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Foreword

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The economy itself is commonly discussed as if it is a goal in its own right rather than a means to an end. The result is economic growth pursued at all costs, without sufficient consideration of its implications for human well-being, equality, social costs, environmental limits, or their interconnection with each other – a socially disembedded version of the economy.

Karl Polanyi's argument, that attempts to disembed the economy from social norms will inevitability result in society re-asserting control over economic activity as the social costs of self-regulating markets become too great to be tolerated, has clear resonance today. We find ourselves poised in the UK to impose regulation on the banking sector with a view to increasing financial stability and reducing the impact of speculative behaviour in that market, in response to the 2008 financial crisis and the faltering global economy. At the global level, we see the increasing recognition of the devastating impact human beings and the unconstrained pursuit of economic growth has had on degradation of ecosystems.[1] If continued unabated, this degradation will pose a major threat to the well-being of future generations. Added to these is the dismal indictment that, despite its economic wealth, the UK has been unable to eradicate its problems of poverty and deprivation.

Karl Polanyi's contribution to economic debate was to demonstrate that, left to their own logic, unregulated markets do not achieve rational and equitable outcomes. He challenged as false utopias self-regulating markets framed both by classical economics and central planning. Instead, he helpfully focused discussion on finding a balance between market and non-market mechanisms, private and public, and the individual and the community.

At **nef** (New Economics Foundation) we argue that the purpose of the economy should be to enhance the well-being of the citizens of the country, in a way that is socially just and environmentally sustainable.

Subordinating the economy to these goals would require a transformation of the economic system in terms of how we value and measure progress, organise markets and structure business. Value determines how we prioritise our activities and allocate scarce resources. If we rely on unregulated markets to price everything then we find ourselves in a situation where we only value something once it is scarce. Comparing the social usefulness

1 Millennium Ecosystem Assessment, *Synthesis Report*, p. 10, www.millenniumassessment.org/documents/document.356.aspx.pdf.

and relative prices of two natural resources – diamonds and water – illustrates this absurdity. The strength of the market as an allocation function could be harnessed to drive towards positive goals, as opposed to constantly undermining them. Market prices, enhanced through the tax system, could ensure that socially desirable "goods" are cheap and socially undesirable "bads" are expensive. Other mechanisms and approaches to socialising economic relationships are debated in the following papers.

This special issue of *NILQ* represents a timely and much needed contribution to the debate about the opportunities of and limits to socialising economic relationships.

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Socialising economic relationships: a critique of business regulation – introduction

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Reforming business regulation?

The 2008 financial crisis and the continuing global economic downturn raise urgent and important questions about the capacity of legal regulation, first and foremost to control business activity, but also to promote economic growth. The editors of this special issue thus seek to explore the contribution of socio-legal scholarship to regulatory reform debates. We want to develop a debate that transcends the dichotomy between "more and better" state regulation and faith in self-regulating markets. We therefore organised in April 2010 a workshop at the Centre for Socio-Legal Studies, Oxford University[1] that discussed the opportunities for and limits to socialising economic relationships as a tool for both regulating and enabling business activity. The work of the nineteenth and early twentieth-century economic sociologist, anthropologist and historian, Karl Polanyi, provided a key reference point.

Karl Polanyi analysed, in his classic study *The Great Transformation*,[2] various ways of organising economic activity across a range of contexts, including tribal societies in Western Melanesia, medieval European economies, mercantilism and, most importantly, industrial capitalism in eighteenth and nineteenth-century England. Polanyi argued that industrial capitalism in England was associated with a disembedding of economic out of social relationships. It gave rise to the "market society" in which society becomes a mere adjunct to the operation of markets.[3] Polanyi therefore perceived industrial capitalism as a radical break with previous forms of organising, including regulating economic exchange, such as

1 We gratefully acknowledge financial support for this workshop by the UK Socio-Legal Studies Association through its annual seminar competition. We also thank a number of colleagues who contributed to the discussions and commented on draft papers: Anthony Bradney, Christopher Decker, Tricia Feeney, Tom Gibbons, Paddy Ireland, Angus Johnston, Kieran Kelly and Mike Varney. A selection of papers from the workshop is published in this special issue of the *NILQ*.

2 K Polanyi, *The Great Transformation: The political and economic origins of our time* (Boston: Beacon Press 1944).

3 Ibid. p. 74.

"redistribution",[4] "householding"[5] and "reciprocity".[6] His account of the rise of industrial capitalism includes a harrowing portrayal of the social side-effects of this great transformation,[7] such as poor living conditions of urban workers and the loss of dignity of an unemployed reserve army of labour, driven off the land during the enclosures, but kept alive by parishes through basic poor law relief.

Polanyi's key contribution to regulation studies is his claim that self-regulating markets are a myth and that society will ultimately always reassert itself and control the conduct of economic activity. He argues that the disembedding of economic out of social relationships, for instance, through the rise of markets in the fictitious commodities of land, labour and money, is always accompanied by a counter-movement through which society re-embeds economic relationships into social norms. Hence, our workshop sought to explore what such a counter-movement may look like in the context of contemporary UK business regulation. Are we really witnessing a rise in socialised economic activity, facilitated through co-operatives, stewardship models of shareholding and "open corporations" that seek to mitigate their social and environmental impacts? Is state regulation which limits competition in some markets on public interest grounds an example of re-embedding economic into social relationships? What does socialising economic activity actually entail and what are its regulatory consequences?

Why Polanyi?

We chose Polanyi's work as the starting point for our workshop because his sociological approach departs from Marxist economic determinism and neoclassical economics. The latter has been predominant in contemporary public policy debates and also influential in North-American regulation studies. But we also critically interrogate Polanyi's work in the context of contemporary regulation. Since Polanyi wrote *The Great Transformation* in the early 1940s[8] globalisation has accelerated and intensified. "Embedding economic in social relationships" is potentially becoming more difficult given increased international mobility of capital and a lack of consensus – in a highly pluralistic "world society" – about the social norms in which economic activity should be embedded.

From public policy debates to an economic sociology of law

This special issue contributes to two interlinked debates. First, a public policy debate initiated by the current UK conservative–liberal Coalition government explores how the vision of a "Big Society" can be realised. This debate examines how the role of social enterprises and voluntary organisations can be increased, not only for generating business activity, but also for providing welfare services, a "counter-regulatory move" that addresses the social side effects of a market-based economic system. The current UK government's

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4 Redistribution involves the storage of agricultural produce by community leaders. Thus, it is a form of taxation for public purposes, or can be used for the defence of the community, or enables foreign trade when exchanged with other groups (Polanyi, *The Great Transformation*, n. 2 above, p. 50).

5 Householding involves organising economic needs and productive capacities around the kinship or employment bonds of a family unit, settlement or the manor.

6 Reciprocity involves organising garden and household economy through social relationships among the members of a community who produce for "non-economic ends", such as display of skill in agricultural production and free gifts (Polanyi, *The Great Transformation*, n. 2 above, pp. 48–9).

7 Polanyi also uses the term transformation to refer to the failure of market society and the rise of fascism in the 1930s in Germany. S Frerichs "Re-embedding neo-liberal constitutionalism: a Polanyian case for the economic sociology of law" in C Joerges and J Falke (eds), *Karl Polanyi, Globalisation and the Potential of Law in Transnational Markets* (Oxford: Hart 2011), p. 72.

8 F Block, "Karl Polanyi and the writing of *The Great Transformation*" (2003) 32(3) *Theory and Society* 276.

Big Society initiative[9] claims to empower citizens and communities in a way that seems to chime with Polanyi's assertion of the democratic primacy of society. The Big Society[10] programme seeks to strengthen the role of the third sector, such as charities, voluntary organisations, mutuals,[11] co-operatives and social enterprises, in delivering and regulating public services in particular at a local level, as well as in rekindling economic growth. But the UK government's Big Society agenda diverges from Polanyi's idea of embedding economic into social relationships in three key regards. First, it deregulates. In particular, traditional legal employment, contract and administrative regulations (e.g. licensing) are proposed to be relaxed for third-sector organisations, in order to facilitate their development. Second, while Polanyi was highly critical of self-regulating markets as the dominant form for organising economic activity, the UK government does not envisage third-sector models of organising and regulating economic activity to replace markets. For instance, the newly set up[12] Big Society bank – called Big Society Capital – which is in fact not a licensed bank but a vehicle for developing social investment funds[13] – seeks to stimulate a "sustainable market in social investment" in the UK, including "social impact bonds"[14] and a secondary market in social investment securities. Big Society Capital seeks to facilitate social entrepreneurs' access to conventional capital markets. Third, in contrast to Polanyi's emphasis on co-operative social relationships framing economic activity, for instance, in the case of redistribution and reciprocity, the market-inspired principle of competition is at the heart of the UK government's Big Society approach towards regulation, public services and economic growth. For example, third sector organisations will have to compete with state public service providers and private businesses when tendering for the delivery of welfare state services.

Hence, the UK government's Big Society vision constitutes a particular way of thinking about relationships between economy, society, the state and law. Different ways of thinking about such relationships are opened up, secondly, through debates in the developing field of the economic sociology of law.[15] Economic sociology of law[16] questions the rhetorical

9 This Big Society discourse is being institutionalised through an Office of Civil Society which has been set up as part of the Cabinet Office and which is supported through a Minister for the Big Society who is responsible for charities, social enterprises and voluntary organisations.

10 While Polanyi defines society in terms of a national policy, the Conservative–Liberal UK Coalition government understands society in narrow and potentially parochial terms as "families, networks, neighbourhoods and communities" (*Building the Big Society*, the government's Big Society programme, at www.cabinetoffice.gov.uk/content/big-society-useful-links, p. 1).

11 Such as public sector mutual joint ventures through which public sector employee co-owned organisations are established that deliver public services. An example of this is My Civil Service Pension (MyCSP) which provides civil service pension administration. These mutual joint ventures can include private companies. The operation of these public sector joint mutuals reflects Big Society themes: 1% of MyCSP net profits will be paid to charities and community projects nominated by employee partners, 1% of partners' time will be spent on local charity and community projects and 1% of its staff will be apprentices and interns. Public sector mutual joint ventures expand the contracting-out agenda of previous UK governments by now including the third sector in the delivery of public services.

12 Launched on 29 July 2011.

13 Such as venture funds, community asset funds, property funds and microfinance funds.

14 "The Big Society Bank: outline proposal", May 2011, at: www.cabinetoffice.gov.uk/content/big-society-capital, p. 5.

15 See e.g. R Swedberg, "The case for an economic sociology of law" (2003) 32 *Theory and Society* 1–37; Frerichs, "Re-embedding neo-liberal constitutionalism", n. 7 above, p. 66; J Caporaso and S Tarrow, *Polanyi in Brussels: European Institutions and the Embedding of Markets in Society*, RECON Online Working Paper 2008/01, www.reconproject.eu.

16 Defined as "a sociological analysis of the role of law in economic life", R Swedberg , "The case for an economic sociology of law", n. 15 above, p. 1.

images of economic life. It develops careful empirical and theoretical accounts of how specific legal concepts which frame economic life, such as property, both private and communal, the corporation and contracts, are sociologically constituted.[17] This special issue seeks to demonstrate the value of linking sociology of law and economic sociology in the newly developing field of economic sociology of law. While sociology of law has already made a significant contribution to understanding business regulation, for instance, by drawing attention to the social processes that inform the development and enforcement of state law and which help to explain why "business law in action" takes the form it does,[18] this is not quite the case for economic sociology. As the contributions to this special issue show, theoretical and empirical sociological analysis of actual business behaviour renders explicit what role political institutions,[19] social interactions,[20] norms[21] and networks[22] play in regulating production and consumption. Hence, an economic sociology of law provides a fertile ground for a critique of contemporary UK business regulation and UK public policy debates about the Big Society. This special issue thus contributes to both normative and analytical debates within an economic sociology of law, by probing the normative claim that business regulation should seek to embed economic into social relationships that express the interests of whole "communities of fate", rather than merely those of rational individual economic actors. It also addresses the analytical claim that some UK business regulation already involves an embedding of economic into social relationships.

Socialising economic relationships through contemporary UK business regulation?

The articles in this special issue comprehensively shed light on Polanyi's idea of embedding economic into social relationships because they examine a range of different business activities, including those of the private modern corporation that trades in competitive markets as well as state-subsidised corporate activity, such as that of the BBC and the new Lloyds banking group, which has been recapitalised by the British taxpayer.[23]

Part I of the special issue starts off with a conceptual discussion of what "embedding economic into social relationships" actually means by critiquing Polanyi's work with reference to Roger Cotterrell's contemporary sociology of law and Karl Marx's social theory. Amanda Perry-Kessaris argues that we can understand more about the role of law in promoting the embedding of economic into social relationships if we see law through Cotterrell's "lens of community". Communities, often internally pluralistic and potentially conflictual, are recognised as shaping whether and how state law can regulate business behaviour. Amanda Perry-Kessaris thus links in an innovative way contemporary sociology of law debates about law's grounding in community bonds with an economic sociology perspective that maps how business activity becomes disembedded out of social

17 Swedberg, "The case for an economic sociology of law", n. 15 above, pp. 12, 29.

18 And thereby provides an important critique of the influence of economic analysis of law, informed by neo-classical economics, on regulation studies.

19 See, for instance, N Fligstein, "Markets as politics: a political–cultural approach to market institutions" (1996) 61(4) *American Sociological Review* 656–73.

20 See, e.g. Swedberg's discussion of the development of a medieval *lex mercatoria* which emerged out of merchants' practices, for instance, during the Champagne Fairs in France. Swedberg, "The case for an economic sociology of law", n. 15 above, p. 13.

21 V Zelizar, *Markets and Morals* (Princeton, NJ: Princeton University Press 1983).

22 M Granovetter, "Economic action and social structure: the problem of embeddedness" (1985) 91(3) *American Journal of Sociology* 481–510.

23 Part II examines the corporate economy, while Part III discusses hybrid economic actors that straddle the distinction between the corporate and the state economy. This special issue leaves for further analysis the household economy and the significant role of gender in shaping its economic relationships. Swedberg, "The case for an economic sociology of law", n. 15 above, pp. 15, 29.

relationships and potentially threatens the survival of communities. The World Bank's Investment Climate Programme and the securitisation practices leading up to the 2008 financial crisis serve as two highly topical examples of disembedding in her analysis.

The next article by Grietje Baars provides a thought-provoking radical critique of what she considers as Polanyi's rather limited regulatory reform agenda. She questions his claim that state law can make a significant contribution to the embedding of economic into social relationships, on the grounds that law itself reflects the commodity form. She also casts doubt on the very idea of corporate social responsibility – a potential example of embedding economic into social relationships – because it "marketises morality". Her article thus engages with a key dilemma: is law dependent on society and economy or can it independently shape economic and political activity?

The following five articles in Part II present a range of specific case studies about the legal regulation of corporate actors with a view to identifying opportunities for and limits to "embedding economic into social relationships". The first two articles, by Wilson and Talbot discuss UK company law, while the three following, by Marzo, McCormack and Thomas, consider how transnational legal and organisational frameworks affect the way corporate actors conduct business. Wilson continues an incisive critique – begun by Baars – of the modern corporation as disembedding economic out of social relationships. He further develops a Polanyian analysis by suggesting that Ulrich Beck's notion of risk regulation in reflexive modernity is the contemporary way of thinking about "embedding economic into social relationships". He charts a change in the conception of the modern corporation from the nineteenth-century vision of the limited liability company as a relatively autonomous economic entity, distinct from the social sphere, to a conception of the corporation in the twenty-first century that seeks to open it up to the social sphere. Despite its potential to do so, given current evidence of limited shareholder activism, he doubts, however, whether s. 172 of the Companies Act 2006 will push directors to do much to remedy the impact of their companies on the environment and the community.

Like Wilson, Talbot, in the next article, is sceptical about the prospects for shareholder activism and its capacity to re-embed the corporation into social relationships. She argues, as Baars and Thomas do, that socialising economic activity will be limited if economic life is mainly organised through markets which are based on private, including financial, property. She suggests that the contribution of a stewardship model of shareholding to socialising economic relationships is limited because it has to operate within a system of corporate governance that is geared towards profit maximisation.

Marzo's article further updates Polanyian analysis by considering techniques for embedding economic into social relationships in a transnational sphere, beyond the nation state. She analyses international framework agreements (IFAs) as voluntary regulation of labour standards shaped by power relationships between multinational companies and international trade unions. Her legal analysis of the nature and enforceability of IFAs prompts us to think about what needs to happen in order for economic relationships to become really "embedded" in social relationships.

McCormack's article continues the analysis of business regulation in a transnational sphere. He discusses the attempts of the United Nations Commission on International Trade Law (UNCITRAL) to establish a global, "liberal" secured credit law regime through its Legislative Guide, modelled on Article 9 of the US Uniform Commercial Code. His analysis is highly topical because easier access to more secure and thus cheaper credit is considered as a key lever for stimulating economic growth and tackling the financial crisis in the US and Eurozone member states. McCormack argues that a Polanyian perspective requires to pay greater attention to local social contexts that shape business transactions and the uptake of credit, as well as existing national credit laws. His article links in an innovative way sociology of law debates about the limits of legal transplants with an empirical economic sociology perspective that questions whether well-documented private property rights really are prerequisites for well-functioning markets in credit.

Thomas' article concludes the discussion in Part II of the special issue through a critical examination of co-operatives as a particular organisational form for facilitating and regulating business activity. She argues that some co-operatives can be perceived as an "epistemic community" that challenges policymakers and researchers to think more creatively and radically about regulating business activity. Industrial democracy, including changed social relationships between workers themselves, and more cooperative relationships between production units and the communities in which they are embedded, can constitute new forms of business self-regulation. She provides a fascinating account of the worker takeovers of factories in the aftermath of the Argentine debt crisis in 2001. In her analysis, disengagement from financial markets that are underpinned by private property is an important condition for the success of cooperatives, a point illustrated also by the experience of demutualisation of building societies in the 1980s in the UK.

The final part of this special issue examines the contribution of the concept of competition and competition law to the embedding of economic into social relationships. It thus further tackles the conundrum – touched upon in some of the articles in Part II – that law's role in embedding economic into social relationships is ambiguous. Law can both disembed, but also re-embed economic into social relationships. It is also unclear which legal forms embed and which disembed.[24] Competition law is a paradigmatic example here. It can, in Polanyian terms, disembed economic out of social relationships by promoting allocatively efficient and competitive self-regulating markets. It can also re-embed economic into social relationships when rendering uncompetitive behaviour lawful on public interest grounds. Moreover, as state regulation which seeks to reduce monopolistic business activity, competition law is part of the "double movement" that constitutes markets in the first place. Andriychuk starts the discussion in Part III by exploring economists' focus on perfect competition. He argues that, even though welfare economists reduce social interests to cost–benefit analysis, their analysis can still contribute to tackling the Polanyian challenge: how to actually achieve the embedding of economic relationships into social ones in order to maintain stability and social cohesion in societies. Andriychuk, however, concedes that the contribution of neoclassical economics is limited when its analytical claims about how markets operate become blurred with normative claims about how they should operate.

Stephan's article puts Andriychuk's abstract discussion into a concrete context by examining whether the approval of the merger between the two UK banks, Lloyds and HBOS, in the wake of the 2008 financial crisis, signalled the end of "economics-based" merger regulation. The merger was authorised by the Secretary of State for Business, with the consent of Parliament on the basis of a newly created public interest ground, "maintaining the stability of the UK financial system", though it had been opposed by the Office of Fair Trading on competition grounds. Departing from a Polanyian perspective,

24 This is an unresolved point in the contemporary economic sociology literature. Some contributors consider contract as disembedding because it promotes in Toennies' terms a shift from *Gemeinschaft* to *Gesellschaft* (K Gemici, "Karl Polanyi and the antinomies of embeddedness" (2008) 6(1) *Socio-Economic Review* 19) while others consider the negotiation of contractual terms in particular for long-term contracts as reducing the "marketness" of an economic transaction and thus as embedding economic relationships into the negotiated social contract norms (F Block, "Contradictions of self-regulating markets" in M Mendell, and D Salée, *The Legacy of Karl Polanyi: Market, state and society at the end of the twentieth century* (London: Macmillan 1991), p. 90.

Stephan argues that this merger should be seen as exceptional and he therefore makes a case for competition law to maintain the operation of self-regulating markets.

Harker's article moves the discussion to a new cutting-edge field of economic activity, the development of new media markets. His article questions the value of competition in such markets, as championed by neoclassical economists. Limiting competition can, for instance, ensure that sufficient revenue is generated for broadcasters in order to pursue public service values that promote citizenship, social cohesion and cultural as well as educational objectives. Harker's article is a powerful illustration of Polanyi's idea of the "always embedded economy". He suggests that existing public service broadcasters, such as the BBC, shape viewers' preferences and thus frame and embed the market also in new commercial broadcasting services. His analysis also further develops Polanyi's ideas by highlighting the contribution of modern technology to disembedding economic out of social relationships. Digital broadcasting, for instance, has accelerated the commodification of broadcasting services.

To conclude, the articles in this special issue provide fascinating and stimulating reading for regulation researchers and public policymakers who want to think about reforming business regulation in light of conceptual discussions about economy, society, state and law intersections in the developing field of the economic sociology of law.

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Part I: Conceptual perspectives

Reading the story of law and embeddedness through a community lens: a Polanyi-meets-Cotterrell economic sociology of law?

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Abstract

In this article I propose that the role of law in Karl Polanyi's concept of the "always embedded economy"[1] *can be enriched by the application of the "lens of community"*[2] *developed by Roger Cotterrell.*[3] *I begin with Polanyi's suggestion that economic action and interaction are always "embedded" in wider social life. Reading through the lens of community, we can be more specific: any actor is at once engaged, to different degrees (from fleeting to stable), in multiple types (whether focusing on instrumental, traditional, affective and/or belief-based action) of social life. I then explore a second, implicit, cornerstone of Polanyi's argument: that analytical and normative approaches to economy may become* dis*embedded from wider social life. Reading through the lens of community we can again be more specific: in the transformation to a market society, the analytical and normative approaches that are central to economic actions and interactions are confused with, and privileged over, those that are central to non-economic actions and interactions. This confusion and privileging can have what we might call a performative effect on action and interaction. Finally, I explore Polanyi's story of law as a facilitator both of disembedding movements and of re-embedding counter-movements. The application of a law-and-community lens suggests some additional details of that storyline and that there are additional plotlines to be pursued. The practical potential of this Polanyi-meets-Cotterrell economic sociology of law is briefly illustrated with references to two twenty-first-century cautionary tales: the World Bank's investment climate programme and the 2008 financial crisis.*

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* Professor of International Economic Law, a.perry-kessaris@soas.ac.uk. With thanks to Bettina Lange and Dania Thomas for organising the Socio-Legal Studies Association Workshop on Socializing Economic Relationships (Oxford Centre for Socio-Legal Studies, April 2010) for which this article was originally prepared; to the British Academy for my Research Development Award; to Diamond Ashiagbor, Roger Cotterrell, Deval Desai, Ben Fine, Terrence Halliday, Martin Krygier, David Nelken, David Schneiderman, Chandra Sriram and an anonymous reviewer for deep and insightful comments; Sabine Frerichs for sharing her work; and to the members of the SOAS Economic Sociology of Law Reading Group for a chance to mull things over.

1 F Block, "Karl Polanyi and the writing of *The Great Transformation*" (2003) 32 *Theory and Society* 275.

2 A Perry-Kessaris, *Global Business, Local Law: The Indian legal system as a communal resource in foreign investment relations* (Aldershot: Ashgate 2008).

3 R B M Cotterrell, *Law's Community: Legal theory in sociological perspective* (Oxford: Clarendon 1996); "Seeking similarity, appreciating difference: comparative law and communities" in A Harding and E Örücü (eds), *Comparative Law in the 21st Century* (London: Kluwer Law International 2002); "Community as a legal concept? Some uses of a law-and-community approach in legal theory" 2 *No[Foundations] Journal of Extreme Legal Positivism* 15; and *Law, Culture and Society: Legal ideas in the mirror of social theory* (Aldershot: Ashgate 2006).

Introduction

The Great Transformation is among the most-rifled of academic works. The theme of embeddedness that weaves through the book, albeit often unnamed,[4] has been a rich source of inspiration for sociologists, political scientists and heterodox economists, and, more recently, legal scholars.[5] Karl Polanyi's key contention with respect to embeddedness is that, during the transformative period of the Industrial Revolution, "market liberals wanted to embed society in the autonomous economy, but their project *could not* succeed" for two reasons: economies are always in fact embedded in society, and "market economies are dependent upon the state to manage the supply and demand for the fictitious commodities" of land, labour and money.[6]

One reason why the "concept of the always embedded economy"[7] has such broad appeal is that it has implications across four social levels: the "micro" level of individual actors and their *actions*; the "meso" level of *interactions* between actors; the "macro" level at which those interactions aggregate into the institutions of social regimes; and the meta-level of *rationalities* – "the basic principles" which underlie and direct social regimes.[8] Put in these terms, Polanyi's own analysis of embeddedness can be said to have focused on how our meta-level thinking and our macro-level policies in respect of economy were first disembedded from wider social life in the course of the Industrial Revolution and then re-embedded in wider social life through regulatory counter-movements.

The naturalisation of once-radical theories often involves awkward estrangements, so it is perhaps unsurprising that some putative "Polanyians" have stretched the fabric of his conceptual framework and muted the colour of his moral outrage. Polanyi laid his normative cards flat out on the table, as the following passage demonstrates:

> [N]othing saved the common people of England from the impact of the Industrial Revolution. A blind faith in spontaneous progress had taken hold of people's minds, and with the fanaticism of sectarians the most enlightened pressed forward for boundless and unregulated change in society. The effects on the lives of people were awful beyond description. Indeed, human society would have been annihilated but for protective counter-moves which blunted the action of this self-destructive mechanism.[9]

By contrast, the economic sociologists for whom his work is a touchstone have often refused to make "normative conclusions about the subject-matter at issue".[10] For example, Richard Swedberg based his case for an economic sociology of law in part on the need to

4 Fred Block has argued that: "Polanyi glimpsed the idea of the always embedded market economy, but he was not able to give that idea a name or develop it theoretically because it represented too great a divergence from his initial theoretical starting point." Block, "Karl Polanyi", n. 1 above, p. 277. However, Gareth Dale has pointed out that, although Polanyi uses the term embeddedness only a few times in *The Great Transformation*, references to it "crop up repeatedly in his published books and articles from the post-war period, and even more frequently in his unpublished notes and manuscripts". G Dale, "Lineages of embeddedness: on the antecedents and successors of a Polanyian concept" (2011) 70 *American Journal of Economics and Sociology* 307, p. 320.

5 See C Joerges and J Falke (eds), Karl Polanyi, *Globalisation and the Potential of Law in Transnational Markets* (Oxford: Hart Publishing 2011).

6 Block, "Karl Polanyi", n. 1 above, p. 279 (original emphasis).

7 Ibid.

8 S Frerichs, "Re-embedding neo-liberal constitutionalism: a Polanyian case for the economic sociology of law" in Joerges and Falke, *Karl Polanyi*, n. 5 above, p. 68.

9 K Polanyi, *The Great Transformation: The political and economic origins of our time* (Boston: Beacon Press 2001 [1944]), p. 79.

10 Frerichs, "Re-embedding neo-liberal constitutionalism", n. 8 above, pp. 68, 69. See also Dale, "Lineages of embeddedness", n. 4 above, pp. 325–9.

provide a neutral alternative to the "explicitly normative" economic approach to law.[11] Sabine Frerichs has responded with a call for an economic sociology of law that is truer to the letter and the spirit of *The Great Transformation* –"Polanyi-*inspired*" economic sociology of law, through which his deft analytical touch and forceful normative spirit could be coherently extended from the meta level of rationalities down to the micro level of action. In this article I propose that such an exploration of the role of law in the "always embedded economy" can be enriched by the application of the lens of community[12] developed by Roger Cotterrell.[13]

I begin with Polanyi's suggestion that economic action and interaction are always "embedded" in wider social life. Reading through the lens of community, we can be more specific: any actor is at once engaged, to different degrees (from fleeting to stable), in multiple types (whether focusing on instrumental, traditional, affective and/or belief-based action) of social life. I then explore a second, implicit, cornerstone of Polanyi's argument: that analytical and normative approaches to economy may become *dis*embedded from wider social life. Reading through the lens of community we can again be more specific: in the transformation to a market society, the analytical and normative approaches that are central to economic actions and interactions (including economic networks of community) are confused with, and privileged over, the analytical and normative approaches that are central to other actions and interactions (including non-economic networks of community). This confusion and privileging can have what we might call a performative effect at the levels of action and interaction. Finally, I explore Polanyi's story of law as a feature of the always-embedded economy, and as a facilitator both of disembedding movements and of re-embedding counter-movements. The community lens adds detail to that story, and suggests additional plotlines to be pursued. The practical potential of this Polanyi-meets-Cotterrell economic sociology of law is briefly illustrated with references to two twenty-first-century cautionary tales: the World Bank's investment climate programme and the 2008 financial crisis. In light of its presence in a special issue devoted to Polanyi, this piece assumes a degree of familiarity with his work.[14]

Embedded economic action and interaction

Economic action and interaction are always embedded in wider social life. Polanyi made this point tangentially when he implied that what we choose to call "labour", a key "element of industry",[15] is in fact comprised of people engaged in just one of the many forms of social relations that are the stuff of their everyday lives. This observation is enriched in two ways by the application of a community lens.

First, we see that economy is always embedded because all actors are engaged in diverse types of social action. Cotterrell's community approach is grounded in Max Weber's categorisation of four ideal types of social action (traditional, instrumental, belief-based and affective) of which economic action and interaction are just one (instrumental) sub-type. So

11 R Swedberg, "The case for an economic sociology of law" (2003) 32 *Theory and Society* 1, pp. 1–2. This description would be met with discomfort, even indignation, by many economists, since economics is typically presented as a neutral technology untainted by politics. Of course, that is a fantasy that authors such as Jonathan Aldred have dispensed with in detail: J Aldred, *The Skeptical Economist: Revealing the ethics inside economics* (London: Earthscan 2009).

12 Perry-Kessaris, *Global Business, Local Law*, n. 2 above.

13 Cotterrell, *Law's Community*, "Seeking similarity" and "Community as a legal concept?", all n. 3 above.

14 In addition to reading *The Great Transformation* itself, a varied introduction to Polanyi's work can be gained from reading G Krippner et al., "Polanyi symposium: a conversation on embeddedness" (2004) 2 *Socio-Economic Review* 109; Block, "Karl Polanyi", n. 1 above; and Dale, "Lineages of embeddedness", n. 4 above.

15 Polanyi, *The Great Transformation*, n. 9 above, pp. 75–6.

we are reminded that any actor is at once embedded, or engaged in, multiple *types* of social action – instrumental activities such as commerce, affective interactions between friends and family, traditional interactions founded across the generations, and interactions grounded in belief.

Second, the notion of "community" allows us to distinguish, in a way that is meaningful in the context of a globalising world, between different *degrees* of embeddedness. Each type of social life can occur in patterns ranging from superficially embedded individual actions, to fleeting interactions between strangers, to relatively stable, deeply embedded, networks of community – whether confined to single neighbourhoods or stretching across the globe. "Networks of community" are primarily a unit of analysis – a way of highlighting those social interactions that "have some stability and moral meaning" whenever, wherever and however they take place. Our attention is drawn not "to distinct social groups" but "to the degree of development of certain aspects of social relationships"[16] – specifically: stable interactions and a sense of belonging. Relations of community can potentially exist wherever interactions (objectively) exist that are relatively "stable and sustained". When these interactions are accompanied by (subjective) feelings of "attachment or belonging to others or to something beyond the individual", then they can be regarded as relations of community.[17] This sense of belonging is grounded in a mutually reinforcing combination of, on the one hand, trust and, on the other hand, shared values and interests. Because trust is vital to *all* types of stable, productive social interactions it serves as a reference point for an integrated analysis across multiple types of social action and relations, economic and non-economic.

Mention of the term "community" tends to generate a number of frequently asked questions. Here I will limit myself to answering two, and strictly from the perspective of Cotterrell's approach. First, no, the application of a community lens is not intended to privilege relations of community over the individual, but a sense of community is valuable in that "social life in any stable and rewarding sense is impossible without it".[18] Second, yes, relations of community, like all relations, involve power, and can be brutal and unpleasant. So, there is nothing inherently warm and fuzzy about networks of community.[19]

Disembedded economic rationalities and regimes

The preceding section established that *any actor, including their actions and interactions, is simultaneously embedded, to different degrees, in multiple types of social life*. We now move to consider embeddedness at the macro/meta levels of rationalities and regime. To the extent "that they are moral, scientific or cultural constructions", economies are also "always embedded" in wider society at the meta and macro levels.[20] In that sense it is as inaccurate to speak of "economy *and* society" as it is to speak of "law *and* society" – neither law nor economy can exist without society. If economic life is always embedded in all levels of social life, how, why and when does Polanyi's *dis*embededdness occur? Sabine Frerichs does much to unravel

16 Cotterrell, *Law, Culture and Society*, n. 3 above, p. 73.

17 Ibid. p. 70.

18 Ibid. pp. 162–3.

19 See, for example, ibid. p. 68.

20 Frerichs, "Re-embedding Neo-liberal Constitutionalism", n. 8 above, p. 70.

this conundrum when she explains that embeddedness can also be thought of in terms of the relative "ranking" of "different principles of social organisation".[21]

I will continue my habit of speaking of these "principles of social organisation" as, on the one hand, the "analytical approaches" by which we organise social life into concepts and relationships; and, on the other hand, the "normative approaches" by which we organise the values and interests at the core of social life.[22] For those who might wish to place them in the context of the social levels identified at the outset, we can say that these approaches form the intersection between the meta and the macro levels: analytical approaches are manifestations of rationalities, normative approaches are implemented in the form of regimes. Analytical embeddedness:[23]

> is, first of all, about how Economy and Society are defined and counterposed, while normative embeddedness is about the institutional relations that interconnect and integrate these (conceptually separated) entities . . . [B]oth can, and, indeed, do, change over time, and it is precisely this which is then perceived as a state of crisis.[24]

So, Polanyi's disembeddedness is associated with the dominance of rationalities and regimes that rank liberal, economic above other approaches. An analytically disembedded approach is one that thinks of *society as economy*; which uses liberal economic concepts and relationships to think not only about economic and other instrumental actions, but also about affective, belief-based and traditional actions. A normatively disembedded approach is one that both puts *economy before society* and *takes economy for society*. It produces regimes which privilege economic values and interests, usually claiming this to be for the good of all types of social action, including other instrumental action, and also affective, belief-based and traditional actions. Rephrased in these terms, Polanyi's outrage was directed to the fact that during the Industrial Revolution approaches to thinking (analytical) and deciding (normative) about social, including economic, action were allowed and encouraged to float free from their proper bed in the broader social sciences. A narrower, liberal–economic approach dominated thinking and practice, even while real social, including economic, action and interaction had remained embedded in the complex diversity of wider social life.

The phenomenon of "economics imperialism" that preceded, facilitated and still serves to consolidate the transformation to a market society is well-documented. For example, Ben

21 Frerichs, "Re-embedding Neo-liberal Constitutionalism", n. 8 above, p. 78. Kurtuluş Gemici made a superficially similar, but fundamentally different, distinction when he described Polanyi as setting two functions for disembeddedness: disembeddedness as a "methodological principle" and as a "historical variable". Gemici agreed with Granovetter's observations made elsewhere that only the methodological version of embeddedness is of any use, and that use is limited because it "falls short of providing a theoretical alternative to mainstream economics". Both of these propositions deserve critical attention. First, that embeddedness does not offer an alternative to mainstream economics is true. But that need not – and, we can surmise, would not for Polanyi – necessarily be perceived as a failing. The aspirations of mainstream economic theory are surely much grander – in flamboyant scope and in intrusive detail – than were Polanyi's. He was not seeking to predict, explain and measure all aspects of social life as instrumental actions, as do mainstream economists, but rather to understand the impacts of market-oriented regimes on human life. Second, the notion of embeddedness as "historical variable" is, in fact, also useful – at least for those interested in an economic sociology of law. However, that utility is better realised when we specify that this "historical variable" relates to the extent to which, at any given time, the dominant normative approach is more or less market-oriented, that is, more or less disembedded from wider social life, producing regimes which privilege, to a greater or lesser extent, economic values and interests. K Gemici, "Karl Polanyi and the antinomies of embeddedness" (2008) 6 *Socio-Economic Review* 5, pp. 22–26.

22 See A Perry-Kessaris, "Prepare your indicators: economics imperialism on the shores of law and development" (forthcoming 2011) *International Journal of Law in Context*.

23 Frerichs uses the term "conceptual embeddedness" for what I am calling "analytical embeddedness".

24 Frerichs, "Re-embedding neo-liberal constitutionalism", n. 8 above, p. 70.

Fine and Dimitris Milonakis have tracked the evolution of economics as a system of thought from inseparable playfellow of other social sciences at the time of Adam Smith's *The Wealth of Nations* in 1776, to its current position as the hollowed out – narrow, asocial, disembedded – coloniser of those social sciences.[25] Each aspect of social life in which economics is successfully naturalised risks becoming analytically and normatively disembedded from wider social life.

Economists are not alone in extending the application of their analytical frameworks to the point of unreality – "analysing one . . . aspect of social relations abstracted from its broader social context . . . taking that part for the whole" and "applying analyses based on such abstractions to all aspects of human activity and social life".[26] While an empire-building economist "starts from the view that [the] primary concern is the analysis of exchange or 'markets', and elevates this into a theory of human history and society based on individual choice"; an empire-building lawyer "views state law as a system of fixed and determinable rules, and assumes that they are instruments which directly and immediately govern all social behaviour".[27] Elsewhere, new economic sociology pioneer Mark Granovetter has noted the tendency of some sociologists to tell "over socialised" tales.[28] But nothing matches the imperial success of economics.

Economics derives much of its drive from the three assumptions "used relentlessly and unflinchingly" that form its analytical "heart": that individuals always seek to "maximise" their utility, profit and so on; that markets "with varying degrees of efficiency coordinate the actions of different participants – individuals, firms, even nations – so that their behaviour becomes mutually consistent"; and that actors (individuals, firms, states and so on) have stable preferences.[29] Although the "boundaries of these assumptions" have been "challenged" by new developments in economic theory, "they remain the preconditions of all remotely mainstream economic analysis – always present, sometimes suspended, sometimes extended".[30] It is this willingness and ability of economics to stick, "relentlessly and unflinchingly", to its story – however incredible – that makes it so broadly appealing. "Often the truth is that economists don't know" but "[t]his kind of modesty is not what many of us want to hear. We yearn for comfort and security of definite answers."[31]

But what are the effects of this analytical and normative disembeddedness, and how might the community lens help to sharpen our vision of them? The dominance of economics is not just irritating for those who would tell other stories in the languages of other disciplines. It threatens their very survival because, as E F Schumacher observed, economics is analytically incapable of accommodating non-economic values and interests. At best it relegates them to a non-speaking cameo role; at worst, it writes them out of the story entirely. One problem is that money has long been the go-to *numéraire* – measure of value – for economists, because of a genuine confidence that everything of value has a price and money is the most efficient signal of those prices. Current efforts to develop

25 B Fine and D Milonakis, *From Economics Imperialism to Freakonomics* (London: Routledge 2009).

26 Campbell and Picciotto make this observation in the terminology of "formalism" as distinct from realism; D Campbell and S Picciotto, "Exploring the interaction between law and economics: the limits of formalism" (1998) 18 *Legal Studies* 251.

27 Ibid.

28 Krippner et al., "Polanyi Symposium", n. 14 above, p. 110.

29 G Becker, *The Economic Approach to Human Behaviour* (Chicago: University of Chicago Press 1976), p. 5.

30 Perry-Kessaris, "Prepare your indicators", n. 22 above.

31 Aldred, *The Skeptical Economist*, n. 11 above, p. 8.

"happiness" indices and measures of "well-being" may yet enable us to see inside the black box of value, but it is early days.[32] It remains the case that:

> something is uneconomic when it fails to earn an adequate profit in terms of money. The method of economics does not, and cannot, produce any other meaning . . . Society, or a group or an individual within society, may decide to hang on to an activity or asset for non-economic reasons – social, aesthetic, moral, or political – but this does in no way alter its uneconomic character.[33]

So, anyone who tells the story of social life (analytically) through an economic lens will necessarily focus (normatively) on economic values and interests.

> The judgment of economics, in other words, is an extremely *fragmentary* judgment; out of the large number of aspects which in real life have to be seen and judged together before a decision can be taken, economics supplies only one – whether a thing yields a money profit *to those who undertake it* or not.[34]

In the language of community, the "fragmentary" judgment of economics is worrying because it is an economic (type) and individualistic (pattern) story in which the speaking roles are given to those engaged in economic interactions, and the script is composed entirely of monologues. So it blinds us to the reality that all actors are engaged in multiple, diverse and complex patterns of social action and interaction.

Further concern is raised by the fact that analytical and normative approaches have what we might call a performative dimension. The analytical and normative disembedding of the Industrial Revolution was in part caused and effected by the introduction of the "fictitious commodities" of land, labour and money – fictions that were suggested by economic theory. When such fictions leak "outside of academia, they turn into powerful social constructions that are equipped with scientific authority". Economic theory simultaneously "produces" and "performs" the very economic reality that it is supposed to describe.[35] The "descriptions" that we use to "organise" markets for labour, land and money are "fictitious", but land, labour and money "are being actually bought and sold on the market; their demand and supply are real magnitudes".[36] By treating society "as if" it were a market, so we create market society. Indeed "market society has ultimately to be understood as an artefact of modern (neo-) liberal economics".[37] Some commentators have made this point by drawing on Michel Foucault's observations on power and discourse. For example, Arturo Escobar refers to the market economy as "a way of organising our perception of the world and our actions in it" – not only a "system" of "production" that places us in "social relations of production", and a system "of power" that places us "in relations of power", but also a "system of signification" which places us in "linguistic and discursive relations".[38] We think economics, do economics and feel economic.[39]

An obvious example of the performative potential of the economic approach came in the form of the sub-prime mortgage crisis that triggered the 2008 global financial crisis.

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32 See J Bronsteen, C Buccafusco and J Masur, "Welfare as happiness" (2010) 98 *Georgetown Law Journal* 1583.

33 E F Schumacher, *Small is Beautiful: A study of economics as if people mattered* (London: Vintage Press 1993 [1973]), p. 28.

34 Ibid. (original emphasis).

35 Frerichs, "Re-embedding neo-liberal constitutionalism", n. 8 above, p. 78.

36 Polanyi, *The Great Transformation*, n. 9 above, p. 76.

37 Frerichs, "Re-embedding neo-liberal constitutionalism", n. 8 above, p. 78.

38 A Escobar, *Encountering Development: The making and unmaking of the Third World* (Princeton, NJ: Princeton UP 1995), p. 142.

39 The implications for counter-movement have drawn out by David Schneiderman, for example, in his presentation at the 2010 Law and Society Association annual meeting in Chicago.

"Buyers" and "sellers" of financial products were encouraged to follow (their perceptions of) a heady combination of their own preferences for risk, and the quality and prices of products on offer. On Main Street and on the High Street, deals were done between commission-hungry mortgage brokers and aspiring homeowners with no income and no assets. On Wall Street and in the City, those mortgages were sold on to investors desperate for somewhere to park their cash with benefits. A regulatory gloss was provided by financial authorities and private sector credit-rating agencies, which intervened with the half-hearted, narrow and shallow self-consciousness of interlopers.[40] Everyone was on the same market-oriented page, even if not everyone was qualified to understand what was written on it.[41]

There is always the chance that economists, their marionettes and their collaborators will spontaneously come to, drop their scripts and exit stage left – a possibility that was hinted at when the scales of disembeddedness fell from the neoliberal eyes of former chairman of the United States Federal Reserve, Alan Greenspan. The following exchange between Greenspan and Representative Henry Waxman during the 2008 hearings at the United States Congress on the financial crisis has been identified as especially enlightening:[42]

> **Rep. Henry Waxman:** "I do have an ideology. My judgment is that free, competitive markets are by far the unrivalled way to organise economies. We've tried regulation. None meaningfully worked." That was your quote. You had the authority to prevent irresponsible lending practices that led to the subprime mortgage crisis. You were advised to do so by many others. And now our whole economy is paying its price. Do you feel that your ideology pushed you to make decisions that you wish you had not made?
>
> **Alan Greenspan:** Well, remember that what an ideology is, is a conceptual framework with the way people deal with reality. Everyone has one. You have to – to exist, you need an ideology. The question is whether it is accurate or not. And what I'm saying to you is, yes, I found a flaw. I don't know how significant or permanent it is, but I've been very distressed by that fact.
>
> **Rep. Henry Waxman:** You found a flaw in the reality . . .
>
> **Alan Greenspan:** Flaw in the model that I perceived is the critical functioning structure that defines how the world works, so to speak.
>
> **Rep. Henry Waxman:** In other words, you found that your view of the world, your ideology, was not right, it was not working?
>
> **Alan Greenspan:** . . . No, that's precisely the reason I was shocked, because I had been going for 40 years or more with very considerable evidence that it was working exceptionally well.

As Raj Patel explains, the "flaw" to which Greenspan referred was neither the "minor problem of shoddy data" scuppering a good model, to which many post-crisis commentators have pointed; nor "the bigger Black Swan problem" of the weak financial models failing to take account of low frequency–high impact events, to which Nassim

40 A jargon-free and comprehensive account of the financial crisis and its fall-out is provided in two podcasts (both with full transcripts) from the National Public Radio production company This American Life entitled "The Giant Pool of Money" and "The Watchmen". Countless issues arising from the crisis have been covered in the same style by another National Public Radio production company, Planet Money.

41 R Dyal Chand, "What would de Soto say about the subprime meltdown?" in D B Barros (ed.), *Hernando de Soto in a Market Economy* (Aldershot: Ashgate 2010); and *Exporting the Ownership Society: A case study on the economic impact of property rights*, Northeastern University School of Law, March 2007, Research Paper No 15-2007, available at SSRN: http://ssrn.com/abstract=968689 (last accessed 24 January 2011).

42 R Patel, *The Value of Nothing* (London: Portobello Books 2011), p. 6.

Taleb[42a] presciently drew our attention in 2007. The "flaw" in Greenspan's model was utterly "fundamental": it was based on a "warped . . . view about how the world was organised, about the sociology of the market".[43] Greenspan's "warped view" came from looking at society through the analytical and normative lens of mainstream economics.

So, although we have not, in fact, been produced solely for sale, we can come to *behave* as if, even believe that we were – mistaking the play for reality, the script and costumes for our own. Because "markets leave their mark",[44] we come increasingly to "know the price of everything and the value of nothing" – as author Raj Patel, UNISON's head of local government in Wales and Friends of the Earth have all recently paraphrased Oscar Wilde.[45] We may thus become less willing and/or able to perpetrate Polanyi's counter-movements. Wherever the balance lies between, on the one hand, the redemptive capacities of the likes of Greenspan and, on the other hand, the susceptibility of all humans to market disciplines, law offers hope for those who would counter-move. However, as the next section explains, the news is not all good. For law is an extension of social life, and thus is itself subject to the disembedding forces of economics and the perils of human frailty.

Law in action and interaction

What can a community lens reveal about the role of *law* in always embedded action and interaction? The law-and-community re-telling of the embeddedness story begins with a simple restatement of the micro–meso level social-embeddedness theme in a legal context: any actor, including their actions and interactions *and their associated law*, is simultaneously embedded, to different degrees, in multiple types of social life *and their associated law*.[46] Law, like economy, is a part of social life.

> What is of interest to socio-legal enquiry is 'how a certain side or part of the social *takes the form of law*' – or, indeed, does not take the form of law; or only partially takes the form of law; or appears to but does not, in fact, take the form of law.[47]

Law, whether generated by state or non-state actors, is used, abused and avoided at every level of social life.

A community lens highlights a distinction between two of law's many faces:[48] one which is directed towards supporting the ad hoc actions and interactions of individuals; and another which is directed towards supporting those relatively stable and trusting interactions that are "networks of community". Law supports individuals by facilitating their efforts to

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42a N Tale, *The Black Swan: The impact of the highly improbable* (London: Random House 2007).

43 Patel, *The Value of Nothing*, n. 42 above, p. 6.

44 M Sandel, "Markets and Morals", Reith Lectures 2009: A New Citizenship, BBC Radio 4, 9 June 2009, www.bbc.co.uk/programmes/b00kt7sh (last accessed 1 September 2011).

45 See www.unison.org.uk/cymruwales/pages_view.asp?did=11422 and www.foe.co.uk/blog/price_everything_31241.html (last accessed 1 September 2011). An anonymous reviewer rightly pointed out that: "The quotation is from Lord Darlington in Act III of 'Lady Windermere's Fan'. Cecil Graham's retort is 'And a sentimentalist, my dear Darlington, is a man who sees an absurd value in everything, and doesn't know the market price of any single thing'. Wilde's position is, at best, more complicated than this selective quotation would suggest." However, the abbreviated version gets across that part of the meaning of the original quotation that is necessary for the present purpose.

46 Cotterrell, "Community as a legal concept?", n. 3 above, pp. 19–20.

47 Perry-Kessaris, *Global Business, Local Law*, n. 2 above, p.18, quoting Cotterrell, "Community as a legal concept?", n. 3 above, pp. 19–20 (original emphasis).

48 Law is, of course, multi-faceted and goes beyond the individual and the communal. For a start, law can be used by the state to direct or enable the individual to do things that they might not choose to do, and that may or may not make them happier, healthier and otherwise better off. Thanks to Martin Krygier for this point.

protect and promote their values and interests. This is the face of law of which contemporary, mainstream, individualistic, market-oriented economics is primarily enamoured. There is no doubt that these are real and legitimate roles for law, but "[l]aw's aspiration is towards something more than . . . the society of morally unconnected, rights-possessing individuals that liberal philosophy tends to presuppose".[49] Law can also act as a communal resource in support of networks of community engaged in all types of social action (instrumental, including economic, traditional, affective and belief-based).

Law supports community, by *expressing* the trust that binds actors together in stable, productive relations. Contracts, constitutions and articles of association are all good examples. Law supports community by securing spaces for the *coordination* of the diverse values and interests of multiple networks of community, thereby ensuring that those diverse stable, productive trusting relations persist and flourish. "An emphasis on community does not imply an absence of conflict." It actually "highlights key foci of legal contradiction and controversy".[50] Law supports community, by encouraging widespread *participation* in social life within and between networks of community. It does this generally by protecting the security and autonomy of individuals, and specifically by creating and maintaining gateways through which participation can occur. In so doing it supports mutual interpersonal trust, which both consolidates existing community-like relations and opens the door to the development of new community-like relations. Public interest litigation, environmental impact assessments and public hearings are all good examples of legal mechanisms which facilitate participation and coordination.[51]

It is primarily in law's capacity to act as a communal resource that the hope of those who would counter-move resides. The values and interests that underpin actions and interactions (individualistic or communal) in one type of social action or interactions (instrumental, affective, belief, or traditional) may be in direct conflict with the values and interests underpinning other actions and interactions. Such conflicts are the beating heart and meaningful soul of embeddedness, and they can be made more productive, or less destructive, when law acts as communal resource.

Law in regime and rationality

Polanyi's vision of law is as a facilitator and collaborator of social transformation. When he proposed that nineteenth-century society was "transformed" in a "double movement", he implied a triple role for law: embedded, disembedding, re-embedding. First, law played an innocent, embedded role when it facilitated the "*extension* of the market organisation in respect to genuine commodities" such as milk, oil and cotton. On the other hand, law played a grubby role as collaborator during the disembedding movement in which the fictitious commodities were created: the "as-if" commodities of labour, land and money were necessarily legal, as well as economic, fictions.[52]

> [A]ny *measures or policies* that would inhibit the formation of [land, labour or money] markets would *ipso facto* endanger the self-regulation of the system. The commodity fiction, therefore, supplies a vital organising principle in regard to the whole of society affecting almost all its institutions in the most varied way, namely, the principle according to which no arrangement of behaviour *should be*

49 Cotterrell, *Law's Community*, n. 3 above, p. 18.

50 Cotterrell, "Community as a legal concept?", n. 3 above, p. 23.

51 See Perry-Kessaris, *Global Business, Local Law*, n. 2 above.

52 As was pointed out by Sabine Frerichs in her presentation "A Polanyian take on the globalised 'as if' economy" during the 2010 workshop around which this special issue is based.

> *allowed to exist* that might prevent the actual functions of the market mechanism on the lines of the commodity fiction.[53]

At the same time, law played a third, heroic role, this time in the counter-movement to re-embed economy: the "*restriction*" of market organisation "in respect to fictitious [commodities]".[54] Economists pretend that the economy is an autonomous "self-regulating" set of relationships. Lawyers collaborate by dressing humans and nature as "fictitious commodities", Labour and Land, and present them as having been produced for the sole purpose of being sold. But off-stage lurks reality, in which the action and interaction remain embedded in society, and society always "protect[s] itself against the perils inherent in a self-regulating market system".[55] As "markets spread" deeper and wider, so a "network of measures and policies was integrated into powerful institutions designed to *check* the action of the market relative to labour, land and money", and a "deep-seated movement sprang into being to *resist* the pernicious effects of a market-controlled economy".[56] Law's capacity to act as a communal resource can be read directly into Polanyi's account: it expressed the acceptable extensions of markets in respect of genuine commodities within economic networks of community; and maintained spaces for the co-ordination of inter-network values and interests in which the counter-moving restricting, checking and resisting of markets duly took place.

What Polanyi did not directly address was the transformation – the disembedding – of law itself. As we have seen, law is "always embedded" in social action and interaction. Equally, regimes and rationalities have legal dimensions, so law is implicated when regimes and rationalities become disembedded and re-embedded in the wider social sphere – as different analytical and normative approaches ascend and descend the "ranking" of "principles of social organisation".

> A critical Polanyian perspective has thus, first, to de-construct the Hayekian way of embedding even the law (and its inherent normativity) in economic rationalities, and, secondly, to reconstruct law as a social institution which also reflects the rationalities and values of other social spheres.[57]

This is a task to which a community lens is ideally suited, for it enables us to both "seek similarity", to pay attention to the common threads that run through all social, including economic, relations; and to "appreciate difference" in the often conflicting values, interests and legal needs that are central to each of these relations.[58] A community lens suggests that the legal embeddedness storyline can be extended at the meta level of rationalities in at least two ways, both of which I have explored elsewhere, albeit in slightly different guises, so I will limit myself to a few edited highlights.

First, the thread of analytical and normative disembeddedness can be extended to the legal context: approaches to social life *and their associated law* may come to float free from

53 Polanyi, *The Great Transformation*, n. 9 above, p. 76 (emphasis added).

54 Ibid. p. 79 (emphasis added).

55 Ibid. p. 80.

56 Ibid. pp. 79–80 (emphasis added).

57 Frerichs, "Re-embedding neo-liberal constitutionalism", n. 8 above, p. 81. Such efforts can be found, for example, among feminist theorists who query the very existence of homo-economicus (e.g. M A Fineman and T Dougherty, Feminism Confronts Homo Economicus: Gender, law, and society (Ithica: Cornell UP 2005)) and lawyers and economic historians who have revealed the normative core of economics (Aldred, *The Skeptical Economist*, n. 11 above), and charted with concern the spread of an exceptionally asocial and ahistorical form of economics into all aspects of social life (Fine and Milonaki, *From Economics Imperialism*, n. 25 above, including its mathematising, marketising, numericising effects on law (Perry-Kessaris, "Prepare your indicators", n. 22 above).

58 Cotterrell, "Seeking similarity, appreciating difference", n. 3 above, p. 49.

their proper bed in the wider social sciences. Here, I am thinking of ever-more commonplace economic approaches (analytical and normative) to law. Analytically, economic concepts and relationships are used to describe law both as a (fictitious) commodity in its own right, and as a facilitator and regulator of markets for other (fictitious and real) commodities. A very real example of this is to be found in the World Bank's current predilection for treating national legal systems "as if" they are an input into a larger fictitious commodity know as an "investment climate", with which states are presented as touting for the attentions of foreign investors. The "commodity" of the national legal system is doubly significant in investment climate discourse because it also facilities and regulates markets for other fictitious commodities such as labour and environmental resources, as well as real commodities. The normative dimension of the rise of the economic approach to law is that economic values and interests are used to judge the merits or desirability of various legal phenomena. A market-oriented approach to law, economy and society sees only economic values and interests, and it insists that those values and interests are valuable, and ought to be interesting, to individuals and networks that are focused on non-economic types of social life. Turning once more to the World Bank, in its investment climate discourse a "good" legal system is one that is efficient, which means quick and cheap. So the bank measures the speed and cost of legal systems and ranks them accordingly in a league table.[59]

Second, we can extend the thread of performativity to the legal context by asking: have we come to know the price of law but lost touch with its value? Here, I am thinking of the commodification of legal systems in the context of investment climate discourse. By treating legal systems "as if" they are merely an input into a larger commodity known as "investment climate", so we can create that reality. For example, states battle to move up the World Bank's economically defined league table, if necessary, sacrificing the legal needs of other types of social life (non-economic instrumental, traditional, belief and affective social). A detailed case study of the impact of investment climate discourse in Indian foreign investor–government–civil society relations showed not only that investment climate discourse was diverting attention from the interests and values that underpin non-economic relations; it was actively undermining the ability of law to support those non-economic relations,[60] and any counter-movements that those relations might have produced. The effects of such a loss can be, as Polanyi pointed out, catastrophic. Without the protection offered by the regulatory counter-movement, "Nature would be reduced to its elements, neighbourhoods and landscapes defiled, rivers polluted . . . the power to produce food and raw materials destroyed."[61]

Conclusion

Law, economy and society have starred in countless tales of derring-do. It is not uncommon, but it is pointless, to reword a perfectly good story without revealing anything in the process. So, what is gained from the effort of translating the socio-econo-legal tangle first into the language of Polanyi's embeddedness, and then into that of Cotterrell's community?

One of the most important benefits of thinking in Polanyian terms is a sense of historical context and perspective – an essential counterpoint to the prevailing tendency to privilege "being in the moment" and to scavenge ceaselessly for record-breakers. *The Great*

59 Perry-Kessaris, "Prepare your indicators", n. 22 above. See the Business Planet website for an instant insight into the power of this project: http://rru.worldbank.org/businessplanet (last accessed 1 September 2011).

60 Perry-Kessaris, *Global Business, Local Law*, n. 2 above.

61 Polanyi, *The Great Transformatio*n, n. 9, p. 76.

Transformation is a story written by an economic historian, in the mid-twentieth century, about the eighteenth and nineteenth centuries, as compared to the fifteenth century and beyond. It puts us in our place and helps us to get over ourselves.

Another benefit of speaking Polanyian is that it enables us to build on the gains of those who have gone before us and diverts us from reinventing analytical wheels. The "concept of an always embedded economy" has already been shown to be an effective transformer of rationalities because it makes it "very hard to gloss over or hide the state's fundamental role in shaping actually existing economies"; because it reveals that there are "no inherent obstacles to restructuring market societies along more democratic and egalitarian lines"; and because it reminds us that "economic actors have to be constructed" – that is, "to learn how to behave in market situations" and in the context of the very different "complexes of ideas" that prevail across what are *varied* market societies.[62] But those transformative messages have less often been translated to the level of regimes, that is, in "public policy – particularly as reflected in the Washington consensus doctrines concerning how the developing world and the economies in transition should make *their* great transformations".[63] So, important untapped authors, tellers and audiences of the story of embeddedness remain.

The already profoundly significant story of *The Great Transformation* is enriched by the application of the lens of community. It allows us to think clearly about the facts that economic action and interaction are always embedded in the sense that any actor is at once engaged, to different degrees (from fleeting to stable), in multiple types (whether focusing on instrumental, traditional, affective and/or belief-based action) of social life; and that economy may become disembedded from wider social life in the sense that the analytical and normative approaches that are central to economic actions and interactions may be confused with, and privileged over, those that are central to non-economic actions and interactions. It also allows us to specify the role of law within and between all these patterns and types of social life, as a facilitator of both disembedding movements and re-embedding counter-movements, and as itself subject to disembedding.

Most importantly, because the law-and-community approach pays particular attention to the presence and absence of interpersonal trust, it has a distinctly human orientation. So we are reminded that the capacity of law, individual or communal, state or non-state, is always subject to the talents, ingenuity, whims and frailties of its human (ab)users and avoiders, whether state or non-state actors, movers or counter-movers.[64] We are also provided with a common vocabulary for tales of hope and of desperation, which can then be told and retold in the same circles, checking extremism of all forms, casting naivety and cynicism to the cutting-room floor in equal measure. All of this is possible through a community lens because it is set to a delicate frequency: "seeking similarity, appreciating difference".[65]

62 Block, "Karl Polyanyi", n. 1 above, pp. 25–6 (emphasis added).

63 J Stiglitz, 'Introduction' in Polanyi, *The Great Transformation*, n. 9 above, p. xiii.

64 Perry-Kessaris, *Global Business, Local Law*, n. 2 above. Thanks to Prabha Kotiswaran for reminding me of this.

65 Cotterrell, "Seeking similarity, appreciating difference", n. 3 above.

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"Reform or revolution"? Polanyian versus Marxian perspectives on the regulation of the economic

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Abstract

Rosa Luxembourg's 1900 pamphlet "Reform or revolution", which critiqued reformist political strategy, has relevance to, and finds echoes in today's debates on the possibility and desirability of using law to protect society from the market's negative effects. It also summed up the nineteenth-century "Polanyian" reformist and Marxist "revolutionary" perspectives. Polanyi argued that "the economic" must be "embedded" in the social by means of legal regulation, an argument he illustrates with the help of the "Speenhamland" example. Marx, while acknowledging the role of the legal struggle as part of class struggle, concludes that ultimately "right can never be higher than the economic structure of society". Marxist legal theorist Pashukanis developed this position in his "commodity form theory of law" which points to the structural impossibility of law's regulation of capitalism. While contemporary "Polanyist" Ruggie again asserts that legal and soft law "global governance" regimes can control capitalism's main instrument, the corporation, Shamir contra *Ruggie argues that the "moralisation of markets" through corporate social responsibility (CSR) leads to the "marketisation of morality" or a change in what we perceive law to be (and who has legitimate authority to regulate) rather than a "taming" of markets. Following Shamir, I add that this corporate-led global governance hastens the collapse of capitalism, and confirms the inevitability of revolution and the subsequent creation of a law-free society.*

Introduction

In her 1900 pamphlet "Reform or revolution", Rosa Luxemburg made short shrift of her contemporary Eduard Bernstein's reformist theory – in which he argues that social-democrats must abandon the idea of revolution, and instead work towards the betterment of the situation of the worker, and increased social control of the economy *within* the capitalist framework.[2] "Bernstein, proposing to change the sea of capitalist bitterness into a sea of socialist sweetness, by progressively pouring into it bottles of social reformist

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2 Bernstein presented this theory in his series of articles "Problème des Sozialismus" in the magazine *Die Neue Zeit*, edited and published by Karl Kautsky, 1896 onwards, and his book *Die Voraussetzungen des Sozialismus und die Aufgaben der Sozialdemokratie* (Berlin: Dietz Verlag 1991).

lemonade, presents an idea that is . . . insipid [and] fantastic" Luxemburg concludes.[3] Bernstein's position is closely related to that of Polanyi, while Luxemburg was a "wholehearted Marxist".[4] In this article, I analyse Polanyian and Marxist perspectives on the (legal) regulation of "the economic". Bernstein's "lemonade" is legal measures aimed at constraining market actors so as to minimise capitalism's negative effects on society. Polanyi also argues that law is required (and adequate) to subject the market to the needs of society. Here I will argue, with Luxemburg and Marx, that subjecting the market to society through law is a structural impossibility, and that nothing less than revolution will achieve the ends envisaged by Polanyians and Marxists alike.

In section two, I examine Polanyi's discussion on the "Speenhamland system": one of the legal measures to curb the extreme poverty resulting from the creation of the free market in seventeenth-century England. In Polanyi's *The Great Transformation*, his discussion of Speenhamland illustrates his general attitude to legal regulation of the market. In section three, I set out Marx's discussion of the eighteenth and nineteenth-century legal regulation of the length of the working day, which in turn illustrates Marx's attitude to the use of law in a capitalist society. There then follows a discussion of further works by Marx, Engels, Luxemburg and Pashukanis to complete the Marxian picture on the utility of law in emancipatory struggle and also *post-capitalism*. In section four I demonstrate the debate's contemporary relevance and analyse a Polanyian take on the regulation of the economy, and specifically the corporation, as exemplified by John Ruggie in his academic work as well as his position as UN Special Representative on Business and Human Rights. His approach is critiqued by Shamir – discussed in section five. Finally, in section six, I take a closer look at the identity of society and the agents of change in each perspective. I return to Rosa Luxemburg and this article's title "Reform or revolution?" to draw conclusions on regulation of the economy through law.

Karl Polanyi: *The Great Transformation*

Polanyi's Speenhamland

The main example of "social regulation" in which Polanyi's theoretical argument is anchored is the Speenhamland system. In Polanyi's idiosyncratic[5] account of the transition to, and maturing of, European capitalism in *The Great Transformation*, Speenhamland is key: in Polanyi's view, "few institutions have shaped the fate of a whole civilization more decisively than this".[6]

The British Speenhamland system was devised in 1795 as a response to widespread poverty following the forcible uprooting of the poor from their countryside abodes in the enclosure regime – a process ongoing since the Tudor period that saw the division of commons land into private property, with the dual aim of increasing agricultural production (through e.g. mass sheep-farming instead of self-sufficiency and cottage industry) and the creation of a class of landless poor who would be employed in the newly developing

3 R Luxemburg, "Reform or revolution" in H Scott (ed.), *The Essential Rosa Luxemburg: Reform or revolution and the mass strike* (Chicago: Haymarket Books 2008), p. 65.

4 J P Nettl, *Rosa Luxemburg* vol. I (London: OUP 1966), p. vii.

5 Polanyi offers unique definitions for commonly used terms such as "market" (p. 59), "commodity" (p. 75), "exploitation" (p. 42), the "division of labour" (p. 46), etc. which sets his work apart from Smithian economists as well as Marxist scholars: K Polanyi, *The Great Transformation: The political and economic origins of our time* 2nd edn (Boston: Beacon Press 2001).

6 Ibid. p. 90.

industries.[7] Probably the best-known account of this process is E P Thompson's *The Making of the English Working Class*.[8]

According to Thompson, "[e]nclosure (when all the sophistications are allowed for) was a plain enough case of class robbery, played according to fair rules of property and law laid down by a parliament of property-owners and lawyers".[9] The historian Merriman contextualises Speenhamland within a tightening (legal) regime of social control to stem growing lower-class restiveness and to prevent the influence of the French Revolution of 1798, and later the European revolutions of 1848, from "blowing over" to Britain.[10] A poor support system had been available since the early eighteenth century, including the "old" Elizabethan Poor Law (an indirect response to the cessation of grain imports from France after British involvement in French wars), which included parishes and townships providing charity to those wearing a badge with the letter "P" for pauper.[11]

The Speenhamland system was a different kind of system, with parishes providing top-up wages to working poor to the level of the price of two loaves of bread per week per worker.[12] It thus tied wages to the price of wheat while the price of wheat (and the availability of wheat for consumption) fluctuated with the quality of the harvest and market manipulation by traders stockpiling wheat for future sales. One effect of the system was that it encouraged employers to pay low wages in the knowledge these would be topped up.[13] Eventually, after a report by the Royal Commission of the Poor Law, which accepted the view that the system interfered with the market, the Poor Law Amendment Act of 1834 abolished the system and replaced it with workhouses, which at their high point in 1841 held more than 200,000 people incarcerated in Britain.[14]

Polanyi presents the enclosure process (which, he notes, was also called a "revolution of the rich against the poor")[15] as a (non-)choice between "habitation or improvement".[16] While he recognises the "avalanche of social dislocation"[17] this process brought about, as well as the "wholesale destruction of the traditional fabric of society",[18] the improvement

7 Enclosures are also described by (amongst others) Marx – who defines them as an essential precursor to capitalism termed "primitive accumulation" – and which we see occurring also in the colonies during the nineteenth and twentieth centuries, e.g. the Congo as described by Renton and Zeilig, in D Renton, D Seddon and L Zeilig, *The Congo: Plunder and resistance* (London: Zed Books 2006); for enclosure and resistance in the twenty-first century, see, e.g., the work of the Movimento dos Trabalhadores Rurais Sem Terra www.mst.org.br/ (last accessed 1 September 2011).

8 E P Thompson, *The Making of the English Working Class* (London: Penguin 1963).

9 Ibid. pp. 237–8.

10 For example, in 1723 the British Parliament passed a law that added 50 capital offences against property, including poaching, gathering of firewood, etc., from land that had been the common source of sustenance before enclosures. The role of, and attitude to, law in the enclosure process is summed up in the folk rhyme of the time: "They hang the man, and flog the woman, That steals the goose from off the common; But let the greater villain loose, That steals the common from the goose." See, generally, J Merriman, *A History of Modern Europe: From the renaissance to the present* 3rd edn (New York: W W Norton & Company 2010), pp. 382ff.

11 Ibid. p. 383.

12 The Speenhamland system is named after the parish of Speenhamland in Berkshire, where it was conceived. Additional wages could be paid for children, and also for clothing, unless such was supplied by the employer or the parish directly. The system was funded through "poor rates", which were property taxes collected from landowners.

13 Merriman, *A History*, n. 10 above, p. 559; see also, Thompson, *The Making*, n. 8 above, pp. 247–8.

14 Merriman, *A History*, n. 10 above, p. 559.

15 Polanyi, *The Great Transformation*, n. 5 above, p. 37.

16 Ibid. p. 35.

17 Ibid. p. 42.

18 Ibid. p. 81.

in agricultural yield, including the increased wool production which eventually led to the development of the cotton industry – the catalyst for Britain's Industrial Revolution – made it worth the sacrifice.[19]

Even so, the fulfilment of the capitalist utopia of the free market was prevented. Polanyi states, "[e]ighteenth-century society unconsciously resisted any attempt at being made into a mere appendage of the market".[20] By the implementation of the Speenhamland system, Polanyi argues, *society* effectively prevented the establishment of a free market for labour. However, the main failure of Speenhamland came with the realisation that "nobody would work for a wage if he could make a living doing nothing".[21] In addition, "no labourer had any financial interest in satisfying his employer, his income being the same whatever wages he earned".[22] Within a few years, the labour of paupers "became indistinguishable from 'boondoggling' or the semblance of work maintained for the sake of appearances".[23] Thus, it was concluded that a regular labour market had to be established, and "mankind was forced into the paths of a utopian experiment".[24]

Elsewhere Polanyi speaks of an emotional awareness of the individual and his or her role in larger society, "the discovery of society", and the moral or emotional effect of Speenhamland: "the dehumanization of the masses began to paralyse national life, and notably to constrain the energies of industry itself".[25] This awareness appealed to the liberal sensitivity and self-image of the emerging middle class. While the law was considered "squirearchy's" (landowners') last attempt to prevent the advent of a new order, "[t]he abolishment of Speenhamland [in 1832] was the true birthday of the modern working class, whose immediate self-interest destined them to become protectors of society against the intrinsic dangers of a machine civilization".

The year 1832 was of course also the year of the Reform Act, which produced far-reaching electoral reforms including eliminating the so-called "rotten boroughs" and "pocket boroughs" and effectively giving the middle class a majority in Parliament.[26] As such, "[t]he repeal of Speenhamland was the work of a new class entering onto the historical scene, the middle classes of England". Furthermore, in 1832 the English Industrial Revolution was about to enter its most productive phase. Enterprise and industry, the traditional realms of the middle classes, were about to increase exponentially. The new Poor Law Amendment Act "assumed a labouring class which . . . was forced to give its best under the threat of hunger, so that wages were regulated by the price of gain".[27] The middle-class dependence on the labour of the working class made the working class the moral protector of bourgeois society, and the legitimiser of its authority.

19 Polanyi, *The Great Transformation*, n. 5 above, pp. 39–40. Polanyi thus cites agricultural efficiency as the sole purpose of the enclosure system, unlike Merriman, Marx and Thompson.

20 Ibid. p. 81.

21 Ibid. p. 82.

22 Ibid. p. 83.

23 Ibid. p. 83.

24 Ibid. p. 85.

25 Ibid. p. 102.

26 An Act to Amend the Representation of the People in England and Wales, short title: Representation of the People Act 1832 (2 & 3 Wm IV, c. 45); Merriman, *A History*, n. 10 above, p. 592.

27 Polanyi, *The Great Transformation*, n. 5 above, pp. 144–5.

Polanyi on "embeddedness"

Law continued to play an important role in "market society" after the English "bourgeois revolution".[28] Polanyi discusses the protectionism that enabled British industry to develop, the centralisation of banking through Peel's Bank Act of 1844 and the creation of an effective policing system and regime of criminal law needed for social control.[29]

Aside from the market requiring law, any attempt at disembedding the economic from society would result in measures taken by society to protect itself. Polanyi's concept of "embeddedness" expresses the idea that the economy cannot (or *should* not be)[30] self-regulating but must be subordinated to politics and social relations.[31] Polanyi argued that market society is unsustainable because it is fatally destructive to the human and natural contexts it inhabits.[32] By his oft-cited statement "[l]aissez faire was planned; planning was not", Polanyi means that these measures are spontaneous, ad hoc. But despite legislative acts adopted to manage problems arising out of modern industrial conditions (including, for example, "public health, factory conditions, municipal trading, social insurance, shipping subsidies, public utilities, trade associations, and so on"), liberal capitalism was also to fail in the early twentieth century.[33]

Collapse and revival?

In Polanyi's view, the attempt to organise high finance along the model of market liberalism through the Gold Standard led directly to both World Wars and the Great Depression.[34] Rothschilds and J P Morgan are accredited with a particular role, although they could be seen as *pars pro toto* for the undoubtedly much larger sector. The failure included not dealing adequately with the *international* aspect of high finance:

> The Rothschilds were subject to no one government; as a family they embodied the abstract principle of internationalism; their loyalty was to a firm, the credit of which had become the only supranational link between political government and industrial effort in a swiftly growing world economy.[35]

Writing during the Second World War (*The Great Transformation* was published in 1944), Polanyi argued that what is needed for a sustainable market-based system is that labour, land and money be "taken out of the market" and regulated by the state. Crucially, he does not give further details of what such regulation might entail – leading to the conclusion that social regulation must remain spontaneous, and reflect the liberal values inhering in society at a given point. Since Polanyi's thesis is that state regulation of the "economic" is required and desirable, the fact that he anchors his thesis in two main examples of failed regulation may seem odd. However, both examples were defective in Polanyi's mind in that their aim had not been to protect "the social", but *particular* interests: the interests of the squirearchy in the first example, and US interests in the second. Below I argue that Polanyi's conception of "the social" also reflects a particular section of society, namely the middle class, but first I examine the working class in relation to regulation of the economic.

28 Polanyi, *The Great Transformation*, n. 5 above, p. 145.

29 To this should be added, that "capitalism's main bearer" or "engine" is of course also a creature of law.

30 Polanyi wavers between arguing that the economy cannot, and should not, be separated from society, which has given rise to arguments over the correct interpretation of his work: F Block, "Introduction" in Polanyi, *The Great Transformation*, n. 5 above, p. xxiv.

31 Block, "Introduction", n. 30 above, p. xxvi.

32 Polanyi, *The Great Transformation*, n. 5 above, p. 3.

33 Ibid. p. 153.

34 Generally, ibid. pp. 11–32.

35 Ibid. pp. 11–12.

Karl Marx and Marxist approaches to the regulation of "the economic"

Marx on the length of the working day

Marx said, unless society forces capital, it will not improve the conditions of labour. Any change in the appalling labour conditions pertaining in the British factories of the time – which included children as young as seven working 16-hour days – like change in general, is achieved through class struggle.[36] In Chapter 24 of *Capital* vol. I, Marx analyses the eighteenth and nineteenth-century legal regulation of the length of the working day, which reflects His assessment of the role of law in capitalist society.[37]

Marx relates how "centuries of 'civil war' between capital and labour" have led to concessions made by capital in favour of workers. At times this has occurred because of labour shortage.[38] Once a concession is made and "enacted" in legislation, another struggle ensues over enforcement,[39] where the capitalist may insist on enforcement in order to avoid competition from "false brethren" – the insistence on a "level playing field".[40]

At other times the capitalist class would agree to compromise in return for a concession on another issue before Parliament. Capital found various ways to compensate for these concessions with economic violence, for example, through responding to a legal limit on the working day (the Ten Hour Act) with a reduction in wages – such that workers would then advocate the repeal of the law that had been passed in their favour.[41]

Enforcement increasingly became a battle between factory inspectors and magistrates. Marx describes one example where the magistrates rule on a particular alleged violation brought by a factory inspector – the magistrates themselves being, like the defendants, powerful cotton-spinners.[42] Dependence on the factory inspectors for enforcement also meant the workers had no direct access to legal mechanisms of redress. As Marx put it, "[t]he isolated worker succumbs"[43] – for this reason, Marx concludes:

> For "protection" against "the serpent of their agonies" the labourers have to put their heads together, and, as a class compel the passing of a law, an all-powerful social barrier that shall prevent the very workers from selling, by voluntary contract with capital, themselves and their families, into slavery and death. In place of the pompous catalogue of the "inalienable rights of men" comes the modest Magna Carta of a legally limited working-day, which shall make clear "when the time which the worker sells is ended, and when his own begins".[44]

This gives the superficial impression that Marx has substantial faith in law's emancipatory potential. From Marx's other writing we learn that this was not the case, and that his call for "an all-powerful social barrier" should be understood rhetorically. As Marx was eminently aware, and as Chris Arthur has surmised:

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36 K Marx and F Engels, *Manifesto of the Communist Party* (Moscow: Progress Publishers 1977), p. 40.

37 K Marx, *Capital: A critique of political economy* vol. I (London: Penguin 1976).

38 Ibid. p. 383.

39 Ibid. p. 392.

40 Ibid. p. 393.

41 Ibid. pp. 396–7.

42 Ibid. p. 401.

43 Ibid. p. 412.

44 Ibid. p. 416. The "modest Magna Carta" may refer to the efforts of the Chartist movement, the mass petition movement for universal suffrage, which, at the moment when other European countries were enacting their revolutions, was forcefully repressed in Britain. Merriman, *A History*, n. 10 above, p. 642.

> No amount of reformist factory legislation can overcome the basic presupposition of the law: that a property freely alienated belongs to the purchaser, and hence that the living labour of the worker becomes, through exchange, available for exploitation by capital.[45]

Marxism and the debate on "law's emancipatory potential"

As indicated above, Marxists are divided on the "emancipatory potential" of law, or, more generally, on the utility of law in class struggle or for the purpose of social regulation. Marx and Engels themselves did not provide an explicit theorisation of the role of law in society, although they include analyses in various texts.[46]

Some Marxists take a purely "functionalist" view of law, where law is conceived as the direct embodiment of the interests of the ruling class,[47] while others follow Pashukanis in his view that not merely the content, but also the *form* of law is inherently capitalist.[48] Marxist legal theorists such as Pashukanis and Stuchka date the origin of "bourgeois law" exactly to "primitive accumulation" (Marx's term for the private appropriation of commons land in the enclosure period occurring throughout Europe)[49] and the capitalist mode of production: the time when man comes to be seen as a legal person, the bearer of rights, who can engage in market transactions with other subjects as a formal legal equal. Pashukanis approximates the legal form to the commodity form.[50]

Miéville summarises the "commodity-form theory of law" as follows: "Law is a relation between subjects abstracted of social context, facing each other in a relationship predicated on private property, dependent on coercion."[51] Coercion and violence are inherent in the legal form as the notion of "mine" necessary to ownership and commodity exchange is only meaningful inasmuch as it is "mine-not-yours".[52] Capitalist law was "universalised" in the transition to capitalism: the rise to dominance of the bourgeoisie and the demise of the feudal system.[53] The rise of capitalism in Europe generally coincided with the advent of parliamentary democracy, through which – after the 1832 Reform Act – the bourgeoisie eventually gained political as well as economic control. The bourgeois state is described by

45 C Arthur, "Introduction" in E B Pashukanis (ed.), *Law and Marxism: A general theory* 1st edn (translation of 2nd edn published in 1926) (London: Ink Links 1978), p. 31.

46 Cain and Hunt provide a useful compendium of texts in which Marx and Engels deal with law: M Cain and A Hunt, *Marx and Engels on Law* (London: Academic Press 1979).

47 Ibid. pp. x–xi.

48 Pashukanis, *Law and Marxism*, n. 45 above; C Miéville, *Between Equal Rights: A Marxist theory of international law* (London: Pluto 2006); R Knox, "Marxism, international law and political strategy" (2009) 22 *Leiden Journal of International Law* 413.

49 Marx, *Capital*, n. 37 above, "Part eight: so-called primitive accumulation", pp. 873ff.

50 The latter point became the main difference between Pashukanis and Stuchka, who accuses Pashukanis of "economism" and holds that not all law is necessarily bourgeois law, but law is "class law" based on the will of the dominant class, and there is thus a possibility for proletarian law. P Stuchka, "State and law in the period of socialist construction" in R Sharlet, P Maggs and P Byrne (eds), *Selected Writings on Soviet Law and Marxism* (Armonk: M E Sharpe 1988), pp. 180–1. Pashukanis later (pragmatically or otherwise) came around to the necessity of law in the Soviet Union but eventually became a victim of one of Stalin's purges.

51 Miéville here speaks about international law, but the analogy applies to domestic law (any law) also. Miéville, *Between Equal Rights*, n. 48 above, p. 318. On the salience of a distinction between national and international law from a Marxist perspective (and taking a different view from Miéville), see A Rasulov, "The nameless rapture of the struggle: towards a Marxist class-theoretic approach to international law" (2008) 19 *Finnish Yearbook of International Law* 243, p. 259.

52 Miéville, *Between Equal Rights*, n. 48 above, p. 95, at n. 99.

53 For a more elaborate discussion of this process, see G Baars, *Law Congealing Capitalism: On the (im)possibility of restraining business in conflict through international criminal law*, PhD thesis expected submission December 2011, University College London.

Marxists as a "committee for managing the affairs of the middle class"[54] and an "ideological smokescreen to conceal [ruling class] hegemony".[55]

Legal struggle as class struggle

In the examples given by Marx in his chapter on the working day, the workers' struggle was a matter of survival – this is also acknowledged by Polanyi above – as according to the theory of surplus value the capitalist will seek to increase his profit by maximising "exploitation", that is, the extraction of surplus value from the worker through keeping her/him in work for the longest time possible at the lowest possible wage. While the "physical" limit on the working day lay at around 18 hours for adults, any further reduction was achieved through class struggle. Workers withheld their labour, resisted by means of strikes when the balance of collective bargaining was in their favour.

At other times power was not in their favour, as in the Ten Hour Act example above. A legislative Act in itself is also but one step, when enforcement of the legal provisions, or their avoidance, or amendment form new sites for struggle.

Class struggle through law has defined limits. According to Luxemburg:

> Trade unions cannot suppress the law of wages. Under the most favourable circumstances the best they can do is to impose on capitalist exploitation the 'normal' limit of the moment. They have not, however, the power to suppress exploitation itself, not even gradually.[56]

At the same time, law is used both to predict (or, *make predictable*) and *contain* class struggle:

> The juridical axiomatic . . . allows political forecasting on the part of the dominant classes: while it expresses a class relationship of forces, it also serves as a prop for strategic calculation by including among the variables of its system the resistance and struggle of the dominated class.[57]

Rosa Luxemburg's critique of Bernstein's programme is that he sees reform, including legal reform, as an end rather than a mere tactic. Like Polanyi, Bernstein believes a state of "freedom" can be achieved through reformist legal regulation and control, such that a revolution becomes redundant. Luxemburg's argument that this is not possible reflects Marx's "Critique of the Gotha programme"[58] and Engels' and Kautsky's critique of "juridical socialism" which are themselves critical commentaries on "reformist" political programmes.[59] In short, law's *form* precludes its emancipatory potential.

Pragmatism, tactics and realism

Some Marxist legal scholars argue for "principled opportunism", i.e. the use of law/legal struggle tactically when a window of opportunity opens.[60] Thus, legal struggle and social regulation can improve the circumstances of the workers and others in the short term or on an individual basis. Again, it can only do so within the parameters set by the current

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54 Marx and Engels, *Manifesto*, n. 36 above, p. 44.

55 Pashukanis, *Law and Marxism*, n. 45 above, p. 140. For more recent analyses, see, e.g., N Poulantzas, *State, Power, Socialism* (London: Verso 1978).

56 Luxemburg, "Reform or revolution", n. 3 above, p. 56.

57 Poulantzas, *State, Power, Socialism*, n. 55 above, p. 92.

58 K Marx, "Critique of the Gotha programme" in D McLellan (ed.), *Karl Marx, Selected Writings*, 2nd edn (Oxford: OUP 2000), pp. 610–16.

59 F Engels and K Kautsky, "Juridical socialism" (1977) 7 *Politics and Society* 203; and see also, P Beirne, "Introduction" (1977) 7 *Politics and Society* 199.

60 Knox, "Marxism, international law and political strategy", n. 48 above, p. 433.

mode of production, and as such it will amount to "attacking the twigs of the tree"[61] or "tinkering on the surface".[62] Such opportunism may indeed also serve to *legitimate* the current system, form a "pressure valve" for capitalism and thus be undesirable on strategic grounds, if a move away from the current system is indeed the aim.

Ultimately, what such a move necessitates is abandoning our "*juristische Weltanschauung*" ("juridical world view"), including liberal conceptions of right and justice which are generated by the capitalist mode of production.[63] Weighing against this perspective is the consideration that the legal struggle may function as a site for the development of class consciousness and practice in social organisation (unions as a precursor to socialism, cooperative worker-owned factories as simulations for the post-capitalist age, etc.).[64] Conversely, for lawyers and professional politicians, the concealment of economic facts (material reality, material inequality) by juridical discourse (discourse structured and contained by law) may *prevent* a coherent overall understanding of society.[65]

The debate among Marxists is far from being resolved, but is to some extent academic in both senses of the word.[66] While there is often a pragmatic need to use law defensively[67] (and one could include survival/hardship struggles such as those over the length of the working day) in this, the range of possible outcomes of a juridical struggle is *always* determined by the parameters set by the capitalist legal system and the underlying power relations,[68] and always forms only a part of a broader struggle. As per Marx, "Right can never be higher than the economic structure of society and the cultural development conditioned by it."[69]

So, while Polanyi expresses the hope or expectation that society would legislate to protect against the worst excesses of the market, Marxists point toward the structural limitations on what can be achieved through law, being essentially a creation, and *sine qua non* of capitalism. Ruggie and Shamir in turn show us that this dilemma is still very relevant today.

John Gerard Ruggie: bringing Polanyi into the twenty-first century

"Embedded liberalism"

In a 1982 article in *International Organization* – which has since become "one of the most frequently cited sources in the study of international political economy"[70] – John Gerard

61 Luxemburg, "Reform or revolution", n. 3 above, p. 82.

62 Miéville, *Between Equal Rights*, n. 48 above, p. 316.

63 Beirne, "Introduction", n. 59 above. Beirne describes this dominant bourgeois world view as "the secularisation of theology", p. 204).

64 See, generally, R Luxemburg, "Mass strike" in Scott (ed.), n. 3 above, pp. 111–81.

65 Beirne "Introduction", n. 59 above, p. 212 and at n. 206.

66 For an overview of different Marxist scholars' attitudes to law over the past four decades, see, P Ireland, "History, critical legal studies and the mysterious disappearance of capitalism" (2002) 65 *Modern Law Review* 120.

67 Elena Loizidou describes the dilemma, and its resolution through "parrhesia" of an anarchist in court, in her analysis of Emma Goldman's trial: E Loizidou, "Anarchism: this is what democracy looks like" (draft chapter, on file with author) in J Martel and J Casas Klausen (eds), *How Not to Be Governed: Readings and interpretations from a critical anarchist left* (Lanham: Lexington 2011).

68 See also, S Marks, "False contingency" (2009) 62 *Current Legal Problems* 1.

69 Marx, "Critique of the Gotha programme", n. 58 above, p. 615.

70 J G Ruggie, "Introduction" in J G Ruggie (ed.), *Embedding Global Markets: An enduring challenge* (London: Ashgate 2008), p. 1.

Ruggie introduces the term "embedded liberalism".[71] Ruggie (an international relations scholar attached to the Harvard Kennedy School of Government)[72] by coining this term engendered a "Polanyi-revival" in the social sciences: inspiring many dozens of attempts to update Polanyi's insights for the late twentieth and early twenty-first centuries.[73] Ruggie's "social constructivist" approach to the regulation of the economy also lies at the basis of the CSR regime which has developed in the past two decades and to which Ruggie contributed significantly in his function as the UN Special Representative on Business and Human Rights. The 1982 article was updated between 2002 and 2008, in particular to include the "corporate connection".[74]

Ruggie uses "embedded liberalism" to describe the post-Second World Ward liberalism which in his view was different from the liberal capitalism that had gone before (and which, he agrees with Polanyi, had led to both World Wars and the Great Depression).[75] The "embedded liberalism compromise" meant that "unlike the economic nationalism of the thirties, it would be multilateral in character; unlike the liberalism of the Gold Standard and free trade, its multilateralism would be predicated on domestic interventionism.[76] The multilateral order that was developed after the Second World War gained acceptance as a result of

> the extraordinary power and perseverance of the United States. But that multilateralism and the quest for domestic stability were coupled and even conditioned by one another reflected the shared legitimacy of a set of social objectives to which the industrial world had moved[77]

Notably, Ruggie did not take up or discuss Polanyi's proposal to "take labour, land and money out of the market".[78]

Embedded Liberalism 2.0: the corporate connection

Between 2002 and 2008 Ruggie developed an updated analysis of the state of "embedded liberalism" and introduced the "corporate connection". In the intervening 20-odd years, which saw "a new wave of globalisation broader and deeper than before",[79] a "global backlash" had occurred, not only against the multilateral financial institutions in amongst others the "Battle of Seattle",[80] but also against "capitalism's main bearer" the corporation. As in the latter half of the nineteenth century, the corporation becomes a major site for contestation, or indeed struggle. One of the causes of the backlash, aside from growing

71 J G Ruggie, "International regimes, transactions, and change: embedded liberalism in the postwar economic order" (1982) 36(Spring) *International Regimes* 379.

72 A survey in Foreign Policy magazine identified Ruggie as one of the 25 most influential international relations scholars in the United States and Canada: J Ruggie's biography on the Harvard University website: www.hks.harvard.edu/m-rcbg/johnruggie/bio.html (last accessed 9 May 2011).

73 Viz. other articles in this special edition.

74 J G Ruggie, "Taking embedded liberalism global: the corporate connection", Ralph Milliband Lecture, London School of Economics, 6 June 2002. The text of this lecture was published in a slightly longer form with the same title in Ruggie, *Embedding Global Markets*, n. 70 above.

75 Ruggie, "International regimes", n. 71 above, p. 392.

76 Ibid. p. 393.

77 Ibid. p. 398.

78 Ruggie, "Introduction", n. 70 above, p. 2.

79 Ibid. p. 4.

80 Ibid. p. 5. See further, generally, N Hertz, *The Silent Takeover: Global capitalism and the death of democracy* (London: Arrow 2002); R Broad (ed.), *Global Backlash: Citizen initiatives for a just world economy* (Lanham: Rowman & Littlefield Publishers 2002).

global wealth disparities, Ruggie asserts, is the "global imbalance in rule-making".[81] What he means by this is the fact that

> [t]hose rules that favor global market expansion have become more robust and enforceable in the last decade or two . . . [while] rules intended to promote equally valid social objectives, be they labor standards, human rights, environmental quality or poverty reduction, lag behind and in some instances actually have become weaker.[82]

In Ruggie's scheme, in order to attain a "socially sustainable globalisation", therefore, (and to avoid the backlash of the "isms": protectionism, nationalism, terrorism),[83] an "embedded legalism" must be generated: "a complex and evolving compromise between legalism and pragmatism, between rule- and power-based approaches".[84] As the "corporation is key to the embedded liberal compromise",[85] it makes sense that this enterprise lays its focus here.

Ruggie as Special Representative on Business and Human Rights: the corporate connection realised

In 2005, Kofi Annan appointed John Ruggie to the position of Special Representative of the Secretary General on Human Rights and Transnational Corporations and Other Business Enterprises.[86] Ruggie held many consultations with, and received thousands of submissions by, non-governmental organisations (NGOs), business leaders, elected representatives and academic experts of various disciplines.[87]

Ruggie's 2008 report, "Protect, Respect, and Remedy" which resulted from this process, rests on three pillars: the state duty to protect against human rights abuses by third parties, including business; the corporate responsibility to respect human rights (which in essence means to act with due diligence to avoid infringing the rights of others); and greater access by victims to effective remedy, both judicial and non-judicial.[88] The Human Rights Council (HRC) unanimously welcomed the framework and renewed Ruggie's mandate for three years.[89]

After "promoting and operationalizing" the framework, in 2011 Ruggie published the "Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework"[90] and has since published reports detailing

81 Ruggie, "Taking embedded liberalism global" in *Embedding Global Markets*, n. 70 above, pp. 233–4.

82 Ibid. p. 234.

83 K Annan, *A Compact for the New Century*, 31 January 1999 (UN Doc. SG/SM/6881) cited in Ruggie, "Introduction" , n. 78 above, p. 5.

84 For this notion, see A Lang, "Reconstructing embedded liberalism: John Gerard Ruggie and constructivist approaches to the study of the international trade regime" in *Embedding Global Markets*, n. 70 above, p. 24.

85 Ruggie, "Taking embedded liberalism global", n. 81 above, p. 253.

86 Commission on Human Rights, Resolution 2005/69, 20 April 2005 (UN Doc. E/CN4/RES/2005/69).

87 Lists can be found on the Human Rights Council website: www.ohchr.org/EN/Issues/TransnationalCorporations/Pages/SRSGTransCorpIndex.aspx (last accessed 3 September 2011).

88 Report of the Special Representative of the Secretary-General on the Issue of Human Rights and Transnational Corporations and Other Business Enterprises, John Ruggie, 7 April 2008 (UN Doc. A/HRC/8/5).

89 Report of the Working Group on an Optional Protocol to the International Covenant on Economic, Social and Cultural Rights on its Fifth Session, 18 June 2008 (UN Doc. A/HRC/RES/8/7).

90 Report of the Special Representative of the Secretary-General on the Issue of Human Rights and Transnational Corporations and Other Business Enterprises, 21 March 2011 (UN Doc. A/HRC/17/31).

applications of the framework by various parties.[91] The HRC unanimously adopted the guidelines in June 2011.[92]

Elsewhere I have contrasted the "respect, protect and remedy" framework with instances of corporate accountability from practice – including most notably the Nuremberg Trials of the industrialists after the Second World War.[93] Considering that the US military tribunals at Nuremberg based their judgments on binding international law norms, Ruggie's substantively weaker, non-binding framework effectively *morphs* law into a (privatised) governance regime[94] (while remaining "bourgeois law" in Pashukanis' sense). A main part of the "Ruggie effect" is the shifting of our gaze from the individual businessperson to the abstract corporate entity, which is nevertheless constituted by the Ruggie framework as an aspiring liberal citizen.[95]

In addition, the framework's "guidelines for implementation" defer normative responsibility to a future moment at which the state may never arrive, while creating a chasm between those affected by corporate activity (and omission) and the locus of the remedy. Affected persons become dependent on (Western) cause lawyers, who (at best) transform their grievance into a negotiable claim for monetary compensation. Primitive accumulation (or, in David Harvey's term, accumulation by dispossession)[96] and slave labour thus become quantifiable in terms of value and negotiable as between *formal legal equals*: the affected individual versus the Western multinational corporation.[97]

Despite Ruggie's own assessment of the failure of embedded liberalism highlighting the global imbalance of rule-making, his newly minted regime suffers from the same pathology. As such, it is unlikely to preserve or reinvigorate embedded liberalism. Instead, it tends more toward *neo*liberalism as described by David Harvey:

> in the first instance a theory of political economic practices that proposes that human well-being can best be advanced by liberating individual entrepreneurial freedoms and skills within an institutional framework characterised by strong property rights, free markets and free trade.[98]

Harvey additionally asserts that "neoliberalism values market exchange as 'an ethic in itself, capable of acting as a guide to all human action, and substituting for all previously held ethical beliefs'".[99] As such the "*neo*" in neoliberalism only refers to its temporal occurrence, and not to a *new* liberalism as such. Neoliberalism in Harvey's definition to all intents and purposes equals the liberal capitalism or market liberalism of the nineteenth century.

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91 www.business-humanrights.org/media/documents/ruggie/applications-of-framework-2-may-2011.pdf (last accessed 03.09.2011).

92 Resolution: Human Rights and Transnational Corporations and Other Business Enterprises, 16 June 2011 (UN Doc. A/HRC/RES/17/4).

93 Baars, *Law Congealing Capitalism*, n. 53 above.

94 See also, G Baars, "International law and the encoding of empire's privatisation", Critical Approaches to International Law Conference "The Force of International Law", Birkbeck College, London, 15–17 May 2006; and see, e.g., M Koskenniemi, "The fate of public international law: between technique and politics" (2007) 70(January) *Modern Law Review* 1.

95 On this notion, see also G Mundlak, "Industrial citizenship, social citizenship, corporate citizenship: I just want my wages" (2007) 8 *Theoretical Inquiries in Law* 719, p. 745.

96 D Harvey, *The New Imperialism* (Oxford: OUP 2003), pp. 137ff.

97 Baars, *Law Congealing Capitalism*, n. 53 above.

98 D Harvey, *A Brief History of Neoliberalism* (Oxford: OUP 2005). See also A Ong, *Neoliberalism as Exception: Mutations in citizenship and sovereignty* (Durham: Duke UP 2006).

99 Harvey, *A Brief History*, n. 98 above, p. 3.

What is "new" about neoliberalism is *the very fact* that it has come after a failed embedded liberalism. This aspect should not be underestimated, in particular for its ideological significance.[100] It allows an "end of history" discourse as well as the assertion that "there is no alternative".[101] A key element of neoliberalism (and indeed liberalism in general)[102] is *consent by the governed*.[103] In his 1982 article, Ruggie looked at "how power and legitimate social purpose become fused to project political authority into the international system".[104]

Likewise, Ruggie's business and human rights project is seeking to rehabilitate the multinational corporations, after the backlash, by instilling them with a legitimate social purpose (CSR) *while at the same time* allowing them (or rather, individual businesspeople *through* them) to exert authority on the global level. One way this authority is achieved is through (incrementally) fundamentally changing the way lawyers view law (which may have been partly the reason that Ruggie, an international relations scholar, was appointed as an expert on a human rights issue) – asserting that on the international level, we have "no international govern*ment*" but instead "gover*nance*" which is a "dynamic interplay between civil society, business and the public sector".[105]

This aspect in particular is picked up by Ronen Shamir in his analyses of the CSR field. Another is that of the "market-embedded morality."

Ronen Shamir: towards a market-embedded morality? A critique of corporate social responsibility

In a series of articles and book chapters, Ronen Shamir critiques the field of CSR.[106] CSR, according to Shamir, is the corporate response to the global backlash also mentioned by Ruggie, but with a particular dimension that makes it relevant to this discussion. Shamir asserts that the CSR regime was designed in particular to ward off legal activism from those seeking corporate accountability through either accountability lawsuits (e.g. through the US Alien Tort Claims Act) or the production of blueprints for the legal regulation of corporate responsibility.[107] This phenomenon itself shows a remarkable inversion, where law becomes the "sword" of choice for members of civil society who until recently mainly used law as a "shield", while the elite used law to constitute, entrench and protect its interests. It

100 In the seemingly endless cycle of liberalisms, it is now being suggested that "neoliberalism's failures" can be met with a "counter-hegemonic globalization", defined as a "globally organized project of transformation aimed at replacing the dominant (hegemonic) regime with one that maximises democratic political control and makes the equitable development of human capabilities and environmental statements its priorities": P Evans, "Is an alternative globalization possible?" (2008) 36(June) *Politics and Society* 271.

101 As used by Frances Fukuyama in *The End of History and the Last Man* (New York: Free Press 1992), and British Prime Minister David Cameron, respectively: "David Cameron: cuts won't be easy but there is no alternative", *The Guardian*, 6 October 2010 (reporting on the 2010 Conservative Party Conference).

102 Pre-liberal capitalist orders relied pre-eminently on coercion, while liberal orders to some extent are able to replace coercion with consent by "manufacturing consent" (N Chomsky, *Manufacturing Consent: The political economy of the mass media* (London: Vintage Books 2006) and creating "docile bodies" (M Foucault, *Discipline and Punish: The birth of the prison* (London: Vintage Books 1995).

103 Harvey, *A Brief History*, n. 98 above, pp. 39ff.

104 Ruggie, "International regimes", n. 71 above, p. 382.

105 Ruggie, "Taking embedded liberalism global", n. 81 above, p. 232.

106 R Shamir, "Corporate social responsibility: a case of hegemony and counter-hegemony" in B De Sousa Santos and C Rodriguez-Garavito (eds), *Law and Globalization from Below: Towards a cosmopolitan legality* (Cambridge: CUP 2005), pp. 94, 531–53; "Corporate social responsibility: towards a new market-embedded morality?" (2008) 9 *Theoretical Inquiries in Law* 32; "Between self-regulation and the alien tort claims act: on the contested concept of corporate social responsibility" (2004) 38 *Law and Society Review* 635; "Capitalism, governance and authority: the case of corporate social responsibility" (2010) 6 *Annual Review of Law Social Science*, pp. 531–53.

107 Shamir, "Between self-regulation", n. 106 above, p. 636.

is therefore not surprising that the corporate response is to break the "sword" by insisting on a notion of CSR as an "essentially voluntary and non-enforceable issue".[108]

The strategic move by businesspeople in this "field of contention" has been "to become actively involved in various displays of corporate responsibility".[109] The effect has been the privatisation of regulatory structures – with businesspeople being able to define (and diffuse) the limits of their own responsibility through layering onto the legal corporation construct various voluntary guidelines, *while looking good doing it*. Having set the parameters, a trend toward the legalisation[110] of CSR forms no threat to the businessperson – on the contrary, concealed from view, she or he can now use the lower standard *congealing into law* to "level the playing field" with competitors and activists alike. As in the example of the struggle over the working day, resistance is domesticated by legal compromise. And, as in the working day example, enforcement necessitates a whole new struggle, involving representation, middlemen and women, institutional and systemic constraints.

Shamir asserts that "an intense interest in ethics and morality has mushroomed alongside the triumphant ascendance of market rationality as a general principle for conducting social relations".[111] At the same time, "[a]uthority itself is being privatized, transforming rules in general and public policies in particular into commodities that are produced, distributed, and consumed by a host of agencies, enterprises, and non-profit organizations".[112] Rather than a re-embedding of the market in society, Shamir finds:

> [T]he discourse and practice of business and morality is a product of the neo-liberal project of dissolving the epistemological distinction between market and society. The greater the drive to embed society in the market, the more socio-moral questions . . . become reframed from within the market.[113]

This (false) synthesis between economy and morality "further consolidates, rather than undermines, the neo-liberal social order".[114]

How did this situation come to be? Shamir argues that the collapse of welfare-state liberalism brought into being a neoliberal order governed through a "market of authorities", where the state is no longer the sole or main site for the production of legitimacy, where law becomes a "shared problem-solving process" and instruments such as guidelines and standards replace much hard law.[115] Neoliberal responsibilisation is directed at individuals and at institutions including corporations and is based on the model of a rational actor who assesses costs and benefits of his or her actions: who, in other words, makes moral decisions on the basis of the logic of the market.[116]

Assessed from a Marxist perspective, this situation is not new. The "cash nexus" that pervades all relationships including basic human relationships in capitalism means cost/benefit or value calculations are made when deciding upon particular (trans)actions. What is new about neoliberalism viewed from a Marxist perspective is that the "relative autonomy" that was accorded to the state (whether or not this autonomy was real or merely

108 Shamir, "Between self-regulation", n. 106 above, p. 636.

109 Ibid. p. 644.

110 In the sense of codification and adoption in formal legal instruments such as a potential future "CSR treaty". As noted above, I include CSR and similar norms produced through global governance in "bourgeois law" in Pashukanis' sense.

111 Shamir, "Corporate social responsibility", n. 106 above, p. 372.

112 Ibid. p. 372.

113 Ibid. p. 373.

114 Ibid. p. 374.

115 Ibid. pp. 378–9.

116 Ibid. p. 380.

ideological)[117] is now in the process of disappearing. While before, states may have produced class law, now, class law is produced directly by the capitalist class without the mediation of the state.

Moreover, the effect of responsibilisation is that we perceive this state of affairs as legitimate. Consciously or otherwise, the discourse of those making moral claims of market actors (NGOs, cause lawyers, activists) forms a constitutive element of the structure it is seeking to subvert.[118] On top of this:

> [o]nce all players involved, namely national governments, global institutions, corporations, and civil society organizations, share the private regulation approach within the broader governance matrix, a whole new set of questions arises concerning the conditions for the perception, articulation and creation of socio-moral sensibilities and their translation into concrete political action.[119]

Henceforth, "welfare-governance" is articulated according to the logic of the market and "de facto 'cancel[s]' any notion of contestation between social interests and economic imperatives".[120] Moral considerations lose their transcendental value and re-emerge as business opportunities.[121]

Shamir highlights the "adaptability" of capitalism that Rosa Luxemburg analysed in "Reform or revolution".[122] Moreover, Shamir demonstrates there is no in-between, between the market and "post-capitalism". What we view as "embedded liberalism" is in fact "market-embedded morality" or neoliberalism, which is classical liberal capitalism.

Governance: society, class, or global domain?

One main weakness of Polanyi's theory is precisely this lack of a clear separation between the "*sein*" and the "*sollen*": the "is" and the "ought".[123] The idea that a self-regulating market ("market society") cannot exist rests on the assumption that "society" can and will prevent this, based on a sense that the destruction brought about by market society is *wrong*, *undesirable*. Likewise Marx's concept of class struggle relies on the idea that the worker/the working class know (and *feel*) themselves to be exploited and in due course gain class consciousness and seek to come out from under the yoke of capitalism through revolution. Both are rather significant assumptions to make but empirical reality points towards a greater likelihood of the (vastly larger) exploited class struggling to better their situation, than it does to "society as a whole" seeking to remedy the negative effects of the market when, for some, the positive effects clearly outweigh the negative.

117 On this notion, see L Althusser, "Contradiction and overdetermination" in F Maspero (ed.), B Brewster (trans.), *For Marx* (New York: Random House 1969), pp. 87–128.

118 Shamir, "Corporate social responsibility", n. 106 above, p. 388.

119 Ibid. p. 389. On the notion of governance and related points in more detail, see also Shamir, "Capitalism, governance and authority", n. 106 above.

120 Shamir, "Corporate social responsibility", n. 106 above, p. 389.

121 Ibid. p. 394.

122 Rosa Luxemburg argues that those measures of capitalist "adaptation" cited by Bernstein, e.g., the development of a credit system, in fact confirm Marx's theory of crisis because such adaptations flow out of, and in fact exacerbate, capitalism's inner contradictions and move capitalism towards its inevitable collapse (Luxemburg, "Reform or revolution", n. 3 above, pp. 47–55). See also, Marx and Engels, *Manifesto*, n. 36 above, pp. 45ff, 60.

123 I use this not in the strict Kelsenian legal sense but in the general sense of the conflation of fact and norm, or, perhaps in this case more accurately, the *fact* and the *wish* or *moral sentiment*.

Polanyi is by no means unaware of class, making frequent reference to "the common people" and their character, and role in society.[124] As Polanyi sees "society" rising up to protect itself, what does he mean by "society", or, what (section of) society would have been "springing up" in the particular historical conjunctures described by Polanyi? At the time of Speenhamland this was the squirearchy, though after the Reform Act and the completion of the transition to capitalism, the society that was "discovered" was the bourgeoisie.

In line with Marxism's internationalism, the notion of global classes has recently been elaborated in legal scholarship by among others B S Chimni: "the 'transnational capitalist class' (TCC) operates in the transnational public sphere and drives globalization in both the developed and third world countries".[125] Ruggie's concept of the "global domain" where civil society, business and states are the norm-creators is clearly a connected notion, albeit perceived from a different ideological standpoint. Ruggie argues that "[a] global public domain is emerging which cannot substitute for effective action by states but may help *produce* it".[126] Shamir's conception of governance is a stronger version of the same idea.

That Ruggie approximates Shamir's horizontal governance "market of authorities" (where the TCC rule) is implicit in his closing observations:

> [t]he very different dynamic at work now compared with the 1980s is that business wants to help channel some of the pressures it faces into the *construction* of at least minimally effective public sectors, including at the global level.[127]

What we have, then, is a "fundamental recalibration of the public–private sector balance".[128] In other words, the contemporary analysts appear to agree in general terms on the current configuration of the global order – which leaves us only the final question: what is to be done?

Conclusion: market or revolution?

Finally, I now return to Rosa Luxemburg and this article's title, "Reform or revolution?", for a conclusion on the regulation of the economy, through law. Luxemburg's own position on the issue is implied here:

> No law obliges the proletariat to submit itself to the yoke of capitalism. Poverty, the lack of means of production, obliges the proletariat to submit itself to the yoke of capitalism. And no law in the world can give to the proletariat the means of production while it remains in the framework of bourgeois society, for not laws but economic development have torn the means of production from the producers' possession.[129]

Of course, for Rosa Luxemburg, to reform or revolt is not a matter of choice, as revolution is inevitable:

> The scientific basis of socialism rests, as is well known, on three principal results of capitalist development. First, on the growing anarchy of capitalist economy, leading inevitably to its ruin. Second, on the progressive socialisation of the process of production, which creates the germs of the future social order. And

124 In addition, Polanyi sees the division of labour being a result of biological (e.g. sex) and geographical factors.

125 B S Chimni, "Prolegomena to a class approach to international law" (2010) 21 *EJIL* 57, and the response to this article, A Rasulov, "Bringing class back into international law", 6 September 2008, available at SSRN: http://ssrn.com/abstract=1675447 (last accessed 9 May 2011).

126 Ruggie, "Taking embedded liberalism global", n. 81 above, p. 232.

127 Ibid. p. 252 (emphasis added).

128 Ibid. p. 253.

129 Luxemburg, "Reform or revolution", n. 3 above, p. 92.

> third, on the increased organisation and consciousness of the proletarian class, which constitutes the active factor in the coming revolution.[130]

"Market-embedded morality" and class law produced through global governance contributes to "the growing anarchy of the economy" – and thus to capitalism's end. When this moment arrives, Marxists envisage capitalism's replacement by a "dictatorship of the proletariat" as a temporary phase before the state withers away and we achieve communism.[131] The idea is that law, too, will wither away, leaving just such "technical regulation" as is necessary for the practical, logistical organisation of society. Such regulation differs from law in its "unity of purpose", as opposed to law, which is based on disunity of purpose or contestation.[132] Production and distribution will be organised, not on the basis of "*equal* rights", but on the basis of "from each according to his ability, to each according to his needs!"[133]

Polanyi emphasises that we need control and legal regulation to ensure, in particular, "freedom".[134] Communist society envisages emancipation from law: instead of "legal emancipation" – which is the abstract equality enjoyed by the citizen as legal subject: "*human* emancipation" we achieve:

> [o]nly when the real, individual man re-absorbs in himself the abstract citizen, and as an individual human being has become a species-being in his everyday life, in his particular work, and in his particular situation, only when man has recognised and organised his "*forces propres*" as social forces, and consequently no longer separates social power from himself in the shape of political power, only then will human emancipation have been accomplished.[135]

Besides "rights", "justice" is another concept which in Marxism is associated with liberalism.[136] Neither are part of the vision, encapsulated in Aristotle's adage, "Where people are in Friendship Justice is not required."[137]

With the aid of the concept of "market-embedded morality", Shamir has shown us, that the dichotomy between liberal capitalism and embedded liberalism is a false one. Combined with Pashukanis' commodity form theory of law, we can conclude that taming the market through legal regulation is a structural impossibility. This being the case, Rosa Luxemburg's equation of the question of "Reform or revolution?" with "To be or not to be?"[138] is once again salient.

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130 E.g. Marx and Engels, *Manifesto*, n. 36 above, p. 60; Luxemburg, "Reform or revolution", n. 3 above, p. 45. On this, in general and on the failure of this process in the example of the Soviet Union, see Sharlet et al., "Introduction" in *Selected Writings on Soviet Law and Marxism*, n. 50 above, especially pp. xii–xx.

131 See, generally, e.g. V I Lenin, *The State and Revolution* (New York: International Publishers 1932); see also, generally, Marx, "Critique of the Gotha programme", n. 58 above.

132 Pashukanis, *Law and Marxism*, n. 45 above.

133 Marx, "Critique of the Gotha programme", n. 58 above, p. 615.

134 Ironically, Polanyi cites this phrase without attributing it to Rosa Luxemburg, "Freiheit ist immer die Freiheit des Andersdenkenden": R Luxemburg, *Die russische Revolution. Eine kritische Würdigung* (Berlin 1920), S. 109; Rosa Luxemburg, *Gesammelte Werke* Band 4, S. 359, Anmerkung 3 (Berlin: Dietz Verlag 1983).

135 K. Marx, "On the Jewish Question" in D McLellan (ed.), n. 58 above, p. 64. Another attractive description of emancipated post-capitalism can be found in O Wilde, "The soul of man under socialism" in *The Complete Works of Oscar Wilde* (London: Book Club Associates 1978), pp. 1079–104.

136 See also C Douzinas, "Adikia: on communism and rights" in S Zizek and C Douzinas (eds), *The Idea of Communism* (London: Verso 2010), p. 95.

137 Aristotle, *Ethics*, Book VIII.

138 Luxemburg, "Reform or revolution", n. 3 above, p. 42.

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Part II: How to embed economic in social relationships?

From black box to glocalised player? Corporate personality in the twenty-first century and the scope of law's regulatory reach

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Abstract

This article seeks to investigate the evolving notion of corporate personality from the nineteenth century to the present and the scope for the regulatory effect of law thereon especially in terms of the ongoing management of the relationship between the economic and the social spheres. Utilising the work of the economic historian Karl Polanyi on the rise of the self-regulating market in the nineteenth century, it will suggest that the most appropriate image underlying the dominant legal conception of the company in the twentieth century was that of a black box by which the company was largely isolated from its broader social and political environment as a result of the complex interaction of legal and economic discourses surrounding the emergence of a distinct market-based economic sphere. In the light of the current financial crisis, and even more pertinently against the backdrop of the risk of potentially irreversible environmental degradation, many of the fundamentals of the market-based economic paradigm are presently being called into question. Accordingly, it will be argued, drawing upon Polanyi's notion of the double movement read in the light of Ulrich Beck's account of reflexive modernity, that the black box model of the company is increasingly perceived as inappropriate for the twenty-first century and that to attain greater institutional legitimacy there is pressure for the legal conception of corporate personality to be reconfigured as that of a glocalised player open to its environment. The article will conclude by examining the scope of law's regulatory power to construct such a holistic corporate personality capable of commanding such institutional legitimacy, with particular reference to the significance of s. 172 Companies Act 2006.

> . . . the corporation is an institutional reflection of the principles of laissez faire capitalism. Changing it must be understood as part of a larger project of economic change.[1]

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1 J Bakan, *The Corporation: The pathological pursuit of profit and power* (London: Constable & Robinson 2004), p. 161. The difficulties inherent in this formulation, given the clear involvement of the state in the incorporation of the corporate entity and the provision of limited liability, will be subject to discussion in the body of this article.

Introduction

Implicit within the theme of socialising economic relations is the notion that the economic and the social occupy separate spaces and, indeed, that the political and ethical spheres also constitute discrete realms within modernity. Whilst this article will argue that the issue is always one of relative autonomy/connectedness between the economic and the social spheres, it will also suggest that law's power to frame issues has been highly influential in constructing a dominant corporate rationality based on a seemingly discrete economic domain. However, as the current financial crisis has demonstrated, when there is a shock to the economic system the seemingly natural boundaries between these spheres become exposed and the different rationalities that govern their operation are opened to general scrutiny and interrogation.[2] Hence, the ongoing public debate over bankers' remuneration, especially in relation to the "publicly owned" banks, illustrates the fault-line between the "economic sphere", which dictates that pay is determined solely pursuant to the rationality of the market, as against wider societal concerns that there is no equity in a situation where support for the banking sector is socialised but the resultant market remains seemingly largely impervious to wider accountability.[3] Although the result of the subsequent formal regulatory analysis of the crisis would appear to be focused principally around a re-assessment of the internal analytical framework of the relevant sphere, as, for example, in the discrediting of the efficient market hypothesis, or the so-called "light touch regulation" model,[4] it has on occasion touched more fundamentally upon the interrelationship between the different spheres as demonstrated by the chair of the Financial Services Authority Adair Turner's condemnation of "socially useless" banking practices.[5]

However, despite the literally mind-blowing figures involved in governments' support for banks and the financial sector across the globe, it is clear that, as Zygmunt Bauman has put it, "[t]he present 'credit crunch' does not signal the end of capitalism – only the exhaustion of the latest grazing pasture".[6] Indeed, for many commentators the opportunity for wider reform has already largely been lost with a return to business much as usual with evidence of essentially the same business culture and rationality in operation.[7] Nevertheless, the crisis has directly highlighted the social dislocation that is capable of emanating from the economic sphere and in this respect it combines with other critical contemporary discourses of capitalism,[8] particularly surrounding the degradation of the environment by

2 See e.g. generally the essays in R Williams and L Elliot (eds), *Crisis and Recovery: Ethics, economics and justice* (Basingstoke: Palgrave Macmillan 2010) and specifically in business literature M E Porter and M R Kramer, "Creating shared value" (2011) 89 (issue 1/2) *Harvard Business Review* 62.

3 At the time of writing the latest settlement of this issue between the state and the banking sector in the UK is to be found in the disclosure requirements attached to the Project Merlin agreement.

4 See e.g. *The Turner Review: A regulatory response to the global banking crisis* (London: FSA 2009), especially paras 1.4 and 2.7.

5 For a nuanced and wide-ranging debate that included this point, see the roundtable discussion, "How to tame global finance", *Prospect Magazine* (issue 162), 27 August 2009.

6 Z Bauman, *Living on Borrowed Time* (Cambridge: Polity 2010), p. 17.

7 See e.g. "Once-zealous reformers in the grip of a Zen-like trance", *Financial Times*, 19 April 2011, p. 14, and Joseph Stiglitz's, "Afterword" in J Stiglitz, *Freefall: Free markets and the sinking of the global economy* (London: Penguin 2010). The text had originally concluded more optimistically with a chapter entitled, "Towards a new society" which, inter alia, expressly noted the role of economic rationality in reducing the responsibility of market actors, ibid. p. 281.

8 See e.g. Stiglitz, *Freefall*, n. 7 above; H-J Chang, *23 Things They Don't Tell You about Capitalism* (London: Allen Lane 2010); and D Harvey, *The Enigma of Capital and the Crises of Capitalism* (London: Profile 2010).

business activity (as all too vividly illustrated by the Deepwater Horizon explosion and oil spillage in the Gulf of Mexico in 2010) given the need for sustainable development.[9]

Taking this contemporary background as a jumping-off point, this article seeks to analyse the rise of a distinctive economic/business space in the context of the development of nineteenth-century capitalism with particular reference to the role and legal conceptualisation of the corporate entity. Utilising Karl Polanyi's analysis in *The Great Transformation* of the rise of the self-regulating market in the nineteenth century and his concepts of embeddedness and the double movement as a meta-framework, this article charts the way in which laissez-faire ideology and judicial formalism combined to generate a legal vision of the company as a black box divorced from its broader social, political and ethical environment. It will argue that the emergence of the limited liability company was of central importance in this story, enabling "the emancipation of business interests from all extant socio-cultural institutions of ethically inspired supervision and control . . . and consequently the immunization of business pursuits against all values other than the maximization of profit"[10] but also ensuring that the regulatory implications of this intervention were largely ideologically suppressed.

By the first decade of the twenty-first century, the result of this governance vacuum, in the intensified market-based environment of a globalised and privatised economic realm,[11] had led commentators such as Joel Bakan to characterise the corporation with its market-based rationality as a psychopathic creature, an externalising machine only capable of acting in its own self-interest.[12] In the terms offered by Polanyi's theoretical framework, such aggrandisement on behalf of the economic realm, through the privileging of a self-regulating market rationality, is bound to result in a protective societal countermovement (which Polanyi terms the double movement), especially considering the growing power of the company during the twentieth century. It is suggested that a contemporary way of theorising this point is through the lens offered by way of the notion of reflexive, or second, modernity by which "[t]he continued, technical, economic, political and cultural development of global capitalism has gradually revolutionised its own social foundations".[13] The ongoing process of "the modernization of modern society"[14] is one that in particular erodes the givenness of the key naturalisations of first modernity such as the differentiation and separation of the political and economic spheres (as well as the commodification of nature) and thereby entails the "necessity of institutionalizing self-consciously fictive boundaries".[15]

9 See e.g. J Porritt, *Capitalism As if the World Matters* (London: Earthscan 2005) and T Jackson, *Prosperity without Growth: Economics for a finite planet* (London: Earthscan 2009).

10 Bauman, *Living on Borrowed Time*, n. 6 above, p. 61. For a discussion of the relationship of Bauman and Polanyi's work concerning the corrosive effects of a market society, see E Christodoulidis, "The politics of liquid modernity: Polanyi and Bauman on commodification and fluidity" in J Přibáň (ed.), *Liquid Society and its Law* (Aldershot: Ashgate 2007).

11 S Picciotto, "Liberalization and democratization: the forum and the hearth in the era of cosmopolitan post-industrial capitalism" (2000) 63 *Law & Contemporary Problems* 157.

12 Bakan, *The Corporation*, n. 1 above, especially chs 2 and 3.

13 U Beck, W Boss and C Lau, "The theory of reflexive modernization" (2003) 20 *Theory, Culture & Society* 1, p. 2. See also U Beck, A Giddens and S Lash, *Reflexive Modernization: Politics, tradition and aesthetics in the modern social order* (Cambridge: Polity 1994).

14 Beck et al., "Theory", n. 13 above.

15 Ibid. p. 22.

Companies,[16] as key institutions in the globalised economy, are thus placed under increasing scrutiny and are required to legitimate their business operations not only by the aforementioned redrawing of boundaries (especially concerning the environment) but also by their increasing role as glocalised players whereby they are required to negotiate the framing of the economic sphere in the light of the fissures generated by the interpenetration of local and global configurations of cultural, social and political spheres.[17]

In this context, it will be argued that s. 172 Companies Act 2006, which concerns the directors' core duty to promote the success of the company, has at the least an important symbolic effect in terms of the *legal* conceptualisation of the company. It does so by *explicitly* recognising for the first time (through the specification of a non-exhaustive list of statutory factors) that the substantive arena of ongoing corporate business activity within the company at board level is one which is *intrinsically* (and not by way of extrinsic independent regulation of the relevant substantive field e.g. health and safety or environmental law) legible to core company law and potentially within its regulatory reach.[18] As such, a legal fissure is generated in the black box of corporate business practice whereby its internal economic rationalities are *formally* placed within a wider framing of a legal landscape which explicitly includes within its contours factors which traditionally would be considered as externalities, such as the environment.

The article will conclude by assessing briefly the scope and practical limitations to the reach of s. 172 Companies Act 2006 and the significance of Polanyi's scholarship on different conceptions of instituting the economic in the light of the opening quote from Bakan.

The Polanyian framework

Karl Polanyi, in his leading work, *The Great Transformation*,[19] sought to chart the development of what he termed the idea of the self-regulating market, enshrining the principles of economic liberalism (viz. free-market exchange motivated by rational self-interest in conditions of scarcity), in the nineteenth century. Unusually, given that it is his most influential book, Polanyi wrote *The Great Transformation* at the beginning of his oeuvre of major works and, as he both hurried to finish it so as to influence the post-Second World War settlement and did not subsequently revisit it, there are inevitably inherent difficulties in the text.[20] Nevertheless, Polanyi's basic position is clearly illustrated by the following quote from *The Great Transformation*:

16 The transformation of the concept of the corporation under conditions of reflexive modernisation is explicitly raised as a research question in Beck et al., "Theory", n. 13 above, p. 29.

17 See, generally, R Robertson, "Glocalization: time-space and homogeneity–heterogeneity" in M Featherstone, S Lash and R Robertson (eds), *Global Modernities* (London: Sage 1995) and U Beck, *Power in the Global Age* (Cambridge: Polity 2005). In relation to companies specifically, see B Holzer and M P Sørensen, "Rethinking subpolitics: beyond the 'iron cage' of modern politics?" (2003) 20 *Theory, Culture & Society* 79, pp. 87–91.

18 Admittedly, once a company has become insolvent, insolvency law and especially the largely associated regime for the disqualification of directors have also some purchase here. See, further, T C Halliday and B G Carruthers, "The moral regulation of markets: professions, privatization and the English Insolvency Act 1986" (1996) 21 *Accounting, Organizations and Society* 371.

19 K Polanyi, *The Great Transformation* 2nd edn (Boston: Beacon Press 2001 [1944]).

20 For further discussion, see F Block and M R Somers, "Beyond the economistic fallacy: the holistic social science of Karl Polanyi" in T Skocpol (ed), *Vision and Method in Historical Sociology* (Cambridge: CUP 1984); F Block, "Karl Polanyi and the writing of *The Great Transformation*" (2003) 32 *Theory and Society* 275; S Halperin, "Dynamics of conflict and system change: *The Great Transformation* revisited" (2004) 10 *European Journal of International Relations* 263; M Harvey, R Ramlogan and S Randles (eds), *Karl Polanyi: New perspectives on the place of the economy in society* (Manchester: Manchester UP 2007); and G Dale, *Karl Polanyi* (Cambridge: Polity 2010).

> A self-regulating market demands nothing less than the institutional separation of society into an economic and a political sphere. Such a dichotomy is, in effect, merely the restatement, from the point of view of society as a whole, of the existence of a self-regulating market. It might be argued that the separateness of the two spheres obtains in every type of society at all times. Such an inference, however, would be based on a fallacy. True, no society can exist without a system of some kind which ensures order in the production and distribution of goods. But that does not imply the existence of separate economic institutions; normally, the economic order is merely a function of the social order . . . Nineteenth-century society, in which economic activity was isolated and imputed to a distinctive economic motive, was a singular departure.[21]

The basis of the self-regulating market lies in the production of commodities, which Polanyi defines as goods produced for sale on a market, whose exchange is determined by the price mechanism. However, for the market to be self-regulating, labour, land and money must also be commodified, but these elements in Polanyi's account are by definition fictitious commodities as they are not produced for sale on a market. Hence, in contrast to the economic liberals, in Polanyi's view, "[t]here was nothing natural about laissez-faire; free markets could never have come into being merely by allowing things to take their course . . . laissez-faire itself was enforced by the state"[22] and thus, paradoxically, and in terms with much contemporary resonance in neoliberal discourse, "[t]he road to the free market was opened and kept open by an enormous increase in continuous, centrally organised and controlled interventionism".[23]

Indeed, Polanyi's overall aim in writing *The Great Transformation* was to present a critical analysis of economic liberalism and to this end he made his viewpoint clear from the outset:

> [o]ur thesis is that the idea of a self-adjusting market implied a stark utopia. Such an institution could not exist for any length of time without annihilating the human and natural substance of society: it would have physically destroyed man and transformed his surroundings into a wilderness.[24]

In other words, the disembedding of the economy (a phrase that Polanyi does not use extensively in *The Great Transformation* itself) pursuant to the development of the self-regulating market was so threatening to the continued existence of society that:

> [f]or a century the dynamics of modern society was governed by a double movement: the market expanded continuously but this movement was met by a countermovement checking the expansion in definite directions. Vital though such a countermovement was for the protection of society, in the last analysis it was incompatible with the self-regulation of the market, and thus with the market system itself.[25]

As can be seen from the wider Polanyi literature, the above formulations have given rise to some considerable difficulties. One reading of the theoretical arrangement is that the self-regulating market does in fact result in a disembedding of the economy from the social system and that the double movement involves a political response by coalitions in society (notably not class-based in Polanyi's own framework, where, indeed, he also refers

21 Polanyi, *The Great Transformation*, n. 19 above, p.74.
22 Ibid. p. 145.
23 Ibid. p. 146.
24 Ibid. p. 3.
25 Ibid. p. 136.

to market society rather than capitalism) to re-embed economic processes in order to generate stability.[26]

Alternatively, it is argued that such a reading would involve Polanyi in endorsing the very "economistic fallacy"[27] (i.e. that the particular institutional arrangement of economic processes in the nineteenth century based on market exchange was universal, comprising an essentialist natural sphere of activity otherwise autonomous from society) that he seeks to critique in economic liberalism. Accordingly, the embeddedness concept should instead refer to the wider problematic of the "shifting place of the economy in society"[28] and the double movement accordingly be configured as "a process of de- and re-regulation, ultimately reflecting a shifting relationship of polity and economy".[29] As a result, "[b]oth the concept and the historical reality of modernity is one of relative differentiation of the economy *within* society".[30]

An extended analysis of Polanyi's theoretical structure in this respect is given by Fred Block,[31] who argues that during the course of writing *The Great Transformation* Polanyi underwent an epistemological break by which he moved away from his initial Marxist influences and came to reject the very ontological possibility of a self-regulating market operating as a discrete economic realm. This led to contradictions in the text particularly concerning the concept of embeddedness[32] for, as Block points out:

> [i]t is not logical for Polanyi to claim both that a system of self-regulating markets was impossible and that any effort to constrain or limit market self-regulation was doomed to produce a systemic crisis.[33]

Block's solution to the conundrum is to determine that, although Polanyi was not able to resolve the tension himself, he had in fact discovered the "idea of the always embedded market economy"[34] which challenges the concept of "an analytically autonomous economic sphere that has a logic and rationality of its own"[35] in favour of an acknowledgment of an always embedded market economy determined pursuant to ongoing constitutive processes deriving from "interaction among self-interested agents, the actions of the state, and forms of social regulation".[36] In Block's view, as the economic, the political and the social are thus intertwined, there is more scope for effective political engagement

26 See e.g. G Baum, *Karl Polanyi on Ethics and Economics* (Montreal and Kingston: McGill-Queen's UP 1996), ch. 2 and pp. 50–2; D Harvey, *Spaces of Global Capitalism* (London and New York: Verso 2006), pp. 80–1; and A Buğra and K Ağartan (eds), *Reading Karl Polanyi for the Twenty-First Century: Market economy as a political project* (Basingstoke: Palgrave Macmillan 2007), especially ch. 9.

27 K Polanyi, *The Livelihood of Man*, H W Pearson (ed) (New York: Academic Press 1977), ch. 1.

28 For an elaboration of this argument see, Harvey et al., *Karl Polanyi*, n. 20 above, p. 4.

29 Harvey et al, *Karl Polanyi*, n. 20 above, p. 8.

30 Ibid. pp. 11–12.

31 Block, "Karl Polanyi", n. 20 above.

32 This concept has led to some difficulties as it is not significantly developed by Polanyi and has been appropriated in a different context by economic sociologists. For a review of the literature, see G Krippner et al., "Polanyi symposium: a conversation on embeddedness" (2004) 2 *Socio-Economic Review* 109; G Krippner and A Alvarez, "Embeddedness and the intellectual projects of economic sociology" (2007) 33 *Annual Review of Sociology* 219; and K Gemici, "Karl Polanyi and the antinomies of embeddedness" (2008) 6 *Socio-Economic Review* 5.

33 Block, "Karl Polanyi", n. 20 above, p. 287.

34 Ibid. p. 298.

35 Ibid. p. 298.

36 Ibid. p. 300.

to bring economic activity within democratic control and to allow for different societies to adopt different institutional arrangements.[37]

In sum, Polanyi can be read as either producing an account of the rise of the self-regulating market as a distinctive radically autonomous economic sphere which acknowledges it as such and hence characterises the double movement as an attempt to re-embed it in society, or (as this writer would prefer) as providing a more iterative constitutive notion of the double movement as mediating the relation of the economic within the social and in which the state, in particular, has a central role. Unfortunately, Polanyi did not continue with his analysis of the market economy and its processes after completing *The Great Transformation* but instead moved to the study of archaic societies to examine how economic processes were instituted therein.[38] Accordingly, the above fault-line remains unresolved in his work, which nevertheless remains stimulating in interrogating the relationship of the economic and the social, and the market and the state, by breaking down the naturalisation of the economic and the market inherent in economic liberalism and situating them firmly within wider social processes.[39]

Interestingly, a parallel dichotomy would seem to run through the development of corporate theory whereby there is again an unresolved tension between viewing the company as a creature created and disciplined by laissez-faire or regarding it as a creature of state-sponsored regulatory intervention and at root a political construct with wider social obligations.[40] Descriptive accounts of the nature of companies would generally associate the former approach with a property/contractual shareholder-focused model of the company and the latter with an entity-based stakeholder-orientated model. However, as David Millon has persuasively demonstrated, there is no necessary normative outcome flowing from the adoption of a particular theory of corporate personality and, indeed, the same theory may in fact be used to support divergent normative prescriptions.[41] Nevertheless, Bakan's quote at the beginning of this article clearly reflects the dominant neoclassical economic approach to the company with its emphasis on the corporate operating rationality reflecting a distinctive market-based rationality.[42]

37 For an example of such a pluralist approach, albeit on a different theoretical footing, see P A Hall and D Soskice (eds), *Varieties of Capitalism: The institutional foundations of comparative advantage* (Oxford: OUP 2001), ch. 1.

38 See e .g. K Polanyi, C M Arensberg and H W Pearson (eds), *Trade and Market in Early Empires* (New York: Free Press 1957) and Polanyi, *The Livelihood of Man*, n. 27 above. Harry Pearson's introduction to the latter book gives a good overview of Polanyi's theoretical position especially in relation to the formalist/substantivist debate in anthropology generated by his later work.

39 This has directly stimulated a wide range of critical approaches, see e.g. P Bourdieu, *The Social Structures of the Economy* (Cambridge: Polity 2005); S Green, *Good Value: Choosing a better life in business* (London: Penguin Books 2010); R Patel, *The Value of Nothing: How to reshape market society and redefine democracy* (London: Portobello Books 2009) and T Schroyer, *Beyond Western Economics: Remembering other economic cultures* (Abingdon: Routledge 2009).

40 See W T Allen, "Our schizophrenic conception of the business corporation" (1992) 14 *Cardozo Law Review* 261 and D Millon, "Communitarians, contractarians and the crisis in corporate law" (1993) 50 *Washington and Lee Law Review* 1373.

41 E.g. both contractarian and communitarian models are based on a de-reification of the corporate entity, see further D Millon, "The ambiguous significance of corporate personhood" (2001) 2 *Stanford Agora* 39.

42 Herbert Simon critiques both neoclassical and new institutional economic approaches to the firm on the basis of their focus on markets rather than organisations. For Simon, the reality of the latter changes the operating rationality of the firm to reflect primarily organisational goals rather than profit, see further H A Simon, "Organizations and markets" (1991) 5 *Journal of Economic Perspectives* 25.

The limited liability company and the creation of the economic domain

Polanyi makes no substantive reference to the concept of the company (other than to the fact that, by the time of the peak of the first period of globalisation, "around 1914, every part of the globe, all its inhabitants and yet unborn generations, physical persons as well as huge fictitious bodies called corporations, were comprised in [the market society]")[43] or of limited liability in his analysis in *The Great Transformation*. However, the concept of corporate limited liability is one that other theorists have clearly linked to the generation of a distinctive economic domain in the nineteenth century.[44] In particular, Mary Poovey has explicitly linked the coming of the general availability of limited liability to a purging of the moral or theological components traditionally attaching to the economic domain by way of the removal, facilitated by limited liability, of the link between business failure and personal bankruptcy.[45] In more concrete terms, Paddy Ireland has analysed the development of limited liability as a political construct designed to further the interests of the *rentier* investor, who by definition is only interested in the economic return attaching to their shareholding and not in exercising a wider governance role in the company.[46]

However, the traditional and dominant *legal* account of the emergence of the limited liability company in the nineteenth century emphasises the inevitability of that outcome due to the need to reach an economically efficient result: a process which the account expressly links with the unfettered freedom of economic action associated with laissez-faire.[47] As Ireland notes:

> One of the effects of the dominance of this economically deterministic account, in which corporate law is seen as a simple expression of economic and technological imperatives, is the naturalization and de-politicisation of the corporate form and its key constituent elements: separate corporate personality, limited liability, shareholder primacy and so on. They are, in effect, placed beyond critical examination and evaluation, and a case is implicitly made for their global extension.[48]

In the light of this comment, the way to viewing the abstraction of a distinct economic space free from moral values and subject to its own laws[49] as a result of laissez-faire is thereby opened, at least to retrospective examination, and this has indeed been a

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43 Polanyi, *The Great Transformation*, n. 19 above, p. 136.

44 See e.g. M Poovey, *Making a Social Body: British cultural formation 1830–1864* (Chicago and London: University of Chicago Press 1995), especially ch. 1; D Loftus, "Capital and community: limited liability and attempts to democratise the market in mid-nineteenth-century England" (2002) 45 *Victorian Studies* 93; J Taylor, *Creating Capitalism: Joint-stock enterprise in British politics and culture, 1800–1870* (Woodbridge: Boydell Press 2006); P Ireland, "Limited liability, shareholder rights and the problem of corporate irresponsibility" (2010) 34 *Cambridge Journal of Economics* 837; and P Johnson, *Making the Market: Victorian origins of corporate capitalism* (Cambridge: CUP 2010), ch. 5.

45 Poovey, *Making a Social Body*, n. 44 above, p. 23. See also B Hilton, *The Age of Atonement: The influence of Evangelicalism on social and economic thought 1785–1865* (Oxford: Clarendon Press 1986), especially ch. 7; B Weiss, *The Hell of the English: Bankruptcy and the Victorian novel* (London and Toronto: Associated University Presses 1986); and S Wilson, "Law, morality and regulation" (2006) 46 *British Journal of Criminology* 1073.

46 Ireland, "Limited liability", n. 44 above.

47 B C Hunt, *The Development of the Business Corporation in England 1800–1867* (Cambridge MA: Harvard UP 1936), ch. VI, especially pp. 116–17.

48 Ireland, "Limited liability", n. 44 above, p. 838 (references omitted). On the universalist implications of the economically deterministic account, see H Hansmann and R R Kraakman, "The end of history for corporate law" (2001) 89 *Georgetown Law Journal* 439 and M Bradley, C A Schipani, A K Sundaram and J P Walsh, "The purposes and accountability of the corporation in contemporary society: corporate governance at a crossroads" (1999) 62 *Law and Contemporary Problems* 9.

49 Loftus, "Capital and Community", n. 44 above, p. 94.

commonplace stance in UK company law scholarship.[50] The bigger mystery to something hinging on such an apparently obvious set of state regulatory interventions is how it was the case that contemporaries also used arguments of free trade and laissez-faire not only against limited liability but also in its favour.[51] The Liberal MP Robert Lowe was a prime example, basing his arguments primarily on freedom of contract[52] and the right of unlimited association (the latter being particularly associated with extending the benefits of investing in companies to the working classes).[53] In this context, shareholders were supposed to be politically active in companies, which were meant to be as self-governing little republics,[54] thereby enabling all to partake in the freedom of the market.[55]

Additionally, drawing upon James Taylor's excellent analysis, it would appear that the commercial crisis of 1847 was generally perceived as having been caused by too great an extension of credit to unlimited companies. In this light, limited liability was thus conceived as making the market-based system more stable by forcing the creditors to conduct due diligence on the relevant company assets to which they alone had recourse in respect of the relevant business debts.[56] Consequently, some arguments, linking both creditors and shareholders' interests to broader laissez-faire ideals seeking to maximise participation in the market, could be made in the context of limited liability. However, this obviously obscures the clearly necessary legislative intervention required: a fact that supports Polanyi's aforementioned notion that laissez-faire would not arise naturally but had to be constructed by the state.[57] This paradox has caused considerable analytical confusion and as a matter of common sense it is clearly the case both that limited liability required state intervention and that it in effect ousted the market of classical economics,[58] but it is submitted that this can be placed within Polanyi's framework and seen as a construction of a distinctive economic rationality based upon the new unhindered economic space thereby created.

The black box: *Salomon*, legal formalism and market discipline

The key UK company law case of *Salomon* v *Salomon & Co. Ltd*[59] raised these issues in a clear way. The basic facts were that Mr Salomon transferred his existing business as leather

50 For a trenchant critique of this position, drawing upon the fact that companies rest upon hierarchy rather than markets and are not, in the case of large corporations at least, amenable to market discipline by Adam Smith's "invisible hand", see D Campbell, "Adam Smith, Farrar on company law and the economics of the corporation" (1990) 19 *Anglo-American Law Review* 185 and "Marxism, the market and corporate responsibility: a comment on Paddy Ireland" (2010) 31 *Adelaide Law Review* 229.

51 See Taylor, *Creating Capitalism*, n. 44 above, ch. 4, and S F Copp, "Limited liability and freedom" in S F Copp (ed.), *The Legal Foundations of Free Markets* (London: Institute of Economic Affairs 2008), p. 181.

52 For the influence of freedom of contract on corporate law, including limited liability, see P S Atiyah, *The Rise and Fall of the Freedom of Contract* (Oxford: Clarendon Press 1979), pp. 562–8.

53 See, generally, Loftus, "Capital and community", n. 44 above, p. 93.

54 For a contemporary appeal to reclaim the constitutional aspect of the company, see S Bottomley, *The Constitutional Corporation: Rethinking corporate governance* (Aldershot: Ashgate 2007).

55 See Hunt, *Development of the Business Corporation*, n. 47 above, p. 134.

56 See Taylor, *Creating Capitalism*, n. 44 above, pp. 17, 211.

57 For detailed constructivist accounts, see Taylor, *Creating Capitalism*, n. 44 above, and Johnson, *Making the Market*, n. 44 above.

58 See D Campbell and S Griffin, "Enron and the end of corporate governance" in S Macleod (ed.), *Global Governance and the Quest for Justice vol. II: Corporate governance* (Oxford: Hart 2006) and Porritt, *Capitalism*, n. 9 above, pp. 33–4.

59 *Broderip* v *Salomon* [1895] 2 Ch 323 (CA), and *A Salomon* v *A Salomon & Co. Ltd* [1897] AC 22 (HL). As befits the seminal case in UK company law, the literature is vast. For an excellent discussion of the legal significance of the case and historical background to the case respectively, see P Ireland, "The triumph of the company legal form, 1856–1914" and G R Rubin, "Aron Salomon and his circle" both in J Adams (ed.), *Essays for Clive Schmitthoff* (Abingdon: Professional Books 1983). For analysis and critique of the contemporary ramifications

merchant and boot manufacturer into a limited company specifically incorporated for the purpose. In order to meet the statutory requirements for incorporation at the time, which required a minimum of seven shareholders,[60] Mr Salomon was issued with one share and a further share was issued to each of six other members of his family. As part of the consideration for the business the company subsequently issued 20,000 fully paid shares to Mr Salomon and granted him a debenture. Unfortunately, the business did not prosper and the company was placed into liquidation, at which point it would not have been able to meet its liabilities to the trade creditors if it had paid Mr Salomon pursuant to his debenture.

All the judges in the lower courts were clearly unhappy with the fact that Mr Salomon was utilising a limited liability company structure in order to create, in the common parlance of the time, a "one-man company". Not only was he thereby avoiding the personal responsibility for the business failure that would have attached to him as a sole trader or partner but he was also able to put himself in a better position than the trade creditors through the priority conferred by his debenture. The terminology used in their judgments reflected their views and clearly harked back to an older tradition of a moral economy where economic activity was freighted with wider moral and social obligation. Hence, in the context of the purpose of the incorporation and transaction as a whole, the company was characterised variously as a device, a fraud, a sham or by Lopes LJ as a "mere *nominis umbra*" or a "myth and a fiction". Indeed, the judgment of Lopes LJ perhaps best reflects the overall judicial sentiment expressed in the case when he states that, "[t]o legalize such a transaction would be a scandal"[61] and, accordingly, that "[i]t would be lamentable if a scheme like this could not be defeated".[62] In the light of this, unsurprisingly, though only by dint of very strained legal reasoning by which at first instance Mr Salomon was determined to be liable to indemnify the company as his legal agent and in the Court of Appeal to indemnify it as his trustee, the lower courts both found in favour of the liquidator.

The House of Lords, however, by contrast specifically affirmed Mr Salomon's (who was by that time a pauper litigant) good character and unanimously applied a highly formalist approach to the construction of the relevant company law statutes in order to reverse the lower courts and vindicate his actions. As the company had been correctly incorporated there could be no question of any sham or fraud arising through the use of the corporate entity in the circumstances of the case. Hence, so long as the simple formalities required by the statute in order to facilitate incorporation were met, the courts would hitherto have no view, or at best a very limited oversight,[63] as to the economic rationalities employed in the use of the corporate form. As Lord Watson and Lord MacNaghten explicitly indicated, it was for the disappointed creditors to look after themselves[64] (however commercially unrealistic this may be) by undertaking sufficient due diligence, an approach which clearly resonated with the doctrine of freedom of contract.

[n. 59 cont.] of the case, see the essays in R Grantham and C Rickett (eds.), *Corporate Personality in the 20th Century* (Oxford: Hart 1998). See also, generally, (1999) 27 *Federal Law Review: Special Issue on Corporate Law: A Century of Salomon*.

60 Companies Act 1862, s. 6.

61 *Broderip* [1895] 2 Ch 323 at 341.

62 *Broderip* [1895] 2 Ch 323 at 340–1.

63 Through the development of the doctrine of lifting the veil, which remains very restrictively applied in the interests of commercial certainty, see *Adams* v *Cape Industries plc* [1990] Ch 433 (CA). The doctrine may be regarded as occupying the fault-line determining the relation of the economic sphere and the social sphere and as such raises profound issues which are highly problematic on a substantive basis for regulation by the common law.

64 *Salomon* v *Salomon* [1897] AC 22 at 40 and 53 respectively.

It is suggested that the combination of judicial formalism and the doctrine of limited liability evidenced in *Salomon* effectively combined to place the company in a position where its economic operating rationality in relation to its ongoing business activity was effectively insulated from wider social considerations and the old moral economy.[65]

The emergent problem of corporate power

Such a vision of the company was, however, forged by the end of the nineteenth century when UK companies were largely still either close companies or family-owned.[66] During the course of the twentieth century, the size and complexity, as well as the power,[67] of the corporate enterprise grew both due to the rise of the multinational enterprise[68] and of the dispersed shareholder company,[69] each of which became an established feature of the business landscape by the 1960s.

The rise of large dispersed shareholder companies, leading to both the separation of ownership and control between shareholders and managers and the generation of significant corporate power, seemingly occurred much earlier in the United States than in the UK. In their classic work on the company published in 1932, *The Modern Corporation and Private Property*, Adolf Berle and Gardiner Means concluded that "the modern corporation may be regarded as not simply one form of social organization but potentially (if not yet actually) as the dominant institution of the modern world"[70], which, as such, merited comparison with the state itself. The idea of the large dispersed shareholder company as a traditional private institution owned by its shareholders was equally found wanting as shareholders were, in such circumstances, no more than passive property holders: in reality *rentiers* interested only in the dividend income stream from their investment. Accordingly, in Berle and Means' ultimate view, the corporation was required to be treated as a political construct and to re-engage in the social sphere in order to act in the interest of all its stakeholders and the community.[71]

In an interesting symposium held in 1960, wherein the future of the corporation in 1985 was postulated by the various participants, Berle held to his view that the corporation's power was to be the central problem and that its activities should be subject to extensive state economic planning, as otherwise (in language highly resonant of that of Polanyi) "the

65 See Johnson, *Making the Market*, n. 44 above, p. 164. For contemporary analysis to this effect, see Bakan, *The Corporation*, n. 1 above, ch. 3, and L E Mitchell, *Corporate Irresponsibility* (New Haven and London: Yale UP 2001), especially ch. 2.

66 See P L Cottrell, *Industrial Finance, 1830–1914* (London and New York: Methuen 1980).

67 For an analysis of corporate power, see e.g. J Parkinson, *Corporate Power and Responsibility* (Oxford: Clarendon Press 1993), ch. 1, and G Wilson, "The significance of corporate collective power to New Labour's project: market values, corporate regulation and the possibilities for a progressive politics" (2005) 56 *NILQ* 492.

68 See G Jones, *Multinationals and Global Capitalism* (Oxford: OUP 2005), ch. 2, and P T Muchlinski, *Multinational Enterprises and the Law* 2nd edn (Oxford: OUP 2007), pp. 8–25.

69 See B R Cheffins, *Corporate Ownership and Control* (Oxford: OUP 2008). It has been suggested that the separation of ownership and control in the UK can be dated significantly earlier: see L Hannah, "The divorce of ownership from control from 1900 onwards: re-calibrating imagined global trends" (2007) 49 *Business History* 404. The issue is thoroughly debated in Cheffins, *Corporate Ownership and Control*, ch. 7.

70 A A Berle and G C Means, *The Modern Corporation and Private Property* revised edn (New York: Harcourt, Bruce & World Inc. 1968) (original edition New York: Macmillan 1932), p. 313.

71 See, generally, Berle's "Preface" in Berle and Means, *The Modern Corporation*, n. 70 above; P Ireland, "Back to the future? Adolf Berle, the Law Commission and directors' duties" (1999) 20 *Company Lawyer* 203, especially p. 209; and, exploring the same theme, D Campbell, "Why regulate the modern corporation? The failure of 'market failure'" in J McCahery, S Picciotto and C Scott (eds), *Corporate Control and Accountability: Changing structures and the dynamics of regulation* (Oxford: Clarendon Press 1993).

fluctuations of the unplanned system are unbearably inhuman".[72] In contrast, Friedrich Hayek took a radically different view and saw the basis of the free market as resting upon imposing one specific purpose on corporations: securing the highest return on their capital for their shareholders.[73] As history shows, it was Hayek's individualist vision that came into prominence with the proponents of the new neoclassical economic theory of the firm.

For this school of theorists, as Dalia Tsuk has ably demonstrated, *The Modern Corporation and Private Property* was no longer to be configured as a book concerned with corporate power and concomitant responsibility but as a book solely concerned with the separation of ownership and control. Furthermore, by employing microeconomics, even this ceased to be a problem of power, as the workings of the company were reduced to a series of private transactions between the various participants each assumed to be operating in a free market as a self-interested rational profit-maximiser and subject to the overall discipline imposed by the financial markets. Hence, Tsuk concludes that "[i]n their hands . . . [the separation of ownership from control] helped legitimate the idea that market competition and the search for profit were the only means of regulating corporate power".[74] Thus, for the proponents of the new economic theory of the firm, the company is conceived in very much the terms put forward by Bakan in the quote at the beginning of this article:

> The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships . . . it makes little sense to try to distinguish those matters which are "inside" the firm (or any other organization) from those matters "outside" it. 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 labour, material and capital inputs and the consumers of output . . . the "behaviour" of the firm is like the behaviour of a market, i.e. the outcome of a complex equilibrium process.[75]

Whilst the nexus of contracts position has been subject to extensive criticism,[76] and some subsequent modification, it nevertheless reflects the dominant contemporary model of theorising the company and leaves very little scope for opening the company to non-economic rationalities. As David Millon has noted, the reduction of the company to a legal fiction is "a potentially powerful rhetorical move because it denies that there is anything distinctive out there to regulate. All there are are natural people engaged in their own individualized wealth-maximizing activities." [77] In such circumstances, it is important to refuse to allow core corporate law to be marginalised by the essentialist naturalised market-based vision presented.[78]

72 A A Berle, "The corporation in a democratic society" in M Anshen and G L Bach (eds), *Management and Corporations 1985: A symposium* (New York: McGraw Hill 1960), p. 82.

73 F A Hayek, "The corporation in a democratic society: in whose interest ought it and will it be run?" in Anshen and Bach (eds), *Management and Corporations*, n. 72 above, p. 100.

74 D Tsuk, "From pluralism to individualism: Berle and Means and 20th century American legal thought" (2005) 30 *Law & Social Inquiry* 179, p. 214. For an extensive analysis of the plurality of readings offered by Berle and Means' seminal text, see W W Bratton and M L Wachter, "Shareholder primacy's corporatist origins: Adolf Berle and *The Modern Corporation*" (2008–2009) 34 *Journal of Corporate Law* 99 and "Tracking Berle's footsteps: the trail of *The Modern Corporation*'s last chapter" (2009–2010) 33 *Seattle University Law Review* 849.

75 M C Jenson and W Meckling, "Theory of the firm: managerial behaviour, agency costs and capital structure" (1976) 3 *Journal of Financial Economics* 305, p. 311.

76 See e.g. W W Bratton, "The 'nexus of contracts' corporation: a critical appraisal" (1989) 74 *Cornell Law Review* 407 and P Ireland, "Property and contract in contemporary corporate theory" (2003) 23 *LS* 453.

77 D Millon, "Personifying the body corporate" (1995) 2 *Graven Images* 116, p. 123.

78 As Kent Greenfield succinctly puts it, responding to this issue, "[c]orporate law matters": K Greenfield, "Reclaiming corporate law in a new gilded age" (2008) 2 *Harvard Law & Policy Review* 1.

In the UK, the nexus of contracts theory has not had the same impact,[79] but the corporatist tendency[80] that was developing prior to the advent of Mrs Thatcher's period in office equally never had a significant impact on the standard *legal* account of the company[81] which, despite its deficiencies, has remained resolutely attached to its nineteenth-century shareholder-orientated contractual model.[82]

Reflexive modernity and glocalised players

As already discussed, the notion of reflexive modernity can be seen as a second phase of modernity that involves a fundamental reassessment of the basic concepts underlying the differentiated social subsystems of first modernity. In particular, for present purposes, Beck et al. highlight:

> the political dynamic that is being set in motion by the perception of a global ecological crisis, which includes the acknowledgement of limited resources. These consequences of the instrumental relation to nature are making it more and more difficult to continue conceiving of nature as a neutral and infinite provider of resources. Nature is no longer perceived as an outside that can be adapted to one's purposes, but increasingly as part and parcel of society.[83]

For transnational corporations, such a re-configuring has an evident potential for impact on their own economic rationalities and business operations. It also has considerable resonance with Polanyi's view as to the results of the attempted commodification of land necessary to enable the self-regulating market and the inevitable societal resistance to such commodification by way of the double movement. Equally, the accelerating pace of technological development is also likely under the conditions of reflexive modernity to generate risks which are not capable of being contained in the sphere of economic or expert rationalities and which will require wider deliberation beyond the company in order to "define them away" in such a manner as to preserve corporate legitimacy.[84]

None of this should underestimate the undoubted power granted to multi-national companies by their ability to withdraw from a particular locale (which is one of the key factors in the undermining of the traditional territorially bound nation state) but, nevertheless, it does emphasise the relative autonomy of the economic sphere and suggests that economic rationality is amenable to wider cultural pressures. In this vein, the somewhat contested concept of globalisation (which can be configured in a largely conflictual homogenising manner by which the global is imposed on the local, or can be regarded in such a way that the two concepts have a mutually constitutive relationship involving

79 Though law and economics inspired approaches have generally become much more influential, see e.g. B R Cheffins, *Company Law: Theory, structure and operation* (Oxford: Clarendon Press 1997).

80 For an overview, see T Hadden, *Company Law and Capitalism* 2nd edn (London: Weidenfeld & Nicolson 1977), especially Part 3.

81 See P Ireland, "Financialization and Corporate Governance" (2008) 60 *NILQ* 1, p. 17.

82 See e.g. M Stokes, "Company law and legal theory" in W Twinning (ed.), *Legal Theory and the Common Law* (Oxford: Basil Blackwell 1986) and S Worthington, "Shares and shareholders: property power and entitlement" (2001) 22 *Company Lawyer* 258 (Part 1), 307 (Part 2).

83 Beck et al., "Theory", n. 13 above, p. 7.

84 This has led Michael Power to view organisations as being turned "inside out" by the need for their internal control systems to attain legitimacy, see M Power, *Organized Uncertainty: Designing a world of risk management* (Oxford: OUP 2007), ch. 2. For a good overview of the concept of risk generally, see A Giddens, "Risk and responsibility" (1999) 62 MLR 1 and J Black, "The role of risk in regulatory processes" in R Baldwin, M Cave and M Lodge (eds.), *The Oxford Handbook of Regulation* (Oxford: OUP 2010).

elements of both convergence and divergence)[85] also problematises the conflicting spatial and cultural relationships between multinational companies' many practical sites of operation and sets them against such companies' need for centralised managerial direction.

The black box of the company would thus seem under pressure and in this context it is submitted that s. 172 Companies Act 2006 (comprising a key part of the new statutory statement of directors' duties)[86] might gain meaningful traction, not through direct substantive regulatory intervention but through an attempt to change the operating culture of business and thereby re-assert the social.

Significance of s. 172 Companies Act 2006

As is well known, the core duty placed upon a company director by s. 172 is to "act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of the members as a whole" having regard to a non-exhaustive list of stipulated matters (including, for example, the long-term consequences of the decision, the impact of the company's operations on the community and environment, and the desirability of the company maintaining a reputation for high standards of business conduct). It is also well known that the section proved to be the most contentious provision in both the Company Law Review (CLR) and debates in Parliament that preceded the enactment of the Companies Act 2006, as it sought to address the central issue of the scope of corporate law in this area by addressing the question as to in whose interests should companies be run. The traditional position of shareholder primacy whereby the directors' duty was to maximise the profit of the company on behalf of the shareholder interest had been the cause of some disquiet due to its perceived sub-optimal consequences in encouraging short-termism and failing to develop the cooperation and trust required of other stakeholders in the company.[87] A duty of shareholder primacy would clearly also have potential import for any environmentalists who were seeking to develop sustainability agendas within a capitalist framework and, indeed, prior to the enactment of the Companies Act 2006, Jonathon Porritt was quite explicit as to the need to have an appropriately formulated core fiduciary duty in order to render any such agenda feasible.[88]

The CLR examined the underlying issues at length and consulted on the desirability of adopting either a pluralist or an enlightened shareholder value model. The pluralist model, by which all stakeholders would be owed a separate duty by the company, was ultimately rejected largely on grounds that with a multi-fiduciary duty there was no effective benchmark against which directors' decisions could be measured by the courts, thus rendering enforceability problematic. The enlightened shareholder value approach was thus adopted in s. 172 as an inclusive duty to promote the success of the company for the benefit of the members as a

85 Hence the use of the term, "glocalization". For a nuanced discussion, see R Robertson, "Glocalization", n. 17 above, and R Lee and E Stokes, "Environmental governance: reconnecting the global and local" (2009) 36 *Journal of Law and Society* 1.

86 For an overview of the codification of directors' duties, see M Arden, "Regulating the conduct of directors" (2010) 10 *Journal of Corporate Law Studies* 1.

87 For a stimulating series of essays giving an overview of this critique, see G Kelly, D Kelly and A Gamble (eds), *Stakeholder Capitalism* (Basingstoke: Macmillan 1997).

88 See Porritt, *Capitalism*, n. 9 above, pp. 100–5. Porritt's book makes general reference to S Hart, *Capitalism at the Crossroads: The unlimited business opportunities in solving the world's most difficult problems* (New Jersey: Wharton School Publishing 2005).

whole with the intention of fostering long-term co-operative and socially responsible approaches to corporate business activity so far as consistent with that end.[89]

The Minster of State at the time, Margaret Hodge MP, published a set of ministerial statements made on the statutory statement of directors' duties during its journey through Parliament by way of guidance as to the intentions underlying the section. The accompanying introductory commentary by the Minister of State contained the following somewhat remarkable passage:

> There are two ways of looking at the statutory statement of directors' duties: on the one hand it simply codifies the existing common law obligations of company directors; on the other – especially in section 172 . . . it marks a radical departure in articulating the connection between what is good for a company and what is good for society at large.[90]

Although this is followed by a heading about continuity, it would seem clear that the minister's aspirations for the provision were captured by the text under the subsequent heading of change:

> the new statutory statement captures a cultural change in the way in which companies conduct their business. Pursuing the interests of shareholders and embracing wider responsibilities are complementary purposes, not contradictory ones.[91]

As John Parkinson put it in relation to the CLR proposals, there was no intention by the CLR to change the law, but there was an intention to change behaviour by rendering the law more visible.[92]

Previously, the common law had maintained a rather circumscribed approach which gave little guidance as to the factors governing the operation of directors' discretion within the context of business activity, as can be seen in the classic statement of the duty of loyalty given by Jonathan Parker J in *Regentcrest plc (in liq.)* v *Cohen*:[93]

> The duty imposed on directors to act bona fide in the interests of the company is a subjective one . . . The question is not whether, viewed objectively by the court, the particular act or omission which is challenged was in fact in the interests of the company: still less is the question whether the court, had it been in the position of the director at the relevant time, might have acted differently. Rather, the question is whether the director honestly believed that his act or omission was in the interests of the company. The issue is as to the director's state of mind.

Although initial indications were seemingly that lawyers were generally neutral as to the potential substantive impact of s. 172,[94] and there has as yet been no substantive caselaw

89 For extensive references to the company law literature, including the theoretical background and genesis and development of s. 172, see J Parkinson, "Inclusive company law" in J De Lacy (ed.), *The Reform of United Kingdom Company Law* (London: Cavendish Press 2002) and A Keay, "Ascertaining the corporate objective: an entity maximisation and sustainability model" (2008) 71 *MLR* 663 and "The ultimate objective of the company and the enforcement of the entity maximisation and sustainability model" (2010) 10 *Journal of Corporate Law Studies* 35.

90 Department of Trade and Industry (DTI), *Companies Act 2006: Duties of company directors, ministerial statements* (London: DTI June 2007), p. 1.

91 Ibid. p. 2.

92 Parkinson, "Inclusive company law", n. 89 above, p. 54.

93 [2001] BCC 494 (HC).

94 A Keay and J Loughrey, "Legal practitioners, enlightened shareholder value and the shaping of corporate governance" (2008) 8 *Journal of Corporate Law Studies* 79.

reported on the point,[95] it is submitted that the section does indeed mark a "radical departure". This is on account of the fact that for the first time it renders the economic rationality governing ongoing mainstream business decisions inside the company explicitly legible to the law and thereby breaks down the economic as the exclusive and hitherto largely inscrutable governing logic thereof.[96] Following the codification of directors' duties in the Companies Act 2006, it would appear that Lady Justice Arden is also prepared to adopt the radical view in relation to the potential scope and reach of s. 172 as, in terms somewhat reminiscent of Polanyi, she has stated that, "[t]he Companies Act 2006 has struck a new balance between companies and society, and it is hoped that by that new balance companies and society may reconnect".[97]

The scope of law's regulatory reach

However, the formal reach of the new duty would still seem to be limited by the fact that it is expressed as a subjective good faith evaluation on the part of the directors and that external disclosure of the relevant information to a wider audience is primarily limited to the requirements of the Business Review[98] and the UK Corporate Governance Code[99] (assuming that the company has a premium listing). Furthermore, pursuant to s. 170(1) Companies Act 2006, the duty is explicitly only owed to the company itself, in default rendering the provision principally enforceable by the shareholders (and not any wider stakeholders) pursuant to a derivative action.[100] Traditionally, this has not been a popular mechanism with UK institutional shareholders and, despite fears expressed during the passage of the legislation in Parliament, there is no evidence of a deluge of litigation by activist shareholders as yet.[101]

Present efforts to develop the new UK Stewardship Code[102] provide a further soft law approach to the issue of institutional shareholder engagement. However, given that the code is voluntary (it is expressly acknowledged that it will not be applicable to institutions whose business model precludes a long-term approach to shareholding) and applies on a comply or explain basis, it is as yet unclear if it will have the capacity to overcome institutional shareholders' own general market mentality in relation to the exercise of their

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95 The area with the most potential for extended judicial consideration at present would seem to be in the context of the new statutory derivative action: see e.g. *Franbar Holdings Ltd* v *Patel* [2009] BCLC 1 (HC).

96 To this end the ill-fated Operating and Financial Review was an intrinsic and important part of the CLR governance package. Space does not permit a detailed discussion of the role of narrative reporting in the context of the issues discussed in this article (though the author is currently developing further work on this point), but excellent general accounts of the role of narrative reporting may be found in A Johnston, "After the OFR: can UK shareholder value still be enlightened?"(2006) 7 *European Business Organization Law Review* 817 and T Burns and J Paterson, "Gold plating, gold standard or base metal? Making sense of narrative reporting after the repeal of the Operating and Financial Review Regulations" (2007) 18 *ICCLR* 247.

97 Arden, "Conduct of directors", n. 86 above.

98 Companies Act 2006, s. 417. See further, J Lowry, "The duty of loyalty of company directors: bridging the accountability gap through efficient disclosure" (2009) 68 *CLJ* 607. At the time of writing, the Coalition government is consulting on extending the requirements of narrative corporate reporting: Department for Business, Innovation and Skills (BIS), *The Future of Narrative Reporting: A consultation* (London: BIS August 2010).

99 Financial Reporting Council (FRC), *The UK Corporate Governance Code* (London: FRC June 2010).

100 Companies Act 2006, Part 11. See, generally, A Reisberg, *Derivative Actions and Corporate Governance* (Oxford: OUP 2007) and Keay, "The ultimate objective", n. 89 above.

101 See Arden, "Conduct of directors", n. 86 above, pp. 13–14, and BIS, *Evaluation of the Companies Act 2006*, vol. 1 (London: BIS August 2010), p. 162.

102 FRC, *The UK Stewardship Code* (London: FRC July 2010).

governance powers.[103] In specific terms, this has traditionally been manifested by a tendency for institutions to exit by selling in the market rather than undertaking the necessary research and committing the necessary time to exercise voice through engagement with senior management.[104]

Nevertheless, wider enforcement issues aside, the potential effect of the disclosure requirements should not be underestimated as the information required to be divulged will be available to stakeholders generally as well as shareholders[105] and is likely to have traction in a culture where it is difficult to maintain the economic as a separate self-legitimating ground of expertise and activity due to the advent of subpolitics (by which issues are rendered political by reflexive modernity, e.g. the manufactured risk flowing from instrumentalist uses of natural resources, and the site of political activity is displaced from traditional formal political structures) in civil society.[106]

Conclusion

Returning to the opening quotation from Bakan, it would seem that the company is, indeed, often regarded as an institutional reflection of laissez-faire both in the US and the UK. By theorising the corporate form in this way companies are "misleadingly conceived of as purely economic beings whose natural state is one free from all political interference"[107] and this encourages the adoption of a particular form of economic rationality. Such a rationality attached to limited liability and the power and reach of a large multinational group generates a "perfect externalizing machine"[108] capable of rendering significant social and environmental damage. It is suggested that Polanyi's modelling of the rise of the self-regulating market and economic liberalism together with his concept of the double movement (as read in the light of theories of reflexive modernity) can help to reclaim the significance and visibility of the social and political spheres in economic processes.[109] In this context, s. 172 Companies Act 2006 has at least the potential to act as a legally mandated conduit of these broader ideas into the heart of corporate operating rationality and to thereby change the culture of business practice.[110]

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103 For a sceptical view based, inter alia, on the increasing fragmentation of ownership of UK listed equities over the last 20 years, see B R Cheffins, "The Stewardship Code's Achilles' heel" (2010) 73 *MLR* 1004. At a deeper theoretical level Cheffins expresses concern that empirically it is far from clear that institutional shareholder involvement generates net benefits, a point which has led other commentators to argue for the elimination of shareholder rights in this context: see further L E Mitchell, "The legitimate rights of public shareholders" (2009) 66 *Washington & Lee Law Review* 1635.

104 The classic work on governance in this broad context is AO Hirschman, *Exit, Voice, and Loyalty: Responses to decline in firms, organizations, and states* (Cambridge, MA: Harvard UP 1970). For a specific application to corporate law, see J Parkinson, "The role of 'exit' and 'voice' in corporate governance" in S Sheikh and W Rees (eds), *Corporate Governance and Corporate Control* (London: Cavendish 1995).

105 For a far-ranging discussion of the potential and drawbacks of disclosure for developing corporate social responsibility and civil regulation, see J Parkinson, "Disclosure and corporate social and environmental performance: competitiveness and enterprise in a broader social frame" (2003) 3 *Journal of Corporate Law Studies* 3 and "Corporate governance and the regulation of business behaviour" in Macleod, *Global Governance*, n. 58 above.

106 See further U Beck, *The Reinvention of Politics* (Cambridge: Polity 1997), ch. 3, and Holzer and Sørensen, "Rethinking subpolitics", n. 17 above.

107 Taylor, *Creating Capitalism*, n. 44 above, p.210.

108 Mitchell, *Corporate Irresponsibility*, n. 65 above, ch. 2.

109 For a recent collection of essays on this broad theme inspired by Polanyi's work see C A Williams and P Zumbansen (eds), *The Embedded Firm* (Cambridge: Cambridge UP 2011).

110 Unfortunately the government's initial review of the impact of s. 172 found no strong indications as to a change of culture, though it was conceded that it was still early days: see BIS, *Evaluation of the Companies Act 2006*, n. 101 above, p. 162.

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Polanyi's embeddedness and shareholder stewardship: a contextual analysis of current Anglo-American perspectives on corporate governance

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Abstract

Polanyi saw the economy as properly embedded in society and argued that the capitalist free market, in commodifying social relations of production, seeks to disembed the economy from society. The resulting lack of continuity between society and economy, he maintained, created conflict which necessarily required state intervention. The market economy, therefore, in contrast to neoclassical/neoliberal economics' vision of an autonomous, self-regulating market, required more, not less, state intervention to sustain it than alternative, more embedded economies. This article explores this conflict in the context of a specific neoliberal claim: that institutional shareholders are capable of being good "stewards" of the companies in which they invest. Utilising Polanyi's embeddedness, this article assesses the "stewardship" approach as it is manifested in the US and in the UK. This approach is posited on a vision of a disembedded, self-regulating market. Putting it into practice is thus a retrograde step which will only exacerbate the problems created by the market-based corporate governance strategies which have prevailed since the late 1970s onwards.

Introduction

The approach of this article is to take Polanyi's notion of embeddedness and use it to elucidate and comprehend the current conception of institutional shareholders as stewards in corporate governance. This new approach to governance requires institutional shareholders to take an active and socially constructive role in corporate governance and empowers them, both legally and morally, to do so. This article differs from contemporaneous work around shareholder stewardship because it aims to refute the idea that shareholders are capable of being useful corporate stewards in this sense. By using contextual analysis, this article contributes to the existing debate on market-based corporate governance strategies by showing that such strategies cannot thwart institutional shareholders' innate drive to seek profit maximisation regardless of the long-term effects on the company and those whom the company affects. To act as stewards for a wider public interest, institutional shareholders would need to be subject to more direct state control.

Shareholder stewardship is a paradox because shareholders lack the central quality that underpinned previous conceptions of stewardship, namely a detachment from share-ownership and therefore a detachment from a sectional interest in profit. This detachment

1 With thanks to Richard Percival, Law Commission, and Professor Ralf Rogowski for their helpful comments.

was thought to enable the steward to pursue a wider public interest.[2] Previous conceptions of stewardship viewed non-owning professional management as worthy stewards of the company's best interests, precisely because they *were* non-owning, trained professionals.[3] Directors could be good stewards because they were personally motivated by a wide range of concerns including personal achievement, good employee relations, product development and economic stability.[4]

The idea that large institutional shareholders may also be considered as stewards has gained momentum in recent years but, unlike the previous conceptions of stewardship, it is the fact of their ownership, indeed the very largeness of their shareholdings, which has prompted interest in their role in corporate governance. Institutional ownership not only appears to subvert the trend to dispersed ownership, evidenced by Berle in *Modern Corporation*,[5] but the size of their holdings has led to them being reconceived as "universal owners" – owners whose stakes are so significant that their self-interest is said to be best served by ensuring general economic stability and social well being.[6] In this model, institutional shareholders are thought to be predisposed to engage in socially guided investment policies.[7] Indeed, as I show in section three, institutional shareholders have been keen to promote this image of the responsible, steward-like investor.

In assessing the shift to shareholder stewardship, I attempt to embrace Polanyi's theme of embeddedness as expressed in *The Great Transformation*.[8] Polanyi's notion is that all economies, including the market economy, are embedded within society and social relations – although they differ as to the degree that they are embedded, the market economy being the most disembedded. As a response to the neoclassical economists' claim that the market economy sits independent from society as a whole – a claim which is also made by neoliberalism – Polanyi stated:

> Economic history reveals that the emergence of national markets was in no way the result of the gradual and spontaneous emancipation of the economic sphere from governmental control. On the contrary, the market has been the outcome of a conscious and often violent intervention on the part of government which imposed the market organisation on society for non-economic ends.[9]

The market economy is the *least* "natural" to human social living and the most disembedded from natural social relations. It is therefore the most in need of state intervention to secure its existence.

Similarly, it can be argued that the neoliberal project from late 1970s was a political project to dis-embed the economy from social relations and to ideologically promote the market economy as self-regulating. In respect of corporate governance, the market was promoted as the most efficient regulator. However, as this article shows, the "self-regulation" of market players has in fact involved and necessitated a great deal of state intervention. In Polanyi's terms, because the market economy is inherently incompatible

2 M Dodd, "For whom are managers trustees?" (1932) 45 *HLR* 1145.

3 A A Berle, *The American Economic Republic* (Harcourt: Brace and World 1963).

4 T Donaldson and J Davis, "Boards and corporate performance – research challenges and conventional wisdom" (1994) 2 *Corporate Governance: An International Review* 151.

5 A A Berle and G C Means, *The Modern Corporation and Private Property* (Harcourt: Brace and World 1968 [1932]).

6 J Hawley and A Williams, *The Rise of Fiduciary Capitalism: How institutional investors can make corporate America more Democratic* (Philadelphia: University of Pennsylvania Press 2000).

7 J Hawley and A Williams, "Universal owners and SRI" in P Camejo (ed.), *The SRI Advantage* (Canada: New Society Publishers, 2002).

8 K Polanyi, *The Great Transformation. The political and economic origins of our time* (Boston: Beacon Press 2001 [1944]).

9 Ibid. p. 258.

with natural human existence, or disembedded, it requires substantial state intervention to operate. Rather than state intervention being antithetical to the market, it is essential to discipline people into adhering to their "unnatural" market roles.

By contrast, in New Deal or progressive America and in post-war UK, governments (and indeed the general international consensus on macroeconomics) consciously drew together social outcomes and the economy. Government policy embedded the economy, to promote stability and equality and to meet the problems caused by the financial crisis of the late 1920s in the US, and by post-war need in the UK; and thus both governments de-prioritised shareholders' interests. Put another way, by decommodifying social relations of production it was able to meet social need.

The article is structured into four parts. Throughout these sections I use Polanyi's embeddedness to further my analysis of stewardship in social and historical context. In section one, I show how stewardship was first exercised as a deliberate policy technique by the state in tandem with management in the interests of the wider public. However, the proceeding neoliberal model from the 1970s charged management with stewardship in the interests of shareholders alone. In section two, I show how the neoliberal response to, first, corporate collapse and then, more recently, financial crisis was to preserve the free market shareholder primacy model by more state intervention to bolster self-regulation. In section three, I show how shareholder stewardship has been promoted, first, by institutional shareholders themselves and, secondly, through soft and hard law. In section four, I show that institutional shareholders are a heterogeneous group similar only in their inability to make a positive impact on corporate governance.

Shareholder stewardship envisages shareholders *actively* influencing management to deliver shareholder value in contrast to the shareholder primacy model where governance mechanisms were designed to ensure that management delivered value to the essentially passive shareholders. Furthermore, shareholder stewardship reconceptualises shareholder value itself as an (idealised) long-term investment through which socially desirable goals are pursued; "enlightened shareholder value", in the language of company law reform in the UK. Shareholder stewardship seeks shareholders' involvement through, largely, soft law mechanisms. Its aim is that institutional shareholders will ensure a less rapacious form of capitalism because the rapacious capitalism, which was the result of the shareholder primacy model, delivered corporate and financial crisis.

In this article, I maintain that there is little to suggest that shareholder stewardship will be any less destructive or rapacious than shareholder primacy, indeed, it is counter-intuitive to suppose that shareholders will be more moderate in their demands for shareholder value than management.

1 The historical origins of shareholder stewardship

The state and management as stewards of the company in the interests of the wider community

Stewardship governance was traditionally posited on the existence of a controlling but non-owning management. The most famous early exposition of this development was the empirical and analytical work of *Modern Corporation*.[10] In this book, Berle showed how massive share dispersal in large corporations had resulted in revolutionary changes in

10 Berle and Means, *Modern Corporation*, n. 5 above.

ownership and control.[11] Berle argued that share dispersal had fundamentally transformed the nature of share-ownership because, as responsibility was devolved to management, shareholders could not (logically or normatively) demand the extensive rights generally attributed to private property. Shareholders had effectively "surrendered the right that the corporation should be operated in their sole interest" and had accordingly "released the community from the obligation to protect them to the full extent implied in the doctrine of strict property rights".[12] Accordingly, shareholders were entitled to modest returns on their investment, after the claims of the community, labour in particular, had been met. Berle's analysis was a conscious recognition that society could, and indeed should, use the economy to meet social ends. And, although Berle initially saw the state as guiding the company to this end, he came around to the view (maintained earlier by others) that directors were also principal stewards in delivering governance for the wider community.

Modern Corporation importantly provided information and direction to the New Deal administrators about the challenges they faced in the economy and why it should be regulated. Berle's role in the administration added force to this.[13] The ability of the New Dealers to regulate the economy to this degree was premised on an unashamed interventionist policy.[14] Key to this, noted Polanyi, was the abandonment of the Gold Standard which removed the power of financial markets to dictate social policy.[15] As a model for enhancing the stewardship of states it was later adopted by other countries and internationalised in the post-war period by arrangements such as the 1944 Bretton Woods agreement. Reduced capital movement across borders enhanced the ability for national adjustments to be made in respect of employment and pricing policies, which helped many national economies to pursue welfare-orientated policies. In the UK, this included the nationalisation of key industries, the empowering of unions and the bolstering of socially orientated funds, particularly pension funds, though tax and dividend reforms. Nationalised industries were designed to provide secure employment for millions, to stabilise the price of basic commodities, and to contribute to the well-being of the community. Their ethos and institutional goals were thought to infect the operations of private industries.[16]

However, the post-war, Keynesian or consciously embedded economy consensus was shaken by economic industrial crises in the 1970s. Both the economy and ideas about the economy were to take a radical shift toward the right. Thus, of the two great books written at the end of the war, Polany's *Great Transformation* and Hayek's *Road to Serfdom*,[17] it was the latter's ethos that began to prevail. In the UK, recession and public debt caused fatal rifts in the delicate balance of power between the tripartite powers of unions, management and state. Years of industrial unrest had fragmented traditional political positions and in 1979 the Conservative party under Margaret Thatcher was voted into government with a new radical, neoliberal agenda. Likewise, in the US, recession and the threat of global competition saw the New Right under Ronald Reagan come into power with a similar agenda; to promote a free market and to strip away non-market, state-centred regulation.

11 In this analysis, Berle differed from the previous work because he saw the progressive possibilities from those changes to the nature of the modern corporation: W Ripley, *Main Street and Wall Street* (Boston: Little, Brown & Company 1927); L D Brandeis, *Other People's Money: And how the bankers use it* (Connecticut: Martino Publishing 2009 [1917]); T Veblen, *The Theory of Business Enterprise* (New York: Cosimo 2005 [1904]).

12 Berle and Means, *Modern Corporation*, n. 5 above, p. 312.

13 W W Bratton and M L Wachter, "Shareholder primacy's corporatist origins: Adolf Berle and *The Modern Corporation*" (2008) 34 *Journal of Corporation Law* 99.

14 J K Galbraith, *The New Industrial State* (New York: Houghton Mifflen Co. 1967).

15 Polanyi, *The Great Transformation*, n. 8 above, p. 237.

16 A Crosland, *The Future of Socialism* 50th edn (London: Robinson Publishing 2006).

17 F Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press 1944).

Thatcherism and Reaganism thereby became synonymous in policy objectives and ideological imperatives in the context of the economy and welfare reform. In the academies, a sophisticated neoliberal model of the corporation was being developed.

The fashioning of neoliberal corporate governance and managers as stewards of shareholder interests

In the academies, a neoliberal corporate governance model replaced the old social model. This model, which I shall term the shareholder primacy model, claims that the pursuit of shareholder value should be the sole guiding force behind management decision-making. In so doing, it embraces two key themes, that of contractarianism and that of efficiency. Contractarianism conceives of the corporation as being a nexus of contracts,[18] so that, in Jenson and Meckling's words, "it makes little or no sense to try to distinguish those things that are 'inside' the firm (or any other organisation) from those things that are outside of it".[19] The company is merely the market in another guise. In this way, the whole notion of "ownership as entitlement" which Berle had so apparently successfully debunked is sidestepped. The rights to which shareholders are entitled come not from their ownership of property but from the terms they have negotiated in their contract with management. In this approach, the arrangement between management and shareholder involves some "agency costs" (instances when the manager may be guided by self-interest rather than the interest of shareholders), which must be addressed by joining managerial goals with shareholder goals or by mechanisms which penalise managerial self-interest.

The argument based on efficiency[20] asserts that more efficient outcomes are achieved when management narrowly focuses on shareholders' interests. Shareholder value is therefore morally justifiable on utilitarian grounds and does not rely on ownership claims to justify its use.[21] Shareholders act as dummies or stand-ins for the most efficient governance orientation because representing shareholder interests is simply the most effective mechanism for achieving efficient outcomes.[22]

Each of these themes can be seen as an ideological attempt to dis-embed the economy and assert that it is self-regulating. The dispersal of ownership that Berle had identified was still evident, but these approaches do not rely on "true" ownership to justify claims for the primacy of shareholders' interests. However, the paucity of the claims of neoliberal corporate governance can be seen when looking at the central market mechanism for achieving efficiency or lowering agency costs, the hostile takeover. First, it is clear that the so-called market for corporate control through hostile takeovers could not have increased shareholder value if it were not for the previous corporate policy of retaining earnings. Second, although this market isn't directly controlled by the state, it has developed a framework of controls over takeovers which tend to a shareholder primacy outcome.

On the first point, a study in 1952 showed that only 52 per cent of corporate earnings (revenues after taxes, running costs and sales) were paid out in dividends, 46 per cent of

18 Originating with A A Alcian and H Demsetz, "Production, information costs, and economic organisation" (1972) 62 *American Economic Review* 777, p. 778.

19 M Jensen and W Meckling, "Theory of the firm: managerial behaviour, agency costs and ownership structure" (1976) 3 *Journal of Financial Economics* 305.

20 Coase's emphasis on efficiency envisaged the most efficient outcome as the necessary result of market relations no matter from what position the parties began transacting. Coase's theorem inspired new more pro-active thinking on promoting efficiency.

21 A West, "Corporate governance convergence and moral relativism" (2009) 17 *Corporate Governance: An International Review* 107.

22 H Demsetz, "Information and efficiency: another viewpoint" (1969) 12 *Journal of Law & Economics* 1, p. 6.

shares purchased by private individuals were for long-term investments and 75 per cent of all transactions had been for investment purposes rather than speculation.[23] Mitchell argues that the increase in share price in the post-war period to the 1960s came from retained earnings. Thus, when changes in regulation facilitated an explosion in hostile tender bids, successful bidders using high-yield debt had access to asset-rich companies at knock-down prices, based on deflated share prices. The large oligopolies of the New Deal did not make shareholder value a governance priority, in part reflecting the community ideal.[24] This new-found wealth was not created because of market efficiency but because the government had enabled investors to get access to corporate wealth.

In the UK in the post-war period, companies had also become untapped piggy banks whose shares and assets were grossly undervalued. This was in large part because of government policies to restrict dividends and because the value of company assets had rapidly increased. Here, hostile takeovers began in the 1950s (following the better financial disclosures required by the Companies Act 1948)[25] but did not become an established feature of the UK economy until the 1980s, partly because of management resistance to them. Charles Clore's hostile takeover of Sears in 1953 was the first successful hostile takeover bid which was able to exploit the advantages of the post-1948 environment but many attempts followed this. So, in response to the threat of further hostile takeovers, many companies began to take defensive measures.[26] A study of a sample of companies showed that anti-takeover measures (including dual shares and voting restrictions on some shares or share blocks by insiders) increased from 3.7 per cent in 1950 to 11.1 per cent in 1965.[27] Alternatively, a number of companies sought protection from hostile takeovers through the use of a protective parent company. For example, Whitbread had substantial stakes in many smaller breweries to protect it from unfavourable alternative takeovers, forming what was known as the "Whitbread Umbrella".[28]

Government policy in the UK enabled shareholders, or to be more precise, institutions which owned shares, to thwart management resistance to takeovers. In 1959, institutional shareholders formed part of a committee set up in that year to self-regulate takeovers. The committee devised a voluntary code of conduct to regulate takeover bids which emphasised shareholder primacy and promoted a shareholder's choice to sell, timely information and board neutrality.[29] This was followed by the 1968 City Code on Takeovers which emphasised shareholder choice and included a general ban on frustrating actions without the approval of the shareholders. The code was overseen by the Takeover Panel which was comprised in part by institutional shareholders.[30] Polanyi's assertion that "the road to the

23 Lawrence Mitchell, using evidence gained from a NYSE study cited in L Mitchell, "Financialism: a (very) brief history" (2010) 43 *Creighton Law Review* 323; P Zumbansen and C Williams (eds), *The Embedded Firm* (Cambridge: CUP forthcoming); GWU Legal Studies Research Paper, available at SSRN: http://ssrn.com/abstract=1655739 (last accessed 10 October 2010).

24 As W Reich put it, following the New Deal period, Americans gained as employees and as citizens – although not as shareholders or consumers. W Reich, *Supercapitalism: The transformation of business, democracy, and everyday life* (Knopf: Borzoi Books 2007).

25 L Hannah, "Takeover bids in Britain before 1950: an exercise in business 'pre-History'" (1974) 16 *Business History* 65.

26 J Armour and D Skeel, "Who writes the rules for hostile takeovers, and why? The peculiar divergence of US and UK takeover regulation" (2007) 95 *Georgetown Law Journal* 1727, p. 1768.

27 J Franks, C Mayer and S Rossi, "Ownership, evolution and regulation" (2006) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=354381, p. 11 (last accessed 4 September 2011).

28 Ibid. p. 4.

29 Issuing Houses Association, *Notes on Amalgamation of British Business* (London: Issuing Houses Association 1959), available at http://nla.gov.au/nla.aus-vn4764542 (last accessed 1 August 2010).

30 Armour and Skeel, "Who writes the rules?", n. 26 above.

free market was opened and kept open by an enormous increase in continuous, centrally organised and controlled interventionism"[31] is thus evidenced in UK takeover regulation.

In both the UK and US, the political question of why speculative investors who were funding takeovers on massive leverage should take advantage of accumulated value in companies, while communities and workers lost out, was answered in the academy. Managers were contractually bound to pursue shareholder value and to resist a takeover because it was not in the interest of the community and would be a breach of their contract with shareholders. This is not because shareholders are entitled to managerial attention by dint of ownership; ownership is otiose in this arrangement. The enabling of hostile takeovers in the shareholder primacy model was said to enhance the availability of accurate information on the efficiency of a company in an accessible form. Furthermore, hostile takeovers were justifiable and desirable because they reduced agency costs caused by self-serving management by disciplining them with the threat of exposure to hostile takeovers. From the contractarian perspective, hostile takeovers ensured that managers fulfil their contractual obligations to shareholders. From an efficiency perspective, hostile takeovers created a more efficient economy by weeding out poorly performing managements.

Neoliberal corporate governance made directors stewards of shareholder interests and the state put policies into place to ensure this. Like neoclassical economics, neoliberalism claimed that the market economy was the unadulterated expression of human nature and that social relations were naturally contractual in essence. Contractual man was natural man and thus a contractual model for corporate governance was a logical extension of this. Polanyi famously turned this position on its head, showing that historically the market economy was brutally forced upon a population resistant to the breakdown of altruistic social relations and their replacement with bargained contractual relations. Similarly, the shift away from social policies to market policies in this period was not a natural expression of human nature but a reorientation to market relations imposed by the state and fashioned from the shapes left by the former policies.

2 Neoliberal governance and corporate crisis and the green shoots of shareholder stewardship

Corporate collapse and corporate governance

The interests of shareholders were promoted in Britain in the 1980s through such policies as transferring nationalised industries to private investors and abolishing all foreign exchange controls. Reconstructing the regulation of financial markets made international finance central to the British economy. Britain's flagging industrial economy was left to largely collapse whilst the City's investment went overseas to find high profits. Britain's transformation into a service-based economy was promoted as economic revival, the invigorating effect of the market and the triumph of individualism over collectivism where shareholder value could properly be realised.

However, by the 1990s, many of these successful companies were collapsing. In the UK, at the beginning of the decade, these included Robert Maxwell's fraud against Maxwell Communications Corporation, the collapse of the Bank of Credit and Commerce International and that of Polly Peck plc.

In the UK, the problem was translated as one of agency costs and auditing standards. Accordingly, the matter was dealt with largely through soft law mechanisms with no attempt to reign in by regulation or otherwise the supremacy of shareholder primacy. The free

31 Polanyi, *Great Transformation*, n. 8 above, p. 146.

market was still the product of "deliberate state action",[32] however, that action was soft or market-based governance. The *Cadbury Report*'s[33] principal mechanism for reducing agency costs was to divide the top roles into chief executive and chair and to introduce non-executive directors to oversee top executive activity (monitors for the monitors). The subsequent *Greenbury Report*[34] looked to rationalise "bonding costs", the costs of reducing agency costs so as to ensure that performance-related pay really rewarded performance. The subsequent Combined Code operated on a semi-voluntary model where listed companies were not obliged to conform to the ideal model board but must explain where they had failed to do so: the "comply or explain" model.

This model, the product of deliberate state action, enabled self-regulation within the sector and sustained the shareholder primacy/short-termism model. This is hardly surprising given the primacy given to institutional shareholders in *Cadbury* and subsequent reports and their designated roles in the 1998 Combined Code and its predecessors.[35] Furthermore, listed companies adopted the model without it being mandatory because the market responded positively to companies that did so. Appealing to the market, adopting governance structures designed to enhance shareholder value and making the largest investors part of the process became even more of a guiding principle for management. The orientation of directors' stewardship became ever more focused on shareholders as other potential claimants for consideration were sidelined.

In the US, corporate collapse on a grand scale came later in the 1990s and the government responded with a rules-based approach to reporting requirements and corporate governance. The corporate failures included Arthur Anderson, Worldcom, Adelphia and the spectacular demise of Enron. As in the UK, the regulatory response was to control top management or chief executive officer (CEO) activity and to ensure better auditing standards. The Sarbanes–Oxley Act 2002 transformed the governance and the reporting requirements of all companies (including non-US companies). The Act requires that both the CEO and chief financial officer sign off the annual reports confirming that they were compliant with financial reporting requirements. The Act also gives the Securities Exchange Commission the power to require the New York Stock Exchange (NYSE) and NASDAQ to prohibit the listing of securities where the company does not have an audit committee consisting entirely of independent directors.[36] In 2003, the NYSE and NASDAQ stock markets adopted additional governance rules which included a requirement to have a majority of independent directors on the board, and for independent directors to have separate and regular meetings. The NYSE rules require that each board has a nomination and compensation committee made up of independent directors.[37]

32 Polanyi, *Great Transformation*, n. 8 above, p. 147.

33 *Report of the Committee on the Financial Aspects of Corporate Governance* (*Cadbury Report*) (London: Gee & Co. December 1992), available at www.ecgi.org/codes/documents/cadbury.pdf (last accessed 1 August 2010).

34 *Directors' Remuneration,* report of study group chaired by Sir Richard Greenbury, July 1995, available from http://www.ecgi.org/codes/documents/greenbury.pdf (last accessed 1 August 2010).

35 Section E. Now superseded by the UK Stewardship Code.

36 Sarbanes–Oxley Act 2002, s. 303.

37 NYSE Corporate Governance Rules 4 and 5, available at www.nyse.com/pdfs/finalcorpgovrules.pdf (last accessed 1 August 2010).

The new economic owners[38]

By the 1990s, 37 per cent of equities in the US markets were owned by financial institutions rising to 60 per cent in 2006.[39] In 1997, 52.7 per cent of shares in the UK market were held by institutional shareholders.[40] They had been significant owners since the 1950s, owning 18 per cent in 1957. However, they became dominant owners over the next few decades and by 1977 they owned 58 per cent of the share market. This was accompanied by a corresponding fall in individual ownership so that, while individuals held nearly 70 per cent in 1957, by 1977 they owned less than 30 per cent. In contrast, institutional shareholders owned only 7 per cent of the US markets in 1950.[41] The disparity between the two countries may be explained by the UK's post-war corporatist government policy which sought to bolster organisations and to undermine private share-ownership. Institutional investment was encouraged through dividend tax policy[42] which, at the same time, penalised individual shareholder's income. The top marginal rate for individual shareholders was 90 per cent until 1979. In contrast, institutional shareholders, such as insurance companies, enjoyed extensive tax relief while pension funds were entirely exempt from tax. As a result, institutions rapidly increased their ownership of shares.[43]

Not surprisingly, in both countries, institutional shareholders gained attention and voice when they gained financial significance as shareholders. In the UK, as noted earlier, institutional shareholders formed part of the self-regulating body which managed takeovers and designed rules which specifically favoured investors' interests and developed mechanisms to ensure they were followed.

In the US, institutional shareholder ownership precipitated a growing academic debate over shareholder empowerment and the governance role of shareholders.[44] The important clout of American corporate law scholarship soon brought institutional shareholders to everyone's attention. Institutional shareholders, unlike Berle's dispersed shareholders, had the economic strength to enforce contractual claims against managers and to reduce agency costs so they seemed to scholars and policymakers ideally placed to act as "monitors". Importantly, their level of ownership was substantial enough to bridge the gap between ownership and control, described in *Modern Corporation*, and thus to enable neoliberal thought to reassert shareholder entitlement as ownership entitlement.[45]

However, the fledgling enthusiasm for institutional shareholders dissipated from the mid-1990s because of their evident aversion to influencing internal corporate affairs. Increasingly, eminent commentators raised doubts over their efficacy. John Coffee noted

38 A phrase used by De Vroey to differentiate controlling shareholders from other shareholders. M De Vroey, "The separation of ownership and control in large corporations" (1975) 7 *Review of Radical Political Economics* 1, p. 3.

39 M Kahan and E B Rock, *Embattled CEOs*, University of Pennsylvania Institute for Law and Economics Research Paper No 08-25, 2008; New York University Law and Economics Research Paper No. 08-43; ECGI, Law Working Paper No 116/2009, available at SSRN http://ssrn.com/abstract=1281516, p. 9 (last accessed 10 October 2010).

40 I Hill (ed.), *Share Ownership: A report on the ownership of shares at 31st December 1997* (London: The Stationery Office 1999), para. 2.2. This had a combined value of £669bn of which £290bn was held by insurance companies.

41 Ibid. para. 2.2.

42 Armour and Skeel, "Who writes the rules?", n. 26 above.

43 Ibid.

44 B S Black, "Agents watching agents: the promise of institutional investor voice" (1992) 39 *UCLA Law Review* 811, pp. 827–8; E B Rock, "The logic and (uncertain) significance of institutional shareholder activism" (1991) 79 *Georgia Law Journal* 445, p. 447.

45 In the UK, this model had been mainly retained.

their extreme passivity.[46] Furthermore, he found that, in the UK, liquidity was of utmost importance for institutional shareholders. This implied a lack of long-term commitment and therefore a correlative lack of interest in monitoring corporate activity.[47] Corporate Codes continued to appeal to them and some academics remained enthusiastic supporters of their entitlement as owners but much of the original expectation had gone. The financial crisis of 2008 changed all that and institutional shareholders were once again crowned as the princes of corporate monitoring.

3 The coming of shareholder stewardship

An overview

There are differing explanations for the current crisis. Some cite risky business strategies,[48] or the emergence of intricate obfuscating financial packages,[49] or regulatory capture.[50] But what underlines these explanations is that the crisis was driven by short-term profit maximisation imperatives. In recognition of this, the most recent post-crisis corporate governance initiatives have emphasised long-term goals rather than short-term shareholder returns. Given this premise, it might seem perverse that a major part of the armoury for this restraint is the empowerment of shareholders themselves. However, reconceptualised as stewards, institutional shareholders have indeed been charged with ensuring the long-term stability and social responsibility of corporations.

There is some logic to this given the "easy" reason for the financial crisis; managerial greed manifested in high remuneration packages. Institutional shareholders may have a self-interest in ensuring that there has indeed been "pay for performance" and could use their voting power to register their assessment of that performance.[51] But, while institutional shareholders may have a role to play in assessing management pay, it is quite a leap to view them as willing and competent to act as guardians of corporate stability and long-term development. In so doing, I believe that governments are being seduced by the rhetoric of institutional shareholders' activism.

Institutional shareholders on why they are trustworthy stewards

The financial crisis has given fresh impetus to institutional shareholders' involvement in corporate governance issues, which had already been emerging over the last 10 years or so. In the crisis context, their claim to be responsible and steward-like has been uncritically accepted. Many investors have strong informal ties with government organisation concerned with good governance. Most investors in the UK are represented by principle investor trade associations, the Association of British Insurers, the Investment Management Association

46 B S Black and J C Coffee, "Hail Britannia?: Institutional investor behavior under limited regulation" (1993–1994) 92 *Michigan Law Review* 1997.

47 J C Coffee, "Liquidity versus control: the institutional investor as corporate monitor" (1991) 91 *Columbia Law Review* 1277.

48 Banks started to act like every other corporation and abandoned their traditional low-risk approach, de-prioritised their creditors and prioritised their shareholders. New regulation facilitated this by allowing them to make risky loans and then to financialise those loans; selling them off as commodities, known as collateralised debt obligations.

49 L E Talbot, "Of insane forms. From collectives to management controlled organisations to shareholder value organisation: building societies a case study" (2010) 11 *Journal of Banking Regulation* 223.

50 D G Tarr, "The political, regulatory and market failures that caused the US financial crisis", 27 December 2009, available at SSRN http://ssrn.com/abstract=1322297 (last accessed 10 October 2010).

51 Shareholders may approve or otherwise the Directors Remuneration Report, Companies Act 2006, s. 439.

and the National Association of Pension Funds.[52] These associations are led by the Institutional Shareholders Committee (ISC) which sets out best practice in its Code on the Responsibilities of Institutional Shareholders (ISC Code). This code is revised in line with the Combined Code. In return, it retains significant voice in current regulative initiatives, for example, in maintaining a dialogue with the Financial Reporting Council (FRC).

Other investors are increasingly vocal about their engagement in wider societal issues, frequently taking on specialist advisors, such as Pensions Investment Research Consultants,[53] to advise on socially responsible investment (SRI). Similarly, Hermes, which is wholly owned by the British Telecom pension scheme, manages 181 clients with total assets of £24.6bn. Hermes advocates "responsible ownership" and recommends that listed companies should adopt a number of principles it associates with good performance before it will advise its clients to invest.[54]

The giant of institutional shareholder organisations, the International Corporate Governance Network (ICGN) advises institutional investors (as well as the myriad of agents and advisors) to embrace both corporate social responsibility (CSR) and SRI by engaging with companies to ensure their commitment to long-term, sustainable investment and to ensure good governance practices.[55] ICGN represents members from 38 countries including professionals and policymakers as well as institutional investors managing capital in excess of $10 trillion.[56] CSR became impossible for big companies to ignore (or to be seen to ignore).[57]

The trend amongst investors toward SRI has crystallised as an approach around the United Nations initiative, the Principles for Responsible Investment (PRI).[58] PRI is a set of best practice guidelines for investors who wish to invest according to environmental, social and corporate governance (ESG) criteria.[59] The principles themselves were heavily influenced by the involvement of 20 large institutional shareholders from 12 countries,[60] as well as reflecting the social aspirations of Global Compact in alerting corporations to human rights issues.[61] Compliance with PRI is (like that of Global Compact) through self-reporting. In the former case, this is through an annual PRI reporting and assessment survey in which members must undertake and show some progress in promoting ESG investment.[62] Members who consistently fail to show progress in their investment policies face possible delisting. The principles are self avowedly "voluntary and aspirational".[63]

The trend toward SRI, or ESG (the currently preferred acronym), conflates what is good for society with what is good for institutional investors. Indeed, the PRI baldly states

52 For example, amendments to the Pensions Act in 2000 require occupational pension funds to show how they incorporate social and environmental concerns in their investment policies.

53 Pensions Investment Research Consultants Ltd, www.pirc.co.uk/ (last assessed 10 August 2010).

54 Hermes Equity Ownership Services Ltd, www.hermes.co.uk/files/pdfs/The_Hermes_Ownership_Principles.pdf (last accessed 4 March 2010).

55 ICGN Principles, www.icgn.org/files/icgn_main/pdfs/best_practice/inst_share_responsibilities/2007_principles_on_institutional_shareholder_responsibilities.pdf (last assessed 10 August 2010).

56 International Corporate Governance Network, www.icgn.org (last assessed 1 August 2010).

57 D Franklin "Just good business", *The Economist*, 19 January 2008 (386(8563)), pp. 3–6.

58 UN Principles for Responsible Investment, available at www.unpri.org/principles/ (last assessed 1 August 2010).

59 Ibid. p. 2.

60 Ibid.

61 UN Global Compact, available at www.unglobalcompact.org/ (last assessed 1 August 2010).

62 UN Principles for Responsible Investment, n. 58 above, p. 8.

63 Ibid. p. 2.

that, "applying the Principles should not only lead to long term financial returns but a closer alignment between the objectives of institutional investors and those of society at large". The PRI mission for institutional shareholders to prevail upon corporate management to further enhance CSR operates to construct institutional shareholders as corporate stewards.

In the wake of the financial crisis it is a claim that the UK government has been content to accept. Thus, the Walker Review in 2009, set up to propose reforms to the governance of banks and other financial institutions (as governance failure was believed to have contributed to the financial crisis), sought the contribution of the ISC. The Walker Review recommended more shareholder involvement in governance monitoring, Furthermore, as a result of this review, the FRC brought forward its own review of the Combined Code so as to harmonise the governance of all listed corporations at the same time. As a result of this review, the FRC concluded that shareholder monitoring of the code should be enhanced as an effective mechanism to improve corporate governance.[64] To this end, the FRC produced the Stewardship Code (2010) which followed the recommendation of the Walker Review that the code should adopt the ISC Code on the Responsibilities of Institutional Investors.[65]

The guidance in the Stewardship Code is aimed, at first instance, at fund managers who are required to "comply" with this guidance or "explain" why they have not done so on their websites. Lacking the teeth of even the current Combined Code's application to listed companies, the Stewardship Code provides little censure or incentive to comply. Investment firms that publish their compliance on the website enjoy the doubtful honour of being listed on the FRC's website. Yet, despite the minimal monitoring requirements and the absence of censure for non-compliance, the Stewardship Code begins with the stated hope that this will "help long term returns", a new stable economy.[66]

In the US, the degree to which shareholders should be part of the corporate governance process has polarised academic discussion over the last few years, with some arguing for the enhancement of shareholder empowerment[67] and others arguing for shareholder disempowerment[68] and director primacy.[69] Earlier reform had assisted the shareholder empowerment lobby. For example, in 1992 the SEC substantially amended the proxy rules to enable shareholders to communicate more easily in proxy solicitations by requiring companies to include shareholders' resolutions in its own materials.[70] The financial crisis has dramatically enhanced the trend to shareholder involvement in corporate governance as a bulwark against avaricious and irresponsible management.[71] In the USA, the Emergency

64 FRC, *Consultation on a Stewardship Code for Institutional Shareholders* (London: FRC January 2010), available at www.frc.org.uk/images/uploaded/documents/Stewardship%20Code%20Consultation%20January%202010.pdf (last assessed 1 August 2010); D Walker, "A review of corporate governance in UK banks and other financial industry entities" (London: July 2009), available at www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf (last assessed 1 August 2010).

65 With some amendments to encourage more interaction between investors and management and to require attendance at AGMs, FRC, *Implementation of the UK Stewardship Code 2010* (London: FRC July 2010), p. 4, available at: www.frc.org.uk/images/uploaded/documents/Implementation%20of%20Stewardship%20Code%20July%2020103.pdf (last assessed 1 August 2010).

66 FRC, *Consultation*, n. 64 above, p. 10.

67 L A Bebchuk, "The case for increasing shareholder power" (2005) 118 *Harvard Law Review* 833.

68 W W Bratton and M L Wachter, "The case against shareholder empowerment" (2010) 158 *University of Pennsylvania Law Review* 653; L A Stout, "The mythical benefits of shareholder control" (2007) 93 *Virginia Law Review* 789.

69 S Bainbridge, "Director primacy and shareholder disempowerment" (2005–06) 119 *Harvard Law Review* 1735.

70 Rule 14a-8 of the Securities Exchange Act.

71 Bebchuk, "The case for increasing shareholder power", n. 67 above.

Economic Stabilisation Act of 2008 introduced "say on pay" mandates for those institutions enjoying the Troubled Asset Relief Program (TARP). Similarly, the Shareholder Bill of Rights Act introduced to the US Congress in 2009[72] conveyed much of the message about the centrality of shareholder empowerment in current thinking.[73] In introducing the Bill, Senator Schumer stated that:

> during this recession, the leadership at some of the nations most renowned companies took too many risks and too much in salary, while their shareholders had too little to say. This legislation will give stockholders the ability to apply the emergency brakes the next time the company management appears to be heading off a cliff.

What is interesting about this debate is that it trails reality. Shareholders' had a great deal to say before the financial crisis and management was already divesting itself of power in response to shareholder demands. For example, because, shareholders thought the market in corporate control did indeed optimise shareholder value, corporations had already largely abandoned staggered boards (the most effective defence against hostile takeovers), with only 16 per cent of companies having them in 2008 compared to 44 per cent in 1998.[74] Ed Rock's work also evidences how much CEOs listened to what institutional shareholders had to say, so that, by 2008, 18 Standard & Poor (S&P) 100 companies used plurality voting (which assures that all nominated directors are generally elected, thus a desirable outcome for management), down from 90 in 2003.[75] Rock observed that in all cases "boards just caved in to demands for majority voting".[76] None of this provided protection against corporate failure. The 15 worst-performing stocks in the S&P 500 companies were less likely to have staggered boards and no more likely to have poison pills than the best performers.[77] Indeed, 80 per cent did not have staggered boards, 80 per cent did not have a poison pill in place and 73 per cent had a majority-voting or director-resignation policy.

In both the UK and the US, from the late 1970s, directors as stewards for shareholders anticipated what shareholders would want. As institutions increased their ownership of shares, neoliberal governance sought (through the codes) the views of the now more identifiable owners. Over this period, we saw successive corporate scandals and then global financial crisis. The current response to crisis retains market-based corporate governance strategies, but now requests institutional investors to be more active. It requires them to be the stewards, partly prompted by institutions' own claims to socially responsible activities. In the final section, I assess the veracity and efficacy of institutional stewardship.

4 Institutional shareholders as stewards

Who are they and how do they behave?

In order to be good stewards, institutional shareholders need to be both active in corporate governance *and* guided by social responsibility. However, institutional shareholders only seem active when engaged in social irresponsibility and rapaciousness, otherwise they are

72 Shareholder Bill of Rights Act 2009, 111th Congress s. 3 by Senator Schumer.

73 This did not become law having been superseded by many provisions in the Dodd–Frank Act 2010.

74 Bratton and Wachter, "The case against shareholder empowerment", n. 68 above, p. 679.

75 Kahan and Rock, *Embattled CEOs*, n. 39 above.

76 Ibid. p. 24.

77 Statistics from Wachtell, Lipton, Rosen and Katz, available at www.law.harvard.edu/.../corporate-governance-and-the-financial-crisis-causes-and-cures.PPT (last accessed 26 July 2010). They cite the worst performers as Lehman Brothers, Washington Mutual, Fannie Mae, Freddie Mac, AIG, Circuit City, General Growth Properties, EW Scrips, Ambac Financial, XL Capital, American Capital, Bear Stearns, National City, Genworth Financial, Developers Diversified.

inactive. Broadly speaking, pension funds fall into the latter category, hedge funds in the former. Pension funds have the largest proportion of shareholdings with public pension funds in the US holding "approximately 20% of publicly traded US equity (or $2.5 trillion) at the end of 2004–5".[78] Since the financial crisis, the value of equities has fallen considerably so that the UK stock market, valued at £1158.4 billion in 2006 has fallen to £699.8billion (or by 37.7 per cent) since the end of 2008.[79] However, the proportion of shareholdings owned by different institutions has remained fairly constant with pension funds owning 12.8 per cent of all UK equity value.[80] The lower proportion of equities held by pension funds in the UK market is a result of the increasingly internationalised character of this market. In 2008, 41.5 per cent of UK equities were owned by foreign investors, up from 11.3 per cent in 1990.[81]

Despite the differences between the US and UK markets, pensions still hold a significant proportion of total equities, however, few utilise it to any effect, let alone as stewards. Recent work on pension funds' governance activity in the US concluded that they have "a very limited spectrum of activities" where "smaller funds delegate more function to active portfolio management and proxy advisory services, such as Institutional Shareholder Services (ISS)".[82] This study found that 53.9 per cent of the funds never submitted a letter to management, and 64 per cent never met with management.[83] They found that public pension funds did not tend to pursue the company-specific forms of activism which impact on corporate governance.[84] Furthermore, they found that public pension funds had very little familiarity "with existing empirical evidence on corporate governance, such as studies analysing the value of poison pills, independent boards, or shareholder litigation".[85] This evidence suggests that pension funds largely do not have the tools to be successful activists, let alone successful stewards.

Pension funds remain the largest of the institutional shareholders in the US[86] (insurance companies are the largest in the UK with 13.4 per cent of total equities in 2008),[87] however, they are not the fastest growing. Thus, the governance potential of institutional shareholders must also be assessed by observing the activity of mutual funds whose holdings in the US rose from 7 per cent in 1990 to 28 per cent in 2006. Rock cites the activities of Fidelity, Lord Abbett & Co. and Morgan Stanley, which led a campaign to get the New York Time Co. to alter its share structure (which assured control for the founding family, Sulzberger), among other campaigns.[88]

However, while these funds are clearly powerful, they are far from stewards. Most institutional shareholders are more concerned with short-term profits and only differ as to

78 S J Choi and J E Fisch, "On beyond CalPERS: survey evidence on the developing role of public pension funds in corporate governance" (2008) 61 *Vanderbilt Law Review* 315, pp. 316–17.

79 Office for National Statistics (ONS), Statistical Bulletin, "Share Ownership Survey 2008" (London: ONS January 2010), p. 1, available at www.statistics.gov.uk/pdfdir/share0110.pdf (last accessed 1 August 2010).

80 Ibid.

81 Ibid. p. 6. Another quirk of investment shifts since the crisis has been the increase of public sector holdings from 0.1% in 2006 to 1.1% in 2008 (p. 2).

82 Choi and Fisch, "On beyond CalPERS", n. 78 above, p. 318.

83 Ibid. p. 329.

84 S J Choi, J E Fisch and A C Pritchard, "Do institutions matter? The impact of the lead plaintiff provision of the Private Securities Litigation Reform Act" (2005) 83 *Washington University Law Quarterly* 869; NYU, Law and Economics Research Paper No 04-08.

85 Choi and Fisch, "On beyond CalPERS" n. 78 above, p. 347.

86 In 1950 private pension funds owned 1% of total equity but by 2006 that figure was over 60%.

87 ONS, "Share Ownership Survey", n. 79 above, p. 2.

88 Kahan and Rock, *Embattled CEOs*, n. 39 above, p. 16.

the rapacious way they will pursue that. Hedge funds, for example, are highly rapacious. From 2001–2006, 236 activist hedge funds were involved in 1056 publicly traded targets.[89] Bratton's study showed that activist hedge funds used three main strategies to increase shareholder value, which included increasing leverage, returning capital to shareholders and selling corporate assets.[90] None of these does anything more than undermine a stable capital base. Further evidence of their concern with short-term gains is provided by the times in which they are active. In the bull market, they were highly active. In 2007, hedge funds conducted 137 activist campaigns which have involved giant corporations such as McDonald's, Time-Warner, Blockbuster and Kraft. However, in the bear market, where opportunities to ruthlessly pursue shareholder value have evaporated, they have withdrawn from activism to a high degree.[91] In other words, they're never around when you need them.

For institutional shareholders to be effective stewards they must be both active *and* concerned with stewardship-like governance. In the UK, institutional shareholders are very conservative in their strategies. They invest in the largest companies and are guided by listings. In 2008, 84.3 per cent of pension funds investment in UK equities was invested in the FTSE 100 companies.[92] In the US, Professor Bushee's classification of institutional investors suggests that in fact they are mainly *either* inactive *or* active in a self-interested and non-stewardship-like way. Based on investment strategies from 1983–2002, Bushee sets out three different types of investor: "transient", "dedicated" and "quasi-indexers".[93] Transient investors, he shows, turn over 70 per cent of their portfolios each quarter and represent 31 per cent of total institutional investors. Dedicated investors were those who held onto at least 75 per cent of their stock for at least two years and represented 8 per cent of total institutional investors. The final group, quasi-indexers, maintained highly diversified portfolios but traded infrequently. They represented 61 per cent of total institutional investors. The last category, though the largest, offers little in terms of promoting corporate governance by utilising new shareholder powers as these investors have small stakes in companies and are not actively engaged in monitoring their investments. Such investors rely on diversification alone as a mechanism to increase value and to balance risk. The next largest group, the transient shareholders, are, Bushee notes, commonly involved in takeover activity and are frequently involved in overbidding for acquisitions. Bushee also noted that as institutional shareholders' fund managers refer to quarterly earnings per share (EPS) the influence of transitory investors will directly and negatively impact on research and development spending. Thus, those investors who are active are only active in the pursuit of short-term personal returns with the result that they undermine long-term productive development.

Thus, the evidence to date shows that, in the few instances where institutional shareholders are activist, it is for short-term profiteering only, not for the long-term strategic governance envisaged by shareholder stewardship.

89 A Brav, W Jiang, F Partnoy and R Thomas, "Hedge fund activism, corporate governance, and firm performance" (2008) 63 *Journal of Finance* 1729, p. 1739.

90 Bratton and Wachter, "The case against shareholder empowerment", n. 68 above.

91 Brav et al., "Hedge funds activism", n. 89 above.

92 ONS, "Share Ownership Survey", n. 79 above, p. 9. This is up from the 2006 survey where pension funds held 77.3% in FTSE 100 companies.

93 B J Bushee, "The influence of institutional investors on myopic R&D investment behaviour" (1998) 72 *Accountancy Review* 305.

Why institutional shareholder stewards would not have made better choices than a shareholder primacy-driven management and avoided crisis

The claim in this section is that institutional shareholder stewards would have made much worse choices because not only would they be driven by shareholder primacy goals, their decision-making would have been less informed and less rational than that of a professional management. Initiatives like the Stewardship Code can do nothing to alter those fundamentals.

Institutional investors make choices about investments based on external indicators such as share price. From a neoliberal perspective, that is a good thing as share price is the most effective and accurate indicator of real value. It is the reification of rational economic actors' calculation of risk, return and current interest rates (inter alia). But is what investors think something is worth the same as what it is worth? Schiller argues that it is not. Rationality, he argues, does not primarily determine investors' choices and an "irrational exuberance" characterises much investment activity.[94] In his study of the psychology of investment he shows that investors may continue to have high expectations of share prices throughout sustained periods of high price–earnings ratio (P/E).[95] While real rises in share values will follow periods of economic depression, this will quickly even out, although investors will continue with the expectation that real share value will rise at the same rate. Similarly, Froud et al.'s study of average returns from shares listed in the S&P 500 from 1982–2002 showed that the rise in share prices did not correlate with the annual return on those shares. Indeed, their statistics show that annual return was frequently below the prevailing rate of interest.[96] The absence of correlation between returns and share price has been variously explained as the incompetence of investors[97] or the sheer volume of active investors operating in the market. In the latter explanation, demand itself has led to price increases. As Lynne Dallas points out, "concurrent with the rise of institutional shareholders has been an increased turnover of stock so that whilst only 12% of stock changed hands in 1960 this increased to 87% in 2005".[98] The rise of institutional shareholders as players in the stock market has obfuscated real value under the sheer weight of buying and selling which has inflated prices.

In their challenge to the growing shareholder empowerment hegemony, Bratton and Wachter argue that we cannot expect shareholders to make better choices than management because there are information asymmetries between the two. Investors act without all the information, and certainly with much less information than managers, therefore it is not "strong form" efficient.[99] The market cannot assimilate all relevant information and enhanced disclosure is often dismissed as too costly. Thus, they conclude, as the market can only assimilate all *public* information, it cannot be more than a "semi-strong form". Bratton and Wachter also cite a body of literature which shows how incompetent the market is when confronted with new technologies. Investors' inability to objectively assess the real value of shares in new technology companies results in an "irrational exuberance" or an urgency to buy which results in high-volume trading and speculative bubbles. Their

94 R Shiller, *Irrational Exuberance* 2nd edn (New York: Doubleday 2005).

95 Which are indicative of heavily overpriced shares, the dot.com shares having a particularly high P/E.

96 J Froud, J Sukhdev, A Leaver and K Williams, *Financialisation and Strategy* (London and New York: Routledge 2006), p. 78.

97 D Henwood, *Wall St* (New York: Verso 1998).

98 L Dallas, "Caring too much about stock prices: managerial myopia and institutional shareholders" presented at Opening Symposium for the Adolf S Berle Jr Center on Corporations, "In Berle's Footsteps", Law and Society Seattle Law School, 7–8 November 2009, p. 399.

99 Bratton and Wachter, "The case against shareholder empowerment", n. 68 above.

position, is not, of course an argument against shareholder primacy, merely that shareholders are not competent to make decisions in their own interest and could potentially introduce more irrationality and instability into the market if allowed to do so.

Thus, despite institutional investors' claims to undertake considered and socially responsible investment such as would justify their role as stewards, the evidence suggests the contrary. It would seem that, not only would they have pursued shareholder primacy with even more alacrity than performance-pay-driven management, they would have done so in a less informed and more destructive manner. Institutional investors range from the slothful (typical in pension funds) to the rapacious (typical in hedge funds), but they all share the same lack of managerial competencies. Given this, shareholder stewardship as a mechanism to bolster better self-regulation seems to have no solid evidential foundation as to its efficacy.

Conclusion

Shifting responsibility onto shareholders in the shareholder stewardship model is an attempt to "fix" the market so that it can successfully self-regulate and avoid crisis. However, as Polanyi shows, the market fails because of its disembedded (or alienating) nature. Self-regulation can never work because it relies on ideological confidence in the market which Polanyi teaches us is only maintainable by external and frequently violent intervention. Historically, "the self-regulating market was unknown; indeed the emergence of the idea of self-regulation was a complete reversal of the trend of development".[100]

Shareholder stewardship is thought to be an effective form of self-regulation because owners will more efficiently reduce the agency costs inherent in modern corporations. However, management failure to adhere to its "contractual" obligations to shareholders in seeking shareholder value was not the cause of the crises. Indeed, it was the very pursuit of profit maximisation, the very adhering to this "obligation" in an enabling environment, which has precipitated crises.

Institutional shareholders are thought to be effective stewards because they have self-adopted responsible investment codes. However, evidence shows that they are variously ill informed, inactive or self-interestedly active. It is not in their nature to be socially responsible because their interest is in profit maximisation alone. And, as this article has attempted to show, effective stewardship was traditionally posited on an absence of self-interest in profit maximisation. Thus, management in large corporations where shareholders were dispersed were ideally placed to act as stewards where the social and economic policies of the government could ensure that the corporation was governed to meet the needs of the wider community. During such periods, a degree of re-embeddedness was assumed.

The shift to neoliberalism and market-based governance disembedded the economy again. It was because governance sought to bind management to shareholder interests that managements were no longer capable of acting as stewards. It is, therefore, even less plausible to look to institutional shareholders themselves to establish stewardship when it is they who have the greatest self-interest in profit maximisation and, arguably, the least in wider public concerns.

Shareholder stewardship will be no more effective than previous market-based governance strategies because the market is *not* essentially self-regulating. As the financial crisis has shown, it requires significant state intervention to ensure its existence and then to manage the social problems it causes. The neoliberals are wrong and Polanyi was right. Institutional investors cannot deliver governance which enhances long-term progress and

100 Polanyi, *Great Transformation*, n. 8 above, p. 71.

stability because it is contrary to their nature, despite what their platitudinous codes and principles say. In the fable of the scorpion and the frog, the scorpion must sting the frog that is carrying him across the river and whom he has promised not to harm. He will do so even though they will both drown as a result. The scorpion's explanation? "I'm a scorpion; it's in my nature."

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From codes of conduct to international framework agreements: contractualising the protection of human rights

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> The fundamental signification of a democratic constitution is to state that the power upon men, whatever it is, and whichever group or person exercises it, should have legally established limits.[2]

Abstract

This article analyses international framework agreements (IFAs) in the light of Polanyi's account of interventions to embed markets and thus regulate them. This special type of voluntary market regulatory arrangement that is shaped by multinational companies and international trade unions and constructed through the activities of the state is envisaged as a possible tool to embed liberalism even though several challenges must be taken into consideration.

Introduction

This article analyses IFAs in the light of Polanyi's account of interventions to embed markets and thus regulate them. An IFA is defined as an agreement between an international trade union and the management of the firm at the transnational level and which aims at the international activities of this firm.[3] According to the European Commission it is:

> an agreement comprising reciprocal commitments, the scope of which extends to the territory of several States and which has been concluded by one or more representatives of a company or a group of companies on the one hand, and one or more workers' organisations on the other hand, and which covers working and

1 British Academy Fellow, London School of Economics and Political Science. The author wishes to thank Bettina Lange for organising a workshop on Polanyi's relevance in Oxford and two anonymous reviewers for their helpful comments. All mistakes remain her own.

2 N Bobbio, "Per la difesa delle libertà democratiche nelle fabbriche"(1958) 1(January) *Risorgimento* 19.

3 "An agreement negotiated between a multinational company and a global union federation concerning the international activities of that company"; see International Confederation of Free Trade Unions (ICFTU), "Global Union Federations framework agreements with multinational enterprises", at www.icftu.org/displaydocument.asp?Index=991216332&Language=EN (last accessed 1 July 2011) and R-C Drouin, *International Framework Agreements: A study in transnational framework agreements: a study in transnational labour regulation* (PhD thesis, Montréal, 2005), p. 1.

employment conditions and/or relations between employers and workers or their representatives.[4]

There are, to date, 66 IFAs.[5] They have been negotiated by multinational companies (e.g. Ikea, Telefonica, Volkswagen, Rheinmetall, France Telecom) and international trade unions in very diverse sectors, such as agricultural, telecommunication, metal and automotive, and signed in many different countries (usually that of origin of the firm, and mainly, but not only, in Europe).[6]

These agreements are the trade unions' answer to the firms' codes of conduct. They aim to create a long-term relationship between the multinational firm and the international trade union.[7] The main difference between these two types of texts lies in their enforcement. Whereas codes of conduct might not have any effect, IFAs can be enforced through diverse national collective agreements.[8] They provide a framework to encourage the recognition of rights and negotiation.[9]

Three elements are at the heart of their definition: they enounce rights such as the right not to be discriminated against, working time rights and so on; they are negotiated; and they involve international sector trade unions.[10] These three features present two advantages: IFAs give greater credibility to the strategies of firms' responsibility; and, because they are not unilateral (like most codes of conduct), they also create a certain legitimacy thanks to social dialogue. They can complement national regulations which might sometimes be seen as insufficient. Their transnational nature and their substantive or wide-ranging rights go beyond the mere cosmetic exercise and they show a growing will to protect fundamental social rights.[11] Can these emergent modes of regulation lead to an alternative protection of labour and human rights? In Polanyi's terms, can IFAs be a tool embedding the market?

An IFA is a special type of voluntary market regulatory arrangement that is shaped by multinational companies and international trade unions and constructed through the activities of the state (through a system of property rights and contract enforcement through the courts). For this reason, they present a good opportunity to revisit the nature

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4 European Commission staff working document, "The role of transnational company agreements in the context of increasing international integration", COM (2008) 419, SEC (2008) 2155, 2 July 2008, p. 3. See also ICFTU, "Global Union Federations", n. 3 above.

5 See *Accords transnationaux d'entreprise, Dialogue, droits, anticipation des restructurations, acteurs: une nouvelle perspective*, 13 and 14 November 2008, Centre de conférence de Lyon, France.

6 E.g. see the Chiquite IFA signed in the United States in 2001. For a list, see Observatoire sur la Responsabilité sociétale des entreprises (ORSE), *Directory for International Framework Agreements Negotiations*, June 2007, p. 57, available at www.orse.org/site2/maj/phototheque/photos/docs_an/IFA_june_2007.pdf (last accessed 1 July 2011).

7 Confédération internationale des syndicats libres (CISL), *Guide syndical de la mondialisation* (Bruxelles: CISL 2002), p. 133.

8 It would be wrong to think that IFAs are the future of CSR. Trade unions consider IFAs as an alternative to CSR not an evolution of it. The ILO also has a slightly more nuanced view of IFAs: "Although framework agreements are not CSR initiatives, they are often referred to in the CSR debate because they are one of the ways in which companies can express their commitment towards the respect of certain principles." See "International Framework Agreements: a global tool for supporting rights at work", www.ilo.org/global/about-the-ilo/press-and-media-centre/press-releases/WCMS_080723/lang—en/index.htm (last accessed 1 July 2011).

9 CISL, *Guide syndicale*, n. 7 above, p. 133.

10 Drouin, *International Framework Agreements*, n. 3 above, p. 250.

11 If fundamental rights are a generally regarded set of entitlements in the context of a legal system, wherein such system is itself said to be based upon this same set of *basic*, *fundamental*, or *inalienable* entitlements or rights, they are here understood as those protected at an international level by the Universal Declaration of Human Rights or the ILO. See, for instance, M Schmidt, *Restructuring and Anticipation Dimension of Existing Transnational Agreements. Analysis and overview table, report prepared for the European Commission* (Bruxelles: EC May 2008).

and characteristics of state interventions in markets or, in other words, Polanyi's "great transformation" proposition.[12]

In order to study the relevance of Polanyi's account in today's world, the new mechanism that IFAs represent needs to be understood within his framework. This raises three questions.

1. First, what are IFAs regulating and can they regulate the market? There seems to be an interesting ambiguity about the role of IFAs in international law. On the one hand, IFAs are informal or soft law initiatives structured to limit the power of market actors. They therefore could be considered as embedding the market, e.g. in values such as consumer choice, employee needs and such like. On the other hand, IFAs are completely immune to public oversight or state intervention.
2. Second, how are IFAs regulated? A first impression is that they currently seem to exist in a realm of no hard law or market regulation and thus appear to be regulated by social rather than market forces.
3. Third, should IFAs be a means to regulate the market? In Polanyi's *The Great Transformation*, the "embedding of economic into social relationships" is defined as the embedding of economic relationships into the wider "public" interest of *society as a whole*. But it is unclear whether privately negotiated soft law frameworks reflect the interests of society at large (whether it is the UK, the EU, or the world as a whole), or simply the vested interests of established providers or dominant market players. In this light, it is also interesting to wonder whether IFAs could have a comparable effect to the Industrial Revolution. In 1944, in *The Great Transformation*, Polanyi argued that the Industrial Revolution was destructive as it entailed the disembedding of economic out of social relationships. Are IFAs promoting the disembedding or embedding of economic activity?

The project of "embedded liberalism" has already shown how corporate social responsibility (CSR) is a key method of furthering the Polanyian project. John Ruggie's work on the UN Global Compact has shown that "embedded liberalism" formed the principled basis of CSR under, for example, the aegis of the UN in the UN Global Compact. In the context of this vast literature that has developed from the Polanyian framework, the examination of IFAs in this article proposes a different interpretation and possible extensions/criticism of embedded liberalism itself.

Overall, IFAs could be a good way to embed or restrict the external effects of self-regulating markets within the framework of CSR. But this is under certain conditions (**2** above): it involves asking:

a. whether IFAs can embed the market; and

b. how IFAs are themselves embedded within the existing system.

It also raises numerous challenges (**3** above), particularly linked to the control that multinational firms have over these instruments in terms of: adjudication; content; and implementation.

The wish: IFAs as a tool to embed liberalism

Polanyi argued in the early 1940s in *The Great Transformation* for the self-regulation of economic activity both in a national and global context. Applying this approach leads to two

12 K Polanyi, *The Great Transformation* 2nd edn (Boston: Beacon Press 2001).

conclusions: first, IFAs show how the economic world, that is multinational firms are turning towards a certain regulation of their social relations. We see that beyond the states' roles, private actors such as multinational firms can evolve towards designing CSR and the emergence of a new kind of regulation. In the field of CSR, the regulation of the market by private actors is more and more a reality. In other words, IFAs are a way to embed the market (see **a** above). Second, contracts, which are the central social relation and a feature of the market society, can enforce IFAs. In this sense, IFAs are embedded within the existing legal orders (**b** above).

The idea: IFAs as a way to embed the market

Is the world becoming a market society? According to Polanyi's famous book *The Great Transformation*, the relationship between the market and society is inverted.[13] Instead of the economy being embedded in social relations, social relations are embedded in the economic system.

This analysis is relevant to the current global economic crisis and thinking about new regulatory approaches. It might help in overcoming the distance between law and economy. A good example lies in employment and human rights law where an inherent tension between employees and employers had to be overcome. The traditional answer in labour law was enounced through the building of hard law around the protection of the employee, for instance in terms of industrial citizenship.[14] For human rights lawyers, the solution went through international law and the recognition and enforcement by states of conventions protecting human rights. These answers appear less valid nowadays. Whether it is a choice of more or less powerful countries or a symptom of their weakness, a trend towards smaller state interference in the field of labour law emerges. The absence of appropriate regulation in a world more and more defined by globalised exchanges leads to rethinking the former protection mechanisms.

Globalisation is seen as the "intensification of worldwide relations which link distant localities in such a way that local happenings are shaped by events many miles away and vice versa".[15]

> Globalization has increasingly disconnected one single element – networks of production and finance – from what had been an overall system of institutional relations, and sent it off on its own spatial and temporal trajectory. This has produced . . . disequilibria in the world political economy, which will persist unless and until the strictly economic sphere is embedded once more in broader frameworks of shared values and institutionalized practices.[16]

13 Polanyi, *The Great Transformation*, n. 12 above.

14 All around Europe, see A Supiot, M E Casas, J De Munck and P Hanau, *Au-delà de l'emploi: transformations du travail et devenir du droit du travail en Europe: rapport pour la Commission des Communautés européennes* (Paris: Flammarion 1999) and A Supiot, *Homo juridicus* (Paris: Seuil 2005), p. 183.

15 A Giddens as quoted in J Habermas, "The European nation state: its achievements and its limitations, on the past and future of sovereignty and citizenship" (1996) 9 *Ratio Juris* 125.

16 G Kell and J G Ruggie, "Global markets and social legitimacy: the case of the 'global compact'", paper presented at international conference, Governing the Public Domain beyond the Era of the Washington Consensus? Redrawing the Line Between the State and the Market (1999) available at www.unglobalcompact.org/NewsAndEvents/articles_and_papers/global_markets_social_legitimacy_york_university.html. See also J G Ruggie, "International regimes, transactions and change: embedded liberalism in the postwar economic order" (1982) 36(Spring) *International Organization* 379–415; M Friedman, "The social responsibility of business is to increase its profits" in W M Hoffman and J Mills Moore (eds), *Business Ethics: Readings and cases in corporate morality* (New York: McGraw-Hill 1984).

In international governance structures, there has been a significant expansion of global economic rule-making and the rights of global corporate actors have been secured, while global concerns, such as the environment, human rights or poverty, were left behind. Ruggie proposes a new version of Polanyi's embedding of the market in order to put forward an innovative response to precisely these kinds of imbalances. What he calls "the embedded liberalism compromise" was a solution in the 1930s[17] and could be of help nowadays.

According to Ruggie, this movement already appears in the interplay between two sets of key actors in the global economy, transnational corporations and transnational non-government organisations (NGOs) in the institutional venue of the UN through the initiative of the Global Compact and in CSR[18]. He contends that this dynamic interplay provides great potential for attempts to bridge the imbalance between economic globalisation and the governance structures that it has left behind.

The Global Compact challenges individual corporations and representative business associations to demonstrate good global corporate citizenship by embracing nine principles in the areas of environment, labour and human rights, and by advocating stronger UN organisations in those and related areas.[19] Described as a Faustian bargain, it offers the advantage of protecting human rights and non-economic interests as well as attracting corporations for practical reasons (one-stop shopping reducing transaction costs for multinational firms interested in these processes) and legitimacy reasons (for acting on universally agreed principles).

It also appears in CSR movements. Because of this geographical reconstruction that globalisation allows, firms are turning towards new methods of self-regulation. CSR is progressively built. CSR is an interesting contemporary attempt to socialise economic relationships.[20] Defined as the "voluntary integration by firms of social and environmental concerns into the commercial activities and their relationships with stakeholders", [21] it is in concrete terms conveyed by numerous texts.[22] The main ones are voluntary codes of conduct and newer ones such as IFAs.

Because of their bilateral nature, IFAs are an interesting tool for dialogue between multinational companies and NGOs and/or international trade unions. It is a way to give a voice to non-economic actors and tackle the identified imbalance. It is also a way to, following the terms used by John Ruggie, embed "global market forces in shared values and institutionalized practices, and bridging the gaps in global governance structures".[23]

The interest: embedding IFAs or their insertion within the existing legal orders

The interest of relying on IFAs to embed the market is that they can, more or less easily, be inserted within the existing legal orders or, in other words, be embedded within broader

17 Kell and Ruggie, "Global markets", n. 16 above.

18 G Whelan, J Moon and M Orlitzky, "Human rights, transnational corporations and embedded liberalism: what chance consensus?" 87 *Journal of Business Ethics* 367.

19 See www.unglobalcompact.org/ (last accessed 1 July 2011).

20 This can also be associated with Ruggie's recent suggestion that a "new consensus" has formed, or is forming, around his "protect, respect and remedy" framework. See Whelan et al., "Human rights", n. 18 above.

21 Commission of the European Communities, "Communication from the Commission concerning corporate social responsibility: a business contribution to sustainable development", 2 July 2002, COM(2002) 347 final.

22 Several types of internal and external codes have been identified. See F McLeay, "Corporate codes of conduct and the human rights accountability of transnational corporations: a small piece of a larger puzzle" in O De Schutter, *Transnational Corporations and Human Rights* (Oxford/Portland, Oregon: Hart 2006), pp. 219–40, and B Teyssie, "La négociation collective transnationale d'entreprise où de groupe" (2005) 11 *Droit Social* 982.

social relations, thus creating a network around the market. This embeddedness is not always seen as a blessing by multinational firms. The question from the company's viewpoint is whether the IFAs represent any danger of formal legal liability.[24]

A preliminary question is to understand what the risks are for a multinational firm which adopts an IFA.[25] In case of a breach of the rights of the employees,[26] the risks are legal, financial and moral and can be sanctioned in different frameworks.[27] After signing the IFA, the multinational firm is supposed to enforce the obligations it contains, which increases the number of obligations in different frameworks and countries and the risks of violating them. The firm has to find a balance between its liability and the preservation of its economic interests. Because IFAs do not fit into the national legal categories, it might be thought that media exposure is the greatest risk, but legal risks should not be underestimated.

I will focus on legal liability risks. They raise two problems: from the point of view of the firm, the aim is to avoid being condemned on the basis of an IFA. From the point of view of the employees or the international federations, the aim is to oblige the firms to comply with the commitments they undertook. The point is to avoid factual or legal immunities.[28]

The main risk for the firm is to be condemned. It incurs criminal,[29] civil,[30] or contractual liability. If there is no clause conferring jurisdiction, national law is applied. The applicable law, the jurisdiction and the characterisation of the agreement have to be determined. The legal consequences of the action will depend on the country in which the

23 Kell and Ruggie, "Global markets", n. 16 above.

24 H Genn, M Partington and S Wheeler, *Law in the Real World: Improving our understanding of how law works. final report and recommendations* (London: Nuffield Inquiry on Empirical Legal Research, Nuffield Foundation 2006); W Streeck, "Social science and moral dialogue: critical forum, toward a new socio-economic paradigm" (2003) 1 *Socio-Economic Review* 126.

25 Also see "Introduction" in T Lewens (ed.), *Risk: Philosophical perspectives* (London and New York: Routledge 2007).

26 The terms "worker" and "employee" are used interchangeably. Some of the IFAs use worker not employee, but some also use employee.

27 Informal meeting between the firm Arcelor Mittal and the ILO.

28 M-A Moreau, "Négociation collective transnationale: réflexions à partir des accords-cadres internationaux du groupe Arcelor Mittal" (2009) 1 *Droit social* 93.

29 See O De Schutter, "Les affaires *Total* et *Unocal*, Complicité et extraterritorialité dans l'imposition aux entreprises d'obligations en matière de droits de l'homme" in *Annuaire français de droit international* LII (Paris: CNRS Éditions 2006); A J Wilson, "Beyond *Unocal*: conceptual problems in using international norms to hold transnational corporations liable under the Alien Tort Claims Act" in De Schutter, *Transnational Corporations*, n. 22 above, pp. 43–72; O De Schutter, "L'incrimination universelle de la violation des droits sociaux fondamentaux", Cellule de recherhe interdisiplinaire en droits de l'homme (CRIDHO), Working Paper 2005/05; T Keithley, "Does the National Labor Relations Act extend to Americans who are temporarily abroad?" (2005) 105 *Columbia Law Review* 2135. Examples of extra-territorial liability were found in *Doe I* v *Unocal Corp.* 395 F3d 932 (9th Cir 2002) and Cour d'appel de Versailles, *Total*, 11 January 2005 in which multinational firms were accused of violations of human rights in Myanmar by a group of employees. They contended that they had been constrained to forced labour by the authorities of this country on behalf of the companies. The federal district court of the United States identified a case of civil liability related to the lack of respect of international obligations by the firms. They are not related to IFAs since the obligations in these cases were fundamental rights protected by international texts such as the ILO conventions, but IFAs, when they exist, can present an added interest linked to contractual liability. K Sontag, "La justiciabilité des droits de l'homme à l'égard des sociétés transnationale" in L Boy, J-B Racine, F Siiriainen, *Droit économique et droits de l'homme* (Bruxelles: Larcier 2009), pp. 569–640.

30 See n. 29 above and E Decaux, "La responsabilité des sociétés transnationales en matière de droits de l'homme" (2005) 4 *Revue des sciences criminelles* 789; M Delmas-Marty, *Globalisation économique et universalisme des*

action has started. Without analysing the law of each country,[31] one can generally distinguish between civil law and common law. In common law, the first condition put to a legal action is that of personal jurisdiction. Defined in the United States as the power of a court to judge, it is twofold: the *in personam* jurisdiction related to the claimant and the *in rem* jurisdiction related to the litigation.[32] Extensive interpretations of these conditions have sometimes been seen where the American courts accepted to judge disputes quite disconnected from American law in cases of violation of human rights.[33] In civil law and European Union law, according to the Brussels 2 regulation,[34] the applicable law is that of the defendant, of the workplace or of the place of hire if the former one is unclear. The competent judge is that of the applicable law.[35] Finally, an international contract can provide for the application of another law,[36] raising the question of the application to a foreign law by national judges.

Then, one has to determine who will be able to claim in respect of these obligations. Beyond classical principles about the interest in bringing the case in front of the judge, United States courts recognise the possibility to start class actions.[37] This trend, which is starting to raise interest in Europe, is not generalised yet.[38]

Finally, the legal characterisation of the agreement can be interpreted in two ways: either the agreement is seen as soft law and it cannot be invoked in front of a court, or it has a legal value which should be determined. In the absence of a legal status recognised in private international law,[39] the IFA should be fitted within existing law categories or texts. Depending on the judge, these agreements can be considered as contracts, gentlemen's agreements, international customs, or labour law collective agreements.[40] In each of these cases, the agreement creates obligations for the employers and for the employees.

IFAs as contracts

droits de l'homme (Montréal: Thémis 2004) ; M. Delmas-Marty, "Aplanir le terrain de jeu" (2005) 4 *Revue des sciences criminelles* 735.

31 In order to limit the field of application of a broad subject, I will not examine the law of each country to determine what exact procedure should be followed to engage the responsibility of multinational firms. Instead, I will rely on the common principles to all legal orders to understand the choices offered to the firm.

32 See A Belatchev, *Jurisdiction in* USE *v* Noriega*: With special reference to the* Honecker *case* (Uppsala: Iustus Förlag 2000).

33 See H Muir Watt, "L'universalité de la compétence juridictionnelle nationale: quelles stratégies pour les acteurs (USA/Europe)" in M-A Moreau (ed.), *Le juge et les relations de travail dans le contexte de la mondialisation de l'économie* (Paris, Dalloz 2010) and C Forcese, "Globalizing decency: responsible engagement in a era of economic integration" (2002) 2 *Yale Human Rights & Development Law Journal* 1.

34 See the Brussels Convention, Regulation 2201/2003 of 27 November 2003 concerning jurisdiction and the recognition and enforcement of judgments in matrimonial matters and the matters of parental responsibility, repealing Regulation (EC) No 1347/2000, Article 14.

35 According to Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I).

36 See n. 64 below, the arbitration clause.

37 See the contribution of E Loquin, "L'arbitrage, mode de règlement des différends internationaux relatifs aux droits de l'homme ou aux droits sociaux fondamentaux" in Moreau (ed.), *Le juge*, n. 33 above.

38 See the Green Paper of the European Commission, *Access of Consumers to Justice and the Settlement of Consumer Disputes in the Single Market*, COM(93) 576, 16 November 1993, p. 64: In 1993, eight of the 12 member states gave consumer associations the right to sue a defendant in order to protect the collective interests of consumers.

39 D Be, "A report on the European Commission initiative for a European framework for transnational collective bargaining" in K Papadakis (ed.), *Cross-border Social Dialogue and Agreements, An emerging global industrial relations framework?* (Geneva: ILO 2008), ch. 9, available at www.ilo.org/wcmsp5/groups/public/—-dgreports/—-dcomm/—-publ/documents/article/wcms_093471.pdf (last accessed 1 July 2011), and Drouin, *International Framework Agreements*, n. 3 above.

In civil law and in common law, a contract, whether it is internal or international,[41] creates rights and obligations for each party. It has a binding value, thanks to the principle of *pacta sunt servanda*, and it creates a duty of good faith.[42] This is particularly interesting for IFAs as they, if they are decided to be contracts, will gain these characteristics.

The contract is defined, in civil law, as a concurrence of wills in order to create legal obligations.[43] In order for the contract to be valid, consents must have been exchanged,[44] the parties should have the ability to contract, and the object of the contract should be lawful. It should also have a cause and a fair contractual price.[45]

In common law countries, a similar definition of the contract is given, this is the interest of this characterisation. A contract is two promises: an offer and an acceptance.[46] The offer is an intimation, by words or conduct, of a willingness to enter into a legally binding contract, and which in its terms expressly or impliedly indicates that it is to become binding on the offeror as soon as it has been accepted by an act, forbearance, or return promise on the part of the person to whom it is addressed.[47] The acceptance is the expression by words or conduct, of assent to the terms of the offer in the manner prescribed or indicated by the offeror.[48] The offer and the acceptance must be certain and an intention to create contractual relations must be shown. When all these conditions are fulfilled, the contract binds the parties. It has a compulsory legal value and it produces legal effects between the parties.[49] This very simplistic doctrinal reading of contracts should be nuanced because, as Hugh Collins indicated, implicit dimensions of contract have fundamentally rewritten the doctrinal rule book and especially how common law judges identify contracts. These social–legal re-readings of the doctrinal rule book blur the boundaries between soft law initiatives and contract law. This opens the path to a bigger impact by IFAs.

A contractual obligation is recognised, under common law, under several conditions: first, the IFA should contain a clear enough promise so that an employee can reasonably believe that an offer was made; second, the agreement must be disseminated or announced in such a way that the employees can consider it an offer; third, the employees must have accepted the offer explicitly or implicitly. Their consent can be expressed by the fact that they started or kept working after they discovered the new policy.[50] An analysis of the letter and the spirit of the agreement must be made. An implicit contract can also be discovered if several criteria – such as the duration of employment, the actions and communications of the employer, the practices and policies of the employer, the attention given to the

40 See I Daugareilh, "Le juge, acteur de la responsabilité sociale de l'entreprise: interrogation à partir du contentieux relatifs aux codes de conduite" in Moreau (ed.), *Le juge*, n. 33 above.

41 The distinction relies on a cross-border element which gives the contract its international characteristics.

42 This is not true in all jurisdictions as judges in the UK have been resistant to the idea of good faith. See A Burrows, *A Casebook on Contract* (Portland, Oregon: Hart 2007).

43 It should be kept in mind that this is not the only definition of contracts. See A Benabent, *Droit civil* 11th edn (Paris: Domat Droit privé, Montchréstien 2007), p. 12. The contract is defined as a concurrence of will in order to create obligations or to transfer rights from one person to the other ("Le contrat est défini comme un accord de volonté en vue de créer des obligations ou de transférer des droits patrimoniaux d'une personne à une autre"): see also B Starck, H Roland and L Boyer, *Obligations* vol. 2, 5th edn (Paris: Litec 1995), p. 1.

44 It is based on the autonomy of the will, see Starck et al., n. 43 above, p. 410.

45 "Public order", ibid. n. 43 above, ch. 3.

46 A contract consists of an actionable promise or promises. These promises are called the offer and the acceptance, see J Beatson, *Anson's Law of Contract* (Oxford: OUP 2002), p. 27.

47 Ibid. p. 37.

48 Ibid. p. 37.

49 Contrary to common law, which states that a contract cannot bind a third party, civil law gives a compulsory effect toward third parties when they have agreed it or when they gave a mandate to the contracting parties.

promises of the employer and the practices of the sector – are fulfilled.

Despite the theoretical interest of this construction, there is no example to this day of such an interpretation, but twice already claimants proposed to interpret similar texts (in these cases, a code of conduct) as contracts. In the *Wal-Mart* case, Chinese, Bengali, Indonesian and Nicaraguan workers decided on 13 September 2005 to sue the multinational firm Wal-Mart in the Court of Los Angeles in the United States alleging that it had not respected the obligations created by its code of conduct towards the employees of its sub-contracting firms. The question was raised whether this code could be considered to be a contract.[51] Wal-Mart had obliged all its sub-contractors to sign the code and to display it in the language of the country in all the centres of production. The claimants claimed that in return Wal-Mart had an obligation to ensure that their working conditions corresponded with the code's requirements. In this particular case, the code of conduct was not interpreted as a contract between the firm and its sub-contractors.[52] Such a judgement favours a restrictive interpretation, but it does not clearly exclude this hypothesis.

In a second case, the same code of conduct and the same firm (Wal-Mart) were challenged in a German court. There, the difference of legal order, of applicable law and of state of mind of the judges has led to the recognition of a contract. But it must be said that the conflict was raised in other circumstances: because the multinational firm was ready to dismiss an employee who did not respect the code, thus, in other words, indicating that it was bound by this text, the German judge recognised a contract.[53] This difference might be explained by the fact that, in the first case, sub-contractors submitted a claim whereas, in the German case, it was an employee. The proximity of the link might explain the outcomes of the cases. Depending on the legal framework in which the dispute is analysed, this solution can be true.

This interpretation of a soft law code of conduct as a binding contract is very encouraging as it opens the way to determining the possible impact of IFAs in existing legal orders. It is a way to embed the multinational companies' choices. Other alternatives can also be contemplated.

IFAs as other legal instruments

An IFA can also be characterised as three different legal texts which create legal obligations and must be implemented by a multinational company: a unilateral commitment, a customary rule or a collective agreement (in the labour law meaning).

First, in civil law as in common law, a unilateral commitment or a gentleman's agreement can create actionable obligations. Saying that an IFA could be characterised as a unilateral commitment (a gentleman‘s agreement) is not contradicting the earlier observation according to which IFAs, contrary to codes of conducts, are not unilateral,[54] but rather providing a legal analysis of the potential legal characterisation of an IFA. It can be legally considered interchangeably as a unilateral commitment or as a gentleman's agreement. In this case, a firm would be sanctioned if it committed to respect some standards and then

See, for instance, the French Civil code, Article 1984 and following.

50 *Weber Shandwick Worldwide* v *Reid*, No 05 C 709, 2005 US Dist LEXIS 144482, at 6 (ND III 12 May 2005).

51 It was a "class action complaint for injunctive Relief and Damages". See K-E Kenny, "Code or contract: whether Wal-Mart's code of conduct creates a contractual obligation between Wal-Mart and the employees of its foreign suppliers" (2007) 27 *Northwestern Journal of International Law and Business* 453.

52 US District Court for the Central District of California, *Jane Doe I et al.* v *Wal-Mart Stores Inc.*, Case No CV 05-7307 AG (MANx), 30 March 2007. An appeal could still take place, see www.iradvocates.org/; see S L Cummings, "Critical legal consciousness in action" (2007) 120 *Harvard Law Review* 62; answering O Lobel, "The paradox of extralegal activism: critical legal consciousness and transformative politics" (2007) 120 *Harvard Law Review* 937; C Estlund, "Something old, something new: governing the workplace by contract again" (2007) 28 *Comparative Labor Law and Policy Journal* 351.

violated them. This hypothesis was found in *Kasky* v *Nike*.[55] In this case, a unilateral declaration[56] had been made by the firm and the US judge considered that this bound its author thanks to commercial law and misleading advertising.[57] This concept, used in consumer law, has one inconvenience: it transforms labour law into consumer law. It reverses the classical tensions: the claimant is not anymore the worker, but the consumer. In other words, the workers becomes object (and not any more subject) of the protection. This is a very interesting point as we see that the outcome is not the only issue. In this case, the probability of the success of the claim is reduced by the impossibility for the workers of submitting a claim. They need to find the support of consumers – highlighting the growing role of media – in order to find protection.

Second, the court can also decide that the IFA is a customary rule which creates binding legal effects if the agreement has been applied for a long period of time. This approach was chosen by a Spanish court.[58]

A third solution is to see in the IFA a national collective agreement (in the labour law meaning) or a clause of this agreement. This implies that the IFA fulfils the criteria of a collective agreement in national law. The agreement then derives its legal value from the law of the state.[59] A classical tool of labour law, it can lead to the condemnation of the multinational firm which does not respect its obligations and it gives the workers the necessary tools to protect their rights. However, this hypothesis is not very reliable because collective agreements have very different legal values across the world. Even within the European Union there is (at the moment)[60] no sufficient uniformity to imagine building common rules.[61] This tool would have been useful as it would allow the employees to ask the representatives to protect their rights, founding the whole protection on the classical functioning of collective bargaining and labour law. It would also create a parallel between the signatories of the agreement and the persons responsible for its application and enforcement as, in both situations, the multinational firm[62] and the international federation[63] would be present.

53 Kenny, "Code or contract", n. 51 above, p. 462.

54 See n. 3 above.

55 *Marc Kasky* v *Nike Inc.*, 02 CDOS 3790, No S087859.

56 The declaration could be found on the firm's website and stated the will of the firm to comply with its code.

57 See A Sobczak, "Legal dimensions of international framework agreements in the field of corporate social responsibility" (2007) 62 *Relations Industrielles/Industrial Relations* 466, p. 477.

58 See M-L Morin, "Le juge français et quelques contentieux significatifs" in Moreau (ed.), *Le juge*, n. 33 above.

59 See A Mengel, "Ramification of appeals judgment on an employer's code of ethics", 30 January 2006, see www.martindale.com/labor-employment-law/article_Wilmer-Cutler-Pickering-Hale-Dorr LLP_215328.htm on a decision of 14 November 2005, by the Court of Appeal of Work of Dusseldorf. This judgment largely confirms the local court's decision and limits the ability of an employer to implement an ethics code without first consulting with the works council – a process known as "co-determination" in Germany. Under German law, all general rules governing the conduct of employees in the workplace (*Ordnungsverhalten*) must be agreed upon by the works council. By contrast, employers are generally free to impose rules about work performance (*Arbeitsverhalten*) without prior consent by the works council. See www.wilmerhale.com/publications/whPubsDetail.aspx?publication=3053 (last accessed 1 July 2011).

60 See an initiative of the European Commission which gave rise to the Edouardo Ales report on transnational collective agreements: S Laulom, "Passé, présent et futur de la négociation collective transnationale" (2007) 5 *Droit Social* 623.

61 See Article 151 and following of the Treaty on the Functioning of the European Union.

62 Management at international and national levels. The chief executive officer often signs the agreement.

63 On the employees' side, the signature can be given by international trade unions, the European works council (which sometimes raises a question about its legitimacy when non-European countries are involved) and

If theoretical propositions to fit IFAs into the international and national legal orders are numerous, the actual tackling of this issue by courts is relatively rare. But, even so, multinational firms prefer to prepare for all risks.

This concern of multinational companies for the legal consequences of IFAs shows a first step towards embedding their behaviours within social relations, here represented by international federations and non-economic organisations. But this embeddedness also raises challenges.

The challenge: IFAs between non-economic actors' participation and control of transnational companies

The main advantage of IFAs is that they are a step towards embedding the transnational companies' behaviours within a social system. In other words the market or economy is embedded in social relations. A question remains: does the firm not have too much say in the IFAs' adjudication and content? In Polanyi's proposal, the embedding of economic relationships is into the wider "public" interest of *society as a whole*. It is unclear whether privately negotiated soft law frameworks reflect the interests of society at large and whether the companies' management can/should play this role. On the other hand, models need to align with reality. And it makes sense that it is the dominant market players, or the most powerful actors, who should be granted a major role in the protection of non-economic interests. To determine whether this compromise is acceptable, I will focus on the IFAs' adjudication, content and implementation mechanisms.

What makes it difficult to assess IFAs' relevance is that they are built on a paradox: whereas one could expect to find minimal participation of the firm in the IFA, we find a paradoxical evolution towards their increasing responsibility. The paradox is that firms try to extract their agreements from national justice by granting rights and procedures, but the unavoidable risk of litigation pushes them to limit these rights. This paradox is triple: i) concerning the choice of adjudication or dispute conflict resolution mechanism, firms foresee the risk of adjudication, thus they make a conscious choice, but try to limit its impact by choosing the least activist judges; ii) concerning the choice of content, firms protect a growing number of rights but in a limited field of application; and, finally, iii) concerning the choice of implementation mechanism, agreements contain procedural guarantees, but their implementation can be imprecise.

The choice of adjudication

Although it is for the defendant to choose to which judge to go to and in our case for the employees to decide whether or not to go to a judge, the stipulation of a mediator or adjudicator allows the firm to anticipate more easily the consequences of hypothetical litigation. The legal culture of the firm has an impact on this choice. One should distinguish between formal adjudication through a court of law and informal alternative dispute resolution mechanisms. Often, the IFA contains a clause conferring jurisdiction or an arbitration clause. Exceptionally, they create an original internal dispute settlement mechanism. One should understand that the goal of these IFAs is to avoid any litigation.[64] In a first phase, the agreements establish internal regulations, but they also foresee the conflict. This is why arbitration has a wide role.[65] Four alternative solutions should be considered.

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national trade unions (which raises a question of coordination and representation in the different countries). See working document, European Commission, "Mapping of transnational texts negotiated at corporate level", EMPL F2 EP/bp 2008 (D) 14511, Brussels, 2 July 2008.

First, a clause conferring jurisdiction is a provision which gives jurisdiction to the court specifically referred to in the agreement.[66] Most agreements which have such a clause usually refer to national law.[67] The referral can be implicit or explicit. For instance, it could be attached to a European works council agreement. The applicable laws are thus to be found in this agreement. The main advantage of the referrals is the participation of an independent and autonomous judge. The firms are nonetheless limited by national justice and its delays.

Second, in order to avoid such disagreements, firms can also call arbitrators. Instead of clauses conferring jurisdiction on courts, arbitration clauses aim at removing litigation from state courts to put it in front of an arbitral tribunal. The parties can derogate from the rules of international jurisdiction. The clause is interpreted independently from the international contract in which it is drafted. It is per se applicable.[68] The clause can also confer jurisdiction to non- or para-jurisdictional tribunals.[69]

Third, the newest solution, and directly linked to IFAs, is the internalisation of conflicts. This technique, sometimes used in national law,[70] is particularly interesting in transnational situations. To this day, five scenarios of internalisation by multinational firms have been counted. They aim is to avoid a trial by finding a solution to the complaint within the firm. In all cases, this procedure is about giving a right to any employee to inform the firm of any behaviour violating the agreement.[71] When a dispute is identified, it will be taken into account by designated members within the firm. The representatives of the European works council can be in charge of it, in collaboration with the management.[72] It can also be a "joint global committee". This hypothesis is usually preferred when international trade unions or European federations are signatories. They are then in charge of the settlement of the litigation in collaboration with the management.[73]

A fourth solution is to call a panel of independent experts. Ad hoc organs usually include, again, trade unions and management.[74] NGOs can also be asked to participate. The bilateral dialogue becomes trilateral and civil. Some authors talk about a trialogue.[75] A similar and last option is the creation of a joint committee.[76] In the best cases, one can imagine the participation of an international organisation. For instance, the International Labour Organisation (ILO) could name a member in charge of settling conflicts. Its institutional dimension would give it legitimacy. But this last hypothesis has never been set up.

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64 See R-C Drouin, "Procédures de règlement interne des différends de droit du travail dans l'entreprise multinationale", in Moreau (ed.), *Le juge*, n. 33 above.

65 See E Loquin, "L'arbitrage", n. 37 above.

66 With the exception of "imperative competences" or "compétences impératives", see Y Loussouam, P Bourel and P De Vareillers-Sommieres, *Droit international privé* 8th edn (Paris: Précis, Dalloz 2004), pp. 611–13.

67 For instance, the agreement signed by Arcelor explicitly refers to Luxemburg law whereas the Suez and Total agreements refer to French law.

68 Loussouam et al., *Droit international privé*, n. 66 above, pp. 611, 614.

69 Reports and complaints to the ILO and the Social Charter of the Council of Europe will not be considered here: see Daugareilh, "Le juge", n. 40 above.

70 For instance in the UK, S Deakin, "The role of collective agreements and social dialogue in large construction projects including Terminal 5, Heathrow Airport", Industrial Law Society evening meeting, 26 November 2009, London.

71 For instance, Renault.

72 For instance, EADS, Generali, Suez in 2007 and Total in 2004.

73 The Schneider Electric agreement states that "the EMF and the General Management shall seek an amicable solution for these disagreements within a reasonable period of time and in a spirit of cooperation".

74 For instance, Ford 2000, Danone 2001.

In all cases, the advantage of these procedures is that they involve directly the different social partners. The IFA rules and procedures are "owned" by all of the partners. The management of the enterprise avoids national or international justice. At the same time, the employee or the sub-contractor sees his/her complaint taken into account. Nonetheless, these mechanisms create a risk of instituting a parallel justice. If the presence of trade unions should ensure a better protection of workers, one can still fear that these actors have less weight in negotiation than the management. This protection is even less certain if one considers that firms try to avoid the attention of the national courts. The solutions proposed are arrived at through negotiations and compromises.[77] Although a positive aspect is that they allow for flexibility and the discovering of original and case-by-case solutions, it is also negative in that this flexibility might lead to less solid protection. The choice of the judge must be strengthened by the choice of wording of the agreement.

The choice of content

Four fundamental rights – the prohibition of forced labour, child labour and discrimination and the recognition of the freedom of association – are usually recognised in IFAs. Like many codes of conduct,[78] IFAs often mention the ILO, sometimes its 1998 declaration.[79] Professor Wilke recently counted fundamental rights in these agreements. He concluded that the right not to be discriminated against occurs in 90 per cent of the agreements, the freedom of association appears in 95 per cent of them, and the prohibition of child labour and the prohibition of forced labour appear in 90 per cent of them.[80] Beyond these standards, the rights vary depending on the material needs of the parties. Some clauses are about the living conditions of workers and of their families. Other agreements are about environmental protection. Others are about the health and security of employees and wages. Then the questions of working time, harassment and training are raised.[81] Finally, an emerging subject is that of information and consultation of workers[82] and restructuring processes.[83]

The scope of application of these agreements is nonetheless limited. It is limited by the choice of the wording and by the circle of beneficiaries. Often, the agreements will state that rights will be protected "as far as possible". This flexibility in the agreement is a way of releasing the firm from its obligations. Also, the rights are very rarely defined,[84] which gives a broader margin of interpretation to the judge trying to discover the meaning of the obligation, but also allows the firm to choose the most restrictive meaning. Firms often produce guidelines which aim at explaining and restricting the effect of the IFAs. Most IFAs do not raise the protection given by national labour law, but create a responsibility of the firm as to the respect of these norms. Thus, the protection is a private regulation, without

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75 I De Jesus Butler, "Non-governmental organisations' participation in the EU law-making process, the example of social non-governemental organisations in the Commission, Parliament and Council" (2008) 14 *European Law Journal* 558.

76 In French, *un comité paritaire*.

77 See Drouin, "Procédures de règlement", n. 64 above.

78 Organisation for Economic Co-Operation and Development, see www.oecd.org/document/12/0,3343,en_2649_34135_35532108_1_1_1_1,00.html (last accessed 1 July 2011).

79 P Wilke and K Schütze, "Background paper on international framework agreements for a meeting of the restructuring forum devoted to transnational agreements at company level", Hamburg, 2 June 2008, p. 8. Out of 59 IFAs, a reference to the ILO appears in 73% of the cases. A reference to the ILO conventions appears in 58% of the cases. A reference to the UN Declaration appears in 27% of the cases. Global Compact is mentioned in 19% of the cases.

80 Ibid.

81 Drouin, "Procédures de règlement", n. 64 above, p. 256.

82 See the Directive 2009/38/EC of the European Parliament and of the Council of 6 May 2009 on the

any intervention of the state, but based on national labour law and implemented by the existing labour institutions.[85]

Another limit is that the scope of application of the agreement is often limited to an ill-defined group. The group, in its functional or economic meaning, is often legally divided. Thus, the protection of some dependent employees is sometimes non-existent.[86] To this day, only 73 per cent of sub-contractors enjoy the protection of an IFA.[87] A definition of the term "sub-contractor" could help avoid the gaps of this protection. A solution could be to impose the respect of the IFA as a condition of the pursuance of the contract. But the reality of working conditions does not always make it possible. Thus, techniques of training and learning are often preferred. In the face of these uncertainties, procedural guarantees reinforce the implementation of the agreement to a certain extent.

The choice of implementation mechanisms

Contrary to codes of conduct, IFAs provide for detailed provisions about the implementation of the agreements. Often, a procedure of monitoring is proposed: the implementation is not limited to signs at the place of work, it gives a real role to national and local trade unions. A new process of dissemination of the rules through trade unions takes place.[88]

An annual assessment is undertaken to ensure the good implementation of the agreement. A procedural logic based on representation in joint committees appears.[89] The provisions can be very precise and innovative. They are articulated with the labour law of the country in which the agreement is applied and the joint committees are in charge of this process.

However, when the power of control of these committees is uncertain, the agreement might be deprived of any real implementation. In order to avoid this lack of implementation, the agreement should be directly applicable in the country or implemented by the trade unions of this country.[90] Then, a procedure would ensure its enforceability. Several techniques are available: first, if the agreement contains vague provisions about procedure, the question of its binding or voluntary effect can be raised.[91] Second, it can be stated that only the local management will be in charge of its implementation.[92] Third, the implementation can be placed in the hands of the local management and the employees' representatives without any other explanation.[93] Other agreements are implemented by collective bargaining.[94] Finally, many agreements provide that they should be implemented in all branches of the firm.[95] In all cases, decentralisation of decision-making is the aim. This is double-edged: it allows for a greater adaptation of the agreement to the local situation, but this flexibility can also be its weak spot. In this way, a nuanced image emerges.

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establishment of a European Works Council or a procedure in Community-scale undertakings and Community-scale groups of undertakings for the purposes of informing and consulting employees.

83 Wilke and Schütze, "Background paper", n. 79 above, p. 7.

84 It could be argued that a definition given in an international text might suffice, but it is not always true.

85 Drouin, "Procédures de règlement", n. 64 above, p. 256.

86 Sobczak, "Legal dimensions", n. 57 above, p. 473.

87 Wilke and Schütze, "Background paper", n. 79 above.

88 It could be noted that sometimes the implementation mechanism and the conflict resolution mechanism will be the same – like the joint committees, for example.

89 For instance, Arcelor, *accord santé*, M-A Moreau, "Négociation collective transnationale", n. 28 above.

90 For instance, Total Platform agreement of 2004. See Schmidt, *Restructuring*, n. 11 above.

91 For instance, the Rhodia agreement and the Suez social charter do not contain any provision about procedures.

The implementation of the procedures, whether ensured by the firm itself or afterwards by courts, remains variable.[96]

IFAs have detailed implementation procedures. They give unions a real role (global, national and local). But guarantees are weakened when when there is uncertainty about who controls the committees. Procedures should ensure the enforceability of the IFA. But decentralisation of decision-making is double-edged: it is more adapted to local conditions but can possibly be a weakness because of power imbalances between management and local unions.

It appears in the end that, contrary to what one might expect, the company plays a major role in enforcement. In order to remove the risk of litigation, companies grant rights and procedures. But the risk this introduces then leads them to impose restrictions. This creates a twin paradox: first, that there are a growing number of rights but their application is restricted; and, secondly, that agreements contain procedural guarantees, but implementation is undermined by a lack of precision.

Conclusion: towards a Polanyian model

The use of IFAs, as well as a rising demand for a CSR framework at the European level,[97] shows the need for firms to evolve a transparent and comprehensible legal framework. It encourages some optimism as to the emergence of transnational regulation. But the use of the IFA is also paradoxical. From the point of view of the firm, risk is unavoidable. Because of this, firms systematically try to make the risk visible in order to limit it. From the point of view of the worker, the ability of firms to establish their plants in particular countries according to the occurrence of risk prevents a majority of workers from efficiently protecting their rights. Where there is division over the approach to be followed by the trade union community, some international federations have concluded that a strategy of cooperation and "constructive engagement" will yield better results than confrontation. At the same time, there is no doubt that, without the threat of confrontation, firms would be less likely to engage in the process. In this sense, IFAs are an interesting way to embed economy into social relations.

In conclusion, not only was Polanyi's work of interest because it raises the idea of embedding the economy into social relations, but also because it pushes towards evolutions. Somehow, there is a certain inevitability about Polanyi's thesis which will result in i) a recognition of the centrality of contracts and ii) further steps to embed the company's social choices in the regulatory framework.

Embedding the company's social choices in the regulatory framework can take several forms and this opens the way to further research. Several theoretical ways to do this could be explored. One is the reinforcement of the role of international organisations. Second, an international court or arbitrator could give more visibility to litigation in this field[98] and calls for CSR frameworks and the increasing use of paralegal jurisdictions[99] indicate that this is a consideration. Third, the development of a soft law framework and the

92 For instance, the Arcelor, EADS 2005, Generali agreements.

93 For instance, Renault.

94 For instance, PSA and EDF.

95 For instance, Generali, Suez 1998, Danone 1992 and Lukoil.

96 L R Price, "International framework agreements: a collaborative paradigm for labor relations" in De Schutter,

recognition of the international legal personality of multinational enterprises[100] could also go hand-in-hand with the research as these developments will ultimately embed social values and relationships within the economic system. Nonetheless, given the current stiff opposition by governments and multinational companies to extending the regulatory framework, this could all turn out to be a case of misplaced optimism. But that is the object of another study.

Transnational Corporations, n. 22 above, pp.241–60.

97 A Lebescond, "Responsabilité sociétale: de l'art et de la manière de moraliser les enterprises" (2009) *Lexbase Hebdo, Edition Sociale* 335.

98 An improved role for the ILO has also been imagined, see Drouin, "Procédures de règlement", n. 64 above.

99 See Daugareilh, "Le juge", n. 40 above.

100 The recognition of the international legal personality of multinational enterprises can also be considered as a

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UNCITRAL, security rights and the globalisation of the US Article 9

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Abstract

This article provides a critical analysis of the UN Commission on International Trade Law (UNCITRAL) proposals for developing – through its Legislative Guide (the Guide) – a "liberal" global secured credit law regime that opens up the range of assets that can be used for securing loans and that limits formal procedures required for taking security interests. The article argues that UNCITRAL's reliance on Article 9 of the US Uniform Commercial Code is problematic for various reasons. First, it neglects reference to indigenous secured credit law norms that also reflect national social policy choices in a range of countries. Second, it questions the idea that global "liberal" secured credit law of the kind articulated in the Guide helps to achieve "economic efficiency", since it relies on a narrow conception of private property. Moreover, by relying on existing property rights distributions, a liberal secured credit law can further entrench existing socio-economic disparities in a society. The article therefore casts doubt on the idea that UNCITRAL's Legislative Guide is an example of a successful "harmonized, modernized and marketized" secured credit law, and instead – in Polanyian terms – draws attention to its potential to further disembed markets in credit out of social relationships.

Introduction

UNCITRAL has recently produced a Legislative Guide on secured transactions, or secured credit law as it is variously called.[1] The Guide follows the broad contours of Article 9 of the United States Uniform Commercial Code though it is not an exact copy. It aims to harmonise and modernise the law of secured credit across the globe.[2] In

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1 The Guide went through the UN General Assembly approval process in December 2008 – UN GA Res. 63/121 though the editorial revisions were only completed in 2009 and an intellectual property annex was "pre-released" on 15 July 2010. For the content of the Legislative Guide, see the UNCITRAL website – www.uncitral.org/ – and for background see B Foex, L Thevenoz, S Bazinas (eds), *Reforming Secured Transactions: The UNCITRAL Legislative Guide as an inspiration* (Geneva: Schulthess 2007); H Buxbaum, "Unification of the law governing secured transactions: progress and prospects for reform" (2003) 8 *Uniform Law Review* 321.

2 UNCITRAL describes its mission as follows: "The core legal body of the United Nations system in the field of international trade law. A legal body with universal membership specializing in commercial law reform worldwide for over 40 years. UNCITRAL's business is the modernization and harmonization of rules on international business.": www.uncitral.org/ (last accessed 3 November 2011). This may represent mission creep from the UN resolution establishing UNCITRAL – Res. 2205(XXI) – which spoke of "progressive

UNCITRAL's view, the Legislative Guide will aid the growth of individual businesses and also economic prosperity in general. Harmonisation and "modernisation" are assumed to equal "liberal" security regimes and the facilitation of secured credit. In this article, the modernisation-equals-liberalisation agenda is subjected to greater scrutiny and in doing so some key Polanyian themes are picked up, including the notion that markets have to be embedded in institutions to function effectively.[3]

UNCITRAL is not the only international organisation working on the design of an "efficient" legal regime for secured transactions. For example, the European Bank for Reconstruction and Development (EBRD) in 1994[4] and the Organisation of American States (OAS) in 2002[5] have both produced Model Laws and done follow-up work of greater or lesser intensity. The World Bank has formulated principles for Effective Insolvency and Creditors Rights Systems (revised in 2005)[6] and has also produced a series of reports designed to evaluate the ease of doing business across the globe. As part of the evaluation process, the *Doing Business* reports have made use of a 10-point template measuring the degree to which secured credit and bankruptcy laws in particular jurisdictions "protect the rights of borrowers and lenders" and thus facilitate secured lending.[7]

So UNCITRAL is not alone in its efforts but UNCITRAL's work gains added credibility and legitimacy from its perceived representatives and its institutional aura as a United Nations organ.[8] UNCITRAL was established as a UN offshoot in 1966 on the basis that a UN-related law reform body would provide more inclusive representation of the world's legal and economic systems and, accordingly, better coordination among other international actors.[9] There has been considerable controversy recently over UNCITRAL's working methods and the extent to which its outputs reflect a "neoliberal" (American) agenda.[10]

[n. 2 cont.] harmonization and unification". The focus now on "modernization and harmonization" sees UNCITRAL in a more proactive light actively striving for the reform of global commercial law: see S Block-Lieb and T Halliday, "Harmonization and modernization in UNCITRAL's Legislative Guide on insolvency law" (2007) 42 *Texas International Law Journal* 475.

3 On Polanyian "embeddedness", see G Knippner et al., "Polanyi Symposium: a conversation on embeddedness" (2004) 2 *Socio-Economic Review* 109.

4 See its website at www.ebrd.com/pages/homepage.shtml and, for some of the later work done by its "secured transactions" team, see EBRD, *Publicity of Security Rights: Guiding principles for the development of a charges registry* (London: EBRD 2004) and *Publicity of Security Rights: Setting standards* (London: EBRD 2005), and see, generally, J-H Rover, *Secured Lending in Eastern Europe: Comparative law of secured transactions and the EBRD Model Law* (Oxford: OUP 2007).

5 See its website at www.oas.org/en/default.asp and, for later work, see OAS, *Adoption of the Model Registry Regulations under the Model Inter-American Law on Secured Transactions*, OEA/SerK/XXI.7 CIDIP-VII/RES.1/09 rev. 2, 16 October 2009. See also the work of the Asian Development Bank at www.adb.org which has produced a *Guide to Movables Registries* (2002).

6 See www.worldbank.org/ and the principles are also available as Annex 5 to World Bank Group, *Secured Transactions Systems and Collateral Registries* (Washington, DC: IFC 2010).

7 The template is available as Annex 3 to World Bank Group, *Secured Transactions Systems*, n. 6 above.

8 See T Halliday, "Legitimacy, technology and leverage: the building blocks of insolvency architecture in the decades past and decades ahead" (2007) 32 *Brooklyn Journal of International Law* 1081.

9 Schmitthoff Report (UN Doc. A/6396), reprinted in (1966) 1 *UNCITRAL Yearbook* 2 and available online at www.uncitral.org/ and associated links.

10 For a discussion of UNCITRAL working methods referring to earlier controversies, see "UNCITRAL rules of procedure and methods of work: note by the Secretariat" A/CN9/676 (2009) and A/CN9/697 (2010). Note too UN General Assembly Official Records 65th session, Supplement No 17 (A/65/17) Annex 111. The controversies covered the role and status of non-state actors, primarily US-based organisations, in UNCITRAL deliberations. On the dangers of "interest group capture", see R Cranston, "Theorizing transnational commercial law" (2007) 42 *Texas International Law Journal* 597, at fnn. 49–55. For analogies with the American Article 9 drafting process, see A Schwartz and R Scott, "The political economy of private

This article does not engage directly with this controversy but it does consider the closeness in approach between the UNCITRAL Secured Transactions Guide and the American Article 9 and the extent to which this proximity may inhibit the prospects of the UNCITRAL Guide achieving widespread international acceptance. A key argument in the article is that the avowed aim of the Guide to reform the law worldwide along neoliberal American lines is fraught with difficulty not least by overlooking the regulatory and cultural plurality of the countries on which it seeks to have an impact.

The article brings out some of the themes that emerge from Karl Polanyi's *The Great Transformation* and were highlighted by Joseph Stiglitz in his foreword to the 2001 edition.[11] These include the myth of completely self-correcting markets; the "embeddedness" of markets in institutions; the interplay between voluntariness and coercion in the functioning of markets; the importance of historical and cultural context and sensitivities; and, finally, the distributional consequences of deference to market-based decision-making.

The article begins by asking: what is the effect of recognising security rights? In short, what do security rights do for you? In a Polanyian perspective, security rights could be considered as "embedding" the market by reducing the possibility of market failure and avoiding the attendant consequences of default. But, on another view, security rights seek to ensure the effective functioning of markets and thus further entrench the self-regulation paradigm. The second part of the article asks why the law of secured credit should be harmonised, particularly in the "liberal" American-nuanced way that the UNCITRAL Guide seeks to do? The third part considers why "liberal" secured credit regimes are considered to be beneficial. The fourth part addresses in greater detail critical perspectives on the international harmonisation and modernisation agenda. The final part concludes and summarises the discussion counselling against the "silver bullet" of secured transactions reform, especially in the American-oriented manner that the Guide seeks to effect.

Security rights

While there is probably no universally recognised definition of security rights, it is generally taken as meaning a right over property to ensure the payment of money or the performance of some other obligation. The property over which security is taken is referred to as "secured" or "collateralised". The security taker has a superior claim to payment of the debt out of the secured property than the generality of the debtor's creditors and will generally have access to speedier enforcement mechanisms. In the event that the secured debt is not repaid, the security taker will normally have a right of sale over the secured assets, whether unilaterally or by seeking the intervention of an administrative mechanism or court. The secured creditor has therefore greater leverage than unsecured creditors. The debtor may also be more likely to pay a secured debt – failure to pay can result in the loss of a crucial asset for the debtor's business – thereby giving the secured creditor a stronger hand in debt-restructuring negotiations. Security also opens up the possibility of the creditor availing of self-help remedies, although self-help is a controversial concept in many jurisdictions, not least because it is seen to be possibly inconsistent with constitutional guarantees safeguarding peaceful possession of property

[n. 10 cont.] legislatures" (1995) 143 *University of Pennsylvania Law Review* 595; E Janger "Predicting when the uniform law process will fail: Article 9, capture, and the race to the bottom" (1998) 83 *Iowa Law Review* 569. More generally, see G McCormack, *Secured Credit and the Harmonisation of Law* (Cheltenham: Edward Elgar 2011).

11 K Polanyi, *The Great Transformation* (Boston: Beacon Press 2001).

Economists suggest that security addresses the problems of adverse selection, moral hazard and uninsurable risk in lending decisions.[12] Security aligns the incentives of creditors and borrowers and adds a credible commitment to the relationship. Security performs a disciplinary function and is a cornerstone of the theory of control rights and incomplete contracts that has been developed by Oliver Hart and others.[13]

Adverse selection refers to the fact that some borrowers may turn out to be unreliable or untrustworthy. A lender cannot simply raise interest rates to screen out these borrowers because honest borrowers with sound projects will drop out of the picture as well. The potential pay-off from the project may not be enough to meet the borrowing costs. Where security is taken, however, adverse selection problems are addressed more powerfully. The lender can back up its assessment of the character of the borrower and the soundness of the business plan with information on the value of the collateral. As well as the revenues generated from the project, the lender can look to the collateral for repayment. Moral hazard refers to the possibility that a borrower may abscond with the loan. The larger the loan, the greater the moral hazard but, if the borrower provides security, the lower are the lender's costs in monitoring moral hazard. The borrower has given the lender a hostage against flight risk in the shape of security. The insurance risk arises from the fact that the borrower may not be able to repay due to certain events that are not easily insurable, or insurable at all. Uninsurable risk may be reduced in unsecured lending through making smallish loans to a large number of borrowers, i.e. spreading. Security allows more concentrated lending and also reduces uninsurable risk since the security serves as an alternative repayment mechanism.[14]

By way of summary, security rights provide the creditor with property rights which strengthen the creditor's contractual claims against the debtor in various ways. Firstly, the security taker should have priority over other creditors in the event of the debtor becoming insolvent. Secondly, the security-taker should have a measure of control over the secured assets or at least share control with the debtor, thereby strengthening the debtor's hands in restructuring negotiations. Thirdly, the security-taker should have easier enforcement mechanisms available to it than the generality of creditors, including a power of sale over the secured assets. Fourthly, the easier debt enforcement opportunities may include self-help measures such as sale of the secured assets through unilateral action by the creditor, without having to seek the permission of a court or administrative agency. But not all these features are present in every jurisdiction.

Not all jurisdictions, for instance, recognise the full priority of secured claims. A proportion of secured asset realisations may be carved out, or set aside, for the benefit of unsecured creditors. There may also be restrictions on the enforcement of security rights and, in particular, limitations or, indeed, wholesale prohibition, on self-help enforcement. The overall effect, however, of recognising security rights is to improve a creditor's hand in dealing with adverse selection, moral hazard and uninsurable risk issues.

12 See, generally, J Stiglitz and A Weiss, "Credit rationing in markets with imperfect information" (1981) 71 *American Economic Review* 393. See also G Akerlof "The market for 'lemons': qualitative uncertainty and the market mechanism" (1970) 84 *Quarterly Journal of Economics* 488.

13 See, generally, O Hart and J Moore "Default and renegotiation: a dynamic model of debt" (1998) 113 *Quarterly Journal of Economics* 1.

14 See H Fleisig, "The economics of collateral and collateral reform" in F Dahan and J Simpson (eds), *Secured Transactions Reform and Access to Credit* (Cheltenham, Edward Elgar 2008), p. 81.

Why harmonise the law of secured credit?

In short, UNCITRAL has advocated harmonisation of the law of secured credit to make the law more liberal and facilitative of security and this, in turn, is seen as producing more economic growth. UNCITRAL has suggested the removal of restrictions on the taking of security and increasing the range of assets that can be used as security. It has also suggested the introduction of mechanisms for the registration of security rights thereby enhancing the available information about such rights. In the UNCITRAL view:[15]

> The key to the effectiveness of secured credit is that it allows borrowers to use the value inherent in their assets as a means of reducing credit risk for the creditor. Risk is mitigated because loans secured by the property of a borrower give lenders recourse to the property in the event of non-payment. Studies have shown that as the risk of non-payment is reduced, the availability of credit increases and the cost of credit falls. Studies have also shown that in States where lenders perceive the risks associated with transactions to be high, the cost of credit increases as lenders require increased compensation to evaluate and assume the increased risk.

There is a suggestion that too many countries have too many restrictions on the taking of security and that countries with "inadequate" secured transactions regimes have suffered significant losses in gross domestic product (GDP) in consequence. These studies suggest that gaps or weaknesses in collateral-based credit systems hinder financial and economic development.[16] Simply stated, banks and other financial institutions will not engage in large-scale lending activities if their position as secured creditors in the liquidation of their borrowers is not sufficiently certain, or that sufficient means for the enforcement of security are not available. More controversially, it has also been suggested that businesses in less developed financial systems and civil law countries substitute less efficient forms of external finance, trade credit and other sources of funds for bank loans and equity.[17]

There are also sector-specific studies that purport to demonstrate the value of particular types of collateral and the economic impact of a stable legal environment for security creation and enforcement. One such study concerns the 2001 Cape Town Convention on International Interests in Mobile Equipment and the Protocol on Matters Specific to Aircraft Equipment.[18] It was estimated that savings to the aircraft industry from the creation of a sound international legal framework governing aircraft financing amounted to $4bn a year in borrowing costs. Moreover, since 2003 the Export–Import Bank of the United States "has offered a one-third reduction of its exposure fee on . . . financings of

15 "Draft legislative guide on secured transactions: report of the Secretary General", A/CN 9/WG VI/WP 2 (2002) Addendum 1 at para. 4 and see also the report from the World Bank Group, *Secured Transactions Systems*, n. 6 above, pp. 6–13.

16 See, generally, H Fleisig, "Economic functions of security in a market economy" in J Norton and M Andenas (eds), *Emerging Financial Markets and Secured Transactions* (London: Kluwer 1998), p. 15. See also D Arner, C Booth, P Lejot and B Hsu, "Property rights, collateral, creditor rights and insolvency in East Asia" (2007) 42 *Texas International Law Journal* 515.

17 See the series of studies carried out by the so-called "law matters" or "legal origins" thesis: R La Porta, F Lopez de Silanes, A Shleifer and R Vishny. Their work includes "Legal determinants of external finance" (1997) 52 *Journal of Finance* 1131 and "Law and finance" (1998) 106 *Journal of Political Economy* 1113.

18 The Cape Town Treaty consists of a main convention that sets out the general governing rules, and a series of supplemental protocols that set out specific rules for particular types of collateral (e.g. aircraft). See, generally, R Goode "Transcending the boundaries of earth and space: the Preliminary Draft UNIDROIT Convention on International Interests in Mobile Equipment" (1998) 3 *Uniform Law Review* 52; I Davies, "The new *lex mercatoria*: International Interests in Mobile Equipment" (2003) 52 *ICLQ* 151.

new US-manufactured large commercial aircraft for buyers in countries that ratify . . . and implement the Cape Town [Convention]".[19]

There is a consensus among international financial institutions that a "liberal" secured credit regime is a general social and economic good. Two examples serve to highlight that consensus. The first example comes from the late-1990s upheavals in the "tiger" economies of East Asia. In the aftermath, an influential G22 report highlighted the importance of debtor/creditor regimes and also set out the features that, in its view, should be contained in such regimes:[20]

> The law should permit . . . all economically important assets to serve as collateral for a loan: and security interests in tangible property . . . and in intangible property . . . to be created. All economically important agents should be able to act as lenders and as borrowers in secured transactions and all economically important secured transactions should be permitted. The creation of security interests should be inexpensive relative to the amounts lent.

Secondly, when the former socialist economies in Central and Eastern Europe were undergoing the transition to a more free-market-oriented system, the task of reforming credit laws assumed a high priority on the legislative agenda.[21] Organisations like the EBRD considered that such laws impacted in a crucial way on the pace of private sector investment activity and were essential in fostering market-based decision-making.[22] Consequently, EBRD produced a Model Law on Secured Transactions to guide states in their reform efforts.[23]

But the UNCITRAL Guide goes much further than the EBRD Model Law. In the context of secured credit law, it is typical to draw a distinction between common law and civil law jurisdictions.[24] Common law jurisdictions – generally sympathetic to the concepts of party autonomy and self-help – have a liberal attitude towards security, allowing security interests to be taken with a minimum of formality over both present and future assets to secure existing and future indebtedness. "[T]hey allow universal security rather than require specific security."[25] By contrast, civil law jurisdictions have been more cautious in their approach to non-possessory security and typically have imposed restrictions on the taking of security.

The EBRD Model Law attempts to accommodate features from both civil law and common law traditions whereas the UNCITRAL guide is firmly in the common law mould.

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19 News Release, "Cape Town Treaty on Cross-Border Financing of Aircraft, Helicopters and Aircraft Engines takes effect today (March 1)", 28 February 2006, www.exim.gov/pressrelease/ (last accessed 3 November 2011); and see, generally, R Goode, H Kronke, and E McKendrick, *Transnational Commercial Law* (Oxford: OUP 2007), p. 441: "the international regime established by the Convention could reduce borrowing costs by several US $billion a year".

20 *Report of the Working Group on International Financial Crises* (Washington, DC: IMF 1988), p. 47, available on the IMF website www.imf.org/external/index.htm.

21 See, generally, Rover, *Secured Lending*, n. 4 above.

22 See also D Berkowitz, K Pistor and J-F Richard, "The transplant effect" (2003) 51 *AJCL* 163, p. 164: "newly designed model laws for secured transactions marketed the value of Western law to their counterparts in the East, backing their campaign to transplant their home legal system with financial aid promises and/or the prospect of joining the European Union."

23 EBRD, *Model Law on Secured Transactions* (London: EBRD 1994); on which see Rover, *Secured Lending*, n. 4 above.

24 See S van Erp, "Civil and common property law: caveat comparator – the value of legal historical–comparative analysis" (2003) 11 *European Review of Private Law* 394, and, more generally, R Cuming, "The internationalization of secured financing law: the spreading influence of the concepts of UCC, Article 9 and its progeny" in R Cranston (ed.), *Making Commercial Law: Essays in honour of Roy Goode* (Oxford: Clarendon Press 1997), p. 499.

25 R Goode, "Security in cross border transactions" (1998) 33 *Texas Journal of International Law* 47, p. 48.

Moreover, it goes far beyond the English common law appropriating the main features of Article 9 of the American Uniform Commercial Code. For instance, the UNCITRAL guide rejects the idea of carving out a proportion of collateral realisations for the benefit of unsecured creditors – an idea that finds recognition in the UK Insolvency Act,[26] but was dismissed in the US.[27] Likewise, the UNCITRAL guide adopts a functional approach towards the creation and registration of security rights effectively recharacterising certain transactions as security rights although they were not ostensibly designed as such. Again, this conforms with the approach evidenced in the US Article 9 but is one that is at variance with the English common law. In addition, in the details of the filing system suggested for security interests, the UNCITRAL Guide maps onto the American rather than the English system.

Filing systems are designed to address information asymmetries in credit markets.[28] Lenders depend on information about borrowers to perform an initial screening function as well as monitoring and controlling the actions of borrowers during the lifetime of the loan. Information-sharing facilities may allow lenders to allocate credit more efficiently and to increase overall lending volumes. Such facilities may also improve the behaviour of borrowers since there is less of an opportunity, or incentive, to over-borrow from several banks simultaneously without any of them knowing. The UNCITRAL Guide, however, follows the Article 9 notice-filing system under which the security agreement itself is not filed but instead a so-called "financing statement" providing limited information. Notice filing is party specific rather than transaction specific. The information filed is an invitation to further inquiry rather than a synopsis of the transaction. The filed notice merely indicates that a person may have a security interest in the collateral concerned but further inquiry by a searcher from the potential creditor and/or debtor will be necessary to ascertain the facts. A degree of scepticism about the merits of notice filing seems appropriate.[29] Divorcing registration from particular individual transactions opens up the possibility that the register may become less reliable as a source of information since a searcher cannot be sure whether a particular entry relates to an actual transaction or to a transaction that was contemplated but never in fact materialised.[30]

Why "liberal" security regimes are considered to be beneficial

In short, liberal security regimes are considered to be beneficial because they are seen to promote economic growth. This is for two general reasons. Firstly, there is the contract/property rights argument which goes along the lines that the secured creditor has bargained for rights of a proprietary nature. The law should respect this contractual bargain and the property rights acquired by the secured creditor in the debtor's assets. Recognition of property rights is good, so the argument goes, for economic growth. Secondly, security is a risk-reduction device and therefore increases the availability and lowers the cost of

26 S. 176A and see also Insolvency Act 1986 (Prescribed Part) Order 2003.

27 S L Harris and C W Mooney, "Measuring the social costs and benefits and identifying the victims of subordinating security interests in bankruptcy" (1997) 82 *Cornell Law Review* 1349.

28 See F Lopez de Silanes, "Turning the key to credit: credit access and credit institutions" in Dahan and Simpson (eds.), *Secured Transactions Reform*, n. 14 above, p. 6.

29 J White, "Reforming Article 9 priorities in light of old ignorance and new filing rules" (1995) 79 *Minnesota Law Review* 529, p. 530; U Drobnig, "Present and future of real and personal security" (2003) *European Review of Private Law* 623, p. 660. According to the Scottish Law Commission, the only civil law jurisdictions to have introduced notice filing are Quebec and Louisiana; see discussion paper, *Registration of Rights in Security by Companies* (Edinburgh: Scottish Law Commission October 2002), para. 1.28.

30 For a far fuller discussion of the technical and other merits of the UNCITRAL Secured Transactions Guide versus other secured transactions model laws and instruments, see G McCormack, "American private law writ large?: The UNCITRAL Secured Transactions Guide" (2011) 60 *ICLQ* 597.

credit. The effect of minimising risk is to encourage lenders to make loans that they would not otherwise make and also to reduce the risk premium that a lender might otherwise input into the interest rate calculations. The overall effect is to facilitate economic activity.

The general value of property rights argument is supported by the new institutional economics school, led by Douglass North, whose proponents argue that financial systems require certain legal and institutional elements to be in place to function effectively.[31] These include the recognition of property rights and the use of property to secure loans. This "property rights including security rights will produce economic growth" argument has been reinforced by the "legal origins" or "law matters" thesis advanced by La Porta, Lopez de Silanes, Shleifer and Vishny.[32] It is also supported by an indirect offspring of La Porta – the *Doing Business* reports commissioned by the World Bank.[33] The thesis was first developed in the area of investor protection but it also encompasses creditor rights and legal institutions more generally. The thesis says that "law matters" in that legal institutions impact on economic growth.[34] But more controversially, the thesis also asserts that countries that adopted the common law perform better than those with a civil law origin. Legal families are evaluated on the basis of their economic performance and, generally, the common law comes out as superior.

The alleged superiority of the common law is founded on two propositions. The first is that judges have greater independence in common law than in civil law systems, so that the government has less influence on market developments. The second is that the common law, being based on caselaw rather than on legislative codes, is more responsive to the changing conditions and requirements of society.

The legal origins literature has, however, been criticised for a US-centric approach.[35] The thesis suggests that US law is the benchmark, the goal of legal convergence, the end of (legal) history. The thesis has also been criticised as the work of a small group of economists whose knowledge of legal differences and cross-cultural legal comparisons displays deficiencies.[36] The civil/common law distinction is fundamental to the thesis with membership of a legal family seen as a cause for past and present economic development. But the way in which legal systems are assigned by proponents of the thesis to one or other legal family is crude. For example, France is assigned to the same legal family as Lithuania but their economies (and their laws) are like apples and oranges in many other ways. All legal systems are mixed to a degree and the civil law/common law divide seems especially irrelevant for the sphere of economic law covered by the legal origins literature. Other

31 North's theories are developed in *Institutions, Institutional Change and Economic Development* (New York: CUP 1990). See also C Goodhart, "Economics and the law: too much one-way traffic?" (1997) 60 *MLR* 1, p. 5 (referring to Mancur Olson).

32 See La Porta et al., "Legal determinants", and "Law and finance", n. 17 above. R La Porta, F Lopez de Silanes and A Shleifer refine the "legal origins" thesis and defend it against criticisms in "The economic consequences of legal origins" (2008) 46 *Journal of Economic Literature* 285.

33 The *Doing Business* reports are available at www.doingbusiness.org/.

34 But see M Roe, "Legal origin and modern stock markets" (2006) 120 *Harvard Law Review* 460 who argues that politics is a more relevant causal factor. In "The economic consequences", n. 32 above, La Porta et al. use "legal origins" as a sort of proxy for politics. They "adopt a broad conception of legal origin as a style of social control of economic life (and maybe of other aspects of life as well) . . . [They] argue that common law stands for the strategy of social control that seeks to support private market outcomes, whereas civil law seeks to replace such outcomes with state-desired allocations."

35 See, generally, R Michaels, "Comparative law by numbers? Legal origins thesis, doing business reports and the silence of traditional comparative law" (2009) 57 *AJCL* 765 and the literature referred to therein. There is also a symposium on the legal origins thesis in the 2009 *Brigham Young University Law Review*.

36 See U Braendle, "Shareholder protection in the USA and Germany: 'law and finance' revisited" (2006) 7 *German Law Journal* 257.

aspects of a society, such as politics, culture or religion, and geographical position are much more likely to influence economic development than membership of a particular legal family.[37]

Despite the criticism, the legal origins literature has heavily influenced the *Doing Business* reports issued by the International Finance Corporation (IFC), a member of the World Bank Group. These reports purport to measure and compare the "ease of doing business" in more than 130 countries worldwide.[38] Indeed, the lead author of the earlier *Doing Business* reports is a frequent co-author with the originators of the legal origins thesis.[39] While the reports purport to assess attractiveness for investors rather than economic performance per se, there are obvious linkages between the two. The reports have tended to show that credit bureaus, stronger creditor rights and simpler civil procedure rules have a significant impact on access to credit.[40] It is argued that strong creditor protection should lead to deeper credit markets and better financing for firms and individuals. The *Doing Business* reports have identified many laws, rules and institutions, in four basic categories, that constitute the basis for private credit: (1) mechanisms for the registration of property; (2) information sharing arrangements or credit bureaus; (3) collateral rules and creditor rights; and (4) contract enforcement. The reports conclude that the wealth of a particular country is an important indicator of the effectiveness of institutions in that country that guarantee access to credit.[41] In the main, richer countries are said to have more expeditious procedures to register ownership of property; a higher presence of private credit bureaus; greater coverage and quality in terms of the information collected by information-sharing institutions; more extensive creditor rights and security rights, as well as better measures of contract enforcement.

The *Doing Business* reports have major resonance with national governments which have often taken conscious steps to improve a country's rankings. This may not be a positive move, however, not least because countries may be more inclined to improve their rankings by "gaming" the system rather than taking the politically more problematic step of addressing problems highlighted in the reports.[42] Otherwise the *Doing Business* reports may be subjected to similar criticism as the legal origins thesis; namely, faulty research, insufficient attention to detail, a common law bias (actual or perceived) and a preference for free-market solutions and deregulation over other values, such as solidarity and justice and the preservation of separate legal cultures.[43]

The deregulatory and free-market agenda was quite explicit in the first *Doing Business* report in 2004 which purported to show that a "heavy" regulatory regime produced the

37 See M Siems, "Legal origins: reconciling law and finance and comparative law" (2007) 52 *McGill Law Journal* 55. See also on legal origins P Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell 2008), ch. 3.

38 See www.doingbusiness.org/ (last accessed 1 November 2011).

39 The reference is to Simeon Djankov, now Finance Minister and Deputy Prime Minister of Bulgaria and for co-authored publications see S Djankov, R La Porta, F Lopez de Silanes and A Shleifer, "The regulation of entry" (2002) 117 *Quarterly Journal of Economics* 1; "Courts" (2003) 118 *Quarterly Journal of Economics* 453 and also with J Botero, "The regulation of labor" (2004) 119 *Quarterly Journal of Economics* 1339.

40 See F Lopez de Silanes, "Turning the key to credit" in Dahan and Simpson (eds), *Secured Transactions Reform*, n. 14 above.

41 Lopez de Silanes, "Turning the key to credit" in Dahan and Simpson (eds), *Secured Transactions Reform*, n. 14 above. p. 20.

42 R Michaels, "Comparative law by numbers? Legal origins thesis, doing business reports and the silence of traditional comparative law" (2009) 57 *AJCL* 765, p. 772; B Arrunada, "Pitfalls to avoid when measuring institutions: is doing business damaging business?" (2007) 35 *Journal of Comparative Economics* 729.

43 See, generally, G Sarfaty, "Why culture matters in international institutions: the marginality of human rights at the World Bank" (2009)103 *American Journal of International Law* 647.

worst results in terms of economic outcomes because it was usually associated with inefficiency within public institutions, long delays in reaching decisions, high costs of administrative formalities, lengthy judicial proceedings, higher unemployment and more corruption, less productivity, and lower investment.[44] The report also said "Common law countries regulate the least. Countries in the French civil law tradition the most. However, heritage is not destiny." The overall conclusion was a stark one that "one size can fit all" in respect of the legal regulation of business.

There have, however, been criticisms of the *Doing Business* reports from the Independent Evaluation Group within the World Bank. In a 2008 critique, the Independent Evaluation Group recommended greater transparency and some modifications to the *Doing Business* methodology.[45] The critique also suggests that the focus on regulatory costs and burdens should only be one dimension of any overall reform of the investment climate in a particular country. Essentially, the *Doing Business* reports use a creditor-centred approach with the highest grading given to countries that emphasise private contractual solutions rather than court-based ones. This approach appears one-dimensional and overly simplistic. It also ignores the recent economic success of countries such as China where many of the desiderata considered necessary by international financial institutions, such as strong property rights, are absent.[46]

In recent times, a popular exponent of the linkage between property rights and economic development has been Hernando De Soto in writings such as *The Mystery of Capital: Why capitalism triumphs in the west and fails everywhere else*.[47] De Soto argues that people in developing countries lack an integrated formal property system and he contrasts this with the US where, in his view, a clear system of property rights was created from early on. De Soto suggests that the absence of such a system makes it impossible for the poor to leverage informal ownership into collateral for the extension of credit. In De Soto's view, the combined effect of bureaucracy and outdated legal systems is to drive economic activities underground in developing countries and to stifle investment activity. But property systems in the wealthy West allow assets, through ownership documentation, to lead an "invisible, parallel life alongside their material existence".[48] In developing countries, comparable means of documentation are lacking thereby creating "dead capital".

Formal property systems are said to produce six effects that facilitate the generation of capital. The first is fixing the economic potential of assets. De Soto uses the analogy of generating electric power from a lake in the mountains, suggesting that the potential value locked up in an asset can be revealed, transformed and energised in the same way.[49] The second effect is the integration of dispersed information into one system. The third is making people accountable – incorporation into a more integrated legal system facilitates

44 See the 2004 *Doing Business* report, p. 83: "Heavier regulation of business activities generally brings bad outcomes, while clearly defined and well-protected property rights enhance prosperity".

45 World Bank Independent Evaluation Group, *Doing Business: An independant evaluation – Taking the measure of the World Bank–IFC Doing Business indicators* (Washington, DC: World Bank 2008).

46 C Paulus, "Global insolvency law and the role of multinational institutions" (2007) 32 *Brooklyn International Law Journal* 755, p. 762. For somewhat varying views on the Chinese example, see World Bank Group, *Secured Transactions Systems*, n. 6 above, pp.67, 104.

47 H De Soto, *The Mystery of Capital* (London: Black Swan 2008). See also G Hardin, "The tragedy of the commons" (1968) 162 *Science* 1243, but for refinement and criticism of Hardin's work see *Governing the Commons: The evolution of institutions for collective action* (New York: CUP 1990) by the winner of the 2009 Nobel Prize for Economics Elinor Ostrom. For a much more nuanced analysis, see R Ellickson, "Property in land" (1992) 102 *Yale Law Journal* 1315 and, in particular, the conclusion at p. 1397.

48 De Soto, *The Mystery of Capital*, n. 47 above, p. 7.

49 Ibid. pp. 47–61.

individual accountability. The fourth effect is to put assets into a more accessible condition so that they can do additional work. Assets become "fungible" and can be fashioned to suit practically any transaction. Fifthly, increased fungibility in turn helps to network people and convert citizens into individually identifiable and accountable business agents. Increased information and integrated law makes risk more manageable not least by facilitating the pooling of assets to secure debts. The final effect is the protection of transactions. To sum up, a documented system of ownership can:

> provide a link to the owner's credit history, an accountable address for the collection of debts and taxes, the basis for creation of reliable public utilities, and a foundation for the creation of securities (like mortgage backed bonds) that can be rediscounted and sold in secondary markets.[50]

De Soto's work has been lavishly praised, with Bill Clinton, for example, calling him the "world's greatest living economist",[51] but the work has also attracted criticism on a number of grounds. Some have questioned the statistical validity of the claims about the size of the informal economy.[52] Others would argue that it is excessively narrow in its approach to economic development – basically a "single bullet" approach. It is suggested that there should be a greater emphasis on culture and the local social context, and how local conditions affect people's perceptions of their opportunities.[53] There are further empirical studies that take issue with the link between property registration mechanisms and the increase in credit to the poor.[54] Also many micro-businesses operate in the informal sector beneath the radar screen of the authorities.[55] They may not see the merit in availing of a reformed law if this meant appearing on the official radar. Moreover, they may not possess much in the way of conventional collateral, and reforming collateral law is unlikely to change that situation. In many countries, improved access to credit has only come about through the willingness of alternative financial institutions to look at cash flows rather than assets. Highlighting secured lending and collateral may put "undue attention on an issue that the pioneer microfinance organizations and practitioners have worked very hard to reduce to a lower status".[56]

There is also the experience in De Soto's native Peru which suggests that property registration, of itself, is unlikely to have much effect. To bring about concrete reform, it may have to be followed by more politically challenging steps, such as improving the norms and efficiency of the judicial system, as well as rewriting bankruptcy codes and restructuring financial market regulation. Reforms of this nature may entail much more challenging

50 De Soto, *The Mystery of Capital*, , n. 47 above, p. 7.

51 See the University of North Carolina at Chapel Hill, News Release, 19 October 2004, available at www.unc.edu/news/archives/oct04/fpg_desoto101904.html and see the praise for De Soto on the Cato Institute website from Richard Nixon and Ronald Reagan www.cato.org/special/friedman/desoto/praise.html (last accessed 3 November 2010).

52 See the review of De Soto's other famous book *El Otro Sendero* (*The Other Path*) by R Rossini and J Thomas (1990) 18 *World Development* 125.

53 See R Samuelson, "The spirit of capitalism" (2001) 80(January/February) *Foreign Affairs* 205: "Unfortunately, de Soto strains too much. He wants to make property rights – or their absence – the center of everything."

54 See S Galliani and E Schargrodsky, *Property Rights for the Poor: Effects of land titling*, Ronald Coase Institute Working Paper (January 2009), who conclude: "Our results suggest that land titling can be an important tool for poverty reduction, albeit not through the shortcut of credit access, but through the slow channel of increased physical and human capital investment, which should help to reduce poverty in the future generations."

55 M Holtmann, "Use of security in challenging environments: the microfinance perspective" in Dahan and Simpson (eds), *Secured Transactions Reform*, n. 14 above, p. 159.

56 Ibid. p. 167.

choices for policymakers.[57] Radical critiques suggest that one must look more to the current distribution of property rights rather than the formalisation of such rights. Mattei, for instance, argues that the "formalisation" movement uses an illusory economic theory to justify the freezing and naturalisation of the status quo.[58]

Whatever the validity of the ideological criticism, certainly De Soto's rhetoric is overblown. "Trifling details", such as significant differences between legal systems and property registration systems in developed countries, simply do not concern him. According to De Soto,[59] in the West "all the property records (titles, deeds, securities and contracts that describe the economically significant aspects of assets) are continually tracked and protected as they travel through time and space". Regimes of personal property without registration thrive, however, in many parts of the developed world. It is almost as if De Soto is carried away by his own rhetoric and forgets the need for qualification, asserting that "citizens in advanced nations can obtain descriptions of the economic and social qualities of any available asset without having to see the asset itself".[60] As a bald, general statement this is simply not true and casts doubt on the accuracy of De Soto's own research and his overall thesis about the role of registration of assets as a necessary concomitant of economic development.[61]

De Soto also ignores the fact that Latin American countries, including Peru, have civil codes modelled on the Napoleonic codes of France and Spain.[62] These codes may not be the most "efficient" and comprehensive in terms of protecting property rights, including the position of secured creditors, but they may not necessarily be any better or worse than the codes in some modern European civilian jurisdictions. In short, De Soto's thesis – and others which suggest that the development of the West is explicable on the basis of a better formal structure of property rights that Western economies possess and developing countries lack – seems much too pat, as well as being belied by the facts.

Improving credit cost and availability

Studies by various international financial institutions have suggested a correlation between enhanced security rights, on the one hand, and greater access to, and cheaper, credit on the other.[63] This correlation has been borne out in an empirical study by Haselmann and Pistor examining the effect of legal change in respect of collateral rights on the lending behaviour of banks in 12 transition economies.[64] The study concludes that banks increase the supply of credit subsequent to legal change and that the ability to "collateralise" or use assets as security seems to be an important determinant of credit supplied in the economy. It also finds that foreign-owned banks respond more strongly to legal change than incumbents. This is consistent with the proposition that, especially in emerging and transition economies, information asymmetries are of greater concern compared to developed

57 See the review of *The Mystery of Capital* by C Woodruff in (2001) 39 *Journal of Economic Literature* 1215.

58 See U Mattei, "The Peruvian Civil Code: property and plunder" (2005) 6 *Global Jurist Topics*, fnn. 18, 19, and see also U Mattei and L Nader, *Plunder: When the rule of law is illegal* (Oxford: Wiley-Blackwell 2008).

59 De Soto, *The Mystery of Capital*, n. 47 above, p. 60.

60 Ibid. p. 53.

61 See B Kozolchyk, "A road map to economic development through law: third parties and comparative legal culture" (2005) 23 *Arizona Journal of International and Comparative Law* 1, pp. 2–3: "a merchant's inventory is nowhere represented by a 'property document' . . . The preceding objections are not intended as quibbles; they go to the heart of de Soto's argument."

62 See Mattei, "Peruvian Civil Code", n. 58 above: "Latin American private law derives in large measure from Spanish and Portuguese law."

63 World Bank Group, *Secured Transactions Systems*, n. 6 above, pp. 7–13.

64 See R Haselmann and K Pistor, "How the law affects lending" (2009) 23 *Review of Financial Studies* 549.

markets. Collateral rights tend to reduce information gaps between lenders and borrowers; to even the playing field between foreign and domestic lenders; and to open up the credit market to new participants.

Where asset collateralisation is legally possible, it is argued that all but the largest borrowers should get better terms on a secured rather than an unsecured loan. Better terms can take the form of lower interest rates, larger loans relative to income and also more generous repayment periods. A more prosaic example has been cited in the case of a credit union for International Monetary Fund (IMF) and World Bank employees:[65]

> When the borrowers offer collateral for a loan instead of only a signature, the credit union offers better terms: it will lend at interest rates that are about half as high, make loans that are five to ten times larger relative to income and give the borrower as much as five times longer to repay.

In other cases, however, there may not be a simple trade-off between interest rates and the cost of credit. For instance, sub-prime borrowers may be charged high interest rates and also required to provide security. With blue-chip borrowers, on the other hand, capacity to service the loan is not considered to be an issue. Security does not enter into the reckoning and the competition among lenders for a valuable source of business keeps interest rates low. Moreover, there are greater costs incurred in secured as distinct from unsecured lending.[66] Secured loans are more expensive to set up since the expenses involved in arranging and documenting the transaction are higher. For this reason, it is not just loans to blue-chip borrowers but sometimes small loans, or loans to buyers with strong repayment records, that may be offered on an unsecured basis. While evidence suggests that 60–65 per cent of loans to businesses in the United States are secured, the precise effect of security on credit cost and availability is very difficult, if not impossible, to verify empirically.[67]

Critical perspectives on the harmonisation and modernisation of secured credit law

This section addresses three critical perspectives on UNCITRAL's harmonisation and modernisation agenda. The first considers general issues of fairness, in particular, fairness to unsecured creditors from enhanced recognition of security rights. The second perspective looks at secured credit law reform as part of a neoliberal economic agenda pushed by international organisations that also includes privatisation and marketisation of key sectors of a national economy. The third perspective considers secured credit reform as a possible instrument of American foreign policy and American economic interests.

Security and fairness

The concept of security runs counter to instinctive conceptions of fairness in that it may involve one creditor being paid whereas other creditors remain unpaid.[68] In short, the idea of proportionate satisfaction of creditor claims, i.e. *pari passu* distribution, is disturbed. This concern can be met in various ways. For instance, one might argue that the general instrumentalist justifications for security override individual conceptions of fairness. In other words, increased credit creation and lower-cost credit will help to stimulate economic activity and lead to better economic conditions for all. Moreover, to the extent that security is seen as a fair exchange for the credit, the secured creditor has bargained for security and

65 See Fleisig, "The economics of collateral", n. 14 above, pp. 81, 85.

66 See, generally, R Mann, "Explaining the pattern of secured credit" (1997) 110 *Harvard Law Review* 626.

67 See Lopez de Silanes, "Turning the key to credit", n. 28 above, p. 10.

68 For a strong critique of *pari passu*, see, generally, R Mokal, "Priority as pathology: the *pari passu* myth" (2001) 60 *CLJ* 581.

priority, whereas other creditors have not. Consequently, it does not seem unfair to privilege the secured creditor over other creditors who could equally have contracted for security but chose not to do so. On the other hand, there may be involuntary creditors, i.e. creditors not in a contractual relationship with the debtor, who are not in a position to bargain for security. Also there are other non-adjusting creditors, or poorly adjusting creditors, where it is unrealistic to suppose that they could bargain for security or where the transaction costs of doing so are too great. These creditors in a weak bargaining position are perhaps most likely to be the ones that will be hit hardest by the debtor's insolvency. The insolvency may impact disproportionately on them in that they are not very capable of sharing or passing on the costs of the loss. Large financial institutions most likely to take security are in a much better position to pass on losses.

Employees and small trade creditors are typically non-adjusting, or poorly adjusting, creditors. Different jurisdictions may have different ways of protecting such creditors whether through social safety nets, or insurance schemes, or the like. Other possible approaches would be to impose restrictions on the taking of security thereby leaving a margin of unsecured assets that are available for payment of unsecured debts, or else to set aside a proportion of secured realisations for the benefit of unsecured creditors. The UNCITRAL Guide, however, follows the thread of Article 9 of the American Uniform Commercial Code and counsels against this, recognising the "full" priority of security rights.

Secured credit and neoliberal economic reforms

Secured credit law reform is generally promoted on the basis that it will foster market-based decision-making on credit issues. Reform is often seen as part of an overall economic agenda – the so-called Washington consensus – that includes privatisation and marketisation.[69] They may be viewed as interlinked ingredients in an overall growth and development strategy.

In the early 1990s, international financial institutions pushed the advantage of a rapid privatisation process but, in many instances, this led to a massive transfer of state resources into the hands of privileged insiders, or the economically powerful. There is a growing recognition that rapid privatisation is not the best prescription for reform.[70] The Chinese experience indicates that a slower, more gradual process is more conducive to long-term economic stability.[71] A gradual process of privatisation allows the restructuring of large firms to take place before their move, in whole or in part, into the private sector.

One of the presumptions underpinning the Washington consensus is that markets will intrinsically lead to efficient outcomes, but the recent global financial crisis has, instead, highlighted the possibility of desirable government intervention that can guide economic growth and make everyone better off. Commentators, such as Joseph Stiglitz, have also criticised the focus of the Washington consensus on GDP, which is seen as the be-all-and-end-all of development. He argues that:

> because GDP is relatively easy to measure, it has become a fixation of economists. The trouble with this is that we measure what we strive for.

69 See J Stiglitz, *Globalisation and its Discontents* (London: Penguin 2002), pp. 16, 53–4.

70 Ibid. p. 6: "countries were told by the West that the new economic system would bring them unprecedented prosperity. Instead, it brought unprecedented poverty . . . The contrast between Russia's transition, as engineered by the international economic institutions, and that of China, designed by itself, could not be greater."

71 See J Ohnesorge, "Developing development theory: law and development orthodoxies and the North East Asian experience" (2007) 28 *University of Pennsylvania Journal of International Economic Law* 219 and see also J Ohnesorge, "The rule of law, economic development, and the developmental states of Northeast Asia" in C Antons (ed.), *Law and Development in East and South East Asia* (London: Routledge/Curzon 2003).

> Sometimes, increases in GDP are associated with poverty reduction, as was the case in East Asia. But that was not an accident: governments designed policies to make sure that the poor shared in the benefits. Elsewhere, growth has often been accompanied by increased poverty and sometimes even lower income levels for individuals in the middle.[72]

It is submitted that this is a valuable insight and that the merits of secured credit reform should be disaggregated from wider notions about the alleged efficacy of market-based decision-making, and the implementation of a privatisation agenda.

The UNCITRAL Guide as an instrument of American economic power

There have been many analyses of the role of transplants in the legal modernisation and harmonisation process.[73] It is the case that a variety of factors drive countries to adopt legal transplants from other jurisdictions and models of greater, or lesser, sophistication have been used to explain the typology of transplants.[74] Professor Alan Watson, for example, has acknowledged that reception and transplants come in all shapes and sizes, speaking of an imposed reception, solicited imposition, penetration, infiltration, crypto-reception, inoculation, and so on.[75] Another approach is to propound a straightforward distinction between coercive transplants and voluntary receptions. The notion of "coercive" transplants can be used to explain the relationship between a colonial power and its dependencies whereby the law of the mother country is imposed on its "foreign" possessions and territories as part of the project of imperial governance. The concept of "voluntary" reception explains situations where the aura, or prestige, of a particular jurisdiction persuades other countries to adopt its laws.[76]

The sufficiency of this basic taxonomy has been challenged. In particular, the distinction between coercive and voluntary transplants could be seen as a matter only of degree, and not of kind. There is not a straightforward dichotomy between "free" or "coercive" transplants of a foreign model – law is a detailed and complex machinery of social control that cannot effectively function without some cooperation from local officials, usually consisting of a professional elite, possibly created by the imperial power. This elite provides the degree of consent to the reception of foreign legal ideas that is necessary for any transplant to occur.[77] In this connection, one might also make use of the notion of reflexive law, thereby acknowledging that the influence exerted by exporting or

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72 See J Stiglitz, *Making Globalization Work* (London: Penguin 2006), p. 45. These points are also highlighted by Stiglitz in his foreword to Polanyi, *The Great Transformation*, n. 11 above.

73 See, generally, W Twining, "Social science and diffusion of law" (2005) 32 *Journal of Law and Society* 203, p. 205; "Diffusion of law: a global perspective" (2004) 49 *Journal of Legal Pluralism* 1. See also F Schauer, *The Politics and Incentives of Legal Transplantation,* Centre for International Development at Harvard Working Paper No 44 (2000), available at www.hks.harvard.edu/var/ezp_site/storage/fckeditor/file/pdfs/centers-programs/centers/cid/publications/faculty/wp/044.pdf (last accessed 1 September 2011); T Waelde and J Gunderson, "Legislative reform in transition economies: Western transplants – a shortcut to social market economy status" (1994) 43 *ICLQ* 347.

74 But for a somewhat different perspective, see O Kahn-Freund, "On uses and misuses of comparative law" (1974) 37 *MLR* 1 and, for a response, see A Watson, "Legal transplants and law reform" (1976) 92 *LQR* 79. See also W Ewald, "Comparative jurisprudence (11): the logic of legal transplants" (1995) 43 *AJCL* 489.

75 A Watson, *Legal Transplants: An approach to comparative law* (Edinburgh: Scottish Academic Press 1974), p. 30.

76 See U Mattei, "A theory of imperial law: a study on US hegemony and the Latin resistance" (2002) 10 *Indiana Journal of Global Legal Studies* 383, p. 385.

77 See Berkowitz et al., "Transplant effect", n. 22 above, who suggest that indigenous law-making operates as a kind of focal point for cooperative law-making behaviour which then serves as the focal point for cooperative economic behaviour. See also G Teubner, "Legal irritants: good faith in British law or how unifying law ends up in new divergences" (1998) 61 *MLR* 11.

"hegemonic" jurisdictions is most likely to be effective when it seeks to achieve its ends not by direct prescription but by inducing second order effects on the part of social actors in the receiving state.[78] One may also tie in the concept of path dependency.[79] The law, and lawyers, tend to absorb change by digging deeper into existing soil, rather than branching out into new fields. Political and other influences may trigger legal development and cause the law to produce certain outcomes but the form that represents these outcomes is determined by the legal doctrine prevailing in the jurisdiction concerned.[80] In short, the law develops in a path-dependent fashion.

Another commentator, Professor Ugo Mattei, has sought to explain transplants on the basis of prestige or efficiency.[81] While acknowledging that each single legal transplant has its own peculiarities that make it different from every other, Mattei deploys economic analysis to explain the perceived convergence of modern legal systems as a movement towards efficiency, despite the large variety of institutional backgrounds. A synergy is also said to exist between "efficiency" and "prestige" with the most efficient models being seen as the more prestigious. The "efficiency" notion links up with concepts of regulatory competition. This implies convergence around a single, efficient system which wins out through the competitive process. But the evidence about regulatory competition suggests that it may produce rules that are far from optimal from the viewpoint of economic theory.[82] There is also the risk of "social dumping"[83] and a so-called race to the bottom.[84] Proponents of the "efficiency" thesis then have to fall back on arguments about the long-term benefits of market solutions. In some cases, the idea of co-evolution may better explain the process whereby countries observe and emulate practices in jurisdictions to which they are closely related by trade and institutional connections. The co-evolution concept assumes that a variety of diverse systems may exist side by side with each one retaining its viability. More fundamentally, a recent empirical study of private credit in over 100 countries over 25 years has amassed evidence contradicting the hypothesis that legal institutions converge toward the more successful ones over time.[85] In addition, the study suggests that since credit institutions vary so much across countries and legal origins, the evidence is also inconsistent with the "functional convergence" hypothesis holding that

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78 See, generally, G Teubner, "Substantive and reflexive elements in modern law" (1983) 17 *Law and Society Review* 239.

79 L Bebchuk and M Roe, "A theory of path dependence in corporate ownership and governance" (1999) 52 *Stanford Law Review* 127.

80 See, generally, E Micheler, *Property in Securities: A comparative study* (Cambridge: CUP 2007), ch. 15, "Legal development as a path-dependent process" and see the statement at p. 228, "Legal doctrine causes the law to develop path-dependently". See also H Spamann, "Contemporary legal transplants: legal families and the diffusion of (corporate) law" (2009) *Brigham Young University Law Review* 1813; J Armour, S Deakin, P Lele and M Siems, "How do legal rules evolve? Evidence from a cross-country comparison of shareholder, creditor, and worker protection" (2009) 57 *AJCL* 579.

81 U Mattei, "Efficiency in legal transplants: an essay in comparative law and economics" (1994) 14 *International Review of Law and Economics* 3. See also A Ogus, "Competition between national legal systems: a contribution of economic analysis to comparative law" (1999) 48 *ICLQ* 405 and see, generally, F von Hayek, "Competition as a discovery procedure" (2002) 5 *Quarterly Journal of Austrian Economics* 3, p. 9.

82 See D Esty and D Geradin (eds.), *Regulatory Competition and Economic Integration: Comparative perspectives* (Oxford: OUP 2001).

83 In the context of EC employment law, the European Court of Justice made specific reference to social dumping in *Laval un Partneri Ptd* v *Svenska* (341/05) [2007] ECR I-5751, para. 103.

84 See, generally, C Barnard, "Social dumping and race to the bottom: some lessons for the EU from Delaware?" (2000) 25 *European Law Review* 57; L Enriques and M Gelter, "Regulatory competition in European company law and creditor protection" (2006) 7 *European Business Organization Law Review* 417.

85 See S Djankov, C McLiesh and A Shleifer, "Private credit in 129 countries" (2007) 84 *Journal of Financial Economics* 299.

institutions in different countries, while distinct on the surface, functionally converge to accomplish the same goals.

Evidence of a lack of a convergence, however, is not necessarily inconsistent with the proposition that certain legal systems may hold an appeal on prestige or other grounds. John Braithwaite and Peter Drahos in their seminal book on *Global Business Regulation*[86] have spoken of how models are adopted

> when they appeal to identities that we hold dear. An identity that is particularly crucial in this regard is that of being successful, modern, civilised, advanced. The periphery models the centre in the world system because of this pursuit of modernity in identity (or postmodernity, for the truly avant-garde).

The French economist Michel Albert has spoken of the irresistible force of US legal expansionism.[87] US legal paradigms gain a competitive advantage from the political and ideological sway exercised by the United States. Alternative approaches are overwhelmed by American political and cultural influences. Albert explains the spread of American influences using notions of seductiveness and appeal. In his view, the intrinsic characteristics of the neo-American model exalt the success of risk-taking, gambling and "glittery" behaviour.

In the same vein, another commentator has talked about how the European Community method of rational planning, bureaucratic solutions, suppression of political passion and a steady incrementalism is incapable of igniting the popular emotions in a way that would allow Europe to mount a true global challenge to the US.[88]

Mattei has now moved away from his earlier reliance on "prestige" or "efficiency" to propound a theory of "imperial law":[89]

> Imperial law is produced, in the interest of international capital, by a variety of both public and private institutions, all sharing a gap in legitimacy . . . Imperial law is shaped by a spectacular process of exaggeration, aimed at building consent for the purpose of hegemonic domination. Imperial law subordinates local legal arrangements world-wide . . . Predatory economic globalization is the vehicle, the all-mighty ally, and the beneficiary of imperial law.

In the realm of literary and cultural discourse, notions of imperialism and American hegemony have been advanced by Edward Said.[90] He talks about American culture's phenomenally incorporative capacity and a system of pressures and constraints which induces other states to follow the essentially imperial identity and direction of US norms.[91] In his view, the pressures are subtle, and generally indirect.[92] Said makes the point that:[93]

> American attitudes to American greatness, to hierarchies of race, to the perils of other revolutions . . . have remained constant, have dictated, have obscured the

86 J Braithwaite and P Drahos, *Global Business Regulation* (Cambridge: CUP 2000), p. 591.

87 M Albert, *Capitalism against Capitalism: How America's obsession with individual achievement and short-term profit has led it to the brink of economic collapse* (London: Whurr 1993).

88 See S Dillon, "Looking for the progressive empire: where is the European Union's foreign policy?" (2004) 19 *Connecticut Journal of International Law* 275, p. 278.

89 See U Mattei, "A theory of imperial law", n. 76 above. See also J Gardner, *Legal Imperialism, American Lawyers and Foreign Aid in Latin America* (Madison: University of Wisconsin Press 1980).

90 E Said, *Culture and Imperialism* (London: Chatto & Windus 1993). See also M Hardt and A Negri, *Empire* (Cambridge, MA: Harvard UP 2000).

91 Said, *Culture and Imperialism*, n. 90 above, p. 392.

92 Ibid. p. 401.

93 Ibid. p. 7.

> realities of empire, while apologists for overseas American interests have insisted on American innocence, doing good, fighting for freedom.

Said also links his theory of imperialism with a law-making creed that suggests it is the goal of US foreign policy to bring about a world increasingly subject to the rule of law, as defined in US terms.

In the sphere of secured credit, the UNCITRAL Guide can be considered as an instrument by which the norms set out in Article 9 of the American Commercial Code are writ large across the globe. The Guide reproduces the key features of Article 9, emphasising the removal of restrictions on the taking of security, all-assets security, notice filing of security interests along American lines, and the full priority of security rights.

US private and public interests combined and collaborated in the formulation and development of the Guide. It is hardly surprising that agencies of the US government, as well as US private interests, should act to defend what they consider to be US business interests. Leading economies, including the US, "have a collective interest in promoting generalized dependency and reverence from the periphery".[94] But, as one US commentator remarks:

> efforts to export US legal models are more likely to succeed if they eschew detailed, distinctively US-derived prescriptions in favour of presenting advise or exemplars in terms of more "general" standards, "international" norms, "universal" principles . . .[95]

The work of bodies such as UNCITRAL is considered to represent best international practice.[96] The US, by virtue of its economic power, and the associated prestige of its economic and legal models, heavily influences the work of such bodies and, putting the point simply, what is considered to be good for the US is also considered to be good for the world.[97] But there are many who disagree with the assessment of what is good not only for the world but also for the US.

Conclusion

Security rights give the credit-provider property rights, normally in the debtor's assets. The whole harmonisation and modernisation agenda appears to be driven largely by a desire to remove restrictions on the taking of security. This is because of a widespread belief that a "liberal" secured transactions regime promotes economic growth. In many World Bank and other studies, the availability of credit has been identified as one of the key factors driving economic growth. Lack of access to credit, and in particular low-cost credit, is seen as a major constraint on economic development. While economic and other factors may hamper access to credit, legal, regulatory and institutional frameworks are also seen significantly to contribute to this problem. In many jurisdictions, the laws relating to secured transactions are fragmented and antiquated. Businesses may be unable to utilise the full value of their

94 See the following statement by the Commercial Finance Association (CFA), General Counsel: (UN Press Release ECO/56 L/3061, 29 March 2010): "CFA members, which include large United States banks but also smaller lenders, often make loans to companies located in other countries supported by collateral. The guide will help countries to modernize their laws, so that lenders who are interested in making loans in other countries will know with certainty and predictability what their rights and obligations are."

95 See J de Lisle, "*Lex Americana*? United States legal assistance, American legal models and legal change in the post-communist world and beyond" (1999) 20 *University of Pennsylvania Journal of International Economic Law* 179, p. 269, and see also his comment at p. 202 about the US government promoting the indirect export of US models through multilateral organisations that shape international standards.

96 See, generally, K Pistor, "The standardization of law and its effect on developing economies" (2002) 50 *AJCL* 97.

97 See Braithwaite and Drahos, *Global Business Regulation*, n. 86 above, p. 587.

assets or, if they try to do so, they are straightjacketed down a particular and restrictive path. Unlocking the value of collateral to serve as security is seen as a highly important task.

But the harmonisation and modernisation agenda also has its critics. The law of secured finance is often perceived to embody cultural attitudes and public policy choices that vary greatly among states. In this area of commercial law, sovereignty issues remain central since many of the rules governing enforcement of security rights reflect policy interests that are external to the credit relationship itself. An agreement between debtor and creditor cannot regulate completely the operation of the resulting security right against third parties. In the event of debtor insolvency, there is an additional layer of policy issues to be considered. The rules governing the distribution of the debtor's assets may reflect local social goals. Polanyi has graphically pointed out the dangers in terms of detrimental social consequences if theoretically free markets are left to enjoy full reign.

Changes to law and legal doctrine in a particular jurisdiction often mirror, to a greater or lesser extent, changes that have taken place in other jurisdictions. The desire for change may stem from societal developments or from a desire to promote the social and economic infrastructure of a particular country. Turkey exemplifies a country that set out on a path of modernity as a result of top-down political leadership and then consciously borrowed laws and legal institutions from other jurisdictions that were considered to offer a superior product.[98] Changes may also to a greater extent be coerced. In decades and centuries past, the UK exported the common law to its overseas territories and possessions and, generally, these former colonies persisted with the common law as they gained political independence. The French Napoleonic Code found its way to Spain as a result of military conquest and from there it passed to the Hispanic world of Central and South America. In recent times, coercion has come in more subtle forms, perhaps through conditions attached to international loans to developing countries from the World Bank and IMF.

The US strongly influences if not entirely controls the workings of these international financial institutions, in particular the IMF. World Bank and IMF conditionality may require economic austerity measures, and also changes to the economic structures of the country concerned, including privatisation and restructuring of state-owned enterprises and strengthening the role of the private sector. The conditions may also require changes to corporate law, as well as the enactment of measures to enhance the availability of credit by means of a modern secured transactions regime. Prescriptions in this regard are most unlikely to be expressed as crudely as "Enact Article 9 of the American Uniform Commercial Code". Instead, they are more likely to call for progress and advancement in line with best international practice.[99] Best international practice is considered to be represented by the work of organisations such as UNCITRAL. The US, through economic power and the associated prestige of its economic and legal models, heavily influences the work of UNCITRAL and analogous bodies. Certainly, the UNCITRAL Secured Transactions Guide reproduces the key features of Article 9 of the American Uniform Commercial Code in apparent preference to alternative models from other jurisdictions.

98 See E Orucu, "Turkey: change under pressure" in E Orucu, S. Attwool and S Coyle, *Studies in Legal Systems: Mixed and mixing* (London: Kluwer 1996), p. 89. See also E Orucu, *Critical Comparative Law: Considering paradoxes for legal systems in transition* (Deventer: Kluwer 1999), p. 81: "No single legal system served as the model. The choice was driven in some cases by the perceived prestige of the model, in some by efficiency and in others by chance. Choosing a number of different models may have given the borrowings 'cultural legitimacy' as the desire to modernise and westernise was not beholden to any one dominant culture."

99 See Pistor, "Standardisation of law", n. 96 above, p. 108, on how the influence of a foreign law can be obscured by the use of an international instrument.

While some of the rhetoric about the economic efficacy of property rights, including security rights, is certainly overblown, there is nevertheless some empirical evidence that enhanced and more widely available security rights may open the door to greater economic growth. On the other hand, there is little evidence that following a detailed blueprint such as the American Article 9 writ large in the UNCITRAL Secured Transactions Guide will necessarily give a further boost to growth prospects. Indeed, it may even harm them. A study based on the Eastern-European experience demonstrates various potential inefficiencies when law is transplanted into an "alien" implementing or enforcing environment.[100] The study sees indigenous norms and institutions functioning better than transplanted ones and, while the possibility of borrowing from other countries is not precluded, the "fit" of foreign with domestic law is enhanced by meaningful adaptation of imported laws to local conditions.[101] There are no magical elixirs that bring about a happy ending to the quest for growth.[102] In short, there is no Holy Grail and the UNCITRAL Secured Transactions Guide, if and to the extent that it implies otherwise, is a false god.

100 See Berkowitz et al., "Transplant effect", n. 22 above.

101 Referring to Cass Sunstein – "the meaning of legal statements is a function of social norms, not of the speaker's intentions" in "On the expressive function of law" (1996) 144 *University of Pennsylvania Law Review* 2021, p. 2050, and see also C Sunstein, "Social norms and social roles" (1996) 96 *Columbia Law Review* 903, p. 925.

102 See W Easterly, *The Elusive Quest for Growth: Economists' adventures and misadventures in the Tropics* (Cambridge, MA: MIT Press 2001), p. 289.

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Cooperativism in a credit crisis: lessons from the Argentine worker takeovers

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Abstract

Contemporary visions of cooperativism – as a political project to limit the social consequences of self-regulating credit markets – inform regulatory debates across the political spectrum. Based on historical examples where similar visions of cooperativism and self-regulation have failed, this article explores the mechanisms by which cooperatives can successfully negotiate the failure of credit markets. It is in this context that lessons can be learned from recent worker takeovers that followed the Argentine debt default in 2001.

In 2001, Argentine workers took over the factories that employed them and proceeded to successfully negotiate their way through the credit crisis triggered by the Argentine debt default as cooperatives. The workers resumed – and in some cases sustained – production in factories where they were formerly employed. Most of the takeovers were organised (and subsequently legally recognised) as cooperatives and some continue to hold the factories as such. Their success – albeit for limited periods for most – is premised on a fundamental restructuring of the property rights that underpinned pre-default, credit markets.

In the case of Argentina, the debt default and the fundamental restructuring this entailed had political consequences in so far as its reliance on self-regulating credit markets had to be renegotiated. This article concludes by showing that self-regulating credit markets engender forms of corporatism and this is – in the absence of a similar political renegotiation – inimical to contemporary visions of cooperativism.

Introduction

This article examines contemporary forms of cooperativism in current debates on regulatory reform in a credit crisis through the lens of the Argentine worker takeovers (the takeovers). In 2001, the worker takeovers successfully negotiated their way through the credit crisis triggered by the Argentine debt default as cooperatives.[1] The takeovers were worker initiated moves to "self-organise and self-direct working life cooperatively as an alternative to owner managed work organisation".[2] They began in the lead-up to the default,

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1 It is assumed here that the crisis created the conditions that facilitated the takeovers discussed in this article. There is one view that similar worker movements can be traced back 40 years. See Toronto School of Creativity and Inquiry, "Recovering and recreating spaces of production" (interview) (2007)(winter) 1(1) *Affinities: A journal of radical theory, culture and action* 33–48, no copyright, available at http://journals.sfu.ca/affinities/index.php/affinities/article/viewFile/6/26 (last accessed 31 August 2011).

2 M Vieta, "The social innovations of autogestion in Argentina's worker-recuperated enterprises: co-operatively re-organising productive life in hard times" (2010) 35 *Labour Studies Journal* 295.

when credit markets collapsed leading to factory closures and widespread unemployment. The workers resumed – and in some cases sustained – production in factories where they were formerly employed. Most of the takeovers were organised (and legally recognised) as cooperatives and they continue to hold the factories as such. However, as the Argentine economy has since recovered, their sustainability as cooperatives is under threat as they struggle to operate with limited access to formal credit markets. This article explores the contribution of the takeovers to regulatory scholarship. It examines whether, their success – in the conditions described – is premised on a fundamental restructuring of the property rights that underpinned self-regulating credit markets. Based on the experience of the takeovers and in a move away from current debates on cooperativism, this article examines whether self-regulating financial markets are premised on a vision of corporatism not cooperativism and whether cooperativism and self-regulating credit markets are potentially contradictory political projects.[3]

Across Argentina, there are currently, 8000 to 10,000 employees – a small percentage of the total active urban workforce of 14.3m – who control production in 170 to 180 takeovers ranging from ceramic firms to printing presses.[4] A key aspect of the takeovers was the workers' reliance on their personal relationships within the factory and with the local community in which they were located. This raises questions about whether and how their embeddedness in the community influenced their cooperative organisational form and, thus, economic viability in the absence of access to credit markets. What were the mechanisms by which they overcame the failure of credit markets in order to achieve their goal to "self-organise and self-direct working life cooperatively". A mechanism, according to Braithwaite and Drahos, is a "tool that actors use to achieve their goals".[5] Mechanisms comprise "causal chains which are not generalizable as laws".[6] This article explores the conditions that engender the mechanisms to which the success of the worker takeovers can be attributed.[7]

The takeovers were characterised by three features. First, they were unplanned worker-initiated strategies to mitigate the consequences of bankruptcies – triggered by the sovereign debt default. They were not trade union mediated responses to the debt crisis.[8]

3 This article explores whether self-regulating credit markets are inimical to cooperativism as a state-sponsored political project. For a discussion of the difficulties that cooperatives face as a consequence of structural adjustment policies in developing economies, see R Simmons and J Birchall, "The role of co-operatives in poverty reduction: network perspectives" (2008) available at www2.lse.ac.uk/internationalDevelopment/research/NGPA/publications/ngpa_wp10.aspx (last accessed 25 August 2011).

4 Vieta, "Social innovations", n. 2 above, p. 297.

5 J Braithwaite and P Drahos, *Global Business Regulation* (Cambridge: CUP 2000), p. 9.

6 According to Braithwaite and Drahos – who rely on Jon Elster – a mechanism is not a general law. A general law is conventionally articulated in the form of "all A's are B's . . . A knowledge of general laws grounds both explanation and prediction." The quest for general laws in the social sciences has a limited chance of success as "rarely will social scientists be able to state necessary and sufficient conditions under which the various mechanisms are switched on . . . what they are more likely to be able to do is identify a causal mechanism that led to an event and thus shed light in why something happened." It is in this sense that the term mechanism is used in relation to the takeovers. Braithwaite and Drahos, *Global Business Regulation*, n. 5 above, p. 15.

7 Though the identification does not per se reflect either the necessary or sufficient conditions under which the various mechanisms are switched on as this would require an empirical examination of the kind undertaken by Braithwaite and Drahos: ibid.

8 Vieta argues that the takeovers were treated with hostility by the mainstream labour movement. Vieta, "Social innovations", n. 2 above, pp. 298–9. Further, the takeovers can be distinguished from recent trade union policies to deal with public sector unemployment. See, for example, "Unite launches cut price membership for students and the unemployed", *The Guardian*, 17 July 2011, available at www.guardian.co.uk/politics/2011/jul/17/unite-start-reduced-membership?INTCMP=SRCH (last accessed 25 August 2011).

Further, though their continued viability depended on the workers securing the collective ownership of the factories that they took over, state intervention to secure their rights came much later. The official recognition was through government-sponsored initiatives[9] and is comparable to the "top-down" initiatives currently being envisaged across the political divide in the UK, for instance, the Big Society UK Coalition government policy.[10] A key report that forms part of this policy is discussed in more detail below. Crucially, however, both trade union and state-sponsored contemporary initiatives assume that the cooperative economy will flourish in the context of what are still essentially self-regulating credit markets. It is here that the takeovers offer new insights to regulatory scholarship on account of the mechanisms they developed as cooperatives to successfully negotiate the failure of credit markets. Further, the takeovers are premised on a fundamental restructuring of a pre-default property rights framework. This article examines whether they provide – albeit briefly for some – a template to renegotiate the reliance of the state on self-regulating credit markets. The nature and impact of such a renegotiated relationship between the state and credit markets on globalisation has not been explored in contemporary regulation scholarship. This issue has been discussed more extensively by political economists. Their insights are brought to bear on this discussion of the significance of takeovers in a post-default economy in this article.

The following section examines contemporary cooperativism and organisational democracy in the United Kingdom which are offered as strategies for credit crisis reform. This examination is followed by a discussion of historical experiences with cooperativism and self-regulating credit markets. This historical examination is contextualised in the section that follows with a discussion of the necessity of state regulation of credit markets. I then explore the relevance of takeovers for regulatory and sovereign debt scholarship. The next section sets out the mechanisms and conditions in which worker takeovers in Argentina successfully resumed and sustained production as cooperatives in a credit crisis. This is followed by conclusions.

Cooperativisms in contemporary debates on post-credit crisis regulation

The current agonising between "Blue" Labour[11] and the conservative-led coalition[12] on how best to manage the severe constraints on public finances and preserve the welfare state with declining capital taxes goes to the heart of how the neoliberal bargain between the state, self-regulating markets and the polity is being renegotiated. This section examines three contemporary visions on how this bargain can be renegotiated: two political visions and one from the cooperative sector. It is important to note that this renegotiation is sought to be achieved in the context of what will remain essentially self-regulating credit markets with the regulatory (and welfare) state in abeyance.

The UK Coalition government-sponsored Big Society vision, for instance, is premised on an extension of existing credit markets to funding social enterprises. In the coalition

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9 For a critical examination of recognition of the takeovers through the state-sponsored project of "institutionalisation", see A C Dinerstein, "Workers factory takeovers and the programme for self-managed work: towards an institutionalisation of radical forms of non-governmental public action in Argentina" (London: NGPA Working Paper Series 2008), available at www.lse.ac.uk/NGPA/publications (last accessed 25 August 2011).

10 "Growing the social investment market: a vision and a strategy", available at www.cabinetoffice.gov.uk/resource-library/growing-social-investment-market-vision-and-strategy (last accessed 25 August 2011).

11 Ibid.

12 Ibid.

paper, "Growing the social investment market: a vision and a strategy",[13] a social investment market is proposed as the third pillar of finance.[14] The Big Society vision is premised on creating a market for social investment and the "Big Society Bank"[15] is structured to be the institution that mediates this transition. The Big Society vision is poised to create new markets for finance and must not be confused with a counter-move aimed at regulating financial markets.

The Big Society vision sets out to distribute power to local communities and citizens in the UK against a backdrop of swingeing cuts in public finances. The credit crunch and the move to incentivise financial institutions to resume pre-crisis lending is a clear attempt to remedy a failure of credit markets by creating new markets *not by regulating existing financial markets*. The renegotiation proposed by the Big Society policy is inter alia to increase opportunities for market investors to invest in social enterprises. The vision does not specify nor address the possibility that the new markets created will increase the downside risk to society. This risk will materialise if the high-risk Big Society Bank-funded ventures do not generate "social returns on investment" for its principle investors: the big banks.[16] In this scenario, the risk of borrowing will either be borne directly by the socially vulnerable who will be denied services provided by these underperforming private ventures (or the welfare state) or be underwritten by the taxpayer who is still positioned to bail out the Big Society Bank.[17] This vision does not set out a framework of cooperativism though it does not exclude the possibility that the social enterprises it seeks to fund may include cooperatives. The creation of new markets – mainly to satisfy investor demand – is a central premise of the Big Society vision.

In the same context – severe constraints on public finances and the ongoing credit crisis – the Blue Labour response to the Big Society vision is focused on "what matters in everyday life . . . the quality of our relationships – our family life".[18] The Blue Labour[19] renegotiation is premised on creating a more "relational" style of politics which "redistributes not just wealth but also power back to local communities". This is sought to be realised through the "revival of the Labour tradition of mutuals, co-operatives and friendly societies, the creation of local banks and a new system of worker representation on company boards".[20] It is clear that cooperatives form a key part of this vision. The downside risk to the polity (blue-collar workers, public-sector employees), in the event that credit markets fail, are not discussed in either vision of organisational democracy. Both proposals are aimed at achieving distinct visions of organisational democracy and assume that these can be realised either through direct (Big Society) or indirect (Blue Labour) reliance on self-regulating credit markets. This is an assumption that informs another contemporary vision of cooperativism which is discussed in the following paragraphs.

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13 "Growing the social investment market", n. 10 above.

14 Ibid.

15 The Big Society Bank is set up as a private company limited by guarantee. The shareholders of the company are Barclays, HSBC, Lloyds and RBS (Merlin Banks) who will be investing £200m as capital into the bank. The policy is committed to making this start-up capital "senior to the unclaimed assets in the event of liquidation". The shareholders' risk is limited by guarantee and in the event that the bank is liquidated it is unclear what the risk is to the social enterprises reliant on funds from the bank: ibid.

16 Ibid.

17 Ibid.

18 Ibid.

19 E Miliband, "Preface" in M Glasman, J Rutherford, M Stears and S White (eds), *The Labour Tradition and the Politics of Paradox* (Oxford: Soundings 2011), p. 7, available at www.soundings.org.uk/ (last accessed 25 August 2011).

20 Ibid.

The recently released report, "The UK co-operative economy: Britain's return to cooperation, 2011"[21] by Cooperatives UK (the report) provides some clues on how cooperativism can be articulated as a vision of organisational democracy in the context of self-regulating credit markets.[22] The report makes interesting reading as it provides a template of post-crisis reform based on the success of cooperatives. In the report, cooperativism refers to the idea that cooperatives are ideally suited to reduce the risk of economic activity or more specifically to limit the social consequences of market failures. This possibility justifies the normative appeal of cooperativism: a new template "for social justice and organisational democracy". The vision of cooperativism set out in the report "[s]trives to breathe fresh air into stale public services" and as such unintentionally provides a fait accompli to both political visions discussed above. Its recommendations are based in part on the financial success of large UK cooperatives, such as John Lewis and Suma Whole Foods, and in part on the political appeal of the vision of a "cooperative economy". This vision is contrasted with the exacerbated socio-economic inequality engendered by corporatism and as such aims to "close the gap between the richest and the poorest". Here, corporativism is set up as a template to redistribute wealth *and* provide an alternative to the welfare state.

In the UK, cooperatives have been economically successful[23] and the report rightly focuses on the benefits of cooperativism. The issue that remains unexamined in the report is the extent to which this vision of cooperativism – a template for "social justice and organisational democracy" – can be realised without fundamentally restructuring self-regulating credit markets and the state's dependence on them. So, for instance, the report challenges the "dominant model of the public limited company where the legal obligation is to put the interest of the shareholders first" and identifies the need to reach "towards a system based on the common good of all". But it does not set out an alternate property rights framework in which cooperatives will form the dominant organisational template or how credit markets will have to be regulated for cooperatives to access credit as such. The report does not specify what the regulatory role of the state needs to be to engender its vision of cooperativism.

The vision of cooperativism set out in the report overlooks the pressures on cooperatives when faced with a credit crisis. The most recent example of this is the demutualisation of building societies in the 1970s in the UK, under pressure from credit markets demanding changes in their horizontal organisational structure to limit investor risk and responsibility. To the extent that the vision of cooperativism in the report relies on minimum government and on what are essentially self-regulating credit markets, it is both decontextualised and ahistorical. This is further discussed is the following section.

Historical experiences with cooperativism and self-regulating credit markets

In his book *The Great Transformation: The political and economic origins of our time*,[24] Karl Polanyi provided a powerful critique of laissez-faire capitalism – at least that form of capitalism prevalent in mid-nineteenth-century England. His critique focused on the changes wrought

21 "The UK co-operative economy: Britain's return to co-operation, 2011", available at www.uk.coop/ (last accessed 11 July 2011).

22 Cooperatives UK is "the national trade body that campaigns for co-operation and works to promote, develop and unite co-operative enterprises". See www.uk.coop/ (last accessed 4 August 2011).

23 See also H Stewart, "Co-operative sector has grown by more than 25 % since credit crunch – report", *The Guardian*, 26 June 2011, available at www.guardian.co.uk/business/2011/jun/26/co-operative-sector-has-grown-more-than-25-per-cent?INTCMP=SRCH (last accessed 4 August 2011).

24 K Polanyi, *The Great Transformation: The political and economic origins of our time* (Boston: Beacon Press 2001).

on the individual, on families and on communities and the damage caused to the countryside in a society reliant on laissez-faire markets. These, he argued, were the inevitable costs that a polity reliant on laissez-faire capitalism would have to accept. One of the key insights of the Polanyian analysis is that markets are essentially social institutions regulated by social mores. There is thus no significant distinction between economy and society. But societies reliant on laissez-faire markets are different in that these are marked by a separation between economy and society. This separation, Polanyi argued, does not evolve slowly but comes about through what are often coercive legal and economic processes. This separation occurs through the commodification of land, labour and money into sources of rent, wages and interest. Polanyi set out in minute detail the pain and suffering caused by the necessity of disembedding these commodities from society so that they could be transacted in what he referred to as "economic society" regulated by market norms.

In his historical analysis of Robert Owen's experiment with an early form of cooperativism, Polanyi showed why this had failed. He showed that the demands of laissez-faire capitalism were inimical to both the organisational structure of cooperatives and its attendant and necessary vision of organisational democracy. So, for instance, cooperativism was not a solution to pauperism in a context where "economic society had emerged as distinct from the political state".[25] There was still a key regulatory role that the state plays in this context. Once the social regulation of markets was in abeyance, Polanyi argued that the state was best placed to counter the social consequences of economic society. At the time, this social protection was often provided in a random and ad hoc way. This has since changed, as will be discussed later in this section. In any event, Polanyi's historical examination indicates that cooperatives have been ill-equipped to fulfil this task. The state would have to re-embed the market in a protective counter-move that would temper the social impact of its reliance on laissez-faire capital markets. From this Polanyian perspective, one of the limitations of contemporary visions of cooperativism lies in the absence of a discussion about whether cooperativism can be realised without a fundamental restructuring of credit markets by the state.

In any event, drawing on the Polanyian analysis discussed above, it is clear that the starting point for exploring the success of cooperatives was through an examination of changes to the property rights framework that underpins the regulation of credit markets. This discussion is absent from the political debates analysed in the preceding section of this article.

Lorraine Talbot makes a similar point in her discussion of the demutualisation of building societies in the United Kingdom in the 1970s.[26] Talbot argues that the need for mutuals to access credit markets was inter alia the trigger for demutualisation. This need gradually proved inimical to the non-hierarchical structure of the building societies and most of them eventually changed into companies. This transformation was necessitated by investor demand for low risk and responsibility. When viewed from this historical perspective, it is clear that a vision of a cooperative economy is realisable only when the property rights that underpin self-regulating credit markets are fundamentally restructured, as was the case in the post-default Argentina. Further, an examination of the mechanisms and conditions required to realise a vision of cooperativism, as the report recommends in the preceding section, does not stop at registering more cooperatives but opens up questions about the regulatory role of the state and the political and economic justifications for its continuing reliance on self-regulating credit markets.

25 Polanyi, *The Great Transformation*, n. 24 above, p. 120.

26 L E Talbot, *Critical Company Law* (Abingdon: Routledge-Cavendish 2008).

In addition to the Polanyian historical examination of the social consequences on the polity of a state reliant on laissez-faire markets, he also reflected on how the state intervened to stymie these consequences.[27] His description of state intervention in this context has been very influential. It has since been extended to identify the role of the state in a society – such as in most developed economies – reliant on self-regulating credit markets as is discussed below.

Contextualising contemporary cooperativisms

As discussed above, in the absence of a clear regulatory role for the state, contemporary visions of cooperativism as a template for regulatory reform are ahistorical. This section contextualises contemporary visions of cooperativism. It begins with an examination of an important justification for regulating credit markets influenced by Polanyi's historical overview of the social effects of laissez-faire capital markets as briefly outlined above.

The influential concept of "embedded liberalism" was developed mainly by political economists who explicitly rely on the Polanyian reading of economic history.[28] Embedded liberalism represents a bargain between the state in developed economies and their polities as follows. The state will rely on financial markets that are essentially self-regulating and, in exchange, shield society from the consequences of self-regulation through a state guarantee of social protection. Embedded liberalism is realised through two moves. First, the provision of public goods and the creation of the welfare state and, secondly, by shifting the social costs of self-regulating markets – as discussed by Polanyi – to the Third World through the intermediation of international organisations such as the World Bank and the International Monetary Fund (IMF).[29]

The mainstream visions of cooperativism discussed above see the swingeing cuts in public finances and the rolling back of the welfare state as an opportunity to expand the financial markets. They, however, completely overlook what Dani Roderik has termed as the "globalisation dilemma".[30] Roderik argues that in developed economies where declining capital taxes can no longer fund the provision of public goods, the bargain on which embedded liberalism is premised is in the process of fracturing. When viewed from this perspective, the vision of social justice and organisational democracy through cooperatives becomes one way of renegotiating the fractured bargain and resolving the "globalisation dilemma". This raises questions about whether cooperatives can be used instrumentally in the way suggested and the implications that this vision of cooperativism will have on worker–members. Will this policy, for instance, responsibilise workers as members where their entitlements to welfare as part of their bargain with the state are withdrawn? Will this increase the incidence of corporatism down the line as cooperatives will need access to formal credit markets to sustain production?[31]

27 Polanyi, *The Great Transformation*, n. 24 above, pp. 81–107.

28 This discussion of "embedded liberalism" relies on the following political economists and philosophers: J C Hays, *Globalisation and the New Politics of Embedded Liberalism* (New York: OUP 2009); J Gray, *False Dawn: The delusions of global capitalism* (London: Granta Books 2002).

29 The call for a protective counter-move to deal with these costs in the Third World led to the formulation of corporate social responsibility (CSR), and internationally through the UN global social compact. For a formulation of CSR, see J G Ruggie, "Taking embedded liberalism global: the corporate connection" in D Held and M Koenig Archibugi (eds), *Taming Globalisation: Frontiers of governance* (Cambridge: Polity 2007), pp. 93–129.

30 D Rodrik, *Has Globalisation Gone Too Far?* (Washington, DC: Institute for International Economics 1997).

31 The recent history of demutualisation is a case in point where mutual membership privileged property ownership and under pressure demutualisation was the only option available to members. Talbot, *Critical Company Law*, n. 26 above, pp. 221–81.

Finally, in the absence of funding initiatives that operate through the state and outside formal credit markets, will entrenched property rights that underpin self-regulating credit markets also marginalise, minimise or even distort the contemporary visions of cooperativism? In the absence of a coherent alternative to self-regulating credit markets, contemporary visions of cooperativism hold out a partial and decontextualised template for regulatory reform. It is here that the successes of the takeovers in post-default Argentina have a contribution to make.

The takeovers were successful and viable because they were embedded in their local communities. This made it possible for the workers to overcome their lack of access to credit and have their welfare needs satisfied by the community: two factors crucial for their recovery and both available outside the financial market. As such, the takeovers are closer to the Polyanian notion of a protective counter-move (though these were initiated by society rather than by the state as in the Polanyian framework). Nonetheless, the takeovers represent solutions to the problems triggered by credit crises, such as, large-scale unemployment. The following part of the article examines their success to reveal both the mechanisms and necessary conditions required to realise a vision of organisational democracy through cooperativism. It begins this examination with an overview of takeovers in regulatory scholarship. This is followed by an overview of the Argentine debt crisis: the context that triggered the takeovers.

Takeovers in regulatory scholarship

Sovereign debt regulation

The takeovers represent "innovative and viable alternatives to chronic unemployment and underemployment" when formal credit markets fail. As far as sovereign debt regulation is concerned, scholars have largely overlooked how societies innovate to cope in the aftermath of a debt crisis. In mainstream sovereign debt regulation, for instance, in the period following the securitisation of sovereign lending in the 1980s, legal scholarship has been focused on issues such as: bond contracts;[32] the regulatory role and culpability of international financial institutions;[33] the behaviour of market actors, such as sovereign borrowers;[34] private investors (hedge funds, investment banks, pension funds);[35] official lenders (the IMF, the World Bank); significant policymakers, such as the United States (Justice Department and Treasury); the role of debt-rating agencies; the Paris and London creditor clubs; and the US judges with jurisdiction over sovereign bond litigation.[36] There has been limited interest in either understanding how societies cope when credit markets fail or the impact of state intervention and the contribution that social movements such as the takeovers make to post-crisis economic recovery.

32 L C Buchheit, "Changing bond documentation: the sharing clause" (1998) 17 *International Financial Law Review* 7, p. 17; L C Buchheit, "The collective representation clause" (1998) 17 *International Financial Law Review* 9; L C Buchheit and M Gulati, "Exit consents in sovereign bond exchanges" (2000) 48 *UCLA Law Review* 13, pp. 59, 83; L C Buchheit and M Gulati, "Sovereign bonds and the collective will" (2002) 51 *Emory Law Journal* 4, pp. 13, 17.

33 T I Palley, "Sovereign debt restructuring: what is the problem?" (2003), available at www.imf.org/external/NP/EXR/seminar/2003/sdrm/pdf/palley.pdf (last accessed 25 August 2011).

34 A C Porzecanski, "From rogue creditors to rogue debtors: implications of Argentina's default" (2005) 6 *Chicago Journal of International Law* 311.

35 Ibid.

36 J T Gathii, "The sanctity of sovereign loan contracts and its origins in enforcement litigation" (2006) 38 *George Washington International Law Review* 251; M Miller and D Thomas, "Sovereign debt restructuring: the judge, the vultures and creditor rights" (2007) 30(October) *World Economy* 1491.

Further, mainstream sovereign debt-regulation scholarship is currently dominated by creditor and debtor concerns. In the context of Argentina, for instance, the self-regulating sovereign debt market is underpinned by a legal framework that protects the property rights of creditors and the interests of the debtor state rather than the interests of the workers. However, in the event of a sovereign default and the collapse of domestic credit markets that trigger large-scale unemployment, the workers are exposed to the risks of profligate lending and borrowing. Apart from the focus on the interests of the dominant market actors, there is a commitment to self-regulation.

Thus, debtor states and creditors have resisted the idea of regulatory intervention such as an international sovereign bankruptcy court. The recently released draft recommendations of the Commission of Experts on Reforms of the International Monetary and Financial System headed by Joseph Stiglitz (under the aegis of the UN), for instance, sets out a model for an international sovereign debt bankruptcy court.[37] In such a court, the social costs of a crisis would need to be identified and stakeholders – such as, the unemployed workforce – would have a forum to voice their claims. The sovereign debt market remains committed to self-regulation. It is, therefore, not surprising that the regulatory debates that followed the Argentine debt crisis were mainly focused on understanding how best to modify the collective action provisions in bond contracts to resolve what economists refer to as the collective action problem.[38]

This commitment to self-regulation also denies affected stakeholders a voice in mainstream regulation and legal scholarship. In this context, the takeovers represent the "weak"[39] who "create opportunities for themselves to change existing regulatory orders".[40] The takeovers represent complex and intersecting "webs of dialogue"[41] between the workers, their families and the communities in which they are located. They generate a template of how to recover factories and initiate and sustain production when credit markets fail and, as such, also provide a snapshot of how societies respond to a debt crisis. In this way, they offer what Braithwaite and Drahos refer to as "alternative models of regulation".[42] Further, in the face of the globalisation dilemma discussed above, the takeovers open up the question of whether an international bankruptcy court is an essential component of a renegotiated "embedded liberalism". It is here that the contribution of the takeovers to the sovereign debt regulation is important. So, an examination of contemporary cooperativism is a crucial part of this discussion.

Cooperative literature

There is a similar reluctance in the cooperative literature to acknowledge the takeovers as a viable template for post-crisis state intervention. This is attributable to several factors, not least ideology, the predominantly local concerns of the takeovers and a couple of high-profile defensive takeovers in the past.[43] Further, the takeovers were independent of state and sometime trade union intervention and are, as such, viewed as "one-off" short-term

37 The recommendations of the Committee of Experts are available at www.un.org/ga/president/63/letters/recommendationExperts200309.pdf (last accessed 10 August 2011).

38 See n. 32 above.

39 Braithwaite and Drahos, *Global Business Regulation*, n. 5 above, p. 32.

40 Ibid.

41 Ibid..

42 Ibid.

43 P Rob (with the assistance of R Duhm, S Gherardi, J-L Lavilee, C Ostero-Hidalgo, R Spear and A Westenholz), *Reluctant Entrepreneurs: The extent, achievements and significance of worker takeovers in Europe* (Milton Keynes/Philadelphia: Open University Press 1989).

successes offering limited justification for state funding and support. Thus, from the perspective of the cooperative literature, there is a perception that takeovers on the whole have limited economic viability and sustainability.[44] This remains true and even more so when compared to the economic resilience of corporations in the context of self-regulating credit markets. However, a focus on the *economic* viability and sustainability of the takeovers tends to obscure their *political* significance.

In the policy initiatives that aim to redress the liquidity problems a distressed sovereign faces, a key aim is to prevent default. In the face of creditor opposition, both bankruptcy and default are not options for distressed sovereigns. This is the case even though bankruptcy is otherwise essential to sustain corporate capitalism. It is clear that smaller takeovers can successfully manage production in periods of crisis.[45] Thus, though they may not be perceived to be economically viable or sustainable in the long run, as mentioned above, the success of the takeovers as cooperatives is premised on the context in which they operate. In the case of the takeovers, their success was attributable to a fundamental restructuring of pre-crisis property rights. It is in this context that the cooperative organisational form successfully cushions labour when credit markets fail.[46] This fundamental restructuring of property rights is an unintended consequence of sovereign default. In the face of creditor resistance to a formal bankruptcy procedure, it is a forum for workers to represent their claims as stakeholders independent of the claims of the debtor state and its creditors. The success of the takeovers indicates what could become a template for social movements that arise in response to a credit crisis when the bargain between the state and the polity is fractured. This is the political contribution of the takeovers and there is thus a clear mismatch between the reputation of takeovers and their putative contribution to post-crisis recovery and regulatory scholarship.

Takeovers – long or short-term – represent a breakdown in the relationship between the state and its polity, as discussed above. This is especially true in post-crisis economies, such as Argentina, where the economic resilience of the takeovers in contexts where credit markets had collapsed had political consequences for them. Their resilience is premised on a restructuring of their relationship with the state. This restructuring is triggered by the failure of the self-regulating markets on which the state was reliant and is evidenced by the transformation of pre-crisis property rights that underpins self-regulation. The political implications of the takeovers are overlooked in the mainstream cooperative literature. This literature is largely confined to contexts other than financial crises, such as the Argentine debt crisis or the ongoing credit crisis in the United Kingdom.[47]

The following section discusses the mechanisms through which the takeovers achieve their principle goal of continuing production without access to credit markets.

Lessons from the Argentine takeovers

The Argentine debt default

In the early 1980s, Argentina restructured its economy to facilitate the access (and therefore the dependence of) small and medium-scale enterprises to foreign credit markets. The Argentine debt crisis was triggered by a default of its debt owed to foreign (mainly US creditors). There is little consensus on what triggered the Argentine debt default. Some

44 Rob et al., *Reluctant Entrepreneurs*, n. 43 above.

45 Ibid.

46 K Bradley, "Employee ownership and economic decline in Western industrial democracies" (1986) 23 *Journal of Management Studies* 57, pp. 64–5.

47 Rob et al., *Reluctant Entrepreneurs*, n. 43 above.

argue that the default was precipitated by irresponsible borrowing by a "rogue debtor",[48] others blame profligate lending by creditors who did not undertake adequate risk assessment of the capability of Argentina to repay its debt.[49] Others squarely blame the IMF in not anticipating default until it was too late. In any event, in the decade leading up to the default, the country was the "spoiled child of the Washington Consensus".[50] Its economy was restructured to accommodate the "Washington consensus"'.[51] Its industry was privatised, its economy deregulated, trade barriers lifted and even its currency (the peso) was pegged to the US dollar.[52] The structural adjustment of the Argentine economy engendered the conditions necessary for self-regulating domestic and sovereign debt markets.

In late 2001, after the IMF refused to rollover the Argentine debt,[53] the "second largest economy in South America with a population of 38 million"[54] collapsed. The country's loss of access to foreign credit markets left "a quarter of its workforce unemployed and a majority of the population under the poverty line".[55] Prices for basic food items such as bread, noodles and sugar rose significantly.[56] With default and widespread bankruptcies, labour markets collapsed with low labour mobility and the market value of land and machinery plummeted. Though there is no agreement on who was responsible for the situation that precipitated the default, there is a broad consensus that the social costs of the debt crisis triggered by default were deeper and more extensive on account of the exposure of the Argentine economy to international financial markets. The social costs were exacerbated by repeated rollovers by the IMF of Argentina's debt obligations; increasing debtor moral hazard and further irresponsible lending.

The debt crisis that followed the default precipitated political uncertainty. For the unemployed workers of bankrupt factories, this uncertainty meant that state intervention to remedy their situation was not immediately forthcoming. As mentioned above, when compared to the pre-crisis economy, the Argentine default caused two fundamental shifts in the property rights structure. At one level, sovereign default is a taking of creditor property (Argentina issued US bonds under US law). At another, the absence of credit led to widespread bankruptcies of the factories that were eventually taken over by the workers.

Socialised production

In the cooperative literature, takeovers are defined as cases "in which a business is continued, or created on the basis of the assets of an endangered or bankrupt enterprise, by the workforce or part of it, within . . . a cooperative framework".[57] This article is concerned with local or "participative" takeovers in a post-crisis economy which is a smaller sub-set of this larger category. Participatory takeovers typically involve the takeover of small or medium-sized production units, with the workers involved in planning, lobbying,

48 Porzecanski, "Rogue creditors", n. 34 above.

49 P Blustein, *And the Money Kept Rolling In (and Out):Wall Street, the IMF and the Bankrupting of Argentina* (New York: Public Affairs 2005).

50 Ibid. p. 5.

51 Ibid. p. 6.

52 Its mainly US creditors only lend in US dollars to minimise their risk. this means that Argentina has to repay the interest and capital it owes in US dollars. It is widely believed that the debt crisis was triggered by the refusal of the IMF to help with its loan repayments, though there is no similar consensus on the reasons for the debt crisis: ibid.pp. 1–12.

53 Ibid.

54 Ibid. p. 7.

55 Ibid. p. 4.

56 Ibid. p. 2.

57 Rob et al., *Reluctant Entrepreneurs*, n. 43 above, p. 16.

providing finance and developing their own participative or self-management structures. However, it is stressed here that the visibility and main impact of participative takeovers are local. The ability to sustain production in a post-crisis economy is a function of their embeddedness[58] in the local communities. The takeovers examined here are both "[g]eographically and ideologically . . . situated deep within the community in which each enterprise finds itself".[59] It follows that "there is both a spatial dimension and a community imaginary that intermingles with [its] emergence."[60]

This section describes the conditions in which takeovers successfully transition into cooperatives. In the absence of access to credit markets, the success of the takeovers in generating new lines of credit is a function of the extent to which they can successfully socialise production. Production is socialised through their innovative use of the factory, shop floor and their time and engendered independently of "the external coercion of the market and the state (and trade unions)." Socialised production is defined as a situation in which the spatial continuity between the factory and the community engenders a community imaginary both among the workers as a group and between them and the community in which they are located. In other words, production in the factory taken over is possible because it is socialised.

In the recovery phase of the takeover, that is when they successfully resume production, this community imaginary becomes an inextricable part of the production process. This allows takeovers to overcome the failure of credit markets. In this respect, a distinction can be made between the "recovery" phase of a takeover and its "sustainability or long term viability"[61] phase. The success of participative takeovers is mostly confined to the recovery phase. There are often insurmountable difficulties in takeovers managing the transition to the sustainability phase.[62] This is attributable in no small part to attempts by the state to reintegrate them into formal credit, labour and property markets.[63] This often entails disembedding the enterprise from the community and dismantling the mechanisms that make socialised production possible. This is also attributable to the restructuring of self-regulating credit markets where the legal and regulatory framework is geared towards limiting creditor risk and liability. Thus self-regulation is conducive to corporatism defined by separate corporate personality and limited liability.

The following paragraph sets out the socio-economic conditions in Argentina that preceded the takeovers and then proceeds to examine socialised production as a mechanism that allows the workers to resume and – in some cases – sustain production. This section develops the argument that socialised production – the mechanism that allowed the workers to resume production – was engendered in conditions where the property rights framework was fundamentally restructured.

58 The word "embeddedness" used here is closer to the term as defined by Granovetter rather than Polanyi. The Polanyian notion refers to actions by the state to fire-fight the consequences of laissez-faire. The Granovetterian notion is closer to the sociological concept of relationships. For a discussion of the Granovetterian conception of embeddedness, see G Krippner, M Granovetter, F Block, N Biggart, T Beamish, Y Hsing, G Hart, G Arrighi, M Mendell, J Hall, M Burawoy, S Vogel and S O'Riain, "Polanyi symposium: a conversation on embeddedness" (2004) 2 *Socio-economic Review* 109.

59 Vieta, "Social innovations", n. 2 above.

60 Ibid.

61 Rob et al., *Reluctant Entrepreneurs*, n. 43 above.

62 Vieta, "Social innovations", n. 2 above.

63 Dinerstein, "Workers factory takeovers", n. 9 above, p. 6.

In his empirical examination of the Argentine takeovers, Marcelo Veita reflects on a key feature of this movement: the "democratization" and "cooperatization"[64] of labour. This translates into workers "caring for one another, horizontality, self-reliance, equity . . . [to ensure] dignified and human working conditions".[65] The takeovers were successful because workers were performing functions beyond those required by their individual jobs or employment contracts. They "learned how to step in for one another for the job to get done".[66] In his empirical examination, Veita notes that the "social bonds" between workers "were solidified during moments of intense political and economic struggle".[67] The extent to which they successfully socialised production made the factories economically viable despite extremely difficult economic circumstances. The following paragraphs describe the nature and characteristics of socialised production using the example of the Brukman takeover.

The Brukman takeover

The Brukman workers manufactured hand-sewn fine silk suits for men. They successfully took over their factory located in a neighbourhood in Buenos Aires. As far as the Brukman workers were concerned, their problems with the management preceded the default. For instance, in the period leading up to the default, their wages had decreased from $100 per week in 1995 to between $5 and $2 per week towards the end of 2001, which was unpaid. In this case, the immediate trigger for the takeover was when the management left the factory on the pretext of getting the unpaid wages from the bank and did not return.[68] On 18 December 2001, 30 workers occupied the factory. They stayed on, returned to their sewing machines and continued to process outstanding orders. Gradually, each worker received an equal wage and all workers were paid weekly in cash. Workers were not paid for the days that they did not work.[69] All the workers had children and the women worked primarily to support their families so initially their incentive for resuming production was to meet pressing needs rather than generating profit. The workers had successfully resumed production in the absence of access to formal credit markets and still manage the factory as a statutory cooperative. This section describes how the workers socialised production – a key feature of Brukman and other takeovers. Through the development of innovative organisational changes and production strategies, they opened up the enterprise to the local community.

As far as Brukman was concerned, at the time of the takeover in 2001, a part of their profit came from exporting finished garments to China.[70] This was one source of their income. Another key source was by selling the goods they produced in local markets.[71] To make the transition from the actual takeover to recovery the workers created a makeshift store on the ground floor.[72] The success of this move gave them access to the cash they

64 Vieta, "Social innovations", n. 2 above, p. 297.

65 Vieta, "Social innovations", n. 2 above, p. 303.

66 Ibid. p. 303.

67 Ibid. p. 312.

68 M C Spieczny, "When workers take over: reclaimed factories in Argentina", unpublished thesis presented in partial fulfillment of the requirements for the degree of Bachelor of Arts, Department of Sociology, Princeton University (2004), available at www.cmd.princeton.edu/papers/Thesis%20Molly%20Spieczny.pdf (last accessed 25 August 2011).

69 Ibid. p. 32.

70 Though information on what extent of their profits came from exports is sketchy, this demand would have been critical at the time of the debt crisis where local market conditions where depressed.

71 This again is surprising as the workers relied on their "embeddedness" in the local community to generate their income at a time when the economy was in a severe downturn. Spieczny, "When workers take over", n. 68 above, p. 14.

72 The fact that they could sell any suits at the time of a severe downturn reflects their innovative ability to develop new lines of credit in the local market.

needed to travel home. A few weeks after the takeover, a client offered to pay them if they could finish the 200 suits he had ordered before the crisis. They took up his offer and successfully executed it. Four months later they were finishing up old orders, selling suits and even taking in new orders. The local demand for the goods they produced sustained the takeover through the economic downturn and was crucial to its success in the recovery period. They were creating new markets by tapping into the demand for suits in the local community in which they were located. Their running expenses were met and wages paid in the absence of access to credit markets. More generally, the takeovers generated new lines of credit through innovations such as barter, reliance on the community to provide childcare, and setting up of communal soup kitchens.

Another feature of the transition of the Brukman takeover to a cooperative was when they socialised production through innovative changes in shop-floor arrangements. In the pre-crisis factory, production was geared to increase profit. The behaviour of the workers was sought to be constrained by their employment contracts. The management sought to minimise personal interactions between workers. The rationale behind this was that such interactions would be inefficient. Also, workers were encouraged to focus on their individual jobs and there was a resistance to allowing workers to undertake more than one task. The workers were deemed unable to multitask.

This management style was reflected in the organisation of the shop-floor. So, for instance, when the factory was run by its former employers the sewing machines were arranged in rows facing the same direction. Each worker faced the back of the worker in front. After the takeover many of the machines faced each other. This new arrangement built on and reinforced the relationships between the workers. This new setup created an environment more conducive to learning and multitasking. So, for instance, workers who usually sewed jacket collars could easily go to machines on the other side of the room and have co-workers teach them how to sew inseams. Without an employer and the absence of an organisational hierarchy, an important aspect of their viability required the workers not only to do their jobs, but also to look around them and make sure everything was running adequately and that nobody was shirking their duties.[73] This strengthened their social relationships.[74] To the extent that production after the takeover relied on the relationships workers shared between themselves, it was socialised.[75]

Socialised production was also characterised by the non-hierarchical and participative management structures the workers developed. In Brukman, for instance, there were no set administrative positions. Instead, the workers created different internal *commissones* (committees) to oversee different aspects of the factory's operations. There were committees for administration, quality control procedures, organisation, accounting, selling and other matters.[76] After the takeover, the workers held weekly meetings with extra meetings scheduled in case of emergencies. At the meetings, workers could bring up any topic or issue and everyone ensured that each had a say and a vote in decisions. Votes were cast by show of hands. All workers were required to attend weekly meetings and, if for some reason several workers were absent, the meetings were cancelled or rescheduled. All decisions made at these meetings were recorded. Outsiders were not allowed to attend these

73 Spieczny, "When workers take over", n. 68 above, p. 46.

74 Ibid. p. 22.

75 This material was used to examine the Brukman takeover from a gendered perspective. See D Thomas, "Women workers take over power at the margins: economic resistance, political compliance" in S Kouvo and Z Pearson (eds), *Feminist Perspectives in Contemporary International Law: Between resistance and compliance?* (Oxford and Portland, Oregon: Hart 2011), pp. 193–214.

76 Spieczny, "When workers take over", n. 68 above, p. 36.

meetings, though specialists were occasionally admitted for specific purposes.[77] This cooperative management structure was not confined to Brukman. Vieta, for instance shows how the workers adopted "the worker cooperative model . . . [that] encourages each worker–member to have an equal say in the running of the recuperated shop. This is most readily visible in the regular worker's assemblies and elected workers councils that administer"[78] them.

Another feature of socialised production was how the workers utilised both the revenues they generated and the factories they took over. As far as the revenues were concerned, there was always some provision made by them for the local community in which they were embedded. This provision varied with different takeovers, some, for instance, divided their revenues into salaries, capitalisation costs and community service. Community service replaced debt and interest payments.[79] Others gave back to the local community by running waste recycling units and maintaining parks.[80] Further, the factory premises were used in a very different way when compared with the pre-crisis use where legal mechanisms, such as incorporation, individualised the ownership of the land, the building and machinery. In the case of the takeovers, the resources that were key to the production process – property, labour and capital – were viewed as community resources rather than for the sole use and benefit of the legal person or the workers that managed them. This indicates how the conditions that engender cooperativism are distinct from those that engender corporatism (a factor overlooked in contemporary visions of cooperativism discussed above).

Organisationally, the boundaries between each takeover and the community in which they were embedded were porous. So, for instance, the factories taken over "were opened up to the community".[81] Many of the factories doubled up as cultural and community centres, free community health clinics, popular education schools, alternative media spaces, and even community dining rooms run by workers, neighbours, or volunteers.[82] This generated new lines of credit outside the formal credit markets. In addition to the economic significance of this aspect of socialised production, the blurring of the boundaries between private and community spaces had two benefits – one social and the other political. First, for the takeover, it entailed giving back to the community for the support they have received. Second, by socialising production in this way the takeovers protected themselves from attempts by the state (at the behest of former employers or otherwise) to evict them as the authorities would have to reckon with the local community as well as the workers.[83]

It is clear that the success of takeovers such as Brukman depended on the extent to which the workers socialised production in the recovery phase of the takeover. This is distinguishable from the pre-takeover factory where their cooperation to achieve production targets had to be "legally" geared. This was usually done through the employer's reliance on externally imposed formal, legal institutional forms (e.g. incorporation) and through the provision of individual incentives (e.g. wages) to cooperate in ways that increased profits and ensured payment of wages. However, despite their successes, socialised production per se did not guarantee either the sustainability or economic viability

77 Spieczny, "When workers take over", n. 68 above, p. 40.
78 Vieta, "Social innovations", n. 2 above, p. 303.
79 Ibid. p. 312.
80 Ibid. p. 312.
81 Ibid. p. 313.
82 Ibid. p. 313.
83 H Palomino, "The workers movement in occupied enterprises: a survey" (2003) 28 *Canadian Journal of Latin American and Caribbean Studies* 71.

of the takeovers. The two main problems the takeovers continue to face in post-crisis Argentina are "chronic underproduction compared with original production levels under owner management and a continued overreliance on competitive markets".[84] A key factor for limited sustainability is a lack of access to credit markets.[85] The experience of the takeovers indicates the dangers of an economy still reliant on self-regulating credit markets. Further, access to capital markets is fraught as it comes at a cost to their cooperative organisational structure. In the long run, takeovers are inter alia pressured into adopting hierarchal management structures that reflect the pre-takeover management and assets are required to be privatised formalising the otherwise open interface with the communities in which these are located. This – as was discussed above – is necessary to limit investor risk and responsibility.

The gains made by the takeovers are significant. They cushion labour in periods of unemployment by meeting both production and welfare needs. However, their success is premised on a fundamental restructuring of the property rights framework that defined the post-crisis economy. It has been argued here that, though the problems of their sustainability in a context where they have to co-exist with self-regulating credit markets are significant, their lasting contribution to regulatory debates lies elsewhere. The takeovers generate a template for renegotiating the bargain between the state and markets that begins with the dismantling of the property rights that underpin self-regulating credit markets.[86]

It is here that the takeovers make an epistemic contribution to regulatory debates in the context of the ongoing current credit crisis. As discussed in the preceding section of this article, the current crisis represents the fracturing of "embedded liberalism": the bargain between the state that relies on self-regulation of financial markets and the polity which agrees on the condition of a guarantee of social protection against the consequences of self-regulating markets. The contemporary visions of cooperativism discussed were seen as attempts to renegotiate this bargain without a fundamental restructuring of the property rights frameworks that underpin self-regulating credit markets (and contemporaneous corporatism).

The takeovers challenge this "talk" of cooperativism. Though the ongoing credit crisis is not as dramatic or convulsive as the Argentine sovereign default, the latter also represented a similar collapse of embedded liberalism or the bargain between the state that relied wholly on self-regulating markets and the polity. In this context, the takeovers – albeit briefly for some – negotiated a new bargain by drawing their political legitimacy from the local community rather than from state or legal recognition.[87]

Conclusions

In his introduction to Polanyi's *The Great Transformation*, Joseph Stiglitz draws the similarities between Polanyi's concerns about the social costs of self-regulating markets and "the issues raised by the rioters and marchers who took to the streets in Seattle and Prague in 1999 and 2000".[88] The rioters and marchers challenged the legitimacy of the policies of international financial institutions and their commitment to self-regulating financial markets. In a similar

84 Vieta, "Social innovations", n. 2 above, p. 304.

85 Ibid. p. 304.

86 The view that sovereign default is an option that is better than restricting is slowly gaining acceptance. For a discussion on the issue see H Stewart, "Defaulting rescued Argentina. it could work for Athens too", *The Guardian*, 10 July 2011, available at www.guardian.co.uk/business/2011/jul/10/european-debt-crisis-argentina-imf (last accessed 25 August 2011).

87 See Thomas, "Women workers", n. 75 above.

88 Polanyi, *The Great Transformation*, n. 24 above, p. vii.

vein, this article draws attention to the likenesses between Polanyian concerns and the takeovers in the aftermath of the Argentine default. Like the marchers Stiglitz refers to, the takeovers also challenge the legitimacy of policies of international financial institutions and their commitment to self-regulating financial markets. The takeovers went even further than "the marchers and rioters who took to the streets". In a post-default economy, they relied on the communities in which they are embedded – rather than the state – to gain their political legitimacy. As cooperatives, they provide an alternate organisational template on which the bargain between the state and the polity can be renegotiated. The Argentine takeovers offer a template of cooperativism that reduces the state's reliance on self-regulating markets and the dominance of corporatism.

The success of the takeovers as cooperatives also highlights the necessity of market regulation. As their experience suggests, the success of cooperativism in a credit crisis is premised on a fundamental restructuring of the property rights framework that currently underpins self-regulating financial markets. Further, their economic viability is premised on access to credit through their links with the communities in which they are embedded. In the absence of such intervention, contemporary visions of cooperativism across the political divide in the UK are in danger of being confined to the margins of self-regulating markets (and corporatism). For the reasons set out, it is time that the takeovers are recognised as epistemic communities in mainstream regulatory scholarship.

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Part III: Competition law as a form of embedding economic relationships in social ones?

The concept of perfect competition as the law of economics: addressing the homonymy problem

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Abstract

The rapid expansion of economic analysis is visible in many areas of law. In some of them – in antitrust in particular – economic reasoning is already perceived as the dominant discourse. This article is an attempt to contemplate a reverse analysis. Instead of addressing the legal domain from the perspective of economics, it tries to explore the economic discipline through the lens of a lawyer. The analysis is directed at one of the main principles of neoclassical economics – the concept of perfect competition: partly to explore its constitutive role in economic reasoning, but also in order to articulate the misconception with which some economists approach legal regulation of economic relations. It attempts to explain why economic analysis is bound to address broader societal problems in a purely pragmatic way, quantifying the whole spectrum of societal values, reducing them to the common economic denominator of efficiency. This feature of economics is embedded in its epistemology and should not be perceived as its normative claim. In other words, the fact that welfare economics reduces the social interests to cost–benefit calculus does not automatically characterise it as being irresponsive to the social embeddedness problem.

Introduction

Social institutions have always played a significant role in the market process. However, this role has not always been recognised. Many thinkers have tried to develop an algorithm for reconciling laissez-faire principles of market economy with broader societal needs. The issue has been addressed particularly by economists, lawyers and political scientists. All three disciplines were later influenced by sociology which, despite developing its apparatus relatively recently (compared to the three older counterparts), often provides guiding principles for other disciplines in this respect. Economic sociology perceives the social aspects of economic relations as its core subject area. Polanyi is considered among the most influential thinkers in this field. He *methodologically* criticises the dominant early twentieth-century view on the natural spontaneity of the market process, conversely considering the societal reaction to laissez-faire as a spontaneous response to excessive liberalism.[1] On the *normative* side, he insists upon the necessity of restricting survival-of-the-

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1 K Polanyi, *The Great Transformation* (New York: Octagon Books 1980), pp. 46–8.

fittest principles of economic selection with a range of institutional limits. He thereby redirects the objectives of economic activity towards more socially significant goals.

This article does not address the *normative* dimension of his concerns, concentrating mostly on the *methodological* part of the embeddedness problem. Polanyi's *normative* argument is now widely accepted by liberal democracies as a redistributive principle of social cohesion, thereby shifting the discussion away from the matter of principle (i.e. either/or) to the matter of scale (i.e. how much market freedom should be reserved versus how significant the social concerns are). The issue therefore becomes more dependent upon the context of its application, providing wider scope for empirical studies and inductive argumentation, and forcing a purely theoretical analysis to be either ideologically prescriptive or historically descriptive.

The task of this article is different. Being written by a competition lawyer, it naturally inclines towards developing two main narratives: the competition-centred and the law-centred. Both can often be approached interdependently, though sometimes they require separate treatment. Inasmuch as the competition-centred narrative should be based upon some normative claims – which go beyond the established borders of the topic – it will only be highlighted for the sake of the consistency of the main argument. It will be presumed that the competitive process is an important element of liberal democracy, which should be reduced neither to the epistemological concept of perfect competition nor to the normative goal of consumer welfare. Instead, the article concentrates mostly on the latter, law-centred, aspect of the problem. Remaining within the realm of theory, it does not address any issues related to the positive law of economic regulation. Its task is to explore from a legal mindset two important aspects of the embeddedness problem: (i) the principles of economic reasoning which predetermine the way in which economics addresses important societal problems (and in particular the market process) and other disciplines (and in particular the law); and (ii) the issue of the interdisciplinary interactions between the legal and economic discourses.

Two other issues remain to be clarified. First, in analysing the economic reasoning, the article takes an approach which is external to economics itself. Its task is not to provide an economic explanation of social problems, but to explore the phenomenon of economic thinking itself. It is made primarily in response to the reverse exercise, which economics is frequently doing with the domain of law. That is, rationalising legal discourse by its cost–benefit calculus, supplemented with the psychological studies on the behaviour of individual agents. Secondly, as will be argued, one of the main components of economic reasoning is the concept of *perfect competition*. This notion should not be confused with the *competitive process*, which is among the primary concerns of competition *law* and is also called "competition".

The homonymy of the concept of *competition* demands that particular attention be paid to its categorisation. The terminological situation is even more complicated because the different meanings of competition are often used interchangeably – partly because they are closely connected, but also because different disciplines are not always aware of the terminological specificities of the word in other subject areas. The term *perfect competition* reflects a stable hypothetical state, whereas competition in the sense of the *competitive process* espouses the dynamism of market agents. Those two concepts are substantially different, though they are often mistakenly considered as synonyms. The economic analysis of competition is centred on the theory of equilibrium, a theoretical model of universal nature that enables us to understand economic relationships in a relatively coherent, logically correct and predominantly mathematical way. The importance of equilibrium in economic thinking is paramount. A majority of economic schools accept it as their main operational principle and even those who reject it still remain within its rationale. By pointing out the problematic aspects of the economic method, they are predominantly set to *improve* the model rather than to *disprove* it. They add to the system more variables, unknowns and subjectivities, but are still considering equilibrium as the starting point and benchmark of economic analysis.

The concept of perfect competition is a main parameter of the equilibrium model. But the terms *perfect* and *competition* are easily misunderstood by social scientists relying on the same concepts in different areas. The term competition in this respect is taken as a hypothetical point at which demand fully meets supply. It is a theoretical parameter that should not be considered as reality. In a real situation, this important methodological tool transforms itself into a utopian dream, a certain reverse communism, where all the actors live a happy and long economic life. Under conditions of perfect competition there is no competition in the dynamic sense of the term. The same holds true for the term perfect: its perfectness should again be taken as an internal value for the purposes of modelling and not as a value judgment on the absolute quality of competition. Therefore, in the dynamic sense, the term perfect competition is neither prefect nor competition. However, for the purposes of equilibrium modelling the term maintains both *perfectness* and *competitiveness* reflecting the situation in abstract logical thinking and not the situation in the real market.[2]

Another homonymy should be highlighted as well. The main principle of welfare economics is based on the central role of free competition ("free" in the equilibrium sense of the term) in the process of maximisation of societal welfare. This role is of natural, mechanical essence. The adjective *free* is used in equilibrium economics in its technical, economic sense. It should not be perceived as an ideological statement against big government and in favour of economic freedom of market participants. Freedom in the equilibrium sense of the term has a different meaning. It is a mechanism of price determination, which implies that suppliers and consumers are not restrained in their choices and react on the situation in the markets by changing their respective supply and demand. Freedom in equilibrium economics primarily has an applied or operational character and is not of a substantive nature. It is pursued for the sake of the equilibrium and not as an ethical standard. The economic equilibrium is not hostile to freedom in its ideological sense but these aspects of freedom go beyond its scope.

The article proceeds as follows: it begins with explanation of the problem of general equilibrium, specifying the context in which the term is used and clarifying its role and significance for economic reasoning. The next section explains why the concept of perfect competition is the central part of economic thinking, followed by an analysis of attempts to modify its main premises. The article seeks to classify the main critical approaches to the concept of perfect competition into three main groups, and in the following section reverts to the third (external) one, which explores the principles of perfect competition from the institutional perspective. In its third part, the article addresses the issue of interdisciplinarity, describing different approaches to the relationship between economics and law. It argues for the necessity of maintaining epistemological borders between the disciplines.

The principle of general equilibrium as the archetype of economic reasoning

The idea of economic equilibrium constitutes the main conceptual narrative of economics. Its dominant apparatus is based on advanced mathematics; its methodological framework is a situation in which the hypothetical supply and demand curves intersect (market clearing

2 The term perfect competition faces in this respect the same problems as the term ideal law. The latter is often misunderstood as being the best and perfect law: ("ideally we would live forever"), whereas from the perspective of legal theory, idealism also encompasses the philosophical foundation of a phenomenon, reflecting its ideal as opposed to material side.

equilibrium). In game theoretic literature, the principle is applicable to a situation where the agents do not deviate from their strategies, having taken into consideration the expected behaviour of their counteragents (Nash equilibrium).

In spite of the intuitive simplicity of the principle itself, its application in economics is very complex and not always unequivocally accepted by different economic sub-disciplines. The principle is applicable in static as well as in dynamic modelling. It plays a bigger role in macro- than in micro-economic analysis. Some fields of the latter – particularly industrial organisation and game theory – are often sceptical as to the universality of equilibrium analysis. Industrial organisation is interested in the structure and strategic conduct of firms. It supplements the basic premises of equilibrium with "real-world" parameters of asymmetrical information, barriers to entry and transaction costs. Behavioural economics concentrates primarily on psychological factors of the individual decision-making process. Approaching their subjects primarily from the bottom-up inductive perspective, both industrial organisation and behavioural economics are capable of overcoming the generalist presumptions of equilibrium.

However, as soon as the observed peculiarities of economic conduct are re-systematised, the proposed substitution may often have a shape of another, more advanced, equilibrium. The more factors included in it, the less universal its functionality becomes, which usually requires another approximation. In general, the opponents of equilibrium economics suggest that its analysis does not leave any room for market subjectivity, unpredictability and the entrepreneurial desire to maximise profits. However, the behaviour of entrepreneurs is taken as a dynamic aspect of equilibrium. It implies that the comprehensive modelling is a perpetual movement from one disequilibrium situation to another. The process itself constitutes an equilibrium which in real-life situations is an unachievable benchmark. The equilibrium is not static in this respect, because the process of adjustment of supply to demand has its natural centre of gravity in equilibrium, but the process itself is predetermined by disequilibrium conditions. A state of equilibrium in this respect is a theoretical, conditional point where profits achieve the level zero.[3] As no entrepreneur is interested in minimising their profits, they reduce their interests in this market, increasing in turn the demand and opening further possibilities for competition, which creates preconditions for new disequilibria. The term "equilibrium" is also used in economics in several other contexts (for instance, the concept of "multiple equilibria" and "non-unique equilibria" to model situations with more than one potential outcome).

Nevertheless, it is possible to argue that, although the principle of equilibrium itself is not always considered to be the main economic instrument of a particular type of economic analysis, it is still a fundamental tool of general economic *reasoning*. However critical some branches of economic theory might be of the principle of economic equilibrium, it can seldom be abandoned by them outright. It should be pointed out, therefore, that this article is limited to the analysis of the concept of equilibrium only in its basic sense. It addresses the more advanced or complicated models of equilibrium solely for apagogical purposes; trying to demonstrate that in spite of their criticism of the basic principles of equilibrium, they are epistemologically embedded into the principle itself. As Kaldor shows, many attempts to disprove the premises of the general equilibrium lead to the thickening of its fundamental premises, making them more impenetrable.[4]

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3 "Profit" in economics is surplus gains over and above costs and profits needed to make the activity worthwhile, known as the difference between normal and super-normal profits. In this respect, it is different from an accountant's understanding of profit.

4 N Kaldor, "The irrelevance of equilibrium economics" (1972) 82 *Economic Journal* 1237, p. 1239.

This article presumes, therefore, that the notion of equilibrium constitutes the *archetype* of economic reasoning, which is extrapolated to the vast majority of the modes of economic analyses. Kaldor further explains in this respect that the notion of the general economic equilibrium, as originally formulated by Walras, was developed by the mathematical economists "with ever-increasing elegance, exactness, and logical precision".[5] From this purest abstract neoclassical perspective, equilibrium could be considered in terms similar to "Newton's theory of forces"[6] or "a Euclidean line or point".[7] Comparing the cognitive role of equilibrium in economic analysis to the role of a constitution in legal theory, the role of ideology in political studies or the role of grammar in linguistics would not overstate its position of natural logical benchmark for economics to collate all relevant factors. Economic thinking by its nature tends to apply mathematical and statistical methods. This *naturalness* means that the equilibrium rationale had been implicitly applicable in economics even before the institutional development of the theory of equilibrium economics as such.

In spite of the extensive *internal* criticism of the methodological purism of the general equilibrium economics – some of the most common types thereof will be addressed by this article – and in spite of the *external* criticism which the article itself puts forward, the concept of equilibrium is treated with due respect. Unlike the criticism from the angle of economics, the opposition as developed in this article strives neither to improve nor disprove the main premises of equilibrium economics. Its task is different. It primarily aims to *understand* the specificity of economic reasoning, perceiving equilibrium analysis as the cognitive economic tool. The secondary task of the article is to demonstrate that the helpful revelations which are possible with equilibrium analysis cannot overcome the disciplinary boundaries of economics. This article acknowledges how equilibrium analysis can be expanded to jurisprudence as well as to broader societal issues, but it is critical of the *exclusivity* of universalising economic modelling. The final task of the article is, therefore, to demonstrate the disciplinary specificity of legal discourse, which *can* be reduced to the principles of economic reasoning, yet does not *have to* undergo such reductionist contemplations.

The concept of perfect competition

The idea of perfect competition reflects the equilibrium situation. Competition achieves its perfect level at the hypothetical point when demand fully meets supply. In this imaginary situation, competition taken in its literal, societal sense does not exist at all, because there is no possibility of pursuing individual interests without destroying the equilibrium. Competition in this sense is a purely theoretical situation. Unlike the Smithian concept of competition, which is essentially one of business behaviour that McNulty associated with the verb "to compete", the concept of perfect competition is deprived of any behavioural content and focuses entirely on its effects. These two definitions of competition are incompatible, to the extent that "[c]ompetition came to mean, with the mathematical economists, a hypothetically realized situation in which business rivalry, or competition in the Smithian sense, was ruled out by definition".[8] McNulty's point is developed in the Hayekian tradition, stating that "'perfect' competition does indeed mean the absence of all competitive

5 Kaldor, "The irrelevance", n. 4 above.

6 O Budzinski, "Monoculture versus diversity in competition economics" (2008) 32 *Cambridge Journal of Economics* 295, p. 297.

7 M Friedman, *Capitalism and Freedom* (Chicago: Chicago UP 1962), p. 120.

8 P J McNulty, "A note on the history of perfect competition" (1967) 75 *Journal of Political Economy* 395, p. 398.

activities".[9] Kirzner concretises this point, claiming that under perfect equilibrium conditions, "the act of choice consists in nothing more than computing the solution *already implicit* in the data",[10] which entails a mechanical nature of the decision process.

The equilibrium-based model "not only allowed for very important insights and advances in economic theory, it also changed the meaning of the term competition in comparison to classical economics".[11] Such a conflation of two different terms significantly limits the meaning of competition under the traditional narrative.[12] This change was not aimed at creating a revolutionary trend by its neoclassical authors. Their re-interpretation of the phenomenon of competition does not emerge from an opposition to classical views, but rather as an attempt to better understand competition through a more advanced apparatus. This is the reason why the neoclassical equilibrium-based perception of competition does not reject classical views, but simply considers them underdeveloped and attempts to *improve* rather than *disprove* the concept of competition as present in classical economic literature. This *improvement*, however, created significant discrepancies between these concepts. While the classical understanding of competition concentrates primarily on the phenomenon of the competitive interactions of market agents, its neoclassical perception constitutes rather an important *theoretical premise* of economic reasoning with no direct implications for the competitive process.

In order to avoid any confusion, therefore, the concept of perfect competition should be perceived solely as a theoretical tool for the harmonisation of demand and supply. From this perspective there is no ethical or political value in competition, because it is an ethically neutral condition. The competitive process is not seen as a societal value, but merely as the actions of individuals which should ultimately correspond with the equilibrium conditions. The competitive process is then reduced to an applied means to reach equilibrium. On the normative side, the model of perfect competition implies that it is in the common interest to maintain the system in which demand always meets supply. The competitive process is, therefore, supported only as a tool that leads to a reduction in the prices and increase in the quality of products.

The theoretical significance of the concept of perfect competition is undisputable. It is particularly relevant for the development of a specific economic *language*, which enables us to address economic topics in the most uniform manner. The model of perfect competition essentially provides the common denominator necessary for economic reasoning. The difficulties begin when the theoretical, mechanical concept of competition substitutes its ethical counterpart. Apart from its static meaning, relevant for the mathematised methodology of economic analysis, the concept of competition also holds significant ethical, normative and substantive value.

Its ethical relevance is not limited to such areas as culture, law, politics or sport; it also plays a pivotal role in economic life. Economic theory itself provides one of the most

9 F A von Hayek, "The meaning of competition" in F A von Hayek, *Individualism and Economic Order* (Chicago: Chicago UP 1958), p. 96.

10 I M Kirzner, *How Markets Work: Disequilibrium, entrepreneurship and discovery* (London: Institute of Economic Affairs 2000), p. 31 (original emphasis).

11 Budzinski, "Monoculture", n. 6 above, p. 298.

12 N Giocoli, "Competition versus property rights: American antitrust law, the Freiburg School, and the early years of European competition policy" (2009) 5 *Journal of Competition Law and Economics* 747, p. 760.

significant contributions to the ethical value of competition.[13] The concept of perfect competition and the ethical perception of this phenomenon, therefore, are situated in two different dimensions. Theoretically, they are irrelevant to each other and should be treated as two different areas which have two specific meanings, theoretical apparatus and normative importance.

The following sections explore the essence of competition taken as a universal cognitive tool of economics, leaving aside the dynamic aspects of the phenomenon of competition. An assumption is made that for a better understanding of the concept of perfect competition it would be useful to explore the historical evolution of this economic principle. By analysing the criticism of the notion of perfect competition which was developed by the economists, it will be shown that both the proponents and critics of the concept inevitably apply the equilibrium-based rationale in the development of their argumentation.

Imperfect and monopolistic competition

Those who are sceptical about the relevance of the concept of perfect competition exercise rather *an apagogical* criticism (proving their argument by demonstrating the weaknesses of the contrary thesis).[14] The economic opponents of the concept refer to its hypothetical nature, introducing as an alternative the theory of *imperfect* competition. In a revisited version of "The economics of imperfect competition",[15] Robinson poetically describes the rationalising monopolist as "the best pilot to find a channel between the Scylla of competitive inefficiency and the Charybdis of monopolistic exploitation".[16] As observed by Kaldor, "[o]n the one hand it is increasingly recognised that abstract mathematical models lead nowhere. On the other hand it is also recognised that 'econometrics' leads nowhere",[17] implying that neither equilibrium-based abstract presumptions (despite their generalist convenience) nor inductive statistical data (despite their refined econometric elegance) are capable of providing the ultimate economic certainty.

Critics of the concept of economic equilibrium also point out that the diversity of human relations, their complexity and peculiarity, make it impossible to rely on equilibrium propositions and conclusions.[18] However, these negative aspects of the methodology of equilibration are internalised by the equilibrium itself. It counterbalances the *unknown unknowns* which are present on one side with the *unknown unknowns* present on the other, reducing them to a common denominator and hence making the *unknowns known*.[19] The

13 It is beyond the limits of this article to develop further the normative argument for the competitive process. Its elaboration can be found elsewhere (e.g. O Andriychuk, "Rediscovering the spirit of competition: on the normative value of the competitive process" (2010) 6 *Competition Law Journal* 581).

14 M C Marcuzzo, "The 'first' imperfect competition revolution'" in W J Samuels, J E Biddle and J B Davis (eds), *A Companion to the History of Economic Thought* (Oxford: Blackwell 2003), p. 294, (original emphasis): "Like most intellectual 'revolutions' imperfect competition was more a reaction against rather than an endorsement of an unified research program; in fact, there was a greater consensus on the reasons for abandoning perfect competition than on how to represent the working of 'imperfect' competition."

15 J Robinson, *The Economics of Imperfect Competition* (London: Macmillan and Co. 1933).

16 J Robinson, "Imperfect competition revisited" (1953) *Economic Journal* 579, p. 581.

17 Kaldor, "The irrelevance", n. 4 above, p. 1240.

18 C Thomasberger, "The two utopias of economics: human freedom and the mechanism of competition",. available at www.f3.htw-berlin.de/Professoren/Thomasberger/pdf/Theorie3.pdf (last accessed 4 February 2011), p. 6: "The Equilibrium Model or the utopia of the self-regulating system has the character of an ideal-type construct, a hypotheses, which does not tell us anything about economic reality."

19 I M Kirzner, "Entrepreneurial discovery and the competitive market process: an Austrian approach" (1997) 35 *Journal of Economic Literature* 60, p. 64: "In the neoclassical world, decision makers know what they are ignorant about. One is never surprised."

universality of equilibrium means that it can include within its modelling the full complexity of the system. In other words, it reduces the peculiarities of all social interests (including such non-economic issues as human rights and redistributive policy) to economically significant factors, which enable their comparison and weighing. However, this modelling is performed in an inductive way, implementing the factors *rationally*. Critics of this method suggest that *rationalisation* is not the best way to address *irrational* aspects of market forces and that sometimes even a tiny mistake in the calculation of the model's parameters can undermine the credibility of the model as a whole.

The ideas of marginalists on the subjective and relative aspects of utility are taken by equilibrium economics with due acceptance. However, they assume (perhaps for the sake of the methodological effectiveness of the model of equilibrium) that any value has its aggregate utility. This utility is reflected in prices and therefore can be measured objectively, while acknowledging the inevitability of subjective, non-rational elements. A conceptual remedy is based on the method of successive approximation, developed by Pareto, the task of which is to bring theoretical abstractions nearer to practical realities by including in the models more nuanced techniques of dealing with the subjectivity problem. The problem has been addressed, but has not yet been eliminated altogether. Complexity and the introduction of nuances, particularities and reservations often deviate from abstract thinking, universality and flexibility, which are all more congenial to stable propositions. This can be seen as a major economic dilemma. For instance, the purely economic perception of rights would, for the sake of clarity and predictability, not take into account their extra-economic aspects. This enables their more coherent treatment, calculating their pros and cons in a mathematical balancing exercise. This reductionist view can infringe upon the societal potential of the rights, however, since their legitimacy goes beyond cost–benefit analysis. But as soon as all the peculiarities of the rights are included in the equilibrium, it complicates the orderliness of the model and can paralyse its functioning entirely.

The method of equilibrium as a central method of economic analysis is characterised by a variety of approaches. Many important economic concepts are developed within its framework. For instance, the theory of monopolistic competition, introduced by Chamberlin, addresses the issue of perfect competition and puts forward that each individual company holds a de facto monopoly over its own products. According to Eucken's description of this theory, "[t]he goods offered by each individual firm must be looked upon as separate kinds of goods. Each individual producer has a 'monopoly' for his products. Each trader, farmer, or businessman sells *his* goods as a monopolist."[20] Each economic sector therefore is characterised by the range of small monopolies that have full control over their products and services.

The main argument of the theory of monopolistic competition is that the classical dichotomy between competition and monopoly is incorrect. Arguably, these two features of the economic process co-exist within each market as long as each market agent is simultaneously monopolist and competitor.[21] In terms of methodology, Chamberlin emphasises the monopolistic part of the analysis. This does not eliminate the competitive part, but would do if the analysis were taken the other way around. The core of Chamberlin's theory is not its criticism of the idea of perfect competition from the perspective of limited knowledge. Monopolistic competition should not be perceived as a

20 W Eucken, *The Foundations of Economics: History and theory in the analysis of economic reality* (Chicago: Chicago UP 1951), p. 141, (original emphasis).

21 E H Chamberlin, "Monopolistic competition revisited" (1951) 18 *Economica*, *New Series* 343, pp. 346–7: "Each seller has a local monopoly based upon his location yet he is surrounded by competitors. Hence, the paradoxical expression 'monopolistic competition'."

part of the theory of imperfect competition, but as "a *general* theory, designed to replace that of generalised pure competition".[22] (The term "pure competition" is one of the synonyms of "perfect competition".)

Different groups have reacted critically to the ideas developed by the alternative approaches to the concept of perfect competition. According to Marcuzzo, "[t]he first competition revolution was a reaction against the lack of realism of the perfect competition assumption but, ironically, was attacked for its inability to stand up to the test of its predictions".[23] Eucken, on the other hand, criticises the concept of monopolistic competition itself for blurring the differences between competition and monopoly, suggesting that the theory has been more inspired by political circumstances than by a genuine scientific endeavour.[24] The Chicago School perceives the concept of monopolistic competition as a set of purely theoretical insights that can lead in real life to "output restriction, higher prices, and an uneconomical utilization of resources".[25] In terms of policy implications, the model of monopolistic competition which influenced antitrust policy during the New Deal era "was far more complicated and made it far more difficult to examine a particular business practice"[26] than its neoclassical welfare-maximisation alternative. The development of the ideas of imperfect and monopolistic competition demonstrates that an economic algorithm embracing *known unknowns* creates significant complications. Alternative visions still address the problem of competition from the *intra*-disciplinary perspective of economic "mechanics", neglecting the ethical and normative value of the competitive process, perceiving it as a mere means to welfare. Such criticism can be classified in the three categories set out in the following section.

The concept of perfect competition: three perspectives of criticism

The methodological criticisms of the concept of perfect competition can be separated into three main groups: internal, dynamic and external. The first two belong to the area of economics, while the third one does not. None directly reflect the ideological dimension of the regulation of competition. Each can simultaneously embrace a libertarian and a regulatory perception of the relationship between state and market. They are of an epistemological rather than a prescriptive nature.

The first (*internal*) perspective acknowledges the methodology of equilibrium modelling, but highlights the necessity of putting a stronger emphasis on *known unknowns*. It submits that the model should internalise many subjective factors in order to maintain its theoretical credibility. These insights are represented by the concept of *imperfect competition* – which again refers to the situation where the absolute parameters of equilibrium models obtain – and have nothing to do with value judgments about the ethical value of competition.

The second (*dynamic*) line of criticism is also developed within economic theory, but rejects the role that the equilibrium model assigns to competition. It insists upon the dynamic qualities of the competitive process, refers to the subjective interests of market participants and stresses the important role played by competition in evolution, innovation

22 Chamberlin, "Monopolistic competition revisited", n. 21 above, p. 343 (original emphasis).

23 Marcuzzo, "The 'first' imperfect competition revolution", n. 14 above, p. 304.

24 Eucken, *The Foundations of Economics*, , n. 20 above, p. 146: "It is in the interests of economic pressure-groups to confuse the distinction between competition and monopoly. The effects of monopolies are shown to be harmless and the special problems of economic constitutional law which the existence of such powerful private bodies creates, are concealed."

25 G W Stocking, "The rule of reason, workable competition, and the legality of trade association activities" (1954) 21 *University of Chicago Law Review* 527, p. 536.

26 H J Hovenkamp, "Antitrust policy after Chicago" (1985) 84 *Michigan Law Review* 213, p. 224.

and progress (the Schumpeterian thesis of creative destruction can illustrate this approach, Hayekian competition as a discovery procedure which provides the link between the first to the second, but can technically be perceived from the third perspective as well). But this second criterion is just as economic as the first. It emphasises the importance of the competitive process, but considers as its main criteria economic parameters such as growth, wealth, welfare, well-being or utility.

The third (*external*) dimension of criticism encompasses the views of other disciplines about the phenomenon of competition. It does not contest the methodological essentiality of equilibrium modelling, acknowledging and respecting its paramount nature for the economic theory, but submits that competition is not an exclusive area of economics, and introduces its own narratives and proposals concerning the role of the competitive process in society.

Although the external method of criticism does not recognise the *normative* power of the equilibrium principle with respect to competition, it fully acknowledges the *methodological* intradisciplinary sovereignty of this principle for economics in general. It accepts that equilibrium serves the role of the epistemological *Grundnorm*, and this internal economic standard is acknowledged and respected. It is economics which is not accepted per se as a dominant apparatus, not the validity of its main internal disciplinary premises. This dissociation is the only way to bypass economic reasoning while addressing ethical problems, because any substantive economic disagreement with the notion of equilibrium requires implementation of this rationale as a prerequisite for such a disagreement (acquiring the form of the discussion on the existence of God, in which even the critics have to accept his existence first as a methodological postulate against which they develop counter-arguments).

Competition and the role of institutions

While the equilibrium approach to competition is aimed at exploring the economic perception of this phenomenon from an internal perspective, the institutional approach provides an insight into how economic scholarship perceives the role of government and other social mechanisms in the process of regulation of competition. This is therefore a perspective external to the phenomenon of perfect competition. The term *institutional* is used in a broader sense, encompassing both institutions *sensu stricto* (rules of the game) and organisations (actors of the game). The institutional perspective does not entail a regulatory response to market problems. It explores the role of institutions in this situation and the proposed normative solutions range from libertarianism to interventionism.

The history of economic thought explores this dimension from the very beginning of the conceptualisation of competition. According to Hovenkamp, "Institutionalism was one of the most important intellectual achievements of the first great law & economics movement and, with marginalism, supplied one of the greatest critiques of classical economics".[27] These ideas took their contemporary shape with the evolution of the cameralist theories,[28] developed mostly within the German – but also French, Dutch, Italian and British – tradition of public administration. Unlike classical economic analysis, this approach tends to adopt an external perspective on competition, concentrating on the institutions which administrate the competitive process more than on the phenomenon of

27 H J Hovenkamp, "The first great law and economics movement" (1990) 42 *Stanford Law Review* 993, p. 1013.

28 D J Gerber, *Law and Competition in Twentieth Century Europe: Protecting Prometheus* (Oxford: OUP 2001), p. 81: "[Cameralism] viewed economic conduct primarily from the perspective of its value to the state."

competition itself.

This external vision of competition also played an important role in developing inter-institutional relations in respect of reconciling conflicts of interests between different economic values. In its broader economic sense, this approach presupposes a mixed economy with active governmental programmes. It is being developed within the framework of many economic schools and contexts, and in particular within the Keynesian tradition. It often uses as an instrument the rationale of imperfect competition in order to justify the regulatory influence of government. However, the regulation of competition represents only one of the many aspects of proactive economic schools. The concept of "externalities" plays a significant role in this respect. It assumes the imperfectness of market transactions and the necessity of regulatory corrections. This approach was dominant in many jurisdictions. It was one of the preconditions for the development of modern law and economics, which emerged as a reaction to the conceptual justification of interventionist theories and policies with Coase's "The problem of social cost".[29] Following Horwitz, Coase's article represents "a brilliant, theoretical counterattack on the left-wing (interventionist) implications of welfare economics";[30] "internalise externalities" became a famous slogan.

Institutional scepticism towards the ability of the markets to self-correct impelled the institutional economists to pay more specific attention to other social institutions (Hovenkamp lists such institutional prerequisites of the markets as "ideology, technology, history, habit, previous investment, and lack of information or difficulty in communication")[31] that influence the market process. This was done in both more general (old institutional tradition)[32] and more mathematical (new institutional tradition) terms.[33] For the analysis of competition, this has both negative and positive implications. The negative consequence of the broader view lies in the fact that the process of competition is not taken as a universal remedy to achieve efficiency. Competition taken in its equilibrium sense remains an important but no longer *the* exclusive method, because explanation of the market processes can be found outside of the equilibrium. On the other hand, unlike market-centred neoclassical views, the regulatory approach does not necessarily need a robust economic justification to promote the ethical aspects of competition, the rivalry process as such. It can potentially protect it as a public value in its own societal right. This possibility is limited, however. Indeed, in spite of its ability to perceive competition from the outside, the institutional approach still belongs to *economics* and shares the discipline's natural inclination towards robust statistically significant evidence. This approach can accept the necessary connection between economics and other social sciences and recognise that not everything can be reduced to the parameters of economic modelling. It can also tolerate a less strict economy-centricity and the bigger role of induction, unpredictability and experiments, but it cannot abandon altogether the intrinsic limits of the discipline and

29 R H Coase, "The problem of social costs" (1960) 3 *Journal of Law and Economics* 1.

30 M J Horwitz, "Law and economics: science or politics?" (1980) 8 *Hofstra Law Review* 905, p. 906.

31 Hovenkamp, "The first great law and economics movement", n. 27 above, p. 1013.

32 W H Hamilton, "The institutional approach to economic theory" (1919) 9 *American Economic Review* 309, p. 311: "'Institutional economics' alone meets the demand for a generalized description of the economic order. Its claim is to explain the nature and extent of order amid economic phenomena . . . in relation to human well-being. . . . Such an explanation cannot properly be answered in formulas . . . Its quest must go beyond sale and purchase to the peculiarities of the economic system."

33 R H Coase, "The new institutional economics" (1998) 88 *American Economic Review* 72: "[Old institutional economists] were men of great intellectual stature, but they were anti-theoretical, and without a theory to bind together their collection of facts, they had very little that they were able to pass on."

perceive social values from an internal perspective.

Therefore, the institutional approach to economics is primarily interested in interpreting the role of institutions and does not necessarily justify deviation from the internal economic reasoning for the sake of value arguments, which these institutions internally adhere to. Institutional economics is interested in knowing more about these values, yet it is less interested in promoting them through economic reasoning. For instance, the areas of economics dealing with social institutions like the law or constitutions (*law and economics* and *constitutional economics* respectively) contribute significantly to the understanding of how law and constitutional theory influence economic processes. These areas are important in order to understand the functioning of these institutions. However, they do not explore the relevant institutions from the perspectives of the natural narratives of *law* and *constitutional theory*. On the contrary, instead of *institutionalising* economic areas, they *economise* social areas. Apart from understanding the role of law and constitutions in economic life, this approach expands the limits of economics from the analysis of the market to the analysis of other social forms. Therefore, the terms "law and economics" or "constitutional economics" can only mean "*law and* its role in *economic* reasoning" (how law *externally* influences economic analysis) or "*law and* how *economics* can help to understand it better" (how law *internally* is understood by economics) – or even "*law and* how *economics* is better at understanding the law and what the law really is". These various approaches remain economics-based at the epistemological level.

The intellectual legacy of Polanyi represents one of the institutionalist traditions. His external examination of economic relations from the perspective of broader societal needs constitutes a significant methodological contribution to the problem of correlating the purity of abstract economic modelling with the necessity to involve non-quantifiable social values. This article does not address (and does not share) Polanyi's main *normative* premise underpinning his objection to the invisible hand as the universal tool for explanation and justification of self-interested behaviour of market agents. However, it does, to a large extent, agree with Polanyi's *methodological* scepticism relating to the ability of abstract economic models to explain the entire complexity of human interactions by reducing them to economically significant variables. In order to articulate properly the main methodological claim which this article develops, it is necessary to explore the epistemic relations between the different disciplines.

The role of economics in legal reasoning

The issue of interdisciplinarity is of paramount importance in social theory. At least three disciplinary discourses – economics, law and political theory – address the problems of embeddedness of social values in economic policy. The interactions between them illustrate the fruitfulness of interdisciplinary research. The problem of homonymy, however, is often apparent as well.[34] Stigler considers that the main problem lies in the substantive goals of each discipline and in their apparatus, submitting that "[t]he difference between a discipline that seeks to explain economic life (and, indeed, all rational behaviour) and a discipline that seeks to achieve justice in regulating all aspects of human behaviour is profound",[35] as well as suggesting that economics and law speak different languages. Kelsen on the other hand

34 P Nicolaides, "An essay on economics and competition law of the European Community" (2000) 27 *Legal Issues of Economic Integration* 7, p. 7: "Economists and lawyers do not often see eye to eye. They are divided by the boundaries of their respective disciplines . . . Lawyers, for example, bemoan the 'pollution' of their discipline by economists who favour the introduction of cost–benefit criteria in legal decisions, while economists find incomprehensible court rulings that appear to disregard obvious, in their eyes, economic facts."

35 G J Stigler, "Law or economics?" (1992) 35 *Journal of Law and Economics* 455, p. 463.

observes that "[t]he sociology of law [and in the present context the economic analysis of law] cannot draw a line between its subject – law – and the other social phenomena".[36] In their mutual attempts to internalise each other's arguments, law was originally more successful than economics, since the pre-modern culture was based on dogmas. Conversely, the age of rationality is characterised by the pervasive application of economic methods to other disciplines. Antitrust is merely an example, even if a particularly explicit one, of a much more general trend. Economics has been successfully applied to many other areas. Gauthier, for example, critically explores at least three important epistemic influences of economics on moral theory (its cognitive alma mater)[37] and philosophy in general:

> [t]he first is that value is utility – a measure of subjective, individual preference. The second is that rationality is maximization. . . . The third is that interests are non-tuistic [a person is not interested in the interests of another person].[38]

Although the centre of gravity of law and economics is primarily concerned with private law adjudication, it does not prevent its application to public law.[39] The economic analysis of the political decision-making process is reflected in public choice theory constitutional economics,[40] and more generally in social choice.[41] Today, one can find studies of economics of just about *every* reasonable area of human practice (economics of education, religion, happiness, football, recycling, art and so on).[42] The ability of economics to address legal, political and ethical questions reflects the universal symbols and interests with which it usually operates.

In legal scholarship the role of economic analysis is usually limited to its positive part.[43] It is hard to deny that economics *can* indeed explain in its *intra*-disciplinary way the phenomenon of law, but in addition the economic analysis often proposes the normative guidelines for the legal field.[44] Monti puts a legitimacy question: "whether the use of economics is legitimate and . . . how economics is used".[45] This concern is substantiated

36 H Kelsen, "The pure theory of law and analytical jurisprudence" (1941) 55 *Harvard Law Review* 44, p. 53.

37 I Lianos, "Lost in translation? Towards a theory of economic transplants" (2009) 62 *Current Legal Problems* 346, p. 351.

38 D Gauthier, "Thomas Hobbes: moral theorist" (1979) 76 *Journal of Philosophy* 547.

39 F I Michelman, "Constitutions, statutes, and the theory of efficient adjudication" (1980) 9 *Journal of Legal Studies* 431.

40 J M Buchanan and G Tullock, *The Calculus of Consent: Logical foundations of constitutional democracy* (Ann Arbor: University of Michigan Press 1962).

41 K J Arrow, *Social Choice and Individual Values* (New Haven: Yale UP 1951).

42 F Parisi, "Positive, normative and functional schools in law and economics" (2004) 18 *European Journal of Law and Economics* 259, p. 261: "[T]he cohesiveness of economic techniques makes it possible for economics to move successfully into another field, such as law, and dominate it intellectually."

43 H J Hovenkamp, "Positivism in law and economics" (1990) 78 *California Law Review* 815, p. 816: "A positive economic analysis says simply that, given a certain set of premises, A, B, and C, some conclusion D will follow."

44 D Wolf, "Competition policy objectives" in C Ehlermann and L L Laudati (eds), *The Objectives of Competition Policy. European competition law annual 1997* (Oxford: Hart 1998), p. 24: "E]conomists have learned to be advocates of the interests of their clients, just as lawyers have learned to do so."

45 G Monti, "EC competition law: the dominance of economic analysis?" in R Zäch, A Heinemann, A Kellerhals (eds), *The Development of Competition Law: Global perspective* (Cheltenham: Edward Elgar 2010), p. 4.

46 J N Keynes, *The Scope and Method of Political Economy* (London: Macmillan and Co. 1897), p. 8: "[T]he general tendency of popular economics is towards rash generalizations and fallacious arguments post hoc ergo propter hoc . . . leading to confusion of thought and the selection of false propositions as self-evident postulates; and where deductive reasoning is employed its results are often applied without regard to the conditions requisite for their valid application. To this it must be added that the sharp distinction drawn by opposing schools, and their narrow dogmatism."

and explained by some economists as well.[46] Law and economics enthusiasts suggest that economics can "teach" the law to be more pragmatic and respond to societal needs more rapidly and effectively. Some suggest that only economic reasoning reflects genuine relations between people.[47] More moderate authors usually acknowledge the important connections between law and economics,[48] suggesting that economics is indeed a useful tool for assessing evidence. At the same time, they submit that economic analysis of law "cannot and should not serve as a general basis of legal decision making".[49] The sceptics make methodological observations about the mutual epistemic incompatibility of the disciplines.[50] In technical areas of law like antitrust, economics always plays a pivotal role. Yet, until recently, it merely explained *competition*, while nowadays it often seeks to explain competition *law*. *Mutatis mutandis*, criminology is of paramount importance to criminal law, but it does not pretend to be its only source of interpretation or guide for its development. As some authors show, the line between positive and normative economic analysis in present-day European antitrust is blurred.[51] This trend is exacerbated by the dominance of the welfare-oriented approach, which jeopardises the other important aspects of competition law. Even if the universality of cost–benefit analysis were to enable its perception as pure objective science, it could not guide the law.[52]

Conclusion

> [I]f we compare the conditions of to-day with those of thirty years ago, we see an increase of economic methods and economic influence in some parts of the work of government.[53]

This statement of the former president of Yale University sounds topical today, though it was made in 1899. The role of economics in legal reasoning can be supported or opposed, but it cannot be ignored. The main task of this article was to explore the basic premises of economic reasoning, making an attempt to understand *how economists think*. After describing the main logical apparatus of economics, it reverted to the issue of interdisciplinarity. The conclusion of the article is that effective interdisciplinary research should be distinguished from a *fusion* of economic and legal methodologies. Each discipline is characterised by established analytical schemes which can be neither merged into, nor supplemented by, each other. True interdisciplinarity means understanding the *language* of the other discipline

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47 Horwitz, "Law and economics", n. 30 above: "Like . . . Marxism, law-and-economics treats law as 'superstructure', merely reflecting what is 'real' in the 'base' of economic rationality."

48 H J Hovenkamp, "The antitrust movement and the rise of industrial organisation" (1989) 68 *Texas Law Review* 105: "Even though they spoke different languages, economists and lawyers derived their ideas from each other."

49 E Engle, "Law and economics: theoretical puffery, exaggerated claims and counterfactual models" (2009) 2 *Journal of Jurisprudence* 29.

50 G Teubner, "The two faces of Janus: rethinking legal pluralism" (1992) 13 *Cardozo Law Review* 1443, p. 1455: "The lawyers observe economic action under the code legal/illegal and misread economic processes and structures as sources of law. Conversely, clever economic actors misread legal norms under the economic code as bargaining chips, as new opportunities for profit-making. Again, we have a symbiosis of mutual distortion."

51 Monti, "EC Competition Law", n. 45 above, pp. 4–5: "[The Commissioner's statement that the aim of competition enforcement is to protect competition in the market as a means of enhancing consumer welfare and ensuring an efficient allocation of resources. An effect-based approach, grounded in solid economics, ensures that citizens enjoy the benefits of a competitive, dynamic market economy] blurs the line between positive and normative economic analysis."

52 H Kelsen, *General Theory of Law and State* (New York: Russell & Russell 1973), p. xiv: "One of the most difficult tasks of a general theory of law is that of determining the specific reality of its subject and of showing the difference which exists between legal and natural reality."

53 A T Hadley, "The relation between economics and politics" (1899) 8 *Yale Law Journal* 194, p. 205.

rather than developing an uncritical Esperanto.

The epistemic border between disciplines implies that "law produces by itself all the distinctions and concepts that it uses, and the unity of law is nothing but the fact of this self-production".[54] This implies that law cannot be explained by non-legal apparatus and the other way around, "[p]articulars are legally relevant only inasmuch as they can be brought within juridical categories".[55] In Kelsen's sense, purely legal silos (analytical jurisprudence) recognise the importance and validity of external views on law (sociological jurisprudence in general),[56] suggesting that both stand side by side but "neither can replace the other because each deals with completely different problems".[57] The origins of this approach can be traced – as Paulson shows[58] – back at least to Jellinek.[59] Kelsen's critics also see these similarities.[60] This explains the position of legal positivism, liberating it from misinterpretation by its critics who perceive legal positivism as a claim "that law must be strictly severed from morality . . . [and economic analysis, which denies] the possibility of any bridge between the obligation to obey law and other moral obligations".[61]

Even the tenants of a purist *intra*-disciplinary interpretation of law do not reject the importance of economic knowledge. They claim merely that the law *can* be defined by economics, but that the ensuing definitions can serve *only* as theoretical modelling with no normative implications, arriving essentially at Frost's "good fences make good neighbours" conclusion.[62]

If these observations are correct, this may reveal one of the main methodological discrepancies between the economic and legal analyses of the broader societal problems. While the former tends to operate within the benchmark of efficiency, addressing the issues of the most effective generation and/or allocation of limited resources, the latter is more dogmatic and therefore less flexible in respect to the inductive discoveries and the specificities of regulated context. While the former tends to be utilitarian, the latter holds important deontological elements. This might be the reason why for economists the idea of competition is usually perceived as a state of the ultimate equilibrium, while lawyers tend to understand better the dynamic aspects of the competitive interactions, disentangling the outcomes of such interactions from the competitive process itself.

For lawyers, the independent support of the competitive process may be fairly reasonable, provided the provisions of positive law enable/require such support. For most

54 R Nobles and D Schiff, "Introduction" in N Luhmann, *Law as Social System* (Oxford: OUP 2004), p. 6.

55 E J Weinrib, "Legal formalism: on the immanent rationality of law" (1988) 97 *Yale Law Journal* 949, p. 976.

56 J M Balkin and S V Levinson, "Law and the humanities: an uneasy relationship" (2006) 18 *Yale Journal of Law & the Humanities* 155, pp. 161–2: "An externalist attitude . . . studies law as a social phenomenon, much as an anthropologist might study the ancient beliefs of the Mayan religion without adhering to them . . . In like fashion, literary critics might be interested in the rhetorical operations of law; historians might be interested in the development of law in its social and political context, and so on."

57 Kelsen, "The pure theory of law", n. 36 above, p. 52.

58 S L Paulson, "Hans Kelsen's earliest legal theory: critical constructivism" (1996) 59 *Modern Law Review* 787, pp. 798–800.

59 G Jellinek, S*ystem der subjektiven öffentlichen Rechte* (Tübingen: J C B Mohr 1905).

60 C Schmitt, *Political Theology: Four chapters on the concept of sovereignty* (Cambridge, MA: MIT Press 1985), p. 18 (original emphasis): "To obtain in unadulterated purity a system of ascriptions to norms and a last uniform basic norm, all sociological elements have been left out of the juristic concept. The old contrast between is and ought, between causal and normative considerations, has been transferred to the contrast of sociology and jurisprudence, with greater emphasis and rigor that had already been done by George Jellinek and Kistiakowski, but with the same unproved certainty."

61 L L Fuller, "Positivism and fidelity to law: a reply to Professor Hart" (1958) 71 *Harvard Law Review* 630, p. 656.

62 P F Hubbard, "'Sociology of law': one view from the lawyer's side of the fence" (1976) 7 *Rutgers Law Journal* 458.

economists, the very idea of such support of the competitive process independently of the outcomes, which can be calculated within the equilibrium model of perfect competition, may well appear to be nonsensical. This explains the scepticism with which mainstream economics addresses the independent normative value of the competitive process.

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Did Lloyds/HBOS mark the failure of an enduring economics-based system of merger regulation?

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Abstract

This article asks whether the merger of Lloyds TSB and Halifax Bank of Scotland (HBOS) in 2008, on public interest grounds, marked the failure of an enduring economics-based system of merger regulation. It argues that, far from marking a failure, the Lloyds/HBOS merger highlights the importance of only allowing public interest interventions on exceptional grounds in specific industries. Economics-based merger control is transparent and preferable to general public interest assessments, which are unpredictable and open to abuse. Concerns raised which support arguments for greater political interventions can be more effectively addressed in other ways.

Introduction

In September 2008, Lloyds TSB and HBOS were allowed to merge into the Lloyds Banking Group, in a deal brokered by the UK government. For the first time since the Enterprise Act 2002 came into force, the UK government used its public interest powers to allow a merger which was opposed by the Office of Fair Trading (OFT) on competition grounds. The Enterprise Act had created a system of regulation which assessed mergers purely on competition grounds. It removed the scope for political interventions on public interest grounds from general merger assessment and restricted them to cases concerning national security and plurality of the media. In order to allow the Lloyds merger on public interest grounds, the Secretary of State for business had to create a new public interest ground with the consent of Parliament. In light of this case and other political pressures in the wake of the financial crisis, some have suggested that the UK may have gone too far in creating an 'unduly purist economic enforcement' regime.[1] The time may have come to consider whether it would be beneficial to allow broader political interventions in merger control, on non-competition grounds. Such interventions would also allow the government to block foreign acquisitions of British firms, considered by many to be damaging. An example of this is the acquisition of Cadbury plc by the American firm, Kraft Inc. in 2010.

* Email: a.stephan@uea.ac.uk. The support of the Economic and Social Research Council (UK) is gratefully acknowledged.

1 S Wilks, "The impact of the recession on competition policy: amending the economic constitution" (2009) 16 *International Journal of Economics of Business* 269, discussing the French Loi de Modernisation de l'Economie, 2008, albeit as the more "radical" option; M McElwee, "Politics and the UK merger control process: the public interest exceptions and other collision points" (2010) 9 *Competition Law Journal* 77.

The state's intervention to approve the Lloyds/HBOS merger on public interest grounds can be viewed as a Polanyian protective counter-move. Karl Polanyi argued that, "constant action on the part of the government is needed to ensure the functioning of free markets without fatal harm to the community".[2] These counter-moves, he maintained, blunted the "self-destructive" trends of the market and empowered the state in its roles as regulator of the economy and guarantor of basic social welfare.[3] In the present case study, this self-destructive trend is characterised by the dangerous consequences of permitting HBOS to collapse, thought at the time to be an inevitable result of the merger being blocked on competition grounds. Polanyi's verdict on competition in 1928 – when there was a notable absence of competition law rules – was that it had been "crushed by its creature, monopoly".[4] Yet competition law can in itself be viewed as a form of counter-move, seeking to protect markets from monopoly and collective market power. Indeed, the enforcement in Europe of Article 102 TFEU (Treaty of the Functioning of the EU, the abuse of dominance prohibition) is sometimes thought to also protect competitors. In contrast to *Chicago School* economics, which is the dominant influence in antitrust, the concern for competitors stems from the influence of *ordoliberalism* which originated in Freiburg in the 1930s. It embraced the free market but felt that that was not in itself sufficient. Economic freedom should be protected from control by private economic power. This was to prevent the private economic power from being turned into political power, as had been the case in Nazi Germany through the misuse of the iron and steel industries.[5] Competition policy can also be viewed as embedding the market, especially in focusing on consumer welfare and choice.[6] There is therefore scope for accommodating competition policy within the Polanyian framework. However, competition law protects against a much narrower set of self-destructive forces than those envisaged by Polanyi, and is shaped almost entirely by economic theory. It is closer to *Gesellschaft* than *Gemeinschaft*. It also seeks to ensure the effective functioning of markets and therefore entrenches the market paradigm. The issue is therefore the extent to which state intervention is necessary in merger regulation in order to afford adequate protection to society.

The purpose of this article is to consider whether the Lloyds/HBOS merger marks the failure of an enduring economics-based system of merger regulation, demonstrating the need for more political interventions on public interest grounds. First, it will review the shift in UK merger control from public interest to a competition-only assessment, noting the narrow retained role for political intervention on public interest grounds. Second, it will set out the circumstances surrounding the merger, the intervention of the Secretary of State and the recommendation of the OFT. It will also identify some of the more general arguments for intervention on public interest grounds, especially in light of Kraft's acquisition of Cadbury in 2010. Third, it will assess whether there is an argument for broader public interest considerations in merger control. This will involve looking at

2 G Dale, "Karl Polanyi's *The Great Transformation*: perverse effects, protectionism and *Gemeinschaft*" (2008) 37 *Economy and Society* 495, p. 499.

3 K Polanyi, *The Great Transformation: The political and economic origins of our time* (Boston, MA: Beacon Press 1957), p. 76.

4 Dale, "Karl Polanyi", n. 2 above, p. 497.

5 L L Gormsen, "The conflict between economic freedom and consumer welfare in the modernisation of Article 82 EC" (2007) 3 *ECJ* 329. For a discussion of German industry's role in the rise of the Nazi party, see D Jeffreys, *Hell's Cartel: I G Farben and the making of Hitler's war machine* (London: Bloomsbury 2008). See also Pinar Akman's arguments that the influence of ordoliberalism has been overstated and that the drafters of Article 102 TFEU were mainly concerned with increasing efficiency: P Akman, "Searching for the long-lost soul of Article 82 EC" (2009) 29 *OJLS* 267.

6 G Krippner et al., "Polanyi symposium: a conversion on embeddedness" (2004) 2 *Socio-Economic Review* 109.

whether the justification for intervention in the Lloyds/HBOS merger could also apply to mergers in other industries, and if the other concerns raised would be well served by public interest interventions. The article argues that, far from marking the failure of economics-based merger control, Lloyds/HBOS highlights the importance of restricting political interventions on public interest grounds to exceptional circumstances in specific industries. Arguments in favour of greater political intervention either relate to the characteristics of a specific industry, like banking, or can be addressed more effectively in other ways.

From public interest to economics-based competition assessment

Under the Fair Trading Act 1973, merger references were made to the Monopolies and Mergers Commission (MMC) by the Secretary of State. The MMC would determine whether a merger situation qualifying for investigation had been created and, if so, "whether the creation of that situation operates, or may be expected to operate against the public interest" (s. 69). A recommendation was then made to the Secretary of State specifying the particular effects, adverse to the public interest, which the merger might raise. He would then determine how these adverse effects should be remedied, in blocking the merger or requiring divestitures. The Secretary of State could also "accept from such of the parties concerned as he considers appropriate undertakings to take specific action which the Secretary of State considers appropriate to remedy or prevent the effects adverse to the public interest" (s. 75G).

The concept of "public interest" was carried from the Monopolies and Restrictive Practices (Inquiry and Control) Act 1948. As Scott et al. note, "[s]uch guidance on interpretation of the phrase as the 1948 Act did offer was expressed at such a level of generality as to amount to an invitation to take into account anything that might seem relevant".[7] The early merger regime was criticised for inconsistent outcomes, apparently arbitrary criteria used to decide each case, and for political interventions on non-competition grounds.[8] Between 1973 and 2001, Secretaries of State acted contrary to advice received from the Director General of Fair Trading on 31 occasions.[9] Some of the more absurd outcomes of this included how "some Secretaries of State [had] been 'softer' on merger control", with the consequence that legal practitioners adjusted their advice to clients accordingly.[10] A relatively recent example of non-competition grounds was the "Lilley doctrine", under which an acquisition should be closely scrutinised if the acquirer was a state-owned foreign firm.[11] This was announced by Peter Lilley, Secretary of State for Trade and Industry in 1990. A small number of references were made to the Competition Commission (CC) on this basis but none resulted in the merger being blocked.[12]

There had long been resistance to defining public interest out of fear this would lead to 'undesirable rigidity' in the MMC's inquiries.[13] Although only a small proportion of all mergers were referred to the Commission, it was very hard for firms to predict when a merger would be blocked. In 1968 Rowley noted:

7 A Scott, M Hviid and B Lyons, *Merger Control in the United Kingdom* (Oxford: OUP 2006), p. 5.

8 C Rowley, "Mergers and public policy in Great Britain" (1968) 11 *Journal of Law and Economics* 83; T Ellis, "A survey of the government control of mergers in the United Kingdom" (1971) 22 *Northern Ireland Legal Quarterly* 251.

9 S Wilks, *In the Public Interest: Competition policy and the Monopolies and Mergers Commission* (Manchester: MUP 1999), p. 226.

10 Ibid. pp. 226–7.

11 Ibid. p. 226.

12 McElwee, "Politics and the UK merger control process", n. 1 above, p. 80.

13 C K Rowley, "Mergers and public policy in Great Britain" (1968) 11 *Journal of Law and Economics* 75, p. 82.

> The Commission has demonstrated its willingness to inquire into merger references without openly committing itself to a specific philosophy. Indeed, the chairman of the Commission . . . refused to be drawn upon the merger philosophy of the Commission: "It is enshrined in the reports which we have published. You must read these. Each case is different."[14]

Public interest encompassed non-competition considerations which ran counter to an objective evaluation of whether a merger was likely to reduce the welfare of consumers in a given market. The lack of transparency and predictability risked deterring mergers and acquisitions which were beneficial to the economy.

However, in many respects the merger control regime set out in the Enterprise Act 2002 had already existed in practice for some years.[15] By the 1990s references were generally cleared by the MMC, unless they raised competition concerns.[16] A report on takeovers and mergers by the Trade and Industry Committee in November 1991 noted that:

> While the emphasis on competition as the main criterion comes from the *Fair Trading Act 1973*, competition was given more prominence in 1984 when the then Secretary of State for Trade and Industry, Mr Norman Tebbit, announced that "references to the Monopolies and Mergers Commission (MMC) would be made primarily, but not exclusively, on competition grounds, taking into account the international dimension of competition." Since then only six out of 74 references have been made to the MMC on non-competition grounds.[17]

British governments had taken on board years of criticism in connection with public interest and had more generally moved towards free market policies.[18] The dominant consideration for mergers had become promoting effective competition and the interests of consumers, but there remained a layer of political involvement in the assessment process.

The Enterprise Act put an end to "substantial room for the exercise of political preferences"[19] and set out an economics-based test for mergers. In all but exceptional cases, the quasi-independent OFT, rather than the Secretary of State, became responsible for referring mergers to the new CC. The new substantive test became whether a relevant merger situation "has resulted, or may be expected to result, in a substantial lessening of competition within any market or markets in the United Kingdom for goods or services"[20] (the SLC test). While the SLC test is not defined within the Enterprise Act, guidance is published by the OFT and CC.[21] The competition authorities examine the prospect of three main factors which could lead to an SLC. *Unilateral effects* arise where there is rivalry between the two firms which would be removed if they merged. *Coordinated effects* arise where the merger increases the ability of firms within the market to coordinate their behaviour so as to raise prices: essentially, tacit collusion. *Vertical* or *conglomerate effects* arise where a merger between two firms at different levels of the production process, or in entirely different markets, can cause its

14 Rowley, "Mergers and public policy", n. 13 above, pp. 83, 130.

15 McElwee, "Politics and the UK merger control process", n. 1 above, p. 79.

16 Scott et al., *Merger Control*, n. 7 above, p. 6.

17 Trade and Industry Committee, *First Report: Takeovers and mergers* (Norwich: The Stationery Office 1991) HC Paper No. 90 (Session 1991/2), para. 223. Discussed in House of Commons Briefing Paper, *Takeovers: the "public interest test"* (4 August 2010) SN/BT/5374.

18 S Goodman, "Steady as she goes: the Enterprise Act 2002 charts a familiar course for UK merger control" (2003) 24 *ECLR* 331; A Scott, *The Evolution of Competition Law and Policy in the United Kingdom*, LSE Law, Society and Economy Working Paper (unpublished manuscript 2009).

19 Wilks, *In the Public Interest*, n. 9 above, p. 228.

20 Enterprise Act 2002, s. 22(1)(b).

21 The latest guidelines are published jointly by the OFT and CC: *Merger Assessment Guidelines* (September 2010) CC2 (revised) and OFT 1254.

presence in one market to reduce rivalry in another. No reference is necessary where "any relevant customer benefits . . . outweigh the substantial lessening of competition concerned and any [attributable] adverse effects".[22] These include greater innovation, lower prices, higher quality or greater choice as a result of the merger. Strong customer buying power is also a relevant factor. The OFT must obtain and review information relating to mergers on UK markets. It is under a duty to refer to the CC any completed or anticipated relevant merger situation, which evinces an SLC. The OFT can negotiate undertakings with the parties to the merger in lieu of a reference where appropriate. The CC will respond to a merger reference by conducting an in-depth investigation. It has no power to undertake an investigation on its own initiative. The Competition Appeal Tribunal performs a judicial review function in respect of merger decisions.

The Secretary of State does retain a limited role under the current merger regime. Under s. 57(1), the OFT has a duty to notify the Secretary of State, in any case where it is considering referring a merger to the CC, of any matter it believes to relate to special public interest considerations. Section 44 also gives the Secretary of State the power to intervene in cases where a relevant merger situation raises public interest issues. These public interest issues were restricted by s. 58 to just two: national security and the media. The latter concerns the accurate presentation of news, free expression of opinion and sufficient plurality of views.[23] However, the Secretary of State can under s. 42 intervene on public interest grounds where the consideration "is not specified [in s. 58] but, in the opinion of the Secretary of State ought to be so specified". Such an order must be approved by Parliament under s. 42(8)(b). Where the Secretary of State chooses to intervene, the OFT (or OFCOM in media cases) will provide him or her with a report containing their advice on the relevant considerations. Crucially, the Secretary of State is bound by the recommendations of the OFT in relation to the competition matters, but not in relation to the public interest considerations. He or she may then decide to refer the merger to the CC. The Secretary of State can also accept from the parties concerned any undertakings considered appropriate in order to remedy, mitigate or prevent any of the effects adverse to the public interest which may result (Schedule 7). However, in the present case the Secretary of State did not seek undertakings which might remedy some of the competition concerns.

The Lloyds/HBOS merger and other arguments for public interest interventions

In September 2008, the UK government pushed for the acquisition of HBOS plc by Lloyds TSB Group Ltd for £12.2bn. Lloyds TSB was chosen because of its relative strength in the wake of the banking crisis and because the merger would not have a European dimension and would therefore be subject to UK merger regulation.[24] This is significant because the government was unlikely to have ensured that the merger would have been allowed if it had

22 Enterprise Act 2002, ss. 21(2)(b) and 33(2)(c).

23 For example, in November 2006 the Competition Commission provisionally found that Sky Broadcasting Group's acquired 17.9% share of ITV plc created a substantial lessening of competition and operated against the public interest due to concerns over media plurality. See D Geey and A Chanter, "*British Sky Broadcasting Group PLC* v *Competition Commission*: broadcasting and control over ITV – SKY reaches its limit" (2010) 21 *Entertainment Law Review* 150.

24 Both banks achieved over two-thirds of their UK turnover within the UK and so the transaction was not subject to EC merger control.

been assessed by the European Commission.[25] While the Secretary of State can issue a European Intervention Notice on public interest grounds, he or she is not able to override a prohibition of a merger by the European Commission.[26] The Secretary of State used his power under s. 42 Enterprise Act to create a new public interest ground, "maintaining the stability of the UK financial system".[27]

The OFT issued a report in October 2008 in which it concluded that it was likely the merger would result in a substantial lessening of competition in relation to personal current accounts, banking services provided to small and medium-sized businesses and mortgages.[28] It recommended that the merger should be referred to the CC for closer scrutiny. The OFT received a large number of submissions from stakeholders including the Bank of England, the Financial Services Authority, the Treasury and the Scottish Government. It summarised them in the following way:

> The majority of third parties considered that, in light of the extraordinary conditions in the financial markets, the merger would benefit financial stability, and was therefore in the public interest. However, some third parties expressed concerns about the impact of the merger on competition in the medium to long term. Concerns were also specifically expressed that the impact of the merger in Scotland would be against the public interest.[29]

It concluded that, not only did customer benefits in relation to the creation of the relevant merger situation not outweigh the SLC, but that its competition concerns were so serious that it would not be appropriate to deal with the matter by way of undertakings.[30] While the OFT did not entirely rule out the possibility of developing structural remedies through further engagement with the parties, it noted that in the attempted merger between Lloyds TSB and Abbey National in 2001, the CC could not find any structural or behavioural remedies which it considered sufficient to alleviate its competition concerns.[31]

The Secretary of State ignored this recommendation and forced the merger through on public interest grounds without the CC having a chance to consider its implications for competition. He did this on the basis of s. 45 of the Act, finding that the benefits of the merger for the stability of the UK financial system outweighed the likely anti-competitive outcomes. A statement published by the Department for Business Innovation and Skills (BIS) stated:

> In the light of extraordinary stress in the worldwide financial markets at the time of the proposed Lloyds/HBOS merger, and the systemic importance of HBOS plc to the UK banking system, the Secretary of State considered that there was a need to act quickly and intervene in the proposed merger given the serious threat to the stability of the UK financial system.[32]

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25 C Pouncey and I Bukovics, "Merger control credit crunch style: UK government intervention in the Lloyds/HBOS merger" (2009) 30 *European Competition Law Review* 67; McElwee, "Politics and the UK merger control process", n. 1 above, p. 88.

26 Ibid. p. 69.

27 BIS, T*he Creation of a New Public Interest Consideration on Stability of the UK Financial System* (Norwich: The Stationery Office 2008).

28 OFT, *Anticipated Acquisition by Lloyds TSB plc of HBOS plc: Report to the Secretary of State for Business Enterprise and Regulatory Reform* (London: OFT October 2008), para. 2.

29 Ibid. para. 19.

30 Ibid. para. 384.

31 Ibid. para. 380.

32 BIS, *The Creation of a new Public Interest Consideration*, n. 27 above, p. 1.

The newly created Lloyds Banking Group now controls around 33 per cent of UK Current Accounts and 30 per cent of UK mortgages. It holds around 40–50 per cent of small business services in Scotland. In addition, in a study conducted by the OFT in July 2008, the market for current accounts was found to have a number of competition concerns which were compounded by high barriers to new entry and reluctance by customers to switch bank accounts.[33] Indeed, when Lloyds had been blocked from acquiring Abbey National in 2001, the market shares at stake were lower than in Lloyds/HBOS.[34]

The Lloyds TSB/HBOS merger occurred in the wake of the financial crisis in which there was a real concern that the banking sector would collapse. The government issued guarantees for depositors, and nationalised banks including Northern Rock and Bradford and Bingley (B&B). B&B was sold to the Santander Group at around the same time as the Lloyds/HBOS merger.

The stability of financial markets provides just one justification for political intervention on public interest grounds. There are arguments for intervention on other grounds which are summarised by Whish.[35] First, mergers may be driven by "short-termism": to make a quick profit where the merger may not be in either firm's long-term interest. In this respect, the decision of shareholders will not always be the best result. Indeed, around half of all mergers may actually reduce the value of the firm.[36] Second, mergers create concentrations of wealth which may not be socially desirable. Third, they frequently lead to factory closures and redundancies, sometimes in regions already suffering from high levels of unemployment. Fourth, foreign acquisitions constitute "selling the crown jewels" with the decision-making process for British firms being taken abroad. The UK's comparatively liberal acquisition laws mean that it is a lot harder for British firms to acquire foreign businesses than it is for they themselves to come under foreign control. Lastly, there are certain sectors, such as the media, which are considered especially sensitive and cannot therefore be regulated purely on competition grounds.

The controversial acquisition in 2010 of British chocolate manufacturer Cadbury PLC by the American confectioner Kraft Inc. highlighted both the foreign acquisition and employment concerns.[37] Cadbury was considered one of the last great British companies to fall into foreign ownership. In addition, Kraft confirmed the closure of Cadbury's Somerdale factory with the loss of 400 jobs once the acquisition was complete, having indicated during the takeover that the jobs would be safe.[38] One of the most vocal critics at the time was Vince Cable, who later that year became Business Secretary under the Coalition government between the Conservatives and Liberal Democrats (Lib-Dems).[39] The prospect of a "Cadbury Law" was discussed, with the Lib-Dem election manifesto in that year promising to "restore a public interest test so that a broader range of factors than just competition can be considered by regulators when takeovers are proposed".[40] There was also some pressure within the Labour party for such a change, but it was opposed by

33 OFT, *Personal Current Accounts in the UK: An OFT market study* (London: OFT July 2008).

34 CC, *Lloyds TSB Group plc and Abbey National plc: A report on the proposed merger* (London: CC July 2001).

35 R Whish, *Competition Law* (Oxford: OUP 2009), pp. 814–15.

36 G Tichy, "What do we know about success and failure of mergers?" (2001) 1 *Journal of Industry, Competition and Trade* 347.

37 See comments by R H Lynne Jones MP, HC Debs, 26 January 2010, vol. 504, 30, from col. 783; House of Commons Briefing Paper, *Takeovers*, n. 17 above.

38 "Kraft confirms factory closure with loss of 400 jobs", *The Times*, 9 February 2010.

39 See, for example, comments by Vince Cable on "The Today Programme", BBC Radio 4, 10 February 2010.

40 Lib-Dem Manifesto 2010, p. 26.

the same Labour Business Secretary who had brokered the Lloyds/HBOS merger, Lord Mandelson. He said, "a political test for policing foreign ownership runs the risk of becoming protectionist and protectionism is not in our interests".[41] The Labour Party manifesto instead proposed extending "the public interest test so that it is applied to potential takeovers of infrastructure and utility companies".[42] No such change was promised by the Conservatives, but the Coalition government did indicate it would "review the range of factors that can be considered by regulators when takeovers are proposed".[43]

Are broader public interest considerations desirable in UK merger control?

As the public interest consideration "the stability of the UK financial system" had not been envisaged by Parliament, there is a question of whether the Lloyds/HBOS merger signals the need for a broader public interest assessment of mergers. In particular, would there be benefits from a formalised system in which the competition authority conducts both a competition and public interest assessment of every merger, with the final decision made by the Secretary of State? Such a system could include guidelines setting out criteria for public interest assessments. This might be more appropriate than the kind of intervention seen in the case of Lloyds/HBOS, in which the recommendations of the OFT were simply over-ruled on a basis which was the Business Secretary's own creation, albeit with the hurried approval of Parliament.

It is worth looking at each of the justifications for public interest interventions individually. This section will consider whether the justification for allowing the Lloyds/HBOS merger, despite the competition concerns raised by the OFT, could apply to other industries. It will also ask whether the other concerns raised in the previous section would be addressed effectively by broader public interest interventions in merger control.

Lloyds/HBOS and the stability of financial markets

The banking sector holds a set of unique characteristics which made it essential for governments to intervene in the financial crisis of 2007–2008.[44] The crisis came about because too much was lent on the basis of a low (and artificially inflated) capital base. When the market corrected itself, borrowers began defaulting on their loans. It quickly became clear that much of the debt was "toxic", meaning that it was not backed by adequate capital. To make things worse, the bundling and exchange of debt between financial institutions made it hard to identify the toxic debt and accurately to determine each institution's liabilities. Bankruptcy became an inevitable consequence. The situation came about through a combination of reckless behaviour by the banks and poor regulatory oversight and adverse incentives created by governments.[45] The question, therefore, is why reckless banks were not simply allowed to go bankrupt. Why did governments seek to protect, not only the savings of individual taxpayers, but also the banks themselves?

Confidence is central to banking and without it failure can become a self-fulfilling prophecy. This is because customers can withdraw their money at short notice but banks do not have the liquidity to pay out all, or even, most of their customers in one go. This is because they lend the money to businesses and other customers. The effect of a loss of confidence was demonstrated by the Northern Rock crisis in September 2007. Thousands

41 Lord Mandelson, Mansion House Speech, 1 March 2010.

42 Labour Party Manifesto 2010, pp. 1–7.

43 HM Government, *The Coalition: Our programme for government* (London: HM Government May 2010), p. 10; House of Commons Briefing Paper, *Takeovers*, n. 17 above.

44 B Lyons, "Competition policy, bailouts and the economic crisis" (2009) 5 *Competition Policy International* 25.

45 V V Acharya and M Richardson, "Causes of the financial crisis" (2009) 21 *Critical Review* 195.

of its customers queued to withdraw their money amid rumours the bank was about to fold. This continued despite the government guaranteeing retail depositors' money.[46] There are very few industries which are so sensitive to confidence.[47]

The availability of credit is of central importance to businesses throughout the economy. When banks restrict lending in order to rebuild their own reserves, there arises a danger that perfectly healthy profitable businesses will become bankrupt because they are unable to borrow in order to cover short-term costs. This is because of the fluctuations businesses face in their revenues and payments. A further unusual characteristic of the banking industry is that institutions will lend money to each other on an informal basis to cover their immediate debts. So a bank which has accepted more deposits than loans on a particular day will lend money to a bank in the reverse situation, in the form of an interbank loan. The banking industry is able to react well to the failure of small banks.[48] However, when the US bank Lehman Brothers, a major bank, collapsed in September 2008, other banks in the industry stopped lending to each other, unsure of which would be next to fold. In the UK, it was feared that the failure of HBOS, the most vulnerable of the UK banks, would have a similar effect on the UK banking sector.[49]

Reduced credit has a strong negative effect on the economy. Bailouts and nationalisation were the only way governments could restore a level of confidence in the banking industry which could once again facilitate lending. Thus, the Banking (Special Provisions) Act 2008 allowed the Treasury to nationalise failing banks or to direct their transfer to a third party. In the short term, governments tried to compensate for the shortage in credit by slashing interest rates, increasing spending and implementing short-term cuts in taxation.

No other sector of the economy can claim the same justification. When a major bank is allowed to fold, the banking sector stops lending and the wider economy risks coming to a halt. In regular industries, bankruptcy has very different consequences. Liquidators reallocate the bankrupt firm's capital and employ it elsewhere in the economy. Competitors move in to supply the bankrupt firm's customers. Bankruptcy is the normal way in which an industry sheds excess capacity or in which an inefficient firm leaves the sector. The treatment of the banking sector should not be extended, during times of crisis, to the wider economy. Indeed, there are empirical studies of the US and Japan which suggest that concentrations of market power during an economic crisis can be extremely damaging. The US National Industry Recovery Act 1933, which effectively legalised cartels in the wake of the Great Depression, and similar measures taken in Japan during the 1990s, are shown to have delayed economic recovery rather than promoting stability.[50]

So, the justification for allowing Lloyds/HBOS to merge on public interest grounds is peculiar to the banking sector. Indeed, some have subsequently argued that the merger failed even in its stated aim of achieving stability. Sir John Vickers, former chief of the OFT, argued that forcing the merger through on public interest grounds was a mistake

46 Lyons, "Competition policy", n. 44 above; P Marsden and I Kokkoris, "The role of competition and state aid policy in financial and monetary law" (2010) 13 *Journal of International Economic Law* 875.

47 Lyons, "Competition policy", n. 44 above.

48 For example, A Akhigbe and J Madura, "Why do contagion effects vary among bank failures?" (2001) 25 *Journal of Banking & Finance* 657.

49 M Reynolds, S Macrory and M Chowdhury, "EU competition policy in the financial crisis: extraordinary measures" (2011) 33 *Fordham International Law Journal* 1670, 1718.

50 H L Cole and L E Ohanian, "New Deal policies and the persistence of the Great Depression: a general equilibrium analysis" (2004) 112 *Journal of Political Economy* 779; M E Porter and M Sakakibara, "Competition in Japan" (2004) 18 *Journal of Economic Perspectives* 27.

because it only restored confidence to the banking sector for a short period of time.[51] In November 2009, the European Commission approved a state recapitalisation of £17bn for the newly formed Lloyds Banking Group. In return for approving this state aid, Lloyds was required to divest 600 branches to create a new bank with a 4.6 per cent share of the personal current account market.[52] Sir John later became the chair of the Independent Commission on Banking. In November 2010, he said that the merger had seriously damaged competition and that HBOS should instead have been nationalised.[53] The Independent Commission on Banking's interim report notes that:

> Although the acquisition by Lloyds TSB gave temporary respite to HBOS, it jeopardised Lloyds TSB. Large sums of public money had to be injected into the merged entity, which was renamed LBG, with the result that the Government now owns 41% of the group.[54]

The merger led to the loss of £2bn in share value for Lloyds, a loss that caused a small group of investors to launch legal action in March 2011, arguing that the Business Secretary deliberately withheld evidence that would have prevented the deal from going ahead.[55]

Kraft/Cadbury and other concerns

Despite criticisms, foreign acquisitions have brought a number of benefits to the UK. As well as encouraging foreign investment – most notably in the UK car industry – the opening of UK markets has transformed systems of management within firms. In stark contrast to the dark days of British Leyland, UK companies are now largely well run, albeit with widespread foreign ownership.[56] When foreign acquisitions are damaging, as is alleged to be the case with Cadbury, it might be more desirable to protect firms through better corporate governance, rather than allowing governments to intervene as they see fit on public interest grounds.

A number of commentators argued that Kraft's acquisition of Cadbury had been driven by investors with only short-term interests in the company's future.[57] These were misaligned with the longer-term interests of the firm, the main challenge being to enhance the power of long-term stakeholders to block damaging acquisitions. In a speech following the takeover, the then Business Secretary Lord Mandelson admitted:

> In the case of Cadbury and Kraft, it is hard to ignore the fact that the fate of a company with a long history and many tens of thousands of employees was decided by people who had not owned the company a few weeks earlier, and probably had no intention of owning it a few weeks later.[58]

51 J Vickers, "The financial crisis and competition policy: some economics" (2008) 1 (December) *Global Competition Policy*.

52 European Commission, "State aid: Commission approves restructuring plan of Lloyds Banking Group", 18 November 2009.

53 "Sir John Vickers calls Lloyds takeover of HBOS a mistake", *The Guardian*, 26 November 2010.

54 Independent Commission on Banking, *Interim Report: Consultation on reform options* (London: Independent Commission on Banking April 2011), para. 5.34.

55 "Lloyds investors sue over HBOS merger", *Daily Mail*, 27 March 2011. At time of writing these cases were at a very preliminary stage.

56 See, for example, R Harris and C Robinson, "Foreign ownership and productivity in the United Kingdom: estimates for UK manufacturing using the ARD" (2003) 22 *Review of Industrial Organization* 207; S Girma et al., "Who benefits from foreign direct investment in the UK?" (2001) 48 *Scottish Journal of Political Economy* 119.

57 House of Commons, Business, Innovation and Skills (BIS) Committee, *Mergers Acquisitions and Takeovers: The takeover of Cadbury by Kraft*, *Ninth Report of Session 2009–2010* (Norwich: The Stationery Office 2010), HC Paper No 234 (Session 2009–2010), available at www.publications.parliament.uk/pa/cm200910/cmselect/cmbis/234/23402.htm. paras 56–60.

58 Lord Mandelson, Mansion House Speech, 1 March 2010.

Suggestions of how to address this problem included:[59] raising the voting threshold needed to secure new ownership from a simple majority to two-thirds; lowering the requirement to disclose share ownership during a takeover bid from 1 to 0.5 per cent; giving the bidding company less time to tie up a deal; forcing bidders to disclose how they intend to finance the takeover; and requiring greater transparency on advisers' fees and incentives.[60] These proposals were not well received by city bosses and have not been adopted by the Coalition government.[61]

The short-termism which characterises many mergers is a valid criticism and is ultimately relevant to assessing a merger on competition grounds. Merger control is not about the finding of an infringement, but about predicting two futures: one with the merged firm operating in the market and one with the counter-factual. It is not always easy to determine whether a merger is likely to result in long-term gains or whether it is purely motivated by short-term profit. However, attempts to restrict parties' freedom to purchase businesses or dispose of their property as they see fit could, without clear justification, simply lead to uncertainty, which discourages both short-termist mergers and those which are beneficial to the economy.

Protecting employment is a social issue which is of great concern to many. However, the history of UK industrial policy is laden with examples of protecting inefficient and uncompetitive firms, only to prolong their painful demise.[62] Mergers can be an important way of increasing efficiency within an economy (for example, through economies of scale) or of consolidating excess capacity. Unemployment is sometimes a consequence of this. Efficiency should lead to lower prices and better quality, freeing up households' disposable income to create new demand and new markets. Similarly, capital operating inefficiently in one industry is better placed elsewhere. In this context, allowing governments to step in simply to protect jobs can ultimately be counter-productive. In the case of Cadbury, the firm had actually earmarked the Somerdale plant for closure before the takeover. Kraft had foolishly indicated that it would save the plant before properly investigating the circumstances surrounding its closure. Instead of intervening in mergers to save jobs, governments should instead focus on supporting those who have been made redundant and helping them to prepare for other jobs in the economy where they are needed. They can also encourage businesses to open operations in areas with high unemployment through regional development projects and tax incentives.

UK merger regulation actually allows for a "failing firm" defence under which a merger will not be blocked on SLC grounds where one of the firms would otherwise fail.[63] Such mergers might actually protect jobs, as compared to allowing the failing firm to fold entirely. It is interesting to note that, in its competition assessment, the OFT did not consider it likely that HBOS would fold and so did not consider the application of the failing-firm defence

59 For a discussion, see B Clarke, "Directors' duties during an offer period – lessons from the Cadbury plc takeover", UCD Working Papers in Law, Criminology and Socio-Legal Studies, Research Paper No 44/2011 (unpublished manuscript).

60 BIS Committee, *Mergers Acquisitions and Takeovers*, n. 57 above, para. 64; "Mandelson calls for tougher takeover rules", BBC News, 1 March 2010; "Lord Mandelson calls for overhaul of takeover rules", *The Guardian*, 1 March 2010.

61 "Cadbury's Law is 'unworkable, costly and a threat to Britain', say City bosses", *Daily Telegraph*, 11 April 2010; HM Government, *The Coalition*, n. 43 above.

62 See, for example, D R Steel, "Government and industry in Britain" (1982) 12 *British Journal of Political Science* 449, and A Mair, "From British Leyland Motor Corporation to Rover Group: the search for a viable British model" in M Freyssenet et al. (eds), *One Best Way? Trajectories and industrial models of the world's automobile producers* (Oxford: OUP, 1988).

63 OFT, *Restatement of OFT's Position Regarding Acquisitions of Failing Firms* (London: OFT December 2008).

as appropriate in the Lloyds/HBOS case.[64] So far, the failing firm defence has succeeded in only a limited number of mergers, between firms operating in the transport, retail and manufacturing sectors.[65]

Finally, while it is true that mergers can create concentrations of wealth, the objectives of social policy and competition do not necessary diverge here. As discussed in the introduction, merger control on competition grounds is about controlling market power to ensure it does not become too concentrated through monopolisation or cartelisation.[66] It seeks to promote efficiency and tends to be focused on the welfare of consumers, rather than companies. Merger laws in the US were actually strengthened at a time when concerns about concentration of wealth were particularly prominent.[67] In addition, abuse of dominance or monopolisation laws are an area of competition policy which specifically aims to curb large concentrations of power. Examples of this include the break-up of AT&T in the US and the European Commission's investigation of Microsoft.[68]

Concluding remarks

Far from signalling the failure of an economics-based system of merger regulation, the Lloyds/HBOS merger highlights the importance of restricting political interventions on public interest grounds to exceptional circumstances in specific industries. Merger control on competition grounds encourages innovation and efficiency, bringing us new products for lower prices and less cost (in terms of resources), while preventing the exercise of excessive market power. The unforeseen circumstances which led to banks being bailed out and nationalised illustrate how difficult it is to foresee where public interest interventions will be needed. The need for protection was due to characteristics which were largely unique to the banking sector. Confidence is vital to the movement of credit and banks react to retractions in their capital base and the bankruptcy of other banks by tightening their lending. This risks starving the economy of vital credit with the consequence that even profitable commerce grinds to a halt because of an inability to cover short-term costs.

Indeed, there is reason to believe that Lloyds/HBOS failed to achieve the stated public interest interventions, having to be bailed out by the government after the merger. This has left a powerful bank which has significantly reduced competition. While competition policy tools do exist which can attempt to address this, for example, the European Commission requirement that 600 branches be sold in return for the bailout, *ex post* review and remedy can never be as effective as regulating a merger *ex ante*. This is because it is "extremely difficult to unscramble the proverbial egg".[69] There is thus a growing consensus that the merger should have been blocked on competition grounds and that HBOS should have been nationalised instead.

64 OFT, *Anticipated Acquisition*, n. 28 above, paras 59–60.

65 See OFT, *Restatement of OFT's Position*, n. 63 above; CC, *A Report on the Completed Acquisition of GV Instruments Limited by Thermo Electron Manufacturing Limited* (London: CC May 2007).

66 N Peterson, "Antitrust and the promotion of democracy and economic growth", Max Plank Institute for Research on Collective Goods (unpublished manuscript 2011) finds that antitrust laws have a positive effect on the level of GDP per capita and economic growth, although no significant positive effect on the level of democracy.

67 Whish, *Competition Law*, n. 35 above, p. 814, citing the example of *Brown Show Co.* v *United States* 370 US 294, 344 (1962).

68 S Coll, *The Deal of the Century: The breakup of AT&T* (New York: Simon & Schuster 1980); Commission Decision of 24 March 2004 relating to a proceeding under Article 82 of the EC Treaty (Case COMP/C-3/37.792 Microsoft).

69 Reynolds et al., "EU competition policy", n. 49 above, p. 1736.

The other concerns raised in support for wider public interest considerations are also unlikely to be well served by political interventions. Foreign acquisitions which are not in the interest of the UK firm are better dealt with through stronger corporate governance. These acquisitions are frequently driven by short-term stakeholders whose interests are misaligned with the long-term success of the firm. Intervening in merger control in order to protect jobs can be counter-productive. Merger control on competition grounds promotes efficiency within the economy and makes exceptions where one of the merging firms would otherwise become insolvent. Political interventions in this area are more likely to be driven by protectionism or populist concerns, rather than reasoned policy. Finally, merger control on competition grounds does not run counter to concerns about concentrations of wealth. Competition policy is about controlling large concentrations of market power and preventing what Polanyi viewed as the creature of competition, monopoly.

A return to broader political interventions on public interest grounds would risk creating inconsistency in merger regulation and uncertainty for firms. While such a regime might prevent some mergers viewed as damaging, it would also discourage mergers which benefit the economy and would make it less likely that foreign firms will invest in the UK. The unpredictable circumstances in which a public interest intervention might be perceived as being necessary – as in the Lloyds/HBOS merger – makes it impossible to provide a satisfactory definition of public interest. The competition authority could be asked to assess a merger on both competition grounds and public interest grounds, but it is the Secretary of State who must always make the final decision regarding public interest.

The ability to intervene in any case on public interest grounds raises a number of dangers, some of which characterised the UK's early merger control regime. First, the Secretary of State may respond to lobbying by special interest groups which represent only a small section of the electorate. Second, he or she may make decisions which are populist or motivated by political self-interest. In the case of foreign acquisitions, the Secretary of State might be far more willing to intervene where there is significant negative media coverage of the takeover. This means that interventions would occur in the case of household names such as Cadbury's, but not acquisitions involving less well-known companies. Interventions might also be more likely in the lead-up to a general election. Finally, the Secretary of State might be influenced by personal prejudice. In December 2010, the Business Secretary Vince Cable was stripped of his responsibility to decide whether News Corporation's acquisition of BSkyB should be blocked on public interest grounds, after telling an undercover journalist that he had "declared war" on News Corporation's owner, Rupert Murdoch.[70]

Despite the pressures of the current economic climate, the government has rightly declared its commitment to maintaining the independence of the competition authorities from political interference.[71] As part of their 2011 consultation on the UK competition regime, it was stated that: "Ministers will continue to take decisions only in the small minority of cases which raise defined, exceptional public interest issues."[72] The importance of this commitment was also stressed by Lord Mandelson, the former Business Secretary, who brokered the Lloyds/HBOS merger:

70 "Humiliated Vince Cable stripped of Sky role after 'war with Murdoch' gaffe", *The Guardian*, 21 December 2010.

71 For a broader discussion of how competition policy has reacted to the financial crisis see: P Lowe, "Competition policy and the global economic crisis" (2009) 5 *Competition Policy International*; D Gerard, "Managing the financial crisis in Europe: why competition law is part of the solution, not of the problem" (2008) 1 (December) *Global Competition Policy*.

72 BIS, *A Competition Regime for Growth: A consultation on options for reform* (London: BIS March 2011), para. 1.13.

> a government's judgment and intervention . . . might give rise to capricious decision-making of one sort or another, depending on the ministers and their official advisers, and it can lead to a loss of transparency and a loss of predictability which at the moment makes the current UK regime open to investors from which, I just underline, we benefit a great deal.[73]

The current system works well in focusing on competition only, according to published guidelines which provide businesses with both transparency and predictability. Public interest interventions are restricted to a tiny number of identified industries where there is good reason to consider non-competition factors. If exceptional circumstances arise which give good reason for adding another industry to the list, it is right that the Secretary of State should need the approval of Parliament. Although the Enterprise Act essentially formalised what had been established practice for some years, it was very significant in preventing the exercise of political preferences in all but a very limited set of circumstances. As Peter Freeman, chair of the CC noted, the Lloyds/HBOS merger shows the UK system "in operation, not disarray".[74]

73 BIS Committee, *Mergers Acquisitions and Takeovers*, n. 57 above, para.73.

74 P Freeman, "Merging is such sweet sorrow", speech to the British Institute of International and Comparative Law, "Mergers Conference", 13 November 2008.

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The transformation of broadcasting: public service broadcasting, the BBC and the distortion of new media markets

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Abstract

Broadcasting markets in Europe have traditionally been highly regulated, with large public subsidies seen as necessary to ensure that cultural and citizenship goals can be realised. While being outside of Polanyi's purview when he wrote his seminal work The Great Transformation*, these "markets" exist alongside other public interest norms; in his words, they are embedded in society.*[1] *In the last 20 years, broadcasting markets in Europe have undergone something of a "transformation", in the sense that technological advances have facilitated a shift away from public provision towards a market-based model. The removal of spectrum constraints has led to new platforms and a proliferation of channels. More importantly, with the emergence of conditional access systems has come the growth of subscription and pay-per-view television, offering significant new revenue streams and the development of new markets in premium content. Latterly, non-linear television services have seen a shift in audience viewing behaviour, and the convergence between television and the internet heralds new, innovative modes of delivery of, and changing pricing mechanisms for, broadcasting services. So, as a consequence of technological developments, we see the rise of a new type of commodity in broadcasting services. Whereas once, such goods were universally available partly because their consumption was physically non-excludable, now technology facilitates charging and the emergence of a market based on willingness and ability to pay.*

1 Introduction

Public service broadcasting (PSB) continues to have a special position in EU law. As a paradigm for quality, universal and free-to-air (FTA) television, however, it is being placed under substantial pressure. With more choice, audiences are becoming increasingly fragmented with a resultant fall in advertising revenues for those who, unlike the BBC, rely partially or wholly upon this type of income. The so-called "spectrum compact", under which commercial broadcasters accepted public service obligations in exchange for access to the spectrum, is now nearing an end, with the largest and most significant of the UK's commercial broadcasters indicating its intentions to merely hand back its licences once digital switchover is complete, thereby ceasing its additional PSB obligations. Similarly, the

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1 K Polanyi, *Origins of our Time: The Great Transformation* (London: Gollancz 1945). For an introduction to the life and works of Polanyi see G Dale, "On the conceptual innovations and intellectual affiliations of Karl Polanyi" (2010) 15 *New Political Economy* 369.

state-owned Channel 4 is arguing that it can no longer afford to meet its current PSB obligations, particularly those pertaining to high quality news provision, a core element of PSB. In contrast, notwithstanding the recent freeze in the licence fee level, the BBC enjoys a privileged position, with a guaranteed income of in excess of £3bn per year.

With the retraction of the commercial public service broadcasters, one might think that the BBC would enjoy an enhanced and more important role in the UK's broadcasting landscape.[2] The challenges to the BBC, however, come from different directions. First, precisely because of its insulation from market pressures, the BBC needs to act with heightened sensitivity, especially when its private counterparts are weathering particularly difficult commercial conditions. Second, with the marketisation of broadcasting services, the BBC is increasingly being the subject of regulatory controls, including competition law, which aim to limit the extent to which it can distort emergent markets. Yet entry into these new markets is crucial if the BBC (and PSB) is to secure a sustainable position in the long term. Hitherto, PSB has lacked a clear rationale, which poses a particular difficulty where it comes into conflict with highly juridified and articulated market-based norms.[3] The difficulty is that while the economic approach, from which the market failure justification derives, is based upon a "well-defined paradigm", the political and cultural perspectives, which argue for a broader conception of PSB, are more "diffuse and less coherent".[4]

Competition law itself might not be seen as antithetical to Polanyi and the idea of embedded markets, now forming the cornerstone of economic sociology.[5] Indeed, the existence of such laws perhaps lends further credence to the view that a market economy cannot survive without state intervention, in this case by limiting the concentration, and abuse, of market power. In the context of the media which, without intervention, tends to be highly concentrated, competition law might serve broader public interest values, such as securing lower prices, more choice and, therefore, greater access to media services.[6] On the other hand, it may be seen to further entrench the market paradigm, especially where the rules restrict the ability of the state to distort markets through subsidies, as is the case in the EU.

The BBC and broadcasting in the UK are at a crossroads. One vision of the future is that the BBC should continue to play an important but receding role, merely filling the gaps left by the market. Another, competing vision would see the BBC as a central player in British broadcasting, continuing to take a leading role in shaping new media markets.[7] The central question in this article is which vision is now reflected in the regulatory arrangements governing the BBC's activities. If the market takes precedence over public service values – if it is disembedded – then PSB will wither away.

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2 For a general discussion of regulation and public interest in broadcasting markets see M Feintuck and M Varney, *Media Regulation, Public Interest, and the Law* (Edinburgh: Edinburgh UP 2006), chs 2 and 3.

3 G Born and T Prosser, "Culture and consumerism: citizenship, public service broadcasting and the BBC's fair trading obligations" (2001) 64 *Modern Law Review* 657.

4 D Helm, "Consumers, citizens and members: public service broadcasting and the BBC" in T Little and D Helm (eds), *Can the Market Deliver?: Funding public service television in the digital age* (Herts: John Libbey 2005), p. 1; S Deakin and S Pratten, "Reinventing the market? Competition and regulatory change in broadcasting" (1999) 26 *Journal of Law and Society* 323.

5 For an explanation of economic sociology and Polanyi's influence upon it, see K Hart, "Karl Polanyi's legacy" (2008) 39 *Development and Change* 1135.

6 Most Western countries have, in addition to competition law, specific rules designed to secure a sufficient level of media pluralism necessary for the functioning of a healthy democracy. Such rules might privilege pluralism over other goals central to competition law, such as lower prices and efficiency.

7 The term "new media markets" is taken to mean, among other things, broadcasting services offered over the internet (as a result of convergence), non-linear television services (such as VOD), and new innovations in user interactivity.

This article is structured as follows. Section 2 explains the definitions of, and continued rationale(s) for the public interventions, including funding, in support of PSB and the BBC. Section 3 then explains some of the criticisms that have been levelled against the organisation and its claimed propensity to "crowd-out" commercial operators. Section 4 explains the legal context in which the BBC's operation on the market is scrutinised and controlled, while section 5 interrogates two recent cases decided by the BBC Trust (the Trust) concerning its entry into new media markets. Section 6 concludes.

2 Definition(s) of, and rationales for, PSB

There is no definitive meaning of PSB. The Communications Act 2003 offers a definition of the purposes of PSB which are to offer a wide range of programming, representing a balance of different genres, meeting the needs of as many different audiences as practicable.[8] High standards are to be maintained; cultural activity reflected, supported and stimulated; information disseminated; and educational aims met, particularly with respect to science, religion and social issues. The BBC's public purposes are enumerated in the Royal Charter and are as follows: sustaining citizenship and civil society; promoting education and learning; stimulating creativity and cultural excellence; representing the UK, its nations, regions and communities, and bringing the UK to the world and the world to the UK.[9] As is explained below, European law secures a special place for PSB in promoting values such as citizenship, democracy, social cohesion and national identity.

There are two principal rationales for PSB. First, there is the market failure rationale, whereby state intervention in broadcasting markets is justified because the market will fail to deliver on consumers' demands, and possibly on society's broader political and cultural needs. Second, there is a broader conception of PSB which rejects the market paradigm, at least one based solely on consumer sovereignty, explicitly founding the need for PSB on broader societal and cultural justifications. Clearly, the difference between these two positions turns on the meaning of market failure. For the purposes of the exposition here a narrow conception of market failure is adopted, that is the extent to which a market-based system of broadcasting will fail to meet fully consumer demand. This important point is returned to in the conclusion to this section.

The market failure rationale for PSB (and the BBC)

The traditional case for intervention in broadcasting fixes upon four key market failures. First, spectrum constraints, or scarcity, meant that few channels could be broadcast with the attendant dangers that there would be insufficient diversity or choice for viewers. Clearly, technology advances have resulted in a proliferation of channels, though this does not necessarily mean an increase in diversity. Second, the advertising funding model for commercial television produces an incentive problem in so far as advertisers' and viewers' preferences may diverge. Advertising revenue will generally vary according to audience size, so that commercial operators will tend to produce content which attracts the highest level of audience share, with the risk that certain audience sectors will be under-supplied. Furthermore, in maximising profit, commercial operators will seek to produce programmes

8 Communications Act 2002, s. 264 (4) and (6). This definition informs Ofcom in its periodic review of PSB. The Digital Economy Act 2010 has extended this review duty to include public service content offered online and on VOD. For the most recent review, see Ofcom, *Public Service Broadcasting Annual Report 2011* (21 July 2011), available at http://stakeholders.ofcom.org.uk/binaries/broadcast/reviews-investigations/psb-review/psb2011/psb-summary-A.pdf (last accessed 26 July 2011).

9 Department of Culture, Media and Sport, *Broadcasting: Copy of Royal Charter for the continuance of the British Broadcasting Corporation* (London: TSO 2006), Cm. 6925.

which attract the lowest production costs (genres such as soap operas and reality television programmes). Third, traditional analogue broadcasting is non-excludable, with the result that there exists no price mechanism to reveal individual viewer preferences or, to put it a different way, there is no incentive to produce programming for those segments of the audience who are willing to pay for high quality, niche programming. A fourth type of market failure centres upon the positive value of having a well-informed public which results from, in part, the provision *and consumption* of high-quality news and current affairs content. In respect of consumption, while the individual's choice in viewing information makes only a negligible contribution to how well-informed society is, in aggregate the effect can be very substantial (the positive externality). The implication is that a model of broadcasting based purely on a model of individual choice (or consumer sovereignty) will fail to deliver the substantial benefits resulting from a well-informed public (for example, greater scrutiny of public institutions, greater participation in democratic processes, and so on).[10]

Will (do) market failures still remain in the digital age?

A number of commentators now question whether PSB is necessary or sustainable in the new digital environment which – it is argued – has corrected or removed some or all of the market failures above. In particular, the development of conditional access systems now mean that broadcasters can be more responsive to audience preferences, both in respect of their demands and, crucially, their *willingness* to pay.[11] Furthermore, a number of writers have pointed to the potential for the BBC to frustrate the achievement of a competitive market, arguing for contestability in public funding.[12]

There are, however, a number of reasons to think that the multichannel environment will not yield the diversity and choice, both in terms of broadcasters and programme genres, one might expect at an intuitive level.[13]

Despite recent technological advances, programme production tends to attract high fixed costs, favouring a search for economies of scale, audience maximisation and, in turn, horizontal concentration. As with cultural goods generally, incentives tend to be affected by the "hit or flop" phenomenon.[14] In the light of uncertainty over consumer demand, it is very difficult for producers to know which investments (possibly only a minority) will actually pay-off, with the need therefore for risk to be managed. Furthermore, on the demand side, it is very difficult for consumers to know *ex ante* whether they will actually enjoy a programme, meaning that strong channel brands and marketing will be important. Consumers also tend to purchase relatively large bundles of channels. High-risk investments reinforce tendencies towards concentration and can also lead towards vertical integration between upstream production and downstream distribution; having an installed subscription base makes upstream investments less risky. While vertical integration can be

10 S Hargreaves Heap, "Television in a digital age: what role for public service broadcasting?" (2005) 41 *Economic Policy* 111, p. 122.

11 M Armstrong, "Public service broadcasting" (2005) 26 *Fiscal Studies* 281. There is, of course, a crucial distinction to be made between willingness and ability to pay and this is reflected in one of the norms underpinning PSB, i.e. universality.

12 See, in particular, A Peacock "Public service broadcasting without the BBC?" in A Peacock (ed.), *Public Service Broadcasting Without the BBC?* (London: IEA 1997), p. 33.

13 For a broad, and early, discussion of market failures in new media markets, see A Graham and G Davies, *Broadcasting, Society and Policy in the Multimedia Age* (Luton: University of Luton Press 1997). A summary of these points can be found in Department of Culture, Media and Sport, *The Future Funding of the BBC: Report of the Independent Review Panel* (chair Gavyn Davies) (London: DCMS July 1999).

14 N Garnham, "The broadcasting market and the future of the BBC" (1994) 65 *Political Quarterly* 1, pp. 13–14.

pro-competitive, it can also result in foreclosure of rivals (both at the levels of production and distribution), leading to less diversity.

With the advent of digital television, spectrum scarcity is no longer an issue and, so, one might expect greater choice and diversity in broadcasting. Some have suggested, however, that audience fragmentation results in greater homogeneity in content as the incumbent suppliers, who still capture around 80 per cent of linear television audiences, become less willing to take risks for fear of losing audience share and, in turn, advertising revenue. The empirical evidence on this point is, however, ambiguous.[15]

There may also be strong efficiency arguments against using charging mechanisms in broadcasting. Broadcast programmes are public goods in the sense that one person's consumption does not rival another's (non-rivalrous and non-excludable).[16] Exclusion here does not turn on the ability to exclude through a pricing mechanism, rather it denotes that the welfare maximising strategy will be not to exclude.[17] In the economic parlance, this is because once a programme has been produced, absent distribution costs, the marginal cost of supplying an additional viewer will be zero. A strategy of fragmenting the audience through subscription has the perverse result of raising the cost to all those at the margin and, in turn, removing more people at the margin.[18] This is a powerful market failure argument for those contending that broadcasting should be underpinned by the universality principle. On the other hand, it is the case that allowing charging generates profits and revenues that may be used to fund better upstream production, leading to higher quality content.

One further issue arises which appears to often fall off the agenda – the interests of viewers as consumers. While broad entreaties are made towards the importance of consumer sovereignty and respecting consumer choice, very often the interests of commercial operators and of viewers (even when narrowly defined as consumers) are seen as coterminous. We see later in one of our cases the very real danger of making this a priori assumption; in the *Local Video* case the ability of the BBC to meet existing product demand was not in question, but commercial interests were given priority, in the short term at least. Indeed, under the present regulatory structure, one which imposes upon the BBC so-called "fair trading obligations", there is the danger that the careful balance between type I and type II errors is being disturbed in favour of outcomes which seek to ensure that markets are kept open to commercial operators, even if this results in harm to consumers.[19]

Even within the narrow consumer welfare rubric, the advent of technologies which allow broadcasters to efficiently price-discriminate while reflecting consumer preferences (i.e. through willingness to pay) has a number of important welfare effects: it results in a transfer of rents from consumers to producers (which may meet a total welfare standard, but would hardly satisfy a consumer welfare standard, the latter being the relevant one for European and UK law); it results in the preferences of those willing to pay being met while

15 See Hargreaves Heap, "Television in a digital age", n. 10 above, pp. 119–20, for a brief review of the literature.

16 Garnham, "The broadcasting market", n. 14 above, p. 13; Helm "Consumers, citizens and members", n. 4 above, p. 7.

17 Garnham, "The broadcasting market", n. 14 above, p. 13; Helm "Consumers, citizens and members", n. 4 above, p. 8.

18 Helm "Consumers, citizens and members", n. 4 above, p. 8.

19 A type I error simply means a false positive (in this context, an incorrect finding that something is welfare-reducing), while a type II error is a false negative (an incorrect finding that something is welfare-enhancing or neutral). In competition law, there are many contexts where a competition authority is dealing with firm conduct that may have ambiguous welfare effects and, in deciding whether or not to intervene, it will need to balance the probability that it will make a mistake against any expected welfare benefits of intervening. Note, however, that the strong obligation upon the BBC to refrain from activities which harm commercial rivals will mean that less emphasis is being placed on the positive effects such activities may have on viewers/consumers.

those unwilling to pay (at the market price) are denied provision; and price is only a proxy for utility (i.e. that markets suffer from a common problem that they are based upon prior entitlement). This is not to say that these pricing mechanisms cannot be justified on welfare grounds, only that the rubric for assessing the welfare consequences of intervention are very much more complicated than is sometimes supposed.[20]

A broader conception of PSB?

So, there are strong reasons to suppose that digital television will remove market failures and leave untouched or exacerbate existing ones, as well as possibly introducing new ones, which in turn require control. There is a second line of defence, however, which goes to the very root of the justification for intervening in support of PSB: to view the public interest case for intervention in broadcasting markets through solely the narrow focus of a market paradigm based on consumer sovereignty ignores many other very important societal and cultural justifications.[21] As Prosser and Born put it in a seminal article on PSB:

> [T]he cultural and citizenship purposes usually taken to characterise the normative basis of PSB should be primary, and not subordinate to economic and commercial criteria in determining the future of such broadcasting.[22]

It is often said that broadcasting services are "dualist" goods, in the sense that they are both commercial and cultural products.[23] PSB should, therefore, be seen to have a wider role than simply filling in the "gaps left by market"; it may play an important role in shaping preferences prior to the market. It is clear also that universality can be argued to be a core value. There is a key danger that, while new technologies have the potential to bring benefits to viewers, when provided on the basis of willingness *and ability* to pay, there is also the potential to exclude, with all the attendant costs that will attract both for those individuals and for society more broadly. Furthermore, if it is true to say that a pure market model of broadcasting will likely lead to high levels of homogeneity and a concentration of providers, then social and cultural diversity will suffer. Raising levels of quality is also often cited as a core justification for PSB, and the BBC in particular. Rather than dampening competition, the BBC can "raise the game" because it has the capacity to give priority to production values over the constraints of the market.

The sustainability of PSB has been questioned. This argument turns on audience behaviour; investment can be made in the provision of PSB content, but this has little value if consumers cannot be persuaded to watch it.[24] In answer to this problem, proponents of PSB reply that this justifies a model of PSB based on a mixture of programming, with entertainment genres scheduled alongside more educational and informative content.[25]

20 Because of the ability to price-discriminate, such that viewers' surpluses can be extracted, commercial broadcasters have an incentive to deliver a diverse range of programmes (M Armstrong and H Weeds, "Public service broadcasting in the digital world" in P Seabright and J von Hagen (eds), *The Economic Regulation of Broadcasting Markets: Evolving technology and the challenges for policy* (Cambridge: CUP 2004), pp. 81, 115–19.

21 For a defence of PSB, see S Pratten and S Deakin "Commentary: the scope of public service broadcasting" and C Fairburn "Commentary: why broadcasting is still special" in Peacock (ed.), *Public Service Broadcasting*, n. 12 above, pp. 8 and 58 (respectively).

22 Born and Prosser "Culture and consumerism", n. 3 above, p. 659.

23 See, for example, the Directive 2010/13/EU on Audiovisual Media Services (Codified version) [2010] OJ L95/1, recital 7.

24 Armstrong and Weeds, "Public service broadcasting", n. 20 above, pp. 115–19.

25 Born and Prosser, "Culture and consumerism", n. 3 above.

Conclusion

In language which resonates with Polanyi's warning over disembeddedness, Helm states:

> Markets . . . exist within a *social* context, with all its politics, freedoms and cultures, rather than the other way around. At stake here is something very fundamental. In discussing [PSB], whilst economics and the market failure framework have a great deal to offer, their universalisation of the problem should not simply be assumed.[26]

A broad definition of market failure, which embraces the importance of the market being embedded in society, might accommodate many of the public interest goals underpinning the broader conception of PSB. The scope of market failure and, therefore, the justification for intervention, in itself depends upon what we want markets to deliver – merely consumer demand or broader public interest goals.

There is a threat to the future of PSB to the extent that it lacks a clearly articulated rationale, especially when broader public interest values come up against the apparently "hard" values of competition law, with a strong presumption in favour of undistorted markets.[27] It goes without saying that market-orientated norms are highly juridified, both at a supranational and national level (these are touched upon briefly in section 4). The difficulty comes where a market-orientated solution will not deliver up, or even conflicts with, the broader public interest goals being pursued under a PSB intervention. So consider, for example, the question of whether a market distortion is proportionate to the pursuit of a PSB value (one of the planks of the public value test explained below). How can the question of proportionality be decided without a clear idea about the goal being pursued and its relative importance within the hierarchy of PSB norms? Furthermore, the lack of a clearly articulated rationale also raises accountability problems and the risk that the institution(s) charged with delivering PSB will seek to forward their own narrow organisational interest at the expense of the broader public interest. While market failure does have to be judged against the possibility of governmental failure, the relevant counterfactual, the latter is more likely to occur, or will be more serious, the less defined is the public service remit. The position in the UK has been contrasted unfavourably with other European countries where PSB has been elevated to constitutional principle.[28]

The future direction of PSB depends crucially upon which rationale predominates. If market failure is the exclusive justification for intervention, then any action which the BBC takes in entering new markets must be judged against what would (might) happen without entry (the need to avoid market failure paradox). On the other hand, if it is based on the broader public interest notions of citizenship, universality and cultural diversity, then market-based norms must *ultimately* give way.[29]

3 The BBC's incentives and ability to distort new markets

It may seem counterintuitive to suggest that a public firm will have an incentive to act anticompetitively, especially where its primary objective is not profit maximisation. Indeed, it seems reasonable to suppose that a public firm would act less aggressively towards its

26 Helm "Consumers, citizens and members", n. 4 above, p. 4 (original emphasis).

27 Born and Prosser, "Culture and consumerism", n. 3 above, p. 659.

28 See ibid. p. 661. See R Craufurd-Smith, *Broadcasting Law and Fundamental Rights* (Oxford: Clarendon Press 1997).

29 This is not to suggest that markets cannot deliver cultural diversity, merely that, given the market failures explained above, they are less likely to do so without some form of public intervention. What form that intervention should take is a question beyond the scope of this article.

competitors than would a private, profit-maximising firm.[30] It has been posited, however, that public firms often have *stronger incentives than private firms* to pursue market strategies which harm their rivals. Moreover, it is precisely because the firm is motivated by objectives distinct from profit maximisation that such strong incentives exist.[31]

The literature in this area turns on the assumption that a public firm has the objective or incentive to maximise output (or revenue), rather than profit. There are a number of reasons for this. First, it might be that the public firm is statutorily mandated to maximise output. The BBC's public purposes are clearly underpinned by the requirement of universality and, further, the licence fee would be vulnerable were the BBC not able to demonstrate that it has broad appeal. Another might be that the government is using the BBC in order to pursue broader social objectives (for example, redistributive goals, by making lower-priced products available to consumers).[32] Here too, with particular relevance to new media markets, the BBC has a specific purpose to encourage the use of new communications technologies across the population.[33]

The BBC certainly enjoys benefits over and above many of its commercial counterparts. As a result of the licence fee, it has the advantage of stable and high levels of funding, a strong brand, and is able to cross-promote its (new) services across its numerous outlets. Some have argued that it has engaged in "crowding out" commercial operators in certain key markets.[34] The Culture, Media and Sport Select Committee has been consistently critical of the BBC's commercial operations, and its record of harming competitors and distorting markets.[35] As a result of such criticisms, the BBC Trust has laid down a number of limiting principles and oversight mechanisms governing the BBC's commercial operations.[36] In recent times, the regulatory framework governing the BBC's entry into new markets has been considerably strengthened and augmented. This stems from the EU's interpretation of the state-aid rules, and from pressure from increasingly powerful commercial operators.

4 The regulatory framework governing the BBC

The application of the general competition rules to the BBC

The BBC is subject to the general competition law. For example, any joint ventures it enters into are subject to control under the prohibition on anticompetitive agreements and the merger laws. With respect to the latter, the UK Competition Commission recently

30 This appears to be the view of the US Supreme Court, see D Geradin and J G Sidak, "The future of the postal monopoly: American and European perspectives after the Presidential Commission and *Flamingo Industries*" (2005) 28 *World Competition* 161, pp. 186–9.

31 For a number of different examples from the US, see R R Geddes, "Case studies of anticompetitive SOE behavior" in R R Geddes (ed.), *Competing with the Government: Anticompetitive behavior and public enterprises* (Stanford: Hover Institution Press 2004), p. 27. Despite its apparent importance, this is an area which is rarely the subject of research (D E M Sappington and J G Sidak, "Review: are public enterprises the only credible predators?" (2000) 67 *University of Chicago Law Review* 271, p. 283).

32 The Universal Service Obligation in postal services is a classic example.

33 Beyond this, the public choice literature points to the possibility that public firms may engage in bureau shaping; that is, given that managers are not constrained by the discipline of the capital market, which would likely remove them were they not maximising profit, they may instead seek to maximise output because of all of the attendant benefits in terms of salaries and prestige. For a discussion, see J Lott "Predation by public enterprises" (1990) 43 *Journal of Public Economics* 237, pp. 240–1.

34 See, for example, M Cave et al., "Regulating the BBC" (2004) 28 *Telecommunications Policy* 249.

35 See, for example, House of Commons, Culture, Media and Sport Committee, *Fifth Report of 2008–2009: BBC Commercial Operations* (London: The Stationery Office 2009), HC 24.

36 BBC Trust, Commercial Operations (November 2009), available at www.bbc.co.uk/bbctrust/our_work/other/commercial_activity.shtml (last accessed 27 April 2011).

prohibited a joint venture between the BBC and other PSB providers to make available their back catalogue of programmes over the internet.[37]

The competition rules do, however, need to be interpreted in accordance with Protocol 29 of the Treaty on the Functioning of the European Union (TFEU)[38] which reserves a special place for public broadcasting and states that the provisions of the treaty – including the competition rules – shall be "without prejudice to the competence of Member States to provide for the funding of public service broadcasting".[39]

More broadly, PSB may benefit from the coverage of Article 106(2) TFEU which provides that undertakings entrusted with the operation of "services of a general economic interest" will not be subject to the competition rules in so far as their application would obstruct the performance of the tasks assigned to them.[40] This is subject to the general qualification that "[t]he development of trade must not be affected to such an extent as would be contrary to the interests of the Union". In the landmark *Altmark* case,[41] the European Court of Justice laid down four cumulative criteria which must be satisfied in order for the undertaking to benefit from the coverage of the provision.[42] Where these criteria are not satisfied, the rules on state aid (Article 107 TFEU) are engaged, with the requirement that the member state must notify the European Commission of any new service which is being funded by public subsidy. The rules generally prohibit, subject to derogations, the use of public subsidies which have a market-distortionary effect.

Several complaints have been made against the BBC under these provisions, on the provision of new digital channels, and on the involvement of the BBC in the provision of interactive learning materials to homes and schools.[43] None of these cases were found to transgress the competition rules. Nonetheless, these cases, together with others, do underline the importance of defining PSB clearly, not least in order for commercial operators to have some level of certainty over whether a state-supported broadcaster might enter a market at some later date. On this point, Harrison and Woods lament:

> Defining PSB runs the risk of ossifying it and therefore preventing change, innovation and growth. This is because either a member state defines PSB too narrowly, forcing a PSB provider to go beyond its proper remit if it is to retain viewers in a changing broadcast environment; or the member state defines PSB too broadly, so as to exceed its competence in the view of the Commission.[44]

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37 Competition Commission, *Anticipated Joint Venture between BBC Worldwide Limited, Channel Four Television Corporation and ITV plc* (London: Competition Commission 2009).

38 Protocol 29 is generally referred to as the Amsterdam Protocol.

39 The protocol enters two key qualifications: first, the funding must be granted for the fulfilment of a defined public service remit; and the funding does not affect trading conditions and competition in the EU to an extent which would be contrary to the common interest.

40 For more detail on the application of the state-aid rules to PSB providers, see J Harrison and L Woods, *European Broadcasting Law and Policy* (Cambridge: CUP 2007), ch. 13; T Prosser, *The Limits of Competition Law: Markets and public services* (Oxford: OUP 2005), ch. 9; I Katsirea, *Public Broadcasting and European Law* (Netherlands: Kluwer 2008).

41 *Altmark Trans GmbH and Regierungspräsidium Magdeburg* v *Nahverkehrsgesellschaft Altmark GmbH, and Oberbundesanwalt beim Bundesverwaltungsgericht* (C-280/00) [2003] ECR I-7747.

42 First, it must be required to discharge a clearly defined public service. Second, the parameters for compensation must be established in advance in an objective/transparent manner. Third, compensation cannot exceed what is necessary (net commercial receipts/reasonable profits). Fourth, where there is no public procurement procedure, the level of compensation must be no more than required to cover the costs of a typical, well-run undertaking.

43 *BBC News 24* (N 88/1998) [2000] OJ C/78; *BBC Licence Fee* (N 631/2003) [2003] C23/6; *BBC Digital Curriculum* (N 37/2003) [2003] C 271/06.

44 Harrison and Woods, *European Broadcasting Law and Policy*, n. 40 above, p. 311.

They characterise the approach of the Competition Commission in the past as being one where the interests of commercial operators seem to be protected without any focus upon the consequences for viewers.[45]

While the need for defining PSB, as a matter of EU law, has not receded, the European Commission has made its position clearer, recently issuing the *Communication on the Application of State Aid Rules to Public Service Broadcasting*, with guidance on the diversification of PSB providers into new media markets.[46] This would appear to have the clear advantage of leaving the assessment of state-aid compliance with member states, in the first instance at least.

The guidance admits the need for PSB providers to enter new media markets, including digital and new markets not traditionally viewed as programming (e.g. internet, video-on-demand (VOD), etc.). This is, however, subject to a series of substantive and procedural safeguards. The use of state aid to support such entry must address the democratic, social and cultural needs of society, and must not entail disproportionate effects on the market which are not necessary for the fulfilment of the public service remit. Member states must have in place mechanisms to monitor PSB providers entering new markets, and arrive at a balanced, reasoned decision which takes into account the interest of commercial operators. It must include an assessment of the impact on the market in question against a counterfactual of non-entry by the PSB provider; the assessment must include inter alia an analysis of existence of substitutable offers, the potential for commercial exploitation, and the crowding-out of private initiatives. The decision must be made by a body independent of management (but internal control is permissible). Other safeguards include the avoidance of over-compensation and cross-subsidisation of public and non-public activities, and the need for universality should be balanced against possible negative effects of funding, including the deterrence of entry, innovation and investment.

No doubt some might criticise the guidance as placing too much emphasis on protecting commercial operators, it does at least provide a clear framework for an assessment at member-state level, while at the same time making clear, as a matter of principle, that PSB providers have a future in new media markets.

The framework for regulating the BBC's entry into new media markets

The procedural and substantive rules under the state-aid regime are given expression through the regulatory controls imposed on the BBC under the Framework Agreement. The latter contains detailed rules on the role of the BBC Trust and the media regulator Ofcom in deciding whether or not the BBC should launch a significant new offering in pursuance of its public purposes. The agreement contains a list of UK public services – including its internet offerings – and significant changes or expansions to these services must first be subject to a public value assessment (PVA) and a market impact assessment (MIA), the latter undertaken by Ofcom. The PVA assesses the value licence fee payers would attach to a new service (or change to a service), its contribution to the BBC's public purposes, and the value for money it represents. The MIA assesses principally the effect on commercial players in the markets in question. The BBC Trust will then apply the public value test (PVT) which provides that before giving consent:

> [T]he Trust must be satisfied that any likely adverse impact on the market is justified by the likely public value of the change . . .[47]

45 Harrison and Woods, *European Broadcasting Law and Policy*, n. 40 above, p. 311.

46 [2009] OJ C 257/01.

47 Department of Culture, Media and Sport, *Broadcasting: An Agreement between Her Majesty's Secretary of State for Culture, Media and Sport and the British Broadcasting Corporation* (London: TSO 2006), Cm 6872, cl. 26(6) (hereafter the Framework Agreement).

There is separate provision made for the launch of a non-service activity. This is a new service which is not contained on the list of UK public services, but nevertheless contributes to the BBC's public purposes.[48] In such a case, the BBC Trust has discretion whether or not to conduct a full PVT, but is still required to have regard to public value and market impact. There is no requirement to engage Ofcom in this exercise, a somewhat curious anomaly given that the provision of these services does not have any explicit legislative backing.

The BBC Trust is also required to make a competitive impact statement.[49] Within this document, the Trust has stated that approvals for non-service activities will only be granted where it is satisfied that "the BBC has endeavoured to minimise its negative competitive impacts on the wider marker, whilst always ensuring the fulfilment of the BBC's Public Purposes".[50]

5 The BBC's entry into new media markets: two case studies

The principal purposes of these two case studies, concerning the entry by the BBC into new media markets, is to explore the application of the BBC's rules on entry into new media markets in order to analyse the extent to which the need to minimise market distortions is given priority over the public interest, or vice versa.[51] In the first case, the Trust appeared to give disproportionate weight to the interests of commercial rivals, while the second can be characterised as a retrenchment of the priority of public interest goals.

The *Local Video* case[52] originated with an application by the BBC to launch a bespoke broadband local news and sports service, in 60 areas, over its current local websites. The BBC management claimed that the proposition would promote two of its public purposes – sustaining citizenship and civil society, and representing the UK, its nations, regions and communities – contributing to the closure of a significant performance gap with respect to the latter.[53] This "purpose gap" was said to be becoming more pronounced with shifts in audience attitudes and behaviour, particularly the value attached to "localness" in content and the increase in demand for on-demand news:

> Local Video will reinvent the BBC's regional/local news offer: compensating for the decline in the reach of the BBC's regional TV audiences, attracting a younger demographic to local news and deepening users' appreciation of the *BBC Local websites*. It will preserve the BBC's valued provision of local news – a role the BBC has played ever since its foundation as a group of local radio stations in 1922 – in an on-demand age.

48 Framework Agreement, cl. 22.

49 Framework Agreement, cl. 66. See BBC Trust, Statement of Policy on Competitive Impact: Competitive impact framework (June 2007) available at www.bbc.co.uk/bbctrust/our_work/protocols_policy/competitive_impact.shtml (last accessed 27 April 2011).

50 BBC Trust, *Statement of Policy on Competitive Impact*, n. 49 above, p. 8.

51 There are a number of other cases decided under this framework: BBC Trust, *BBC Trust final conclusions on BBC Participation in a "Freesat" proposition* (April 2007) – concerning the BBC's involvement in a joint venture offering FTA digital television via satellite; BBC Trust, *BBC high definition television channel: public value test final conclusions* (November 2007) – considering the launch of a BBC HD channel; BBC Trust, *Gaelic digital service: public value test final conclusions* (January 2008) – concerning proposal to launch a dedicated digital TV channel in Gaelic; BBC Trust, *BBC mobile apps: Trust final decision* (July 2010) – concerning the provision of BBC services over smart phone applications. All available at www.bbc.co.uk/bbctrust/our_work/index.shtml (last accessed 28 July 2011).

52 BBC Trust, *Local Video public value test, final conclusions* (February 2009), available at www.bbc.co.uk/bbctrust/our_work/pvt/local_video_proposal.shtml (last accessed 27 April 2011].

53 BBC, *BBC Management's assessment of the public value of its Local Video proposals* (June 2008), available at www.bbc.co.uk/bbctrust/our_work/pvt/local_video_decision_supporting.shtml (last accessed 27 April 2011).

After a lengthy investigation, comprising both a PVA by the Trust and a MIA by Ofcom, permission to launch the new service was declined. The Trust relied primarily upon the limited public value of the proposal. Chief among the considerations was the lack of universality, that is that the service would fail to reach certain key audiences, particularly those in rural areas and those on low incomes, partly due to the limited availability and take-up of broadband among those groups. It also questioned the potential demand among younger user groups, especially given that the content did not extend to general entertainment, listings and reviews.

Ofcom's MIA pointed to a number of potential negative impacts on commercial providers, particularly local newspapers, and the prospect for them to monetise the provision of online video content.[54] The difficulty for Ofcom was that this was very much a nascent market with few newspapers having successfully launched their own local video services. As it readily admitted, predicting the future in the face of so many uncertainties posed particular difficulties,[55] and while it was possible to estimate the static effects of the proposal on revenues for commercial operators,[56] it was not possible to quantify "in any meaningful way" the dynamic effects.[57] The latter would result from the BBC's dominant presence in the new market for local video content since commercial operators would not be capable of operating at anything like an equivalent scale.[58] Ofcom concluded that the dynamic effects could be "substantial".[59] Nevertheless, a counterfactual – how would this market develop absent entry by the BBC? – was particularly difficult to predict; it was "possible, but by no means certain, that at least some [local newspapers] will develop substantial online services".[60]

Taking both the PVA and negative market impacts identified by Ofcom together,[61] the Trust concluded that the permission for the new service would not be granted. Instead, the resources for the project should be redirected towards the enhancement of the BBC's current linear television and local radio services.

The case can be criticised on a number of different grounds. First, it was clear that the counterfactual being forwarded by the commercial operators was illogical. On the one hand, they were pointing towards a significant and persistent decline in revenues over time, and characterising this emergent market as potentially creating new revenue streams for them. Yet, it is difficult to see how, in the light of their parlous finances, they would be able to invest substantially in new offerings over the internet, or how such services could generate new revenue streams in the light of fierce competition for internet advertising. A rigorous analysis of the counterfactual should also have included the negative effects on consumers of leaving demand for these new services unmet, at least for the foreseeable future. Second, as was pointed out by a number of respondents to the Trust's consultation, this gave the BBC an opportunity to reconnect with younger audiences. Others pointed to the potential for the BBC to fill the gap left with the scaling back of the commercial broadcasters' local news

54 Ofcom, *Market Impact Assessment of the BBC's Local Video Service: Statement* (November 2008), available at www.bbc.co.uk/bbctrust/our_work/pvt/local_video_decision_supporting.shtml (last accessed 27 April 2011).

55 Ibid. para. 2.4.

56 Principally the effect of a fall in newspaper sales as a result of the service.

57 Ofcom, *Market Impact Assessment*, n. 54 above, para. 2.95.

58 Ibid. para. 2.96.

59 Ibid. para. 2.103.

60 Ibid. para. 2.99.

61 BBC Trust, *Local Video public value test, final conclusions*, n. 52 above, para. 3.1.4.

provision and the falling quality of the local press. The Trust, however, was of the view that it would have limited appeal to the young, despite evidence to the contrary from Ofcom.[62]

The *Project Canvas* case appears to represent a more robust assertion of the public purposes.[63] It originated with an application in November 2008 from the BBC Executive for permission to participate in a joint venture that would set and promote a common standard and user-interface for the delivery of on-demand TV and other internet content through a broadband connected device. The relative contribution of the BBC in financial terms was small, but by frontloading of its stake, investing in research and development, and bringing credibility to the proposition, the participation of the BBC was clearly of central importance. This was underlined by the experience of the launch of the BBC's VOD proposition (the BBC iPlayer), which remains one of the leading products in the market. Objections to the proposition came from those who were in the process of developing alternative hybrid platforms, and two pay-TV operators that offer VOD services over their platforms.

Controversially, the BBC Trust determined that the proposed activity was a non-service activity, with the consequence that it, rather than Ofcom, would conduct the MIA. The joint venture involved all of the other public service broadcasters, two telecommunications firms and a communications infrastructure provider. The proposition if approved would provide a successor to Freeview (the digital terrestrial platform in which the BBC also plays a leading role) and would not be subject to any subscription fee. It would bring a new dimension to FTA television, allowing such viewers the ability to access VOD services, including the BBC iPlayer and cognate services offered by the other public service providers. Currently, other than over the internet, such services are generally limited to subscription platforms.

After a lengthy consultation process, the BBC Trust eventually settled upon allowing the BBC to participate in the joint venture, subject to a number of conditions intended to limit the negative impact on other industry players and as a means of securing compliance with competition law, particularly the state-aid rules.

The Trust's PVA concluded that the proposition was consistent with the furtherance of the BBC's public purposes (in particular the sixth, helping to deliver the benefits of digital communication technologies), represented value for money and was in the interests of licence fee payers.[64] It considered this against the counterfactual of what would happen absent the proposal. There was considerable controversy over whether it was necessary for there to be a common user-interface (UI) in order to fulfil the public purposes being pursued. The MIA had revealed that mandating a single UI and linking that to the Project Canvas brand would reduce the incentives of other potential entrants to innovate and invest in alternatives, as well as having the potential for the BBC and other joint venture partners the opportunity to give undue prominence to their VOD services, to the detriment of other content providers.[65] Other broader negative impacts were noted, including the potential to reduce the subscription base for pay-TV operators offering such services, either currently

62 Ofcom, *Market Impact Assessment*, n. 54 above, para. 2.13. Ofcom's own research found that around half of broadband users surveyed indicated that they would either definitely or probably use the new service, and this did not vary significantly between age groups. It did note, however, the propensity of respondents to overstate their potential interest in the service.

63 BBC Trust, *Canvas proposals, final conclusions* (June 2010), available at www.bbc.co.uk/bbctrust/our_work/canvas/ (last accessed 27 April 2011).

64 BBC Trust, *Canvas, public value assessment* (December 2009), available at www.bbc.co.uk/bbctrust/our_work/television/canvas_provisional_conclusions.shtml (last accessed 27 April 2011).

65 BBC Trust, *Canvas, Market Impact Assessment* (December 2009) available at www.bbc.co.uk/bbctrust/our_work/television/canvas_provisional_conclusions.shtml (last accessed: 27 April 2011).

or in the future.[66] In balancing the two assessments against each other, and consistent with the regulatory framework, the Trust noted that some negative impacts could not be mitigated without compromising the delivery of the public purposes. This was true in particular of the use of a common UI, which established a "simple upgrade path" for viewers, providing choice and reducing confusion, offering a consistent experience from one box to another and enhancing accessibility.[67] In this regard, the Trust privileged the interests of viewers over those of commercial operators.

The Trust did, nevertheless, make the approval of the BBC's involvement subject to a number of conditions. With respect to the drawing-up of the standard, it required that there was sufficient time for industry consultation before launch, notwithstanding the joint venture partners' concerns that this might result in a delay in bringing the product to market.[68]

Concerned with raising barriers to entry from third-party content providers, the joint venture partners' could not impose editorial controls on content beyond those required by law, inconsistent with the original proposition which had proposed controls consistent with PSB values. The Trust also stipulated that access to Project Canvas branded platforms should be on a cost-recovery-only basis and, in response to concerns that undue prominence would be given to the PSB partners, listing on the electronic programme guide and the UI would be awarded on a fair, reasonable and non-discriminatory manner.

Syndication was another particular concern. According to competing platform providers, the PSB partners' participation in the joint venture would reduce their incentives to syndicate their content and they might tacitly engage in a common syndication strategy to the disadvantage of rival platforms.[69] The Trust sidestepped this issue alluding to a separate review being undertaken of the BBC's syndication policy, although it did signal that it would be particularly concerned if any the PSB partners refused to syndicate their content to third parties without objective justification, especially given the "nascent" state of this market.[70]

The Trust had clearly been concerned with state-aid laws, given the public source of its funding and the "very high level of assurance" that it sought that the BBC's involvement was compliant.[71] To this end, there had to no subsidy given to the joint venture partners. Two issues were of particular concern. The first related to the front-loading of the BBC's contribution to the joint venture, which might be characterised as shifting the investment risk disproportionately upon it. The second issue concerned the research and development expenditure which the BBC had undertaken before the entry of the other commercial partners. With respect to the latter, and despite being contrary to the advice of independent auditors, the Trust required a contribution from the other partners. It also stipulated that any frontloading of the BBC's contribution should be treated as a loan subject to repayment on the "market economy investor principle", thereby reflecting the cost of any additional risk.

These two cases have been used to demonstrate how the BBC has to justify clearly the public benefits resulting from entry into new media markets. As was stated at the outset, if

66 Positive market impacts were also noted, such as the increase in broadband demand, and the increased competition in the triple-pay markets (i.e. where telephone, broadband and TV services were offered together).

67 BBC Trust, *Canvas Proposals, final conclusions*, n. 63 above, para. 3.8.

68 Ibid. para. 4.23.

69 A similar concern had been raised by the Competition Commission in the *Project Kangaroo* decision, n. 37 above.

70 BBC Trust, *Canvas Proposals, final conclusions*, n. 63 above, para. 4.87. Virgin nevertheless pursued this issue in a competition law complaint to Ofcom which declined to open an investigation. Ofcom Press Release, "No investigation into Project Canvas", 19 October 2010, available at http://media.ofcom.org.uk/2010/10/19/no-investigation-into-project-canvas/ (Last accessed 28 July 2010).

71 BBC Trust, *Canvas Proposals, final conclusions*, n. 63 above, para. 4.105.

PSB is to be sustainable over time then the BBC must be permitted to have a central presence on new platforms and innovations in delivery. If PSB is broader than simply correcting market failure, then the pursuance of the BBC's public interest remit must take priority over any necessary market distortions and the interests of commercial operators. The Trust clearly has a difficult task and is subject to much criticism, especially from the commercial media, whose interests are often implicated in its decisions. The *Project Canvas* decision appears to suggest that, while cognisant of the need for state-aid compliance, the Trust is willing to give priority to the public purposes even if this prejudices the interests of commercial operators.

5 Conclusions

As the European Parliament recently observed, the future of PSB lies in new media markets.[72] The difficulty for PSB providers in the UK and other jurisdictions is that the entry of a PSB provider into these markets will often rely upon a prospective analysis. The rationale for PSB – market failure or broader public interest goals – has a key bearing upon the outcome of such an assessment. It the market failure rational is the exclusive justification for intervention, this would suggest that entry into new media markets should only occur when *and only when* it can be demonstrated that commercial operators will not enter or develop the market. With respect to nascent markets, this may require a wait-and-see approach, as in the *Local Video* case, with obvious adverse consequences for consumers in terms of unmet demand. It also implies only a residual (and receding) role for PSB providers. On the other hand, if PSB is underpinned by a broader public interest rationale, then entry should only be prevented if the market will deliver an equivalent level of service, range and quality, and within a reasonable timeframe. The *Project Canvas* decision more closely reflects the latter approach.

Focusing on the subject of this article, the control of the BBC's new market entry is subject to a curious regulatory framework. First, some have questioned the independence of the BBC Trust; it is entrusted with the apparent incongruous task of being an economic regulator, while at the same time is perceived to be the champion of the BBC and its interests.[73] The alternative might be to assign its powers to the media regulator, Ofcom, although this might lead to a pro-market bias. Second, the level of scrutiny as between service and non-service activities appears anomalous, being more intense where the activity is one where the BBC has an explicit legislative mandate. Third, the processes could hardly be characterised as being streamlined, and the need to conduct such an in-depth analysis might in itself constitute a significant barrier to entry.[74]

On the substantive side, there are a number of problems with the way in which the rules are being applied. Market distortions appear to be the core concern, yet competition and markets are a means to an end and not an end in themselves. This issue is especially present in the MIA which only looks at the effects of the BBC's entry on commercial

72 European Parliament resolution of 25 November 2010 on PSB in the digital era: the future of the dual system (2010/2028(INI)), available at www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2010-0438+0+DOC+XML+V0//EN#def_1_1 (last accessed 27 April 2011).

73 House of Lords, Select Committee on Communications, *The Governance and Regulation of the BBC* (London: The Stationery Office), HL Paper 166.

74 In the *BBC Jam* case, the BBC Trust refused to renew a permission for the BBC to continue with a service on the basis that complaints by commercial operators would trigger the need for a full review: "A complex and costly review, in addition to the full review of the service to which the Trust was in any case committed, is not a commonsense way of securing value to licence fee payers.": BBC Trust Press Release "BBC Trust suspends BBC Jam", 14 March 2007, available at www.bbc.co.uk/bbctrust/news/press_releases/2007/march/14_03_2007.shtml (last accessed 28 July 2011).

competitors rather than asking, it is submitted, the overriding question of the net welfare effects on consumers.

This article has been concerned with the underlying rationale for PSB in the context of new media markets. It is not concerned with how those values should be pursued; in the alternative to state funding, there may be other ways of regulating markets in the public interest so as to ameliorate the effects of market failure.

Ultimately, everything turns on the justification for PSB. Market failure is not and should not be seen to be the exclusive justification for intervention. Even if it were, however, market failures still remain. Tendencies towards concentration, a lack of diversity, and the undersupply of programmes crucial to democracy and a culturally rich society are all still present in the digital environment. Whichever rationale is correct, media markets cannot be disembedded. This is as true now as it has ever been. Going forward, we need a confident vision of PSB where the market is subordinate to the public interest.