

# **Multinational enterprises and the law**

**Module A: MNEs in context**

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## Chapter 3 Company and international law

### Learning outcomes

By the end of this chapter, and the relevant readings, you should be able to:

- discuss the status of MNEs in international and company law
- list and describe the various types of MNE
- discuss the extent to which the legal forms adopted by MNEs match up with their actual control structures.

### Essential reading

- Muchlinski, P.T. *Multinational enterprises and the law*. Chapter 2 'Business and legal forms'.
- Hansmann, Henry and Reinier H. Kraakman 'What is Corporate Law?' in R. Kraakman, P. Davies, H. Hansmann, G. Hertig, K. Hopt, H. Kanda, and E. Rock (eds) *The anatomy of corporate law: a comparative and functional approach*. (Oxford: Oxford University Press, 2004) pp.1–19. Available at SSRN: <http://ssrn.com/abstract=568623>
- Bakan, J. *The Corporation*. (London: Constable, 2005) Chapter 1, 'The corporation's rise to dominance'.

## Introduction

We have a variety of aims to address in this chapter, but they follow two broad themes. The first is the status of MNEs in the eyes of the law (whether it be international law, or national company law). The second is the extent to which the law's view of MNEs accurately, or at least adequately, captures the realities of their operations.

## 3.1 How the law sees MNEs

### 3.1.1 Public international law basics

Public international law is the law that regulates relations between states. It is to be distinguished from private international law (also known as conflicts of law rules) which regulates the ways in which national courts deal with private (commercial, personal and so on) international disputes, including matters of adjudicative jurisdiction.

The sources of public international law are listed in Article 38(1) of the Statute of the International Court of Justice as:

- **Treaties:** which are entered into by specific states, in which they agree to abide by specific rules about particular topics. Treaties are broadly similar to contracts. Note that there is no multilateral treaty to comprehensively govern foreign direct investment or multinational enterprises, but there are bilateral, regional and multilateral treaties that govern aspects of those issues.
- **Customs:** which are principles commonly followed by states on the understanding that they are bound to do so. Customary law is somewhat similar to case law in the limited sense that a court will make a judgment based on what has been done before and on the

understanding that it is bound to do it. Note that there is very little customary international law in the field of foreign investment, with the exception of the matter of expropriation (the taking of private property by the state).

- **General principles of international law:** which 'are recognised as a source of law' but of a lesser weight than custom and treaty. Note that 'many of the claims as to the existence of principles of the international law on foreign investment have been based on general principles of law' and, as such, must 'be evaluated carefully'.
- **Judicial decisions:** which are the decisions of the International Court of Justice and represent 'a subsidiary source of international law'. Note that arbitral awards, which are relatively common in the field of foreign investment, are not binding on third parties, but they may 'provide evidence of possible norms which could be used for the construction of norms of international law'.

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**Source:**

M. Sornarajah 'Sources of international law in foreign investment' in *The international law on foreign investment*. (Cambridge: Cambridge University Press, 2010) third edition pp.79–87. [ISBN 9780521747653].

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### 3.1.2. MNEs in public international law

Under public international law, MNEs are considered to be 'non-state actors'. Non-state actors are defined negatively, by the fact that they lack one or more characteristics of a state. These are a permanent population, defined territory and government and the capacity to enter into relations with other states.

Malanczuk explains that the generally accepted categories of non-state actor are international organisations, insurgents and liberation movements, ethnic minority or indigenous peoples groups, non governmental organisations and individuals and companies. MNEs fall within the latter two categories.

The international legal status of MNEs is unclear and evolving. As Malanczuk explains, it is generally agreed that non-state actors have 'some degree' of legal personality in international law. However, the precise extent is much debated and is usually seen to be quite limited, certainly much narrower than that of international organisations.

This leaves MNEs in a complicated position with respect to international law. In general, international rules exist for the benefit of MNEs, but do they confer rights on MNEs? In this respect, MNEs have an international legal status strangely similar to that of animals, which are protected by law but cannot take independent action to demand such protection.

MNEs must usually rely on states to ensure they benefit from rules, and they cannot participate fully and independently in international institutions such as the World Trade Organisation (WTO). However, there are important exceptions to this state of affairs. In particular, MNEs may represent themselves independently in institutions such as the International Centre for the Settlement of Investment Disputes (ICSID) and the North American Free Trade Agreement (NAFTA).

This complexity has led José Alvarez (2010) to argue that the 'top-down' question of whether or not corporations are 'subjects' of international law is 'likely to lead to unintended consequences'. Instead, he argues, 'corporations, like international organisations, should more properly be seen as "participants" in international law (See further reading).

### 3.1.3 Some basic national company law

It has been the norm since the nineteenth century for large-scale businesses in all the major economies to use the legal form of **incorporation**. As Joel Bakan explains: 'The genius of the corporation as a business form, and the reason for its remarkable rise over the last three centuries, was and is its capacity to combine the capital, and thus the economic power, of unlimited numbers of people' (2004 p.8).

Corporations or companies are made up of shareholders, directors, officers and employees. If you are not familiar with the functions of these individuals, see 3.1.4 below.

Five characteristics are recognisable in corporations: legal personality, limited liability, transferable shares, delegated management under a board structure, and investor ownership. '[I]n market economies, almost all large-scale business firms adopt a legal form that possesses all five of the basic characteristics of the business corporation' (Hansman and Krakmaan 2009, p.1). Corporations have **full legal personality**, which allows them to enter into legal relationships in the same way as a human being. Second, that legal personality is separated from the legal personality of their owners (shareholders) and managers by a device known as the '**corporate veil**' or the '**veil of incorporation**' behind which regulators and judiciaries tend to be reluctant to look. Consequently, the **liability** of the shareholders is **limited** to the capital that they invest in it (that is, the purchase price of their shares). Together these legal characteristics mean that shareholders and managers of a company are able to do business through the corporation without putting their personal assets at risk. These and the remaining three characteristics (transferable shares, delegated management, and investor ownership) are discussed in the Hansmann and Kraakman reading.

As we will see, these characteristics are of particular interest to us when the shareholders of a company (subsidiary) are in fact another company (parent), as is the case in an equity-based MNE. They are also deeply controversial.

### 3.1.4 Who does what in a company?

A company's **shareholders** elect the directors of a company, to give or withhold approval for extraordinary actions, such as a merger with another company; and where necessary to use the courts to ensure that the company is run according to the law.

The **Board of Directors** appoints, supervises and determines the remuneration of the senior management of the company, decides the price of company shares and the amount of dividends to pay to shareholders and initiates extraordinary actions such as mergers.

Responsibility for the day-to-day management and operation of the company falls to the company **officers** – for example, the Chief Financial Officer (CFO). They will be supported by company **employees** such as factory workers, middle level managers and secretaries.

### 3.1.5 The dominance of the Anglo-American shareholder-oriented corporate model

Hansmann and Kraakman (2000) have argued that there is now also a convergence towards the particular type of corporate form known as the 'shareholder-oriented' model. Under this model, managers are to act solely in the economic interests of shareholders. This model is in contrast to the manager-oriented model which dominated the US in the 1950s and 1960s, the German labour-oriented model and the Asian/French state-oriented model. Hansmann and Kraakman attribute this convergence towards the Anglo-American model to the fact that companies following it have proven to be more profitable and to the increase in range (for example, the widespread ownership of shares in privatised companies) and activism of shareholders in recent decades.

This orientation towards the needs of shareholders, as opposed to the state or society, will be an important factor later in the course. (See for example Chapter 4: 'State-MNE-civil society relations'.) We will also examine the question of legal convergence further in Chapter 6: 'Creation and convergence of law'.

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**Source:**

Henry, Hansmann and H. Reinier Kraakman, *The end of history for corporate law* (January 2000). Yale Law School Working Paper No. 235; NYU Working Paper No. 013; Harvard Law School Discussion Paper No. 280; Yale SOM Working Paper No. ICF - 00-09. Available at SSRN: <http://ssrn.com/abstract=204528>.

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However, there remain distinct differences between different corporate legal and business systems. For example, the 'stark contrast' between US and German versions of corporate capitalism was illustrated by Curtis Milhaupt's and Katarina Pistor's account of the Mannesmann executive compensation trial (see further reading). In the context of negotiations for the merger of German firm Mannesmann with British telecommunications firm Vodafone in 2000, it was agreed that an 'appreciation fee' would be paid to the chairman of the Mannesmann management board. While in the US this would have been regarded as 'business as usual', in Germany it attracted the attention of the state prosecutor's office in Dusseldorf where Mannesmann has its headquarters (pp.70–71).

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## 3.2 Legal and business forms of MNE

It is possible to identify two main categories of MNE from the Muchlinski reading. First, there are formal MNEs, which may be either equity-based or contract-based. Second, there are informal MNEs. In the following subsections, these types of MNE are represented in diagrams for clarity. The important point stressed by Muchlinski is that the legal form and business form of MNEs do not always coincide.

### 3.2.1 Formal MNEs: equity and contract

An **equity-based** MNE is a collection of companies held together by share ownership in which units of the MNE owns shares in other units of the MNE. Well known variations on this form of MNE are:

- Anglo-American 'pyramid' group, in which a parent exerts top-down control on a subsidiary. (See Figure 3.1.)
- European transnational merger in which a unified management board controls a number of holding companies, which in turn control separate subsidiaries. (See Figure 3.2.)
- Japanese Keiretsu, in which there are extensive but small scale cross-shareholdings between companies in divergent sectors. (See Figure 3.3.)

A **contract-based** MNE exists where there is a long-term contractual relationship, which is aimed at distribution or production and in which one party retains some control over the other. The latter point is essential in order to distinguish between mere contractual relationships on the one hand and MNEs on the other. For example, the relationship between Nike and its suppliers can be said to be that of a contractual MNE (see Chapter 2: 'Globalisation and the rise of the MNE'). The Muchlinski reading outlines a number of variants to these two basic forms of MNE. These are summarised in Table 3.1.

The rising importance of contract-based MNEs is evidenced in the fact that the UNCTAD World Investment Report of 2011 was devoted to non-equity modes of international production and investment.

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**Source:**

UNCTAD (2011) *World Investment Report 2011: Non-Equity Modes of International Production and Development*. Geneva: UNCTAD. [www.unctad.org/Templates/WebFlyer.asp?intltemID=6018&lang=1](http://www.unctad.org/Templates/WebFlyer.asp?intltemID=6018&lang=1)

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### 3.2.2 Informal MNEs

Unlike the contract and equity MNEs set out in Table 3.1, **informal** MNEs have no legal form. Their business form is that of an informal alliance, involving the co-ordination of many business units. For example, a 'federation of companies' might hold minority shares in each other, and have common Directors. As a result, they may be able to act in concert. The benefits of this structure are that it is a flexible way to increase in size, and therefore in power, without necessarily attracting the regulatory attention that would exist if the relationship were more formal.

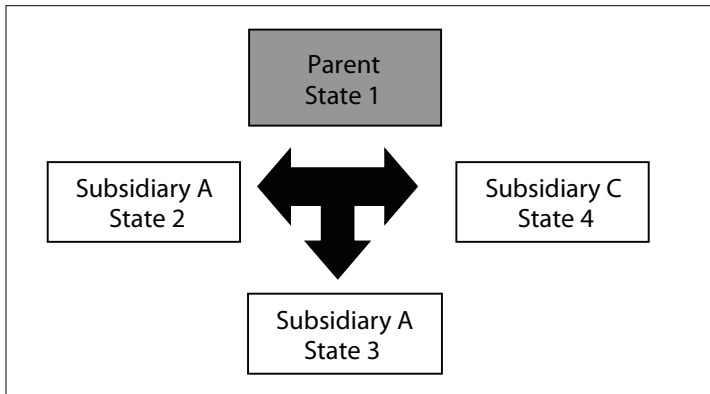
### 3.2.3 The significance of gaps between legal and business forms of MNEs

To what extent do the legal forms adopted by MNEs fit with their business form? In particular, since legal responsibility for an event usually lies with those who are in control of it, does control within the MNE lie in the place where the law expects it to be? Note that gaps will be important to a range of individuals, including:

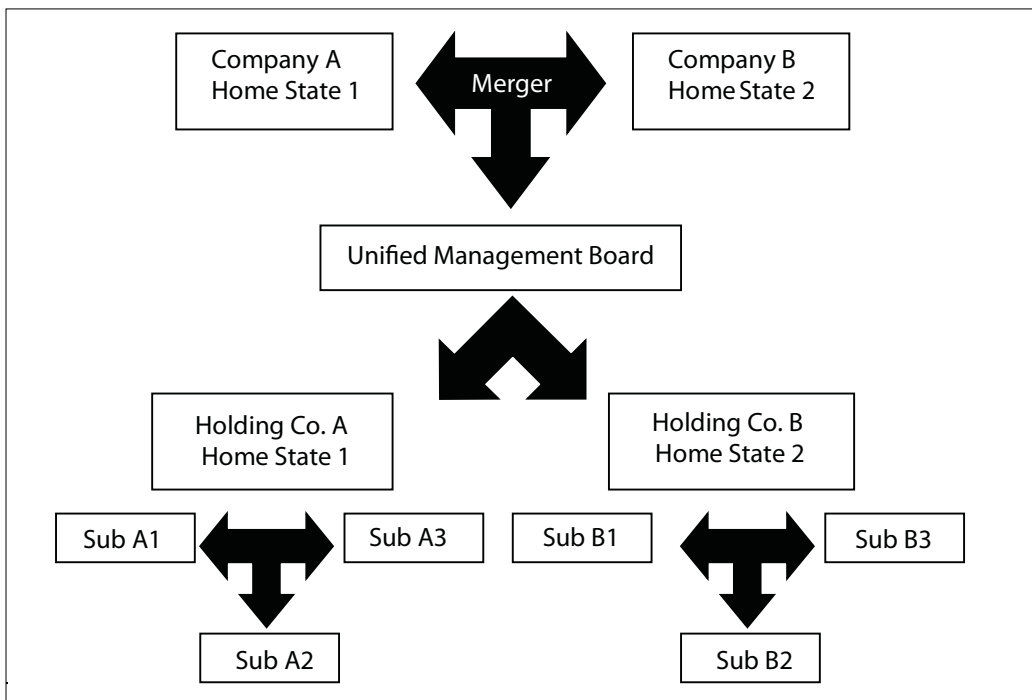
- Investors in an MNE – that is, their shareholders or voluntary creditors (such as banks).



- Regulators of MNEs, such as tax or competition authorities.
- Involuntary creditors or victims of an MNE (such as civil society representatives or victims of industrial disaster), who will want to attach liability for an action to the correct (wealthiest and, or most responsible) part of the MNE.
- Managers of MNEs, who will want to minimise or at least properly allocate, risk of liability.



**Figure 3.1: Anglo-American pyramid group**



**Figure 3.2: European trans-national merger**

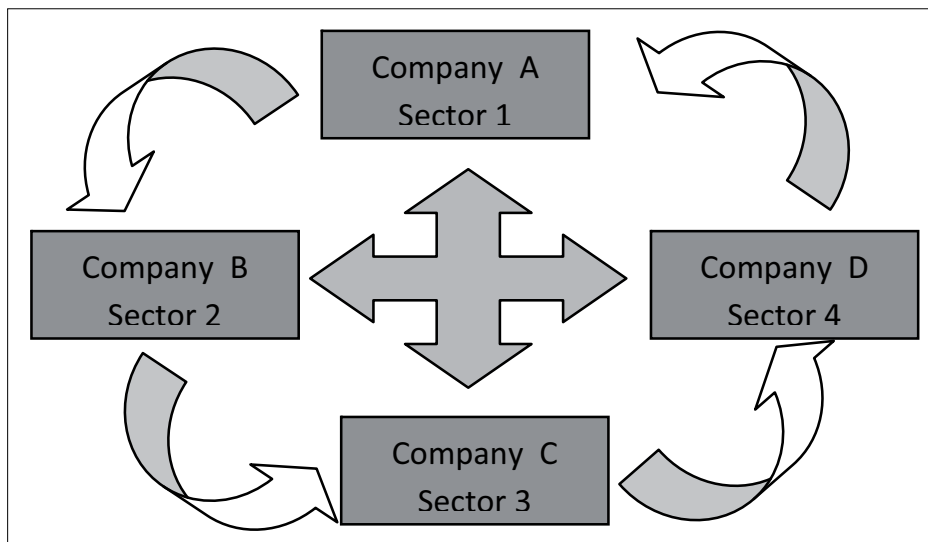


Figure 3.3: Japanese Keiretsu

	Legal form	Business form	Benefits
<b>Merger</b>	Equity	Total integration of two or more units.	Integration and economies of scale, with limited liability.
<b>Network organisation</b>	Contract	One-way dominance/control structure similar in effect to equity-based.	Flexibility, but with legal backup.
<b>Consortia and joint ventures</b>	Contract or equity	Two or more companies cooperate so as to act as a single entity for a 'specific and limited purpose'. Integration of business activities, even to a level found in mergers.	Integration and economies of scale, but limited to purpose at hand.

Table 3.1: Formal variants of the equity and contract MNE form

### 3.3 The corporation as psychopath?

As Joel Bakan explains: limited liability in particular 'had its detractors' from the outset. 'On both sides of the Atlantic, critics opposed it mainly on moral grounds. Because it allowed investors to escape unscathed from their companies' failures, the critics believed it would undermine personal moral responsibility, a value that had governed the commercial world for centuries.' (2004, p.10)

Bakan draws intriguing parallels between the characteristics of the typical corporation and those of a psychopath. Drawing on the expertise of psychologist Robert Hare, he argues that, like psychopaths, corporations (as distinct from their executives) 'singularly self-interested and unable to feel genuine concern for others.' More specifically, they are 'irresponsible', 'manipulat[ive]', 'grandiose' and interact only 'superficially' with others. Furthermore, corporations 'lack empathy', exhibit 'asocial tendencies', 'often refuse to take responsibility for their own actions' and are 'unable to feel remorse' (2004, pp.56–57).

To be clear, Bakan is arguing that when we give corporations legal personality, we must not forget that they are not human. We ought not to expect them to behave other than as psychopaths. We ought to regulate with that certainty in mind.

To explore this idea further see this 'chapter' documentary that accompanies Bakan's book:

- [3/23] 'A Legal "Person" The Corporation'  
<http://youtu.be/wkygXc9IM5U>

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### Reminder of learning outcomes

By this stage you should be able to:

- discuss the status of MNEs in international and company law
- list and describe the various types of MNE
- discuss the extent to which the legal forms adopted by MNEs match up with their actual control structures.

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### Self-assessment questions

1. Consider the following quotation. What is the status of the MNE under international law and why does it matter?  

'Writing in 1912, in his famous treatise on international law, L. Oppenheim still found: "Since the law of nations is based on the common consent of individual States, and not of individual human beings, States solely and exclusively are the subjects of international law." While states have remained the predominant actors in international law, the position has changed in the last century, and international organizations, individuals and companies have also acquired some degree of international legal personality; but when one tries to define the precise extent of the legal personality which they have acquired, one enters a very controversial area of law' (Malanczuk, 1997, p.91).
2. What is the relationship between the 'corporate veil' and the shareholders of a company?
3. The shareholder-oriented model has proved to be the most widely and enduringly popular corporate paradigm. Who or what is able to be a shareholder? What effect has the 'rise of a shareholder class' had on corporate governance?
4. Unlike the contract and equity MNEs informal MNEs have no legal form. What implications might this have for efforts to regulate MNEs?
5. To what extent has there been a convergence of laws (as well as practice) in the field of corporate governance? Is convergence likely to be good or bad for MNEs?
6. Consider the business structure of MNEs:
  - a. What is the distinction between the 'hierarchically' and the 'heterarchically' organised MNE?
  - b. What difficulties may be caused to the regulation of MNEs if the MNE form does not coincide with its business organisation?
  - c. In what ways is the joint venture distinct from the usual parent-subsidary relationship in corporate groups?

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**Useful further reading**
**Print**

- Alvarez, J.E. (2010) 'Are Corporations 'Subjects' of International Law?' NYU School of Law, Public Law Research Paper No. 10-77. Available at SSRN: <http://ssrn.com/abstract=1703465>
- A. De Jonge (2011) 'Bringing the TNC under the Jurisdiction of international law: Theory and Principles' in *Transnational Corporations and International Law: Accountability in the global business age*. [ISBN 9781849803687] Chapter 6.
- J. Bakan 'The corporation's rise to dominance' in *The Corporation*. (London: Constable, 2005) Chapter 1.
- Milhaupt, C. and K. Pistor (2008) 'The Mannesmann executive compensation trial in Germany' in *Law and Capitalism: What corporate crises reveal about legal systems and economic development around the world*. [ISBN 13 9780226525273] (London: University of Chicago Press) Chapter 4.
- Kraakman, R. R., P. Davies, H. Hansmann, G. Hertig, K.J. Hopt, H. Kanda and E.B. Rock *The anatomy of corporate law: A comparative and functional approach* (Oxford: Oxford University Press, 2003) [ISBN: 0199260648].
- Malanczuk, P. 'Introduction', 'Sources of international law' and 'International organisations, individuals and groups' in *Akehurst's Introduction to International Law* (London: Routledge, 2001) [ISBN 0415243564] pp.1-8, 35-51 and 96-104.
- Dine, J. 'Theoretical underpinnings of companies and their governance' in *The governance of corporate groups*. (Cambridge: Cambridge University Press, 2007) Chapter 1.
- Subedi, S.P. *International investment law: reconciling policy and principle*. (Oxford: Hart Publishing, 2008) [ISBN 9781841138794]. Chapter 1: 'Evolution of foreign investment law'.

**Web**

- [3/23] 'A Legal "Person"' The Corporation  
<http://youtu.be/wkygXc9IM5U>
  - The pathology of commerce  
<http://youtu.be/s5hEiANG4Uk>
  - American Society of International Law. [www.asil.org](http://www.asil.org).
  - British Institute of International and Comparative Law. [www.biiicl.org](http://www.biiicl.org).
  - Hansmann and Kraakman, 'The End of History for Corporate Law', 2000, NYU Center for Law and Business WP #CLB-99-013. [www.stern.nyu.edu/clb/99-013.pdf](http://www.stern.nyu.edu/clb/99-013.pdf).
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