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The Effects of Entity Shielding on Claims to Assets: Implications for Financial Reporting

By Todd Sayre

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Keywords: reporting entity; reporting perspective; entity shielding; liquidation protection.

I. Introduction

The IASB and FASB's goal to converge accounting standards faltered over conflicts regarding the "nature of the reporting entity," which is part of the Conceptual Framework Reporting Entity, Phase D. In a 2008 joint Exposure Draft, IASB and FASB recommended that "[a]n entity's financial reporting should be prepared from the perspective of the entity (entity perspective) rather than the perspective of its owners or a particular class of owners (proprietary perspective)" (IASB 2008, 5). But when FASB realized that a business corporation's balance sheet from the entity perspective would not label net assets as Shareholders' Equity, it abandoned plans to converge reporting entity perspectives.[1]

An entity perspective for business corporations would have balance sheet simply that the corporation itself holds exclusive ownership claims to the net assets. For example, FASB requires that nonprofit corporations label the net assets as "Net Assets." In contrast, FASB continues to require business corporations to use the proprietary perspective, which show shareholders with exclusive ownership claims to the firm's net assets, including the profit.

The reporting perspective most appropriate for each reporting entity (i.e., firm) should depend on underlying principles to which standard setters agree.

This paper assumes that the claims that various entities (i.e., firm-members) have to the firm's resources (i.e., firm-assets) implies what reporting perspective is appropriate for each type of reporting entity (i.e., firm-type).

The paper finds that shareholders, unlike sole proprietors, of business corporations have no legal claims to the corporation's net assets or profit. Instead, shareholders of business corporations have similar claims to those of beneficiaries of nonprofit corporations. The reason for the similarity is that both business and nonprofit corporations have liquidity protection because their firm-assets are shielded from firm-members, as well as the firm-members' creditors. The ability to shield the creditors of firm-members cannot be accomplished through private contracting and, as such, this type of liquidity protection distinguishes the business corporation from other business firm-types (e.g., partnerships).

The paper concludes that this unique feature of liquidity protection afforded to business corporations necessarily restricts shareholders' claims to firm-assets. Specifically, shareholders, because of liquidity protection, have no claims to the firm's net assets, while sole proprietors with no liquidity protection have exclusive claims to firm-assets. Therefore, requiring business corporations to present net assets as part of Shareholders' Equity misrepresents shareholders claims to the net assets. Shareholders do not have identical claims to firm-assets to those of sole proprietors; rather the opposite is true, they have no claims. The shareholders' lack of claims is more similar to those of nonprofit corporation's beneficiaries, who also lack claims.

The shareholders' lack of claims to the firm-assets implies that the proprietary perspective is inappropriate for the balance sheet of the business corporation. FASB is aware of the inconsistency, recently replacing FASB (1978 paragraph 30) "claims to those resources," (i.e., firm-assets) with FASB (2008 OB12), "claims against the reporting entity." Unfortunately, this adjustment was not based on any explicit underlying principle useful to the goal of converging accounting standards.

Author: e-mail: sayre@usfca.edu

[1] www.iasplus.com/en/meeting-notes/iasb/2010/agenda_1011/agenda1551#entity-versus-proprietary-perspective

The goal of the FASB/IASB joint convergence project was to find underlying principals to guide the rules of standard setters. Toward this end, Van Mourik (2014) recommends categorizing firms according to whether they have limited liability or not, based on Demsetz (1967). Demsetz (1967, 358) defines the public corporation as having 3 characteristics, a legal personality, limited liability, and transferable shares. But, as this paper explains, limited liability is unnecessary for corporations to exist and can be privately contracted to a large degree. More importantly, Demsetz' definition does not include entity shielding as a characteristic of a corporation when, without it, transferable shares could not exist. If stock markets can and have existed with limited liability, but not entity shielding, which is a more important characteristic of the firm?

Instead, to determine the appropriate reporting perspective for each firm-type, academics should focus on how entity shielding affects firm-members' claim to the net assets. Entity shielding uniquely identifies firm-type, cannot be privately contracted, and enables transferable shares, without which founders could not maintain personal liquidity. Entity shielding, not limited liability, should serve standard setters as the principle underlying determining the reporting perspective is required for each firm-type.

II. Entity Shielding

Hansmann, Kraakman, and Squire (2006, 1336) explains that firms, like individuals, are legal persons in the sense that they "…enjoy the legal power to commit assets to bond their agreements with their creditors and, correlatively, to shield those assets from the claims of their owners' personal creditors."Firms differ from natural persons in that their firm-assets or "bonding assets are, at least in part, distinct from assets owned by the firm's owners or managers, in the sense that the firm's creditors have a claim on those assets that is prior to that of the personal creditors of the firm's owners or managers."In the quote, the authors use the term "owners" loosely to include sole proprietors, partners, founders, investors, shareholders, creditors, managers, employees, and customers. In this paper, "firm-members" is used to describe these groups.

a) Types of Entity Shielding

Hansmann et al. (2006, 1337-1338) call this separation of firm-assets from personal assets, "entity shielding," defining 3 types. The first type is "weak entity shielding," which provides the claims of the firm's creditors priority over those of personal creditors. Weak entity shielding is found in all firms, including sole proprietorships and general partnerships. The second type is "strong entity shielding," which provides weak entity shielding as well as two forms of "liquidation protection," one that shields firm-assets from firm-members, like shareholders, and another that shields firm-assets from the personal creditors of firm-members. Strong entity shielding is found in business corporations. The third type of entity shielding, called "complete entity shielding," provides complete liquidity protection by more strongly, relative to strong entity shielding, restricting firm-members and their personal creditors from any claim to the firm-assets. This form of entity shielding is found in nonprofit corporations.

b) Liquidity Protection

In strong and complete entity shielding, there are 2 types of liquidation protection. The first type of liquidation protection bars firm-members (e.g., shareholders, partners) from unilaterally withdrawing any portion of the firm-assets. Partnerships, through private contracting, have never achieved this type of long-term liquidation protection, as courts have been, "reluctant to enforce restrictions on free alienation of property if made in perpetuity." (Hansmann et al. 2006, 1342)

The second type of liquidation protection bars the personal creditors of firm-members (e.g., shareholders) from forcing withdrawals to satisfy personal debts. Partnership have not accomplished this type of liquidation protection, even in the short-run, as it cannot be accomplished through private contracting and, instead, requires special rules of entity law. For corporations to contractually shield firm-assets from the personal creditors of shareholders, it requires that corporations secure contractual waivers from all shareholders' personal creditors. Since such waivers would increase personal borrowing costs, shareholders would have an incentive to conceal their personal creditors. This problem increases as more shareholders are added and shares are made freely transferrable. According to Hansmann et al. (2006, 1338), "These problems can be solved only by impairing the rights of personal creditors without their contractual consent [through] a special rule of property law respecting assets committed to the firm, and entity law provides that rule."

c) Benefits of Entity Shielding

Entity shielding enables firms to embrace relatively longer-term and larger-scale projects with longer-term contracts, bonded by locked-in assets. Specifically, according to Ciepley (2013, 144), strong entity shielding enables the firm to"…increases its productivity (by enabling asset and labor specialization) and lowers its capital costs (by lowering the risk and monitoring costs of its creditors and investors)." Moreover liquidity protection enables tradable shares, which, in turn, enables founders to relinquish their personal assets to the corporation, yet maintain personal liquidity.

Dari-Mattiacci (2017) documents anecdotal evidence on how entity shielding benefits productivity by examining differences between the Dutch East India Company (VOC), founded in 1602 and the British East

India Company (EIC), founded in 1600. Dari-Mattiacci (2017, 196) explains that "[t]he two companies started with comparable capital but differed in an important dimension: the VOC charter adopted a longer maturity for its equity. This induced immediately another innovation, namely the free transferability of shares to ensure liquidity for the locked-in capital." When the States General of the Netherlands granted the (VOC) strong entity shielding in 1612"…for the first time in history, a private firm had gained the prospect of indefinite life." As a result, "…VOC could thus outspend and outperform the EIC for decades," consistent with the assertion above that entity shielding results in increased productivity.

d) Limited Liability

Hansmann et al. (2006, 1338) assert that entity shielding is the core defining feature or the "sine qua non of the legal entity…"Corporations cannot exist without government-granted liquidity protection against the shareholders' personal creditors. In contrast corporations can exist without limited liability. In fact, corporations existed for over 250 years until England and America enacted limited liability protection for shareholders in the mid-1800s. In America, California did not grant limited liability until 1931. Moreover, firms can privately contract with creditors to provide shareholders with limited liability protection against firm creditors. Although they cannot do the same against torts, if the risks are know and reserves establish, the effect on stock prices should be minimal. (See Weinstein 2003, 2005; Hessen 1979)

Thus, liquidity protection is necessary for corporations to exist, but limited liability is not. The same is true for freely tradable shares. Hansmann et al. (2006, 1350) notes that, "…firms with unlimited liability have been traded in public markets into the twentieth century;" therefore, unlike liquidity protection, "…limited liability is in fact neither necessary nor sufficient for freely tradable shares to exist."

III. Predictions

This paper focuses on the effects of entity shielding on firm-members' legal claims to firm-assets in order to potentially provide standard setters with a principled basis on which to determine the appropriate reporting perspective (e.g., entity, proprietorship) for each firm-type (e.g., partnership, nonprofit corporation). Specifically, the prediction focuses on the effects of entity shielding on firm-members' claims to firm-assets.

Alternative Hypothesis 1: Firm-members of firm-types with liquidity protection have less legal ownership claims to firm-assets than do firm-members of firm-types without liquidity protection.[2]

FASB (1985, 10) requires that "[E]quity (net assets) describe levels or amounts of resources or claims to or interests in resources at a moment in time."[3]If the results show that the legal claims of firm-members to the firm-assets vary across reporting entities (i.e., firm-type), the balance sheet should reflect this in its reporting perspective. To the extent the paper indicates a mismatch between reporting perspective and legal claims to firm-assets, the results are potentially useful in resolving the conflict over reporting perspective between the FASB and IASB.

IV. Evidence

a) Assumptions and Method

To test Alternative Hypothesis 1, this paper examines the legal claims firm-members have to firm-assets across firm-types. To this end, we evaluate firm-members with regard to their legal rights (i.e., claims) and powers (i.e., ability to claim) to the firm-assets for the firm-types: sole proprietorship; general partnership; business corporation; and nonprofit corporation.

The paper assumes that the term, "claim," as used in the standards, represents *legal* claims. This assumption is consistent with FASB (2010, BC 26), which states that, Wrong.

This paper assumes that the legal claims creditors have to firm-assets are uncontroversial, leaving the firm's net assets for others to claim. For the sole proprietors and partners, the analysis is straightforward as they both have exclusive legal ownership claims to the firm's net assets. For the nonprofit business, no firm-member at any time has any claim to the firm's nets assets. Therefore, the only firm-type that requires examination is the business corporation.

This section examines the shareholders' legal claims to the corporation's net assets and compares them to the firm-members' claims in other firm-types. Given the assumed claims of the sole proprietors, partners, and firm-members of nonprofit corporations, the Null Hypothesis cannot be rejected. The test of the hypothesis continues with evaluating the shareholders' claims to the business corporation's net assets.

b) Rights of Share Ownership

To determine the extent to which shareholders have claims to the firm-assets, this paper first identifies the rights and powers engendered from share

[2] Since all firms have weak entity shielding, which gives priority to firm-creditors over the personal creditors of firm-members, it is not investigated. Firm-types differ in their degree of liquidity protection.

[3] FASB (2008), Concept Statement No. 8, replaces the term "claims to resources" with "claims against the reporting entity." Without a clear definition otherwise, this paper interprets the phrases to mean the same thing, that the balance sheet should present the various firm-members legal claims to the firm-assets.

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ownership. Blair and Stout (1999, 250-251) note that, "corporate assets belong not to the shareholders but to the corporation itself." Blair (2003, 293) explains that when founders incorporate, they become shareholders giving up the property rights to their personal assets in exchange for shares of he firm's stock, which maintains their liquidity.

Shareholders do not own the firm; they simply own the firm's shares. The rights and duties shareholders have to the firm-assets stems solely from the contractual rights of shares. Shareholders who own voting shares have the right (a) to sell the share, (b) receive dividends if declared, (c) file derivate lawsuits against the board, (d) vote the proxy in important decisions, and (e) nominate and vote in board member elections. These rights that accrue to shares provide shareholders with political influence over board decision, but they are not property rights.

c) *Rights of Property Ownership*

As discussed, the FASB's phrase, "claims to…resources" refers to the legal claims firm-members have to the firm-assets. Therefore, we use property law to evaluate the shareholders legal claims to firm-assets. While the notion of property ownership is embodied in the law, jurists have yet to "…capture the relation between the idea of ownership and the detailed rules of a private property system in a precise legal definition" (Waldron 1985, 334). Rather, our legal system defines ownership as a family of legal relationships to a thing,[4] sometimes referred to as a "bundle rights."[5] These "rights" are actually a collection of *rights, powers, duties, and liabilities*,[6] where any single "right" is neither necessary nor sufficient to conclude ownership.[7] Despite its subjectivity,[8] the bundle of rights approach to the question of ownership represents the dominant paradigm of property law.

Legal scholars credit A. M. (Tony) Honoré (1921-) with advancing the most generally accepted set of legal relations for ascertaining ownership.[9] In his seminal paper, "Ownership" (1961), Honoré lists 11 "standard incidents of ownership."[10] The list includes: the *rights* to (1) possess, (2) use, (3) manage, (4) income, (5) capital, and (6) residuarity; the *powers* to (7) alienate (i.e., sell) and (8) transfer; the (9) *duty* to prohibit harmful use; the (10) *liability* to execution for personal debts and the (11) *immunity* (i.e., no liability) from expropriation.[11]

d) *Legal Relations*

These legal terms, *rights*, *powers*, *duties,* and *liabilities*, have precise meanings. Credit this to Wesley Newcomb Hohfeld (1879-1918),[12] a legal scholar who, tiring of the misuse of these terms, suggested a system of corresponding legal relations. Specifically, to exist, *rights* require *duties* and *powers* require *liabilities*, and vice versa. For example, in order for one to claim a *right* to possess a thing, others must have a *duty* to exclude themselves from that thing.[13] Similarly, in order for one to claim a *power* to create legal relations, another must have a corresponding *liability* to those relations once created.[14] For example, an agent has the *power* to create legal relations to which a principal will have a *liability*."A general claim of most recent major works on the subject of property, especially the books of Becker, Waldron, and Munzer, is that the actual nature of property has been satisfactorily explained by the Hohfeld-Honoré bundle of rights analysis." (Penner

[4] For instance, "You have property in the suit of clothes you are wearing; your property is not the suit of clothes, but the rights you have in it…" (Bowen 1926, 41). "Property relates to the legal relationship with a thing and the power that is able to be exercised over the thing - not the thing itself (*Yanner v. Eaton* 1999, HCA 53 per the majority Gleeson, CJ, Gaudron, Kirby and Hayne, JJ)." (Toner 2006, 81).

[5] "The currently prevailing understanding of property in what might be called mainstream Anglo-American legal philosophy is that property is best understood as a "bundle of rights." (Penner 1996). Also, "The conception of property as an infinitely variable collection of rights, powers, and duties has today become a kind of orthodoxy." (Merrill & Smith 2001, 365).

[6] Black's Law Dictionary (2009, 1138) defines ownership as, "The bundle of rights allowing one to use, manage, and enjoy property, including the right to convey it to others."

[7] Honoré (1961, 138), referring to "right" as an "incident," states that, "[These] incidents, though they may be together sufficient, are not individually necessary condition for the person of inherence to be designated owner of a particular thing…the use of 'owner' will extend to cases in which not all the listed incidents are present."

[8] While the family of resemblances approach results in blurred edges, as when a duck fails to quack, the term "ownership" is still meaningful. "[T]here is no common essence shared by all things we call 'games': board games, football, solitaire, throwing ball against a wall, and so on. But we can nevertheless use the word 'game' meaningfully. Wittgenstein uses the phrase 'family resemblance' to refer to this sort of overlapping and criss-crossing resemblance." (Warburton 2001, 232-233)

[9] Penner (1994,861) notes that Honoré's incidents of ownership, "[d]espite its oversimplicity,…still operates as a background understanding of property.." (p. 859) […] "A.M. Honoré played a decisive role in advancing the bundle of rights metaphor by cataloguing a generally accepted list of the "incidents" of property or ownership."

[10] I have adapted these incidents at the margins based on Munzer (1990).

[11] If one has immunity from expropriation, this means that others have no power to take ownership. In terms of correlatives, if others have no power, the owner has no liability. Thus, immunity and no liability mean the same thing.

[12] Wesley Newcomb Hohfeld (1879-1918) posthumously authored the seminal text, *Fundamental Legal Conceptions, As Applied in Judicial Reasoning and Other Legal Essays* (1919), largely based on his articles published in 1913 and 1917 in the Yale Law Review.

[13] "The existence of a right is the existence of a state of affairs in which one person (the right-holder) has a claim on an act or forbearance from another person (the duty-bearer) in the sense that, should the claim be exercised or in force, and the act or forbearance not be done, it would be justifiable, other things being equal, to use coercive measures to extract either the performance required or compensation in lieu of that performance." (Becker 1977, 8)

[14] Regarding power, "The nearest synonym for any ordinary case seems to be (legal) 'ability.'" (Hohfeld 1913, 45)

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1996, 713) Table 1 shows the Incidents of Ownership of Honoré sorted by Hohfeld's legal relations.[15] These legal relations capture whether firm-members have a claim to firm-assets.

Table 1: Incidents of Ownership

Legal Relations	Incidents of Ownership*
Rights	(1) Right to possess—to have exclusive control of the thing.
	(2) Right to use—personal use and enjoyment of the thing.
	(3) Right to income—to receive exclusive benefits from others using the thing
	(4) Right to capital—to have the exclusive control over destroying the thing and exclusive benefit of what remains.
	(5) Right to manage—to have exclusive control over use of the thing.
	(6) Right to residuarity—to have the right to receive rights and powers of others when contracts expire.
Powers	(7) Power to alienate—the ability to sell ownership to others.
	(8) Power to transfer—the ability to transfer ownership to successors.
Duties	(9) Duty to prohibit harmful use—to have personal liability if the thing harms others.
Liabilities	(10) Liability of execution—to have liability in what you own for personal debt.
	(11) Immunity (i.e., no liability) from expropriation—the immunity from others taking ownership without consent (e.g., for debts).

Based on Honoré (1961), Munzer (1990)

e) Analysis

The sole proprietor has every incident of ownership, while the firm-members (e.g., beneficiaries) of nonprofit corporation have none. A shareholder of a business corporation can be its sole shareholder, its controlling shareholder, or its non-controlling shareholder. The analysis focuses on non-controlling shareholders since they represent most shareholders.

This paper provides a legal analysis of ownership claims to firm-assets for accountants, who are not legal experts. The legal experts agree that, "[c] ontrary to widely held 'common sense', shareholders do not own corporations; nor do they own the assets of corporations. Shareholders only own shares…"[16] (Also see Stout 2012)

While accountants as non-experts in law should accept the consensus of the legal experts, they should also understand the legal intuition as to why the legal experts conclude that shareholders do not own the firm-assets. That is, accounting standard setters should understand basic property law and corporation law if they require corporate balance sheets to show firm-members' claims to firm-assets. The following sections explain the shareholders' legal claims to net assets in terms of their legal rights, powers, duties, and liabilities of ownership.

f) Right to possess

Do shareholders have a *right to possess* corporate assets? As Professor Ian Lee states, "…shareholders have no property rights in the corporation's assets: a shareholder of Wal-Mart Stores, Inc. can be prosecuted for shoplifting from Wal-Mart." (Lee 2005 p. 11) Even "…a sole shareholder has no independent right which is violated by trespass upon or conversion of the corporation's property."[17] Rather, a sole shareholder, like other outsiders, has a *duty to exclude* him or herself from the corporate assets. Shareholders have no *right to possess* corporate assets.

g) Right to Use

Do shareholders have a *right to use* corporate assets? Although shareholders have no to *right to possess*, but do they still have the power to contract with corporate assets, which is a form of *use*? The answer is, "no." The Model Business Corporation Act (MBCA) states that, "All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors…" (MBCA Ann. §8.01b 3d ed. Supp. 2000-2002) and Delaware General Corporation Law (DGCL) states that the corporation's business and affairs "shall be managed by or under the direction of a board of directors." [DGCL § 141 (a) (2001)]

Stout (2002, 1191) states that, "…shareholders…enjoy neither direct control over the firm's assets nor direct access to them…" and "…do

[15] Hohfeld's jural correlatives are rights and duties, powers and liabilities, privileges and no rights and immunities and disabilities. To simplify the discussion, I translated the latter two correlatives into of opposites of the former two.

[16] For the quote and signatories, see https://themoderncorporation.wordpress.com/company-law-memo/

[17] Per W. Clay Jackson Enterprises, Inc. v. Greyhound Leasing and Financial Corp., 463 F. Supp. 666, 670 (D. P.R. 1979) as quoted in Bainbridge (2002).

not have the right to exercise control over the corporation's assets. The corporation's board of director's holds that right." Thus, it is the board, not the shareholders, that has the *power to contract* with corporate assets. This finding, combined with the previous finding that shareholders have no *right to possess*, results in the verdict below. Shareholders have no *right to use* corporate assets.

h) Liability of Execution

Do shareholders have the *liability of execution* against corporate assets? The liability of execution is "the liability of the owner's interest to be taken away from him for debt, either by execution of a judgment debt or on insolvency..." (Honoré 1961, 123) In order for shareholders to have the *liability of execution*, personal creditors would need the *power* to legally enforce payment in corporate assets. Entity shielding, as defined in this paper, disables personal creditors from this *power*; thus, shareholders cannot have the *liability of execution*. Shareholders do not have the liability of execution.

i) Prohibit Harmful Use

Do shareholders have a duty to *prohibit harmful use* of the corporate assets? In order for shareholders to have a *duty to prohibit harmful use*, others must have corresponding *rights* to recourse, if the duty is breached. State statues prohibit parties wronged by the corporation from pursuing recourse against the shareholders. For example, "A shareholder of a corporation is not personally liable for the acts or debts of the corporation..." (MBCA §6.22(b)) Thus, because of limited liability, the most shareholders can lose is the market value of their stock. Shareholders have no *duty to prohibit harmful use* of corporate assets.

j) Right to Manage

Do shareholders have a *right to manage* the corporate assets? Honoré defines the *right to manage* as the "…right to decide how and by whom the thing owned will be used." […] "This right depends, legally, on a cluster of powers, chiefly powers of licensing acts which would otherwise be unlawful and powers of contracting: the power to admit others to one's land, to permit others to use one's things, to define the limits of such permission, and to contract effectively in regard to the use (in the literal sense) and exploitation of the thing owned." (Honoré 1961, 116)

The analysis on the *right to use*, established that shareholders cannot directly contract with corporate assets. But, as Honoré implies, the *right to manage* also includes the *power* to permit others to use the thing and to "define the limits of such permission." For our purposes, this definition translates to the following questions: (1) To what degree do shareholders have the *power* to designate board membership? (2) To what degree do shareholders have the *power* to limit board discretion in managing corporate assets?

Related to the first question, legal experts maintain that the shareholder's right to vote in board elections gives shareholders negligible *power* to designate board membership. These experts cite several contributing factors. First, absent a proxy contest, the nominees of the existing board are automatically elected.[18] Second, shareholders who do launch proxy contests pay for the printing and distribution of the proxy materials, while incumbent directors and management pay with corporate funds. Third, shareholders are "rationally apathetic" toward proxy fights, in part, because they have the option to sell their shares.[19] Forth, boards can create obstacles for insurgents by staggering the terms of its members[20] and increasing the number and heterogeneity [21] of shareholders in order to reduce "…the incentive and ability of each shareholder to gather information and monitor effectively…" (Monks 2001, 102)The result, explains Former SEC Chair, Arthur Levitt Jr., is that "…board elections are one-party affairs, with the incumbent board's choices winning in virtually every case" […] "A director has a better chance of being struck by lightning than losing an election." (Levitt 2006, 14) Others who voice similar opinions include Vice Chancellor of the Delaware Court of Chancery, Leo Strine, [22] and legal scholars Bob Monks, [23] Stephen Bainbridge,[24] and Jill Frisch.[25]

[18] "In practice…the election of directors (absent a proxy contest) is predetermined by the existing board nominating the next year's board." (Bainbridge 2002, footnote 10).

[19] "Rather than try to control the decisions of the management, which is harder to do with many stockholders than with only a few, unrestricted salability provides a more acceptable escape to each stockholder from continued policies with which he disagrees." (Alchian and Demsetz 1972, 13)

[20] Many boards are staggered, meaning that discontent shareholders must have their insurgents prevail in two consecutive elections in order to elect a majority of the board. Delaware General Corporation Law section 141(d) permits a corporation's charter to create up to three classes of directors, only one of which is elected each year, or boards may be classified with shareholder approval.

[21] To the extent shareholders differ in levels of information and preferences, they are a heterogeneous group. "When, as is often the case today, the corporation has a complicated capital structure consisting of several classes of shares or is part of a holding company system which has such a capital structure, the interests of the dominant shareholders may be widely divergent from those of the holders of other classes, particularly if the corporation fails to prosper." (Dodd 1941, 926)

[22] Vice Chancellor of the Delaware Court of Chancery, Leo Strine, has noted in a law review article that the "proxy mechanism is titled heavily in favour of the management slate, and contested elections rarely occur outside the takeover context," [which of course raises questions about] "a corporate election process that is so heavily biased towards incumbents and their self-chosen successors." (Quoted in Donaldson 2005)

[23] "[T]he American shareholder cannot nominate directors, he cannot remove them, he cannot--except at the arbitrary pleasure of the SEC--communicate advice to them. Democracy is a cruelly misleading word

In addition, Professor Bebchuk studied proxy contests conducted by all listed companies between 1996 and 2004, finding that only seventeen corporations, with a market capitalization over $200 million, experienced proxy contests to replace management outside of the takeover context. Of these, only two of the insurgents won. "A plausible interpretation of the evidence is that, even when shareholder dissatisfaction with board actions and decisions is substantial, challengers face considerable impediments to replacing boards." (Bebchuk 2005, 13) Thus, we can conclude that the shareholders' *power* to designate board membership is negligible.

This conclusion has implications for the second question involving the degree to which shareholders have the *power* to limit board discretion over corporate assets. The negligible power to designate board membership confers a similarly negligible threat to board discretion. Even so, shareholders hold political influence of the board, conferring some control over the firm-assets. At a higher political level, shareholder groups and advocates can lobby the SEC for more influence over board decisions.

The only other threat shareholders have over board discretion stems from their power to file derivative lawsuits against the board. But like to the right to vote, this power to sue has only a negligible affect over board discretion. First, the board has a fiduciary duty not to its shareholders, but to the corporation itself.[26] For this reason, shareholders do not file lawsuits for fiduciary breaches on their own behalf, but on that of the corporation, and recovery is typically for the sole benefit of the corporation.[27] Second, the "business judgment rule" makes it difficult for shareholders to win suits against the board for breaches in fiduciary duties.[28] The business judgment rule shifts "…the duty of care from negligence to gross negligence: violations are found only where there is 'reckless indifference' to or a deliberate disregard of the interests of the whole body of stockholders."[29] (Dibadj 2006, 485) Third, constituency statutes, adopted by the majority of states since the early 1980's, authorize the board to consider the interests of other corporate constituents. Frisch (2004, 16) notes that "[i]n many cases, the statutes explicitly provide that directors will not be required to regard the effects of a corporate decision on any particular group – including shareholders – as a dominant factor." [30] Fourth, corporations may include in the articles of incorporation provisions that, in effect, insulate directors from monetary damages for breaching the director's duty of care.[31]

to describe the situation of the American shareholder in 2006." (Bob Monks quoted in The Economist, Mar 09, 2006).

[24] Even in contested elections, the proxy regulatory regime discourages even large shareholders from conducting proxy fights. (See Bainbridge 2002, footnote 92).

[25] "[W]hile shareholders nominally have the right to elect directors, their limited power over the nominating process and the corporate proxy machinery prevent shareholders from using their voting rights." (Frisch 2004, 16).

[26] Under the Standard of Conduct for Directors: "Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation." (RMBCA §8.30 (a)). "Under Delaware law, the board of directors owes the *corporation* the fiduciary duties of care good faith, and loyalty." (Bainbridge 2002)

[27] "A stockholder seeking redress for a wrong done to the corporation as of which the directors fail to act may bring suit derivatively in the name of the corporation. In addition to the real defendants (i.e., the alleged wrongdoers), the corporation is included as a nominal defendant. Yet, the suit proceeds on its behalf, and ordinarily recovery is solely for the benefit of the corporation." […] "A derivative action is the functional equivalent of a suit by a stockholder to compel the corporation to sue plus a suit by the corporation, asserted by the stockholder on its behalf, against those liable to it. Since a derivative action asserts a right belonging to the corporation, the recovery belongs to the corporation." (Bork 2005 p. 6) Also, see Blair & Stout, (1999, 294-95 footnote 48) stating, "management's fiduciary duty to shareholders is payable, not to those shareholders, but to the corporation itself, where its benefits "accrue to all the corporation's stakeholders."

[28] The Delaware Supreme Court states that it "will not substitute its own notions of what is or is not sound business judgment" if "the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." The first quote is *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) and the second, *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971). Also, according to the business judgment rule, "…courts must defer to the board of directors' judgment absent highly unusual exceptions." (Bainbridge 2008, 6).

[29] "[I]n the rare instance where the Delaware Supreme Court found directors to have behaved in a grossly negligent manner, the Delaware legislature subsequently permitted corporations to contract out of even gross negligence, at least as to monetary liability…" [Moreover], "…directors invariably have indemnification rights and insurance, and courts have limited the ability of shareholders to obtain discovery in derivative actions alleging director misconduct." (Dibadj 2006, 486, quoting Loewenstein 2004, 377). Also, see Solomon & Palmiter (1994 §9.1.1).

[30] Corporate constituency statutes are, "…laws that either required or allowed corporate management to exercise their fiduciary duties with regard to the effects on employees, customers, and larger communities of interest. (Winkler 2004, 123) "As the court explained in *GAF v. Union Carbide Corp.,* the board must balance investors interests, on the one hand, and the legitimate concerns and interests of employees and management . . . on the other." (Frisch 2004, 17). "While most of these laws are permissive—allowing but not requiring directors to take into account the non-shareholder constituencies—at least one state, Connecticut, obliges management consideration of 'interests of the corporations employees, customers, creditors and suppliers, and … community and societal considerations including those of any community in which any office or other facility of the corporation is located.'" (Winkler 2004, 123)

[31] "Following the court's decision in Smith v. Van Gorkom, and in reaction to it, the Delaware General Assembly enacted Del. Gen. Corp. Laws Section § 102(b)(7). Section 102(b)(7) permits a corporation to include in its articles of incorporation a provision, which states, in essence, that no director shall be liable in monetary damages for a breach of the director's duty of care. Section 102(b)(7) was intended to eliminate director liability for conduct that, at worst, involved mere breaches of the duty of care. Importantly, though, it was also intended to protect directors from protracted, expensive and time-consuming litigation." (Bodner 2005, 6) "Daines and Klausner have even found cases in which corporations in states that lacked statutory non-shareholder constituency provisions, such as Delaware, adopted such provisions in their charters." (Frisch 2004, 18)

In summary, shareholders have negligible *power* to designate board membership. In addition threats deriving from the shareholder's rights to vote and sue have negligible impact on limiting board discretion. Indeed, other constituents, such as labor, arguably have more influence over board discretion than do shareholders. Shareholders have no *right to manage*.

k) Right to Income

Do shareholders have a *right to income* of the corporation? Honoré (1961, 169) defines income as "…a surrogate of use, a benefit derived from forgoing personal use of a thing and allowing others to use it for reward." In order for shareholders to have a *right to income*, others must have a corresponding *duty to exclude* themselves. But corporate law does not prohibit other corporate constituents (e.g., labor) from seeking to obtain this same income. Therefore, shareholders do not have an exclusive right to *all* income. This does not necessarily imply, however, that shareholders have no right to *any* income.

In order for shareholders to have a *right to any income*, the board would need a *duty* to declare dividends. State statutes *permit* the board to declare dividends from corporate income, but there is no legal obligation.[32] Therefore, strictly speaking, shareholders have no right to *any* corporate income.

Still, for the sake of argument, shareholders could have the *power* to force the board to declare dividends and thus, in effect, they would have the *right* to at least some income. This issue is related to the *right to manage*, regarding whether shareholders have the *power* to limit board discretion. The difference is that the board decision under examination here is not one of general management, but is specific to declaring dividends.

The classic case law on this subject is Dodge v. Ford Motor Company (Mich. 1919) in which the Michigan Supreme Court ruled in favor of Dodge, ordering Ford to pay a special dividend of $19 million--$1.9 million to Dodge and over $10 million to Ford. The specifics of this case were unique. First, Dodge owned a large (i.e., 10%) minority interest. Second, Dodge argued that, "…Ford was cutting off dividends to kill one competitor (the Dodges) and building a huge new factory to threaten the competitive position of them and others." Third, Ford's testimony professed a business strategy antithetical to capitalism.[33] These special circumstances make the ruling difficult to generalize to other situations.[34]

The precedent for Dodge v. Ford is expressed in Pyle v. Gallaher, 75 A. 373 (Del. 1908) has been that "[t]hat a shareholder in a corporation has no property interest in the profits of the business carried on by the corporation until a dividend has been declared out of such profits" is "substantially correct", which the court applied in Dodge v. Ford follows:

It is a well-recognized principle of law that the directors of a corporation, and they alone, have the power to declare a dividend of the earnings of the corporation, and to determine its amount. Courts of equity will not interfere in the management of the directors unless it is clearly made to appear that they are guilty of fraud or misappropriation of the corporate funds, or refuse to declare a dividend when the corporation has a surplus of net profits which it can, without detriment to its business, divide among its stockholders, and when a refusal to do so would amount to such an abuse of discretion as would constitute a fraud, or breach of that good faith which they are bound to exercise towards the stockholders…so long as they do not abuse their discretionary powers, or violate the company's charter, the courts cannot interfere. (*Dodge*, 204 Mich. at 500.)

This summary illustrates the obstacles shareholders face in bringing lawsuits against the large, diversified corporation for the board not paying dividends. As a result, to my knowledge, there has not been another successful shareholder lawsuit for dividends against a large corporation.

Legal experts agree, the business judgment rule obliterates the power of shareholders to force boards to declare dividends. Professor M. Todd Henderson states that, "The decision to withhold dividends and invest in new businesses is, under current law, unassailable." (Henderson 2007, 28) Professor Ken Greenwood states that, "…legal doctrine makes clear that shareholders have the same legal right to dividends as waiters have to tips: an expectation that is not enforceable in court…" (Greenwood 2006,108). Professor Lynn Stout explains that corporate profit can be used to, "…raise managers' salaries, start an on-site childcare center, improve customer service, beef up retirees' pensions, or make donations to charity." (Stout 2002, 1194)

[32] If anything, state statutes place restrictions on the size of the dividend the board can declare. "No distribution may be made if, after giving it effect: (1) the corporation would not be able to pay its debts as they become due in the usual course of business..." (MBCA 2002 § 6.40(c))

[33] "Ford's testimony was too much for the trial court to bear. After all, if a firm as large and important to the American economy were permitted to pursue an overtly socialist strategy, the political impact and the effect on other firms could be enormous. The geopolitical context of the trial made this point clear." (Henderson 2007, 21)

[34] Some use this decision to argue that corporations have a legal obligation to maximize profit for shareholders. First, legal scholars disagree with this interpretation. For example, "Dodge is often misread or mist aught as setting a legal rule of shareholder wealth maximization. This was not and is not the law." (Henderson 2007, 1) Second, case law related to takeovers suggests that corporations have no such obligation. For example, in *Paramount Communications Inc. v. Time Inc*. Delaware Supreme Court, 1990. 571 A.2d 1140: "[A] board of directors . . . is not under any per se duty to maximize shareholder value."

In conclusion, shareholders have no *right* to *any* of the corporate income because state statues do not force the board to declare dividends. Moreover, case law shows that courts will force the board to declare dividends only under idiosyncratic circumstances. Thus, legal experts agree that shareholders have negligible *power* to force the board to declare dividends.

l) Right to Capital

Do shareholders *have a right* to capital? One with the right to capital has the, "…liberty to consume, waste or destroy the whole or part of it." (Honoré 1961, 120) Taking this definition less literally, upon dissolution, shareholders may receive the remaining assets after all other claimants are paid. But for shareholders to claim the *right to capital*, they would need the *power* to dissolve the corporation. A shareholder does not have unilateral *power* to dissolve the corporation, as state statutes provide that the board has sole discretion.[35] Therefore, shareholders have no *right* to capital.[36]

m) Right to Residuarity

Do shareholders have a *right to residuarity* in the corporate assets or income? When a person's incident of ownership terminates, the person who receives that incident is said to have a "residuary right" to it.[37] For example, when a lease terminates, the less or claims the *right to possess*; thus, the lessor has the *residuary right to possess*. In the principal-agent model, when the agency relationship terminates, the principal regains the right to manage. In this case, the principal has the *residuary right to manage*.

One might argue that the shareholder's right to vote gives shareholders *residuary rights* to those incidents claimed by the board (e.g., the *right to manage*). Certainly, the more *power* shareholders have to designate board membership, the more powerful their *residuary rights*. Since, as was noted, non-controlling shareholders have negligible power to designate board membership, their residuary rights are negligible.

For this incident of ownership, the situation is different for sole and controlling shareholders. The sole shareholder, through the exclusive *power* to nominate and elect the full board, has strong *residuary rights* to *manage* and *income*. Controlling shareholders have less power to designate board membership[38] and, thus, weaker *residuary rights* to *manage* and *income*.[39] In addition, controlling shareholders also have the *residuary right to capital*, which the sole shareholder has outright.[40] Non-controlling shareholders' residuary rights are negligible, while the sole shareholder and controlling shareholders have *residuary rights to manage and income*--the controlling shareholder also has the *residuary right to capital*.

Regarding the *power to alienate & transfer* and *immunity from expropriation*. An analysis is unnecessary for these 3 incidents of ownership since they are either subsumed by other incidents or contingent on the presumption of ownership.[41] That is, the presence of these incidents is contingent upon ownership, without which the incidents are meaningless. Since corporate assets cannot be transferred or expropriated if they are not owned in the first place, these incidents are not discussed further.

n) Test of Hypothesis

Table 2 summarizes the evidence, listing whether the legal relation necessary to claim an incident of ownership is present, absent, or a residuary right for each firm-type. As previous noted, the sole proprietor has every incident of ownership, while the firm-members

[35] Per DGCL § 275: "Dissolution generally; procedure. (a) If it should be deemed advisable in the judgment of the board of directors of any corporation that it should be dissolved, the board, after the adoption of a resolution to that effect by a majority of the whole board at any meeting called for that purpose, shall cause notice to be mailed to each stockholder entitled to vote thereon of the adoption of the resolution and of a meeting of stockholders to take action upon the resolution. (b) At the meeting a vote shall be taken upon the proposed dissolution. If a majority of the outstanding stock of the corporation entitled to vote thereon shall vote for the proposed dissolution, a certification of dissolution shall be filed with the Secretary of State pursuant to subsection..." Also, see RMBCA § 14.02.

[36] The sole shareholder is a special case. According to the DGCL § 275(c), "Dissolution of a corporation may also be authorized without action of the directors if all the stockholders entitled to vote thereon shall consent in writing and power to secure its vote." Thus, a sole shareholder has the power to dissolve the corporation, which, combined with the right to the capital upon dissolution, gives a sole shareholder the residuary right to the capital that remains after all other claimants are paid.

[37] Regarding the right to residuarity, Honoré (1961, 127) states, "…whenever an interest less than ownership terminates, legal systems always provide for corresponding rights to vest in another. When easements terminate, the "owner' can exercise the corresponding rights…"

[38] Technically, cumulative voting can, at times, reduce a controlling shareholder's power to vote in every board member.

[39] However, the controlling shareholder's residuary right to manage would be diminished by additional fiduciary duties to minority shareholders.

[40] The sole shareholder's power to propose dissolution combines with a sole shareholder's power to secure the vote, resulting in the right to capital (See footnote 36).

[41] The power to alienate refers to the transfer of ownership (i.e., a sale). Alienating "all or substantially all" corporate assets occurs upon dissolution, which is discussed later in relation to the "right to capital." Alienating *some* corporate assets falls under the "right to manage." Thus, the *power to alienate* is subsumed by other incidents of ownership. The incidents of ownership, *power to transfer* and *immunity from expropriation*, while they involve economic benefits, are only *contingently* related to ownership. Waldron (1985) argues that power to transfer is not, in fact, part of the definition of ownership, "but only contingently connected with it." "…in France the operation of the doctrine of *legitima portio* casts a different complexion on wills, bequest and inheritance altogether. What does this show? Does it show that the French have a different concept of ownership from the Americans and the English, so that it is a linguistic error to translate '*propriete*' as 'ownership'? Or does it show that the power of transmissibility by will is not part of the definition of ownership but only contingently connected with it?" (Waldron 1985, 316)

(e.g., beneficiaries) of nonprofit corporations have no incidents of ownership. These firms serve as benchmarks for the claims of shareholders to the corporation's assets.

Table 2: Summary of Findings

	Liquidity Protection is Not Present		Liquidity Protection is Present			
Incidents of Ownership**	Sole Proprietor	General Partner	Sole Shareholder	Controlling Shareholder*	Non-Controlling Shareholder*	Nonprofit Member
Right to possess	Present	Present	Absent	Absent	Absent	Absent
Right to use	Present	Present	Absent	Absent	Absent	Absent
Right to income	Present	Present	Residuary	Residuary	Absent	Absent
Right to capital	Present	Present	Present	Residuary	Absent	Absent
Right to manage	Present	Present	Residuary	Residuary	Absent	Absent
Duty to prohibit harmful use	Present	Present	Absent	Absent	Absent	Absent
Liability of execution	Present	Present	Absent	Absent	Absent	Absent

** Compared to the sole shareholder, these residuary rights are diminished by cumulative voting and fiduciary responsibilities to minority shareholders.*

*** There are 7 incidents of ownership because 3 were eliminated from the analysis and the right of residuary relates to all other incidents.*

Thus, the main result of the analyses is that, like firm-members of nonprofit corporations, the non-controlling shareholders have no incidents of ownership. They have no right to *any* of the corporate income or assets, and arguably less power than other firm-members (e.g., managers, employees) to obtain them. In no meaningful sense do these non-controlling shareholders possess ownership claims to the corporation's assets.

Regarding the Alternative Hypothesis, the evidence supports the hypothesis that firm-members of firm-types with liquidity protection have less legal ownership claims to firm-assets than do firm-members of firm-types without liquidity protection. [42] Specifically, the firm-members of those firm-types without liquidity protection (i.e., sole proprietorships and partnerships) have greater ownership claims to firm-assets than do firm-members of firm-types with liquidity protection (i.e., business corporations and nonprofit corporations).No statistical test is necessary because all firm-types legally must have identical incidents of ownership to the firm-assets.

V. Implications for Accounting

In a sole proprietorship, the equality, assets equal liabilities plus net worth, ignoring measurement concerns, makes eminent economic sense. Calling the sole proprietor's net worth, "Owner's Equity" in order to imply that s/he has legal claim to the firm's net assets does not appear unreasonable. A balance sheet with a "proprietary perspective" presents the firm's net assets, particularly the profits, as claimed by one type of firm-member. Calling the net assets, "Owner's Equity" shows that the sole proprietor has legal claims to the net assets.

Applying this "proprietary perspective," to large, widely held corporations, Sprague (1908) called net assets, "net worth," while Hatfield (1909) called net assets, "proprietorship." Couchman (1921) asserted that the "rights of persons to these assets" include "the rights of creditors, known as liabilities, and the rights of proprietors," the shareholders of corporations. In arguing that the proprietary perspective applies to the business corporation, Couchman (1921, 265)asserts that,

> …surplusforms a part of the proprietorship, [as] it was either contributed to the organization by the proprietors themselves or has accrued to their credit within the organization...As to the surplus arising from earnings…[s]ome organization in their annual balance-sheets use the term "undivided profits" to display that portion of the net earnings of the preceding period which has not been appropriated, transferring the undivided profits of other periods to the surplus account. Portions of earned surplus may be set a side under many distinctive headings to sow the purposes for which hey are appropriated, such as "reserve for sinking fund," "reserve for betterments," "reserve for new factory…It is also desirable that in the balance-sheet the accountant should display surplus in such manner that the amount available for dividends may be readily ascertainable. [43]

[42] Obviously, everything could be restated using a null, rather than an alternative, hypothesis, but the result would be clumsy wording with no substantively different conclusion.

[43] Couchman (1921, 265) uses the term "surplus" "in its widest sense, that is, to measure any excess of asset value which a corporation may have over the sum of its liabilities and outstanding capital stock."

The larger size of the corporation, with more dispersed share ownership led to questioning whether the proprietary perspective was appropriate for such corporations. For example, Berle and Means (1932) called shareholders of such corporations "nominal owners," arguing that they would more accurately be described as "creditors." "By the late 1920's, it had become commonplace to remark on the resemblance between shareholders and bondholders." (Ireland 2001, 149; also, Lippman, 1914, 60-61)[44]

Accounting academics responded with what became known as "entity theory" or the "entity perspective." For example, Paton (1922, p. 38) argued that "an equity" is a "value representation of a right in property…Properties connote equities and equities connote properties…" in order to prescribe listing the claims of shareholders and creditors as "equities." This version of the entity perspective prescribing a balance sheet with assets equal to equities was included in Paton and Littleton (1940), a report commissioned by the American Accounting Association to establish a "framework of accounting theory" (Bedford & Zeigler 1975, 438). In 1941, the committee of the American Institute of Accountants rejected Paton and Littleton to avoid "…de-privileging of stockholders, inherent in entity theory" (Cilloni, Marinoni & Merino 2013, 61). Since then, standard setters have required the proprietary perspective for the balance sheets of business corporations.

FASB (1985, 18) states that, "In a business enterprise, the equity is the ownership interest. It stems from ownership rights (or the equivalent)and involves a relation between an enterprise and its owners *as owners* rather than as employees, suppliers, customers, lenders, or in some other nonowner role. FASB (1985, Footnote 30) continues, "Other entities with proprietary or ownership interests in a business enterprise are commonly known by specialized names, such as stockholders, partners, and proprietors…but all are also covered by the descriptive term *owners*."

Therefore, the balance sheet of the business corporation substitutes the sole proprietor's "Owner's Equity" with "Shareholders' Equity," implying that shareholders and sole proprietors have identical claims to the firm's net assets and profits. The only reasonable inference to draw from this balance sheet presentation is that shareholders, like sole proprietor's and partners, have exclusive legal ownership claims to the corporation's net assets and profits.

In contrast, according to the evidence, non-controlling shareholders have no ownership claims to the net assets or profits. Specifically, shareholders have far fewer legal claims to firm-assets than do sole proprietors and partners and only slightly more claims to firm-assets than beneficiaries of nonprofit corporations.

Nonprofit and business corporations both have liquidation protection and, as the evidence reveals, their firm-members (e.g., non-controlling shareholders for the business corporation) have no legal ownership claims to firm-assets. Therefore, perhaps the balance sheet of the business corporation should be more similar to those of the nonprofit corporation than to those of the sole proprietorship. For example, firm-members of nonprofit corporations have no claims to firm-assets; therefore, FASB requires nonprofits to label the net assets as, "Net Assets." If the shareholders of business corporations have no claims to the firm-assets, how accurately does the balance sheet represent firm-members' legal claims to corporation's net assets if it calls them "Shareholders' Equity"? Does calling the net assets of the business corporation "Net Assets," like nonprofit corporation better represent the non-existent claims of firm-members, including shareholders, to the firm-assets?

This question is perhaps why a recent accounting standard, FASB (2008, OB12) Concepts Statements No. 8, uses the phrase "the claims against the reporting entity," replacing, "the claims to those resources" and similar phrasing FASB used for decades.[45]FASB (2010, 14) provides the justification for the change, arguing, "…that in many cases, claims against an entity are not claims on specific resources. In addition, many claims will be satisfied using resources that will result from future net cash inflows. Thus, while all claims are claims against the entity, not all are claims against the entity's existing resources."The takeaway for this paper is that FASB itself knows that the balance sheet does not accurately show shareholders' legal claims to net assets.

What is the Solution?

The IASB and FASB's goal to converge accounting standards faltered over conflicts about whether financial reporting should take an entity or proprietary perspective, as noted in the introduction. Van Mourik (2014) examines the conflict, finding confusion on both sides and providing a list of papers on various types of equity theories, which would be helpful in understanding the different reporting perspectives. Ultimately, Van Mourik (2014) uses limited liability as the principle by which to determine reporting perspective for each firm-type. Van Mourik's focus on limited liability is based on Demsetz (1967) three

[44] According to Holstrom & Kaplan (2003, 15), untilthe late 1970s, "management was loyal to the corporation, not to the shareholder," where management, "…was not to maximize shareholder wealth, but to ensure the growth (or at least the stability) of the enterprise by 'balancing' the claims of all important corporate 'stakeholders'-- employees, suppliers, and local communities, as well as shareholders."

[45] FASB (1978, 6) Concepts Statement No. 1 states, "Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources..."

characteristics of public corporations: (1) its legal personality, (2) its limited liability for common shareholders, and (3) its free transferability of shares.

But, as this paper has explained, limited liability is unnecessary for a corporation to exist and can be privately contracted to a large degree. More importantly, Demsetz' definition does not include entity shielding as a characteristic of a corporation when, without it, transferable shares could not exist. If stock markets can and have existed with limited liability, but not entity shielding, which is a more important characteristic of the business corporation? Instead, to determine the appropriate reporting perspective for each firm-type, academics should focus on how entity shielding affects firm-members' (e.g., shareholders') claim to the firm-assets.

VI. Conclusion

In a 2008 joint Exposure Draft, IASB and FASB recommended that "[A]n entity's financial reporting should be prepared from the perspective of the entity (entity perspective) rather than the perspective of its owners or a particular class of owners (proprietary perspective)" (IASB 2008, 5). But when FASB realized that an entity perspective would not list net assets and profits under Shareholders' Equity, it abandoned plans to converge reporting entity perspectives. [46] Instead, FASB continues to require the proprietary perspective for business corporations, which implies that shareholders have exclusive ownership claims to the firm's net assets, including the profit.

The reporting perspective most appropriate for each reporting entity should depend on underlying principles to which standard setters agree. This paper assumes that the claims firm-members have to the firm-assets implies what reporting perspective is appropriate for each firm-type.

This paper finds that shareholders, unlike sole proprietors, of business corporations have no legal claims to the corporation's net assets or profit. Instead, shareholders of business corporations have similar claims to those of beneficiaries of nonprofit corporations. The reason for the similarity is that both business and nonprofit corporations have liquidity protection because their firm-assets are shielded from firm-members, as well as the firm-members' creditors. The ability to shield the creditors of firm-members cannot be accomplished through private contracting and, as such, this type of liquidity protection distinguishes the business corporation from other business firm-types.

The unique feature of liquidity protection afforded to business corporations necessarily restricts shareholders' claims to firm-assets. Specifically, shareholders, because of liquidity protection, have no claims to the firm's net assets, while sole proprietors with no liquidity protection have exclusive claims to firm-assets. Therefore, requiring business corporations to present net assets as part of Shareholders' Equity misrepresents shareholders claims to the net assets. Shareholders do not have identical claims to firm-assets to those of sole proprietors; rather the opposite is true, they have no claims.

The shareholders' lack of claims to the firm-assets implies that the proprietary perspective is inappropriate for the balance sheet of the business corporation. Academics should focus on how entity shielding affects each firm-members claim to the net assets., because entity shielding uniquely identifies firm-type, cannot be privately contracted, and enables transferable shares without which founders could not maintain personal liquidity. Entity shielding, not limited liability, should serve standard setters as the principle underlying what reporting perspective should be required for each firm-type.

[46] www.iasplus.com/en/meeting-notes/iasb/2010/agenda_1011/agenda1551#entity-versus-proprietary-perspective

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