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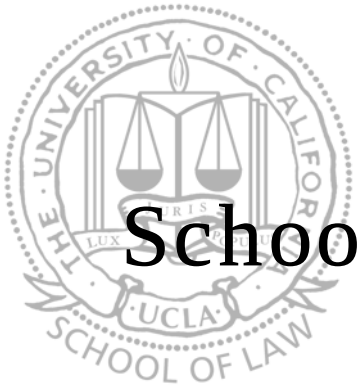
The Board of Directors as Nexus of Contracts: A Critique of Gulati, Klein & Zolt's "Connected Contracts" Model

Stephen M. Bainbridge

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Stephen M. Bainbridge*

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I. INTRODUCTION

If scholarship is to transcend mere description, it must be situated in a model that guides analysis. Inevitably, however, the limits of human cognition require us to adopt models that make simplifying assumptions.[1] Accordingly, a model is

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* *Professor*, UCLA School of Law. This Article is based on portions of Chapter 5 of my Foundation Press text, CORPORATION LAW AND ECONOMICS (forthcoming 2002). Subject to the usual disclaimers, I thank Bill Klein for his typically useful critique.

[1] The term bounded rationality was coined by Herbert Simon. *See* Herbert A. Simon, *Rational Choice and the Structure of the Environment*, in MODELS OF MAN 261, 271 (1957). According to the theory of bounded rationality, economic actors seek to maximize their expected utility, but the limitations of human cognition often result in decisions that fail to maximize utility. Decisionmakers inherently have limited memories, computational skills, and other mental tools, which in turn limit their ability to gather and process information. *See generally* Roy Radner,

properly judged by its predictive power with respect to the phenomena it purports to explain, not by whether it is a valid description of an objective reality.[2] As such, "the relevant question to ask about the 'assumptions' of a theory is not whether they are descriptively 'realistic,' for they never are, but whether they are sufficiently good approximations for the purpose in hand."[3]

The chief criteria for any model of the corporation must be the model's ability to predict the separation of ownership and control, the institutional governance structures following from their separation, and the legal rules responsive to their separation.[4] Shareholders, who are said to "own" the firm,[5] have virtually no power to control either its day-to-day operation or its long-term policies. Instead, the firm is controlled by its board of directors and subordinate managers, whose equity stake is often small.[6]

Both the origins and economic merits of this separation are disputed,[7] but there can be no dispute that corporate law carves this separation into stone as a matter of basic doctrine. Under all corporation statutes, the key players in the formal decisionmaking structure are the members of the board of directors.[8] The

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Bounded Rationality, Indeterminacy, and the Theory of the Firm, 106 ECON. J. 1360, 1362-68 (1996) (providing an especially detailed taxonomy of the various forms bounded rationality takes, with special emphasis on the theory's relevance to the organization for firms).

[2] Milton Friedman, *The Methodology of Positive Economics*, in ESSAYS IN POSITIVE ECONOMICS 23, 27 (1985).

[3] *Id*.

[4] *See* Patrick Bolton & David S. Scharfstein, *Corporate Finance, the Theory of the Firm, and Organizations*, 12 J. ECON. PERSP. 95, 96 (1998) (arguing that "a fully satisfactory theory of the firm" must account for the separation of ownership and control).

[5] Although I follow convention in using the term "separation of ownership and control," ownership is not a particularly useful concept in the corporate context. *See* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1427-28 (1993) (arguing against applying ownership concepts to the corporation); *see also infra* note 51 and accompanying text (same).

[6] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 84-89 (1932).

[7] *Compare, e.g.*, MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994) (claiming that the separation of ownership and control was a relatively late development resulting from political forces rather than economic efficiency) *with* Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J. L. & PUB. POL'Y 671 (1995) (arguing that the separation of ownership and control was an early development occasioned by its efficiency advantages).

[8] *See infra* note 105 and accompanying text.

vast majority of corporate decisions thus are assigned by statute to the board of directors.[9] Consequently, shareholders have essentially no power to initiate corporate action and, indeed, are entitled to approve or disapprove only a very few board actions.[10] The vote thus confers neither decisionmaking nor even oversight rights on shareholders in any meaningful sense.[11] By virtue of the

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[9] The statement in the text is subject to several qualifications. First, we will use "decision" as a shorthand for a process that often is much less discrete in practice. Most board of director activity "does not consist of taking affirmative action on individual matters; it is instead a continuing flow of supervisory process, punctuated only occasionally by a discrete transactional decision." Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1494 (1984). Second, operational decisions are normally delegated by the board to subordinate employees. The board, however, retains the power to hire and fire firm employees and to define the limits of their authority. Moreover, certain extraordinary acts may not be delegated, but are instead reserved for the board's exclusive determination. *See, e.g.*, Lee v. Jenkins Bros., 268 F.2d 357, 370 (2d Cir.), *cert. denied*, 361 U.S. 913 (1959) (holding that "the [corporation's] president only has authority to bind his company by acts arising in the usual and regular course of business but not for contracts of an 'extraordinary' nature").

[10] Under the Delaware code, for example, shareholder voting rights are essentially limited to the election of directors and approval of charter or by-law amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolution. *See* MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 174-77 (1995) (summarizing substantive shareholder voting rights). As a formal matter, only the election of directors and amending the by-laws do not require board approval before shareholder action is possible. DEL. CODE ANN. tit. 8, §§ 109, 211 (2000). In practice, of course, even the election of directors (absent a proxy contest) is predetermined by the existing board nominating the next year's board. *See generally* Bayless Manning, *Book Review*, 67 YALE L.J. 1477, 1485-89 (1958) (describing incumbent control of the proxy voting machinery). These direct restrictions on shareholder power are supplemented by a host of other rules that indirectly prevent shareholders from exercising significant influence over corporate decisionmaking. Three sets of statutes are especially noteworthy: (1) disclosure requirements pertaining to large holders; (2) shareholder voting and communication rules; (3) insider trading and short swing profits rules. These laws affect shareholders in two respects. First, they discourage the formation of large stock blocks. Second, they discourage communication and coordination among shareholders. For a more detailed treatment of the effects of these statutes on shareholder control, see Stephen M. Bainbridge, *Constraints on Shareholder Activism in the United States and Slovenia* (2000), *at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=28780.

[11] Despite the limitations of shareholder voting rights, some scholars argue the market for corporate control ensures a residual form of shareholder control, transforming transforms "the limited de jure shareholder voice into a powerful *de facto* form of shareholder control." John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable are U.S. Public Corporations?,* 24 J. CORP. L. 837, 850 (1999). To be sure, the market for corporate control depends on the existence of shareholder voting rights. Yet, while it is fair to say that the market for corporate control is an important accountability mechanism, market-based accountability and control are distinct concepts. Directors are held accountable to shareholders through a variety of

business judgment rule and the closely related rules governing shareholder litigation, moreover, indirect shareholder oversight of directors through litigation is also foreclosed.[12]

To explain these basic features of corporate law, legal scholars have drawn on numerous models. These models can be classified in various ways and some defy classification. For our purposes, however, models of the firm can be divided into two basic categories: managerialism versus shareholder primacy. The former treats the corporation as a bureaucratic hierarchy dominated by professional managers. Directors are figureheads, while shareholders are nonentities.[13] Managers are thus autonomous actors free to pursue whatever interests they choose (or society directs). [14]

Managerialist models long dominated corporate law scholarship and remain influential in some other disciplines,[15] but no longer have much traction in the legal academy. Instead, most corporate law scholars today embrace some variant of shareholder primacy.[16] Traditional variants of shareholder primacy claim that

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market forces, moreover, such as the capital and reputational markets, but one cannot fairly say that those markets confer control rights on the shareholders. How then can one say that the market for corporate control does so? The right to fire is not the right to exercise fiat—it is only the right to discipline. In any event, takeover defenses—especially the combination of a poison pill and a classified board—go along way towards restoring director primacy vis-à-vis the shareholders. *See* Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 125-26 (2001) (discussing effectiveness of pill-classified board combination as a means of ensuring continued board control); *see also* Robert B. Thompson, *Shareholders as Grown-Ups: Voting, Selling, and Limits on the Board's Power to "Just Say No,"* 67 U. CIN. L. REV. 999, 1017-18 (1999) (using legal treatment of poison pill and classified board provisions as a measure of jurisdictional commitment to shareholder primacy).

[12] *See generally* Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 471-512 (explaining how these doctrines protect the board's discretionary authority).

[13] *See* PETER F. DRUCKER, CONCEPT OF THE CORPORATION 92 (rev ed. 1972) (describing outside directors as figureheads). Instructively, the index to Drucker's classic analysis of General Motors does not contain an entry for shareholders. *See id.* at 318-19 (index).

[14] *See generally* William W. Bratton, *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989) (discussing managerialist theories of the firm); Allen Kaufman & Lawrence Zacharias, *From Trust to Contract: The Legal Language of Managerial Ideology*, 1920-1980, 66 BUS. HIST. REV. 523 (1992) (same).

[15] The classic managerialist account remains ALFRED D. CHANDLER, THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1977).

[16] Those scholars who reject shareholder primacy commonly do so on normative rather than positive grounds. *See, e.g.,* David Millon, *New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001 (2000) (arguing that

shareholders own the corporation and, accordingly, directors and officers are mere stewards of the shareholders' interests.[17] A more recent variation, which arguably is the dominant model in today's scholarship, blends two economic theories—the nexus of contracts theory of the firm and agency cost economics. In contractarian theory, shareholders are merely one of many factors of production bound together in a complex web of explicit and implicit contracts.[18] Influenced by agency cost economics, however, most law and economics scholars continue to treat directors and officers as agents of the shareholders, with fiduciary obligations to maximize shareholder wealth.[19] Shareholders therefore retain a privileged position among the corporation's various constituencies, because their contract with the firm has ownership-like features, including the right to vote and the fiduciary obligations of directors and officers.

Director primacy asserts that neither position is correct. Neither shareholders nor managers control corporations—boards of directors do. Prevailing models of the firm in legal scholarship all too often pay insufficient attention to the power of

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shareholder primacy remains the law, while critiquing shareholder primacy on normative grounds). On one side of the corporate law academy spectrum are those who contend corporations should be run so as to maximize shareholder wealth. On the other side are those who argue that directors and managers should consider the interests of all corporate constituencies in making corporate decisions. This axis reflects the division in corporate law scholarship along private-public lines. *See* William W. Bratton, *Berle and Means Reconsidered at the Century's End*, 26 J. CORP. L. 737, 760-61 (2001) (noting private/public divide); Lawrence E. Mitchell, *Private Law, Public Interest? The ALI Principles of Corporate Governance*, 61 GEO. WASH. L. REV. 871, 876 (1993) (noting debate as to "whether the modern corporation is essentially a matter of public or private concern"). The former treats corporate governance as a species of private law, such that the separation of ownership and control does not in and of itself justify state intervention in corporate governance. The latter school of thought treats corporate governance as a species of public law, such that the separation of ownership and control becomes principally a justification for regulating corporate governance so as to achieve social goals unrelated to corporate profitability. Bainbridge, *supra* note 7, at 691-92. The public law school is now dominated by various forms of stakeholderist models, which typically argue that corporate decisionmakers must be sensitive to the needs of all of a corporation's constituencies and, as a result, intra-corporate relationships must not be unilaterally abrogated to benefit shareholders. *See* Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 877 (1997) (discussing stakeholderism).

[17] *See* Bainbridge, *supra* note 5, at 1427-28 (discussing the traditional shareholder primacy model as famously articulated by economist Milton Friedman).

[18] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 12 (1991) (noting the "many actors" who collectively participate in the firm).

[19] *See, e.g., id.* at 91 (describing corporate managers as "agents of the equity investors" who "pledge their careful and honest services").

fiat exercised by the board. Some scholars go so far as to claim that fiat does not exist.[20] Still others acknowledge the board's discretionary powers, but treat those powers mainly as a source of agency costs to be constrained by market and/or legal forces.[21] In doing so, however, they have allowed the tail to wag the dog. To be sure, deterrence and punishment of misconduct by the board is necessary. Accountability standing alone, however, is an inadequate normative account of corporate law. Fiat exists—and fiat matters. A fully specified account of corporate law therefore must incorporate the value of authority—i.e., the need to develop a set of rules and procedures that provides the most efficient decisionmaking system.[22]

At the core of the director primacy model therefore lies the normative claim that the virtues of fiat, in terms of corporate decisionmaking efficiency, can be ensured only by preserving the board's decisionmaking authority from being trumped by either shareholders or courts. Achieving an appropriate mix between authority and accountability is a daunting task, but a necessary one. Ultimately, authority and accountability cannot be reconciled. At some point, greater accountability necessarily makes the decisionmaking process less efficient, while highly efficient decisionmaking structures necessarily entail nonreviewable discretion.[23]

This Article is one of the first in a planned series intended to work out the implications of director primacy across a range of core corporate law doctrines. Subsequent articles will address the director primacy model's application to such basic principles as the shareholder wealth maximization norm, the business judgment rule, shareholder voting rights, and the powers of the board with respect to corporate takeovers.

The director primacy model proposed herein is grounded in the prevailing law and economics conception of the firm; namely, the so-called nexus of contracts model. Part II of this Article therefore summarizes (as briefly as possible) the standard contractarian account. As I have observed elsewhere, contractarians and non-contractarians no longer have much of interest to say to one another—we

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[20] *See infra* notes 71-72 and accompanying text (describing that position).

[21] *See infra* note 128 and accompanying text (describing that position).

[22] *Cf.* Dooley, *supra* 12, at 464 (opining: "Authority and Responsibility are both essential values because each responds to one of the two principal kinds of costs incurred in operating as a firm.").

[23] *See infra* notes 131-134 and accompanying text (explaining tension between authority and accountability).

pass like two ships in the night with an occasional exchange of broadsides.[24] Accordingly, this Article is not intended to defend the contractarian model against its external critics. Instead, this Article looks inward to work out an often-overlooked implication of contractarianism.

In doing so, however, the Article must respond to an important recent internal critique of the contractarian model. In a provocative article, my friends and UCLA colleagues Mitu Gulati, Bill Klein, and Eric Zolt challenged the nexus of contracts model. Although their new model remains contractarian in nature, it lacks a critical feature of the standard contractarian account—namely, a nexus. "In [their] model there is no primacy, no core, no hierarchy, no prominent participant, no firm, no fiduciary duty."[25] Instead, there is simply a set of contracts among the enterprise's various constituencies.[26] Their challenge is significant for my purposes, because a nexus competent to exercise fiat is central to the director primacy model. Indeed, defending the idea of a nexus was the original motivation for this Article. The bulk of Part II of this Article therefore is devoted to a critique of the connected contracts approach.

Part III makes the affirmative case for identifying the board of directors as the nexus of contracts within the firm. The director primacy model developed in Part III thus contrasts not only with the connected contracts approach, but also with the standard contractarian version of shareholder primacy. In the director primacy model, the corporation is a vehicle by which the board of directors hires various factors of production. Hence, the board of directors is not a mere agent of the shareholders, as standard contractarian theory claims,[27] but rather is a *sui generis* body—a sort of Platonic guardian[28]—serving as the nexus for the various contracts making up the corporation. The board's powers flow from that set of contracts in its totality and not just from shareholders.

Part IV examines the relative predictive power of the director primacy and connected contracts models. It argues that the predictive of director primacy is

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[24] Bainbridge, *supra* note 16, at 860.

[25] G. Mitu Gulati et al., *Connected Contracts*, 47 UCLA L. REV. 887, 947 (2000).

[26] *Id*. at 894-95 (defining the term "connected contracts").

[27] *See infra* note 125 and accompanying text.

[28] In THE REPUBLIC, Plato describes an idealized community led by philosopher-kings—so-called Platonic guardians—whose decisions are made in the best interests of the community. In making decisions, the guardians draw on reason and their knowledge of the good, as inculcated by life-long education. *See* PLATO, THE REPUBLIC 289-90 (Benjamin Jowett trans. 1991), in which Socrates describes the education of philosopher-kings who rule "for the public good, not as though they were performing some heroic action, but simply as a matter of duty." *Id.*

demonstrated in the host of legal doctrines and governance structures that resolve the tension between authority and accountability in the favor of the former. Because only shareholders are entitled to elect directors, for example, boards of public corporations are insulated from pressure by nonshareholder corporate constituencies, such as employees or creditors. At the same time, the diffuse nature of U.S. stockownership and regulatory impediments to investor activism insulate directors from shareholder pressure. Part IV thus develops the normative claim that the board ought to have virtually unconstrained freedom to exercise business judgment. Preservation of this largely unfettered discretion is—and should always be—the null hypothesis. Hence, the term director primacy, which reflects the board's sovereignty. As Part IV begins to explain, and as subsequent articles in this series will elaborate, the director primacy model makes both "ought" and "is" claims. On the one hand, the model is normatively superior to competing models. On the other hand, the director primacy model is also superior at the positive task of explaining and predicting the content of legal rules in the corporate law area.

II. THE CONTRACTARIAN FOUNDATIONS OF DIRECTOR PRIMACY

Ever since Berle and Means brought the separation of ownership and control to public attention, that phenomenon has been the defining characteristic of the modern public corporation.[29] Berle and Means argued that dispersed ownership was "inherent in the corporate system."[30] But why? Answering that question is the critical test for any model of the firm. Regrettably, the corporations literature frequently devolves into mere pedantry. The "firm" is an inherently indeterminate concept, whose nature depends very much on the eye of the beholder.[31] Yet, models nevertheless matter. Reality is so complex and in such rapid flux that it can only be understood through the use of simplifying models.

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[29] *See* BERLE & MEANS, *supra* note 6, at 2-5 (arguing that shareholders of public corporations exercise virtually no control over either day-to-day operations or long-term policy; instead, control is vested in the hands of professional managers). Although Berle and Means are popularly credited with bringing the phenomenon to light, the idea was not new. HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW: 1836-1937 357 (1991). Alfred Marshall had made the same point in 1890, *id*., as did William W. Cook in 1891. *Id*. at 16.

[30] BERLE & MEANS, *supra* note 6, at 47.

[31] *Cf.* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 19 (7th ed. 2000) (discussing how perspectives of lawyers and economists differ with respect to thinking about firms).

A. The Standard Contractarian Account

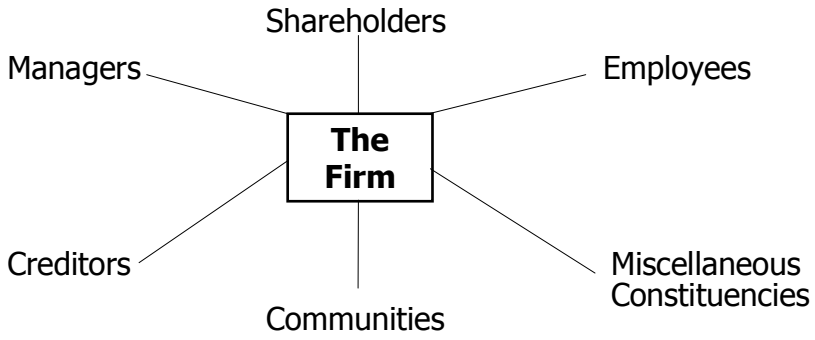
The dominant model of the corporation in legal scholarship is the so-called nexus of contracts theory. This model's origins fairly can be traced to Nobel Prize laureate Ronald Coase's justly famous article, *The Nature of the Firm*.[32] Building on Coase's work, modern law and economics scholars view the corporation not as an entity but as an aggregate of various inputs acting together to produce goods or services.[33] Employees provide labor. Creditors provide debt capital. Shareholders initially provide equity capital and subsequently bear the risk of losses and monitor the performance of management. Management monitors the performance of employees and coordinates the activities of all the firm's inputs. The firm is the nexus of explicit and implicit contracts establishing rights and obligations among the various inputs making up the firm. (See Figure 1.)

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[32] R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA (N.S.) 386 (1937).

[33] *See generally* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989); Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 318-28 (1993). As no less an authority than former Delaware Chancellor William Allen has acknowledged, contractarianism is now the "dominant legal academic view." William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993). Contractarianism nevertheless still has critics, including some very distinguished ones. *See, e.g.*, Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703 (1989); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989). For defenses of contractarian theory, see Bainbridge, *supra* note 16, at 858-71; Fred S. McChesney, *Economics, Law, and Science in the Corporate Field: A Comment on Eisenberg*, 89 COLUM. L. REV. 1530 (1989).

Figure 1
The nexus of contracts model:
The firm *is* a nexus



The name "nexus of contracts" is somewhat unfortunate. For lawyers, the term "contracts" carries with it all of the baggage learned in Contracts class during the first year of law school. Among that baggage are two particularly problematic features. First, the word contract focuses attention on legal notions such as consideration and mutuality. Second, the word contract mainly seems to invoke transactions on spot markets that are thick and relatively untroubled by asymmetric information. Neither has much to do with the internal governance of corporations.

As used by contractarians, however, the term is not limited to relationships constituting legal contracts. Instead, contractarians use the word contract to refer generally to long-term relationships characterized by asymmetric information, bilateral monopoly, and opportunism.[34] The relationship between shareholders and

[34] *See, e.g.*, Oliver Williamson, *Corporate Governance,* 93 YALE L.J. 1197 (1984) (discussing the transaction cost economics variant of the contractarian theory of the firm). A variant associated most closely with Oliver Hart focuses on processes by which property rights to assets are created, modified, or transferred. *See, e.g.*, Oliver D. Hart, *Incomplete Contracts and the Theory of the Firm*, in THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 138 (Oliver E. Williamson & Sidney G. Winter eds. 1991) (discussing property rights approach to the theory of the firm). Hart's insight is significant because it reminds us that business organization

creditors of a corporation is contractual in this sense, even though there is no single document we could identify as a legally binding contract through which they are in privity.[35] Hence, I have elsewhere opined:

> [T]he nexus-of-contracts model is properly viewed as a metaphor rather than as a positive account of economic reality. Contractarianism is analogous to Newtonian physics, which no longer claims to be an accurate representation of the laws of physics, but yet provides a simple model that adequately explains a large and important set of physical phenomena.[36]

All models have metaphorical aspects, of course. In recent years, however, I have come around to the view that the corporation *is* a nexus of contracts in a literal sense, albeit a limited one.[37]

In any case, in order for contractarian theory to be useful, it must be concerned not only with identifying the contracting parties, but also with how they contract. Put another way, we must examine the institutional governance features created within firms by contract. If we overstretch the contract metaphor, encompassing virtually all voluntary arrangements, it will become far less useful.

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law lies on a spectrum between contract and property law. Because contract rights are *in personam*, they apply to persons directly on whom they impose prescribed obligations. In contrast, property rights are *in rem* and tend to impose generalized duties on a large and indefinite number of persons. Thomas Merrill and Henry Smith argue that *in personam* relations are governed by flexible default rules designed to minimize the costs of delineating prescribed duties imposed on particular parties, while *in rem* relations are governed by bright-line rules that impose immutable and standardized obligations on a large and indefinite class. Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 COLUMBIA L. REV. 773, 789 (2001). They further contend that the distinction between the two types of relations is grounded in information costs. *Id*. at 798-99. Although corporate law has contractual elements, some corporate law rules impose generalized duties on a large and indefinite class of persons. In thinking about which transactions are effected across markets versus those effected within firms, accordingly, it seems plausible that transactions are brought within firms when it makes sense to impose immutable and standardized obligations on a large and indefinite class. For example, Henry Hansmann and Reinier Kraakman argue that it makes sense to use firms in situations in which is desirable to obtain affirmative asset protection against creditors. Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 406-23 (2000).

[35] *See* Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 232 (1999) (asserting that the contractarian metaphor "is similar to, but not nearly as fanciful as, the classic description of fundamental social relations as a 'social contract.'").

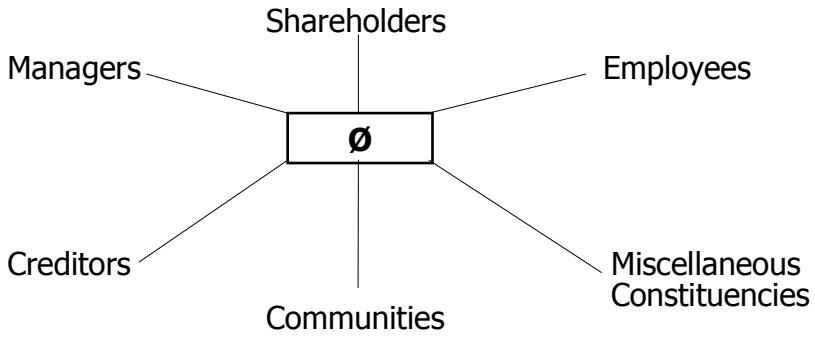
[36] Bainbridge, supra note 16, at 871.

[37] *See infra* notes 62-69 and accompanying text.

B. The Connected Contracts Challenge to Conventional Contractarianism

In an important recent article, Gulati, Klein, and Zolt challenged the standard contractarian account. To be sure, their account remains contractarian in nature. Specifically, Gulati, Klein, and Zolt contend that the firm is usefully understood as a set of connected contracts.[38] Their model departs from contractarian orthodoxy, however, by denying the existence (and even the relevance) of the nexus concept. As illustrated by the null set symbol in Figure 2, the firm described by Gulati, Klein, and Zolt neither *is* nor *has* a nexus.[39]

Figure 2
The connected contracts model



[38] *See* Gulati et al., *supra* note 25, at 894-95 (describing the connected contracts metaphor). The set of contracts metaphor is not entirely new, of course. In 1976, Jensen and Meckling argued the "firm is not an individual ... [but] is a legal fiction which serves as a focus for a complete process in which the conflicting objectives of individuals (some of whom may 'represent' other organizations) are brought to equilibrium within a framework of contractual relations." Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. Fin. ECON. 305, 311-12 (1976) (elaborating agency cost theory). The contractarian model thus treats the firm as "a neutral nexus within which equilibrium relations are worked out." OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 179 (1996). (See Figure 1.)

[39] On the significance of the *is*/*has* distinction, see infra notes 62-72 and accompanying text.

Put more generally, Gulati, Klein, and Zolt object to any model that reifies the corporation. While Gulati, Klein, and Zolt acknowledge the semantic utility of reification, they assert that "it is dangerous to ignore the reality that firms transact only through individuals."[40] Consequently, they offer an alternative metaphor focused on "allocation and specification of control" by contract.[41]

1. Denying Boundaries

Gulati, Klein, and Zolt claim that the firm lacks boundaries. Or, more precisely, that it is often "futile to try to map out the boundaries of the firm."[42] In fact, however, firm boundaries exist and, more important, firm boundaries matter. A recent empirical study of the plastic manufacturing industry, for example, suggests that integrated and nonintegrated manufacturers allocate resources differently and demonstrate differing sensitivities to changes in external demand.[43] Hence, boundaries matter, because real consequences follow from conducting economic activity within firms rather than across markets. One reason firm boundaries matter is that the incentives applicable to spot market transacting frequently do not work within firms and may even be undesirable in the relational employment characteristic of firms.[44] A more important reason, as explained in the next section, is that firms and markets are chiefly distinguished by the existence of a boundary within which the firm's decisionmaker has power to exercise fiat.

2. Denying the Nexus

It is Gulati, Klein, and Zolt's rejection of the nexus, however, that is critical for my purposes. Their analysis begins with three highly stylized hypotheticals in which three players have claims of varying seniority in a trust holding a zero-coupon U.S. treasury bond.[45] From these hypotheticals they conclude that the

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[40] Gulati et al., *supra* note 25, at 891.

[41] *Id.*

[42] *Id.* at 897.

[43] Sendhil Mullainthan & David Scharfstein, *Do Firm Boundaries Matter?,* 91 AEA PAPERS AND PROCEEDINGS 195 (2001).

[44] *See* George Baker et al., *Bringing the Market Inside the Firm?,* 91 AEA PAPERS & PROCEEDINGS 212 (2001) (modeling incentive structures in spot markets versus relational settings).

[45] Gulati et al., *supra* note 25, at 898-904.

concept of ownership has little meaning.[46] Instead, there are simply three contractual claims on the asset, and what matters is the bargain the parties strike with respect to the right to control any alteration of the asset's variance.[47] If the point is simply that scholars need to examine bargains over the control of variance rather than simply relying on labels, it is well taken, but hardly new.[48]

Gulati, Klein, and Zolt then turn to an equally stylized analysis in which equity is viewed as an option to buy the firm rather than an ownership interest.[49] In this model, "the debtholders are actually the ultimate owners of firm's assets, having written a call option on them to the equity holders."[50] If the point is simply that stock ownership does not entail ownership of the enterprise, it is well taken, but hardly new.[51] If the claim is a more expansive one, however, option-based

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[46] *Id.* at 899.

[47] *Id.* at 901.

[48] In an important article written two decades ago, Bill Klein developed a model emphasizing that the enterprise's participants bargain over four key deal points: risk of loss, return, control, and duration. *See* William A. Klein, *The Modern Business Organization: Bargaining under Constraints*, 91 YALE L.J. 1521 (1982); *see also* KLEIN & COFFEE, *supra* note 31, at 2-3 (discussing "bargain elements" and "constraints"). Over a decade ago, Oliver Hart also observed that treating "the firm as a nexus of contracts is helpful in drawing attention to the fact that contractual relations with employees, suppliers, customers, creditors, and others are an essential aspect of the firm." Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757, 1764 (1989).

[49] Gulati et al., *supra* note 25, at 908-18.

[50] *Id.* at 909 (quoting Robert A. Jarrow, *In Honor of the Nobel Laureates Robert C. Merton and Myron S. Scholes: A Partial Differential Equation that Changed the World*, 13 J. ECON. PERSP. 229, 241 (1999)).

[51] *See supra* note 5 (noting argument that shareholders do not own the corporation). In a recent article, Melvin Eisenberg argued shareholders possess most of the incidents of ownership, which he identified as including "the rights to possess, use, and manage, and the rights to income and capital." Melvin A. Eisenberg, *The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 825 (1999). Accordingly, he argued, shareholders own the corporation. *Id*. In fact, however, shareholders have no right to use or possess corporate property. *Cf.* W. Clay Jackson Enterprises, Inc. v. Greyhound Leasing and Financial Corp., 463 F. Supp. 666, 670 (D. P.R. 1979) (stating that "even a sole shareholder has no independent right which is violated by trespass upon or conversion of the corporation's property"). Management rights, of course, are assigned by statute solely to the board of directors and those officers to whom the board properly delegates such authority. *See infra* text accompanying note 105. Indeed, to the extent that possessory and control rights are the indicia of a property right, the board is a better candidate for identification as the corporation's owner than are the shareholders. As an early New York opinion put it, "the directors in the performance of

models are too slender a reed to support it. Just as one can view the equity claim as representing a call option to buy the firm, one can also view the equity claim as the owner of the firm with a put option to sell the firm to the creditors.[52] Option-based models thus are inherently indeterminate.

In any event, it is one thing to say that understanding the firm requires close scrutiny of bargains among the firm's constituents or that shareholders do not own the firm. It is quite another thing to deny that the corporation has a real nexus. The latter assertion hardly follows ineluctably from the former.

3. Disclaimers

In an important sense, Gulati et al. and I are talking about two distinct phenomena. I am concerned with developing a model possessing predictive power with respect to the Berle-Means corporation—i.e., the large public corporation characterized by separation of ownership and control. In order to be useful for my purposes, a model must facilitate making predictions about the key institutional features of the relationships between directors, managers, employees, and shareholders. In contrast, Gulati, Klein, and Zolt seem more concerned with the problem of organizing economic activity on a larger scale—with the enterprise as a whole and, especially, with respect to relations between enterprises. Hence, for example, in offering real world examples of their model in action, they focus on internet start-ups, the construction industry, and the motion picture industry.[53] Firms in those industries, they claim, are "characterized by contracts and subcontracts among many individuals and small firms."[54] Gulati, Klein, and Zolt assert that the nexus of contracts model fails "to capture the complex relationships between and among the participants" in such firms.[55]

Granted, the so-called virtual firm phenomenon is important and worthy of study. "There seems to be something of the trend today toward disintegration, outsourcing, contracting out, and dealing through the market rather than bringing

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their duty possess [the corporation's property], and act in every way as if they owned it." Manson v. Curtis, 119 N.E. 559, 562 (N.Y. 1918).

[52] Frank Partnoy, *Adding Derivatives to the Corporate Law Mix*, 34 GA. L. REV. 599, 610-11 (2000).

[53] Gulati et al., *supra* note 25, at 896.

[54] *Id.* at 896 n.31.

[55] *Id.* at 896.

everything under the umbrella the organization."[56] It is with respect to such arrangements that Gulati, Klein, and Zolt's connected contracts model seems most useful.[57] Instructively, however, so-called "governance contracts" that allocate highly nuanced ownership-like decision rights are a common feature of joint ventures and strategic partnerships.[58] Hence, although Gulati, Klein, and Zolt do not adequately acknowledge the point, fiat remains important even in virtual firms.[59] Even in high-tech firms, it is still a Dilbert world.[60]

In any event, despite their emphasis on virtual firms and related concepts, Gulati, Klein, and Zolt contemplate broader applications for their connected contracts model. They note, for example, the model's potential utility with respect to such paragons of hierarchy as General Motors and Ford Motor Company.[61] In addition, they assert the model "can also be useful in thinking about more traditionally organized economic activities and might open new possibilities for legal rules." It is therefore fair to test the connected contracts model's predictive powers with respect to the institutional features of the classic Berle-Means corporation. In particular, can a model lacking the concept of a nexus make useful predictions about such firms?

C. The Necessity of a Nexus

1. The Firm is a Nexus of Contracts

In one sense, the corporation *is* a nexus.[62] To be sure, the traditional insistence

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[56] Bengt Hölmstrom & John Roberts, *The Boundaries of the Firm Revisited*, 12 J. ECON. PERSP. 73, 80 (1998).

[57] *See* Gulati et al., *supra* note 25, at 896 n.31 (discussing the "virtual" firm).

[58] Hölmstrom & Roberts, *supra* note 56, at 85.

[59] *See The Future of the Company: A Matter of Choice*, THE ECONOMIST, Dec. 20, 2001, *available at* http://www.economist.com/printedition/displayStory.cfm?Story_ID= 884121 (opining that "the idea that the basic agent in the modern economy is ceasing to be the firm and becoming the network is unconvincing").

[60] *Cf.* Martin M. Broadwell, *Why Command & Control Won't go Away*, TRAINING, Sep. 1995, at 62 (explaining why command and control persist as an organizational feature) ; *see also infra* note 104 and accompanying text (discussing empirical evidence on role of fiat in the workplace).

[61] Gulati et al., *supra* note 25, at 897.

[62] *See, e.g.*, HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 18 (1996) (describing the firm as "a nexus of contracts," by which he means that the "firm is in essence the common signatory of a group of contracts" among various factors of production).

that the firm is a real entity tends towards mindless formalism.[63] Yet, perhaps some deference should be shown the corporation's status as a legal person. Corporate constituents contract not with each other, but with the corporation. A bond indenture thus is a contract between the corporation and its creditors,[64] an employment agreement is a contract between the corporation and its workers,[65] and a collective bargaining agreement is a contract between the corporation and the union representing its workers.[66] If the contract is breached on the corporate side, it will be the entity that is sued in most cases, rather than the individuals who decided not to perform. If the entity loses, damages typically will be paid out of its assets and earnings rather than out of those individuals' pockets. To dismiss all of this as mere reification ignores the axiom that ideas have consequences.

If the connected contracts model is correct, and there is no nexus, employment contracts would cascade—looking rather like a standard hierarchical organization chart—with each employee contracting with his or her superior.[67] (Debt contracts would be even more complex.) Such a cascade would be costly to assemble, if not impossible.[68] Most corporate constituents lack any mechanism for communicating with other constituencies of the firm—let alone contracting with one another. Instead, each constituency contracts with a central nexus. Accordingly, constituencies must be (and are) linked to the nexus and not each other.[69]

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[63] *Cf.* KLEIN & COFFEE, *supra* note 31, at 108-09 (critiquing reification of the corporation).

[64] *See, e.g.*, Lorenz v. CSX Corp., 1 F.3d 1406, 1417 (3rd Cir. 1993) (stating "It is well-established that a corporation does not have a fiduciary relationship with its debt security holders, as with its shareholders. The relationship between a corporation and its debentureholders is contractual in nature."); Simons v. Cogan, 549 A.2d 300, 303-04 (Del. 1988) (holding that "a convertible debenture represents a contractual entitlement to the repayment of a debt").

[65] *See, e.g.*, Berman v. Physical Med. Assocs. 225 F.3d 429, 12 (4th Cir. 2000) (holding that, "as to Berman's claims under the employment agreement and severance benefit agreement, only the corporation owed Berman a contractual duty").

[66] *See* John Wiley & Sons, Inc. v. Livingston, 376 U.S. 543, 546 (1964) (asking "whether the arbitration provisions of the collective bargaining agreement survived the Wiley-Interscience merger, so as to be operative against" successor corporation).

[67] *Cf.* Hansmann & Kraakman, *supra* note 34, at 391 (noting this alternative to the nexus model).

[68] *See infra* notes 77-79 and accompanying text. Such a cascade also would be subject to opportunistic disassembly threats in which one or more of the contracting parties seeks to hold up the others. *See infra* notes 107-120 and accompanying text (discussing the role of opportunism—a/k/a agency costs—in the theory of the firm).

[69] *See* Jean-Jacques Laffont & David Martimort, *The Firm as a Multicontract Organization*, 6 J. ECON. & MGMT. STRATEGY 201, 207 (1997). *See also* Eisenberg, *supra* note 51, at 830 (stating

2. The Firm has a Nexus of Contracts

In a more important sense, however, the corporation *has* a nexus. After all, to say that the firm *is* a nexus is to imply the existence of a core or kernel capable of contracting. But kernels do not contract—people do. In other words, it does us no good to avoid reifying the firm by reifying the nexus at the center of the firm. Hence, we must search for the person or persons who serve as the nexus of the set of contracts making up the firm. Our search will be facilitated if we first identify the central characteristic of "firmishness."[70] In this part, I argue that the defining characteristic of a firm is the existence of a central decisionmaker vested with the power of fiat. Identifying that central decisionmaker is the task of Part III below.

Economists Armen Alchian and Harold Demsetz famously claimed that the firm "has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people."[71] Hence, Alchian and Demsetz argued, an employer's control over its employees differs not all from the power of a consumer over the grocer with whom the consumer does business.[72] If Alchian and Demsetz are right and fiat is not an essential attribute of "firmishness," the firm would be just a legal fiction describing the space within which the set of contracts are worked out. This seems to be what Gulati, Klein, and Zolt claim.

Power exists within firms, however, and it matters.[73] The corporation has a nexus—and that nexus wields a power of fiat different from that of a consumer

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that "a particular corporation consists of all and only those reciprocal arrangements that are linked not just to each other, but to *something*"; emphasis in original). Eisenberg contends that the nexus of contracts model lacks intellectual coherence. *Id.* at 830-31. The director primacy variant of contractarian theory, however, answers his critique. Eisenberg asks, for example, "how we know that an individual is the manager or common agent of a firm unless we have a prior conception of the firm?" *Id.* at 831. We know because the director primacy conception of the firm starts with the board and then assumes that the board hires all other inputs of production. Yet, Eisenberg may object, that many contracts are executed by "nonmanagerial employees." *Id*. True, but when one agent hires another, the latter becomes a sub-agent of the original principal. Just so, nonmanagerial employees are ultimately linked contractually (at least in the economic sense of the word) to the corporate nexus—i.e., the board of directors.

[70] I borrow this useful phrase from KLEIN & COFFEE, *supra* note 31, at 19.

[71] Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 777 (1972).

[72] *Id.*

[73] *See generally* Raghuram G. Rajan & Luigi Zingales, *The Influence of the Financial Revolution on the Nature of Firms*, 91 AEA PAPERS & PROCEEDINGS 206, 206-07 (2001) (discussing sources of power within firms).

over a grocer. Indeed, fiat is the chief characteristic that distinguishes firms from markets.

As Coase explained long ago, firms emerge when it is efficient to substitute entrepreneurial fiat for the price mechanisms of the market.[74] In markets, resources are allocated by the price system, while in firms resources are allocated by authoritative direction.[75] This was Coase's fundamental insight: "If a workman moves from department *Y* to department *X*, he does not go because of change in relative prices, but because he is ordered to do so."[76] Accordingly, economic activity will be conducted within a firm when the costs of bargaining exceed those of command-and-control. The relevant costs can be divided into three basic categories:

(1) *Search and other transaction costs associated with bargaining:* Consider Adam Smith's classic example: the manufacturing of pins in eighteenth century England.[77] Smith observed that making a pin involves eighteen distinct operations. A substantial synergistic effect resulted when a team was organized in which each operation was conducted by a separate individual: the team was able to produce thousands of pins a day, while an individual alone might produce one pin a day at best. In theory, the team could be organized through a decentralized price mechanism. In practice, however, team production requires personnel interactions too complex to be handled through a price mechanism.[78] The firm therefore acts as a central coordinator—some team member is charged with seeking out the necessary inputs and bringing them together for productive labor.[79]

(2) *Asset specificity*: Whereas Coase emphasized the transaction cost minimizing potential of the firm, institutional economists focus on the firm as a

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[74] *See* Coase, *supra* note 32, at 389 (arguing that "the distinguishing mark of the firm is the suppression of the price mechanism").

[75] *Id.* Drawing a distinction between across-market transactions and intra-firm transactions serves a useful pedagogic purpose, but is not a wholly accurate description of the real world, in which there is a wide array of choices falling between purely contractual relationships and the classical economic firm. *See* Klein, *supra* note 48, at 1523 (discussing intermediary forms); *see also* KLEIN & COFFEE, *supra* note 31, at 19 (suggesting that the dichotomy between firms and markets "could usefully be replaced" by the concept of "firmishness").

[76] Coase, *supra* note 32, at 387.

[77] ADAM SMITH, THE WEALTH OF NATIONS 4-5 (Modern Library ed. 1937).

[78] Sherwin Rosen, *Transaction Costs and Internal Labor Markets*, in THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 75, 84-85 (Oliver E. Williamson & Sidney G. Winter eds. 1991).

[79] Coase, *supra* note 32, at 390-91.

mechanism for preventing opportunistic appropriation of quasi-rents.[80] A transaction specific asset is one whose value is appreciably lower in any other use than the transaction in question.[81] Once a transaction specific investment has been made, it generates quasi-rents; i.e., returns in excess of that necessary to maintain the asset in its current use.[82] If those quasi-rents are appropriable by the party with control of the transaction specific asset, a hold up problem ensues. Vertical integration brings both parties within a single firm and, accordingly, is a common solution to the hold up problem.

(3) *Uncertainty and complexity:* Uncertainty arises in business relationships because it is difficult to predict the future conditions the parties will face. Complexity arises when the parties attempt to contractually specify how they will respond to a given situation. As the relationship's term lengthens, it necessarily becomes more difficult to foresee the needs and threats of the future, which in turn presents an ever-growing myriad of contingencies to be dealt with. The more contingencies to be accounted for, and the greater the degree of uncertainty that is present, the more difficult it becomes for the parties to draft completely specified contracts.[83] Indeed, the phenomenon of bounded rationality implies that incomplete contracts are inevitable under conditions of uncertainty and complexity.[84] In turn, incomplete contracts leave greater room for opportunistic behavior. All of which tends to encourage reliance on central coordination.

According to the Coasean theory of the firm, firms arise when it is possible to mitigate these costs by delegating to a team member the power to direct how the various inputs will be utilized by the firm. One team member is empowered to

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[80] *See, e.g.*, Benjamin R. Klein et al., *Vertical Integration, Appropriable Rents and the Competitive Contracting Process*, 21 J. L. & ECON. 297 (1978). Institutional economics also suggests that hierarchical ordering of production within a firm can reduce costs associated with informational asymmetries and bilateral monopolies. Oliver E. Williamson, *Introduction*, in THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 3, 4 (Oliver E. Williamson & Sidney G. Winter eds. 1991).

[81] Hölmstrom & Roberts, *supra* note 56, at 74.

[82] *Id.* at 74 n.1. The asset may also generate true rents—i.e., returns exceeding that necessary to induce the investment in the first place—but the presence or absence of true rents is irrelevant to the opportunism story. *See id.* (discussing true rents).

[83] *See* OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES 23 (1975) (under conditions of uncertainty and complexity, it becomes "very costly, perhaps impossible, to describe the complete decision tree").

[84] *See generally* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 30-32, 45-46 (1985) (defining bounded rationality and describing its effects on the contracting process).

constantly and, more important, unilaterally rewrite certain terms of the contract between the firm and its various constituents. By creating a central decisionmaker—a nexus—with the power of fiat, the firm thus substitutes *ex post* governance for *ex ante* contract. Uncertainty and complexity are no longer as problematic, because the central decisionmaker can exercise its power of fiat to mandate a chosen adaptive response to new circumstances. Opportunism is deterred by the prospect of *ex post* sanctions, obviating the necessity of drafting a complete contract *ex ante*.

Coordination need not imply fiat, as illustrated by the democratic decisionmaking processes of many partnerships and other small firms.[85] In the public corporation, however, fiat is essential. All organizations must have some mechanism for aggregating the preferences of the organization's constituencies and converting them into collective decisions. Kenneth Arrow identified two basic mechanisms for carrying out this task: "consensus" and "authority."[86] Consensus is used where each member of the organization has identical information and interests, which results in preferences that are easily aggregated. In contrast, authority-based decisionmaking structures arise where group members have different interests and amounts of information. Because collective decisionmaking is impracticable in such settings, authority-based structures are characterized by the existence of a central agency to which all relevant information is transmitted and which is empowered to make decisions binding on the whole.

The necessity of an actual nexus—a center of power capable of exercising fiat—thus follows in large part from the asymmetries of information and interests among the corporation's various constituencies. Shareholders care about the value of the residual claim on the corporation. Customers care about the quality and quantity of the goods produced by the corporation. Workers care about salary and conditions of employment. And so on. Under such conditions, efficient decisionmaking demands an authority-based governance structure in which information is channeled to a central decisionmaker empowered to make choices binding on the firm as a whole.[87]

Consider the problems faced by shareholders, who are conventionally assumed to be the corporate constituency with the best claim on control of the decisionmaking

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[85] *Cf.* Dooley, *supra* note 12, at 467 (noting that partnerships tend to make decisions informally and by consensus).

[86] KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 69-70 (1974).

[87] *Cf. id.* at 69 (opining: "under conditions of widely dispersed information and the need for speed in decision, authoritative control at the tactical level is essential for success.").

apparatus.[88] At the most basic level, the mechanical difficulties of achieving consensus amongst thousands of decisionmakers impede shareholders from taking an active role. Yet, even if those collective action problems could be overcome, active shareholder participation in corporate decisionmaking would still be precluded by the shareholders' widely divergent interests and distinctly different levels of information.

Although neoclassical economics assumes that shareholders come to the corporation with wealth maximization as their goal, and most presumably do so, once uncertainty is introduced it would be surprising if shareholder opinions did not differ on which course will maximize share value. More prosaically, shareholder investment time horizons are likely to vary from short-term speculation to long-term buy-and-hold strategies, which in turn is likely to result in disagreements about corporate strategy. Even more prosaically, shareholders in different tax brackets are likely to disagree about such matters as dividend policy, as are shareholders with differing views on the merits of allowing management to invest the firm's free cash flow in new projects.

As to Arrow's information condition, shareholders lack incentives to gather the information necessary to actively participate in decisionmaking.[89] A rational shareholder will expend the effort necessary to make informed decisions only if the expected benefits of doing so outweigh its costs.[90] Given the length and complexity of corporate disclosure documents, the opportunity cost entailed in making informed decisions is both high and apparent. In contrast, the expected benefits of becoming informed are quite low, as most shareholders' holdings are too small to have significant effect on the vote's outcome. Corporate shareholders thus are rationally apathetic.[91] Instead of exercising their voting rights, disgruntled shareholders typically adopt the so-called Wall Street Rule—it's easier to switch than fight—and sell out.[92]

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[88] I follow convention here without attempting to justify the limitation of voting rights to shareholders. For a defense of that convention, see Stephen M. Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 DEL. J. CORP. L. 979, 1060-75 (1998).

[89] *See generally* Laffont & Martimort, *supra* note 69, at 206-07 (discussing asymmetries of information within firms).

[90] *See* ROBERT C. CLARK, CORPORATE LAW 391 (1986).

[91] *See id.* at 390-92. The problem is compounded by the likelihood that a substantial number of shareholders will attempt to free ride on their fellow shareholders. *See id*. at 392-93.

[92] Some scholars have argued that institutional investor activism can give real teeth to shareholder control. See, e.g., MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994); Bernard S. Black, Shareholder Passivity

The efficient capital markets hypothesis provides yet another reason for shareholders to eschew active participation in the governance process. If the market is a reliable indicator of performance, as the efficient capital markets hypothesis claims,[93] investors can easily check the performance of companies in

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Reexamined, 89 MICH. L. REV. 520 (1990). For more skeptical analyses, see Edward Rock, *The Logic and Uncertain Significance of Institutional Investor Activism*, 79 GEO. L.J. 445 (1991); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993); Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163 (1991). Acknowledging that the rational apathy phenomenon precludes small individual shareholders from playing an active role in corporate governance, even if the various legal impediments to shareholder activism were removed, these scholars focused their attention on institutional investors, such as pension and mutual funds. Institutional investors, at least potentially, may behave quite differently than dispersed individual investors. Because they own large blocks, and have an incentive to develop specialized expertise in making and monitoring investments, they could play a far more active role in corporate governance than dispersed shareholders. Institutional investors holding large blocks thus have more power to hold management accountable for actions that do not promote shareholder welfare. Their greater access to firm information, coupled with their concentrated voting power, might enable them to more actively monitor the firm's performance and to make changes in the board's composition when performance lagged. *See* ROE, *supra*, at 237-38 (arguing that large block holders can improve firm performance by, *inter alia*, personifying the shareholder community).

There is relatively little evidence that institutional investor activism has mattered, however. Due to a resurgence of direct individual investment in the stock market, motivated at least in part by the day trading phenomenon and the technology stock bubble, the trend towards institutional domination has stagnated. Although about 50% of equity securities are still owned by institutions, large blocks held by a single investor are rare, and few U.S. corporations have any institutional shareholders who own more than 5-10% of their stock. *Cf*. Black, *supra*, at 567-68 (summarizing data). Even the most active institutional investors spend only trifling amounts on corporate governance activism. *See* Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459, 460 (1998). Institutions devote little effort to monitoring management; to the contrary, they typically disclaim the ability or desire to decide company-specific policy questions. *Cf.* ROE, *supra*, at 235 (opining: "The model institutional overseer would not micromanage the firm from day to day, but be ready to make changes during crisis and hold the managers accountable during the interim."). Institutional investors rarely conduct proxy solicitations or put forward shareholder proposals. Black, *supra*, at 460. Not surprisingly, empirical studies of U.S. institutional investor activism have found "no strong evidence of a correlation between firm performance and percentage of shares owned by institutions." *Id*. at 462.

[93] According to the orthodox view, "there is no other proposition in any of the social sciences" than the efficient capital market hypothesis. Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, MIDLAND CORP. FIN. J., Summer 1986, at 6, 11. For nonorthodox critiques of the hypothesis, see Donald A. Langevoort, *Theories, Assumptions and*

which they hold shares and compare their current holdings with alternative investment positions. An occasional glance at the stock market listings in the newspaper is all that is required. Because it is so much easier to switch to an new investment than to fight incumbent managers, a rational shareholder will not even care why a firm's performance is faltering. With the expenditure of much less energy than is needed to read corporate disclosure statements, he will simply sell his holdings in the struggling firm and move on to other investments.

In large corporations, the desirability of authority-based decisionmaking structures is further enhanced by the potential for division and specialization of labor. Bounded rationality and complexity, as well as the practical costs of losing time when one shifts jobs, make it efficient for corporate constituents to specialize.[94] Directors specialize in the efficient coordination of other specialists.[95] In order to reap the benefits of director specialization, shareholders (and all other corporate constituents) should prefer to specialize in functions unrelated to decisionmaking, such as risk-bearing (shareholders) or labor (employees), delegating decisionmaking to the board.[96] This natural division of labor, however, requires that the chosen board members be vested with discretion to make binding decisions. Separating ownership and control by vesting decisionmaking authority in a centralized nexus distinct from the shareholders and all other constituents—i.e., the board—therefore is what makes the large public corporation feasible.[97]

Securities Regulation: Market Efficiency Revisited, 140 U. PA. L. REV. 851 (1992); Lynn A. Stout, *How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 CARDOZO L. REV. 475 (1997).

[94] Clark, supra note 90, at 802.

[95] More precisely, monitoring and oversight of other specialists is one of the board of directors' three primary functions—and arguably the most significant. *See* Jonathan L. Johnson et al., *Boards of Directors: A Review and Research Agenda*, 22 J. MGMT. 409, 411 (1996) (mapping the board of directors "responsibilities into three broadly defined roles … labeled control, service, and resource dependence."

[96] Put another way, economies of scale in the information transmission process can be achieved by elite control of organizations. Kenneth J. Arrow, Scale Returns in Communication and Elite Control of Organizations, 7 J. L. Econ. & Org. (s.i.) 1 (1991).

[97] Portfolio theory offers a distinct justification for separating ownership and control. By virtue of their nondiversified investment in firm specific human capital, managers bear part of the risk of firm failure. As the firm's residual claimants, however, shareholders also bear a portion of the risk associated with firm failure. Portfolio theory tells us that individual shareholders can minimize that risk through diversification, which managers cannot do with respect to their human capital. Separating ownership and control thus unbundles the risks associated with the firm and allocates each of those risks to the party who can bear it at the lowest cost.

Consequently, it is hardly surprising that the modern public corporation's decisionmaking structure precisely fits Arrow's model of an authority-based decisionmaking system. All state corporate codes provide for a system of nearly absolute delegation of power to the board of directors, which in turn is authorized to further delegate power to subordinate firm agents.[98] This must be so, because shareholders lack both the information and the incentives necessary to make sound decisions on either operational or policy questions.[99] Overcoming the collective action problems that prevent meaningful shareholder involvement would be difficult and costly. Under these conditions, it is "cheaper and more efficient to transmit all the pieces of information to a central place" and to have the central office "make the collective choice and transmit it rather than retransmit all the information on which the decision is based."[100] Accordingly, shareholders will prefer to irrevocably delegate decisionmaking authority to some smaller group.

In sum, under conditions of asset specificity, bounded rationality, and opportunism, the ability to adapt becomes the central problem of organization.[101] In large public corporations, adaptation is effected by fiat. Obviously, fiat within firms has limits. Some choices are barred by contract, such as negative pledge covenants in bond indentures. Other choices may be barred by regulation or statute. Still other choices may be unattractive for business reasons, such as those with potentially adverse reputational consequences. Within such bounds, however, adaptation effected through fiat is the distinguishing characteristic of the firm.

D. Fiat by Contract

At first blush, there may appear to be an inconsistency between the command-and-control theory of the firm and the contractarian model outlined above. In their classic article, for example, Alchian and Demsetz rejected Coase's argument that fiat was the factor distinguishing firms from markets.[102] As noted, they argued that a firm has no power of fiat; instead, for example, an employer's power to direct its

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[98] *See* MODEL BUS. CORP. ACT ANN. § 8.01 (1995).

[99] Similar analyses apply to other corporate constituents on whose behalf claims to control of the decisionmaking apparatus might be made, such as employees or creditors. *See* Bainbridge, *supra* note 88, at 1052-75 (explaining why employees do not have board representation).

[100] Arrow, *supra* note 86, at 68-69.

[101] See Oliver E. Williamson, *Transaction Cost Economics Meets Posnerian Law and Economics*, 149 J. INSTITUTIONAL & THEORETICAL ECON. 99, 102 (1993).

[102] *See supra* note 71 and accompanying text.

employees does not differ from a consumer's power to direct his grocer.[103] Coase may well have erred in treating the firm as a non-market institution in which prices and contracts are of relatively little consequence, but there is a sharp disconnect between Alchian and Demsetz's argument and the real world. Command-and-control is the norm in most corporations.[104]

In any case, there is no necessary contradiction between a theory of the firm characterized by command-and-control decisionmaking and the contractarian model. The set of contracts making up the firm consists in very large measure of implicit agreements, which by definition are both incomplete and unenforceable. As we have seen, under conditions of uncertainty and complexity, the parties cannot execute a complete contract, so that many decisions must be left for later contractual rewrites imposed by fiat. It is precisely the nonenforceability of implicit corporate contracts that makes it possible for the central decisionmaker to rewrite them more-or-less freely. The parties to the corporate contract presumably accept this consequence of relying on implicit contracts because the resulting reduction in transaction costs benefits them all. It is thus possible to harmonize the Coasean and contractarian models without having to reject a theory of the firm in which the board of directors has the power to, say, direct the firm's workers. Instead, the firm's constituents voluntarily enter into a relationship in which they accept the board's power of fiat, while reserving the right to disassociate from the firm.

III. LOCATING THE NEXUS

Part III argued that a central decisionmaker with essentially nonreviewable authority is the defining characteristic of firms in general and the modern public corporation in particular. It is for this reason that the firm must have a nexus—a central coordinator that is a party to the set of contracts we call the firm and that has the power to effect adaptive responses to changed conditions by fiat.

If the corporation has a nexus, however, where is it located? The Delaware code, like the corporate law of every other state, gives us a clear answer: the corporation's "business and affairs... shall be managed by or under the direction

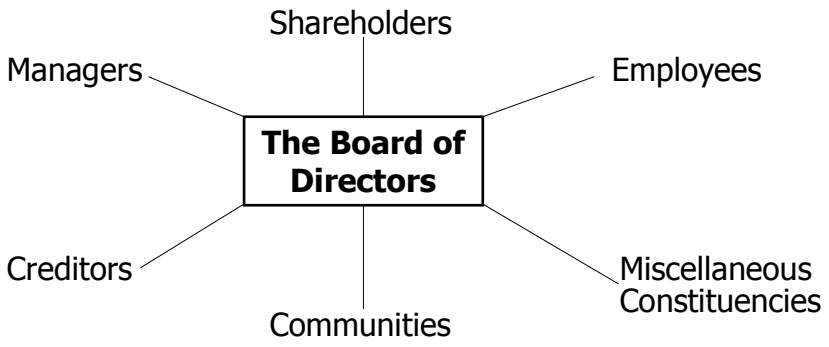
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[103] *See supra* note 72 and accompanying text.

[104] *See* Joseph E. Stiglitz, *Incentives, Risk, and Information: Notes Toward a Theory of Hierarchy*, 6 BELL J. ECON. 552, 553 (1975) (stating: "The employer is allowed to assign the workers different tasks ..."); *see also* JOHN F. WITTE, DEMOCRACY, AUTHORITY, AND ALIENATION IN WORK: WORKERS' PARTICIPATION IN AN AMERICAN CORPORATION 38 (1980) (arguing that workers generally accept hierarchical authority and perceive obedience to authority as an integral part of their job: "for the majority, disobedience is unthinkable").

of the board of directors."[105] Put simply, the board is the nexus. (See Figure 3.)

Figure 3
Director Primacy:
The firm ***has*** a nexus



The board of directors as an institution of corporate governance does not follow inexorably from the necessity for fiat, of course. After all, an individual chief executive could serve as the hypothesized central coordinator. Yet, corporate law vests ultimate control in the board. Why a board rather than an individual? Part of the answer seems to be that, under certain conditions, groups make better decisions than individuals.[106] For present purposes, however, the board's function as an adaptive response to the agency cost phenomenon is more significant.[107] As we shall see, the

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[105] DEL. CODE ANN., tit. 8, § 141(a) (2000). For a summary of comparable state corporation code provisions, see MOD. BUS. CORP. ACT. ANN. § 8.01 at 8-10 (1997 supp.).

[106] *See* Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, __ VAND. L. REV. __ (2002) (reviewing evidence).

[107] Agency costs are defined as the sum of the monitoring and bonding costs, plus any residual loss, incurred to prevent shirking by agents. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301, 304 (1983). In turn, shirking is defined to include any action by a member of a production team that diverges from the interests of the team as a whole. As such, shirking includes not only culpable cheating, but also negligence, oversight, incapacity, and even honest mistakes. Dooley, *supra* note 12, at 465. In other words, shirking is simply the inevitable consequence of bounded rationality and opportunism within agency relationships.

board of directors emerged as an governance institution capable of exercising fiat primarily to solve the age-old problem of "who shall watch the watchers."

A sole proprietorship with no agents will internalize all costs of shirking, because the proprietor's optimal trade-off between labor and leisure is, by definition, the same as the firm's optimal trade-off. Agents of a firm, however, will not internalize all of the costs of shirking: the principal reaps part of the value of hard work by the agent, but the agent receives all of the value of shirking. Consider the canonical example of two workers who jointly lift heavy boxes into a truck.[108] The marginal productivity of each worker is very difficult to measure and their joint output cannot be easily separated into individual components. In such situations, obtaining information about a team member's productivity and appropriately rewarding each team member are very difficult and costly. In the absence of such information, however, the disutility of labor gives each team member an incentive to shirk because the individual's reward is unlikely to be closely related to conscientiousness.

Although agents *ex post* have strong incentives to shirk, *ex ante* they have equally strong incentives to agree to a corporate contract containing terms designed to prevent shirking.[109] Bounded rationality, however, precludes firms and agents from entering into the complete contract necessary to prevent shirking by the latter. Instead, there must be some system of *ex post* governance: some mechanism for detecting and punishing shirking. Accordingly, an essential economic function of management is monitoring the various inputs into the team effort: the manager meters the marginal productivity of each team member and then takes steps to reduce shirking.[110] Note, again, how fiat emerges as an essential attribute of organization.

Instructively, the existence of fiat-based monitoring systems is most obvious in the firm of greatest interest for my purposes; namely, the large M-form corporation. This firm type has two defining characteristics: many distinct operating units and management by a hierarchy of salaried executives.[111] Monitoring is an essential function of hierarchy within such firms.[112] It would be difficult, at best, for a plant manager with hundreds of employees to determine which deserve rewards and which

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[108] Alchian & Demsetz, *supra* note 71, at 779.

[109] *See* Alchian & Demsetz, *supra* note 71, at 785 (discussing contractual solutions to the agency cost problem); Jensen & Meckling, *supra* note 38, at 325-26 (discussing bonding by agents).

[110] Alchian & Demsetz, *supra* note 71, at 794.

[111] CHANDLER, *supra* note 15, at 1.

[112] *See* WILLIAMSON, *supra* note 84, at 289 (stating: "the organizational logic of the M-form structure runs very deep—serving, as it does, both to economize on bounded rationality ... and safeguard the internal resource allocation process against the hazards of opportunism").

deserve reprimands. Such a task obviously becomes impossible for the board of directors of a large public corporation with thousands of employees. A branching hierarchy provides a ready solution. The board delegates responsibility to senior management and monitors their performance.[113] The senior managers in the firm's central office delegate responsibility to managers of operating units.[114] In turn, the managers of each operating unit are responsible for monitoring the productivity of their unit. The process continues down to the foreman on the shop floor. Creating such a branching hierarchy addresses the problems of uncertainty, bounded rationality, and shirking faced by monitors in all team situations by breaking the firm team into discrete segments, each of which is more readily monitored than the whole. At each hierarchical level, the responsible monitor is responsible for supervising only a few individuals, which usefully limits and focuses his task.

The structure just described, of course, raises the question of who will monitor the monitors?[115] In any team organization, one must have some ultimate monitor who has sufficient incentives to ensure firm productivity without himself having to be monitored. Otherwise, one ends up with a never ending series of monitors monitoring lower level monitors.

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[113] Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1225 (1984). The board of directors should not be confused with a mere executive committee. Unlike the executive committee of a large law firm partnership, for example, the board of directors is not principally an instrument by which some managers control others. Although the flexible governance rules of partnership and limited liability company law permit such firms to draft operating agreements effecting a substantial separation of ownership and control, such as with a manager-operated LLC, those who control such firms usually retain both day-to-day operating control and a significant equity stake in the enterprise. In contrast, a unique attribute of the modern public corporation is the ever-increasing use of independent board members. Independent board members of a public corporation typically lack both day-to-day management power and any significant equity stake in the corporation. These characteristics highlight the unique nature of the corporation and its board-based governance system. Note that I ignore the problem of management-captured boards, as well as the question of the extent to which the board's function is limited to monitoring or also encompasses managing, both of which I have treated elsewhere. Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034 (1993).

[114] The central office is critical to understanding monitoring in M-form corporations. The monitoring mechanisms described in the text could be accomplished through a simple pyramidal hierarchy of the sort found in U-form corporations. The M-form corporation adds to this structure a rationalization of decisionmaking authority in which the central office has certain tasks and the operating units have others, which allows for more effective monitoring through specialization, sharper definition of purpose, and savings in informational costs. WILLIAMSON, *supra* note 84, at 320.

[115] Alchian & Demsetz, *supra* note 71, at 782.

Alchian and Demsetz elegantly solved this dilemma by consolidating the roles of ultimate monitor and residual claimant.[116] According to Alchian and Demsetz, if the constituent entitled to the firm's residual income is given final monitoring authority, he is encouraged to detect and punish shirking by the firm's other inputs because his reward will vary exactly with his success as a monitor. Unfortunately, their model breaks down precisely where it would be most useful. Because of the separation of ownership and control, it simply does not describe the modern publicly-held corporation. As the corporation's residual claimants, the shareholders should act as the firm's ultimate monitors. But while the law provides shareholders with some enforcement and electoral rights, these are reserved for fairly extraordinary situations.[117]

In the absence of effective monitoring by a residual claimant, a hierarchy of individuals whose governance structures contemplate only vertical monitoring cannot resolve the problem of who watches the watchers. But the vicious circle can be broken by placing a group at the apex of the hierarchy. Where an individual autocrat would have substantial freedom to shirk or self-deal, the internal dynamics of group governance constrain self-dealing and shirking by individual team members and, perhaps, even by the group as a whole. Within production teams, by way of analogy, mutual monitoring and peer pressure provide a coercive backstop for a set of interpersonal relationships founded on trust and other noncontractual social norms.[118]

While the old adage opines "familiarity breeds contempt," personal proximity to others in fact deeply affects behavior. As people become closer, their behavior tends to improve: "something in us makes it all but impossible to justify our acts as mere self-interest whenever those acts are seen by others as violating a moral principle"; rather, "[w]e want our actions to be seen by others—and by ourselves—as arising out of appropriate motives."[119] Membership in a small group

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[116] *Id.* at 781-83.

[117] Derivative suits and proxy contests, for example, constrain managerial behavior to some extent. These remedies are so costly and their outcome so uncertain that they are invoked only episodically. Moreover, many aspects of the legal rules governing these devices (such as the derivative suit demand requirement, the federal proxy regulations, and state rules governing reimbursement of expenses) seem calculated to discourage frequent recourse to them. *See* Dooley, *supra* note 12, at 525.

[118] *See* Bainbridge, *supra* note 88, at 1027-30 (discussing role of peer pressure in self-directed work teams).

[119] James Q. Wilson, *What is Moral and How Do We Know It?,* COMMENTARY, June 1993, at 37, 39.

strengthens this instinct in several ways. First, because people care about how they are perceived by those close to them, communal life provides a cloud of witnesses whose good opinion we value. We hesitate to disappoint those people and thus strive to comport ourselves in accordance with communal norms. Second, small groups provide a network of reputational and other social sanctions that shape incentives. Finally, close knit groups know a lot about one another, which reduces monitoring costs and thus further encourages compliance with group norms. Taken together, these factors suggest that group decisionmaking is a potentially powerful constraint on agency costs. It creates a set of high-powered incentives to comply with both effort and cooperation norms.

In sum, the board of directors can be understood as an adaptive solution to the problem of "who shall watch the watchers." The board solves that problem by creating a self-monitoring hierarch whose internal governance structures provide incentives for optimal monitoring of its subordinates. Mutual monitoring and social norms, enforced through peer pressure and reputational sanctions, provide important constraints on behavior. In addition, a multi-member board is inherently harder for misbehaving subordinates to suborn than would be a single autocrat. Instead of having to bribe or otherwise co-opt a single individual, the wrongdoers now must effect a conspiracy amongst a number of monitors.[120] Consequently, we vest corporate power in boards rather than individuals so as to create an institutional constraint on agency costs.

IV. PREDICTIVE POWER

As we saw at the outset, a model is validated by its predictive power.[121] To be useful in corporate law, a model must possess predictive power with respect to the core problems occasioned by the separation of ownership and control.[122] Gulati,

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[120] If one individual serves as the final authority on corporate decisions, the corporation's managers need only coerce or entice that single individual into complying with their self-interested requests to give them effect and, hence, harm the corporation as a whole. If a group of individuals has the final authority on questions of corporate governance, however, managers must coerce or entice multiple individuals to acquire the *de facto* power to pursue their self-interest. Because managers are less likely to capture a group than an individual, managers are less likely to self-deal with a corporation that is ultimately governed by a group rather than an individual. In addition, diffusion of responsibility in corporate decisionmaking among a group constrains agency costs because it requires a conspiracy to make opportunism effective. Group conspiracies commonly are harder to pull off than misconduct by a single individual.

[121] *See supra* text accompanying note 3.

[122] *See supra* text accompanying notes 4-6.

Klein, and Zolt teased out the implications of their connected contracts model with respect to 5 corporate law doctrines: limited liability; insider trading; incentive compensation; capital structure; and the disciplining effect of corporate debt.[123] Their analysis, however, tends to be diffident and inconclusive. With respect to limited liability and veil piercing, for example, they merely opine that:

> From the perspective of the connected contracts model, it is interesting and surprising that no one seems to have considered the possibility of applying the arguments for shareholder personal liability to other participants such as creditors, suppliers, customers, directors, officers, and employees. From that perspective, at first blush, all of these other participants might be fair game. … The connected contracts model invites this kind of inquiry directly, whereas other models seem to have foreclosed it or, at best, to have reached it indirectly.[124]

The inquiry is left for another day. In an earlier article, moreover, Bob Thompson had used standard contractarian analysis both to make essentially the same point and to explore possible explanations for the phenomenon in question.[125]

Curiously, Gulati, Klein, and Zolt devote little attention to the central doctrine of corporate law: the business judgment rule. The rule pervades every aspect of the state law of corporate governance, from the review of allegedly negligent decisions by directors to self-dealing transactions to board decisions to seek dismissal of shareholder litigation and so on.[126] No other corporate law doctrine, moreover, as directly implicates the separation of ownership and control. Yet, Gulati, Klein, and Zolt simply dismiss the problem by asserting that in their model "there is … no fiduciary duty."[127]

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[123] Gulati et al., *supra* note 25, at 929-36.

[124] *Id.* at 930-31.

[125] *See* Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise,* 47 VAND. L. REV. 1, 34 (1994) (opining: "a more fundamental question is why shareholders should face expansive liability that other corporate providers of capital do not. A common refrain of many economic-based analyses of corporate law has been to de-emphasize the centrality of shareholder ownership of corporations in favor of a nexus of contracts among various contributors of capital and other assets that the corporation needs…. Why should shareholders bear the liability and responsibility for the acts of others that other groups do not?").

[126] See, e.g., Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (fiduciary duties of controlling shareholder); Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. 1968) (operational decision); Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979) (dismissal of derivative litigation).

[127] Gulati et al., *supra* note 25, at 947.

In contrast, the director primacy model developed herein possesses considerable predictive power with respect to the relationship between the legal doctrine encapsulated by the business judgment rule and the economic problems inherent in the separation of ownership and control. The apparent lack of managerial accountability inherent in separating ownership and control has properly troubled legal commentators since at least Adolf Berle's time.[128] Given the significance of and validity of this concern, the business judgment rule is a most curious doctrine.

The business judgment rule is properly understood as a rule of judicial abstention. Put another way, the rule creates a strong presumption against judicial review of duty of care claims. The court will abstain from reviewing the substantive merits of the directors' conduct unless the plaintiff can carry the very heavy burden of rebutting that presumption.[129] As a result, much director misfeasance—and probably a fair bit of malfeasance—goes unreviewed.[130] How then can this principle be reconciled with the historic concern for minimizing the agency costs occasioned by the separation of ownership and control?

The director primacy model concedes that agency costs are an important component of any viable theory of the firm. The model suggests, however, that a narrow focus on agency costs easily can distort one's understanding of the firm. Corporate managers operate within a pervasive web of accountability mechanisms that substitute for monitoring by residual claimants. Important constraints are provided by a variety of market forces. The capital and product markets, the internal and external employment markets, and the market for corporate control all constrain shirking by firm agents. In addition, the legal system evolved various adaptive responses to the ineffectiveness of shareholder monitoring, establishing alternative

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[128] "The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge and where many of the checks which formerly operated to limit the use of power disappear." BERLE & MEANS, *supra* note 6, at 6.

[129] *See, e.g.*, Shlensky v. Wrigley, 237 N.E.2d 776, 777-78 (Ill. App. 1968); Kamin v. American Express Co., 383 N.Y.S.2d 807 (N.Y. Sup. 1976), aff'd, 387 N.Y.S.2d 993 (N.Y. A.D. 1976); *cf.* Brehm v. Eisner, 746 A.2d 244, 262-64 (Del. 2000) (rejecting plaintiff shareholder's contention that the business judgment rule includes an element of "substantive due care" and holding that the business judgment rule requires only "process due care").

[130] "While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading. . . . Whatever the terminology, the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labeled the business judgment rule." Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

accountability structures to punish and deter wrongdoing by firm agents, most notably the board of directors.

An even more important consideration, however, is that agency costs are the inevitable consequence of vesting discretion in someone other than the residual claimant. We could substantially reduce, if not eliminate, agency costs by eliminating discretion; that we do not do so suggests that discretion has substantial virtues, an inference that finds strong support in the theory of corporate decisionmaking set forth in the preceding Parts. A complete theory of the firm thus requires one to balance the virtues of discretion against the need to require that discretion be used responsibly.[131] Neither discretion nor accountability can be ignored, because both promote values essential to the survival of business organizations. Unfortunately, they are ultimately antithetical: one cannot have more of one without also having less of the other.[132] As Kenneth Arrow has observed, the power to hold to account is ultimately the power to decide.[133] The board thus cannot be made more accountable without shifting some of its decisionmaking authority to shareholders or judges:

> [Accountability mechanisms] must be capable of correcting errors but should not be such as to destroy the genuine values of authority. Clearly, a sufficiently strict and continuous organ of [accountability] can easily amount to a denial of authority. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.
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> To maintain the value of authority, it would appear that [accountability] must be intermittent. This could be periodic; it could take the form of "management by exception," in which authority and its decisions are reviewed only when performance is sufficiently degraded from expectations ....[134]

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[131] Dooley, *supra* note 12, at 464-71.

[132] *Id*. at 470.

[133] ARROW, *supra* note 86, at 78.

[134] *Id.* In a provocative series of recent articles, Margaret Blair and Lynn Stout have set out a so-called "team production" model somewhat resembling director primacy, but also differing from director primacy in key respects. *See, e.g.,* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247 (1999); Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. Corp. L. 743 (1999). Insofar as control is concerned, Blair and Stout take a director primacy-like view of corporate governance. Blair and Stout argue, for example, that directors "are not subject to direct control or supervision by *anyone*, including the firm's shareholders." Blair & Stout, *supra*, at 290 (emphasis in original). A critical difference between our respective models, however, is suggested by Blair and Stout's argument "that hierarchs work for team members (including employees) who 'hire' them to control shirking and rent-seeking among team members." *Id*. at 280 (emphasis removed).

Accordingly, the director primacy model does not contend that the board should have wholly unfettered authority. In some cases, accountability concerns become so pronounced as to trump the general need for deference to the board's authority. Establishing the proper mix of deference and accountability thus emerges as the central problem of corporate governance. Given the significant virtues of discretion, however, one must not lightly interfere with management or the board's decisionmaking authority in the name of accountability. Hence, we arrive at the defining normative claim of the director primacy model; namely, that preservation of board discretion should always be the null hypothesis.

V. CONCLUSION

"The theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters."[135] So opines former Delaware Chancellor William Allen, whom many regard as the leading corporate law jurist of our era.[136] To paraphrase a television commercial of my youth, when Chancellor Allen speaks, people listen.[137] Yet, as Horace cautioned, "even the worthy Homer sometimes nods."[138] The central thesis of this Article is that

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Director primacy claims this is exactly backwards—directors hire factors of production, not vice-versa. The distinction has an important normative consequence. Blair and Stout contend that, as mediating hierarchs, directors are charged with serving the interests of the legal entity known as the corporation, which are defined in turn as the "joint welfare function" of all constituents who make firm specific investments. *Id.* at 288.

[135] Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651, 663 (Del.Ch. 1988).

[136] John C. Coffee Jr., *Court Has a New Idea on Directors' Duty*, NAT'L L.J, Mar. 2, 1992, at 18 ("Chancellor Allen is probably the country's most influential and respected judge on corporate law matters ...."); Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59, 59 (2000) ("Chancellor William Allen ... was one of the most respected judges in the area of corporate law ...."); Thomas A. Cole, *United States*, INT'L FIN. L. REV., Special Supplement, Apr. 1998, at 64, 64 ("Chancellor William Allen ... [is] one of the most influential living corporate law jurists and thinkers ...."); Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 669 (1996) ("Chancellor William Allen [is] one of the nation's most respected judges on corporation law ....").

[137] *See* James Lyons, *Conflicting Interests*, FORBES, Mar. 30, 1992, at 48 ("Allen is one of the most respected jurists on corporate governance. When he writes, lawyers listen.").

[138] Chancellor Allen came closer to the mark when he explained in *Time* that: "The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage the firm.... That many, presumably most, shareholders would prefer the board to do otherwise than it has done does not ... afford a basis to interfere with the effectuation of the board's business judgment." Paramount Communications

directors are not mere agents of the shareholders. To the contrary, the corporation's board of directors in fact *is* a Platonic Guardian. All others with interests in the corporation are mere constituents.

Director primacy works well for those firms for which corporate law seems to be designed; namely, large publicly held corporations with no controlling shareholder. As we have seen, director primacy does a better job of predicting and explaining the legal rules governing such firms than do competing models such as the connected contracts hypothesis put forward by Gulati, Klein, and Zolt. Director primacy works less well for those firms for which the default rules of corporate law are often a poor fit. In closely held corporations, for example, ownership of the equity claim and *de facto* control of the enterprise typically are joined. Shareholders of such firms commonly opt out of those default corporate law rules that effect director primacy.[139] Similarly, director primacy does not work well with respect to wholly-owned subsidiaries or publicly held corporations with controlling shareholders. Again, in both settings, ownership of the equity claim and *de facto* control tend to be united. Connected contracts may be a better model for such firms.[140] Interestingly, however, the default rules of corporate law frequently prove to be an uncomfortable fit for such firms. The fact that director primacy does not work well for these types of firms is not evidence of the model's invalidity. Instead, the struggles undertaken by constituents of such firms to modify those corporate law rules that effect director primacy demonstrate the utility of the model as an explanation for those very rules.

Inc. v. Time Inc., 1989 WL 79880 at *30 (Del. Ch. 1989), *aff'd*, 571 A.2d 1140 (Del. 1990). In other words, corporations are not New England town meetings. To the contrary, as we have seen, while the board of directors resides at the top of the corporate hierarchy, shareholders not only are not at the top of the hierarchy—they are not even part of the hierarchy.

[139] *See, e.g.,* Galler v. Galler, 203 N.E.2d 577 (Ill. 1964) (discussing use of shareholder agreements in close corporations).

[140] *See supra* note 57 and accompanying text.