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Comparative Research in Law & Political Economy

RESEARCH PAPER SERIES

Research Paper No. 30/2012

Indeterminacy and Balance: A Path to a Wholesome Corporate Law

Fenner L. Stewart Jr.

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Comparative Research in Law & Political Economy

Osgoode CLPE Research Paper 30/2012

Vol. 08 No. 07 (2012)

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Forthcoming: Rutgers Business Law Review, Vol. 9, Fall 2012

Abstract: This article argues that corporate legal scholarship needs to focus primarily upon the indeterminacy of essentialist theories about the corporation. This will result in greater pluralism, since no essentialist legal theory would become heavily privileged over any other. When such a balance is created between theories, a robust debate can occur where no ideas are raised to the status of being "undiscussable preferences" and no essentialist theory is off the table before the debate begins. This would lead to fewer consensuses but more complexity than presently exists within corporate legal discourse, helping to immunize the law from the sort of oversimplifications that might offer ease of comprehension at the risk of positive error.

Key words: Corporate Legal Theory, Corporate Law, Concession Theory, Entity Theory, Nexus-of-Contracts, Law and Economics

JEL Classifications: B25, G30, K22

I. INTRODUCTION

The needs of markets are largely uncontested. They include the need for scarce resources to be efficiently distributed,[1] a regulatory environment that secures certainty for business transactions over time,[2] and additional advantages necessary to win customers in a competitive global marketplace.[3] Society's needs are highly contested. They include, at a minimum, the need for access to fundamental human rights.[4] The needs of markets and society ought always to be aligned; however, in practice they are not.[5] This article assumes that striving and re-striving for such a balance is a central challenge for regulators today. Furthermore, this assumption is a foundational premise from which this article is built.

Corporations are central players in the mediation of tensions between markets and society.[6] Thus, it stands to reason that we as corporate legal scholars ought to invite a robust debate that encourages broad discussions about the role of the corporation in society in order to help in finding and re-finding the "appropriate"[7] balance. To achieve this end, we must be constantly challenging and reassessing our assumptions about how the

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[1] Friedrich A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 525–26 (1945).

[2] Max Weber wrote, "The modern capitalist enterprise rests primarily on calculation and presupposes a legal and administrative system, whose functioning can be rationally predicted, at least in principle, by virtue of its fixed general norms, just like the expected performance of a machine." MAX WEBER, ECONOMY AND SOCIETY: AN OUTLINE OF INTERPRETIVE SOCIOLOGY, 1394 (1968).

[3] After a comparative study of a ten important trading nations, Michael Porter concluded that in each case the firms that were globally successful enjoyed legal, social, and/or economic conditions in "the home country," which provided a competitive advantage for their industry. MICHAEL E. PORTER, THE COMPETITIVE ADVANTAGE OF NATIONS (2d ed. 1998).

[4] The most commonly accepted framework of basic human rights includes, Universal Declaration of Human Rights, G.A. Res. 217 (III) A, U.N. Doc A/RES/217(III) (Dec. 1948); Convention for the Protection of Human Rights and Fundamental Freedoms, Nov. 4, 1950, 213 U.N.T.S. 221; International Covenant on Civil and Political Rights, Dec. 16, 1966, S. Treaty Doc. No. 95-20, 6 I.L.M. 368 (1967), 999 U.N.T.S. 171; American Convention on Human Rights, Nov. 21, 1969, 1144 U.N.T.S. 143; Convention on the Elimination of All Forms of Discrimination Against Women, Dec. 18, 1979, 1249 U.N.T.S. 13; Convention on the Rights of the Child, Nov. 20, 1989, 1577 U.N.T.S. 3. A more controversial outlier for the more conservative minded might include the International Covenant on Economic, Social and Cultural Rights, Dec. 16, 1966, S. Treaty Doc. No. 95-19, 6 I.L.M. 360 (1967), 993 U.N.T.S. 3.

[5] For instance, see generally SURYA DEVA, REGULATING CORPORATE HUMAN RIGHTS VIOLATIONS: HUMANIZING BUSINESS (2012); JERNEJ LETNAR ČERNIČ, HUMAN RIGHTS LAW AND BUSINESS: CORPORATE RESPONSIBILITY FOR FUNDAMENTAL HUMAN RIGHTS (2010); FLORIAN WETTSTEIN, MULTINATIONAL CORPORATIONS AND GLOBAL JUSTICE: HUMAN RIGHTS OBLIGATIONS OF A QUASI-GOVERNMENTAL INSTITUTION (2009).

[6] Andreas Georg Scherer, Guido Palazzo & Dorothee Baumann, *Global Rules and Private Actors - Towards a New Role of the Transnational Corporation in Global Governance*, 16 BUS. ETHICS Q. 505 (2006); Neva Goodwin, *The Social Impacts of Multinational Corporations: An Outline of the Issues with a Focus on Workers*, *in* LEVIATHANS: MULTINATIONAL CORPORATIONS AND THE NEW GLOBAL HISTORY, 24-28 (Alfred D. Chandler, Jr. & Bruce Mazlish eds., 2005); Dennis A. Rondinelli, *Transnational Corporations: International Citizens or New Sovereigns?*, 107 BUS. & SOC'Y REV. 391 (2002).

[7] This term (and others) is in quotations because this article sets aside the questions of whether evaluations such as "better" are possible in this context. In other words, this article is mindful, and wary, of drawing distinctions between good/legitimate forms of governance and bad/illegitimate ones, leaving such attempts at "objective" measure to others.

law ought to mediate corporate conflicts.[8] Put differently, we need to be aware of how the processes of socialization impact our norms, preferences, and politics as academics.[9]

Today, the corporation is generally assumed to be a nexus-of-contracts.[10] It is also assumed that the contracts that bind corporate constituents are both consensual and efficient.[11] Such efficiencies occur because legal requirements upon corporate governance have been relaxed, and relaxed legal requirements allow market forces to inspire corporate constituents to use their ingenuity to negotiate contracts in their own best interest.[12] What follows from this is that corporate law ought to be permissive in nature, rejecting mandatory legal rules as generally suboptimal.[13]

Recent corporate and financial scandals appear to challenge the prudence of these assumptions,[14] yet they prevail over corporate legal thinking.[15] To be fair, they may still be the best option available, and conceding this, this article ought not to be construed as an attack on these prevailing presumptions. Rather, this article merely suggests that more self-reflexive debates about the "right" way to mediate corporate conflicts will improve the ways we think about and discuss the corporation and thus, it is assumed, will improve our understanding of corporate governance. In other words, if we accept the tenuous nature of the choices we make, we can be more open-minded to a broader spectrum of considerations. With a more open-minded understanding, we ought to make "better" choices about how corporate governance ought to be regulated.[16] Such a critical mindset is important, as our assumptions frame how corporate governance is conceptualized,

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[8] William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 464–65 (1988).

[9] PETER L. BERGER & THOMAS LUCKMANN, THE SOCIAL CONSTRUCTION OF REALITY: A TREATISE IN THE SOCIOLOGY OF KNOWLEDGE 74, 177 (1966).

[10] Bratton, *supra* note 8, at 458 (arguing that "the nexus of contracts concept places the corporation on a foundation of contractual consent"). For an example of a "real adherent," see STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 30–31 (2008) (Bainbridge's application of "The Hypothetical Bargain Methodology").

[11] Thomas W. Joo, *Theories and Models of Corporate Governance*, *in* CORPORATE GOVERNANCE: A SYNTHESIS OF THEORY, RESEARCH, AND PRACTICE 157, 170 (H. Kent Baker & Ronald Anderson eds., 2010) (arguing that "incorporating efficient-market assumptions, contractarianism makes two claims: that governance is consensual and that it is efficient").

[12] Thomas W. Joo, *Contract, Property, and the Role of Metaphor in Corporations Law*, 35 U.C. DAVIS L. REV. 779 (2002) (arguing that the contractarian vision of contract is a laissez-faire one, which justifies the assumption that "economic relationships are the product of individual free will and rational deliberation, and the law respects them for this reason"). For an excellent example of an adherent to this theory, see BAINBRIDGE, *supra* note 10, at 30–31 (2008) (Bainbridge's application of "The Hypothetical Bargain Methodology").

[13] Joo, *supra* note 11, at 171.

[14] For examples and analysis, see ENRON AND OTHER CORPORATE FIASCOS: THE CORPORATE SCANDAL READER (Nancy B. Rapoport, Jeffery D. Van Niel & Bala G. Dharan eds., 2d ed. 2009). However, also consider the wider literature on the Credit Crisis of 2008. *See* SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN (2010); ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES (2009).

[15] Joo, *supra* note 11, at 170.

[16] *Id.*

influencing the way that participants within corporate governance calculate and respond to problems.[17]

Specifically, to improve the processes of understanding how to mediate corporate conflicts,[18] this article recommends focusing upon the indeterminacy of corporate legal theories. In doing so, corporate legal thinking "habitualizes" being critical and mindful of such indeterminacies,[19] resulting in greater pluralism, since no corporate legal theory would become "heavily privileged" over any other, allowing each to make contributions within legal thinking.[20] When such a balance between theories exists, a robust debate can occur where no ideas are raised to the status of "truth" while other theories are off the table before the debate begins.[21] This would lead to fewer consensuses,[22] but more complexity than presently exists within corporate legal discourse, helping to immunize the law from the sort of oversimplifications that might offer "ease of comprehension" at the risk of "positive error."[23] This article argues that adding such complexity and balance to corporate legal discourse would be "wholesome" for corporate law.[24]

To be clear, this article does not reject the argument that relaxed legal requirements lead to optimal corporate governance results over time.[25] Rather, it argues that the assumptions that underpin this argument are too fragile to assert that relaxed legal requirements will produce the assumed outcome in all circumstances.[26] Thus, such fragile *a priori* knowledge[27] of the corporation must be recursively subject to careful scrutiny in today's fast-changing society. If this is true, then no single theory or model ought to be treated as authoritative.

If an idea "works," then that is the best we can hope for, and if circumstances change and what worked stops working, then we had better figure out how to adapt so that theory reflects practice as quickly as possible.[28] As Fred Block suggests, "market societies"[29] are

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[17] For the interplay of corporate legal discourse, theory, doctrine, and policy, see Ron Harris, *The Transplantation of the Legal Discourse on Corporate Personality Theories: From German Codification to British Political Pluralism and American Big Business*, 63 WASH. & LEE L. REV. 1421 (2006). For challenges to Harris's position, see Lawrence E. Mitchell, *The Relevance of Corporate Theory to Corporate and Economic Development: Comment on The Transplantation of the Legal Discourse on Corporate Personality Theories*, 63 WASH. & LEE L. REV. 1489 (2006).

[18] Bratton, *supra* note 8, at 464–65.

[19] BERGER & LUCKMANN, *supra* note 9, at 74, 177.

[20] Bratton, *supra* note 8, at 464–65.

[21] *Id.*

[22] *Id.* at 465.

[23] Joo, *supra* note 11, at 170.

[24] Bratton, *supra* note 8, at 465.

[25] FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 35 (1991).

[26] For arguments supporting this anti-essentialist notion of corporate law, see William W. Bratton, *Welfare, Dialectic, and Mediation in Corporate Law*, 2 BERKELEY BUS. L.J. 59, 70 (2005); Bratton, *supra* note 8.

[27] *A priori* knowledge is "knowledge that rests on *a priori* justification. *A priori* justification is a type of epistemic justification that is, in some sense, independent of experience." Bruce Russell, *A Priori Justification and Knowledge*, *in* THE STANFORD ENCYCLOPEDIA OF PHILOSOPHY (Edward N. Zalta ed., 2011), *available at* http://plato.stanford.edu/entries/apriori/.

[28] William James wrote of pragmatism: "Rationalism sticks to logic. . . . Empiricism sticks to the external senses. Pragmatism is willing to take anything, to follow either logic or the senses and to count the humblest and most personal experiences. She will count mystical experiences if they have practical consequences. . . . Her only test of probable truth is what works best in the way of leading us, what fits every part of life best and combines with

patchworks of regulations which do not necessarily fit together easily, generating social systems that have an "always under construction" nature.[30] Within this context, it is suggested that embracing the indeterminacy of corporate theory will necessarily generate a more responsive and critical discourse that, over time, will improve corporate function within an ever-changing global marketplace.

Part 2 of this article introduces three essentialist theories of the corporation: the concession theory, the entity theory, and the aggregate contractarian theory. These three theories have always been relevant variables when considering the modern corporation.[31] Put differently, since the rise of the modern publicly traded corporation,[32] the corporation has always been a group of aggregate constituents[33] connected through contract,[34] while at the same time being an entity with personhood that only exists because of a concession made by the state.[35] It is argued that each of these three theories is indeterminate.[36] Indeterminate, in this context, means that these essentialist theories do not support or reject any position with corporate governance until combined with additional normative claims.[37]

Parts 3 and 4 trace this history of indeterminacy, pulling together a synthesis of these three essentialist theories of the corporation throughout the twentieth century to present. They offer insight into how each essentialist theory has been used to rationalize contrasting policy positions. In other words, they focus on how each of the essentialist theories have been used to embed a prescription as to how to regulate the corporation, and then later, how that same theory was used to advocate for a policy prescription that undermines the original.[38] Thus, they present historical examples of this indeterminacy in action. Specifically, this article explains how this has occurred in the use of both the

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the collectivity of experience's demands, nothing being omitted." WILLIAM JAMES, PRAGMATISM: A SERIES OF LECTURES BY WILLIAM JAMES, 1906–1907, 40 (2008).

[29] Fred Block uses the term "market society," which he attributes to Karl Polanyi. Block describes "market society" as Polanyi's conception of a society that is constituted by two opposing movements: "the laissez-fair movement to expand the scope of markets, and the protective countermovement that emerges to resist . . . the impossible pressures of a self-regulating market system." Fred Block, *Introduction* to KARL POLANYI, THE GREAT TRANSFORMATION: THE POLITICAL AND ECONOMIC ORIGINS OF OUR TIME xxviii (2d ed. 2001).

[30] *Markets and Society: The Life and Thought of Karl Polanyi, Part 5: The Legacy*, CANADIAN BROADCASTING CORPORATION (Posted Aug. 8, 2006, 9:53 pm) (interviewing Fred Block), *available at* http://www.insidethecbc.com/ideas-series-markets-and-society-available-for-download/.

[31] David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 204, 242–51 (1990); *see also* Joo, *supra* note 11.

[32] For an historical account of the rise of the modern corporation at the end of the 19th century, see Fenner Stewart, Jr., *The Place of Corporate Lawmaking in American Society*, 23 LOYOLA CONSUMER L. REV. 147, 151–55 (2010).

[33] *Mateo v. S. Pac. R.R.*, 118 U.S. 394 (1886); *see also* Joo, *supra* note 11, at 159.

[34] Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 783–84 (1972).

[35] For more on the historical roots of the concession theory, see William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1502–05 (1989).

[36] John Dewey, *The Historic Background of Corporate Legal Personality*, 35 YALE L.J. 655, 669 (1926).

[37] *Id.*

[38] *See infra* notes 60–61, 69–72 & 74–76 and accompanying text.

concession and entity theories. Part 4 ends by predicting how the prevailing aggregate contractarian theory has already past its high-water mark, pointing to how alternative and contrasting versions of it may emerge. This history of legal thought draws attention to the patterns of how we manufacture knowledge about the corporation and corporate law over time.[39]

In conclusion, the article reasserts that embracing the indeterminacy of corporate theory will generate the sort of robust debate that we as corporate legal scholars ought to have. In the end, the article leaves the reader with a simple proposal for conceptualizing the corporation: be self-critical of one's role in the manufacturing of corporate legal knowledge and, in part, be leery of accepting *a priori* knowledge as fact.

II. THREE ESSENTIALIST THEORIES OF THE CORPORATION AND THEIR INDETERMINATE NATURE

The thoughts of John Dewey explain how the essentialist theories of the corporation[40] are indeterminate. This part explains his position and then evaluates its implications, before disagreeing with his recommendations on what ought to be done about this indeterminacy. Then this part delves into an explanation of the three essentialist theories of the corporation: the concession theory, the entity theory, and the aggregate contractarian theory. Finally, it foreshadows the historical narrative explored in Parts 3 and 4 by briefly explaining how each of these essentialist theories can be used to endorse contradictory policy prescriptions by altering the additional normative suppositions attached to the essentialist theory in question.

It may not be accurate to call Dewey a realist, but he was most definitely an antiformalist, who was very sympathetic to the realist movement against formalism that was occurring in a number of disciplines, including law,[41] in the early part of the twentieth century.[42] He was acutely aware that social modeling and formal reasoning easily became safe havens for undisclosed normative agendas separate from the reasoning itself.[43]

In 1926, Dewey published one of the most important articles that the *Yale Law Review* ever printed on corporate theory.[44] In the article, Dewey expressed concern over how a number of notions about the "inherent and essential attributes" of the corporation

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[39] For the interplay of corporate legal discourse, theory, doctrine and policy, see Harris, *supra* note 17. For challenges to Harris's position, see Mitchell, *supra* note 17. *See also* BERGER & LUCKMANN, *supra* note 9, at 74, 177.

[40] For the purpose of this article, essentialist theories of the corporation are models of the corporation that assert it has a set of characteristics that all corporations must possess. There will be three considered: the concession theory, the entity theory, and the aggregate contractarian theory. These theories purport to be determinative for particular normative positions. However, if Dewey's anti-essentialist theory of corporate law is correct, then this is not the case. *See* Dewey, *supra* note 36, at 669.

[41] *See generally* OLIVER WENDELL HOLMES, THE PATH OF THE LAW (2011); WILLIAM W. FISHER III, MORTON J. HORWITZ & THOMAS A. REED, AMERICAN LEGAL REALISM 4 (1993); Felix S. Cohen, *Transcendental Nonsense and the Functional Approach*, 35 COLUM. L. REV. 809, 816 (1935); Morris R. Cohen, *Property and Sovereignty*, 13 CORNELL L.Q. 8, 12 (1927); Robert L. Hale, *Coercion and Distribution in a Supposedly Non-Coercive State*, 38 POL. SCI. Q. 470 (1923).

[42] MORTON WHITE, SOCIAL THOUGHT IN AMERICA: THE REVOLT AGAINST FORMALISM (1976).

[43] JOHN DEWEY, EXPERIENCE AND NATURE 422–27 (Dover Publications 1958) (1925).

[44] Dewey, *supra* note 36.

had been "shov[ed] . . . under the legal idea" of the corporation, leading to "a confused intermixture."[45] In fact, he insisted that "there [was] no clear-cut line, logical or practical, through the different theories" and that "[e]ach theory [had] been used to serve the same ends, and each [had] been used to serve opposing ends."[46] He argued that since these essentialist theories were indeterminate, legal thinkers must learn to assess critically whether legal assumptions attached to these theories reflected functional reality of the corporation.[47]

By identifying such legal assumptions and pragmatically assessing their merit, Dewey asserted that the law could better address corporate legal problems.[48] Put differently, Dewey's solution was not to take essentialist theories too seriously until "the concrete facts and relations involved [had] been faced and stated on their own account" [49] in order to forge direct connections between legal reasoning and the facts.[50] The weakness of Dewey's suggestion is that by discounting essentialist theories when mediating corporate legal conflicts, a normative void can emerge, which might tempt the less pragmatically minded to fill the void, potentially compromising the problem solving Dewey had envisioned for corporate legal thought.[51]

This article agrees with Dewey's observations about the potentially negative impact of essentialist theories of the corporation, but it disagrees with his solution. Rather than largely disregarding essentialist theories as Dewey recommended,[52] this article advocates focusing primarily upon the indeterminacy of these essentialist theories.[53] Such methodology defends against the meritless privileging of any one theory over any other, tearing down monopolies of thought, and creating more balance between competing ideas and interests. Corporate legal debates would then become less shielded from the complexity of governance and more prepared to reject the sort of oversimplifications of corporate function that increase the risk of "positive error"[54] within corporate governance.

This article next considers each of these essentialist theories: the concession theory, the entity theory, and the aggregate contractarian theory. The concession theory asserts that corporations are merely creatures of statute.[55] The classic articulation of the concession theory was proffered by William Blackstone in his *Commentaries on the Laws of England*.[56] He argued that for a corporation to exist, the monarch's consent was "absolutely

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[45] *Id.*
[46] *Id.* at 669.
[47] *Id.* at 657–58.
[48] *Id.* at 673.
[49] *Id.* at 673.
[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] Bratton, *supra* note 8, at 464–65.
[54] *Id.* at 465.
[55] *Trs. of Dartmouth Coll. v. Woodward*, 17 U.S. (4 Wheat.) 518, 636 (1819). For more on the historical roots of the concession theory, see Bratton, *supra* note 35, at 1502–05.
[56] 1 WILLIAM BLACKSTONE, COMMENTARIES 460 (1979).

necessary."[57] Today, this observation is still technically correct: government authority must grant permission for the incorporation of a business. However, since the dawn of the twentieth century, corporate law has made the approval of this granting process guaranteed as long as the rules of incorporation are not violated.[58] In other words, instead of the legislature creating each corporation through legislation, corporations could be created merely through compliance with a general enabling statue. Incorporation now occurs automatically as long as the appropriate information and fees are submitted in accordance with regulatory requirements.[59]

That said, such legislative reforms do not diminish the basic claim that the corporation is a creature of statute. This is a characteristic that all corporations possess. It is an essential consideration. It is also indeterminate until additional normative claims are introduced. For instance, when the additional normative claim is introduced that incorporations are granted in order to help ensure society's economic welfare,[60] the concession theory suggests that whether or not a corporation meets this standard will dictate if the state will intervene. However, when the additional normative claim is introduced that "the state provides the corporate form… solely as a means of facilitating private ordering amongst people,"[61] then the concession theory suggests something much different. In sum, incorporation is essential to the corporation, but what follows from this acknowledgement is indeterminate.

The entity theory asserts that the corporation is something that exists beyond its aggregate parts.[62] The clearest case of this is how the law treats the corporation. Examples of this include: judicial enforcement of limited liability,[63] judicial reluctance to pierce the corporate veil,[64] the general refusal of courts to burden corporations with pre-incorporation contractual obligations made by its promoters,[65] and the capacity of the

[57] *Id.*

[58] For legislative treatment of this issue, see, for example, DEL. CODE ANN. tit. 8, § 101 (West 2011) (requiring only the filing of a certificate of incorporation with the Division of Corporations in the Department of State); MODEL BUS. CORP. ACT §§2.01, 2.03 (2002); N.Y. CONST. of 1846, art. VIII, § 1.

[59] Of course, this is an oversimplification of the job that lawyers must undertake to organize the governance structure of a corporation in a manner that best suits their client's needs. *See* CHARLES R. T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 8–19 (6th ed. 2010).

[60] *Citizens United v. FEC*, 130 S. Ct. 876, 971 (2010) (Stevens. J., dissenting) (arguing that "[u]nlike other interest groups, business corporations have been 'effectively delegated responsibility for ensuring society's economic welfare'; they inescapably structure the life of every citizen").

[61] Stephen Bainbridge, *Citizens United v. FEC: Stevens' Pernicious Version of the Concession Theory*, (Jan. 1, 2010), http://www.professorbainbridge.com/professorbainbridgecom/2010/01/citizens-united-v-fec-stevens-pernicious-version-of-the-concession-theory.html.

[62] George F. Canfield, *The Scope and Limits of the Corporate Entity Theory*, 17 COLUM. L. REV. 128 (1917).

[63] Consider the emergence of limited liability companies. *See* O'KELLEY & THOMPSON, *supra* note 59, at 535–38; *see also Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286 (Del. 1999).

[64] *See* O'KELLEY & THOMPSON, *supra* note 59, at 608–11. In contractual situations, see *Consumer's Co-op v. Olsen* 419 N.W.2d 211 (Wis. 1988); *K. C. Roofing Ctr. v. On Top Roofing, Inc.* 807 S.W.2d 545 (Miss. 1991). In torts situations, see *W. Rock Co. v. Davis* 432 S.W.2d 555 (Tex. 1968); *Baatz v. Arrow Bar* 452 N.W.2d 138 (S.D. 1990).

[65] *See* O'KELLEY & THOMPSON, *supra* note 59, at 658–59; *see also RKO-Stanley Warner Theatres, Inc. v. Granziano* 355 A.2d 830 (Pa. 1976).

corporation to enter into contracts,[66] hire workers,[67] and acquire property.[68] In each of these legal examples, the law treats the corporation as though it was separate from, and something other than, the sum of its aggregate parts. This is a characteristic that all corporations possess; it is an essential consideration. And like the concession theory, it is also indeterminate until additional normative claims are introduced. For instance, the entity theory could regard the corporation as the private property of shareholders,[69] justifying a shareholder primacy perspective,[70] or it could be defined as a social corpus that is separate from its shareholders,[71] justifying a stakeholder perspective.[72]

Finally, the aggregate contractarian theory argues that the corporation is the sum of the contractual obligations that each of its constituents (labor, management, shareholders, creditors, the community-at-large, etcetera) owe to each of its other constituents.[73] Again, all corporations possess this characteristic. Again, it is an essential consideration. And again, it is also indeterminate until additional normative claims are introduced. For instance, the aggregate contractarian theory could stand as a barrier to state intervention, based on the assumption that contracting is consensual and efficient,[74] or it could transcend the notions of market/state and public/private[75] based on the assumption that contracting is a complex, multi-polar governance practice, which animates and transcends "the contract."[76] This revitalization of relational contract theory invites one to take seriously "the larger context and framework within which someone enter[s] into and assume[s] a particular contracting position."[77]

These three theories represent dimensions of the corporation that ought to be taken into consideration when mediating corporate conflicts, because they are essential components to a complete understanding of the modern corporation. Furthermore, all of

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[66] Morton J. Horwitz, *Santa Clara Revisited: The Developments of Corporate Theory*, 88 W. VA. L. REV. 173, 221 (1985) (quoting GERARD CARL HENDERSON, THE POSITION OF FOREIGN CORPORATIONS IN AMERICAN CONSTITUTIONAL LAW 166 (1918)).

[67] *Prudential Ins. Co. of Am. v. Cheek*, 259 U.S. 530, 536 (1922) (holding that corporations have a right "to enter into relations of employment with individuals" subject to the law creating the corporation).

[68] *Jones v. N.Y. Guar. & Indem. Co.*, 101 U.S. 622 (1879).

[69] A. A. Berle, Jr., *For Whom Corporate Managers are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932) [hereinafter Berle, Jr., *A Note*]; A. A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931) [hereinafter Berle, Jr., *Corporate Powers*].

[70] *Id.*

[71] E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1153 (1932).

[72] *Id.*

[73] *Id.*; *see also* Michael C. Jensen & Clifford W. Smith, Jr., *Stockholder, Manager, and Creditor Interests: Applications of Agency Theory*, *in* A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS 136, 136 (Michael C. Jensen ed., 2000).

[74] Joo, *supra* note 12, at 800 (arguing that the contractarian vision of contract is a laissez-faire one, which justifies the assumption that "economic relationships are the product of individual free will and rational deliberation, and the law respects them for this reason"); *see also* BAINBRIDGE, *supra* note 10, at 30–31 (Bainbridge's application of "The Hypothetical Bargain Methodology").

[75] Peer Zumbansen, *Rethinking the Nature of the Firm: The Corporation as a Governance Object*, 32 SEATTLE. U. L. REV. 1469, 1496 (2012).

[76] *Id.* at 1490.

[77] *Id.* at 1493.

these theories are indeterminate, meaning that they could be used as a platform to take either side of any corporate governance debate. Accordingly, each of the theories could support or reject any central issue within corporate governance.[78] In other words, these essentialist theories do not bias one normative claim over another. For instance, aggregate contractarian theory does not inherently support the claim that the corporation is private, that default rules are superior to mandatory rules, that efficiency is more important than fairness, that the law should focus on process and leave substance to corporate governance, and that reputational enforcement is better for all concerned than state enforcement.

That said, certain normative preferences tend to attach to each theory at different times in history.[79] For instance, Morton Horwitz rejected Dewey's indeterminacy argument, in part, when he used a critical legal history analysis to explain how the entity theory became associated with the private nature of the corporation. He asserted that conservative interests used the entity theory in a determinate way in order to reject governmental intervention.[80] Thus, Horwitz claimed that the entity theory was a private theory of the corporation.

David Millon qualified Horwitz's argument by illustrating that the entity theory was later used to support the public nature of the corporation.[81] By highlighting the indeterminacy of the entity theory, Millon did not however diminish Hortwitz's argument that "the rise of a natural entity theory of the corporation was a major factor in legitimating big business,"[82] because, although theories may be inherently indeterminate, they become less indeterminate when studied within their historical contexts. Put differently, indeterminate theory can be used in a determinate manner when additional normative claims are imported. Horwitz asserted, "[W]hen abstract concepts are used in specific historical contexts, they do acquire more limited meanings and more specific argumentative functions. In particular contexts, the choice of one theory over another may not be random or accidental because history and usage have limited their deepest meanings and applications."[83]

In sum, the concession, entity and aggregate contractual theories are all essential to an understanding of what the corporation is. Each of these theories is indeterminate and can be used to justify or reject any position within corporate governance. To build an argument for or against any position, additional normative claims need to be imported. These claims are not inherently connected to the essentialist theory. Finally, examining these theories within their specific historical contexts helps to expose how additional normative claims are imported to these essentialist theories in order to create safe havens for undisclosed normative agendas separate from the theories themselves.

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[78] For a more exhaustive list of debates within corporate governance and how they play out in the American legal context, see Bratton, *supra* note 35.

[79] MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW: THE CRISIS OF LEGAL ORTHODOXY, 1780–1960, 68 (1992); Horwitz, *supra* note 66, at 204–06.

[80] HORWITZ, *supra* note 79, at 68; Horwitz, *supra* note 66, at 204–06.

[81] Millon, *supra* note 31, at 204, 242–51; Dewey, *supra* note 36, at 669.

[82] HORWITZ, *supra* note 79, at 68.

[83] *Id.*

III. THE CONCESSION AND ENTITY THEORIES - A BRIEF HISTORY

A. The Concession Theory

The concession theory was quite compelling in the early part of the nineteenth century when corporations were created exclusively through the legislative process.[84] The legislation in question would prescribe the corporate powers and purpose,[85] which would almost always be for the satisfaction of the public interest.[86] Corporations had no right to act outside of these legislated boundaries, and they bore only some resemblance in function to the modern corporation.[87]

As early as 1819, the shift away from the concession theory can be observed within American case law.[88] In *Trustees of Dartmouth College v. Woodward*, the United States Supreme Court rejected the argument that corporations were created by the unilateral legislative act of the state and endorsed the argument that a corporate charter was a bilateral contract between the state and the incorporator.[89] Put differently, instead of accepting Blackstone's more traditional view of a unilateral sovereign authority over incorporation,[90] this process was regarded as a contractual relationship.[91] The state granted the power and privilege to operate as a corporation, and the incorporator promised to engage in the objectives for which corporation was created.[92] Thus, the court held that the power of the state to either revoke incorporation or modify the terms of the corporate charter was quite limited.[93]

The case that marked the demise of the concession theory, as well as the death of the public corporation within American legal thinking and practice, was *Santa Clara County v. Southern Pacific Railroad Company*.[94] Up until Morton J. Horowitz wrote his

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[84] *Trs. of Dartmouth Coll. v. Woodward*, 17 U.S. 518, 636 (1819) ("A corporation is an artificial being…*existing only in contemplation of law*." (emphasis added)); *Cassatt v. Mitchell Coal & Coke Co.*, 150 F. 32, 44 (3d Cir. 1907) ("[A corporation] is a creature of the state."); Adolf A. Berle, Jr., *Constitutional Limits on Corporate Activity—Protection of Personal Rights from Invasion Through Economic Power*, 100 U. PA. L. REV. 933, 935 n.3 (1952); Adolf A. Berle, Jr., *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343, 343 (1947).

[85] *Dartmouth*, 17 U.S. at 636 ("Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created."); *see also Bank of Augusta v. Earle*, 38 U.S. (13 Pet.) 519, 584 (1839); *Bank of U.S. v. Dandridge*, 25 U.S. (12 Wheat.) 64, 68 (1827); *Head & Amory v. Providence Ins. Co.*, 6 U.S. (2 Cranch) 127, 162 (1804).

[86] *See Dartmouth*, 17 U.S. at 637 ("The objects for which a corporation is created…are deemed beneficial to the country; and this benefit constitutes the consideration, and in most cases, the sole consideration of the grant.").

[87] *See* THE COLUMBIA ENCYCLOPEDIA 688 (Paul Lagasse ed., 6th ed. 2000).

[88] *See Dartmouth*, 17 U.S. at 518.

[89] *Id.*

[90] *See supra* notes 56–57 and accompanying text.

[91] *Dartmouth*, 17 U.S. at 658–59.

[92] *Id.*

[93] *Id.*

[94] *Santa Clara Cnty. v. S. Pac. R.R. Co.*, 118 U.S. 394 (1886); *see also* Horwitz, *supra* note 66.

determinative article on the case,[95] it was conventionally understood that the *Santa Clara* Court granted the corporation Fourteenth Amendment rights because Justice Field, writing for the majority, adopted the entity theory. [96] Horowitz considered the theoretical deliberations at the time, and then argued that it was more likely that Justice Field was following an early prototype of the aggregate theory of the corporation, which asserted that it could be treated much like a partnership.[97]

This point of technical clarity is not as important as Horowitz's argument about the significance of the case. His argument proceeded to contextualize *Santa Clara* within the larger shift in corporate legal theory and practice to privatize corporate power at that time.[98] Later, David Millon wrote that the development of corporate theory and doctrine was a more complicated matter than Horwitz's critical narrative suggested; in particular Millon suggested that the theory at the time was employed not only to advocate for a private conception of the corporation, as Horwitz's critique might suggest, but also a public one.[99] That said, Millon himself also asserted that this case was a watershed moment in the shift toward protection of corporate power from state interventions.[100]

There were a series of corporate law reforms immediately after *Santa Clara*, which contributed to this turn to private theories of the corporation. Starting in 1888, states began to allow business people to acquire incorporation through an administrative process, rather than a legislative one.[101] This made incorporation more or less automatic.[102] At the same time, the *ultra vires* doctrine[103] was largely dismantled.[104] States also legislated the right for corporations to possess all of the freedoms of a natural businessperson.[105] Other corporate law reforms that were enacted at this time granted the corporation the capacity to buy and sell shares of other corporations.[106] The corporate form could now become a holding company with many new powers and potentials.[107] These new corporate holding companies created the ability to construct complex and opaque ownership structures. Each of these chipped away at the idea that the corporation was merely a creature of government concession, which resulted in the denial of its public dimension.

Upon reflection, if one accepts that all essentialist theories ought to be taken equally seriously because they are all necessary components to a comprehensive appreciation of

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[95] *Id.*

[96] *Id.* at 174, 178.

[97] *Id.* at 182, 204.

[98] *Id.* at 204–06.

[99] Millon, *supra* note 31, at 204, 242–51.

[100] *Id.* at 213.

[101] *See* DAVID SCIULLI, CORPORATIONS VS. THE COURT: PRIVATE POWER, PUBLIC INTERESTS 89–91 (1999); WILLIAM G. ROY, SOCIALIZING CAPITAL: THE RISE OF THE LARGE INDUSTRIAL CORPORATION IN AMERICA 152–53 (1997).

[102] O'KELLEY & THOMPSON, *supra* note 59, at 162–63; *see also supra* note 58.

[103] In this context, the ultra vires doctrine forbids a corporation from acting beyond the scope of powers granted to it. Henry Winthrop Ballantine, *Proposed Revision of Ultra-Vires Doctrine*, 13 A.B.A.J. 323 (1927).

[104] Millon, *supra* note 31.

[105] Horwitz, *supra* note 66, at 186–88.

[106] Joel Seligman, *A Brief History of Delaware's General Corporation Law of 1899*, 1 DEL. J. CORP. L. 249, 265 (1976).

[107] For more on the rise of holding companies, see Fred Freedland, *History of Holding Company Legislation in New York State: Some Doubts as to the "New Jersey First" Tradition*, 24 FORDHAM L. REV. 369 (1955).

the modern corporation, then it is unfortunate that American legal scholarship largely rejects the concession theory today. The prevailing attitude toward the concession theory is reflected in the following passage from Stephen Bainbridge:

> It has been over half-a-century since corporate legal theory, of any political or economic stripe, took the concession theory seriously. In particular, concession theory is plainly inconsistent with the contractarian model of the firm, which treats corporate law as nothing more than a set of standard form contract terms provided by the state to facilitate private ordering. The state provides the corporate form not so the corporation can ensure social welfare, but solely as a means of facilitating private ordering amongst people.[108]

It is significant to note that Bainbridge's statement demonstrates much of what is problematic about corporate law from Dewey's perspective. If Dewey is right, then it follows that the "contractarian model" [aggregate contractarian theory] and the concession theory can be "used to serve the same ends," or "to serve opposing ends;"[109] thus, they can be consistent or inconsistent with each other. In other words, both essentialist theories are indeterminate. So how can they be "plainly inconsistent?" In actuality, Bainbridge proves that they can be consistent in the last sentence of the passage: "The state provides the corporate form not so the corporation can ensure social welfare, but solely as a means of facilitating private ordering amongst people."[110] Bainbridge is employing a variation of the concession theory here that states: at the point of incorporation the state does not impose an obligation upon the corporation to ensure social welfare, but merely offers a means to facilitate private ordering without a social welfare obligation. This is a version of the concession theory, one he takes seriously, and it is consistent with his version of the aggregate contractarian theory.

B. The Entity Theory

It is important to note from the outset that there can be a distinction drawn between the corporation as an artificial entity and the corporation as a natural entity.[111] For the purpose of this article, the artificial entity theory is considered to be a version of the concession theory, based on the reasoning that the artificial entity theory concentrates on the concession and the consequences of that concession.[112] This version claims that the corporation is created by incorporation, and thus it is an artificial construction of the state. By contrast, the natural entity theory [hereinafter just "entity theory"] suggests that the corporation is a "'natural' phenomenon" that is something more than merely an artificial

[108] Bainbridge, *supra* note 61.
[109] Dewey, *supra* note 36, at 669.
[110] Bainbridge, *supra* note 61.
[111] Millon, *supra* note 31, at 211.
[112] *Id.*; Joo, *supra* note 11, at 158.

creation of the state.[113]

Millon explains that prior to the twentieth century the corporation was considered to be an artificial entity and it was not until the beginning of the twentieth century that the entity theory started to gain popularity.[114] In the American context, the entity theory was first used as a vehicle to make the normative claim that "the corporation [was] the creation of private initiative rather than state power."[115] As Millon explains:

> The triumph of the new theory therefore signaled a willingness to dispense with the use of corporate law as a regulatory tool designed to address the special social and economic problems that Americans saw as stemming from the rise of the business corporation. Theory instead tended to assimilate corporate persons to the status of natural persons, eliminating the many special limitations on corporate freedom of action that the states had imposed in the past. With this change in theory came a new willingness to treat corporate activity as fundamentally private in nature, differing in no important ways from ordinary individual commercial activities and therefore free from special legal regulations designed to protect public welfare.[116]

Millon's explanation is an example of Horwitz's "history and usage" analysis,[117] which acknowledges that the "deep[er] meanings and applications" of an essentialist theory may be limited by the social context in which it is used.[118] Although this version of the entity theory was used to block state intervention in corporate affairs,[119] much like how the aggregate contactarian theory is used today,[120] in time, a new version emerged that changed this usage. This new version of the entity theory was used to attempt to tie corporate managers to a social responsibility agenda, as the works of scholars such as Adolf A. Berle[121] and E. Merrick Dodd[122] demonstrate.

It is important to note that European scholars have had a much richer intellectual history of contemplating the corporate form as a natural entity.[123] Generally, these European scholars advanced entity theories, which asserted that there was something essentially natural about how individuals congregated in order to accomplish tasks and

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[113] *Id.* at 161.

[114] Millon, *supra* note 31, at 211.

[115] *Id*.

[116] *Id.* at 213.

[117] *See supra* note 83 and accompanying text. For more commentary on Horwitz's "history and usage" analysis, see Joo, *supra* note 11, at 171.

[118] HORWITZ, *supra* note 79, at 68.

[119] Millon, *supra* note 31, at 213.

[120] Joo, *supra* note 11, at 164–70. Some might protest this point arguing that the aggregate contractarian model has already been exposed as indeterminate. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999). That said, although this is evitable, it is still primarily being used at this time as a tool to block state intervention, like the entity theory was used at the turn of the twentieth century.

[121] Berle, Jr., *A Note*, *supra* note 69; Berle, Jr., *Corporate Powers*, *supra* note 69.

[122] Dodd, *supra* note 71.

[123] For instance, Otto Gierke drew upon the medieval understanding of the corporation (universitas) as the collection of people that formed a "mystical body." *See* OTTO GIERKE, POLITICAL THEORIES OF THE MIDDLE AGE 10, 22 (reprint 1913) (1900), *available at* http://www.archive.org/stream/politicaltheorie00gieruoft#page/n7/mode/2up.

that the power and complexity that emanated from such organization ought to be studied at a social rather than an individual level.[124] Such theories took very seriously the effects of the social dimensions of group activity. For instance, Marjatta Maula is taking the German theory of the corporation as a social system[125] in a promising direction, offering an accessible theory of "the model of living organizations, which explains the processes or learning and renewal . . . that are based on continuous co-evolution and self-production of an organization."[126]

American corporate legal scholars never attempted to grapple as deeply with these more social implications of the entity theory. This could be because, as Thomas Joo suggests, "[t]he general emphasis on groups as entities may have been too reminiscent of socialism and communism and too alien to American individualism" to be seriously contemplated. Thus, although the potential options for understanding the corporation as an entity were and are numerous,[127] American scholars narrowly conceived the corporate entity, the general scope of which can be appreciated from a reading of the Berle–Dodd debate of the 1930s.[128]

The dawn of the twentieth century marked the rise of large corporations, professional management, and passive investors.[129] This shift to professional management created new opportunities for the exploitation of the shareholder class,[130] which was not only growing in size, but was also increasingly less sophisticated.[131] This created a fear in some that the social bonds, whether fiduciary or contractual in nature, between ownership and control were too weak to adequately prevent managerial opportunism. The champion of these concerns was Adolf A. Berle, who, starting in 1923, developed legal arguments to the effect that the contractual and fiduciary bonds owed by corporate managers to shareholders needed to be taken more seriously.[132] Accordingly, his shareholder primacy

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[124] Most notably, Gunther Teubner built on Niklas Luhmann's theories, constructing a theory of the corporation as an autopoietic social system. Gunther Teubner, *Enterprise Corporatism: New Industrial Policy and the "Essence" of the Legal Person*, 36 AM J. COMP. L. 130 (1988). For more on the corporation as an autopoietic social system, see Dirk Baecker, *The Form of the Firm*, 13 ORGANIZATION 109 (2006).

[125] *Id.*

[126] MARJATTA MAULA, ORGANIZATIONS AS LEARNING SYSTEMS: "LIVING COMPOSITION" AS AN ENABLING INFRASTRUCTURE 3 (2006).

[127] *See, e.g.*, GIERKE, *supra* note 123; Baecker, *supra* note 124; Teubner, *supra* note 124.

[128] E. Merrick Dodd, Jr., *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?*, 2 U. CHI L. REV. 194 (1935); Berle, Jr., *A Note*, *supra* note 69; Dodd, *supra* note 71; Berle, Jr., *Corporate Powers*, *supra* note 69. For more on the history of the Berle–Dodd debate, see Fenner Stewart, Jr., *Berle's Conception of Shareholder Primacy: A Forgotten Perspective For Reconsideration During the Rise of Finance*, 34 SEATTLE U. L. REV. 1457 (2011); William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and The Modern Corporation*, 34 J. CORP. L. 99 (2008).

[129] *See* ROY, *supra* note 101 (large corporations and the corporate revolution); Bratton, *supra* note 55, at 1487–89 (management corporations); Michael Lounsbury & Ellen T. Crumley, *New Practice Creation: An Institutional Perspective on Innovation*, 28 ORG. STUD. 993, 997 (2007) (passive investments).

[130] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (2d ed. 1968).

[131] *Id.*

[132] For more on the development of Berle's theory, see ADOLF A. BERLE, NAVIGATING THE RAPIDS 1918–1971: FROM THE PAPERS OF ADOLF A. BERLE 19 (Beatrice Bishop Berle & Travis Beal Jacobs eds., 1973) (entry from

argument declared that stock ownership was a type of private property, which imposed fiduciary and contractual obligations upon corporate managers.[133] Yet, these obligations were not between the managers and the owners; rather, the obligations were between the managers and the property, which had "a corporal existence distinct from that of its owners."[134] These rights have sometimes been characterized as being owed to the shareholders as a class, thus excluding the particular rights that individual shareholders might have had.[135]

Underpinning Berle's efforts was the ever-widening diversity of share ownership, which he thought continued to increase the potential for democratizing corporate power.[136] For this reason, Berle theorized that if the law compelled corporate managers to act for the sole benefit of shareholders, then the corporation would eventually be aligned with the broader polity of American society.[137] This was the foundational motivation for Berle's shareholder primacy argument.[138]

As a side note, it is important to note that in 1932 Berle published *The Modern Corporation and Private Property* with Gardiner C. Means.[139] This book, in part, has a much different message than his shareholder primacy argument, proposing that the modern corporation was challenging the traditional conception of property.[140] Berle understood that shareholder primacy was not the only path to making corporate power respect public interest concerns.[141] He also believed that another path was that of greater government intervention in corporate affairs, which he endorsed in the last chapter of the book.[142] However, he also appreciated that greater government intervention was only possible if the political landscape shifted. And by the early 1930s, Berle began to appreciate that such a shift might occur if Roosevelt won the election in 1933.[143]

The first article of the Berle–Dodd debate is a replication of a chapter from *The Modern Corporation and Private Property*, with one key omission: Berle's shareholder primacy argument was constructed "with full realization of the possibility that private property may one day cease to be the basic concept in terms of which the courts handle problems of large scale enterprise."[144] He also admitted in this omitted text that it was possible that "the entire system [had] to be revalued" and that "the corporate profit stream in reality no longer [was] private property," asserting that a new theory of the modern corporation would likely develop.[145] But he qualified these views as a matter of sociological

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Berle's personal diary on Aug. 25, 1932); A. A. Berle, Jr., *Non-Voting Stock and "Bankers' Control,"* 39 HARV. L. REV. 673 (1926) [hereinafter Berle, Jr., *Non-Voting Stock*]; A. A. Berle, Jr., *Participating Preferred Stock*, 26 COLUM. L. REV. 303 (1926); A. A. Berle, Jr., *Problems of Non-Par Stocks*, 25 COLUM. L. REV. 43 (1925); A. A. Berle, Jr., *Non-Cumulative Preferred Stock*, 23 COLUM. L. REV. 358 (1923).

[133] Berle, Jr., *Corporate Powers*, *supra* note 69.

[134] BAINBRIDGE, *supra* note 10, at 27.

[135] BERLE, *supra* note 132.

[136] Stewart, *supra* note 128, at 1460–63.

[137] *Id.*

[138] For more on the development of Berle's theory, see sources cited *supra* note 132.

[139] BERLE & MEANS, *supra* note 130.

[140] *Id.* at 302–08.

[141] Stewart, *supra* note 128, at 1473.

[142] BERLE & MEANS, *supra* note 130.

[143] Stewart, *supra* note 128, at 1485–90.

[144] BERLE & MEANS, *supra* note 130, at 219.

[145] *Id.*

study, which had not yet attained a standing as a "matter of law."[146]

Accordingly, Berle recommended that until a new corporate theory became a "matter of law," lawyers and legal academics must do their best within the existing legal framework—that being to think "in terms of private property."[147] Berle did just that in his 1931 article, arguing "all powers granted to a corporation . . . are . . . at all times exercisable only for the ratable benefits of all the shareholders as their interest appears"[148] without qualification. Knowing that the concession theory would not be accepted in the 1920s, and still wanting to tie corporate power to the concerns of the boarder polity, he believed that the only corporate theory that could adequately serve as a tool to regulate the firm—at that time—was the corporation as private property.[149] Berle saw this as his only solution.[150]

Berle did not directly explain the entity as private property, but the theory is simple enough. The law regulates the corporation as property. This property is owned by shareholders. Shareholders have the authority to elect directors because of their ownership interest in the corporation. When shareholders elect directors, they also delegate the authority to run the corporation to the directors. Directors then in turn delegate part of this authority to executive management to oversee the day-to-day affairs of the corporation. Thus, directors and management had an obligation to shareholders as a class and not merely to the group of shareholders that consolidated control.[151] This created fiduciary and contractual obligations to protect minority shareholder interests in all circumstances.[152] In other words, the law imposed obligations upon directors and management to treat all shareholders evenhandedly, guaranteeing that the interests of ownership were not undermined.[153]

E. Merrick Dodd thought Berle's shareholder primacy argument was dangerous, because such shareholders only cared about profits and not about the broader issues of corporate social responsibility.[154] Dodd endorsed a more radical entity theory of the firm that hinted at the idea that the corporation was more than private property, and thus when managers served the best interests of the corporation, they would be serving more than merely the interests of property holders.[155] Dodd was, in fact, suggesting that the corporation was separate from its aggregate parts, a social entity which tied managers to serve the interests of a broader spectrum of corporate constituents.[156] He never clearly articulated what the corporation was as an entity, and yet he pushed forward, advocating

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[146] *Id.*

[147] *Id.* at 219–20.

[148] *Id.* at 220; Berle, Jr., *Corporate Powers*, *supra* note 69, at 1049.

[149] BERLE & MEANS, *supra* note 130; Berle, Jr., *A Note*, *supra* note 69, at 1367; Berle, Jr., *Corporate Powers*, *supra* note 69.

[150] *Id.*

[151] Berle, Jr., *Non-Voting Stock*, *supra* note 132.

[152] *See supra* note 133 and accompanying text.

[153] *Id.*

[154] Dodd, *supra* note 71, at 1146–48.

[155] *Id.* at 1146.

[156] *Id.* at 1149.

for managers to be freer than Berle thought they should be.[157] Dodd thought this would protect better employees, creditors and the community-at-large;[158] this theory, which promotes a broader discretion for managers over corporate function, has been called managerialism.[159]

Although Berle was sympathetic to the ends of Dodd's managerialism, he thought that Dodd's agenda was dangerously optimistic, because his theory was theoretically impoverished.[160] Berle argued that this form of managerialism would free directors and executive officers from the constraints of their fiduciary duties to shareholders, basically granting them broad discretion over corporate power in the vain hope they would be responsible.[161] This freedom to engage opportunism was precisely what Berle was attempting to avoid, and he was thus skeptical and leery of Dodd's corporate social responsibility agenda.[162]

Berle's and Dodd's entity theories of the corporation survived in some form until the start of the 1970s. For instance, in 1970 Milton Friedman took up a version of Berle's private property entity theory of the corporation,[163] writing:

> In a free enterprise, private property system, a corporate executive is an employee of the owners of the business. He has [a] direct responsibility to his employers. That responsibility is to conduct business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of society.[164]

It is interesting to note that Friedman constructed the interests of shareholders as those of profiteers with minimal regard for corporate social responsibility, while Berle constructed the interests of shareholders as those of the broader polity with great regard for corporate social responsibility. Thus, with the shift in normative claims attaching to the entity theory, a shift in the policy prescriptions that logically flow from it can be observed.

A counter example to Friedman's entity theory was that of his mid-twentieth century contemporary John Galbraith. Galbraith argued that management of the economy was to be carried out as a public–private partnership between large corporate entities and government; implicit in this argument is a Dodd-ish managerialism that suggested that managers were not accountable to shareholders but to the corporation, which in turn was accountable to broader public interest concerns.[165] It is also important to note, for general context, that this sort of heroic managerialism exploded in popularity at the time. It was deeply enamored with the vision of corporate managers as stewards of society. Like with

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[157] *Id.*

[158] *Id.* at 1153–56.

[159] For one of the best descriptions of the evolution of managerialism in the American context, see Bratton, *supra* note 35.

[160] Berle, Jr., *A Note*, *supra* note 69, at 1372.

[161] *Id.*

[162] *Id.*

[163] Although Milton Friedman could not be considered ideologically aligned with Berle, he did endorse Berle's fiduciary model in 1970.

[164] Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970 (Magazine). For more on the interpretation of Friedman's position, see BAINBRIDGE, *supra* note 10, at 26–27.

[165] JOHN KENNETH GALBRAITH, THE NEW INDUSTRIAL STATE (2007).

Dodd's theory, there was little concern for theoretical assumptions that underpinned this enthusiasm, regarding the corporation as a "social institution" without further contemplation for what sort of entity this might be.[166]

Upon reflection, what is clear about the use of the entity theory during the mid-twentieth century was that it could be, and was, employed by both advocates for free markets, like Friedman,[167] and by advocates for government control, like Galbraith.[168] This observation conforms to Dewey's[169] and Millon's[170] arguments, which contended that these essentialist theories are indeterminate, and also Horwitz's[171] historical narrative that argued that this indeterminacy has been narrowed at different points in history, because of its political usage by prevailing interests. Thus, although the entity theory was used to advocate the private nature of the corporation, it was also used to argue for government intervention. When the indeterminacy of an essentialist theory is exposed in this manner, it becomes more translucent and the interests behind the theory become more visible.

As with his rejection of the concession theory, when Bainbridge rejects the entity theory, he provides another excellent example of how some aggregate contractarian theorists fail to appreciate that all essentialist theories, including the aggregate contractarian theory, are indeterminate. Bainbridge writes:

> [An entity theory] requires one to reify the corporation; i.e., to treat the corporation as something separate from its various constituents. While reification provides a necessary semantic shorthand, it creates a sort of false consciousness when taken to extremes. The corporation is not a thing. The corporation is a legal fiction representing the unique vehicle by which large groups of individuals, each offering a different factor of production, privately order their relationships so as to collectively produce marketable goods or services.[172]

Bainbridge steps into the world of the sociology of knowledge when he chooses to discuss how theory reifies reality, and he is only partly correct in his assessment. The entity theory reifies the corporation, but all essentialist theories "reify the corporation."[173] The entity theory provides a form of "semantic shorthand," but all essentialist theories are forms of "semantic shorthand."[174] The entity theory creates "false consciousness," but all theories

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[166] For one of the best explanations of this, see Harwell Wells, *"Corporation Law is Dead": Heroic Managerialism, The Cold War, and the Puzzle of Corporation Law at the Height of the American Century* (forthcoming 2013).
[167] Friedman, *supra* note 164.
[168] GALBRAITH, *supra* note 165.
[169] Dewey, *supra* note 36, at 669.
[170] Millon, *supra* note 31, at 204, 242–51.
[171] HORWITZ, *supra* note 79, at 68.
[172] BAINBRIDGE, *supra* note 10, at 27–28.
[173] *Id.*
[174] *Id.*

create "false consciousness."[175] Bainbridge slips when suggesting that aggregate contractarian theory is superior to the other theories. Simply put, his tacit claim that aggregate contractarian theory is non-reifying is unsupportable.

Dewey appreciated this point: the factualness of a claim was neither absolute nor arbitrary.[176] He suggested that the "eventful character of all existences" was no reason to attempt to find balance by clinging to either extreme.[177] Instead, he advised that the inquirer should examine the relevant variables involved in a problem,[178] so that no claim is uncritically reified as fact.[179] Dewey suggested that without a reflective re-assessment of claims within specific social contexts, these claims stop serving as tools for the honest observation of social function, and can start "prevent[ing] the communication of ideas,"[180] and thus learning. Consequently, if Dewey is correct, embracing the indeterminacy of all essentialist theories ought to better equip legal thinkers to learn how corporations function.

IV. THE RISE OF THE AGGREGATE CONTRACTARIAN THEORY

The entity theory of the corporation as private property began to lose its hold on American corporate legal thinking in the 1960s.[181] In 1962, Henry Manne attacked Berle's model of ownership and control, arguing that there were links between the price of stocks on secondary markets, the residual value of the corporation, and managerial behavior that anachronistic thinkers like Berle never appreciated.[182] For instance, Manne detailed how poor corporate management can depress share price to a level in which share price does not reflect the corporation's potential profitability; the corporation at this point may lure an investor to take over the corporation and replace its management team in order to improve corporate performance (profitability).[183] Such threats to corporate boards thus become a control mechanism for managerial performance.[184] What is most germane to the rise of the aggregate contractarian perspective is that, to make such arguments, Manne employed classical economic thinking, which understands the corporation by observing it through the lens of the aggregate theory.[185]

Manne borrowed from the contribution made by classical economists, like Ronald Coase,[186] who set out to challenge the entity theory of the corporation.[187] Coase suggested that to better understand the corporation, observers ought to focus on the transaction costs

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[175] *Id.*

[176] DEWEY, *supra* note 43, at 64.

[177] *Id.*

[178] *Id.*

[179] *Id.*

[180] 13 JOHN DEWEY, *The Unity of the Human Being*, *in* THE LATER WORKS, 1925-1953, 323, 323 (Jo Ann Boydston ed., 1988).

[181] Henry G. Manne, *The "Higher Criticism" of the Modern Corporation*, 62 COLUM. L. REV. 399, 402–07 (1962).

[182] *Id.*

[183] Henry G. Manne, *Mergers and The Market for Corporate Control*, 73 J. POL. ECON. 110, 112–14 (1965).

[184] *Id.* at 114.

[185] Manne, *supra* note 181, at 430–32.

[186] *Id.*

[187] R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 386–87 (1937).

that a corporation confronted when operating within the market.[188] By directing legal thinkers to understand the corporation in terms of how its aggregates make decisions about how to allocate resources based on price indicators, Manne planted the seeds of the modern aggregate theory within corporate legal thinking.[189] At the core of Manne's thinking were ideas like Friedrich Hayek's. Hayek suggested that private ordering depended upon the price mechanism, which facilitated the necessary information transfers between actors for decentralized market-based transactions to occur.[190] Such decentralized transactions were desirable, Hayek argued, because they were efficient at allocating scarce resources to meet demands within an economic system.[191]

Coase's work went further than Manne's. He observed the operation of large corporations and concluded that these economic units function in a manner that circumvented the operation of the price mechanism.[192] The corporation took what was occurring in the market and internalized that function of the market within itself.[193] For instance, instead of a shoe producer contracting individually in the market with the makers of shoe soles, leather uppers, laces, insoles, and so forth, a corporation may hire all of the people necessary to make the shoes and thus it centralizes all of the components of production in-house. The result is that the corporation makes shoes less expensively by controlling production.

From Coase's perspective, the corporation was like a more highly coordinated micro-market that operated within the larger market and imposed cost efficiencies upon the components of production.[194] Put differently, the corporation was a centrally controlled production system within the larger economy that avoided transaction costs by reducing the price of production to less than what occurred in the market without such coordinated efforts. Thus, the function of the corporation could be understood in terms of the transaction costs within the firm versus those outside the firm.

From this understanding of the corporation, Coase argued that it was possible to understand what controlled the size of corporations.[195] He suggested that corporations are created to lower costs below the cost of production in the market.[196] The corporation would only internalize transactions (components of production) until the cost of production was equal to or higher than the cost of transactions in the market.[197] At this point, the centralized system was no longer more efficient than the function of the market.[198] Thus, firm size was dependent on the transaction costs inside and outside of the

[188] *Id.* at 392.
[189] Manne, *supra* note 181, at 430–32.
[190] Hayek, *supra* note 1, at 526–27.
[191] *Id.* at 527.
[192] Coase, *supra* note 187, at 389–91.
[193] *Id*. at 391–92.
[194] *Id.* at 394–96.
[195] *Id.* at 396–98.
[196] *Id*.
[197] *Id*. at 394–98.
[198] *Id.* at 395–97.

corporation.[199] A good example of how this theory actually translated into practice is when a number of corporations reduced their size in the 1990s as a result of innovations in communication, logistics and transportation, which made outsourcing more cost-effective than maintaining many components of production in-house.[200] In other words, innovations in communication, logistics and transportation made production in market more efficient than production in the corporation.

In 1970, Manne's theory for a market for managerial control was reinforced by a brilliant young economist named Eugene Fama, who had just completed his doctoral work on the efficiency of markets.[201] Building upon how price mechanisms reflect the available knowledge about products and the role that competitive markets played in gathering that knowledge, Fama suggested that the price of corporate securities was based on the available information about corporate stocks known by investors.[202] His research became synonymous with the "efficient capital markets hypothesis," which assumes that financial markets efficiently respond to available information.[203]

In a practical sense, Fama's economic model provides an empirical basis for studying how sophisticated financial analysts and investors, who closely examine the data about publicly traded companies, ensure that stock markets are always highly efficient at pricing firm value.[204] As new information about a company becomes publicly known, the theory asserts that stock price will adjust accordingly.[205] Thus, the price of a stock reflects the best available opinion as to whether or not a company will be profitable moving forward.[206]

Fama's theory helped to make sense of the complex interrelationship of managers (directors and executives) and risk bearers (investors) as aggregate participants within corporate governance. Fama's work reinforced the work of Henry Manne, which argued that investors far removed from the nuances of a corporate governance structure could meaningfully participate in corporate governance by responding to price signals that reduced the complexity of information into a readily understandable signal: the rise and fall of stock value.[207] Thus, the evolution of "efficient capital markets hypothesis" helped to kindle faith in the ability of market competition to produce optimal corporate governance outcomes, leading to the general opinion that government intervention in corporate governance and markets was not only unnecessary, but could in fact hamper the performance of corporations, and even possibly as Milton Friedman suggested lead to

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[199] *Id.*

[200] BARRY C. LYNN, END OF THE LINE: THE RISE AND COMING FALL OF THE GLOBAL CORPORATION (2005).

[201] Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970) [hereinafter Fama, *Efficient Capital Markets*]; Eugene F. Fama, *The Behavior of Stock-Market Prices*, 38 J. BUS. 34 (1965) (Fama's Ph.D. dissertation) [hereinafter Fama, *Stock-Market Prices*].

[202] *Id.*

[203] Fama first mentioned the idea of "efficient" market in his 1965 Ph.D. dissertation. Fama, *Stock-Market Prices*, *supra* note 201, at 90, 94. However, his 1970 article solidified his idea of "efficient" markets. Fama, *Efficient Capital Markets*, *supra* note 201.

[204] Eugene F. Fama, Lawrence Fisher, Michael C. Jensen & Richard Roll, *The Adjustment of Stock Prices to New Information*, 10 INT'L. ECON. REV. 1 (1969).

[205] *Id.*

[206] This conclusion is implicit in the conclusion of his 1970 article. Fama, *Efficient Capital Markets*, *supra* note 201.

[207] Manne, *supra* note 183.

totalitarianism![208] If markets occurred naturally, and if regulation impeded their natural operation, then it was assumed that efficient function of financial markets prevented suboptimal corporate governance arrangements, simply by exit (selling their stocks).[209] In other words, if financial markets were largely free from regulation, and if securities law required corporate managers to provide relevant information about corporate governance, sophisticated financial analysts and investors could adjust stock value based on the present potential for profitability of any particular corporation.

Fama's theory and method for establishing the correlations that existed between poor corporate governance performance and stock price gave Manne's "market for corporate control" empirical prowess.[210] Discounting the stock value not only impacted the capability of a corporation to raise capital, but it also increased the risk of corporate takeover, which directly threatened the jobs of corporate managers.[211] The theory made a convincing argument that it was possible to accurately discount stock value as a response to poor corporate governance performance.[212] It also provided a flexible, responsive and consensual mechanism for enforcement, which ensured that corporate managers were performing effectively. More specifically, it provided a picture of corporate governance as a complex web of aggregate risk bearers and managers all joined by the price mechanism.

A couple of years after Fama published his seminal 1970 article,[213] Armen Alchian and Harold Demsetz made another landmark contribution to the aggregate theory of the corporation by introducing the nexus-of-contracts theory as an expansion and revision of Coase's theories.[214] They argued that Coase exaggerated the importance of transaction costs when attempting to understand why corporations exist.[215] For Alchian and Demsetz, it was not the reduction of transaction costs that made the firm more efficient than markets; rather the firm was more efficient because it could channel information between aggregate constituents of the corporation better than the market could (resulting in lower information costs).[216]

Another perspective that added to the advancement of the aggregate theory was the 1976 article by Michael Jensen and William Meckling.[217] This article changed the way American legal scholarship thought about agency theory by more firmly harnessing an expanded theory of transaction costs to agency theory.[218] The authors argued that one way

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[208] MILTON FRIEDMAN, CAPITALISM AND FREEDOM 119–36 (2002).

[209] For more on the power of exit and the precursor of the theory of shareholder exit, see ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970).

[210] Manne, *supra* note 183.

[211] Manne, *supra* note 183.

[212] Fama, Fisher, Jensen & Roll, *supra* note 204.

[213] Fama, *Efficient Capital Markets*, *supra* note 201.

[214] Alchian & Demsetz, supra note 34, at 783–84.

[215] *Id.*

[216] *Id.* at 783, 785, 793–95.

[217] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[218] Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449 (1989); *see also* Bratton, *supra* note 8.

that managers could be held accountable would be to require financial disclosure and inspection of the firm's accounts by independent auditors.[219] The work of such independent auditors necessarily created "monitoring costs," which were necessary evils if competition was to police managerial discretion.[220] This suggestion was much in line with Fama's work on efficient capital markets[221] and Manne's work on market for control.[222] However, the authors admitted that monitoring strategies[223] could not eliminate the risk of opportunism and other inefficiencies created by the agency relationship.[224] They called these inevitable costs "residual loss,"[225] referring to the shareholder's residual claim on the corporation. With the growing acceptance of this understanding of the agency relationship, the issues of agency theory were decisively shifted from the entity to aggregate theory.[226] Jensen and Meckling's theory also was much in line with Alchian and Demsetz's.[227] They also argued that all of the firm's activities could be explained in terms of the contracts (the formalized normative legal information) that shape the relationships between constituents.[228] They suggested that the corporation was no more than a "nexus for a set of contracting relationships among individuals."[229]

In the 1980s, Easterbrook and Fischel crystalized the aggregate contractarian theory within American corporate law by publishing the lion's share of this legal and economic theorizing.[230] Their translation of the arguments of Coase,[231] Hayek,[232] Friedman,[233] Fama,[234] and other economists[235] persuaded corporate legal thinkers that if corporate law better facilitated freedom of contract, then the potential of markets could be

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[219] Jensen & Meckling, *supra* note 217.

[220] *Id.* at 308–10, 319–28.

[221] Fama, *Efficient Capital Markets*, *supra* note 201; Fama, *Stock-Market Prices*, *supra* note 201.

[222] Manne, *supra* note 183.

[223] In addition to monitoring costs the authors also discussed "bonding costs," which provided managers the opportunity to demonstrate their performance and loyalty, but are being left out of the present discussion. *See* Jensen & Meckling, *supra* note 217, at 308–10, 325–30.

[224] *Id.* at 357.

[225] *Id.* at 308–10, 319.

[226] Well, at least it had in economics; it would not be until the 1980s that it was popularized in corporate legal scholarship. *See* Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986); Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611 (1985); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985); Frank H. Easterbrook, & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984); Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395 (1983); Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L. J. 737 (1982); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

[227] Alchian & Demsetz, *supra* note 34, at 783–84.

[228] *Id.*

[229] Jensen & Meckling, *supra* note 217, at 311.

[230] *See* sources cited *supra* note 226.

[231] R. H. Coase, *The Problem of Social Cost*, 3 J. L. & Econ. 1 (1960); Coase, *supra* note 187.

[232] Hayek, *supra* note 1.

[233] FRIEDMAN, *supra* note 208.

[234] Fama, *Efficient Capital Markets*, *supra* note 201.

[235] *See, e.g.*, Jensen & Meckling, *supra* note 217; Alchian & Demsetz, *supra* note 34.

unleashed.[236] Furthermore, there was no need to be concerned about the loss of regulatory control, because competitive markets insured a consensual enforcement mechanism for managerial decision-making based on the ability of self-interested actors to hold each other in check.[237] Thus, if markets were left to their own devices, then they would find an equilibrium that established an optimal balance between all corporate constituents.[238] With Easterbrook and Fischel's publications, these already popular economic notions about corporate governance, markets and regulation soon prevailed over other essentialist theories within corporate legal thought.[239]

By the 1990s, Easterbrook and Fischel marveled at the efficiency of modern corporate law.[240] They detailed the consequences of providing off-the-rack default rules for incorporation.[241] On one hand, these optional rules assisted less sophisticated incorporators to select a low-cost framework that, for most firms, would "maximize the value of corporate endeavor[s] as a whole".[242] On the other hand, their optional nature averted corporate law from imposing a rigid regulatory framework, which most certainly would restrict shrewd business people from customizing corporate entities to exploit uncommon business opportunities.[243] They described modern corporate law as an "economizing device" which reduced the cost of consensual bargaining without sacrificing dynamism.[244]

Easterbrook and Fischel compared corporate law to the regulation of other areas of society, determining that it was unique.[245] They compared it to administrative law, observing that the discretion of administrative officials was tightly constrained by regulation and closely scrutinized by judicial oversight.[246] By comparison, they observed that corporate law "allow[ed] managers and investors to write their own tickets, to establish systems of governance without substantive scrutiny from a regulator,"[247] and furthermore, that the "business judgment rule" instructed courts to adopt a "hands-off approach."[248] While the administrative officials were tightly regulated and closely scrutinized, corporate managers were free to do basically whatever they like.[249]

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[236] *See supra* note 226 and accompanying text.

[237] For production of these economic presumptions in corporate legal scholarship, see EASTERBROOK & FISCHEL, *supra* note 25, at 38.

[238] *See, e.g.*, BAINBRIDGE, *supra* note 10, at 30–31 (Bainbridge's application of "The Hypothetical Bargain Methodology").

[239] Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391 (1992).

[240] EASTERBROOK & FISCHEL, *supra* note 25.

[241] *Id.* at 34–35.

[242] *Id.* at 35.

[243] *Id.*

[244] *Id.*

[245] *Id.* at 2.

[246] *Id.*

[247] *Id.*

[248] *Id.*

[249] *Id.*

Easterbrook and Fischel explained that, upon close inspection, corporate managers were not as free as they might appear at first glance.[250] Although corporate law stepped back from imposing command-and-control regulation upon corporate governance, they asserted that there were still enforcement mechanisms that regulated the action of corporate managers.[251] They detailed how other constituents of the firm (such as investors, employers, consumers, creditors etc.) contracted/negotiated with corporate managers in a manner that would make some decisions profitable and others not.[252] For instance, corporate managers did not engage in opportunistic behavior, not because the law was capable of preventing such behavior, but because it would decrease the performance of the corporation, which would in turn decrease the value of its shares, resulting in ex ante contractual penalties for the managers.[253] Examples of such ex ante contractual penalties include the decreased potential value of a manager's stock options, the threat of removal due to poor performance and/or the threat of damage to reputation.[254] Thus, a cocktail of free contracting, highly liquid markets, free flow of information, and self-interest created a balancing of interests between market actors within corporate governance that tended to optimize corporate performance in each particular situation, depending upon the competence of the negotiating parties in question.[255] And, in a world of consensual contracting, without notable power imbalances and information asymmetries, equity was satisfied in all but a few cases, because those who freely obliged themselves to bad bargains could be expected to suffer the burden of the bargains, hopefully learning from the experience, and thus, better equipping themselves for future contracting.[256]

The classic concern of corporate governance was the separation of ownership and control.[257] From this perspective, the most obvious challenge to letting markets police managerial behavior was that investors did not have the time, skill, or knowledge in order to be able to properly negotiate and enforce the terms of corporate governance.[258] The authors were quick to suggest how this was a misconception.[259] They explained that American stock markets had teams of professional investors working alongside investment advisors in order to oversee corporate performance.[260] Even though an individual investor might not have the capacity to contract effectively they would be able to respond to increases or decreases in stock value triggered by more sophisticated and powerful investors in the market.[261]

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[250] *Id.* at 3.
[251] *Id.*
[252] *Id.* at 2–3.
[253] *Id.* at 6.
[254] *Id.*
[255] *Id.* at 6-7.
[256] *See, e.g.*, Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627, 639 (1996) ("[O]ver time investors should learn from their mistakes, acquiring a natural humility."); *see also Carlson v. Hamilton*, 332 P.2d 989, 990 (Utah 1958) ("People should be entitled to contract on their own terms without the indulgence of paternalism by courts in the alleviation of one side or another from the effects of a bad bargain.").
[257] BERLE & MEANS, *supra* note 130.
[258] EASTERBROOK & FISCHEL, *supra* note 25, at 17–19, 23.
[259] *Id.* at 23–24.
[260] *Id.* at 17–19, 23–24.
[261] *Id.* at 23–24.

The large sophisticated investors, having enough financial might in stock markets, could push the price enough to signal other investors that a stock value is too high or too low.[262] These professional investors constantly engage in detailed analysis of corporate management, governance structure, debt/equity ratios, and relative prowess when compared to competitors.[263] Thus, tacitly relying on the commonly accepted arguments of Friedrich Hayek,[264] Henry Manne[265] and Eugene Fama,[266] the authors suggested that the operation of an effective price mechanism provided enough information for decentralized actors to make efficient decisions.[267] The corporate legal world quickly warmed to the idea that a corporate law that allows actors to "consensually" contract to protect their own interests resulted in more optimal corporate governance structures.[268] By doing less and allowing markets to function efficiently, corporate law encourages "what is optimal for the firm and investors."[269]

In the 1980s and 1990s, a number of powerful critiques reacted to the aggregate contractarian theory.[270] In 1985, Mark Granovetter noted that modeling based on this theory tended to either undersocialize[271] or oversocialize[272] the corporation, leading to the same result of formalizing the actual social relationships to a degree that did not reflect what was actually happening within corporations.[273] In 1989, Bratton carefully contemplated a number of questionable assumptions about discrete contracts and contractual gaps, which needed to be accepted, if the theory was to work.[274] In 1995, Lawrence Mitchell argued that the theory favored shareholders at the expense of other corporate constituents, who either had no contract (like the community at large), or had little power to negotiate the terms of their contract (like un-unionized workers).[275] Each of these critiques, and others like them, suggested that, in the end, this seemingly neutral

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[262] *Id.* at 17–19.

[263] *Id.* at 17–19, 23–24.

[264] Hayek, *supra* note 1.

[265] Manne, *supra* note 183.

[266] Fama, *Efficient Capital Markets*, *supra* note 201.

[267] EASTERBROOK & FISCHEL, *supra* note 25, at 19.

[268] *Id.* at 6–7.

[269] *Id.* at 7.

[270] *See, e.g.*, Mark Granovetter, *Economic Action and Social Structure: The Problem of Embeddedness*, 91 AM. J. SOC. 481 (1985); Bratton, *supra* note 1; Lawrence E. Mitchell, *Cooperation and Constraint in the Modern Corporation: An Inquiry into the Causes of Corporate Immorality,* 73 TEX. L. REV. 477 (1995) [hereinafter Mitchell, *Cooperation and Constraint*]; Lawrence E. Mitchell, *Trust. Contract. Process., in* PROGRESSIVE CORPORATE LAW 185 (Lawrence E. Mitchell ed., 1995) [hereinafter Mitchell, *Trust. Contract. Process.*].

[271] For instance, Granovetter describes undersocialized as an atomized utilitarianism, which emanated from the Hobbesian tradition and underestimates the importance of how actors are embedded within a social context. Granovetter, *supra* note 270, at 483.

[272] Granovetter describes oversocialized as "a conception of people as overwhelmingly sensitive to the opinions of other and hence obedient to the dictates of consensually developed systems of norms and values, internationalized through socialization." *Id.*

[273] *Id.* at 485–87.

[274] Bratton, *supra* note 1, at 461–63.

[275] Mitchell, *Cooperation and Constraint*, *supra* note 270; Mitchell, *Trust. Contract. Process.*, *supra* note 270.

theory might not be as objective as some assumed.[276] But, in the end, these critiques had little impact on the use of this theory in corporate legal academia.

During the last decade, there has been one model aggregate contractarian theory that stands out: Bainbridge's director primacy model.[277] Bainbridge adopts a hierarchical management structure that earlier contractarians tempted to flatten.[278] These earlier contractarians used contract to explain away corporate hierarchy,[279] but Bainbridge rejects such temptations, embracing the need for contract theory to account for "asymmetric information" and "bilateral monopoly."[280] Bainbridge is not as willing as Easterbrook and Fischel were in 1991 to optimistically believe in the power of the market to arbitrate equity within corporate governance.[281] For this reason, Bainbridge's efforts ought to be celebrated as an admirable advancement in this version of the aggregate contracarian theory. Bainbridge describes his model as follows:

> Instead of viewing the corporation either as a person or an entity, contractarian scholars view it as an aggregate of various inputs acting together to produce goods or services. Employees provide labor. Creditors provide debt capital. Shareholders initially provide capital and subsequently bear the risk of losses and monitor the performance of management. Management monitors the performance of employees and coordinates the activities of all the firm's inputs. Accordingly, the firm is not a thing, but rather a nexus of explicit and implicit contracts establishing rights and obligations among various inputs making up the firm.[282]

This model does have its contractarian challengers. Contractarian purists, like Lucian Bebchuk, are not so willing to give up the market for corporate control.[283] Bebchuk rejects Bainbridge's notion that allowing for managerial discretion maximizes shareholder wealth and most effectively protects the interests of shareholders as a class.[284]

The now classic Bebchuk–Bainbridge debate[285] may prove to be the high watermark for the present embodiment of the aggregate contractarian theory. The debate exemplifies how, in the highest echelons of American corporate legal discourse, such debates could fit comfortably within the still largely uncontested aggregate contractarian theory. This article uses the words "largely uncontested," because in 2005–2006, when their debate occurred, cracks had emerged in this paradigm. The succession of shockwaves, which started in March 2000 when the Dot-Com Bubble started to burst, damaged the credibility of this

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[276] Mitchell, *Cooperation and Constraint*, *supra* note 270, at 448, 455, 461, 464.
[277] BAINBRIDGE, *supra* note 10.
[278] *Id.*
[279] Bratton, *supra* note 8.
[280] BAINBRIDGE, *supra* note 10, at 24.
[281] *Id.*
[282] *Id.* at 28.
[283] Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).
[284] Lucian A. Bebchuk, *Reply: Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006).
[285] *Id.*; Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006); Bebchuk, *supra* note 283.

previously unquestionable theory.[286] The Enron fiasco did not help things either.[287] However, after 2008, confidence in the efficient market hypothesis was clearly shaken;[288] even some of the most prominent advocates of the market efficiency theory, such as Alan Greenspan, publicly began to express doubt about it as presently conceived.[289]

In light of this, Thomas Joo envisions that corporate legal scholarship is about to enter into a new post-contractarian era, [290] seeing promise in the work being done in behavior finance.[291] This article agrees with Joo's observation that a shift appears to be occurring,[292] but predicts a different outcome. It expects that the emerging innovations will be generated within the aggregate contractarian theory. As this article has illustrated, history indicates that the indeterminacy of a given essentialist theory of the corporation allows for counter positions and apposing policy positions to emerge within it.[293] There does not appear to be any reason why it would not happen again within the aggregate contractarian theory. In other words, it is predicted that the aggregate contractarian theory will remain the dominant theory approach in legal academia. Leading thinkers will still regard the corporation as being a group of aggregate constituents who are connected through contract, but their assumptions about contracts and markets will change to accommodate factual circumstances, leading to different policy prescriptions.

V. CONCLUSION

The contestation that has emerged about aggregate contractarian theory is like the history of the entity theory at the beginning of the twentieth century.[294] As covered in this article, the entity theory shifted from defending claims about the private nature of the corporation to defending the opposite claim by the 1930s.[295] And yet, the future of corporate legal theory does not need to be this path dependent; history does not have to repeat itself. As an alternative, we could embrace the indeterminacy of the aggregate

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[286] For a critique highlighting the flaws in the efficient markets hypothesis just prior to the crash, see ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (2000). To put the Dot-Com Bubble within a historical context, see CHARLES P. KINDLEBERGER & ROBERT Z. ALIBER, MANIAS, PANICS AND CRASHES: A HISTORY OF FINANCIAL CRISES (6th ed. 2011).

[287] ENRON AND OTHER CORPORATE FIASCOS: THE CORPORATE SCANDAL READER, *supra* note 14.

[288] Paul Krugman, *How Did Economists Get It So Wrong?*, N.Y. TIMES, Sept. 6, 2009, at MM36; John Cassidy, *After the Blowup: Laissez-faire Economists Do Some Soul-Searching—And Finger-Pointing*, THE NEW YORKER, Jan. 11, 2010, at 28.

[289] Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, N.Y. TIMES, Oct. 24, 2008, at B1). For an example of the Chicago School academia distancing itself such theory, see RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION (2009).

[290] Joo, *supra* note 11, at 170. Joo points to the work of Donald Langevoort, see Donald C. Langevoort, *Taming the Animal Spirits of the Stock Market: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135 (2002).

[291] *Id.*

[292] *Id.*

[293] *See supra* notes 154–171 and accompanying text.

[294] *See supra* notes 129–171 and accompanying text.

[295] Joo, *supra* note 11, at 170.

contractarian theory (and the other essentialist theories of the corporation), providing a path to a corporate legal discourse with greater contestation and complexity. Such contestation and complexity ought to be welcomed. Joo argues when considering post-contractarian directions in corporate theory that, "[a]s the best theorists appreciate, rational behavior theory, and grand constructs generally, offer ease of comprehension at the cost of oversimplification. The spectacular recent failures in the financial markets illustrate how the costs of oversimplification can outweigh the benefits."[296]

Of course, Joo is not suggesting that there is a direct correlation between the prevailing version of the aggregate contractarian theory and the recent failures in the financial markets. Rather, he is suggesting that this example provides a dire warning about how theorizing that blindly adheres to oversimplified versions of reality risks disastrous results.[297] If Joo is correct, then corporate legal theory ought to offer complexity and indeterminacy to legal thought, not an "ease of comprehension," because such "oversimplification" can lead to the serious risk of misapprehension and poor judgment.[298]

This final thought brings this article back to the introduction with Bratton's comment about the elements of a "wholesome" corporate legal dialectic.[299] Consider his words carefully:

> 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.[300]

Unfortunately, this particular message of Bratton never gained enough traction in corporate legal academia to bring about the quality of discourse that this passage suggests.

This article will end with the recommendation that it endorsed at the onset. We as corporate scholars need be self-critical of our roles in the manufacturing of corporate knowledge and, in part, be leery of accepting *a priori* knowledge as fact. If we will do this, it should lead to a more wholesome corporate law, whatever that law might look like.

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[296] *Id.*
[297] *Id.*
[298] *Id.*
[299] Bratton, *supra* note 8, at 465.
[300] *Id.* at 464–65.