

Understanding Real World Organizations

TSE M1 – Semester 1

October 2023

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Week 5: What's Special About Firms?

The separation of ownership and control

- Has been a management buzz-phrase since the 1940s but the underlying predicament is ancient
- Ideas need to work with resources, but those who have ideas do not necessarily own resources
- Why can't they simply sell their ideas?
- Managerial talent is as hard to transfer as ideas



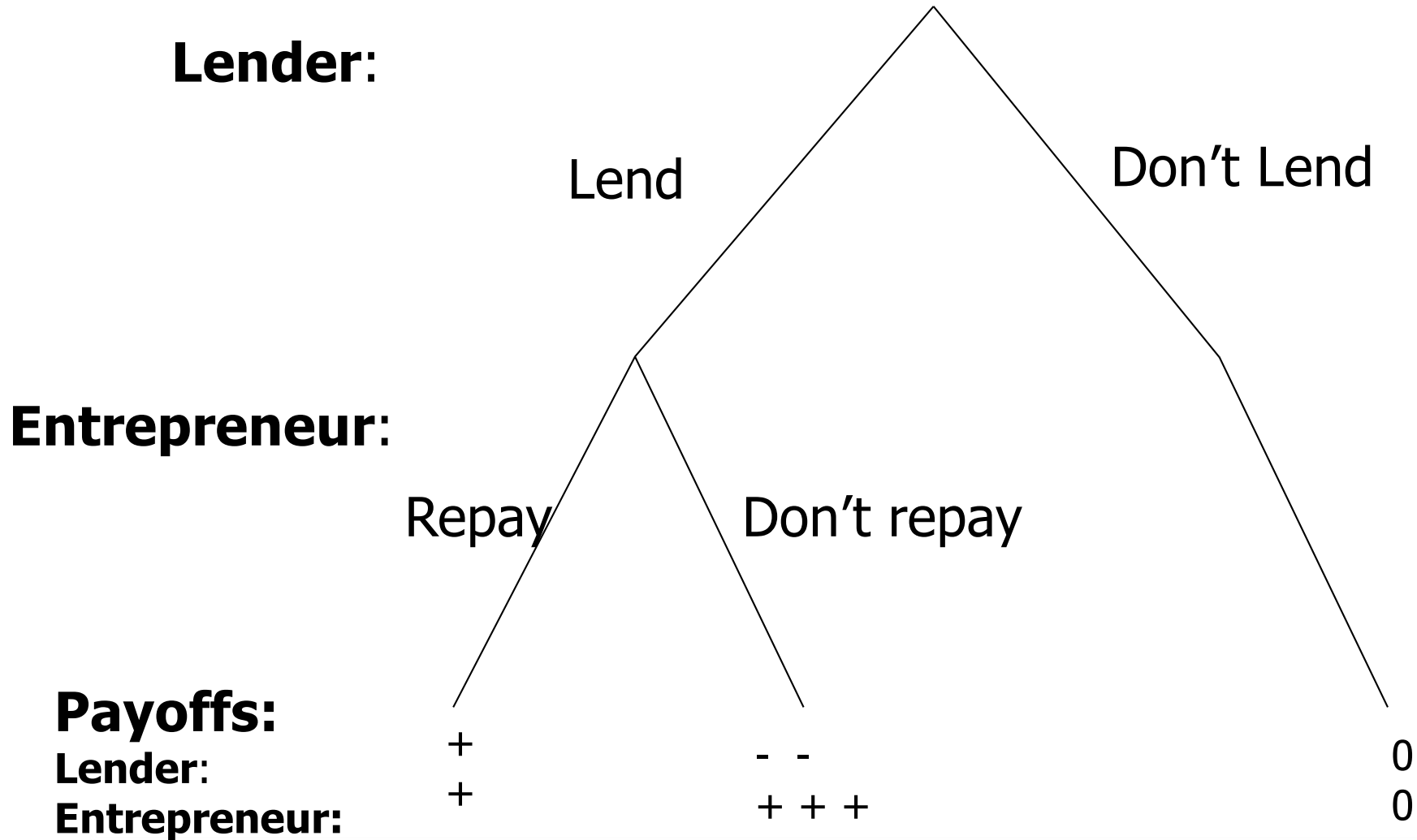
Ownership and control: why is there separation?

- In a modern economy many activities take place at too large a scale for one person to be the sole owner
 - Even if possible, it would not be a good idea for one person to concentrate wealth in one activity (very risky)
 - So often collective ownership by many shareholders
 - Even if one owner, cannot manage all activities; need to employ manager(s)
 - How to make the manager act in interests of owner(s)?
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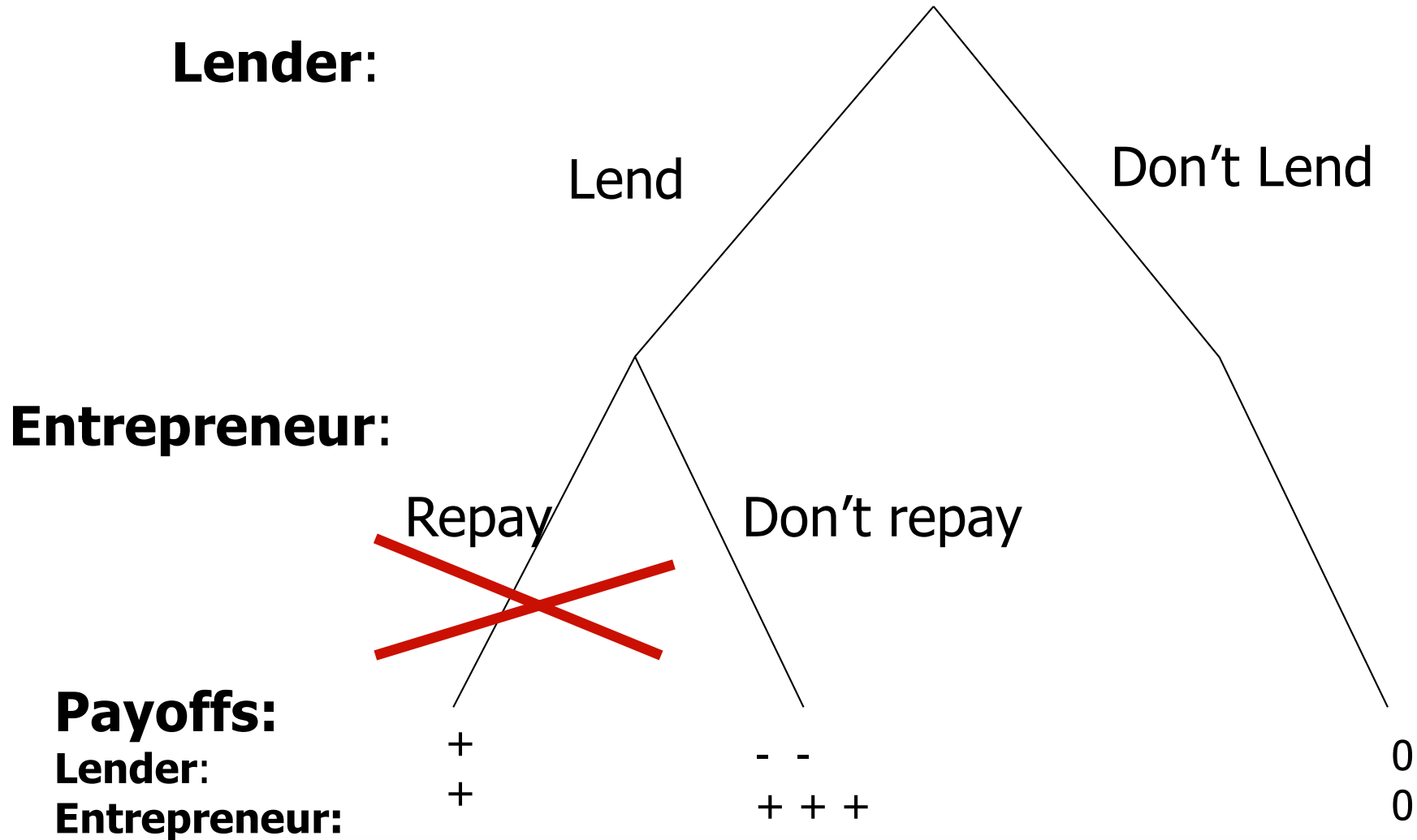
As the firm grows, what can its owner do?

- The owner may need to hire managers
 - How to motivate them to work effectively?
 - The owner may need outside finance
 - How to make a credible promise of repayment?
 - Owner may be willing sincerely to promise \$1 million repayment for an investment yielding \$1.2 million
 - But repayment promise may not be credible – because of limited liability which, was necessary for the investment
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The Investment Game:



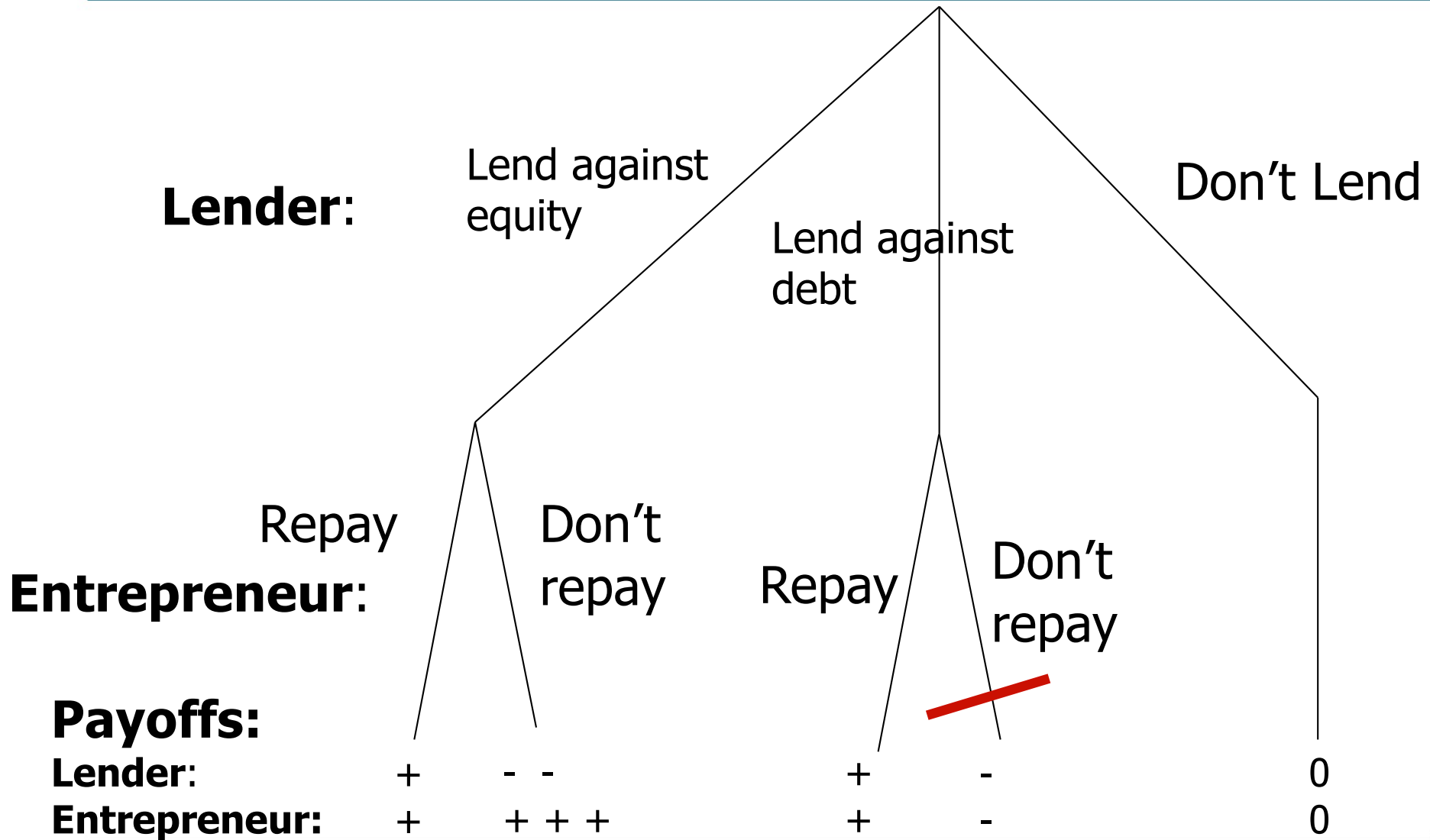
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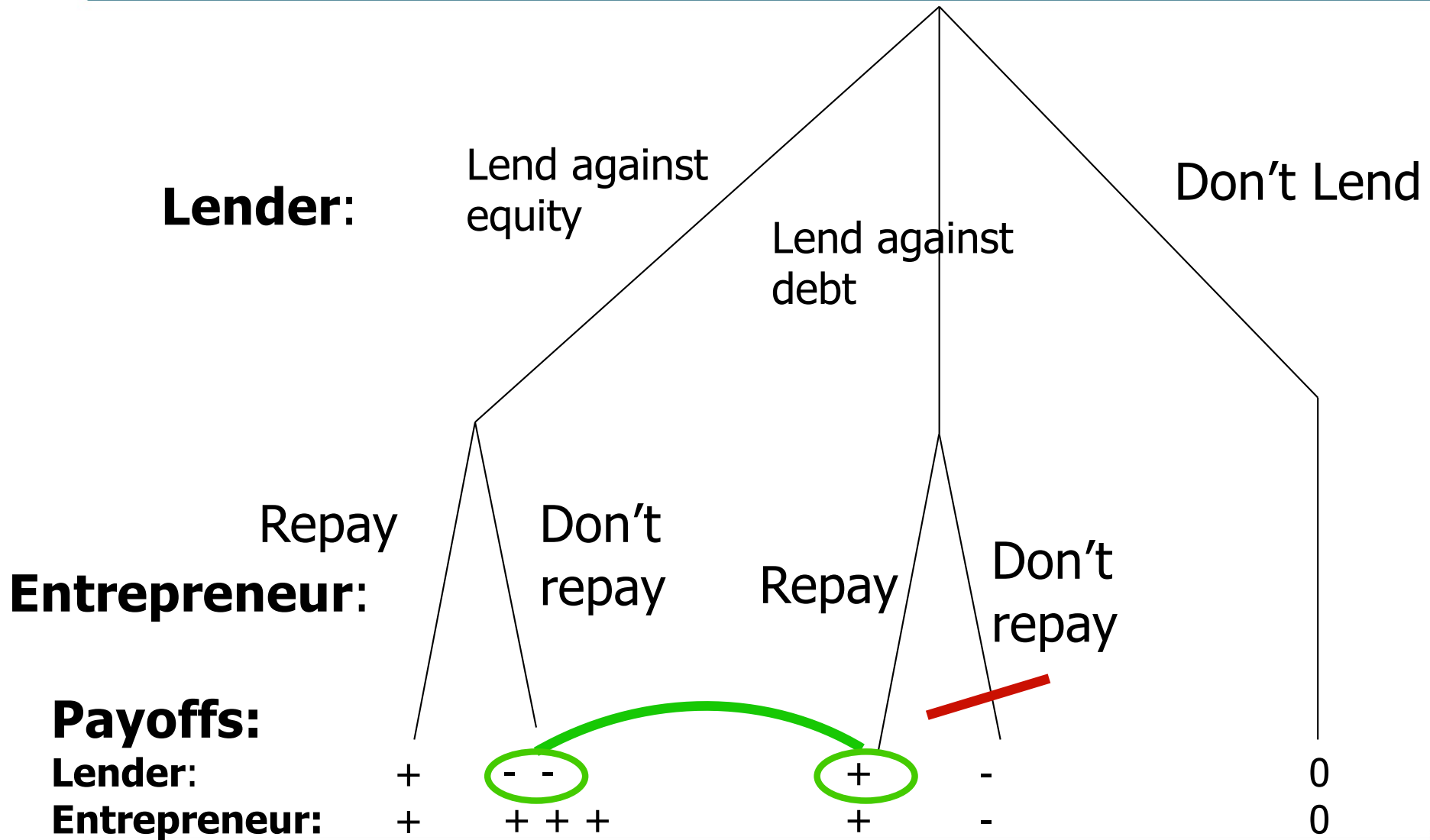
Two alternatives: debt and equity

- Equity means giving rights of ownership to suppliers of outside finance - they have rights to affect management decisions
 - Debt does not involve ownership rights – so no right to affect management decisions
 - But debt involves inflexible repayment commitments – enforced by an outside authority (the courts)
 - You can't have both – if you want flexible repayments you must give up some ownership rights
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The Investment Game with debt and equity:



The Investment Game with debt and equity:



Firms in law: three legal ideas that define the modern corporation

- Legal personhood – the concept goes back at least to Roman times
 - Tradable shares - we have evidence of this from around 1250 (Bazacle in Toulouse)
 - Limited liability – consolidated by UK Companies Acts of the 19th century and rapidly copied in other jurisdictions
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The prehistory of the modern firm

- Families, Gangs, Armies, Traders
 - Temples, Kingdoms, Imperial works
 - Roman *societates*
 - Medieval guilds
 - The first shareholding enterprises
 - Chartered trading companies
 - Royal manufactures
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