are vulnerable, relatively speaking, because other firm constituents can protect themselves with contracts; and, fourth, a multiple constituent model would lack yardsticks with which to measure management performance, where the shareholder model can measure performance with standard metrics like the stock price and periodic earnings.

Three of the four legs that thus support the shareholder primacy table are looking shaky. The first justification—governance incoherence—never did a lot of work. To rebut it, all one needs to do is follow the doctrine and direct management's duties to the enterprise and then take a confirming look across the Atlantic to large German companies with dual boards. The second and third justifications—shareholder incentive alignment and shareholder vulnerability—have lost cogence as shareholder power has waxed in recent years. With short-termist hedge funds now taking the lead as shareholder value shock troops, shareholder incentives are no less problematic than anyone else's. Nor do shareholders any longer stand out as a vulnerable constituency. Indeed, the remission of other constituents to contractual protection never did resonate very well in world dominated by at will employment contracting.

This leaves shareholder advocates with only a single powerful justification—the point that shareholder-directed metrics like the stock price and periodic earnings provide the only workable yardsticks with which to evaluate management performance. In a multiple-constituency firm without these focal points, it is said, self-serving managers would hide behind vaguely defined constituency interests with negative effects on productivity. There is much to be said for this point.

Belinfanti and Stout push back against it, drawing on systems theory's account of interconnected processes. No silver bullet metric emerges. Indeed, in the authors' description, the whole point of systems theory is that things are way too complicated to yield such a metric. What we get instead are multiple indicators, all directed toward the measurement of the system's health and sustainability. A warning emerges in cumulative picture that results—excess emphasis on shareholder concerns can cause systemic damage.

I did not finish the paper persuaded that systems theory provides a viable basis with which to discipline management in a multiple constituency firm. But I am thinking about it. Meanwhile, this thought-provoking essay is the most constructive intervention on the constituents' behalf in a long, long time.

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