Cornell Law Review

Volume 74
Issue 3 *March 1989*

Article 1

Nexus of Contracts Corporation: A Critical Appraisal

William W. Bratton Jr.

THE "NEXUS OF CONTRACTS" CORPORATION: A CRITICAL APPRAISAL

William W. Bratton, Jr.†

Firms are bundles of unruly phenomena. They entail not just production, but production by groups of people. Therefore, theories designed to contain and regnlarize the appearance of firms go beyond concepts about economic production to articulate concepts about communities. These concepts variously distinguish the individual and the group, usually according the interests of one or the other greater moment.[1] They change from generation to generation and vary from theorist to theorist. No single comprehensive, objective theory of the firm has taken hold. Firms still represent different things to different observers.[2]

Given this, it would seem unlikely that any new school of firm theorists—even a new school armed with the methodological tools of modern social science—could advance a radically altered theory of the firm simultaneously possessing the virtues of accuracy and political neutrality. Nevertheless, a theory of the firm now advanced in corporate law literature, here termed the "new economic theory of the firm," makes this claim.[3] This theory explains corporate rela-

---

† Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University. This article is dedicated to Drucilla Cornell, with appreciation for her belief in it. My thanks to David Carlson, Arthur Jacobson, Ian Macneil, Paul Shupack, Katherine Van Wezel Stone, and the participants in the Law and Economics Workshop of the University of Toronto Faculty of Law, for commenting on earlier drafts, and to the Samuel and Ronnie Heyman Center on Corporate Governance, Cardozo School of Law, for supporting the project.

1 *See* Horwitz, Santa Clara *Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173, 179-81 (1985).

The fundamental question in any theory of the firm is whether the appropriate unit of analysis is the individual or the group. For a positive gloss on the firm and the problem of conflict between the individual and the group see Vinogradoff, *Juridical Persons*, 24 COLUM. L. REV. 594, 594 (1924) ("An adjustment between selfish and altruistic tendencies in social life is rendered possible by the fact that men are allied not only by moral insight but by the necessities of business cooperation.").

2 Nevertheless corporate law presupposes some theoretical conception: "[W]e must make *some* pre-legal cognitive peace with the phenomenon of the organization before we can intelligibly tackle the question of its appropriate normative treatment." M. DAN-COHEN, RIGHTS, PERSONS AND ORGANIZATIONS: A LEGAL THEORY FOR BUREAUCRATIC SOCIETY 27 (1986) (emphasis in original).

3 This phrase is used despite the usage of the title "modern theory of the firm" by the theory's proponents. The "modern" title is not employed here for two reasons. First, opponents of the new economic theory call their own ideas "modern." *See* Eisenberg, *New Modes of Discourse in Corporate Law Literature*, 52 GEO. WASH. L. REV. 582, 582

tionships and structures in terms of contracting parties and transaction costs.

This construct originated among economists,[4] but came ready made for use by legal scholars. Its apparent objectivity and formal integrity promised the comfort and security of formalistic legal doctrine. Law and economics writers recast corporate law in its terms[5] and succeeded in reorienting corporate law discourse—cost analysis of corporate relationships in terms of agency problems has become commonplace.[6] At the same time, managerialist concepts subsumed under the rubrics of "separation of ownership and control"[7] and of "corporate governance"[8] have fallen from their position of general

---

(1984). Given this contest for the legitimating mantle of modernity, prudence dictates a neutral position. Second, many of the component notions of the new economic theory have been around since the seventeenth and eighteenth centuries and therefore are not "modern." *See* Bratton, *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1482-85 (1989).

4 Economists proclaimed a major discovery. Professor Michael Jensen, one of the theory's originators, has predicted that this infant "science of organizations" will cause a "revolution . . . in our knowledge about organizations" during the next two decades. Jensen, *Organization Theory and Methodology*, 50 ACCT. REV. 319, 324 (1983).

5 *See, e.g.*, Baysinger & Butler, *Revolution Versus Evolution in Corporation Law: The ALI's Project and the Independent Director*, 52 GEO. WASH. L. REV. 557 (1984); Easterbrook & Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986); Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982) [hereinafter Easterbrook & Fischel, *Corporate Control Transactions*]; Easterbrook & Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985); Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L.& ECON. 395 (1983) [hereinafter Easterbrook & Fischel, *Voting*]; Fischel, *The Appraisal Remedy in Corporate Law*, 1983 AM. B. FOUND. RES. J. 875; Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982) [hereinafter Fischel, *Corporate Governance*]; Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984); Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982); Scott, *Corporation Law and the "American Law Institute Corporate Governance Project"*, 35 STAN. L. REV. 927 (1983); Wolfson, *A Critique of Corporate Law*, 34 U. MIAMI L. REV. 959 (1980).

6 Several recent articles demonstrate the prevelance of these conceptions; they assume contractualism. On takeovers, see Gordon & Kornhauser, *Takeover Defense Tactics: A Comment on Two Models*, 96 YALE L.J. 295 (1986); Macey & McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13 (1985). On fiduciary duties and the possibility of contractual modification, see, e.g., Bebchuk, *Limited Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989); Coffee, *No Exit? Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOKLYN L. REV. 919 (1988).

7 *See generally* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1967). Proponents of the "modern" theory have mounted the attack on the Berle and Means thesis explicitly. *See Corporations and Private Property*, 26 J. L. & ECON. 235, 496 (1983).

8 Defenders of "separation of ownership and control" and of "corporate governance" within the community of corporate legal academics, practitioners, and policymakers have responded. *See, e.g., American Law Institute's Corporate Governance Project*, 52 GEO. WASH. L. REV. 495 (1984); *The ALI's Corporate Governance Proposals: Law and Economics*, 9 DEL. J. CORP. L. 513 (1984).

The anti-managerialist response to the new economic theory has engaged it mostly on matters of practice. For commentaries on basic theoretical assertions, see Clark,

acceptance.[9]

The new economic theory's core notion describes the firm as a legal fiction that serves as a nexus for a set of contracting relations among individual factors of production.[10] This notion has achieved wide currency, showing up even in contexts in which the rest of the theory has little or no influence.[11] Some have accorded this notion the weight of scientific truth[12]: It has been received in the legal literature as an ontological discovery with immediate and significant implications for corporate law discourse.

Thus received, the nexus of contracts concept has been taken

Agency Costs versus Fiduciary Duties, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55-79 (J. Pratt & R. Zeckhauger eds. 1985); Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Buxbaum, *Corporate Legitimacy, Economic Theory and Legal Doctrine*, 45 OHIO ST. L.J. 515 (1984) (arguing that economic analysis, though helpful, cannot be the sole basis for developing behavioral rules); Cox, *Reflections on Ex Ante Compensation and Diversification of Risk as Fairness Justifications for Limiting Fiduciary Obligations of Corporate Officers, Directors, and Controlling Shareholders*, 60 TEMPLE L.Q. 47 (1987); DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879 (differentiating fiduciary and contract concepts).

9 Doctrine respecting the nature of the corporate firm and corporate governance policies have changed substantially during the past twelve years or so. The extent of the change can be grasped by recalling the earlier discussions. The anti-managerialists dominated. The leading corporate law article was Professor Cary's attack on the Delaware legislature and courts and his call for limited Congressional intervention. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974). Popular literature advocated more thorough-going federal controls. *See* R. NADER, J. SELIGMAN & M. GREEN, TAMING THE GIANT CORPORATION (1976). At that time, it seemed that some of the anti-managerialists' suggested reforms might find their way into the law through the medium of Rule 10b-5. *See* Cary, *supra*, at 699-700; Jennings, *Federalization of Corporate Law: Part Way or All the Way*, 31 BUS. LAW. 991, 1002-13 (1976); Rosenfeld, *An Essay in Support of the Seond Circuit's Decisions in* Marshel v. AFW Fabric Corp. and Sante Fe Industries, 5 HOFSTRA L. REV. 111, 127-34 (1976). Nobody seems to talk about federal chartering anymore. Today's anti-managerialist policy discourse looks to much less intense models of legal control over corporate behavior. *See* Schwartz, *Genesis: Panel Response*, 8 CARDOZO L. REV. 687, 688-91 (1987) (Professor Donald Schwartz commenting on changes in the thrust of corporate law policy discussions between the late 1970s and early 1980s).

10 This formulation draws on the original language of Jensen and Meckling. Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976). *See, e.g.*, Fama & Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 302 (1983); Jensen, *supra* note 4, at 326. For restatements of the concept in the legal literature, see e.g., Fischel, *Corporate Governance*, *supra* note 5, at 1261-62; Kraakman, *supra* note 5, at 862; Scott, *supra* note 5, at 930.

11 *See* Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus"*, 75 NW. U.L. REV. 1018, 1026-27 n.27 (1980); Whitford, *Ian Macneil's Contribution to Contracts Scholarship*, 1985 WIS. L. REV. 545, 550 n.16; *see also* Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986) (corporate application of the contractual perspective in a more relational mode).

12 At least one polemicist writing within the framework of the new theory has claimed the legitimacy of "organized theoretical and empirical processes." *See* Wolfson, *supra* note 5, at 961. *See also* A. KAUFMAN & L. ZACHARIAS, THE PROBLEM OF THE CORPORATION AND THE EVOLUTION OF SOCIAL VALUES (University of MA, School of Management, Management Research Center Working Paper 1987).

for more than it is worth. It has not been well understood even though it has been well accepted. It embodies less an ontological breakthrough than a shift of perspective. Characterized in a lawyers' terms, the point that the firm is a nexus of contracts is merely an assertion, or a legal conclusion. Characterized in literary terms, the point is a metaphor. Characterized in the technical terms of social science methodology, the point is a tautology—a statement true by definition.[13] Unlike some economic theory, but like much legal theory, the nexus of contracts (and much of the theory built on it) resists empirical verification. As with legal theory, verification depends on the tester's characterizations of real world institutions and relationships.[14] Yet the legal academy has accorded the nexus of contracts a status far higher than usual for the latest legal conclusion, metaphor, or tautology.

This article explains the overvaluation of the nexus of contracts concept. It accounts for the new economic theory's success in the legal academy and identifies its serious shortcomings. It further proposes that we pursue a different contractual theory of the firm, one which offers greater positive accuracy and normative responsiveness.

The new economic theory's contractual perspective of corporations fares well in legal contexts because, in practice, corporate relationships do exhibit a significant basis of voluntary exchange. Its contractual pictures better account for many aspects of relationships between corporate managers and security holders than do competing managerialist pictures.[15] By pushing corporate legal theory away from a single-minded concern with "governance"—the positive law control of corporate hierarchies—the new economic theory vindicates values widely held among those who deal with corporate law.

But the new economic theory suffers from a single-mindedness of its own, and, as a result, fails to offer a viable contractual theory of the corporation. It employs a strictly delimited concept of contract congenial only to microeconomic methodology. Richer, alter-

---

13 Jensen, *supra* note 4, at 329. Identifying the idea at the core of new theory as a tautology does not purport critique.

14 *Id.* at 332-33. It should be noted, however, that strategies for refutable implications are being pursued. Institutional theorists, for example, study real world arrangements and "match" transactions and governance structures. *See* Williamson, *The Logic of Economic Organization*, 4 J.L. ECON. & ORGAN. 65, 72-76 (1988); Joskow, *Asset Specificity and the Structure of Vertical Relationships: Empirical Evidence*, 4 J.L. ECON. & ORGAN. 95, 95-102 (1988).

15 These relational points are (a) the general acceptance of pro-managerial conceptions of management duties by state courts, despite decades of criticism by legal academics, and (b) the eclipse of managerialism by the rising market for corporate control. *See* Bratton, *supra* note 3, at 1499-1500, 1520-25.

native legal theories of contract fail to inform its pictures of the firm. Consequently, it mischaracterizes corporate contracts, making normative and political assertions in the guise of ontological statements. At best, the new theorists' contractual firm makes a limited, but still significant, heuristic contribution.

This article offers a different, more relational conception of the contractual corporation, grounded in business practice. It includes not only the discrete, arms-length exchanges that constitute the new theorists' corporation, but also the managerialists' hierarchical structures. The article asserts that a contractual theory of the corporation should not privilege either of these aspects of organizational life. Instead, their complex coexistence should be accepted as a starting point and the theory should go on to describe their interrelationship. The exercise offers the possibility of a neutral basis for corporate legal theory—a basis permitting the understanding of normative issues in corporate law (if not their ultimate resolution) in an atmosphere free of exogenous political imperatives. Corporate law doctrine, which has been shifting between contracts, hierarchies, and the state for more than a century, provides a useful starting point in the endeavor to articulate this relational dynamic.

The article has four parts. Part I describes the new economic theory. Parts II, III, and IV unpack it, isolating the nexus of contracts concept's ontological and political components in successive theoretical contexts—first corporate legal theory, then political theory, and, finally, contract theory.

Part I states the new theory, drawing on the primary sources in the economics literature. It places the theory in the larger context of earlier legal and economic thinking, particularly the post-war managerialist concept of the corporation. It distinguishes two variants of the theory. One, termed "neoclassical," deconstructs corporations into transactions hewing closely to the neoclassical microeconomic model.[16] The other, termed "institutional," recasts the corporation as a series of contracts somewhat more relational in character.[17]

Part II appraises the new economic theory using concepts from corporate legal theory. This analysis extracts the concepts of the firm operating deep within managerialism and contemporary corporate law doctrine and then compares these concepts with those of the new economic theory. The comparison reveals a surprisingly wide zone of present and potential congruence. At the same time,

16 *See infra* notes 42-57 and accompanying text. The phrase "neoclassical microeconomic model" is Professor Macneil's. *See generally* Macneil, *supra* note 11.

17 *See infra* notes 58-67 and accompanying text.

however, it shows that many of the new theory's assertions are too closely tied to neoclassical microeconomic methodology to permit their plausible transposition to the corporate law context.

Part III appraises the political component of the nexus of contracts, and rebuts the new economic theorists' proposition that freedom of contract is a corporate law absolute. The analysis reviews the new theory against a range of propositions about government/corporate relations—specifically, the concession theory of the corporate origin, the theory of sovereign coercion of contracts, and "public-private" debate over the nature of the management corporation.[18] It draws two conclusions. First, contrary to the new economic theory, the corporate contract remains an archetypical case of limited contracting freedom. Second, corporate doctrine provides a better basis than microeconomic theory for an accurate and flexible positive political theory of the corporation.

Part IV appraises the "contract" in the nexus of contracts. It shows that the new theory's positive picture of the management corporation overemphasizes the discrete contract and understates the significance of hierarchical relations. It also shows that the new theorists lodge more legitimating power in contractual consent than it plausibly can sustain. Again the analysis concludes that corporate doctrine provides a better source of concepts for corporate legal theory than microeconomics, in this case a theory of the corporate contract.

I
THE NEXUS OF CONTRACTS AND THE NEW ECONOMIC THEORY OF THE FIRM

Proponents of the "nexus of contracts" tend to assert it flatly, without explication. Yet the concept is not self-explanatory. Even as they confront the claim that the concept represents a methodological and ontological breakthrough with radical implications for corporate law, observers have trouble understanding what a corporate "nexus" is supposed to be.

Part I seeks to clarify the concept. It sets out the new economic theory's basic assumptions in a wider institutional context, drawing directly on the economics literature, rather than on the secondary accounts in the law reviews. This exposition permits clear identifi-

---

18 In this article, the phrase "management corporation" denotes large mass-producing corporations and other large corporate entities, the shares of which are widely held. The usual term, "public corporation," is avoided because it implies a position in respect of a theory of the firm in question. *See infra* notes 123-33 and accompanying notes.

cation of the economics underlying the new economic theory's legal conclusions.

Contrasting the nexus of contracts concepts with the opposing concepts their proponents sought to rebut permits better understanding. Therefore, this discussion begins with an account of the managerialist conception of the corporation that prevailed in legal and economic theory prior to the new economic theory's appearance.

A. The Managerialist Conception of the Corporate Firm

Since about 1930, discussions of corporate doctrine and policy have been based on a particular management-centered conception of large corporate entities. Until the new economic theory challenged it, this conception enjoyed such widespread acceptance that it preempted most deeper inquiry into the nature of the firm in legal theory.[19]

The managerialist picture puts corporate management at the strategic center of the large firm. Management, because of its expertise in organizing resources, possesses power and real discretion in its exercise. Management's power has three aspects. First, management groups determine the processes of production and distribution. Second, management groups dominate enormous hierarchical bureaucracies and exercise authority over all of those lower in the hierarchy. Third, management-dominated corporate entities impose externalities on those outside the entities.[20] In the standard view, the corporate legal doctrine that emerged at the turn of the century facilitated and protected management power.[21]

Many observers, here termed "anti-managerialists," acknowledged the accuracy of the consensus picture of management power, but denied the legitimacy of management's position. They charged in a three-part argument that management exercised its power without accountability. First, legal doctrine vests governing power of the corporate entity in the board of directors subject to shareholder vote. Second, management in fact controls the board. Third, the financial community supports management. Therefore, management groups are unaccountable to higher authority.

Management's defenders, here termed "pro-managerialists," countered with a two part defense. First, expertise legitimated man-

---

19 This consensus picture also was widely held amongst economists as well. *See* Bratton, *supra* note 3, at 1494-96.

20 *See, e.g.*, A. BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION 31-37 (1954); R. NADER, J. SELIGMAN & M. GREEN, *supra* note 9, at 62-65.

21 *See, e.g.*, J. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970 59, 62, 70, 82 (1970); Horwitz, *supra* note 1, at 181-83.

agement authority; the management corporation functioned more effectively than any alternative form.[22] Second, they offered assurances of responsibility; managers, they insisted, were capable of statesmanship.[23]

The debate over the legitimacy of management power involved disputes over the nature of the corporate firm at only one level—whether the management corporation was public or private. The anti-managerialists analogized the management corporation to government to demonstrate its public nature. If the corporation was public, then uncontrolled management illegitimately wielded its power and should be subjected to additional legal controls.[24] The contrary assertion of the corporation's private nature affirmed the legitimacy of the substantial discretion legally vested in management.[25]

The post-war law reviews contain extensive criticism of corporate doctrine for its pro-managerialist bias. This academic movement gathered force in the 1960s, eclipsing the pro-managerialist approach based on managerial expertise.[26] Anti-managerialists dominated the law reviews in the 1970s.[27] Despite this reversal, state corporate law remained substantially pro-managerialist into the 1980s.[28]

Aside from the "public-private" disagreement, all participants in the post-war pro- and anti-managerialist debate held common managerialist assumptions about the nature of the corporate firm. All saw the firm as a "structure" which gives rise to power relationships. All agreed that management dominates the structure by organizing subordinated factors of production. And all agreed that management owes its position to its organizational expertise.

---

22 *See generally* W. BAUMOL, BUSINESS BEHAVIOR, VALUE AND GROWTH (1959); R. MARRIS, THE ECONOMIC THEORY OF "MANAGERIAL" CAPITALISM (1964).

23 Frug, *The Ideology of Bureaucracy in American Law*, 97 HARV. L. REV. 1276, 1297-98 (1984).

24 Like government, large corporations took actions affecting those outside the organization. Like government authorities, managers exercised their power by means of a rationalized system of control and administration. Like government, the "public" firm was a "political" entity. *See* Latham, *The Body Politic of the Corporation*, in THE CORPORATION IN MODERN SOCIETY 220 (E. Mason ed.) (1960).

25 The public-private debates of the pro- and anti-managerialists are covered in more detail in the text accompanying notes 123-33 *infra*.

26 *See* Frug, *supra* note 23, at 1311.

27 *See, e.g.*, Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978); Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974); Cary, *supra* note 9.

28 The literature on "transfers of control" provides a good example of this phenomenon. Academics argued strongly against the legitimacy of managers exchanging control power for money. Only a few cases took up the idea. *See* Bratton, *supra* note 3, at 1498 n. 135.

B. The Advent of the New Economic Theory

We can precisely date the advent of the new economic theory with the publication of an article by Alchian and Demsetz in 1972.[29] The appearance of Jensen and Meckling's well-known analysis of the firm made 1976 the watershed year.[30] These papers proposed a picture of management interaction with factors of production quite different from the managerialist picture. Ironically, they appeared at the time the anti-managerialist movement in the law schools achieved maximum influence.[31]

The nexus of contracts assertion, accepted in accordance with its intended meaning, displaces the management-centered conception of the firm. It maintains that the firm is a legal fiction that serves as a nexus for a set of contracting relations among individual factors of production.[32] Unlike the managerialist firm, the nexus of contracts firm is not a hierarchy in which management determines terms by fiat. Firms, said Alchian and Demsetz, have "no power of fiat, no authority, no disciplinary action. [They do not differ] in the slightest degree, from ordinary market contracting between any two people."[33] "Management," they concluded, usually described as a hierarchical exercise, is really a continuous process of negotiation of successive contracts.[34]

The nexus of contracts concept opened up a new line of microeconomic inquiry—the analysis of the internal functions of firms within the assumptions and methodology of neoclassical microeconomics. Before 1972, neoclassical microeconomists theorized only about markets. Their models explained coordination of the use of resources and distribution of income by the price system[35] and accorded the firm "black box" status—a "production function" deemed to follow profit considerations exclusively and

---

29 Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

30 Jensen & Meckling, *supra* note 10. With it appeared the "nexus of contracts" tautology. Significant substantially contemporaneous work on the theory of the firm included O. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975); K. ARROW, THE LIMITS OF ORGANIZATION (1974); Smith, *Economic Theory and its Discontents*, 64 AM. ECON. REV. 320 (1974).

31 *See supra* note 28.

32 This school also is called the "property rights" school. *See* O. WILLIAMSON, *supra* note 30, at 251-52.

33 Alchian & Demsetz, *supra* note 29, at 777. For example, the dissatisfied party always can terminate its dealings with the firm.

34 *Id.* at 794.

35 *See* Chueng, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1 (1983). Neoclassical microeconomists followed Adam Smith's dictum that the division of labor, and thus the firm, marks the extent of the market. They did not look at production processes inside the firm or at the contracting arrangements underlying them. *See also* Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375, 377-78 (1983).

behave as an entity in rational patterns no different from those of human actors.[36]

Neoclassical microeconomists accepted these limits on their field of inquiry[37] because they viewed internal corporate activities with distaste. They perceived actions inside of firms as "engineering," functions of hierarchical structures, and, therefore, as unsuited to a discipline that studies markets.[38] This hierarchical conception of internal firm affairs echoed the view prevalent in corporate law.

Ronald Coase made the earliest suggestion within microeconomics that operations inside the firm could be described as contract. In an essay published in 1937,[39] he explained firms and markets as alternative forms of contracting, with the minimization of transaction costs determining the choice between the two. Coase saw the price system directing production through exchange transactions on the market, while coordinators directed protection within firms. Firms, said Coase, exist where the costs of using the price system to ascertain the price are too high. But this seminal work achieved no noticeable influence until after 1970.[40] Even then it influenced the two variants of the new economic theory in different ways. Only the institutionalists took seriously Coase's distinction between markets and firm hierarchies.[41]

The Alchian and Demsetz and Jensen and Meckling papers opened a way around management hierarchies and succeeded in bringing the interior of the firm to neoclassical microeconomics and in bringing neoclassical microeconomics inside the firm. The nexus

---

36 Their models' assumptions of costless creation and enforcement of contracts and of perfect information obviated the need to inquire into organizational details. *See* Jensen, *supra* note 4, at 325-26; *see also* Rosenberg, *Comments on Robert Hessen, "The Modern Corporation and Private Property: A Reappraisal,"* 26 J.L. & ECON. 291, 295 (1983).

37 For criticism of the neoclassical model see A. CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 489-90 (1977); McNulty, *On the Nature and Theory of Economic Organization: The Role of the Firm Reconsidered,* 16 HIST. POL. ECON. 233, 240-41 (1984).

38 *See* Demsetz, *The Theory of the Firm Revisited*, 4 J.L. ECON. & ORG. 141, 142-44 (1988); Jensen & Meckling, *supra* note 10, at 306-07; Meckling, *Values and the Choice of the Individual in the Social Sciences*, 112 SCHWEIZERISCHE ZEITSCHRIFT FÜR VOLKWIRTSCHAFT UND STATISTIK 545, 557 (1976); Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1220-21 (1984); Winter, *On Coase, Competence, and the Corporation*, 4 J.L. ECON. & ORG. 163, 164-69 (1988). This distaste is part of a wider mistrust of nonexchange utility maximization.

39 *See* Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

40 Coase later said that his 1937 essay was "much cited but little used." *See* Coase, *Industrial Organization: A Proposal for Research*, in ECONOMIC RESEARCH: RETROSPECT AND PROSPECT: POLICY ISSUES AND RESEARCH OPPORTUNITIES IN INDUSTRIAL ORGANIZATION 63 (V. Fuchs ed. 1972); *see also*, Coase, *The Nature of the Firm: Meaning*, 4 J.L. ECON. & ORG. 19, 23 (1988).

41 *See infra* notes 56, 60 and accompanying text.

of contracts concept provided the means of success. It pointed out a new picture of the firm in which hierarchy is irrelevant. Under it, neoclassical microeconomists could discuss organizations while remaining within the traditions of their discipline and without sullying their hands with "engineering."

C. The Neoclassical Variant

1. *Basic Assumptions*

The "neoclassical" variant of the new economic theory begins with the nexus of contracts and then builds models of the management corporation that closely follow the neoclassical microeconomic model and that draw on its body of assumptions. Its actors are rational, economic actors driven by their divergent self-interests,[42] and seeking to maximize values for themselves. They resourcefully conceptualize and predict future courses of action effectively.[43] The neoclassical theorists reconstruct the firm as the product of their contracting behavior: Their contracts are equilibrium market contracts[44]—instantaneous exchanges between maximizing parties. The parties make complete choices, dealing with unknown factors in the exchange price.[45]

The neoclassicists also make assumptions about the contracting process. They assume effective competition among the contracting parties. They apply the principle of natural selection to successive generations of the contracts. This follows from their assumption that rational economic actors, consciously or not, solve problems in the process of maximizing wealth. Given their level of capability and intense competition, only optimal contracting strategies survive.[46]

2. *Basic Model*

Within this framework, firm contracts take forms determined by the imperative of reducing agency costs. Contracts that allocate risk have winners and losers. Losers maximize their positions by taking actions to avoid having to perform their promises fully—the theorists call this "shirking." Agency costs are the costs of shirking. Rational economic actors know all about possibilities for shirking and charge the agency costs against their contracting partners ahead of time. Given competition, the party who most reduces agency costs

---

42 Jensen, *supra* note 4, at 331; *see also* Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980).

43 *See* Meckling, *supra* note 38, at 548-49.

44 *See* Jensen, *supra* note 4, at 327.

45 *See* Macneil, *supra* note 11, at 1022-23, 1039-40.

46 Jensen, *supra* note 4, at 322, 327.

has the edge. And contract forms with the lowest costs survive.[47] Theorists apply this model to explain a range of corporate arrangements including such diverse phenomena as the positive law of relations among shareholders, boards of directors and officers; the internal decisionmaking structures, policies, and procedures of corporate bureaucracies; and the contracts firms make with employees, suppliers, and creditors.

In 1976 Jensen and Meckling published the most widely-circulated of the model's several treatments of shareholder-management relations.[48] Their article set out the model's basic themes. Managers act as agents to shareholder principals. When securities are sold publicly by management groups to outside shareholder principals, the purchasing shareholders assume that the managers maximize their own welfare and will bid down the price of the securities accordingly. Thus management bears the costs of its own misconduct and has an incentive to discipline its own behavior. Management increases self-control and thereby increases the selling price of the corporation's securities by offering monitoring devices. These devices include such common features of the corporate landscape as independent directors and accountants, and legal rules against self-dealing.[49]

Subsequent essays expand the Jensen and Meckling picture, pointing out that pressures from the management labor market[50] and from the market for corporate control also impel management to reduce agency costs. Commentators explain the received division

---

47 *See, e.g.*, *id.* at 331-32; Fama & Jensen, *supra* note 10, at 301.

48 *See* Jensen & Meckling, *supra* note 16, at 312-19.

49 This explanation has been widely employed in the law reviews. *See e.g.*, Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 128-29 (1987); Fischel, *Corporate Governance*, *supra* note 5, at 1262-65.

Alchian and Demsetz's predecessor article also explained corporate structure in terms of agency costs. But it had a different focus. Jensen and Meckling built a financial model—they set out a hypothetical close corporation in which an owner management group sells equity to outsiders. Alchian and Demsetz built a production model, discussing shirking problems amongst individuals on production teams. The existence of management groups is explained as a function of shirking by input factors. Monitors (i.e., managers) must receive power to observe. Further arrangements are necessary since managers themselves will shirk. Residual income shares reduce this incentive. *See generally* Alchian & Demsetz, *supra* note 29, at 781-82, 787-88.

50 Fama suggests that management labor markets provide the primary discipline by (1) forcing greater responsiveness in rewarding performance (brought on by outside market for management labor), (2) firm performance being reflected in outside opportunity wages (i.e., a firm performing well, vis-a-vis profits and agency costs, can demand a higher price in the management labor market), and (3) the incentive created by the internal firm market for lower managers to seek advantage over shirking co-workers. *See* Fama, *supra* note 42, at 294-95; *but see* Klein, *Contracting Costs and Residual Claims: The Separation of Ownership and Control*, 26 J. LAW & ECON. 367, 368 (1983) (taking the position that wage discount cannot be taken into account in wage contracts ex ante).

of authority between officers and director in terms of low cost information flow.[51]

Proponents introduced this basic model to legal theory as the product of compelling science. But their science is not the kind that survives successful testing of falsifiable propositions. The theory's several basic assumptions—contract, rationality, the desire to maximize profits, competition, and survival of the fittest—state propositions as much political as empirical. Even accepted on their own terms, these propositions leave open a wide area for discussion. Within the model's parameters one can rationally construct various and conflicting pictures of the firm. Perhaps the theory's proponents concur on no single point—other than the nexus of contracts point itself. A single, detailed picture of the firm will not emerge from the school.[52]

The school's internal differences on who should bear the costs of managerial shirking illustrate this indeterminacy. Jensen and Meckling's present the most prevalent view that agency costs reduce the value of the firm's equity, but the equity participations are priced so as to force the agents—the firm's managers—to bear the costs themselves.[53] Demsetz's counter model maintains that agency relationships do not reduce the value of the firm's equity at all. Rather, the costs flow through to the firm's customers and, given competition in the product market, no firm suffering agency costs could compete. Therefore, managerial on the job consumption will persist only if it lowers the costs of production![54] The differences in the pictures stem from different versions of the assumption of competitive markets. Demsetz's world is more intensely competitive, and the firm looks different as a result.[55]

---

51 Fama and Jensen distinguish between decision management (the intiation and implementation of decisions) and decision control (the ratification and monitoring of decisions). These functions become divided because knowledge is widely spread in complex organizations and this particular diffusion reduces costs. *See* Fama & Jensen, *supra* note 10, at 302-05.

52 *See* Winter, *supra* note 38, at 163 (". . . I think we must acknowledge that the present state is one of incoherence.").

53 *See supra* text accompanying note 47.

54 *See* Demsetz, *supra* note 35, at 379.

Demsetz has made another destabilizing suggestion more recently. Transaction and monitoring cost analysis, he says, confine the inquiry too much. He suggests that sights be expanded to include information cost considerations. Demsetz, *supra* note 38, at 154.

55 The basic picture is undermined one step further by Klein's point that agency costs cannot be presented for discounting when actors price securities. Klein, *supra* note 50, at 368 n.2. This picture differs from the generally accepted transactional model of the new theory because of a slightly different assumption respecting the calculative capacity of rational economic actors.

3. *The Rebuttal of the Managerialist Picture*

The neoclassical variant's picture of the corporate firm contrasts with the managerialist picture and implicitly challenges its accuracy. In the neoclassical picture, the corporate entity—a prominent figure in the managerialist picture—almost disappears. It dissolves into disaggregated but interrelated transactions among the participating human actors. Some transactions involve the fictive firm entity as a party, but only as a matter of convenience. The "firm" has no precise boundaries; unlike legal academics, the neoclassicists have no interest in categorizing transactions as occurring inside or outside of the firm.[56]

The separation of ownership and control, a partial basis of management power in the managerialist picture, disappears in the new economic picture. Ownership becomes as irrelevant a concept as the firm entity. The "firm" represents a mere series of contracts joining inputs to produce output. Equity capital, the traditional legal situs of ownership, devolves into one of many types of inputs,[57] and the body of corporate law becomes just part of the contract governing that input. Assuming that the fittest arrangements survive, the contract's profit-sharing terms presumably effect an optimal sharing of risk.[58] The neoclassical picture, then, affords no reason for government to intervene to protect shareholders.

Even though the neoclassical picture purports only to explain, its operative assumptions give it a strong normative aspect. It implicitly justifies what it depicts by inserting a basis of arms-length contractual negotiation. For example, extant customs of managerial self-dealing must figure into the contract, or cost competition would have eliminated them long ago. In the legal academy, the picture counters the standing critique that corporate law establishes management power and protects self-interested management behavior. Indeed the neoclassical picture denies altogether the existence of the management power on which lawyers and legal academics have long focused their analysis of corporate law.

D. The Institutional Variant

Economists see "the theory of the firm" as a unitary discourse. But, for purposes of law and economics, different exercises in theory have a materially different bearing. The neoclassical approach

---

56 *See id.* at 373; Klein, Crawford & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. LAW & ECON. 297, 326 (1978); Jensen & Meckling, *supra* note 10, at 311.

57 Alchian & Demsetz, *supra* note 29, at 781-82.

58 Klein, *supra* note 50, at 370.

should be distinguished from the "institutionalist" approach taken by Oliver Williamson and some others. The institutionalists work with different basic assumptions and produce a different model, whose positive and normative aspects contrast less sharply with that of managerialist corporate legal theory.

1. *Distinctions*

Several significant distinctions can be drawn between the neoclassical and institutional variants. First, institutionalists recognize the existence of the firm as a single maximizing unit; their firm entity represents more than an aggregate of transactions among maximizing individuals.[59] While comprised of contracts, the firm entity constitutes a hierarchical "governance structure" significantly distinguishable from market contracting.[60] Institutionalists also follow Coase by inquiring into differences between market and firm organization.

Second, the institutionists' economic actor possesses a wider repertory of human traits than the neoclassical counterpart. Specifically, the institutional contracting party suffers from "bounded rationality" and engages in "opportunistic conduct."[61] Bounded rationality gives the actor limited ability to solve problems. It prevents it from achieving the neoclassical actor's concrete risk analysis and from making such complete choices. Opportunistic conduct goes beyond the neoclassical actor's self-interested maximization to "guile," untrustworthy behavior deemed "culpable" by a lawyer.[62]

These human failings inform the institutionalist picture of the firm contracting process. Actors know they cannot achieve complete exchanges in all situations. In incomplete exchange, they leave terms open and consent to structures and processes to govern the relationship's future.[63] Parties choose these "governance structures" over market exchanges to guard against appropriation:

---

59 *See* Macneil, *supra* note 11, at 1022-23.

60 *See* O. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 294-97 (1985); Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LIT. 1537, 1537-1546 (1981); *see also* Spence, *The Economics of Internal Organization: An Introduction*, 6 BELL J. ECON. 163, 172 (1975) (affirming that, while the line between the firm and the market collapses to some extent, the varieties of nonprice interactions on the marketplace, the hierachical nature of the firm, and the control management exercises over resource allocation, makes them meaningfully different).

61 *See generally* Williamson, *supra* note 60, at 1544-45.

62 *See* Macneil, *supra* note 11, at 1023-24 n.20, for criticism of the concept of opportunistic conduct for its failure to include self-interested behavior unnecessarily injurious to another party's interests—a behavior pattern included in the legal concept of "bad faith."

63 *See id.* at 1043.

where one or both parties' performance entails investment specific to the transaction and opportunitism could threaten that investment, the parties invent a structure to mitigate that threat. Firm organization, along with most other forms of long-term contracting, represents such a mitigating transactional structure.[64]

Other factors affect the institutionalists' transaction structures. Some, like free rider problems and agency costs, also figure prominently into the neoclassicists' models.[65] But the institionalists also consider nonrational influences, such as human attitudes.[66] Authority and ethics also enter into the parties' transactional solutions. Fiat may provide the cheapest way to solve problems; co-operation and reciprocity may reduce uncertainties, and hence costs, by causing expectations to converge.[67]

These considerations give institutionalists a more thickly textured picture of the firm than the neoclassicists present. With its hierarchies, planning failures, and bad faith conduct, the institutionalist picture often resembles the picture of the firm operative in corporate legal doctrine.

2. *Commonalities*

We should not overstress the differences between the neoclassical and institutional variants however. Viewing the two approaches together against the universe of alternative explanations of the firm, they represent a substantially common point of view.

The institutionalists, like the neoclassicists, view the firm as a construct of contract and explain its structural features as cost saving devices of transacting parties. Like the neoclassicists, they espouse a noninterventionist political perspective. As a form of contract the institutionalists' firm is private rather than public. It affords no apparent constructive role for public policy because the institutionalists reject the idea that "government has any special powers to reorganize the merits of organizational innovations . . . ."[68] Like the neoclassicists, their methodology delimits the

---

64 *See* Klein, Crawford & Alchian, *supra* note 53, at 298, 307, 319 (examples of firm specific investments and transaction structures). *See also* O. WILLIAMSON, *supra* note 60, at 298-99, 301-02 (analysis of corporate organization in terms of firm specific investment, bounded rationality and opportunistic conduct); Grossman & Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1988) (identifying ownership of an asset with residual rights of control over the asset); Williamson, *supra* note 57, at 1546; and Williamson, *supra* note 38, at 1209-12.

65 *See* Williamson, *supra* note 60, at 1547-48.

66 O. WILLIAMSON, *supra* note 30, at 256-57; O. WILLIAMSON, *supra* note 57, at 405.

67 O. WILLIAMSON, *supra* note 30, at 38.

68 *See* Williamson, *Organization Form, Residual Claimants, and Corporate Control*, 26 J. LAW & ECON. 351, 361 (1983).

scope of their inquiry and analysis. Since transaction cost reduction best explains private contracting patterns, they seek to explain firm phenomena as means to reduce those costs; if no such functional explanation appears at first, they keep looking.

II
THE NEXUS OF CONTRACTS AND THE CORPORATE ENTITY OF LEGAL THEORY

The central recurring question addressed by juridical theories of the corporate firm is the "entity or aggregate" inquiry. This question concerns the line of demarcation between the corporation and the separate relationships in and around it. It asks to what extent the corporate firm constitutes a separate entity, possessing characteristics of its own, separate from the characteristics of the persons connected with it. Finding the existence of a meaningful corporate entity raises further questions respecting the components of its separate nature. One is whether the corporate firm is a real thing, whether it exists, like a spiritual being, apart from the separate existences of the persons connected to it. Or is the firm entity at most a reification—a construction of the minds of humans connected with the firm or otherwise aware of it? Even if the observer concludes that only the reified firm entity exists, questions about the source and character of the ideas constituting the reification still arise. One question concerns personification of the firm—the appropriateness of modelling the reified entity as an economic and social actor with the behavior patterns of an individual.[69]

A significant line of thinking, of which the neoclassical variant of the new economic theory is the latest manifestation, applies methodological individualism to answer the initial "entity or aggregate" query. This thinking denies the existence of a meaningful corporate entity. It finds the firm's separate characteristics to be insignificant and attaches determinant significance to the relationship's aggregate parts. This approach distills a contractual essence from the corporation.

Many different answers to these questions have been offered throughout the history of American corporate law.[70] The first part below sets out the configuration of answers that prevailed around 1980 when the nexus of contracts concept appeared in the legal literature. The second part below contrasts this received legal conception with the nexus of contracts concept and discusses the implications of their joint presence in legal theory. This discussion

---

69 For a more extended discussion see M. DAN-COHEN, *supra* note 2, at 15-16.

70 *See* Bratton, *supra* note 3, at 1482-1500.

identifies the incompatible methodologies of microeconomics and law as the source of the boldest contrasts between the nexus of contracts concept and the legal conception. It filters out elements of the nexus of contracts concept peculiar to economics and ill suited to legal theory. It concludes that the legal conception of the firm, a capacious collection of ideas, will function similarly, filtering out incompatible economics and then assimilating the residuum of the nexus of contracts into legal theory. The ultimate benefit will be heightened sensitivity to the relational elements that make up the normative issues in corporate law.

A. Conceptions of the Nature of the Firm in Legal Theory

The economists who first formulated the nexus of contracts conception announced a teaching mission. The world needed to be shown that organizations have neither consciousness nor independent rationality; the new theory would dispel the tendency to regard organizations as persons.[71] But the legal academy had no urgent need for the economists' lesson because legal theory had assimilated it almost a half-century before.

1. *The Nineteenth Century Consensus Picture and the Turn-of-the-Century Dispute*

During the nineteenth century, a consensus picture prevailed which accorded the corporate entity a reified existence. This picture, however, simultaneously accorded private contract the generative economic role in corporate life. The corporate entity represented a state-created juridical structure only—a "legal fiction" or an "artificial entity." The consensus picture conceptually distinguished this juridical form from the conduct of business. Corporate business, like that conducted by individuals and partnerships, was a contractual aggregate.[72]

These concepts lost influence near the turn of the century. Firm entities gained prominence in the economic and social landscape as management corporations appeared. Intensive discussion of the nature of the corporate firm ensued, lasting until the 1920s. A rearguard of observers hostile to the new mass-producing entities challenged traditional doctrinal notions by introducing contractual, disaggregated conceptions of the firm. But theorists with the more prominent voices attacked the traditional doctrine from the other side, affirming the entity's economic and social existence as well as

---

71 *See* Jensen, *supra* note 4, at 327.

72 *See* Bratton, *supra* note 3, at 1502-08 (more complete description of nineteenth century doctrine on the nature of the firm).

its juridical status. These academics, influenced by European theories of group existence,[73] advanced an organic theory: the corporation was an entity and was real. Group will and group loyalty combined in corporate life to transcend the beings of the individual participants. It created a new being with a will of its own. These transcendental "realist"[74] notions, supported the new management interest.[75]

This "realist" theory attracted opponents, who rebutted it with complete success during the 1920s.[76] The opponent's propositions about the nature of the firm provided the basis for a new consensus view and became the basic assumptions underlying corporate discourse during the managerialist period that began around 1930.

2. *The Mid-Twentieth Century Consensus Picture*

The "anti-realist" consensus picture emphasizes the firm's aggregate parts by describing the firm's nature as a result of the actions of human actors.[77] It explains habitual references to corporations as "persons," as a matter of convenience only.[78] The corporate entity remains, even so. It retains a cognizable social reality even as it returns to the diminished status of a reification.[79] The firm, like other institutions, retains a meaningful existence as a separate entity because it carries on while individuals, with their narrower interests and whims, come and go.[80] This reified entity receives separate substantive content from the "common purpose"

---

73 The most influential European was Gierke. *See* Radin, *The Endless Problem of Corporate Personality*, 32 COLUM. L. REV. 643, 663-64 (1932); Dewey, *The Historic Background of Corporate Legal Personality*, 35 YALE L.J. 655, 658-59 (1926); Vinogradoff, *supra* note 1, at 595, 602. *See also* Horwitz, *supra* note 1 (recent retrospective of the turn of the century discourse).

74 They are termed "realist" because they hold the firm to be a "real," albeit transcendental thing. This "corporate realism" therefore has no conceptual relation to "legal realism."

75 Horwitz posits a cause and effect relationship between realist theory and the success of the managerialists. *See* Horwitz, *supra* note 1, at 176, 224. For criticism of this position, see Bratton, *supra* note 3, at 1511-13.

76 *See generally* Dewey, *supra* note 73; Radin, *supra* note 70; Vinogradoff, *supra* note 1. Little discussion of corporate realism appears in American law reviews after the 1920s. Indeed, with the close of the debate over realism, extended discussion of the nature of the firm disappears from the law reviews altogether. Apparently, those dealing with corporate law found further discussions unnecessary.

77 Dewey, *supra* note 73, at 660-61. Berle assisted in the transition of anti-realist ideas into conventional wisdom. *See* A. KAUFMAN & L. ZACHARIAS, *supra* note 12.

78 *See* Radin, *supra* note 73, at 664.

79 Dewey, *supra* note 73, at 673.

80 Dan-Cohen, emphasizing the meaningful existence of the firm by its lifespan, describes the corporation as an "intelligent machine." M. DAN-COHEN, *supra* note 2, at 49.

of its participants.[81] While collective, this entity is not collectivist—it enjoys a primarily functional existence. It provides a means to the end of production, setting the common goals of the participants apart from those of the rest of the world. It also facilitates decision-making and conflict resolution within the group and external action in the name of the group.

This "anti-realist" concept of the firm complemented the concept operative in twentieth century corporate doctrine. In the doctrine, the corporation has held reified status all along. The doctrine embraces a range of entity and aggregate notions and offers two models of the corporation. One presents the corporation as a separate entity to which managers owe duties; the other presents the corporation as an aggregate wherein managers owe duties directly to shareholder principals.[82] The facts of the situation, rather than some theoretical essence derived *ex ante*, determine the choice between the entity or aggregate models in any given situation.[83]

The "anti-realist" conception of the corporation continues to inform corporate law commentary.[84] Commentators differ over matters of degree, filling in the entity reification with differing configurations of group objectives, values, and actions. But they all subscribe to the picture's broad ontological outlines. Even as the commentator's political views vary over the contemporary spectrum, they share an individualistic conception of corporations. Under this conception, the group exists to advance individual objectives. Although the commentators recognize the existence of group and community values, they deny them as ends in themselves.[85] For example, some legal scholarship calls for self-sacrifice in business relationships as an ethical proposition. This approach invariably preconditions the self-sacrifice on reciprocity in the relationship; duties to sacrifice always relate in some way to actual or potential returns of some kind.[86] The value of reciprocity assures recognition of the sacrificing party's interests.[87] Contrariwise, the beneficiary

---

81 1 A. DEWING, THE FINANCIAL POLICY OF CORPORATIONS 4 (5th ed. 1953); Vinogradoff, *supra* note 1, at 603.

82 Interplay between the two conceptions pervades corporate doctrine. The doctrinal division of power between shareholders and directors provides a particularly sharp contrast. *See* M. EISENBERG, THE STRUCTURE OF CORPORATION 85-94 (1976).

83 Bratton, *supra* note 3, at 1508-10.

84 *See, e.g.*, C. STONE, WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR 6-7, 46, 48, 57 (1975); Buxbaum, *supra* note 8, at 527; Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1523 (1982).

85 While they have concerned themselves with the redistributing corporate power, they assumed effective creation of wealth by corporations in pursuing this end.

86 *See generally* Macneil, *Exchange Revisited: Individual Utility and Social Solidarity*, 96 ETHICS 567 (1986).

87 Macneil, one of the more organicist writers on business relations in the contem-

never gets something for nothing.

Contemporary commentators tend to look past the doctrinal corporation to constitutive contractual relationships.[88] But this disregard of doctrinal barriers need not entail disregard of the entity notion. In fact, contemporary contract theory which isolates the values constitutive of long term contractual relationships—"relational" contract theory—permits the contents of the entity reification to be identified more clearly. Relational contract theory may account for the entity notion's prevalence and persistence. The entity idea exists and matters because of heightened interdependence among the parties participating in corporate ventures and institutions. Their positions demand ongoing cooperation, and the entity reification embodies and strengthens common goals, such as the preservation of the relationship, that enhance cooperation.[89]

B. The Nexus of Contracts Concept and Received Legal Theory

1. *Similarities*

The nexus of contracts concept challenges many details of the generally accepted picture of the corporation, but it does not challenge that picture's fundamental outline. It does not assert that firm entities do not exist. Instead, it modifies the traditional juridical theme of the corporation as a combination of reified entity and aggregate parts, taking many directions already followed in twentieth century legal theory. It reinforces the proclivity to look through the entity to constitutive contractual relations, the proclivity to look at the entity reification as a means to the end of wealth creation, and the proclivity to resist the introduction of organicist thinking in business contexts.

The institutionalist picture reinforces the generally accepted picture with particular force. Even though the institutionalists insist that cost reduction explains all firm phenomena, in the end they approximate the received legal picture.[90] They recognize the value of the firm reification, in effect offering cost reduction as the explana-

---

porary legal academy, emphasizes reciprocity. *See, e.g.*, I. MACNEIL, THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS 44-47 (1980).

88 *See, e.g.*, Klein, *supra* note 84, at 1523. This approach, best termed relationalism, discards explanations and classifications in received doctrinal terms in favor of transactional analysis. Macneil's work during the 1970s provided the groundwork. *See generally* I. MACNEIL, *supra* note 87.

89 *See, e.g.*, I. MACNEIL, *supra* note 87, at 30; Macneil, *Values in Contract: Internal and External*, 78 NW. U. L. REV. 340, 362-63 (1983).

90 For contrast between a broader relational approach and the cost-reductive approach of the institutionalists, *compare* Macneil, *supra* note 11, at 1025 n.26, *with* Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J. LAW & ECON.

tion for the appearance of the entity notion in legal doctrine.[91] Their entity has a quantifiable value in the firm-specific knowledge of its employees.[92] They associate cooperative and other collective values with the entity.[93] Their recognition of bad faith, incompetent actors, and openness to group values find easy analogues in conventional doctrinal concepts. The institutionalist firm easily could enter the legal mainstream, perhaps disappearing somewhere within it.

2. *Contrasts*

Of course, the new economic theory does not merely reinforce the received legal picture. The institutional variant, while integrating into the juridical landscape with relative ease, reduces it and removes all details not consonant with the methodology of cost reduction. The neoclassical variant poses even more significant contradictions.

The neoclassical theory conflicts with received legal theory by recasting firm relations in terms of discrete, bilateral contracts.[94] The neoclassical theory deemphasizes the entity, attempting to strip the reification of virtually all substantive content. The neoclassical firm entity becomes a constructed reference point, bearing a relation to the economic substance of firm life analogous to the relation of a punctuation mark to the words on a written page. To find the firm's essence, the theory looks solely to the behavior of individual economic actors. Unlike reifications, individuals produce goods and services; through their actions the firm performs its essential cost functions.

Political ideals inform the neoclassicists' firm. They envision an environment of complete individual integrity and then recast group related thoughts and feelings in individual terms. As a result, they wring the community values from the firm entity even as they affirm the legitimacy of much of the legal landscape. Under standard legal theory, the firm reification embodies group interests which may supersede those of the individual participants in given situations. The neoclassicists recognize these values but recharacterize them as in-

233, 236 (1979). *See also* O. WILLIAMSON, ECONOMIC ORGANIZATION: FIRMS, MARKETS AND POLICY CONTROL 103-30 (1986).

91 *See, e.g.*, Kraakman, *supra* note 5, at 862-63 (entity liability shifts risks to efficient risk bearers).

92 Klein, *supra* note 50, at 374. Firm-specific knowledge is knowledge possessed by employees of the firm which is particular to the operation of that firm and cannot translate usefully to other firms. Its value lies in its ability to lower operating costs when employees are familiar with the procedures peculiar to that firm.

93 *See supra* text accompanying note 64.

94 *See* Masten, *A Legal Basis for the Firm*, 4 J.L. ECON. & ORG. 181 (1988) (comparing legal doctrine regarding employment with doctrine governing commercial contracts).

strumental devices directly serving the rational actor's self-interested ends. Cooperation becomes a means to the end of productivity. Team spirit arises not because of any inherent value or because of psychological rewards of participation in group effort, but because it increases the pay off for individuals. Corporate loyalty benefits the individual by helping him overcome self-destructive tendencies to indolence.[95] No other values exist in group economic life other than self-interested rationality.

Despite themselves, the neoclassicists fail to denude the firm reification of all content. Nexuses, like punctuation marks and other formal devices, bear on substance. Meckling, for example, speaks of the "fusion" and "coalescence" of rational economic actors into firms;[96] "fusing" and "coalescing" actors, like merging and combining companies, emerge altered. Alchian and Demsetz model the firm as a means to the end of team production centered on management. Their model gives the reification significant content by infusing it with the functions of the management team.[97] Jensen notes that the economic counterpart of the entity-based firm theory, the neoclassical "black box" conception, remains useful in some contexts.[98] He, in effect, recognizes that the entity performs many functions inadequately described by cost reduction. Viewing the firm as an actor in the neoclassical marketplace doing things that markets cannot do demonstrates some of these entity functions. For example, firms, whether sole proprietorships, partnerships, or corporations serve as repositories of productive knowledge.[99] They determine output and price levels in response to changes in data and then determine the quality of products before turning them over to the market for evaluation.[100] From the perspective of the outside marketplace, these actors are entities.[101]

---

95 *See* Alchian & Demsetz, *supra* note 29, at 777, 790-91 (formulating these characterizations).

96 *See* Meckling, *supra* note 37, at 559.

97 *See* Alchian & Demsetz, *supra* note 29, at 787-88. Any elements of the entity not explained are thrown into a person called the "owner" who possesses a bundle of rights. *Id.* at 783. Demsetz recently went so far as to mention "cooperative efforts," "continuity of association," and "reliance on direction," as firm characteristics. Demsetz, *supra* note 38, at 156.

98 *See* Jensen, *supra* note 4, at 328.

99 Winter, *supra* note 38, at 169.

100 *See* McNulty, *supra* note 37, at 245-47, 251-52.

101 Contemporary economic literature from outside the discourse of the new theory of the firm similarly affirms the proposition that group life has a cognizable social reality. Hayek's comments on the dangers posed by individuals grouped in organizations stand out for their affirmation of the social reality of the structures of thought that make up organizational entities. *See* 3 F. HAYEK, LAW, LEGISLATION AND LIBERTY: THE POLITICAL

3. *Incompatibilities*

The neoclassical variant contradicts legal theory as a result of its methodological strictures and extreme individualism. For example, the neoclassicists' methodology makes easy their ultra-individualistic dismissal of altruism as a delusion. They recognize only rational economic actors. But legal theorists work from a different concept of the individual; they recognize more holistically constituted actors. These actors both subscribe to and act subject to community values of giving and cooperation.[102] Of course, legal scholars deemphasize these communitarian characteristics and envision actors closely resembling those employed by the neoclassicists, when considering some situations, particularly business relationships. Like economists, they sometimes treat altruism as a contracting device and as a means to the end of wealth creation.[103] But, even in business relationships, they recognize no principles that bar them from accounting for altruism as a value rather than an instrument manipulated by self-interested individuals.

So long as legal theory recognizes the possibility of altruism and the related values of cooperation and shared goals, and so long as it associates them with the firm entity, its conception of the firm will exclude the neoclassicists' picture of a contentless firm reification. Values springing from group endeavor give the entity substantive and normative content. They prevent the larger relation from disaggregating into a neoclassical bundle of discrete transactions. Because these values have an ingrained character, their resistance to the neoclassical conception should endure.

4. *Assimilation*

This discussion of incompatibility does not suggest that no neoclassical conceptions will enter legal theory. Nor does it suggest that the new economic theory will bring no improvements to corporate law. But, so long as legal theory resists the core concept of the

---

ORDER OF A FREE PEOPLE 90 (1979). According to Hayek, organizations derive their power from the moral support of collective action and feelings of group loyalty. *Id.*

For a very different example making a similar point see A. CHANDLER, *supra* note 37, at 8. Writing about the emergence of the modern management structure, Chandler notes that the management hierarchy became a source of permanence that "took on a life of its own." *Id.*

102 Sometimes these values affect the actors as internal ethical drives and sometimes they affect the actors as objectified community norms.

103 *See, e.g.*, Kronman, *Contract Law and the State of Nature*, 1 J.L. ECON. & ORG. 1, 20-23 (1985). Kronman describes a "union" concept, a contractual arrangement of parties seeking to reduce divergence by promoting a spirit of fellow-feeling. The parties establish routines to reinforce altruism. Altruism is thus a strategy to reduce the risks of nonsimultaneous exchange, rather than a community value imposed on contracting parties by an outside agency.

contentless reification, neoclassical conceptions will fail to transform legal perspectives in any fundamental way.[104]

The combined influence of institutional and neoclassical literature should bring improvement by encouraging more determinedly relational applications of corporate doctrine. Through this influence, the doctrine's structures and norms will be applied with sensitivity to the many distinguishing characteristics of different corporate contracts. Imagine a close corporation actually comprised of arms-length discrete contracts along the lines of the enterprise Jensen and Meckling hypothesized in their seminal article. Crude application of traditional corporate doctrine might impose the values of altruism and cooperation. Given a relational approach, a legal decisionmaker would instead employ a normative model incorporating the individualistic values of discrete contracting, avoiding doctrine built on entity conceptions.

A relational approach, however, results in quick and clear normative signals only when confronting neatly hypothesized firms and issues. In more complicated real world situations, it serves the lesser (but still significant) function of delineating normative issues more clearly. Viewing the real world management corporation relationally, with due regard to the new economic theory's conceptions, it represents a complex of contracts, some discrete and some relational. Corporate doctrine does not conclusively fix the appropriate characterization of even the more common contracts; stock and bond ownership may appear both ways, given public trading markets. The holder enters a relationship with the firm through a discrete contract. The holder can exit through a discrete contract. Therefore, norms appropriate for discrete contracts may plausibly govern the holder's relationship to the other participants in the firm.[105] On the other hand, the focus of the picture of the stock and bondholders' relationship to the rest of the corporation can shift from the individual stock or bondholder to encompass the entire group of security holders. The moment this shift to the "entity" occurs, relational values spring from the contract. Conflicts arise between discrete and relational aspects of other intrafirm contracts, especially the employment terms of its managers and employees. Corporate doctrine, in operation, hedges between the relationships' discrete and relational aspects, allowing the determination of the dominant model to depend on concrete fact patterns.

---

104 Such a transposition, however, may enervate and distort the new economic theory.

105 *See* M. DAN-COHEN, *supra* note 2, at 24 (considerations of self-interest can argue against active participation in the internal decisionmaking of an organization); A. HIRSCHMAN, EXIT, VOICE AND LOYALTY (1970).

Enhanced relational sensitivity in corporate law would not make these normative decisions easier. It would introduce no formulaic solutions for general acceptance and application. Instead, it would bestow the doctrine with the heightened awareness that results from a formal admission that the situation is ambiguous. It thereby would permit a range of theoretical conceptions of firms (and associated legal approaches) to bear on the contracting behavior of particular parties and particular types of businesses. It also would accord theoretical sanction to the coexistence of different corporate law approaches—entity-based approaches presupposing high degrees of interdependence,[106] and aggregate-based approaches modelled on the arms length sale of goods contract. All firms would be recognized as entities, but group-based norms would apply in given instances with intensities varying with the particular transacting patterns.

III

THE NEXUS OF CONTRACTS AND THE POLITICAL ECONOMY OF THE CORPORATE FIRM

The nexus of contracts assertion has a political aspect. The assertion matches the firm's economic substance with individual actors and their respective contracts and classifies the firm's state created components as fictions. The assertion thereby suggests limits on the state's legitimate role in the corporate firm's life.

This Part critically appraises this political component. First, it juxtaposes politics of the new economic theory with the wider range of current theory respecting the relations of the corporation and the state. This exercise shows that the new economic theorists have misstated materially the political issue underlying corporate law. They frame the issue as an absolute choice between the firm as a contract and the firm as a concession of sovereign authority. In fact, concession concepts are outmoded. More flexible, and enduring concepts inform contemporary jurisprudence of an anti-managerial and proregulatory disposition. The new theorists' picture of absolute political rights and wrongs dissolves upon restating the issue in terms of the public or private heuristic long prevalent in theoretical discourse of the political status of the firm. In the "public-private" framework, political questions become matters of degree resolved according to variant political dispositions of different observers.

Second, the discussion draws on corporate doctrine for an alternative approach to the politics of corporate law. The theories

106 *See* Knauss, *Corporate Governance—A Moving Target*, 79 MICH. L. REV. 478, 490, 496-99 (1981) (association of intense fiduciary duties with entity notions).

jockey against each other to advance their respective state or individual perspectives. Corporate doctrine, in contrast, moves more flexibly. It declares a limit on freedom of contract within corporations. Beyond that, it incorporates an open-ended view of state-corporate relations, facilitating an ongoing political accommodation between the collective interests manifested by the state and the individual interests of contracting parties.

A. Contract or Concession

1. *The Nexus of Contracts versus Concession Theory*

Commentary grounded in the nexus of contracts concept declares "contract or concession" to be the political issue regarding the theory of the firm.[107] It asserts that advocates of government regulation subscribe to a concession theory of the corporation's origin[108] and then draws on the nexus of contracts to rebut concession theory.

This commentary renders concession theory as follows: The corporation is a creature of the state. The state gives the corporation life and concedes to it the special privileges of entity status, perpetual existence, and limited liability.[109] In exchange, corporate actors owe services to the public good. The state must regulate corporations to enforce this obligation to reciprocate. Concession theory appears together with entity conceptions of the corporation,[110] and with organicist conceptions of community interests.[111]

The nexus of contracts assertion rebuts this picture of concession theory. The contractual firm comprises voluntarily associating sovereign individuals. They enjoy no special state privilege. Instead, they exercise their individual right to contract. The contractual corporation pursues no public purpose dictated by virtue of its creation, it pursues the private purposes of contracting parties.[112] Given a firm entity reduced to a contentless reference point, nothing of substance remains for the state to add by concession to these contracts.

This neat argument wins some points, but it fails to win any points worth making. No one advocates the theory it rebuts. A half-

---

107 The "debate" is mostly a figment of the imagination of Robert Hessen. *See infra* notes 108-12 and accompanying text.

108 *See* R. HESSEN, IN DEFENSE OF THE CORPORATION 3-33 (1979); Hessen, *A New Concept of Corporations: A Contractual and Private Property Model*, 30 HASTINGS L.J. 1327, 1327-28 (1979); Karmel, *The Independent Corporate Board: A Means to What End?*, 52 GEO. WASH. L. REV. 534, 535 (1984).

109 Hessen, *supra* note 108, at 1327, 1330.

110 Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 933 (1984).

111 *Id.* at 933-34.

112 *Id.* at 933-34.

century has elapsed since advocates of government regulation of corporations emphasized concession theory. Strangely, its recent resurrection as a foil for the new economic theory has passed into the discourse without criticism.[113] No one, however, seems to step forward to join the debate actively on the concession side. Meanwhile, the unchallenged presence of this one-sided argument obscures the new economic theory's political vulnerabilities. The following discussion clarifies the place of concession theory by outlining its history and showing its disappearance as a focal point of American corporate law discourse.

2. *The Historical Decline of Concession Theory*

The new economic theorists correctly recognize that the basic doctrinal assertion of concession theory is that corporations must derive positive authority from the state.[114] Sovereigns have asserted this requirement in different guises since Roman times,[115] in order to suppress potential rival agglomerations of power.[116] Significantly, no sovereign in the English speaking world has asserted concession theory with complete success for several centuries. From the sixteenth until the eighteenth century, the British government maintained that only the state could create an artificial person. But the lawyers of the time, like today's new economic theorists, resisted departures from the scheme of natural persons in private dealings and advanced an opposing contractual conception of the firm. They circumvented concession doctrine by devising structures for the conduct of business affairs, such as the trust and the joint stock company,[117] that worked without sovereign participation.[118]

In the United States, concession theory enjoyed vitality during the first half of the nineteenth century. This was the special charter

---

113 *See, e.g.*, M. DAN-COHEN, *supra* note 2, at 200; Fischel, *Corporate Governance*, *supra* note 5, at 1273 n.44; Karmel, *supra* note 106, at 535 n.5; Romano, *supra* note 108, at 933-35; *cf.* Frug, *supra* note 23, at 1305-06 n.82, 1307 n.90 (correctly noting that Hessen revives a nineteenth century perspective).

114 *See* Dewey, *supra* note 73, at 666; Vinogradoff, *supra* note 1, at 600-01.

115 R. SAVIGNY, JURAL RELATIONS § 88 (W. Rattigan trans. 1888); R. SOHM, THE INSTITUTES § 38 (J. Ledlie trans. 1940).

116 Dewey, *supra* note 73, at 666; Vinogradoff, *supra* note 1, at 600-01.

117 *See* Jacobson, *The Private Use of Public Authority: Sovereignty and Associations in the Common Law*, 29 BUFFALO L. REV. 599, 644-60 (1980). Parliament tried to put a stop to the joint-stock company with the Bubble Act of 1720 which forbade the transfer of shares in joint stock companies. *See id.* at 662.

118 British lawyers enjoyed such success that by 1800 partnerships and joint stock companies were as much utilized as vehicles for the raising of capital as specially chartered corporations. During the eighteeth century, the British parliament only chartered some half dozen corporations for manufacturing. *See* Handlin & Handlin, *Origins of the American Business Corporation*, in PUBLIC POLICY AND THE MODERN CORPORATION 5-6 (D. Grunewald & H. Bass eds. 1966).

phase of American corporate history, during which concession theory accurately described the practice of corporate creation. It circulated in tandem with the "legal fiction" conception of the nature of the firm;[119] the early nineteenth century corporation was an entity that was a state-created reification. But public law premises of corporateness failed to achieve absolute adherence even during this period. Contractual notions of corporateness also circulated, as the most famous corporate law case of the time, *Dartmouth College v. Woodward*[120] demonstrates.

Concession theory lost its vitality as general incorporation laws proliferated. Once equal and substantially free access to the corporate form became the norm,[121] the notion of "concession" no longer described the practice of incorporation. The doctrine declined gradually; the state continued to figure into corporate creation, and the doctrine continued to appear in law books.[122]

By the time the dispute between realists and anti-realists was resolved during the late 1920s, the constitutive imagery of concession theory no longer made practical sense. The only corporate doctrine supporting concession theory was the requirement of filing with the state. To twentieth century observers this was a technicality. States incorporated businesses as a ministerial matter; they did

---

119 *See* Dewey, *supra* note 73, at 667-68; Vinogradoff, *supra* note 1, at 600.

120 17 U.S. (4 Wheat.) 518, 636 (1819). For discussion of this case's place in the history of theory of the firm, see Note, *The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441, 1447-55 (1987).

121 *See* Horwitz, *supra* note 1, at 181, 184; Horwitz, *The History of the Public/Private Distinction*, 130 U. PA. L. REV. 1423, 1425 (1982) [hereinafter Horwitz, *Public/Private*].

122 With no sovereign actively asserting it in accordance with its original purpose, concession theory fell into manipulating hands in the complex of late nineteenth century corporate law discussions. From one perspective, concession theory supported expanded management power. If the corporate form was a concession of authority, now invested by means of the ministerial act of state incorporation under the general incorporation statutes, then the state conceded quite a bit of authority. Dewey, *supra* note 73, at 667-68. Because the corporation was only a "legal fiction," its individual interest holders had cognizable rights available for simultaneous assertion against government regulation from outside of business corporation law. Concession theory also figured into the debate between realists and anti-realists over the nature of the firm. Here concession theory was turned against management by anti-managerialist individualists. Viewed in the abstract, a concession theory of corporate origin opposes both the anti-realists' contractual conception and realists' natural entity conception. Unlike concession theory, both of these approaches advance the notion that the corporation is a normal and natural mode of doing business rather than a special privilege. The managerial interests found realism the most congenial alternative. As masters of the real entities they stood to gain to the extent that the realist theory produced rights for corporate persons. Individualists uncomfortable with managerial bureaucratic power-centers countered by embracing the old concession and artificial entity doctrines. While entailing something less than a regime of absolute free contract, these doctrines at least shared the individualist methodological premise that the individual is the starting point of legal and political theory. *See* Horwitz, *supra* note 1, at 179-83. Compounding the irony, anti-individualist socialists joined with managerialists in embracing realism.

not "breathe life" into them. As Berle explained, were the law to decree that the corporations no longer existed, they would carry on anyway.[123] Incorporating states no longer endowed businesses with sovereignty.[124] In practice, corporations operated by means of contract and agency relationships. Certainly management hierarchies exercised unilateral power, but state action was not involved. Although reified rather than real to twentieth century taste, the corporation no longer appeared the state-created "legal fiction" of the early nineteenth century. The observers looked at the practice and traced the reification to the firm's human participants.[125] Twentieth century corporate doctrine reflects these underlying conceptions.[126]

B. The Firm According to Mid-Twentieth Century Anti-Managerialists: The Public Product of Sovereign Coercion

1. *The Public-Private Distinction and the Management Corporation*

Discussions of sovereign involvement in corporate life continued after concession theory disappeared. These discussions centered on theories about the public or private nature of institutions. These theories achieved prominence in American legal thinking in the nineteenth century.[127] They manifest a liberal individualist political outlook. This perspective exalts neutrality with respect to individual visions of the good, maximum autonomy for each individual, and strict limitations on social obligations to achieve the minimum necessary for social cooperation.[128] The law serves the ideal

---

123 A. BERLE, *supra* note 20, at 18.

124 *See* 1 A. DEWING, *supra* note 81, at 11 (realistic critique of the components of concession doctrine). Dewing offers two broader theoretical justifications for concession doctrine. First, the sovereign articulates the common purposes of the corporation's constituent parties. *Id.* This justification, of course, was as anachronistic as the doctrine. The state had withdrawn from the business of contributing concepts to governing corporate documents with the spread of general incorporation. Second, the state exercises final control in all relationships of its inhabitants, *id.* at 12, but this serves less as a justification for concession doctrine than as the theoretical impetus behind the asssertion that the corporation is "public" rather than "private." *See infra* text accompanying notes 130-41.

125 *See supra* text accompanying note 112.

126 As an example, consider the post-war proliferation of contractual modifications of the structures of close corporations. *See generally* O'Neal, *Molding the Corporate Form to Particular Business Situations: Optional Charter Clauses*, 10 VAND. L. REV. 1 (1956). *See also* Bratton, Book Review, 1985 DUKE L.J. 237, 255-59 (reviewing R. HAMILTON, CORPORATION FINANCE: CASES AND MATERIALS (1984)).

127 Horwitz, *Public/Private*, *supra* note 121, at 1423.

128 *See* Rosenfeld, *Contract and Justice: The Relation Between Classical Contract Law and Social Contract Theory*, 70 IOWA L. REV. 769, 772, 794-95 (1985). These values lead liberal individualists to seek limitations on state power. One principal theoretical means to this end is to employ the natural rights idea first elaborated in the seventeenth century. *See* Horwitz, *Public/Private*, *supra* note 121, at 1423.

by providing rights to protect private matters.

Corporate doctrine took on a private cast by the turn of the century. This shift brought the practical effect of endowing corporate managers with insulation from government oversight under the business judgment principle. Anti-managerialists challenged this protected status on public-private grounds. The commentary began with Berle and Means and intensified after the Second World War.[129]

Post war anti-managerialists argued that management corporations—termed "public corporations"—had a public character that justifies regulation. The argument appears in both extreme and moderate versions. In the extreme version corporate law privatized the firm between the mid-nineteenth century and the mid-twentieth century.[130] But the received, private picture mistakenly rests on doctrinally-based conceptions of private property. Shifting eyes away from doctrine and to a functional view, a public entity appears along with the power, impact, and control of corporations. Corporations, in substance, amount to "private governments."[131] Furthermore, proof of public character illustrates the "need" for accountability. Democratic models from political science provide bases for reform.[132] This presentation acknowledges concession theory but relegates it to a role subordinate to corporate "publicness"; it figures in only as a favorable historical antecedent.[133] More

---

129 The "public" theme figured into doctrinal fairness jurisprudence as well as policy debates. *See* Stone, *Corporate Vices and Corporate Virtues: Do Public/Private Distinctions Matter?*, 130 U. PA. L. REV. 1441, 1449, 1480 (1982). A public model of corporations implies strict scrutiny of the behavior of corporate managers in matters affecting the interests of investors. Corporate doctrine, however, follows the trust model in name only. In practice, it leaves substantial room for self-interested conduct by corporate managers.

130 *See* Dahl, *Governing the Giant Corporation*, in CORPORATE POWER IN AMERICA 12 (R. Nader & M. Green eds. 1972).

131 *See* R. NADER, J. SELIGMAN & M. GREEN, *supra* note 9, at 1, 7; Dahl, *supra* note 130, at 2; Friedmann, *Corporate Power, Government by Private Groups, and the Law*, 57 COLUM. L. REV. 155, 176 (1957); Latham, *supra* note 24, at 220.

Observers sympathetic with the new economic theory also confirm that the "public or private" question is the leading contemporary corporate law issue. *See* Winter, *The Development of the Law of Corporate Governance*, 9 DEL. J. CORP. L. 524, 525-26 (1984).

132 Since they perceived the firm as public and political, they applied current political theories respecting government to the firm. The analytical framework of interest group pluralism prevalent during the post-war period came to bear on matters of corporate governance policy. *Cf.* Horwitz, *Public/Private*, *supra* note 121, at 1427.

133 The anti-managerialists supported their public and political assertions with a historical story:

In the beginning, in the early nineteenth century, corporate formation was a matter of special chartering by state legislatures. In those days, legal doctrine treated corporate power legally as a concession of sovereignty. Thus, before 1830 corporations were "chips off the block of sovereignty," R. NADER, J. SELIGMAN & M. GREEN, *supra* note 9, at 33-37, and bodies created to "obtain public ends." *Id.* at 62-63; *see also* Latham, *supra*

moderate commentators restructure the argument.[134] Corporations remain on the private side of the line, but represent private law creatures in which the public has an interest arising from functional considerations. But these functional considerations have a politically neutral cast, such as protecting reasonable expectations and maximizing efficiency.[135] When the functional considerations combine so as to legitimate government intervention in the case of "public" corporations, the certificate of incorporation has "constitutional" as well as "contractual" implications.[136] Again concession theory figures in only as an historical phenomenon.[137]

2. *Sovereign Coercion Theory*

Broader theories of sovereign involvement in private contract inform the anti-managerial arguments. These theories began with legal realists like Morris Cohen[138] and Robert Hale,[139] and survive in the post-realist writings of H.L.A. Hart[140] and Hans Kelsen.[141] These theories conjoin the government and the contract through sovereign enforcement of private contracts. The private market represents an artifact of "public violence."[142] Contractual arrangements always entail sovereign commands and, therefore, are never fully private. Stating the point more expansively, the necessity of public enforcement makes contract a "delegation" of "coercive

---

note 24, at 222-23. Then, during the course of the nineteenth century, special chartering waned and disappeared as a means to the end of promoting equal access to the corporate form. Unfortunately, dark forces took control around the turn of the century. States ceded legal control to management groups in exchange for tax dollars. These bad faith transactions permitted corporations to escape their historical duty to serve public ends, even as corporations continued to derive their constituent and legitimating power from the state and to share its sovereignty. *See* Latham, *supra*, at 223; *see generally* Jacobson, *supra* note 117.

134 The anti-managerialists also differed on matters of detail. They differed on the selection of the interest groups entitled to participate in corporate governance. Technical questions also came up about means of achieving representation. They held different opinions about the degree of control on management discretion actually exercized by market forces and other institutional constraints, and made accordingly different recommendations of necessary degrees of legal control of management. *See* A. BERLE, *supra* note 20, at 58-60.

135 *See* Eisenberg, *supra* note 3, at 588.

136 Ratner, *Corporations and the Constitution*, 15 U.S.F. L. REV. 11, 21, 27 (1980-81); *see also* M. EISENBERG, *supra* note 82, at 1.

137 Ratner, *supra* note 136, at 19-20; Eisenberg, *supra* note 3, at 588.

138 *See* M. COHEN, PROPERTY AND SOVEREIGNTY AND THE BASES OF CONTRACT LAW AND THE SOCIAL ORDER 41, 69, 102 (1938).

139 *See* Hale, *Coercion and Distribution in a Supposedly Non-Coercive State*, 38 POL. SCI. Q. 470 (1923).

140 H.L.A. HART, THE CONCEPT OF LAW 77-96 (1961).

141 H. KELSEN, PURE THEORY OF LAW §§ 36-40 (1967).

142 *See* Kennedy, *The Stages of the Decline of the Public/Private Distinction*, 130 U. PA. L. REV. 1349, 1352 (1982) (reviewing Hale, *supra* note 139).

power" to individuals.[143] Contracting becomes "legislation"[144]—a public event. As the public coloration of the particular contract becomes more intense, the argument that the delegated coercive power should be publicly accountable becomes more persuasive.[145] The management corporation represents, of course, the most colorably public of all private contracts.

Extreme statements of this theory of sovereignty in contract resemble concession theory by asserting that the sovereign delegates in theory and the delegation justifies sovereign intervention in business relationships in practice. But concession theory and sovereign coercion theory are materially different. Concession theory employs a crude and absolute concept of delegation. The delegation transforms the business arrangement; the transformed business owes all of its many essential parts to the sovereign. Sovereign coercion theory recognizes a more complex reality and settles for considerably less sovereign involvement. Although every contractual relationship threatens sovereign coercion, this fact results only in a diminution of the private arrangement's claim to voluntariness. It denies neither freedom of contract nor the obviously individual aspects of contractual arrangements categorically.

Sovereign coercion theory pleases political moderates by allowing them to identify situations of meaningful voluntariness requiring no reform. Within the theory, they need only look at the contractual relationship in practice and ascertain whether the actors involved believe it to be voluntary and remain largely unconscious of or unconcerned with the sovereign coercion entailed. Actors in many situations partake of this largely unalienated consciousness. Concession theory, once applied to a contractual relationship, does not anticipate these practical moments of free contract. This results in both its general implausibility and its attractiveness to enthusiasts of the new economic theory looking for easy anti-statist theoretical victories. The sovereign coercion assertion, in contrast, does not admit of flat refutation. The state's presence is undeniable.

C. The Firm According to New Economic Theorists: The Private Product of Consenting Actors

1. *The Private Firm*

The new economic theory brings unmitigated liberal individualism back to corporate legal theory. The nexus of contracts assertion

143 M. COHEN, *supra* note 138, at 41, 69, 102; *see* Horwitz, *Public/Private, supra* note 121, at 1426.

144 Jacobson, *supra* note 117, at 605-06.

145 Kennedy, *supra* note 142, at 1351-52.

simultaneously reinforces the public-private distinction and pulls the corporation to the private side. It counters decades of anti-managerialist writing, inviting us to wring the tort out of our concept of corporate law and to reconstruct the concept on a consensual basis.

Liberal individualism appears boldly in the neoclassicists' picture of the firm. Their contentless nexus of contracts formed by rational economic actors approximates Hayek's "spontaneous order."[146] In Hayek's political vision, individuals pursuing their own ends effect successful social orders. Institutions function without deliberate design by higher powers and sovereigns need not impose directives on individuals. The neoclassicists bring this vision of social order to the management corporation, carrying the concept even further than Hayek did.[147] Their contractual firm is spontaneous, arising from the contracts of free economic actors rather than through the planning of hierarchically placed superiors. The actors pursue their own interests within each discrete contractual arrangement. Yet a larger, integrally functioning mechanism emerges from the atomistic conduct. The necessary cohesion springs from the resourcefulness and evaluative capacity of the constantly contracting participants.[148] No higher authority or intelligence establishes a "purpose" or imposes duties entailing subordination of individual purposes.

The notion of spontaneous order is new to the theory of the firm. More traditional firm contractualism perceives the parties as the source of energy, but also recognizes the constitutive function of planning. For example, the institutional new economic theorists recognize structure, hierarchy, and planning but they erect it on a contractual constitution.[149] Since the structures are means to achieve cost reduction, the state has no formative role to play; it possesses no more expertise at cost reduction than the contracting parties themselves.[150] Thus the firm is "private."

2. *The Actors' Consent*

The new economic theory implicitly rebuts sovereign coercion theory. Sovereign enforcement manifestly exists, but sovereign en-

---

146 *See* 1 F. HAYEK, LAW, LEGISLATION AND LIBERTY: RULES AND ORDER 2, 11, 289 (1973). To Hayek, the mere existence of an institution provides evidence that it was created to achieve human purposes.

147 Hayek views corporations as "organizations"—institutions distinct from spontaneous orders. *See id.*

148 *See* Meckling, *supra* note 38, at 550 (contrasting the vision of man as a rational economic actor with that of economists who advocate planning).

149 *See supra* notes 59-68 and accompanying text.

150 *See* Williamson, *supra* note 68, at 361.

forcement occurs legitimately only when people want enforcement.[151] So long as the contracting parties consent, sovereign enforcement of contracts presents no theoretical problem. The economic actors of the new economic theory—both the neoclassical and the institutional casts—make all requisite consents.

Professor Anthony Kronman, writing in the institutionalist vein,[152] advances the consent point several steps further and equates all techniques of contract enforcement, private and sovereign. They are similar in kind because the process of cost reduction generates them all. Since state mechanisms provide the lowest cost enforcement mechanisms in many situations, state intervention is justifiable. If the state did not exist, contracting parties presumably would invent it in their effort to reduce lower costs.[153] This view of the state as a cost reducing agency equates the firm and the state, according them a common constitutional essence. The legitimacy of both rests on contract; the "governed" want more wealth, and their rationality allows the assumption of their consent to cost reductive institutions.

Oddly, this institutionalist cost-reductive conception of the state resembles the concession theory of centuries ago. Under both, no fundamental differences exist between the nature of the legitimate corporation and of the legitimate state. The institutionalist theory differs, of course, in locating the analysis in private rather than public quarters, and in contract rather than positive law.

3. *Summary*

Institutionalists and neoclassicists employ different political strategies to a similar end. Neoclassicists refashion the firm in bold outlines to anchor its immovable location on the private side of the public-private divide. In so doing they reconstruct the firm to eliminate the phenomena on which anti-managerialists rely in calling the firm public. The institutionalists admit the existence of many "public" phenomena. They advance the case for privatization, however, by refashioning the public-private divide. Less formalist than the neoclassicists, they present a gray area of mixed elements, reconstructing our thinking so as to highlight the contractual and the private in what otherwise appears public. Carried to its ultimate conclusion, their perspective makes cost-reductive contractualism the essence of all sovereign and individual interaction respecting

---

151 *See* Jacobson, *supra* note 117, at 612-13 (describing sovereignty as merely a "pretext to suppress and control the energy of persons").

152 *See* Kronman, *supra* note 103, at 28.

153 *Id.*

business relationships.[154]

D. Political Theories of the Firm and Corporate Doctrine

1. *Public and Private Conjoined*

Theories that separate the world into public and private elements offer two plausible and instructive pictures. One sees the world as a complex of contracts; the other sees it as delegated sovereign authority. Neither depiction, however, is wholly accurate. Public and private elements simultaneously pervade the lives of most persons and institutions. Freedom of contract is freedom to ask the sovereign to confer power constraining your freedom on another party. At the same time, contract cannot exist where sovereign control is complete; it requires some minimum of individual autonomy.[155] In theory, market and political environments may be distinguished,[156] but in practice they intermix. Just as one may view markets as erections upon sovereign coercive power, so one may view government bureaucracies as operating on contractual norms.[157] An individualist observer may see recent history in terms of government imposing public duties on private parties.[158] At the same time, a collectivist may see the same history as a fall from the belief in a distinctively public realm standing above private self interest.[159] Yet both make legitimate observations.[160]

---

154 This cost-reductive contractualism is utilitarian in nature. Under it, wealth creation is consonant with individual freedom because people want it and institutions are justified to the extent that they increase wealth. But one wonders how institutionalists would respond to a real world case in which people did not wish to take advantage of a cost-reductive institution. Perhaps they believe that such cases do not exist and that human freedom and cost reduction are entirely harmonious in practice.

The contractualism of the neoclassicists has a more deontological character. They most likely believe human freedom to be worth protecting for its own sake. Of course they also believe that rational economic actors reach efficient results if left alone. But one wonders which they would choose in cases where wealth is better produced by collective endeavor than by self-interested pursuit of individual ends. One supects that they would escape this deontological-utilitarian tension by deconstructing the proferred collective endeavor and reconstructing it in terms of individual pursuits.

155 *See* Macneil, *supra* note 89, at 368-69.

156 *See* Stone, *supra* note 129, at 1445-56.

157 Macneil identifies contractual relationships within as well as outside of government. *See, e.g.*, Macneil, *Bureaucracy, Liberalism and Community—American Style*, 79 Nw. U.L. REV. 900, 934-39 (1984-85) (describing bureaucracies as relational communities).

158 *See* 1 F.HAYEK, *supra* note 146, at 132.

159 *See* Horwitz, *Public/Private*, *supra* note 121, at 1427. Horwitz sees interest-group pluralism as a privitization of public matters.

160 Viewed from a metapolitical level, interest group pluralists arguing that management corporations are public institutions occupy substantial common ground with individualists arguing that they are private institutions. Both sides hold a suspicion of organicist thinking—a point of view under which the interests of collectivities, absolutely conceived, may be deemed paramount. Romano, *supra* note 110, at 935 (organicist

Corporate doctrine instantiates this complex reality. Concession theory, strongly asserted, as a result never achieved quiet enjoyment as determinative doctrine. Instead, corporate doctrine recognized that autonomous individuals generate the determinative energies in business arrangements and reach for the state's aid only to make their arrangements stick.[161] Corporate doctrine, however, has never looked solely to contract either to constitute or to explain business organizations. Again practice constrains the theory; state involvement remain visible to all.

Theoretical tugs of war across the public-private dividing line have limited value. At some point, political discussions based on characterizations of the corporation derived *ex ante* from economic or political theories retain only a tenuous bearing on the corporation as a practical legal institution. Positive learning about corporations ceases and instruction elucidates only the observers' political values and aspirations. Corporate legal discussion should apply theories of public and private gently, to highlight matters of degree. The practical tie can gain strength by *ex post* inspection of corporate doctrine for its ontological and political contents.

2. *Corporate Doctrine as Corporate Political Theory*

Corporate doctrine accommodates both individual and sovereign roles of firms with much less apparent strain than the theoretical discourse suggests. The coexistence of public and private elements in the doctrine teaches a lesson about the political values operating in corporate regulation. For example, the concession notion survives in corporate doctrine[162] even though it disappeared from theory. Corporations still are created only upon application to states. This formalism persists even though no one seriously accepts the notion that the state "breathes life" into the corporation and even though corporate lawyers assume that corporations are reifications stemming from the shared consciousness of individuals.

No commentary of the new economic theory, however, challenges this last incident of concession theory in corporate doctrine. The commentators dismiss corporate creation through state filing as

---

thinking has attracted few adherents in American corporate governance literature). Both sides seek a politics structured around respect for the interests of smaller social units—the interest group in one case, and the individual in the other. Both sides are nonhierarchically disposed, albeit in different degrees. *See* Frug, *supra* note 23, at 1356-59, 1374. Both sides pursue a vision of freedom that counsels restraint of the power of bureaucracies.

161 *See generally* Jacobson, *supra* note 117.

162 *See* 1 H. OLECK, MODERN CORPORATION LAW 4, 21 (1958) (example of post-war doctrinal conceptions).

ministerial and de minimis.[163] In the alternative, they explain filing and other mandatory provisions of state corporation law as cost saving ways of giving economic actors what they want.[164] Such explanations carry weight, of course, but they incompletely depict corporate doctrine's political operations.

The shortcomings of cost reduction as an explanation for state creation of corporations become apparent upon comparing the different formalities attending the contractual creation of substantively similar business arrangements. Complex joint ventures and other organizations arise without state filing as do large issues of long term debt securities. Debt securities are long-term corporate investment arrangements between management groups and outsiders. The same actors, when dealing in equity securities, avail themselves of the positive law terms which the new economic theorists characterize as "off the rack" contract terms. The debt securities carry contractually-imposed governance structures dealing with the same subject matter as state corporate law.[165] But debt governance structures emerge without *ex ante* state participation.

An act of consent may be implied to explain the state's absence from the creation of "off the rack" terms respecting debt securities—the parties have decided to keep the state out. Their own standardized contracts keep the cost of bond contract terms down, so the state is unnecessary.[166] It follows that if the parties keep governance costs down by writing their own debt contracts, corporate law should evolve similarly to treat the creation of relationships between equity holders and corporate entities. The technical changes are accomplished easily; upon this change in the law, any skilled corporate law technician could devise a contractual governance system for a given corporation. Investors would contract with managers or contract *inter se* to form corporations under standard contracts containing provisions much like present state corporation laws, or

---

163 *See* Hessen, *supra* note 108, at 1336-38.

164 *See, e.g.*, Easterbrook & Fischel, *Voting*, *supra* note 5, at 401 (voting rules of state corporate law explained as means of economizing on costs of contracting); Easterbrook & Fischel, *Corporate Control Transactions*, *supra* note 5, at 702 (state corporate law fiduciary duties as cost-saving approximations of what the parties would bargain for themselves).

165 Among other things, trust indentures have procedural provisions governing securityholder voting; they state groundrules for litigation by securityholders; they establish securityholder rights to inspect books and records; they forbid managerial self-dealing; and they restrict management discretion. *See generally* AMERICAN BAR FOUNDATION, CORPORATE DEBT FINANCING PROJECT, COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS 1965, MODEL DEBENTURE INDENTURE PROVISIONS ALL REGISTERED ISSUES, 1967 AND CERTAIN NEGOTIABLE PROVISIONS (1971); *Model Simplied Indenture*, 38 BUS. LAW. 741 (1983).

166 *See* Bratton, *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667, 680-88 (discussing the efficiency of the standard form bond contract).

significantly, such different provisions as the actors deem appropriate. Choice of law clauses would bring the benefits of the law and of decisionmaking of sympathetic jurisdictions. On this model, corporate contract formation works like other contract formation. It requires no *ex ante* obeiscence to some sovereign. Concession theory finally disappears from the law.

Corporations as we know them could be created easily by conventional contract. If the corporation really "is" contract, as the new economic theory tells us, then the last doctrinal vestiges of state interference should have withered away by now, along with the superannuated political theories that prompted their invention in the first place. But the sovereign presence persists. Traces of concession theory survive in the mundane corporate formalities mandated in law. Whether or not most parties want these formalities in most situations, they remain as a practical matter, restrictions on freedom of contract. They foreclose organizational and governmental alternatives ordinarily available to contracting parties, and in a dynamic economic environment ordinarily chosen by them.

This sovereign presence, mediated by corporate lawyers, limits and conditions the freedom of contract in corporate relationships. The contracting capacity of corporate actor suffers little impairment as a practical matter since they can comply with corporate formalities at low cost and since corporate formalities rarely obstruct attainment of significant economic objectives. But the state clearly reserves the right to rewrite the ground rules and to constrain the freedom of corporate actors.[167] Even as corporate law lets the participants proceed, it in effect cautions them that they may act at will only if on good behavior.[168] Corporate law facilitates and legitimates private behavior, but with a reservoir of suspicion and a threat of constraint.

One function of corporate law, then, is symbolic: It reminds actors that corporate contracting rights have a lessor magnitude than the contracting rights attending most other business relationships. This function explains and justifies corporate law's survival as a positive law phenomenon in a world where other complex business relationships proceed under the private, general law of contracts.[169]

---

167 This appears to be the message of our greatest corporate law case, Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819), with its simultaneous provision for a contractual corporation and the constitutional reservation of sovereign right to change the terms governing the corporate contract.

168 The enduring possibility of state dissolution by means of a *quo warranto* proceeding makes this threat explicit. *See, e.g.*, DEL. CODE ANN. tit. 8, § 124(3) (1983).

169 Corporate law has more than one function, of course. It also influences the contracting process by stating the terms that govern absent contrary agreement. Since con-

Even as corporate law imposes a positive law framework, however, it tends to leave corporate actors self-regulated. Corporate law decisionmakers accept the doctrine's mixed basis and hesitate to question the balance it strikes between individual, contractual initiative, and positive law restraint. Indeed, the theory of the firm rarely influences corporate law decisionmaking, even though such decisionmaking routinely formulates corporate law in terms of both corporate entities and separate relationships, and in terms of both "public" corporations and "private" contract rights. Conveniently, the mixed doctrine provides *ad hoc* theoretical justification for a range of dispositions, from sovereign intervention to individual self-responsibility. The doctrinal discourse focuses on practical questions and answers, considered situationally. The sudden assertion of an absolute proposition that the corporation is contract will not disturb this pattern, even though it may influence the balance struck in particular situations.

IV
THE NEXUS OF CONTRACTS, CONTRACT THEORY AND THE CORPORATE FIRM

Lawyers and economists employ different, although related, notions of contract. The lawyer understands contract as a business or commercial exchange: Classical contract doctrine and the lawyer's mental images of the documentation of particular transactions circumscribe this conception. The economist thinks more broadly in terms of voluntary exchanges and other relations among free agents. For the economist, any particular transaction will be a theoretical construct, devised outside history through the manipulation of hypothetical economic actors.

Legal scholars draw on both conceptions of contract and on others besides. They associate with the concept of contract a range of different assertions, both positive and normative, from theory and from practice, and perhaps varying the contents of the assertions in different contexts. Through Macneil's capacious relational theory academic contract now extends from the narrow confines of classical contract doctrine to accommodate virtually all relationships among the actors in a modern, heavily bureaucratized, and exhaustively governed society.[170]

This multiplicity of contract concepts has made difficult the reception of the nexus of contracts corporation into legal theory.

---

trary agreement is reached only at additional cost, the law inevitably bears on the contract terms.

170 *See* I. MACNEIL, *supra* note 87; Macneil, *supra* note 89; Macneil, *supra* note 157; Macneil, *Relational Contract: What We Do and Do Not Know*, 1985 WIS. L. REV. 483.

When the new economic theory first appeared, most corporate legal academics shared the legal practitioner's understanding of contract. Corporate scholarship drew doctrinal distinctions between corporate and contract law,[171] displaying little consciousness of the fundamental place contract, more broadly conceived, always held in corporate legal theory. The nexus of contracts assertion introduced a different, very particular concept of contract. Prior corporate literature offered no basis for informed and critical evaluation of this unfamiliar economic concept of contract. Yet no commentary identifying this concept's distinguishing characteristics accompanied its introduction. Interdisciplinary exercises, mismanaged in this way, carry a danger of communicative failure and, worse, an opportunity for strategic obfuscation of meaning. Not surprisingly, confusion resulted.

The nexus of contracts assertion entered popular corporate law discourse with a somewhat mystifying aspect. It made sense. Its unspoken individualist underpinnings resonated and its advocates employed analytical tools of an undoubtedly contractual character. But their analyses, while called "contractual," did not resemble corporate law applications of the principles of the latest contracts *Restatement.*[172] Sometimes, these applications of "contract" to corporate law questions brought results flowing from neither prevailing corporate doctrine nor prevailing contract doctrine.[173]

Evaluating the new economic theory as a corporate law tool requires an initial understanding of the meaning of the "contract" in the "nexus of contracts." This part of this article seeks to provide the necessary explication. Its first subpart sets out the range of approaches to contract that appear in contemporary legal theory. It identifies the elements that distinguish these theories—the stress of

---

171 *See* Bratton, *supra* note 166, at 730-35 (black letter law distinguishing corporate duties from contract duties); M. EISENBERG, *supra* note 82, at 9-10; 1 F. O'NEAL & R. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 5.05 (1987) (contrasting corporate law model with close corporation arrangements based on bargains among the parties).

172 RESTATEMENT (SECOND) OF CONTRACTS (1981).

Recent work begins to clear up this confusion by selectively drawing on contract doctrine instead of economic theory in elaborating contractual modifications of corporate law. Coffee offers a "web of contracts" counter, inspired by the neoclassical contract doctrine of Corbin and the Restatement (Second). *See* Coffee, *supra* note 6, at 924-25; Coffee, *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups*, 1988 WIS. L. REV. 435; *see generally* Masten, *supra* note 94.

173 Easterbrook and Fischel suggest, for example, a rule of managerial passivity in the face of a take-over bid. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1174-82 (1981); *see also* Scott, *supra* note 5, at 935-37 (suggesting abolition of the corporate law duty of care on the ground that market monitoring mechanisms are adequate); Wolfson, *supra* note 5, at 975-78, 980-82 (suggesting fiduciary scrutiny of management salaries and the corporate opportunity doctrine are unnecessary).

discrete and relational contracts, the stress of different individual and community values, and the use of differently conceived contracting actors. It draws on these elements of contract theory to describe the corporation and corporate doctrine. It presents the corporation as a complex contract, simultaneously containing discrete and relational elements, and presents corporate doctrine as a mediating device that permits the legal treatment of corporate situations to vary according to varying contract particulars.

The succeeding subparts examine the concepts of power and consent operative in the nexus of contracts concept. This discussion asserts that the new theory's primary contribution is the interpretation of corporate relationships in terms of voluntary participation. It contrasts the different assumptions underlying the hierarchical, managerialist picture and it concludes that, while the new theory isolates consensual and transactional elements in corporate relations, and while the managerialist picture unduly minimizes these elements, the new theory ultimately asks far too much of the concept of consent. In reaching this conclusion, the discussion isolates the narrow base of liberal and utilitarian values that inform the new economic theory and draws on twentieth century contract theory for its critique of consent as a basis for justifying enforcement of contracts.

A. Theories of Contract—Discrete and Relational

1. *The Individual versus the Contract*

Theories of contract embody concepts of human relations. In part, these concepts are the positive results of observation of the behavior patterns of real world contracting actors. But the concepts also contain values. Sometimes the values originate with real world contracting actors, sometimes they originate with the theorist, and sometimes they originate with some wider community. When they originate with the theorist or the community, the values will likely manifest themselves as norms.

Different theories of contract incorporate different visions of the contracting actor. Where the theory casts neoclassical rational economic actors in all the roles, the resulting contracts will be "discrete"[174] or "purposive."[175] These ideal contracts resemble the abstract market transactions of the real world. They are complete, concrete, and delimited and they "presentiate"[176] and quantify all

174 I. MACNEIL, *supra* note 87, at 10-11.

175 M. WEBER, ECONOMY AND SOCIETY 668-81 (G. Roth & C. Wittlich eds. 1968); *see* A. KRONMAN, MAX WEBER 101 (1983).

176 I. MACNEIL, *supra* note 87, at 59-60.

foreseeable matters respecting the relationship. The actors separate their identities from the contract. Since the actors enter completely planned relationships, they in theory bind themselves to the contract and restrict their future choices without impairing their freedom as individuals.[177] Legal scholarship that draws on the neoclassical microeconomic model applies the discrete mode to business relationships. Classical contract doctrine tends to do so as well.

Other theories of contract envision differently constituted actors with cognitive and analytical failings. These actors sometimes fail to presentiate and quantify entire relationships, particularly when relationships endure for long periods of time and depend on contingent events. The theories draw on a wide range of values to formulate principles that explain, facilitate, and justify the survival of these relationships in the face of these difficulties. The actors' initial acts of consent provide a starting point, but time and events sometimes distance the participants from their initial consents. As the scope and effective range of the actors' initial consent narrows with respect to the developing and changing relationship, other values must provide sustenance. The relationship continues on a foundation of reciprocal exchange, but the actors feel bound less by their past actions than by their present state of mutual dependency. Such mutually dependent actors look to values of relational preservation, solidarity, and flexibility to integrate themselves and their individual interests with the terms of the ongoing relationship.

Recognizing these relational elements in contracts raises a political question whether the relationship, and values internal to it, may be privileged over the independence of the individual participants. Assuming individualist values of any intensity, sovereign intervention on behalf of the relationship poses dangers. The literature contains various responses to the problem. Some theories strain to leave the individual dominant and fully respected and, at the same time, recognize both relational contingency and sovereign intervention. They usually interpret creatively the individual's act of consent as the means to this end. The consenting individual in some measure creates and in some measure controls; thereby he bears responsibility for the later dominant relationship.[178] The institutional variant of the new economic theory represents one ver-

177 This description encapsulates Macneil's discussions. *See id.* at 59-64; Macneil, *supra* note 89, at 360-61.

178 Professor Charles Fried interprets the promise expansively. The promise invokes a convention giving another moral ground on which to expect performance. Thus the relationship is based on trust. When the parties' explicit arrangements fail to provide determining rules for the relationship, judges intervene to protect the parties' trusting expectations. Since the contracting actors seek fairness and consent to a fair regime,

sion of this approach.[179]

Under other theories, the relationship may dominate the individual and *ex ante* individual consent need not be drawn on for legitimation. These "communitarian" theories recognize independent value in symbiotic relationships between individuals and between groups and individuals.[180] Most of these theorists refrain from embodying these values in norms manifested in positive law.[181] While not individualists, they share the American aversion to the constraints on freedom imposed within the modern bureaucratic state.

2. *Contract Theory and the Corporate Firm*

The corporate firm raises the same theoretical choices between the individual and the relationship that other contracts raise—choices between discrete and relational conceptions and between individual and community values. Corporate doctrine, in effect, takes positions on these choices. It suggests the possibility that individual interests may be legitimately subordinated to those of a larger firm community and it imposes this treatment as a matter of positive law. Despite this recognition of relational bonds, however, corporate doctrine does not privilege the group over the individual unequivocally. The corporate community is voluntary, and its common goals tend to play limited roles in the lives of its members. The same individualist values supporting the discrete vision of contract inevitably influence corporate relationships, creating tension between these values and utilitarian goals of the group and related group values. Corporate doctrine eases this tension. It mediates disputes between the interests of corporate participants and those of the group. It draws both on values of discrete contract and on relational values of mutual support. It affords a basis on which group interests may dominate individual interests legitimately on a fact specific basis. The legal model of the discrete contract influences corporate doctrine but does not dominate it.

Relational contract theory explains the subordinated position

later sovereign intervention and direction does not violate their individual autonomy. *See* C. FRIED, CONTRACT AS PROMISE 14-17, 83 (1983).

179 *See supra* text accompanying notes 59-86.

180 *See* I. MACNEIL, *supra* note 87; Feinman, *Critical Approaches to Contract Law*, 30 UCLA L. REV. 829 (1983); Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563 (1982) [hereinafter Kennedy, *Paternalism*]; Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976).

181 Macneil accomplishes this by limiting his positive theorizing to values while simultaneously treating the sovereign with critical scrutiny. Critical legal studies adherents draw on the utopian tradition of the Frankfurt School instead.

At least one theorist looks to sovereign imposition of communitarian values. *See* Unger, *The Critical Legal Studies Movement*, 96 HARV. L. REV. 561 (1983).

of discrete contract in corporate legal doctrine. The discrete contract, with its expectations of individual advantage secured by the threat of state enforcement, fails to provide a sufficiently durable foundation for cooperative action. Planning depends on mutual trust, and the law facilitates mutual trust through state created obligations.[182] In the corporate law context, the fiduciary conception usually plays this role.

The new economic theory proposes that we reconceive the firm on a less relational basis than that previously established and manifested in corporate doctrine. The neoclassical variant proposes the more substantial departure. As we have seen, its nexus of contracts consists of discrete contracts among rational economic actors, and the firm springs up as a spontaneous productive order. This conception unequivocally favors individual values. Communitarian norms disappear since they serve neither as instruments for productivity nor as appropriate ethical responses in the market-like world envisioned.

The institutional variant offers a vision of the firm more closely related to traditional corporate doctrine. When confronted with the problem of justifying a complex relationship, however, the institutionalists make the common move among individualist theories of contract. They establish individual dominance by elaborating a structure of consensual participation.

Both variants conflict with the more relational assumptions conventionally held by corporate lawyers. The following discussion addresses these conflicts. It first contrasts the concepts of power operative in the new theory with those operative in corporate doctrine. It then considers concepts of consent.

B. Power

1. *The Managerialist Hierarchy*

The managerialist approach views the firm as hierarchical—a structure of power relationships[183] whose purpose is to organize productive behavior.[184] The power is exercised unilaterally. That is, the superior in the hierarchy has the authority to direct the subordinate's actions or otherwise subject the subordinate to particular effects without the subordinate's consent.[185]

---

182 Gordon, *Macauley, Macneil, and the Discovery of Solidarity and Power in Contract Law*, 1985 WIS. L. REV. 565, 569-70 (describing Macauley and Macneil's relational/discrete contract distinction in the corporate setting).

183 C. LINDBLOM, POLITICS AND MARKETS 21 (1977).

184 Many of course, recognize subsidiary purposes, among them the maximization of returns to the stockholders and the enrichment and empowerment of the managers.

185 Macneil, *supra* note 11, at 1049.

Power relations based on discrete contracts and other market-based relationships have a very different structure. In the unrelated, atomistic situations of the market, economic actors also seek to organize productive behavior. But actors in the market only have the power to abstain from conferring benefits on one another. By effecting exchanges, they forego continued exercise of this power. In other words, instead of creating unilaterally held powers, discrete contracts vitiate unilaterally held powers through consent.[186]

The firm, viewed as an hierarchical structure of unilateral power relationships, stands apart from the market as an entity. The firm experiences market forces because it buys or hires inputs on the market and sells its output on the market. But internally, the firm resembles a little government.[187] This conception pervades modern legal and economic commentary on the firm appearing in works of those with widely divergent political dispositions.[188] Even Hayek, who advances the spontaneous order as a political and social ideal, places the modern corporation in the different category of organizations whose governing principles do not mix freely with those of markets.[189]

Carried over to the scrutiny of management corporations, these assumptions about firm organization raise the basic managerialist point: Corporate organization generates power and management is strategically situated to possess this power. Many dispute the propriety of this corporate power as wielded by management. On one side stands familiar anti-managerial discourse, with its special emphasis on management's power to effect results external to the corporation.[190] This discourse fits into broader critiques of bureaucratic organizations, both corporate and governmental, and of the power they wield.[191] At the other end of the range stand ob-

186 *Id.* at 1036, 1050.

187 C. LINDBLOM, *supra* note 183, at 36-38.

188 *Compare id.* at at 21-22, 33-38, 45-47, *with* O. WILLIAMSON, *supra* note 30, at 25-26 (both describe and distinguish market-based and hierarchical organizations from quite different political points of view). *See* I. MACNEIL, *supra* note 87, at 7-8 (describing bureaucratic economic organizations and showing their exercise of unilateral power); Macneil, *supra* note 157, at 906 (individuals and organizations are ultimately separate; internal boundaries separate the goals of organizations from the goals of individual participants).

189 *See* 1 F. HAYEK, *supra* note 146, at 47-51; 3 F. HAYEK, *supra* note 101, at 80-88. According to Hayek, organizations are constitituted of rules and commands. The rules come from the designing mind of the organizer and set forth organizational structures. They make it possible to make use of knowledge which no one individual possesses as a whole. Commands prevail over rules.

Hayek's spontaneous orders exist subject to conventional rules without the necessity of commands. 1 F. HAYEK, *supra* note 146, at 47-51.

190 *See generally supra* notes 127-37 and accompanying text.

191 *See* Macneil, *supra* note 157; Frug, *supra* note 23.

servers like Hayek. He recognizes that organizational structures produce dangerous powers but finds corporations to be benign organizations as a practical matter and remains unconcerned with their internal and external activities.[192]

Somewhere in the middle stands the moderate anti-managerialism of many post-war corporate legal academics. Berle elaborated the conventional wisdom in the mid-1950s. Management wields power in several arenas: It directs the activities of subordinates; it determines the existence and course of corporate business operations; it determines the markets the corporation supplies; it initiates technical developments; it directs the direction and extent of capital expansion; and, within limits, it participates in the formulation of public opinion.[193] Berle argued that market forces and public opinion in a democratic state substantially constrain this power. Under this widely-held view, corporate law directed its policy-making energies to creating moderately intensified fiduciary principles and market disclosure regulations.[194]

Two new forces, one theoretical and the other practical, disturb this Berlian picture of corporate power relationships. The theoretical challenge comes from the new economic theory. The practical challenge comes from the disruptive effects of the market for corporate control. The following discussion considers only the former.[195]

2. *The Voluntary Corporation of the New Economic Theory*

Consider again the unilateral power relationship that makes an organization hierarchical: A superior tells a subordinate what to do. To the extent that subordinate obeys involuntarily, the relationship impairs his freedom and the superior coerces. Anti-managerial descriptions of the corporation implicitly or explicitly assert that those empowered in the hierarchy coerce others. The new economic theorists differ by emphasizing the voluntary nature of corporate participation.

This is a crucial move: Once corporate relationships are conceived as fully voluntary, a different picture of the corporate hierarchy emerges. Hierarchical power impairs no freedom, even though the superior tells the subordinate what to do. As consent becomes

---

192 Hayek would restrain monopolies. Otherwise corporate power does not worry him. Organizations, he says, wield little power over "those who join to further their own benefit." 3 F. HAYEK, *supra* note 101, at 80-89.

193 *See* A. BERLE, *supra* note 20, at 32-34.

194 The most recent, thorough-going restatement of this view comes from outside of the legal academy. *See* E. HERMAN, CORPORATE CONTROL, CORPORATE POWER (1981). For a condensation, see Herman, *The Limits of the Market as a Discipline in Corporate Governance*, 9 DEL. J. CORP. L. 530, 533-34 (1984).

195 For consideration of the latter see Bratton, *supra* note 3, at 1517-26.

the relationship's core, the model of discrete contract looks more and more appropriate. Fully voluntary participation negates the existence of the superior's unilateral power and, in turn, allows reconstruction of a classic arm's length exchange, but in an apparently hierarchical context.

The seminal articles in the new theoretical canon made this move to voluntariness. The subsequent literature adds little to this basic theoretical paradigm, even as it applies the paradigm more elaborately. Coase[196] first looked inside the firm and asked why the owner of an input would sacrifice his property rights in it to be told what to do by the owner of firm. He answers, of course, that the owner of the input gets value by reducing transaction costs. Although they could eliminate the firm and could price and sell all the factors of production separately, information costs would make the determination of price too expensive. But Coase posited more than an explanation of the firm's existence in terms of transaction cost reduction. He simultaneously introduced a transactional conception of participation in the firm in which the surrendering input holder strikes a deal. Hierarchical power springs from and coexists with the participant's choice.

Alchian and Demsetz, the first to advance the neoclassical variant, succeeded to these points.[197] They constructed a firm not only transactional, but consisting of discrete contracts. The firm, they asserted, lacks power to settle issues by fiat or by disciplinary action that is superior to that of a conventional market. As they purged conventionally conceived power relationships from the firm, they also pushed out the conventional morality that restrains the powerful. Corporate actors, they said, should restrict their conduct toward others to what it would be if they fully bore the full costs of that conduct.[198] One might read this and similarly spirited rhetoric,[199] to assert the nonexistence of the corporate hierarchy. Happily, Alchian and Demsetz did not deny theoretical existence to this most familiar real world phenomenon.[200] Their "joint team produc-

196 Coase, *supra* note 39, at 390-91.

It is generally accepted that people create firm hierarchies and subject themselves to their governance in order to create wealth. Disputes arise as to the particular wealth-creating effect possessed by firm organization. Coase's emphasis on transaction costs is one of a number of suggestions. The division of labor, the coordination of production, and the allocation of investment risk all also have been suggested. *See* Cheung, *supra* note 35, at 3-5.

197 *See* Alchian & Demsetz, *supra* note 29, at 777, 794.

198 *Id.* at 791.

199 *See supra* notes 95-97 and accompanying text.

200 Indeed, it is likely that a completely unhierarchical firm would fail to hold together. Macneil notes that discreteness and presentiation cannot be made absolute in relational situations. They can prevail only so long as they avoid conflict with other

tion" model of the firm centers on a combined owner and residual claimant which looks like an entity and possesses numerous powers. Among other things, it observes the input behavior of team members, determines the terms of firm participation contracts, and terminates firm membership.[201] "Hierarchical" seems a fair description of this organizational structure.

Sympathetically read, then, Alchian and Demsetz's work posits that the hierarchical structures necessary in complex production processes do not constrain their participants. The firm lacks superior directive power because a participating rational economic actor who dislikes the terms of the deal offered can walk away and find an arrangement that better suits him. The hierarchical structure exists, but on a foundation of perfect consent of participants without human weaknesses.

All exercises in the new economic theory after Coase and Alchian and Demsetz assume voluntary participation in the firm. The subsequent models develop an inverted conception of some of the hierarchical relations described in the managerialist pictures of the firm. Within the new economic theory, investors in the firm *delegate* decisional authority to firm managers.[202] The managers, accordingly, lose their status as hierarchical superiors; in the switch, they become the "agents" of the participants. For example Fama and Jensen's reconstruction of the relationships between directors, officers and stockholders refrains from employing the image of hierarchy in characterizing corporate organization.[203] It conceives of the organization in power-neutral terms, as a "decision process." The stockholders, or residual claimants, delegate decisional authority. Transactional efficiency dictates that decision-making be split into two functions, decision "control" and decision "management." Interestingly the officers do *not* possess decision control, as the managerial picture would suggest. Rather, Fama and Jensen echo the doctrinal model of corporate organization and place decision control in the board of directors, which ratifies and monitors the managers. The subordinated managers do not control; they "manage" by initiating and implementing decisions. This structure has, of course, evolved as means toward cost reduction.

The two variants of the new economic theory share Fama and Jensen's notions that the firm hierarchy arises from delegations of

---

relational values. In case of conflict, either the other values prevail or the relationship falls apart. I. MACNEIL, *supra* note 87, at 86.

201 Alchian & Demsetz, *supra* note 29, at 783-85.

202 *See, e.g.*, Easterbrook & Fischel, *Corporate Control Transactions*, *supra* note 5, at 700; Romano, *supra* note 110, at 929.

203 *See* Fama & Jensen, *supra* note 10, at 302-03, 307-08, 310-11, 314.

power by firm participants and that the delegations occur as means to the end of cost reduction. Both also recognize that the delegations themselves produce their own costs—agency costs. From here, their differing operative conceptions of the economic actor cause the neoclassical and institutional variants to diverge. The fully rational actor tends to accomplish the delegation and the reduction of attendant agency costs by entering into discrete contracts. The bounded rationality and opportunistic tendencies of the institutionalists' actors, in contrast, lead to contract failures in the delegation process. A more relational inquiry into the contract of delegation results, but it remains strictly contained by the assumption of voluntary cost reduction.[204]

Professor Anthony Kronman uses cost effective delegation to explain virtually every value that distinguishes relational contracts from discrete contracts.[205] His explanatory concept is "union," a device employed by contracting parties to reduce the risks of nonsimultaneous exchange. The concept of union encompasses all arrangements reducing divergences of interest by promoting the spirit of identity or comradery. Thus, union would seem to explain nearly all community values. The explanation implies that these values do not exist simply because people pursue common notions of the good. Union is a "strategy" that works by eliminating the separateness that makes opposition of interests possible, and thus reduces costs.

3. *Comments*

The new economic theory makes a contribution with these reconstructions of the elements of long-term contractual relationships. It shows the elements of exchange in relations previously viewed as entirely hierarchical. But it has a concomitant weakness. The new economic theorists overstate their insight by relentlessly modelling the relationships in terms of exchange and delegation only. The neoclassicists achieve this one-sided picture by reshaping the real world to fit the paradigm. The institutionalists' concept of "union" reshapes the paradigm of the contract to encompass more of the real world.

Both exercises are too reductive. Complex corporate organizations involve both a consensual element and the constraints of the superior's exercise of authority. Looking only at consent in characterizing the relationship unduly restricts our view, causing us to lose

---

204 Recently, the leading institutionalist suggested that new economic theorists study hierarchy, remedying previous neglect. *See* Williamson, *supra* note 14, at 87-88.

205 Kronman, *supra* note 112, at 20-25.

touch with the participants' perceptions. Neither the subordinate employee who sees himself following directions, nor the investor who suffers from a manager's questionable application of contributed capital attributes the situation to a choice made from an independent position. Instead, both perceive a position of regrettable dependence stemming from the received structure of the relationship. Examining the relationship restricted to a notion of a single deep level of consent ignores whole dimensions of practical reality—economic, psychological and social.[206] Furthermore, attributing a participant's perceptions of dependency and powerlessness to false consciousness and weakness accords the participant less than full respect.

C. Consent

The nexus of contracts concept places the corporation on a foundation of contractual consent. Models pursuant to it conjoin initial consent to contract with corporate governance structures. The "delegation" of power in management corporations and the "consent" to contract describe different aspects and different consequences of the same act of participating in the new economic firm. Thus united, the concepts do not permit easy and complete separation, and the new economic construct deploys them jointly. Without consent, the actor could not plausibly delegate power to other corporate participants; if the ongoing exercise of authority by those empowered in the firm stems from delegation, then the subordinates' consent is implicit.

1. *Consent, Liberalism and Utilitarianism*

Whether denominated "consent" or "delegation," these actions perform the same function as the "manifestation of assent" under classical contract law. Consent binds the actor to the arrangement and makes enforcement by the sovereign consonant with human freedom.[207] This approach manifests a liberal vision in

---

206 The discussion in the text draws on Macneil's criticism of Alchian and Demsetz. *See* Macneil, *supra* note 11, at 1053 n.92. *Cf.* M. DAN-COHEN, *supra* note 2, at 34-35 (discussing the behavior patterns of individuals who attach themselves to organizations).

207 The new theory's consent applies more readily to a pure economic context than to a corporate law context. Economic methodology permits hypothetical actors to contract against blank slates. Within a model, a single act of assent may bespeak consent to volumes of restrictions. In the more complex world of intermixed theory and practice of corporate law, the contracting parties, even if still rational economic actors borrowed from the neoclassical microeconomic model, contract against a background of positive law. In tbe coventional view, the parties submit to the standing legal regime wben selecting the corporate form. Law and economics scholarship under the rubric of the new theory deals with this legal addition to contracting consent by imposing the paradigm on the law to the extant necessary: Since the firm exists to reduce transaction costs, corpo-

which individual choice shapes social life.

This intrinsic liberalism makes the new economic theory attractive to the contemporary legal academic audience, the members of which tend to share the liberal ideal. Prior to the theory's appearance, liberalism hardly ever entered corporate law discourse. The managerialist picture, with its hierarchies and dependencies, was heavily socialized. Liberally inclined observers worked under the paradigm with a sense of unease and hostility, particularly given constant suggestions of sovereign interference with internal corporate affairs. The new theorists effected a theoretical coup when they highlighted the market-like characteristics of management corporations: All of a sudden phenomena thought to constrain liberal freedom could be legitimated in liberal terms. The discomfort with the managerialist paradigm finally received theoretical articulation.

The new theory carries additional attraction to the liberal observer. When forced to decide what is good for others, liberals tend to be completely comfortable only with the utilitarian norm of wealth maximization. While recognizing the presence of other human values, they hesitate to incorporate them in the law for fear of inhibiting freedom.[208] By inviting corporate observers to ignore these other values, the new economic theory offers an enticing solution to this problem. Liberal observers need not worry about sovereign intervention because actors have already given consent to a wealth maximizing arrangement. The liberal goal of autonomy and the utilitarian goal of wealth maximization for once act in concord.[209]

2. *The Critique of Contractual Consent*

Although the core of consent has made the nexus of contracts concept attractive, it simultaneously ensures a well-articulated critique by its opponents. Contract law literature contains commentary effectively challenging classical contract's conjunction of

---

rate law is legitimate only so long as it serves this end. Normally, of course, contracting parties may be expected to make their own governing rnles and should be left alone to do so. But where the terms are standard, the sovereign may save them costs by providing the terms in advance. Corporate law thus is justifiable so long as it provides the terms the contracting parties would provide for themselves at greater expense if left to their own devices. Easterbrook & Fishel, *Voting, supra* note 5, at 401; Fischel, *Corporate Governance, supra* note 5, at 1264. Where inspection of corporate rules pursuant to this norm shows that it mandates terms the parties would not provide for themselves, then law and economics pursuant to the new economic theory takes on a reconstructive aspect. *See supra* the materials cited in note 150; *infra* materials cited in note 227.

208 Whitford, *supra* note 11, at 559.

209 *See* Carlson, Book Review, 85 MICH. L. REV. 1341, 1356-61 (1987); *cf.* Rosenfeld, *supra* note 128, at 800 (discussing utilitarians' simultaneous attachment to individualism and to distributive justice).

contract, consent, and freedom. The contract critique carries over to the corporate context. For present purposes, its lessons may be reduced to two points.

First, contract and freedom conflict intrinsically. Human freedom represents a lack of constraint against the ongoing choice of courses of action in pursuit of one's own purposes. Contractual consent to be bound potentially conflicts with this freedom. The contract, and its sovereign enforcer, constrain future choices. Binding contracts and freedom coexist in complete peace only when the parties understand all future applications of all contract terms upon granting consent. Yet even a perfectly understood contract can constrain freedom if a party changes its mind.

Second, the contracting process works imperfectly. Contracts often fail to detail rules for all contingencies. Sometimes they contain rules, but articulate them unclearly. Parties often fail to understand the contract's future implications. Such imperfections enhance the potential for conflict between the contract and the parties' freedom of choice.[210] The danger is particularly acute under an objective regime of contract law, such as classical contract. The power created by the classical contract often preempts the parties' conscious consent.

Contract theory outside of the classical tradition recognizes these problems and tends to justify binding a party to a rule not consciously accepted by invoking some norm in addition to consent. Different commentators look to different norms. But they tend to go beyond utility maximization, the supplemental nonliberal norm chosen by the new economic theorists. Communitarians look to relational values, particularly preservation of the relation and harmonization with society outside the relationship.[211] Individualist commentators have more difficulty. Charles Fried, when forced to look beyond the contract's literal words, avoids utility and justifies enforcement on trust and on respect for individual autonomy. In so doing he envisions a human actor different from the rational economic actor. Reasonableness, he says, may be constrained by fairness because reasonable people seek to apply the fairness norm.[212]

---

210 For further discussion of the distinction between contract and choice see I. MACNEIL, *supra* note 87, at 49-50; Macneil, *supra* note 89, at 395. Macneil questions the application of classical contract law theories to complex contractual relations. Equating an act of consent with full planning, he says, is silly.

211 Macneil, *Bureaucracy*, *supra* note 157, at 934-39.

212 *See* C. FRIED, *supra* note 178, at 16-17, 73, 83. Fried's theory of contract is rooted in the promise justifying enforcement against a contracting party because the party has intentionally invoked a convention giving another moral grounds to expect performance. At bottom, individual autonomy and trust, rather than utility, figure as norms. Utility is served incidentally because contracting parties accomplish things. *Id.* at 16-17.

Corporate law fiduciary principles restraining management power draw on the same relational values that contract theory draws on to ameliorate the limitations of consent. Appropriately, Victor Brudney and Robert Clark, in their respective critiques of the new economic theory, parallel the substance of the contract critique of consent.[213] They question the normative force of the act of participation, identify values informing corporate law beyond the norms of discrete contracting, and envision a more holistically modelled actor.

More specifically, Brudney and Clark both point out that the new theorists' corporate contracts lack empirical grounding,[214] so far reducing reality as to depart from it. Corporate law has significant noncontractual aspects. It operates in an area beyond the conscious agreements that are the subject matter of legal contract. Shareholders neither select managers nor issue instructions to them.[215] Far from seeing themselves as parties to discrete contracts, shareholders expect managers to work hard for them and do not consent to management self-dealing.[216] The shareholders become dependent. The relationship is trusting and rests in part on fiduciary underpinnings.[217] These points highlight the weaknesses in the new theorists' agency notion and the delegation of power it presupposes.

To Brudney and Clark, corporate law contains the lawmakers' assumptions of the characteristics and preferences of the parties subject to it, rather than of some actual or implicit act of consent.[218] To the extent corporate law is contractual, it is contractual only metaphorically, like the philosophical social contract.[219] Even the construction of a metaphorical corporate contract is a dubious exercise. *Ex post* contract construction on a "would have agreed to" basis cannot permit a strictly rational basis. The endless quantity of contingent considerations bearing on corporate contracting precludes

213 Brudney, *supra* note 8; Clark, *supra* note 8.

214 Brudney, *supra* note 8, at 1405-06. Legal scholars applying the new economic theory like to imply that the economists have discovered consciously determined contractual arrangements. *See also* Clark, *supra* note 8, at 62-63.

215 Brudney, *supra* note 8, at 1421; Clark, *supra* note 8, at 61-62 (corporate actors consent to legal roles but do not generally bargain over particular terms); *see also* Stone, *supra* note 129, at 82-83.

216 Brudney, *supra* note 8, at 1405-06, 1439-40.

217 Clark, *supra* note 8, at 67.

218 *Id.* at 67; Brudney, *supra* note 8, at 1414-15 n.29.

219 This is Professor Clark's point. *See* Clark, *supra* note 8, at 61, 62. The "social contract" characterization comes from Ratner, *supra* note 136, at 20-21. Ratner draws a distinction between close corporations and public corporations. Close corporations involve private rights based on consensual agreements. On the other hand, the managers of public corporations do not act on this sort of contractual basis. The certificate of incorporation here more closely resembles a national constitution.

it.[220]

3. *The Contractual Corporation Founded on Consent—Strengths and Weaknesses*

Brudney and Clark both offer valid criticisms. But despite the success of their respective critiques, neither renders the nexus of contracts concept irrelevant to corporate law. Brudney and Clark both look to practice to show the model's weaknesses, but practice may also show its strengths.

The liberal association of contractual consent and human freedom is inherently flawed as a universal theory of business relationships, but as a practical matter, seems valid in the context of discrete contracts. Management corporations, viewed contractually, represent complexes of both discrete and relational contracts.[221] Institutional stock and bondholders, for example, buy and sell securities on the open market, taking short term positions. As both Brudney and Clark point out, different investors have different expectations, but all depend on management. On the other hand, institutional investors going in and out of positions in given corporations enter into these contractual relations through discrete, arm's length transactions and maintain short term expectations. Investors can protect themselves through diversification and quickly exit.[222] These investor-corporate relations have a real individual and self-reliant aspect. The same self-protective patterns obtain respecting many individual investors. Trustee-beneficiary relations and their governing law are by no means strictly analogous, and the values embodied in classical contract law have relevance. The discrete values these investors bring to these relationships may be read back into their initial manifestations of assent.

The new economic theory offers a theoretical exploration of these discrete aspects of practical corporate relations. It illuminates arm's-length points only dimly recognized in academic corporate work of the anti-managerialist variety. It thereby begins to explain the strains of corporate doctrine that persistently refuse to apply the fiduciary principle. The new theorists' vast overstatement of their case through their insistence on a discrete contractual model across the board does not vitiate their contribution.

Even the overstated, absolutely discrete contractual model makes a positive contribution at a purely theoretical level. Brudney and Clark both correctly assert that the theory does not translate to

---

220 Brudney, *supra* note 8, at 1415 n.31; Clark, *supra* note 8, at 65.

221 *See supra* text accompanying note 32.

222 *See generally* A. HIRSCHMAN, *supra* note 105.

practice. The "contract" and the "consent" do not really exist, and corporate "contracts" are in large measure positive law constructs. But, despite this fundamental objection, the new theory remains attractive to a liberal observer, even one familiar with corporate practice. In liberal theory, legitimating contracts need not be actual. Liberals caught between respect for individual autonomy and recognition of the need for a coercive sovereign routinely surmount the difficulty by employing contractarian paradigms of the formation of the sovereign. These collective contracts legitimate social arrangements through constructive consent. They never refer to individual behavior. Instead, they assume that all autonomously acting individuals in the larger social unit have a set of common characteristics. This allows predictions as to whether individuals would consent to a particular institutional arrangement. They assign the actor the trait of rationality in determining the direction taken by this free choice. Justice then depends on whether those subject to the arrangement would choose it freely *ex ante*.[223]

Many in American legal culture practice this mode of contractarian legitimation. Not surprisingly, artfully constructed applications of it to large corporate bureaucracies resonate well within that culture.

But the new economic theory's picture of liberal-utilitarian concord holds validity only in theory, and even the theoretical construct depends on rational economic actors denuded of significant human characteristics.[224] As a result, its hypothetical bargaining inadequately captures the social reality real people face.

Legal scholarship adopting the new economic theory takes different approaches to the problems of practical application. Some legal scholars applying the neoclassical variant simply ignore the problem. This work collapses theory into practice, treating all contracts, discrete or collective, actual or constructive, as if similarly constituted.[225] The work nicely manifests liberal theoretical as-

---

223 This model of the liberal's method is drawn from Rosenfeld, *supra* note 128, at 817-18.

224 *See* Carlson, *supra* note 209, at 1361-68.

225 *See supra* the materials cited notes 54, 91; Easterbrook & Fischel, *supra* note 5, at 283-86 (arguing against the *ex post* interpolation of dissolution rights and fiduciary duties in close corporation situations because "there will be situations where all parties decide that they are better off without them."); *cf.* Fama, *supra* note 42, at 293 (suggesting that subordinates monitor superiors), *but see* Eisenberg, *supra* note 3, at 584 n.4.

The neoclassical tendency to justify existing arrangements as efficient market solutions (*see, e.g.*, Baysinger & Butler, *supra* note 5, at 561, 564-66) has led to a whole body of literature justifying corporate governance arrangements as they appeared around 1980. Awkwardly, corporate governance practices changed dramatically around 1984. *See* Bratton, *supra* note 3, at 1520-21.

sumptions. It less successfully explains corporate doctrine composed of complexes of relational values.

Legal scholarship in the institutional variant encounters fewer practical problems. Institutional actors better approximate real people. Even so, the institutionalists manage to deploy their actor and at the same time satisfy the liberal goal of noninterference by the sovereign. Institutional actors understand their own failings and erect contract structures around them. Their success in erecting these structures makes state intervention into corporate relationships unjustifiable. They recognize communal values, but only as contracting strategies designed as means to individualist ends.

This rendition of liberal values in an imperfect world of transactions is attractive. But it omits too much from the picture to afford a basis for a reconstructed corporate doctrine. The imperfect institutional actor always remains the best judge of his or her own best interests, placing the paradigm outside our sense that individuals often act other than in their own best interests. The possibility of such errant conduct, according to Mill, is particularly likely to occur where the act of consent binds for a long period of time.[226] Corporate legal doctrine also recognizes this possibility, providing layers of paternalistic protections for investors. Labelled fiduciary, this doctrine straddles the corporate complex of discrete and relational contract, effective and ineffective self-interested action, and self-protected and dependent positioning. Despite all its liberal attractions, the new theory will probably fail to suppress paternalistic impulses of lawmakers and legal scholars.[227] These impulses of course remain dangerous to the freedom of corporate actors[228]—thus the new economic theory retains an ongoing critical role.

D. Comments

Placing the "contract" in the "nexus of contracts" concept against the broad background of corporate doctrine and contract theory dramatically reduces its heuristic force. One can, as the new economic theorists assert, account for corporate law contractually. But one can account for it accurately only by *ex post* review with an open concept of contract with broad notions of consent.

---

226 J.S. MILL, PRINCIPLES OF POLITICAL ECONOMY 950, 952-53, 960-61 (Ashley ed. 1921); *see* Rosenfeld, *supra* note 128, at 801-02.

227 *Compare* Kennedy, *Paternalism*, *supra* note 180, *with* Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763 (1983) (explanations of decisionmaker paternalism in contracts); *see also* Bratton, *Manners, Metaprinciples, Metapolitics and Kennedy's Form and Substance*, 6 CARDOZO L. REV. 871, 903-13 (1985) (discussing both Kennedy and Kronman's articles).

228 *See* Kennedy, *Paternalism*, *supra* note 180, at 642-49.

With a more flexible notion of contract, the contract heuristic can build a theoretical picture that respects corporate practice. Limiting conceptions of the corporate contract, whether discrete or relational, classical or neoclassical, managerialist or individualist, cause distortions in the theoretical picture. No such limitation should be privileged. Flexibility helps us better appreciate the range of values—liberal and communitarian, utilitarian and relational—at stake in corporate law decisions.

CONCLUSION—THEORY AND PRACTICE

Models of the corporation constructed within the new economic theory's limited analytical framework can neither conclusively explain the firm nor adequately serve as blueprints for an improved, reconstituted, fully rationalized future firm. Yet the theory has brought academic corporate law closer to business practice by highlighting the elements of voluntary exchange in corporate relationships. At the same time, the theory has mischaracterized these corporate contracts, making what amount to political assertions.

The theory's very appearance in legal theory affects practice. Its proponents advance a perspective that strikes deep political resonances as it recasts the basic components of received corporate theory in a classic, sometimes extreme, individualist mode. This counters a decades old orthodoxy of group orientation in corporate policy discourse. Thus positioned, the theory can achieve a cognizable practical influence, even though it attracts only a handful of real adherents, by virtue of its acceptance as a legitimate, respectable part of legal discourse. This acceptance by itself reshapes prevailing consciousness regarding management corporations in significant ways. It changes the ongoing debate about corporate governance, which often comes down to a "burden of proof" contest between proponents and opponents of governmental intervention; the contestant imposing the burden on the other side wins. The new economic theory adds weight to the side opposing intervention.

Alterations in business and legal practices may result ultimately from the new theory's appearance, but they may be more enabled than dictated by it. Given this variety of practical-theoretical interplay, perhaps the theory has had its greatest influence already. Today, power flows to the theorist who constructs a picture of corporate power in appropriate "post managerialist" terms.

Whatever the future interplay of theory and power, the concepts that make up theories of the firm—entity and aggregate, contract and concession, public and private, discrete and relational—will stay in internal opposition. This tendency toward contradiction should be accepted, not feared. The contradictions are intrinsic.

No foreseeable scholarship or legislative reform will resolve them. The contradictions also are wholesome. Studying and reflecting on their interplay in the law enhances our positive and normative understanding. Legal theories that heavily privilege one or another opposing concept risk positive error. Theory, instead of denying the existence of the contradictions, should synchronize their coexistence in law.

From this it follows that corporate doctrine is a necessary referent for a legal theory of the firm. The doctrine provides an authentic source for a positive theory—a source providing a useful counterweight to economic theory. The doctrine follows from practice. It is a residue of corporate life filtered through and written out by corporate lawyers. It mediates between opposing theoretical conceptions. It privileges different concepts at different points, but unlike academic theory, it never does so absolutely. Studying the doctrine offers a sense of how contradictory theory of the firm concepts are synchronized in practice.