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Shareholder Voting and the Symbolic Politics of Corporation as Contract

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SHAREHOLDER VOTING AND THE SYMBOLIC POLITICS OF CORPORATION AS CONTRACT

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American corporations are structured in such a way that shareholders, and shareholders alone, have the right to vote in all significant corporate decisions. Over the years, this exclusive shareholder franchise has been supported by an ongoing procession of justifications. But as those arguments have fallen by the wayside, shareholder primacists have circled back and latched upon a final argument for the special voting status of shareholders, arguing that this fundamental feature of corporate governance is the product of the set of freely-bargained-for agreements among all corporate constituents. Because this set of agreements reflects the preferences of all parties to the corporate contract, they contend, it should thus be viewed as the best way to structure the corporation.

The thesis of this Article is that the "nexus of contracts" theory is both descriptively wrong and normatively hollow, and, in particular, provides a poor foundation for the exclusive shareholder franchise. The corporation is neither a mere contract nor a set of contracts, literally or metaphorically. Indeed, the whole notion of the corporation as a nexus of contracts has been a theatrical production of dodges, feints, and posturing designed to rationalize and justify the existing order of things and create the kind of rhetorical space corporate law scholars need to advance their own particular policy positions. Once freed from the constraints of false theories, it is time to do the hard work of starting over and determining what the ideal structure or structures might be for organizations that bring together capital and labor in a process of joint production.

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I. INTRODUCTION

A corporation is a person—a legal person. Of course, the idea of a corporation as an actual "person" has been roundly mocked as both a ridiculous fantasy and a sinister power grab.[1] But constitutional law has long recognized that a corporation is a legal person and, as such, has certain legal rights and duties.[2] Given the pedigree and notoriety of the "corporation as person" doctrine, it comes perhaps as some surprise that this conception is almost entirely absent in corporate law literature. Instead, ever since the law and economic revolution of the 1980s, the reigning idea is that the corporation is a contract, or alternatively, a nexus of contracts.[3] Either way, the implication is clear: corporations are nothing more than private agreements between parties.[4]

1. *See, e.g.*, Stephen Colbert, *Hobby Lobby Case*, COLBERT REP. (July 14, 2014), http://www.cc.com/video-clips/xivy3m/the-colbert-report-hobby-lobby-case [http://perma.cc/NZT6-W5KM] ("Oh, and it's probably not a big deal, but they also ruled that corporations have religious beliefs.").

2. First Nat'l Bank of Boston v. Bellotti, 435 U.S. 765, 780 n.15 (1978) ("It has been settled for almost a century that corporations are persons within the meaning of the Fourteenth Amendment."); Note, *The Personality of the Corporation*, 19 HARV. L. REV. 222, 223 (1906) (reviewing W. Jethro Brown, *The Personality of the Corporation and the State*, 21 L. QUAR. REV. 178 (Oct. 1905)) ("The phenomenon of corporate personality does not fit into known legal categories, but since it satisfies the test of personality in having capacity for legal rights and duties, it is most natural to treat it as though it were a person, with a slowly growing recognition that the analogy is more real than fictitious.").

3. *See* Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 939 (Del. Ch. 2013) (finding "the bylaws of a Delaware corporation constitute part of a binding broader contract among the directors, officers, and stockholders"); Jill E. Fisch, *Governance by Contract: The Implications for Corporate Bylaws*, 106 CALIF. L. REV. 373, 374 (2018) (noting that "scholars widely accept the utility of the contract metaphor" in the corporate context).

4. *See* Fisch, *supra* note 3, at 375 (noting modern corporate law revolves around the contractual approach).

Over the years, corporate law scholars have relied on this view to support many core features of modern corporate governance. To take one example, corporations are structured in such a way that a single group of constituents—shareholders—has the right to vote for the governing board of directors and other significant corporate decisions. All other corporate constituents—most notably employees, suppliers, and customers—have their preferences captured through individual contracts rather than by casting a vote. Although this exclusive shareholder franchise has been supported by several different arguments, prominent among them is the idea that the corporation is a contract. Corporate law scholars argue that this fundamental feature of corporate governance, like many others, is merely the product of the set of freely-bargained-for agreements among all corporate constituents.[5] As the exclusive shareholder franchise reflects the preferences of all parties to the corporate contract, it should be viewed as the best way to structure the corporation.[6]

The problem with this contention is that the corporation is neither a contract nor a set of contracts. The idea is almost nonsensical. Business organizations (including corporations) are state law entities that have their own legal personality and internal governance structure. If corporations were purely creatures of contract, there would be no need for them under the law. Notably, one of the truly salient features of corporations—limited liability—is not contractual in nature. It is anti-contractual. Moreover, reducing corporations to contractual components makes no theoretical sense. The "theory of the firm" was developed to explain why some business relationships were handled internally through a firm rather than through contractual relationships within a market.[7] Delaware, the most popular state of incorporation, handles its corporate litigation through its courts of chancery; contracts, in contrast, have long been handled by courts of law.[8]

So why do courts and commentators rely on contract theory and contractual metaphors when discussing corporations? The answer is the symbolism of contract. Because contracts are generally considered Pareto optimal at the time of their making, they are presumptively recognized as in the best interests of the parties and

5. *See id.* (noting that corporate participants are engaging in individualized terms to customize their corporate governance).

6. *See id.* (highlighting contractual relationships benefiting the corporation on "autonomy and efficiency grounds").

7. *See* Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 388 (1937).

8. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 280 (1985) (observing that a major asset of the state of Delaware is the experience and expertise of its judiciary in the area of corporate law).

the most efficient result.[9] Arguing that corporations are contracts therefore becomes a useful first step by creating the rhetorical space to advocate for a particular policy position. The exclusive shareholder franchise is just such a position. Having the nexus of contracts model on your side of the debate is an effective weapon against adversaries.

What is particularly curious, then, is that this view of the corporation-as-contract argument has been used to support a wide variety of perspectives in the corporate law literature. Frank Easterbrook and Daniel Fischel used the nexus of contracts theory as a table-setter for their comprehensive law and economics approach to corporate law.[10] In their view, because the corporation acted as a default contract for the parties involved, policymakers needed to design the "hypothetical bargain" that worked best for all parties.[11] They then offered their perspective on what tweaks to the current system would best benefit the participants.[12] From here, however, the debate has split off into various camps, each using nexus of contracts theory to support its side. Stephen Bainbridge argues that the contractual approach supports Delaware's status quo approach, which favors strong managerial deference to the board of directors.[13] More fervent contractarians, however, have argued that the public corporation is far from the contractual ideal, and newer types of business entities, like limited liability companies, more closely follow the contractual model.[14] Finally, shareholder activists have argued that their "contract" with corporate management should provide them with a more robust role in corporate governance.[15]

The corporation-as-contract rhetoric is simply part of the symbolic corporate governance politics of the last half-century.[16] Because corporations are not contracts, or contractual

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9. *See* Bruce R. Lyons, *Empirical Relevance of Efficient Contract Theory: Inter-Firm Contracts*, 12 OXFORD REV. ECON. POL'Y 27, 28 (1996) (assessing that business contracting has evolved to be an efficient response).

10. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1426 (1989).

11. *See id.* at 1428 (noting that without a knowledge of the rights among participants in the economy at any given time, default rules are difficult to establish).

12. *See id.* at 1447 ("Each investor must live with the structure of risks built into the firm. . . . It is all a matter of enforcing the contracts.").

13. *See generally* Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1 (2002).

14. *See e.g.*, LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 4 (2010).

15. *See, e.g.*, NYSE GOVERNANCE SERVS., THE EFFECT OF SHAREHOLDER ACTIVISM ON CORPORATE STRATEGY 3 (2016) https://www.nyse.com/publicdocs/Shareholder_Engagement_Survey_Report_2016.pdf (noting a rise in shareholder activism bolstered by increased contractual power through proxy contests and board positions); DAVID WEBBER, THE RISE OF THE WORKING-CLASS SHAREHOLDER: LABOR'S LAST BEST WEAPON 1 (2018) (discussing the efforts of large public-sector pension funds).

16. Marcel Kahan & Edward Rock, *Symbolic Corporate Governance Politics*, 94 B.U. L. REV. 1997, 1998 (2014).

agglomerations, it makes no theoretical sense to use that model as a paradigm. But the rhetoric is used to support the continuing reign of shareholder primacy, which is a cornerstone shared by all of the "corporation as contract" proponents. Shareholders hold the voting power exclusively because they have contracted for corporate control. That power excludes any other would-be participants.

This Article asserts that the nexus of contracts theory is both descriptively wrong and normatively hollow, and, in particular, provides a poor foundation for the exclusive shareholder franchise. Part II of the Article will describe the basic structure of American corporations with special focus on the role of corporate voting. It will then detail the rise and fall of two other arguments for the special status of shareholders when it comes to voting. Part III, the heart of the Article, will detail and critically examine the many, sometimes overlapping versions of the corporation-as-contract. No version of this theory, regardless of its motivation or particular features, stands up to even casual scrutiny, and as such does not support the exclusive shareholder franchise. Part IV will explore theories of the firm and how they offer more nuanced and complete models for business organizations than the nexus of contracts theory. None of these theories of the firm provides specific justification for the exclusive shareholder franchise as part of the firm. In the end, this final argument for the exclusive shareholder franchise should be put out of its misery, opening the way to a broader discussion of corporate governance.

II. THE STRUCTURE OF CORPORATE GOVERNANCE

American businesses conduct joint economic enterprises, particularly large-scale ones, as corporations.[17] Although a variety of different business organizational forms exist, such as the partnership, the limited liability company ("LLC"), and the sole proprietorship, the corporation clearly dominates the economic landscape.[18] The corporation (or "company") has been described as "[t]he most important organization in the world . . . [as] the basis of the prosperity of the West and the best hope for the future of the rest

17. *See* Andrew Lundeen & Kyle Pomerleau, *Corporations Make up 5 Percent of Businesses but Earn 62 Percent of Revenues*, TAX FOUND. (2014), http://taxfoundation.org/blog/corporations-make-5-percent-businesses-earn-62-percent-revenues.

18. *See id.* (noting that only 5% of the organizational entities in the United States are corporations, but 62% of organizational tax revenues come from corporations).

of the world."[19] The United States is exemplary of the broader global approach.[20]

Under US law, corporations are legal entities that are created through state corporate law.[21] The process of forming a corporation is relatively straightforward. Generally, the incorporating individuals must file a corporate charter, also known as the articles or certificate of incorporation.[22] The articles of incorporation provide the firm's basic structure, including the corporation's name, the identity of the incorporators, the corporation's business, and the total number of shares the corporation may issue.[23] Other governance structure provisions are not necessary for the formation of the corporation but are allowed.[24]

Once the corporation is established, control shifts from the entity's incorporators to its board of directors.[25] The board manages the firm and has the ability to bind the corporation.[26] Shareholders typically select the directors at the annual shareholders meeting.[27] Directors must act in the firm's interests through certain fiduciary duties, such as good faith and loyalty.[28] However, they delegate the actual job of running the business to the officers, primarily through a hierarchy headed by the chief executive officer ("CEO").[29] This structure—shareholders select the directors, who in turn select the

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19. JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA xv (2005); *see also* RIBSTEIN, *supra* note 14, at 4 ("The corporation undeniably has driven business growth in the United States since the Industrial Revolution.").

20. *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001). Hansmann and Kraakman stated,

> We must begin with the recognition that the law of business corporations had already achieved a remarkable degree of worldwide convergence at the end of the nineteenth century. By that time, large-scale business enterprise in every major commercial jurisdiction had come to be organized in the corporate form, and the core functional features of that form were essentially identical across these jurisdictions.

Id.

21. *See, e.g.*, DEL. CODE ANN. tit. 8, § 101(a) (2018).

22. *See, e.g.*, *id.*

23. *Id.* § 102(a)(1)–(6).

24. *E.g.*, *id.* at § 102(b)(7) (limiting the liability of directors for breaches of a fiduciary duty); *id.* at § 141(d) (staggering the board of directors).

25. Matthew T. Bodie, *Employees and the Boundaries of the Corporation*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 86 (Claire Hill & Brett McDonnell eds., 2012).

26. DEL. CODE ANN. tit. 8, § 141(c)(1)–(2).

27. *Id.* § 211(b).

28. Bodie, *supra* note 25, at 86.

29. *See, e.g.*, DEL. CODE ANN. tit. 8, § 142(a) ("Every corporation organized under this chapter shall have such officers with such titles and duties as shall be stated in the bylaws or in a resolution of the board of directors which is not inconsistent with the bylaws . . . .").

officers to run the corporation—represents the foundation of corporate law.

When a corporation is up and running, it encompasses the daily activities of a variety of different players inside and outside the main lines of control. The officers choose executives, who in turn oversee managers and employees. There are also outside "stakeholders" who have interests in the activities of the corporation: bondholders, suppliers, customers, even the community at large. The interests of most of these constituents are captured in contracts that spell out their (largely) economic relationship with the corporation.[30] Employees work under contracts of employment; suppliers provide materials and services under supply contracts; and customers buy products and services under sales contracts. All of these constituents are vital players in the life of a corporation. But when it comes to selecting members of the board of directors, one group of constituents is privileged above all others. Shareholders, and shareholders alone, vote in corporate elections. So why are shareholders the only group granted the right to vote?

A. *Background on the Exclusive Shareholder Franchise*

The primary normative justification for shareholder voting is the theory of shareholder primacy.[31] Shareholder primacy is the theoretical driver not only for the vote, but also for such key concepts as the fiduciary duties of care and loyalty. Shareholder primacy essentially means that corporations exist to serve the interests of shareholders.[32] Put more specifically, the theory mandates that the corporation be run with the goal of maximizing shareholder wealth.[33]

Shareholder primacy could simply be viewed as a democratic legitimacy argument: the corporation has to keep shareholder interests at the forefront because shareholders are the voting polity. But this puts the cart before the horse: after all, who made the shareholders the voting polity? The choice of this group as the enfranchised citizenry is what needs justifying. A variant of this justification is that shareholders are the corporation's "owners" and thus are entitled to the ownership rights of profits and control.[34] However, the ownership justification is also doomed by its circularity:

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30. Bodie, *supra* note 25, at 90.

31. Much of this Subpart recounts arguments made at greater length in Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445, 472–76 (2008).

32. *See* D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 277 (1998) ("The structure of corporate law ensures that corporations generally operate in the interests of shareholders.").

33. *Id.* at 278.

34. The classic example of this perspective is Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32–33, 122–26.

who made the shareholders the "owners"?[35] As corporate law commentators have convincingly pointed out, shareholders simply purchase a set of rights from the corporation.[36] The right to vote is made part of the stock ownership "bundle," but a stock could be constructed (and has at times been constructed) without the right to elect directors.[37] Even shareholders with the right to vote do not possess many of the rights that traditionally accrue to property owners—the right to exclude, for example, or the right of possession.[38] Labeling shareholders "owners" is no more of a justification for the vote than is labeling them "voters."

Thus, shareholder voting is not the result of shareholder primacy. It is, instead, simply one of its reinforcing mechanisms. Of course, as has been dogma since the seminal work of Adolf Berle and Gardiner Means, the shareholder vote in publicly-held companies has not been a particularly effective way of maintaining shareholder primacy.[39] Shareholder votes have generally been an empty exercise in rubber-stamping the slate of candidates nominated by the board. But this is an oversimplification. At the level of closely-held corporations, shareholder votes are a much livelier affair. Here, shareholder primacy is generally effectuated directly by the shareholders themselves through the vote. Even in publicly held companies, a majority, or even a properly situated minority shareholder, has the power to appoint its representatives to the board and thus control the corporation's fate.

It is primarily the power of a "controlling" interest[40] that drives the law and economics of shareholder voting. At a traditional publicly held corporation, the individual shareholder has little or no motivation to monitor the company or even vote in the election.[41] But when those votes are amassed together into a controlling interest, they can vote out the current board, often immediately.[42] The

35. *See, e.g.*, Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1190–92 (2002) ("[T]he claim that shareholders own the public corporation simply is empirically incorrect.").

36. *Id.* at 1192.

37. *See* Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 694 (1986) (discussing the practice of selling shares without the right to vote).

38. Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 754 (2007).

39. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1932).

40. A majority will have de jure control, but a minority interest may also have de facto control over the corporation. *See, e.g.*, Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1114–15 (Del. 1994) (finding ownership of 43.3% of shares to be a controlling interest).

41. Hayden & Bodie, *supra* note 31, at 474.

42. DEL. CODE ANN. tit. 8, § 228 (2018) (allowing a majority of shareholders to execute any action that may be taken at a shareholders' meeting, including removal of directors, through a written concurrence of those shareholders).

shareholders' votes can be amassed through the mechanism of a tender offer—an offer by one entity to buy 50% or more of the company's shares.[43] The market for corporate control imposes the discipline necessary to effectuate the shareholder primacy norm.[44] If the shareholders are ignored or unhappy, they can sell their shares to another entity that can agglomerate the shares into a majority holding.[45] This new majority holder then can take complete control and attempt to make the profits that prior management had failed to generate.[46] In this way, the market for corporate control leads to greater efficiency: the shareholders can sell their shares at a premium, and the acquirer can realize the benefits of control.[47] This potential for market discipline keeps the board and management focused on the shareholders' interests.[48]

All these explanations, however, are little more than recapitulations of the way corporate law currently operates. In order to justify the exclusive shareholder franchise, something beyond mere labels ("shareholders are owners") or descriptions of the current mechanics of corporate law ("shareholder voting relies on the market for corporate control to effectuate shareholder primacy") must justify the exclusive shareholder franchise. Corporations, after all, are collective enterprises with a range of constituents, all of whom contribute to and benefit from the activities of the firm. Shareholder primacy, and the exclusive shareholder franchise that comes with it, needs to be justified in some non-circular fashion. There have been a few arguments that go beyond mere labels and investigate these questions. Two of the most prominent are the argument from the residual and the argument from Arrow's Theorem.

B. *The Argument from the Residual*

In their foundational work *The Economic Structure of Corporate Law*, Frank Easterbrook and Daniel Fischel attempt to ground shareholder primacy in standard economic theory, arguing for it in terms of creating the highest level of efficiency or overall social utility.[49] They believe that maximizing shareholder wealth would

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43. *See* Paul H. Edelman & Randall S. Thomas, *Corporate Voting and the Takeover Debate*, 58 VAND. L. REV. 453, 460 (2005) (detailing how voting control can be obtained through during hostile take overs by purchasing a majority of the company's stock).

44. Jonathan R. Macey, *Market for Corporate Control*, LIBR. ECON. & LIBERTY, http://www.econlib.org/library/Enc/MarketforCorporateControl.html.

45. Hayden & Bodie, *supra* note 31, at 475.

46. *Id.*

47. *Id.*

48. *See* Edelman & Thomas, *supra* note 43, at 454 (discussing the importance of shareholder votes in the takeover setting).

49. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 35–39 (1991). Many of the arguments in the book were first made in an earlier article: Frank H. Easterbrook & Daniel R. Fischel, *Voting in*

generate the highest amount of surplus, and thus would result in the greatest overall social utility.[50] Instead of justifying wealth maximization by labeling shareholders as the "owners" of the corporation, nexus of contracts theory treats shareholders as just one set among many contractual partners.[51] Nevertheless, shareholders are unique as the sole "residual claimants" because their returns are not payable until the other contractual participants—creditors, employees, customers, suppliers—have been fully satisfied.[52]

This perspective assumes that all other claimants have rigid contractual entitlements, and that shareholders are not paid until all other claimants receive their appropriate contractual entitlements. As such, all participants in the corporate nexus benefit from the maximization of the residual. As Easterbrook and Fischel write:

> As residual claimants, shareholders have the appropriate incentives . . . to make discretionary decisions. . . . Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertakings of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion.[53]

This allocation of the residual justifies the exclusive shareholder franchise: the board of directors should have its eye on the residual, and they know their positions are at stake if they fail to deliver for the shareholders. The same theory also applies to the market for corporate control: the holders of residual rights should make the decision over whether they sell control over the corporation to an outside entity. The residual provides the appropriate incentives to shareholders to maximize their returns while leaving the other firm participants to their contractual rights (and remedies).[54]

A logical consequence of the residual theory of shareholder primacy is the notion of "one share, one vote."[55] The idea behind "one share, one vote" is that each individual share of stock has equal voting weight with all other shares. This is done to ensure that each share's

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Corporate Law, 26 J.L. & ECON. 395, 408 (1983) [hereinafter Easterbrook & Fischel, *Voting in Corporate Law*]. We will refer to the book when similar arguments are made in both places. Much of this subsection recounts arguments first made in Hayden & Bodie, *supra* note 31, at 473–76.

50. EASTERBROOK & FISCHEL, *supra* note 49, at 35–39.

51. *Id.* at 36.

52. *Id.*

53. *Id.* at 68.

54. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965), for a discussion of the importance of the market for corporate control to shareholder wealth maximization.

55. EASTERBROOK & FISCHEL, *supra* note 49, at 73 ("Votes follow the residual interest in the firm, and unless each element of the residual interest carries an equal voting right, there will be a needless agency cost of management.").

voting interest is equal to the share's interest in the residual.[56] Shares with disproportionate voting power would create skewed incentives: those with control would have the incentive to seek gains outside of the residual, in ways that do not inure proportionately to the other owners of the residual.[57] Because of these skewed incentives, the residual would no longer be maximized.

The principle that all shareholders—that is, all voters in the corporate franchise—have equal interests in the residual is foundational to the idea of the exclusive shareholder franchise. Because maximizing the residual maximizes the return to shareholders while leaving all other stakeholders contractually satisfied, shareholder control over the corporation will improve social welfare by focusing on increasing the corporation's residual profits. Shareholder primacy is enforced through shareholder voting and by the market for corporate control, which uses the shareholder vote to effectuate changes in management. This connection between the residual and control, as calibrated by the "one share, one vote" rule, appears to set up the proper incentives for maximizing the residual. But this argument is missing one crucial link: a reason why shareholders should be assigned the residual in the first place. Why shareholders? After all, any of the corporation's stakeholders could be assigned the residual and would theoretically then have the appropriate incentives.

Easterbrook and Fischel have an answer to this question. Shareholders are best positioned to be assigned the residual because they have relatively homogeneous interests in wealth maximization.[58] They explain that shareholders are likely to have "similar if not identical" interests because "the shareholders of a given firm at a given time are a reasonably homogenous group."[59] And they argue that this homogeneity is critical to the success of shareholder primacy. First, it gives all shareholders an equal interest in the residual, and thereby an equal incentive to monitor agency costs so as to reduce conflicting incentives.[60] Second, limiting the interests of

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56. *Id.*; *see also* Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1945–46 (1996) ("The case for the one share, one vote rule turns primarily on its ability to match economic incentives with voting power and to preserve the market for corporate control as a check on bad management.").

57. *See* Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 851–52 (2006) (discussing concerns that controlling shareholders without a commensurate economic stake in the corporation are more likely to "tunnel" away a disproportionate share of firm value).

58. EASTERBROOK & FISCHEL, *supra* note 49, at 70.

59. *Id.*

60. Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 776 (2005) (noting that the notion of "one share, one vote" is based on "agency costs considerations"); Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. L. REV.

the residual holders to the residual itself provides shareholders with the same interests and thereby the same objectives for the firm. Otherwise, voters will have conflicts between preferences that will muddy the governance waters and lead to irresolvable disputes over corporate policy. Easterbrook and Fischel, along with others, have argued that this consistency amongst voter preferences is the key to the stability and prosperity of the corporate form.[61]

The argument from the residual, then, largely rests on this claim of shareholder homogeneity. It is what makes this discussion of the shareholder residual into a meaningful normative theory, rather than a simple restatement of positive corporate law. While it is true that shareholders, under modern corporate law, have contractual entitlement to the residual, this does not explain *why* they should have it. One could imagine assigning the residual to any one of the corporate constituents, and then giving it the voting rights as well, in order to maximize the residual and generate the greatest amount of social utility. Capital contributors could all be contractually assigned a fixed rate of return, as other constituents are under the current structure. (Bondholders already get something like this.) Easterbrook and Fischel believe that shareholders are best suited for this because their preferences are so alike, much more alike than those of other constituent groups, and certainly more than any combination of groups.

This assumption of shareholder homogeneity, however, has come under quite a bit of pressure over the last couple of decades. Many types of shareholders have interests in the firm that go beyond a simple desire to maximize the residual, including majority shareholders, shareholders with disproportionate voting rights, members of voting trusts, bribed shareholders, hedged shareholders, sovereign wealth funds, and employee and management shareholders. The list goes on and on.[62] In each case, those particular shareholders have interests that threaten to override their shared interest in the residual.

Moreover, shareholder heterogeneity is not simply a matter of shareholders with discrete competing interests. There is also heterogeneity amongst otherwise similarly situated shareholders with respect to their definitions of wealth maximization.

1103, 1121 (2002) (noting that any rule other than one share, one vote "wastefully increases the agency costs associated with the corporate form").

61. EASTERBROOK & FISCHEL, *supra* note 49, at 69–70; *see also* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 62 (1996) ("Investor-owned firms have the important advantage that their owners generally share a single well-defined objective: to maximize the net present value of the firm's earnings.").

62. *See* Hayden & Bodie, *supra* note 31, at Subparts III(A)–(G); *see also* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1258–59 (2008) (discussing how activist shareholders may seek to advance their own interests to the exclusion or detriment of other shareholders' interest).

Shareholders may have very different time horizons for their investments.[63] A flash trader looking to capitalize on a minute change in price is different than a pension fund manager looking to fund the retirements of state employees. There is also the question of diversification: to what extent is the shareholder seeking to maximize this individual stock or, instead, maximize the entire portfolio? This divide has led some commentators to suggest a normative system of portfolio wealth maximization, rather than share wealth maximization.[64] Correspondingly, shareholders have different risk preferences and may have different tastes for the corporation's approach to risk based on the ratio of their holdings in the individual firm compared to their overall holdings.[65] Finally, even if shareholders agree on the goal of wealth maximization and share risk and time horizon preferences, they still might very well disagree about strategic business choices the corporation makes in these areas.[66]

This is all to say that a key assumption in the argument from the residual has turned out to be wrong. Shareholder interests are actually quite heterogeneous. And even if shareholders are thought to at least be more homogeneous than other groups (such as employees), or certainly more so than any combination of shareholders and another group, exponents of the residual argument have never really made the case that there's some kind of smooth, inverse relationship between preference homogeneity and firm

63. Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 579–83 (2006) (discussing the different financial interest of short-term and long-term shareholders).

64. Robert G. Hansen & John R. Lott, Jr., *Externalities and Corporate Objectives in a World with Diversified Shareholder/Consumers*, 31 J. FIN. & QUANTITATIVE ANALYSIS 43, 44 (1996); *see also* Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021, 1056 (1996) (discussing the differences between the fictional shareholder envisioned by corporate law and actual shareholders who are generally portfolio investors).

65. For example, a middle-class investor on the brink of retirement will have different risk preferences than a young hedge fund manager with billions under management, even if both have $25,000 worth of shares in the same company. The declining marginal utility of wealth also means that the performance of the company has less effect on the utility of the hedge fund manager, even though both have the same number of shares.

66. For example, Hewlett-Packard shareholders battled over the wisdom of the merger between Hewlett-Packard and Compaq. Michael Brick & Steve Lohr, *Fiorina Claims Victory in Hewlett-Compaq Proxy Battle*, N.Y. TIMES (Mar. 19, 2002), https://www.nytimes.com/2002/03/20/business/technology-hewlett-packard-claims-a-victory.html; *see also* Lauren Hirsch, *P&G Says Shareholders Reject Peltz's Bid for Board Seat by Slim Margin, Activist Says Vote a Dead Heat*, CNBC (Oct. 10, 2017, 10:33 AM), https://www.cnbc.com/2017/10/10/procter-gamble-shareholders-vote-against-adding-nelson-peltz-to-board.html (discussing a closely divided vote at Proctor & Gamble regarding a director proposed by activist shareholders who advocated for the company to streamline its structure and make small acquisitions of innovative brands).

function. They've also never pointed to some tipping point—some non-smooth point at which the firm slips into chaos. And they've long ignored the fact that other constituents—most prominently, workers with firm-specific skills—also have incomplete contracts and residual interests in a corporation.[67]

As the argument from the residual came under greater scrutiny, corporate law scholars began to look around for other potential justifications for the exclusive shareholder franchise. They didn't have to look very far. Easterbrook and Fischel made a second argument: that shareholder voting is also compelled by the teachings of social choice theory.[68] In particular, they and other like-minded scholars focused on Arrow's theorem, the crown jewel of social choice theory, to take issue with expanding the corporate electorate to include anyone besides shareholders.[69]

C. *The Argument from Arrow's Theorem*

The argument from Arrow's theorem was first made by Frank Easterbrook and Daniel Fischel in their article on corporate voting[70] and later recounted in their book on the economic structure of corporate law.[71] Citing Kenneth Arrow's groundbreaking work in social choice theory, they explain:

> The voters, and the directors they elect, must determine both the objectives of the firm and the general methods of achieving them. It is well known, however, that when voters hold dissimilar preferences it is not possible to aggregate their preferences into a consistent system of choices. If a firm makes inconsistent choices, it is likely to self-destruct. Consistency is possible, however, when voters commonly hold the same ranking of choices (or when the rankings are at least single-peaked).[72]

Easterbrook and Fischel then argue that shareholders have relatively homogeneous preferences—they are all interested in profit

67. Margaret Blair has forcefully argued for the neglected importance of workers' interest in the residual. *See* MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 27 (1995); Margaret M. Blair, *Firm-Specific Human Capital and Theories of the Firm*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 58, 67 (Margaret M. Blair & Mark J. Roe eds., 1999); Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, 31 J. CORP. L. 719, 738–39 (2006).

68. Easterbrook & Fischel, *Voting in Corporate Law*, *supra* note 49, at 403–04.

69. *Id.* at 405–06.

70. *Id.*

71. EASTERBROOK & FISCHEL, *supra* note 49, at 69–70.

72. Easterbrook & Fischel, *Voting in Corporate Law*, *supra* note 49, at 405 (citing KENNETH J. ARROW, SOCIAL CHOICE AND COLLECTIVE VALUES (2d ed. 1963); DUNCAN BLACK, THE THEORY OF COMMITTEES AND ELECTIONS (1958)).

maximization.[73] The corporate franchise, therefore, should be limited to this class of like-minded participants.[74]

So, what is Arrow's theorem? The theorem is the centerpiece of a broader enterprise known as social choice theory.[75] Social choice theory attempts to explain how individual preferences are aggregated into social choices.[76] It focuses upon the social choice functions—usually some type of voting procedure—used to move from individual preferences to social choices.[77] Arrow's theorem holds that no social choice function can simultaneously satisfy four relatively undemanding conditions of democratic fairness (non-dictatorship, Pareto efficiency, universal domain, and independence from irrelevant alternatives) and guarantee a transitive outcome.[78] A transitive outcome just means that, with respect to the social preference order: if A is preferred to B, and B to C, then A must be preferred to C.[79] The contrary—an intransitive preference order where A is preferred to B, B to C, and C to A—is referred to as a voting cycle, and indicates that the social choice function is unable to declare a winner, at least one that is meaningful.[80]

As applied to corporate voting, then, the argument from Arrow's theorem may be described as follows. The theorem explains that

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73. EASTERBROOK & FISCHEL, *supra* note 49, at 70.

74. *Id.* This is also, Easterbrook and Fischel mention, the reason why the law makes little effort to require firms to pursue goals other than profit maximization. *Id.* at 69–70.

75. Social choice theory, and Arrow's theorem, have mainly come into legal scholarship under the guise of public choice theory. For summaries of the literature, see DANIEL A. FARBER & PHILIP P. FRICKEY, LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION 38–39 (1991), and Saul Levmore, *Foreword* to MAXWELL L. STEARNS, PUBLIC CHOICE AND PUBLIC LAW: READINGS AND COMMENTARY, at xi–xiv (1997).

76. *See* Levmore, *supra* note 75, at xi–xii.

77. *Id.* at xii.

78. *See* KENNETH J. ARROW, SOCIAL CHOICE & INDIVIDUAL VALUES ch. 3 (2d ed. 1963) (laying out the logical foundations and conclusions for the theorem); *see also* NORMAN FROHLICH & JOE A. OPPENHEIMER, MODERN POLITICAL ECONOMY 19–23 (1978) (summarizing the assumptions, conditions, and conclusions of the theorem); PETER C. ORDESHOOK, GAME THEORY AND POLITICAL THEORY: AN INTRODUCTION 62–65 (1986) (providing a concise outline of a proof of the theorem). Some of the terminology in this section is drawn from WILLIAM H. RIKER, LIBERALISM AGAINST POPULISM: A CONFRONTATION BETWEEN THE THEORY OF DEMOCRACY AND THE THEORY OF SOCIAL CHOICE 293–98 (1982). For a good summary of the state of social choice theory and Arrow's theorem, see 1 HANDBOOK OF SOCIAL CHOICE AND WELFARE, at ix (Kenneth J. Arrow et al. eds., 2002).

79. *See* RIKER, *supra* note 78, at 119, 297.

80. *See* Grant M. Hayden, *The Limits of Social Choice Theory: A Defense of the Voting Rights Act*, 74 TUL. L. REV. 87, 101–02 (1999) (describing intransitivity as a voting cycle and explaining the problems with a system displaying this characteristic); Grant M. Hayden, Note, *Some Implications of Arrow's Theorem for Voting Rights*, 47 STAN. L. REV. 295, 299 (1995) (defining intransitivity and stating that it may in essence lead to dictatorial power being exercised in a social choice function by way of agenda control).

there is no corporate voting procedure that meets the four fairness conditions and, at the same time, guarantees an acyclical outcome. Something—either one of the fairness conditions or a guaranteed transitive outcome—must give. For example, adhering to the condition of universal domain by allowing those with preferences that are dissimilar in certain ways to vote in corporate elections could result in inconsistent corporate decision-making, which, in turn, would cause a corporation to, in Easterbrook and Fischel's terms, "self destruct."[81] Relaxing the condition of universal domain by restricting the vote to a class of participants with similar individual preferences would avoid such an outcome.[82] Shareholders, given their homogeneous interest in profit maximization, fit the bill.[83]

This argument has been very influential in the decades since its initial formulation. Henry Hansmann, for example, uses it to argue against allowing every group of stakeholders to have representation on a corporate board of directors: "because the participants are likely to have radically diverging interests, making everybody an owner threatens to increase the costs of collective decision making enormously."[84] Among these costs: the possibility of a voting cycle, which "increases as preferences among the electorate become more heterogeneous."[85] Similarly, Gregory Dow worries that employee representatives may introduce the possibility of "voting . . . pathologies."[86] This argument for exclusive shareholder franchise has even been cited by scholars like Margaret Blair and Lynn Stout, whose "team production" theory of corporate governance does not otherwise demand it.[87] The perceived power of the argument from Arrow's theorem, then, is such that a fairly wide variety of corporate scholars rely upon it.

The problem, though, is that the argument from Arrow's theorem was deeply flawed from the very beginning.[88] Its shortcomings do not stem from some vulnerability in the theorem itself, but instead from its application to the social choice function in question—corporate board voting. We note initially that the argument from Arrow's

81. EASTERBROOK & FISCHEL, *supra* note 49, at 70.

82. *See id.*

83. *Id.* at 69–70.

84. *See* HANSMANN, *supra* note 61, at 44.

85. *Id.* at 41–42.

86. Gregory K. Dow, *The New Institutional Economics and Employment Regulation*, *in* GOVERNMENT REGULATION OF THE EMPLOYMENT RELATIONSHIP 57, 69 (Bruce E. Kaufman ed., 1997).

87. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 257 (1999). In their model, people who hope to profit from team production give up some of their rights to the corporation and, in return, the corporation coordinates the activities of the team members and allocates the resulting production in a way that minimizes shirking and rent-seeking. *Id.* at 264.

88. *See generally* Grant Hayden & Matthew Bodie, *Arrow's Theorem and the Exclusive Shareholder Franchise*, 62 VAND. L. REV. 1219 (2009).

theorem shares a central premise with the argument from the residual—that shareholders have homogeneous preferences with respect to wealth maximization. But, as discussed above, this premise has come under increasing scrutiny because shareholders have interests that diverge along a number of dimensions. The presence of heterogeneous shareholder preferences undercuts a crucial assumption of the argument from Arrow's theorem.

Even with the assumption of shareholder homogeneity, there are many other reasons why Arrow's theorem fails to provide a suitable foundation for restricting corporate voting to shareholders alone. First, shareholder agreement on the goal of wealth maximization, even if true, does not indicate agreement on how best to achieve that goal.[89] Shareholders may, and often do, wildly disagree over the proper course of action for their corporation. And even if shareholders were to agree on the direction for their corporation, they may have very different ideas about which directors would best effectuate it. Because Arrow's theorem operates on the level of individual preference orders over an array of alternatives (here, director candidates), agreement on the general goals or methods of the corporation does little to ensure that a particular voting system for board membership will be free from Arrovian intransitivities. It just operates at the wrong level.[90]

Second, the argument ignores the fact that avoiding all possible voting cycles comes at great cost. Remember, Arrow's theorem demonstrates that no voting procedure can simultaneously fulfill the four conditions of democratic fairness and guarantee a transitive outcome, but it says nothing about which condition should be sacrificed. That decision depends on an assessment of the costs associated with sacrificing one of the conditions of democratic fairness and, on the other side, the practical likelihood and costs associated with intransitive outcomes. Restricting voting rights to shareholders because of their purported agreement with each other is a straightforward violation of the condition of universal domain. That condition demands that a voting procedure work with every permutation of voter preferences over a set of alternatives. And like the other fundamental requirements of democratic fairness, universal domain is relatively uncontroversial. Giving up this condition—by restricting individual preference orders—runs counter to the fundamental democratic principle that people should not be ineligible to vote because of their preferences; it also runs counter to a

89. *See* Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657, 665 (1996) (discussing various explanations, such as investment time and tax bracket, for disagreement over how best to achieve the goal of wealth maximization). If there was complete agreement, there would, of course, be no reason to have board elections in the first place, since we could just ask one of the shareholders to report the shared preference ranking.

90. *See* Hayden & Bodie, *Arrow's Theorem*, *supra* note 88, at 1230–32.

fundamental principle of standard economics to take people's preferences as they come. There is something deeply wrong about "solving" a problem of preference aggregation by deciding not to listen to certain people. But, more broadly, the point here is that the case for sacrificing universal domain comes with tremendous costs.[91]

Third, the argument from Arrow's theorem fails to analyze the likelihood or cost of intransitive corporate election outcomes. As it turns out, the likelihood of cyclical outcomes, even when voting is not limited to shareholders, is probably quite small, and the cost of such outcomes, when they do occur, is negligible (and certainly not likely to cause corporations to "self destruct"). Empirical observations across a broad range of voting mechanisms have failed to discover the large number of intransitivities initially predicted by social choice theory.[92] This is probably because those early predictions were based on the assumption that all individual preference orders were equally likely to occur in a preference profile—that individual preference orders were somehow randomly distributed.[93] They are not, and when more real-world preferences are considered, the likelihood of voting cycles considerably declines.[94]

Moreover, even when voting cycles do occur, there is no reason to think that they will lead to inconsistent firm choices. A nascent intransitivity does not automatically translate into an unstable outcome, because there are many features to corporate (and political) elections that operate to produce stability. For example, most corporate board voting procedures are structured to produce a winner regardless of the presence of lurking intransitivities. Board elections generally only require the vote of a plurality to win; as long as a director gets one vote, in some cases, she will win if unopposed.[95]

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91. *See id.* at 1232–34.

92. *See* Scott L. Feld & Bernard Grofman, *Partial Single-Peakedness: An Extension and Clarification*, 51 PUB. CHOICE 71, 71 (1986) (explaining that "empirical observations of a wide variety of actual collective decision-making processes indicate that cyclical majorities are very rare"); Bernard Grofman, *Public Choice, Civic Republicanism, and American Politics: Perspectives of a "Reasonable Choice" Modeler*, 71 TEX. L. REV. 1541, 1553 (1993) (noting that cycles are much harder to find than early Social Choice models have predicted).

93. *See* Richard G. Niemi & Herbert F. Weisberg, *A Mathematical Solution for the Probability of the Paradox of Voting*, 13 BEHAV. SCI. 317, 321 (1968).

94. *See* Hayden & Bodie, *Arrow's Theorem*, *supra* note 88, at 1234–39.

95. Joshua R. Mourning, Note, *The Majority-Voting Movement: Curtailing Shareholder Disenfranchisement in Corporate Director Elections*, 85 WASH. U. L. REV. 1143, 1144 (2007). Some shareholders have pressed corporations to change their voting rules so that a director must win a majority of the votes cast in order to win the seat. *See id.* at 1143–46 (discussing this movement). However, even under such a "majority-vote" regime, a director who fails to get a majority will stay on until a replacement is chosen or until the majority of shareholders vote to remove the person. *See* DEL. CODE ANN. tit. 8, § 141(b) (2018) (stating that "[e]ach director shall hold office until such director's successor is elected and qualified or until such director's earlier resignation or removal"). However, some companies have established resignation policies which require directors to resign

Some boards have staggered seats, in which directors have three-year terms, and only one-third of the directors are elected in any given year.[96] In cases where there actually are top cycles, the candidate selected by the voting procedure may, indeed, be the contingent product of that process. But the voting procedures themselves, and the "structure-induced" equilibria they produce,[97] would ensure that the firm would not suffer for lack of directors. In addition, even assuming a complete board turnover, the subsequent board members presumably would know the recent history of the firm's decisions, its current situation, and whether it is now in the firm's interest to change course. In other words, the board members would be able to exercise independent judgment as to whether their original plans for the firm still make sense in the current situation. (Indeed, Jeffrey Gordon claims that cycling at the board level is, for this and several other reasons, very unlikely.)[98] Proponents of the argument from Arrow's theorem have not connected the long series of points between a board election cycle and a self-destructive firm.[99]

The argument from Arrow's theorem for the present state of the corporate franchise is flawed at many levels. Shareholders do not have homogeneous interest in profit maximization. Even if they did, it would not directly translate into the kind of agreement on candidates necessary to avoid intransitive results in corporate elections. Further, even if shareholder homogeneity did translate into the requisite agreement on candidates, restricting voting rights to shareholders involves sacrificing a fundamental condition of democracy in a situation where the likelihood and impact of intransitive results is already negligible. This argument for restricting corporate voting rights to shareholders, then, is far from compelling.

For several decades, these two arguments—from the residual and from Arrow's theorem—provided the theoretical support for the exclusive shareholder franchise. The main debates over corporate voting moved on to the details: What, exactly, should shareholders be voting on? How responsive should the electoral mechanisms be? How should shareholder power be balanced against board authority? But as the two underlying arguments began to break down, corporate scholars began to rely on a final argument, one that has long been

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if they are not elected by the shareholders. Mourning, *supra* note 95, at 1182–85. For criticism of majority voting as an ineffective reform, see Vincent Falcone, Note, *Majority Voting in Director Elections: A Simple, Direct, and Swift Solution?*, 2007 COLUM. BUS. L. REV. 844, 881–82 (2007).

96. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(d) (allowing such a staggered election procedure).

97. *See generally* RIKER, *supra* note 78, for some background on structure-induced equilibria.

98. *See* Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 372–73 (1991).

99. *See* Hayden & Bodie, *Arrow's Theorem*, *supra* note 88, at 1239–43.

used to justify many other aspects of corporate governance. This is the argument that the corporation, and all of its governance structure, is merely a product or reflection of freely bargained-for contracts.

III. CORPORATION AS NEXUS OF CONTRACTS

As discussed above, most corporations share the same fundamental governance characteristics.[100] The firm is controlled by a board of directors, who in turn select the officers who run the day-to-day business of the operation.[101] This board is elected by shareholders.[102] The shareholders share in the profits of the corporation through dividends and can sell their shares on the open market.[103] This same basic structure—shareholders electing directors who then appoint officers—may be found in every public corporation.[104] Why is this tripartite power dynamic so uniform across corporations? Is it because corporate law requires this structure, or because this structure is freely chosen and therefore the most efficient?

For contractarians, the answer is that corporate constituents freely choose the basic features of corporate governance. The nexus of contracts theory, in its purest form, holds that a corporation is merely a central hub for a series of contractual relationships.[105] In other words, a firm is a "legal fiction"; it is not an individual and has no real independent existence.[106] Instead of thinking of the corporation as an independent entity, the nexus of contracts theory breaks it down into its component parts.[107] These parts are the contractual relationships between the various parties involved with the firm: shareholders, directors, executives, creditors, suppliers, customers, and employees.[108] Under this approach, corporate law is an extension of contract law and should focus on facilitating the interrelationships between contractual participants in the most efficient manner.[109]

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100. Gordon, *supra* note 98, at 373–74.
101. *Id.*
102. *Id.*
103. *Id.*
104. The same is true of closely-held corporations, although the roles overlap to a great extent.
105. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309 (1976).
106. *Id.* at 310–11.
107. *See, e.g.*, William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 411 (1989) (defining the "nexus of contracts" approach as "the firm is a legal fiction that serves as a nexus for a set of contracting relations among individual factors of production").
108. *Id.* at 418.
109. Easterbrook & Fischel, *supra* note 10, at 1444.

While we've noted before that the preferences of corporate constituents are captured through a mix of voting (shareholders) and fixed contracts (everyone else), the contractarian argument goes beyond this description. It grounds this basic division (and other aspects of corporate governance) in the free contractual choices of corporate participants. The exclusive shareholder franchise is, then, part and parcel of this set of contracts. And because it is seen as part of an interlocking set of free choices of all of the participants, it is therefore the most efficient way to structure the enterprise. To question the corporate governance structure is to dispute the market choices of those who are, presumably, in the best position to make them.

The nexus of contracts theory has been extremely influential in shaping corporate law theory over the last four decades.[110] But despite its dominance, there is still confusion over whether the theory is a descriptive model, a normative prescription, or some combination of both.[111] Michael Jensen and William Meckling presented it as a positive theory of the corporation and its concomitant relationships.[112] That thread was picked up in the legal literature, with Easterbrook and Fischel cementing the concept in place.[113] But they too have waffled over whether the model should be seen as a positive description or as a normative framework—or both.[114]

The nexus of contracts theory has been sufficiently successful that its branches have grown in several different directions off of the same trunk. We start with the strong contractarians who most closely adhere to the idea that a corporation is and should be considered a

110. Bainbridge, *supra* note 13, at 9 ("The dominant model of the corporation in legal scholarship is the so-called nexus of contracts theory."); Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449, 1449 (1989) ("Critics and advocates agree that a revolution, under the banner 'nexus of contracts,' has in the last decade swept the legal theory of the corporation."); Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 303 (1993) (arguing that "the nexus-of-contracts view of the modern corporation and the principal-agent explanation of some important aspects of the firm . . . have had profound implications for some of the most important issues of corporation law").

111. Melvin A. Eisenberg, *The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 824 (1999) ("Unfortunately, it has proved easy to confuse the positive proposition that the corporation is a nexus of reciprocal arrangements with the normative proposition that the persons who constitute a corporation should be free to make whatever reciprocal arrangements they choose, without the constraints of any mandatory legal rules.").

112. Jensen & Meckling, *supra* note 105, at 310–11.

113. Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 780 (2006) (describing Easterbrook and Fischel as "the primary expositors of the contractarian theory").

114. *Id.* at 783 ("Easterbrook and Fischel's theory of corporate law is both normative and positive: that corporate law *should* take this form; and that it 'almost always' does.").

contract or set of contracts. Second, we take a look at the "hypothetical bargain" popularized by Easterbrook and Fischel, as well as managerialists who use the theory to support the board-centered status quo of traditional Delaware law. Finally, we explore the influence of "the corporate contract" on recent debates about the power of shareholders within the corporate structure.

A. *Strong Contractarians*

In their article *Agency Costs and a Theory of the Firm*, Jensen and Meckling set out the straightforward proposition that "most organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals."[115] Rather than seeing the firm as something different in the economic landscape, Jensen and Meckling sought to remove the fictional conception of organizational identity to expose the network of relationships beneath.[116] They argued that:

> [I]t makes little or no sense to try to distinguish those things which are 'inside' the firm (or any other organization) from those things that are 'outside' of it. There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output.[117]

In a sense, Jensen and Meckling are correct: corporations are fictional legal entities without individual corporeal or spiritual existence. But to claim they are merely an agglomeration of contracts is a legal simplification too far. They are forced to hedge their position when talking about corporations, rather than "most organizations," as they state:

> The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals.[118]

Notice the framing: there are claims on assets and cash flows "which generally can be sold" without permission. The passive voice elides the exact mechanics, but even Jensen and Meckling admit that these transfers take place without contractual sanction from all parties. Rather, the corporate structure is doing the basic work of managing these flows of claims and cash. And they do not even mention basic

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115. Jensen & Meckling, *supra* note 105, at 310 (italics omitted).
116. *Id.* at 310–11.
117. *Id.* at 311.
118. *Id.* (italics omitted).

aspects of the corporation such as fiduciary duties, the board's managerial power, or limited liability.

In truth, it is unfair to put too much weight on the two pages of Jensen and Meckling's article that gave birth to the nexus of contract theory. The article itself focuses on the agency costs between shareholders and managers, provides an economic model designed around the difference in interests between shareholders and managers, and interrogates the use of debt and inside equity to balance these interests.[119] But as subsequent theorists have recognized, the nexus of contract theory is not a theory of the firm.[120] It is, instead, an illustrative set-up for an article that focuses on a theory of corporate capital distribution.

Despite the thinness of Jensen and Meckling's claims, their literal take on the nexus of contracts approach has found adherents in the legal literature. Advocating for a strong version of contractarianism, these commentators argue that the corporation is primarily contractual, and as such it represents terms that the parties have freely chosen amongst themselves.[121] Since the corporation is merely an intersection of voluntary agreements, corporate law should eschew mandatory rules.[122] Instead, the role of corporate law is to create default terms that line up with the standard terms for which the parties would bargain. And since the terms have been freely chosen, we can presume they are efficient.[123]

The strong descriptive claim is the nexus of contracts theory in its purest form. The corporation is entirely the product of freely bargained-for contracts. These contracts, not corporate law, determine the structure of corporate governance. But this literal

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119. *Id.* at 312–57.

120. *See* Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 692 (1986).

121. But it is sometimes difficult to parse the language of the theory to determine what is actually being claimed. *See* Bainbridge, *supra* note 13, at 11 ("I have come around to the view that the corporation is a nexus of contracts in a literal sense, albeit a very limited one."); Julian Velasco, *Shareholder Ownership and Primacy*, 2010 U. ILL. L. REV. 897, 919 ("[A]lthough it may be technically accurate to describe a corporation as a nexus of contracts, it is entirely inadequate.").

122. Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 860 (1997) ("The nexus of contracts model has important implications for a range of corporate law topics, the most obvious of which is the debate over the proper role of mandatory legal rules."); Lucian Arye Bebchuk, *Foreword: The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1397 (1989) (noting that corporate law contractarians argue "that the contractual view of the corporation implies that the parties should be totally free to shape their contractual arrangements").

123. A more nuanced version of this would be: having the parties choose their terms is the system most likely to lead to an efficient result over time, as there is no other system likely to result in greater efficiency.

version of the corporation-as-contract claim is simply incorrect. Corporations are not creatures of contract. One cannot contract to form a corporation.[124] The individuals involved must apply to a state for permission to create such an entity. The fact that this permission is readily granted (as long as fees and taxes are paid) does not change the fact that permission is required.[125]

Corporate contractarians chafe at the idea of permission, because such permission has been used in the past as justification for corporate regulation.[126] The idea of concession theory is that corporations only exist thanks to a grant—a concession—by the state, and the state is thereby justified in extracting a quid pro quo for the concession. The history of early business entities reveals that such entities were in fact specific grants of authority by the crown over industries, territories, infrastructure, or trading routes.[127] Like the nexus of contracts theory, concession theory is both positive and normative: it provides a descriptive theory of corporation based on state creation and argues that the state should have a freer hand to regulate corporations because of this creative power.[128] Contractarians have been particularly vicious and dismissive in their rejection of concession theory.[129] But the basic premise is sound: corporations are creatures of the state and cannot be formed purely through contract. It is impossible to do so.[130]

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124. This fact is acknowledged by contractarian theorists. *See* Easterbrook & Fischel, *supra* note 10, at 1444–45 (acknowledging that statutory corporate law is necessary to create a corporation).

125. *Cf.* Bratton, *supra* note 107, at 445 ("If the corporation really 'is' contract, as the new economic theory tells us, then the last doctrinal vestiges of state interference should have withered away by now. . . . But the sovereign presence persists.").

126. *See* Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183, 208 (2004) ("This state-creation characterization effectively sets a presumption in favor of regulating corporations that does not apply to other business associations or contracts.").

127. *See, e.g.*, Paul G. Mahoney, *Contract or Concession? An Essay on the History of Corporate Law*, 34 GA. L. REV. 873, 893 (2000) ("The 'concession' theory of the corporation in the English-speaking world owes its lineage to two aggressive assertions of the sole right of government to create legal persons: Coke's decision in 1615 and the Bubble Act in 1720.").

128. Stefan J. Padfield, *Rehabilitating Concession Theory*, 66 OKLA. L. REV. 327, 329 (2014) (looking "to 'rehabilitate' concession theory, which views the corporation as fundamentally a creature of the state and thus presumptively subject to broad state regulation").

129. *See, e.g.*, STEPHEN M. BAINBRIDGE & M. TODD HENDERSON, LIMITED LIABILITY: A LEGAL AND ECONOMIC ANALYSIS 68–69 (2016) ("[I]t has been over half-a-century since corporate legal theory, of any political or economic stripe, took the concession theory seriously."); Henry N. Butler & Larry E. Ribstein, *The Contract Clause and the Corporation*, 55 BROOK. L. REV. 767, 775 (1989) ("There is no longer any justification for regarding the corporation as a concession of the state.").

130. *See* RIBSTEIN, *supra* note 14, at 11.

Having to acknowledge this factual reality, contractarians then contend that corporate law statutes are mostly default rules, not mandatory rules that might interfere with private bargains struck through contracts. But there is one critical feature to modern corporate law that is not a default rule and could not be reproduced through contract: limited liability. In *The Rise of the Uncorporation*, Larry Ribstein described corporate limited liability as the result of a grand bargain: "[t]he corporate form represents a quid pro quo: big firms get corporate features, and government gets an opportunity to regulate governance."[131] The corporate tax—characterized as "double taxation," since dividends are taxed as well—was "in a sense a fee for incorporating."[132] In return, the corporation's investors were protected by limited liability. As Ribstein makes clear, limited liability is distinctly non-contractarian: "Limited liability is particularly important because, unlike other corporate features discussed above, partnerships could not easily contract for it without lawmakers' cooperation as they have to include the creditors in these contracts."[133] Because limited liability is a feature "that parties cannot replicate by private contract[,] . . . whether a statutory form provides for limited liability therefore will dominate parties' choice of form."[134] In sum, limited liability is the main reason why the corporation succeeded where the partnership failed.[135]

Despite the factual errors endemic to the theory, the literal interpretation of the nexus of contracts approach does important rhetorical work for strong contractarians. By divorcing the corporation from the state, contractarians render efforts to regulate the corporation as outside interference and illegitimate.[136] In this libertarian approach to corporate law, government can then be cast not as the creator of the corporate form, but rather its opponent.[137] If

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131. *Id.* at 66.

132. *Id.* at 99.

133. *Id.* at 79. Although he recognizes that there may have been (cumbersome) contractual methods for limiting liability for contractual claimants, it would have been "impossible" to secure limited liability against tort claimants without the government's help. *Id.* This thinking is a departure from Ribstein's earlier contentions that limited liability could somehow be rendered contractual. Butler & Ribstein, *supra* note 129, at 775 ("Nor does state concession status flow from limited liability of shareholders as against involuntary creditors. Limited liability is merely a consequence of the shareholders' contract, just as it is of participants in other arrangements, such as non-partner creditors.").

134. *Id.* at 138. The importance of limited liability is a theme Ribstein turns to over and over again in the book. *See* RIBSTEIN, *supra* note 14, at 5, 8, 10–11, 25, 37, 43–44, 72, 79–85, 95–97, 99–101, 120–21, 127, 138–47, 153, 162, 164–65, 256.

135. Discussing the characteristics that are specific to corporations, Ribstein notes that "partnerships long have been able to contract for such corporate-type features, with one critical exception—limited liability." *Id.* at 76.

136. *Id.*

137. Mahoney, *supra* note 127, at 874 (arguing that "the state, far from facilitating organizational development, often tries to thwart it").

corporations are contracts, government should step back and let the private parties create their nexus; any effort to intervene would interrupt and interfere with the market process. This applies to the shareholder vote as well. Contractarians need not come up with an independent justification for the shareholder franchise if that governance structure is simply the outcome of private ordering. Particularly if seen as a "nexus" of contracts, the corporation's exclusive shareholder voting structure can be cast as a joint and consensual arrangement between *all* of the participants in the corporate form. Creditors, suppliers, customers, and employees—all have agreed to the shareholder franchise because none of them included voting rights in *their* contracts.

Of course, the irony is that state corporate law has likely stifled efforts to expand the franchise beyond shareholders. A truly free-flowing contractual approach to governance would open the door to a variety of corporate forms, instead of the directors-shareholders structure that is so ensconced in the law. If corporations were truly just an agglomeration of separate deals, it's unlikely they would all look the same. But corporate law has successfully put its stamp on governance, particularly on the shareholder franchise. It is one of the reasons that a true contractarian like Larry Ribstein seemed to give up on the corporate form in favor of the limited liability company.

The range of choices that do appear within the statutory framework are often illusory. For example, section 141 of Delaware General Corporation Law ("DGCL") states: "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, *except as may be otherwise provided* in this chapter or *in its certificate of incorporation*."[138] This apparent flexibility, however, is belied by the actual structure of most corporations and the presence of other mandatory requirements. In practice, corporate charters are extremely homogenous.[139] The diversity that one might expect from a collection of firms with heterogeneous governance needs is nowhere apparent.[140] Moreover, the apparent flexibility of corporate law on paper is undercut by a more complex reality. The textual openness of section 141(a), for example, masks a fairly rigorous defense of managerial power. Shareholders' power to amend the corporation's bylaws under section 109(b) of the DGCL takes a back seat to the more free-ranging power of section 141(a).[141] In addition, many

138. DEL. CODE ANN. tit. 8, § 141(a) (2018) (emphasis added).

139. Klausner, *supra* note 113, at 784, 786–91.

140. *Id.* at 784.

141. John C. Coates IV & Bradley C. Faris, *Second-Generation Shareholder Bylaws: Post-*Quickturn *Alternatives*, 56 BUS. LAW. 1323, 1353 (2001) ("A bylaw is impermissible if its primary purpose is to prevent or interfere with the board's discretion under section 141(a) to manage the business and affairs of the corporation . . . ."); Lawrence A. Hamermesh, *Corporate Democracy and*

aspects of federal securities law, particularly SEC Rule 14a-8[142] and the Sarbanes-Oxley Act,[143] assume the existence of certain governance mechanisms, such as the board and shareholder meetings, before adding additional requirements.[144] Centralized management is "[t]he feature that best characterizes the large-firm nature of the corporation," and the board of directors is "one of the most distinctive features of the corporate form."[145] Similarly, shareholder voting, transferable shares, fiduciary duties, and capital lock-in are other essential "governance" elements of the corporation that are mandatory to the form.[146]

There is another, less ambitious form of contractarianism that acknowledges corporate law's imposition of mandatory, noncontractual terms but argues that participants nonetheless exercise a kind of contractual freedom by choosing the corporate form over others. Businesses need not choose the corporation as their organizational form; they can create general and limited partnerships, limited liability companies, and other variations.[147] But the availability of choice amongst a set of possible forms does not mean that the choice is contractual. For a variety of reasons, the corporation is the best (or only) choice for certain types of businesses.[148] Although the number of choices has increased, there are still only a handful of options. At best, there is an argument that, of the existing options, the participants who do the choosing seem to prefer the corporate form. This, though, doesn't justify the most basic aspects of corporate governance, such as the exclusive shareholder franchise. A similar argument could be made for the many businesses

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Stockholder-Adopted By-Laws: Taking Back the Street?, 73 TUL. L. REV. 409, 428–44 (1998).

142. 17 C.F.R. § 240.14a–8 (2018).

143. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

144. For example, Rule § 240.14a-8 gives shareholders the authority to propose actions to the board at the annual meeting, and Sarbanes-Oxley puts independence requirements on audit committees, which are subcommittees of the board. Sarbanes-Oxley Act § 301, 15 U.S.C. § 78j-1 (Supp. III 2003).

145. RIBSTEIN, *supra* note 14, at 67 (arguing that "only a corporation *must* have a board of directors that is separate from the executives and appointed directly by the owners").

146. *Id.* at 68–75.

147. *See id.* at 26–27. Another new and increasingly popular form of business association is the benefit corporation. *See* Joan MacLeod Heminway, *Corporate Purpose and Litigation Risk in Publicly Held U.S. Benefit Corporations*, 40 SEATTLE U. L. REV. 611, 612 (2017) ("Currently, thirty states and the District of Columbia have passed benefit corporation statutes, and seven additional states have legislation pending.").

148. These reasons include: the complexity of drafting LLC or LLP charters; tax treatment of LLCs can be more difficult for many investors to manage; the unavailability of tax-deferred stock swaps for LLCs; the difference in treatment of equity compensation for executives and employees; and differences in state tax treatment.

in Germany, with its system of codetermination, who have chosen to locate or remain in Germany and give workers a vote and a seat at the boardroom table.[149]

Although sometimes the rhetoric slips,[150] it is hard to find strong contractarians who believe that the nexus of contracts theory is the literal truth.[151] The theory is instead used metaphorically to present a narrative about the operation of the firm. Under this narrative, the corporation represents the contracts that the parties would have made had they been able to do so. This brings us to the "hypothetical bargain."

B. Corporation as Metaphorical Contract: The Hypothetical Bargain

Even if corporations are not actually a nexus of contracts, maybe all the participants *would have* agreed to the structure used within corporate governance in the absence of all the pesky, real-world transaction costs that would bog down such decisions and otherwise limit free choice. The idea behind this argument is the hypothetical bargain. Though invoked by many scholars, the hypothetical bargain has been most forcefully articulated by Easterbrook and Fischel.[152] In trying to explain the presence of corporate law in what should—to them—be a world of pure contract, they maintain that "corporate law is a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting."[153] They continue:

> There are lots of terms, such as rules for voting, establishing quorums, and so on, that almost everyone will want to adopt. Corporate codes and existing judicial decisions supply these terms "for free" to every corporation . . . . Corporate law—and in

149. *See* Dieter Sadowski et al., *The German Model of Corporate and Labor Governance*, 22 COMP. LAB. & POL'Y J. 33, 36–40 (2000).

150. It is difficult to measure the extent to which contractarians shift their metaphor into the realm of literal truth. Certainly, most contractarians will admit that a corporation cannot be formed through contract. However, the theory is often described in shorthand as a positive description. *See, e.g.*, JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES MADE, PROMISES KEPT 22 (2008) ("It has long been recognized . . . that the corporation . . . should be viewed as a 'nexus of contracts' or a set of implicit and explicit contracts."); Stephen M. Bainbridge, *Unocal at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 781 (2006) ("[I]t is commonplace and correct to say that the corporation is a nexus of contracts . . . .").

151. Fred McChesney, for example, stated: "Admittedly, as a descriptive matter state corporation codes and other sources of law contain many mandatory terms that parties cannot contract around . . . . [T]o claim that contractarians would deny the existence of coercive legal rules is to accuse them of blindness or stupidity." Fred S. McChesney, *Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg*, 89 COLUM. L. REV. 1530, 1537 (1989).

152. EASTERBROOK & FISCHEL, *supra* note 49, at 34.

153. *Id.*

> particular the fiduciary principle enforced by courts—fills in the blanks and oversights with the terms that people would have bargained for had they anticipated the problems and been able to transact costlessly in advance.[154]

Thus, in situations where certain features of a corporation cannot be grounded in actual bargaining of any sort, they are justified as the product of an imagined, ex ante bargain among members of the many corporate constituencies.[155]

The hypothetical bargain provides three rhetorical moves to these quasi-contractarians. First, the theory captures much of the rhetorical power of the more direct nexus of contracts theory without the illogical commitments that the unalloyed version of the theory requires.[156] Second, the theory allows supporters to defend current practices by pointing to their roots as bargains (even if only hypothetical ones).[157] Third, it provides the intellectual support for a corporate law architecture that includes default and mandatory terms.[158] Judges and legislatures are permitted to impose terms if the participants in the corporation would be better off, as long as the narrative supports a hypothetical bargain that would arrive at the same place.

Because the hypothetical bargain is based on a "best guess" as to what the parties really want, the success of the contractarian argument depends on how well this guess matches reality. Contractarians spend at least some time trying to figure out the preferences of corporate constituents. They look to actual bargains on certain subjects. And they make some simplifying assumptions about human motivation and behavior. The problem with these approaches is that the actual bargains are often limited to more minor features of corporate governance negotiated between a few constituents, and the simplifying assumptions are often off that mark. In the end, the hypothetical bargains, and the imagined preferences they are based on, reveal much more about the desires of those doing the guessing than people's actual preferences.

Easterbrook and Fischel, for example, believe that they have a "ready source of guidance" when it comes to making their guesses:

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154. *Id.*

155. *See also* Bainbridge, *supra* note 122, at 865 n.31 (explaining that "corporate default rules . . . [are not] entitlements but . . . our best guess as to what parties would rationally agree to in the absence of any pre-existing set of imposed terms"); Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84. NW. U. L. REV. 542, 544 (1990) (claiming that many features of non-contractual corporate law were trivial because they represent terms that would have been in corporate charters or bylaws anyway).

156. EASTERBROOK & FISCHEL, *supra* note 49, at 15.

157. *Id.* ("The rhetoric of contract is a staple of political and philosophical debate. Contract means voluntary and unanimous agreement among affected parties. It is therefore a powerful concept.").

158. *Id.*

"the deals people actually strike when they bargain over the subject."[159] Legislatures and courts, then, should build corporate law by looking at the bargains struck by private actors in similar situations. This seems fine when working out some of the details. For example, there are good reasons to assume that minority shareholders will want protections against opportunism from majority shareholders—ones that already exist or that assume power in the future. But it's hard to see how this works when it comes to the more fundamental aspects of corporate governance structure, such as who has voting and control rights. There really aren't any guiding bargains over these more basic aspects of governance because we never have a bunch of atomistic providers of capital and labor floating around in the æther of free contract making such deals. The grand hypothetical bargain requires us to visualize all of the corporate constituents sitting around a table negotiating the ideal governance form ex ante. But by the time most of the actual constituents come to the bargaining table, the basic governance procedures have already been selected by the founders—they've approached the state and formed a corporation. There's no real-world analog that allows us to discern much of anything about the form that corporation would take. The "deals people actually strike" are of little use here.

Without the guidance of real-world bargains on the basic aspects of corporate governance, contractarian scholars are forced to take a step back, consider the preferences of all constituent groups, and then argue from those preferences to the hypothetical bargains. Here, the best Easterbrook and Fischel can do is assume that "[i]nvestors and other participants agree on the stakes: money. They therefore would agree unanimously to whatever rule maximizes the total value of the firm."[160] For them, every single corporate constituent group—shareholders, employees, creditors, and customers—agrees on the goal of wealth maximization. Again, most scholars and lawmakers making these guesses have tended to focus more specifically on the preferences of shareholders. But they've largely made the same guess—that shareholders want to maximize wealth.[161] And these guesses, and the hypothetical bargains based on them, are used to justify a broad range of the features of corporate law and governance.

Here, though, we have a guess to test against reality to see if it makes sense. It doesn't. The guess isn't even accurate when it comes to shareholder preferences. As we saw above, there's no reason to think that every shareholder has the same type of preferences—their preferences are much more heterogeneous than previously

159. *Id.* at 34.
160. *Id.* at 23.
161. For a critique, see Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L. FIN. & ACCT. 247, 248 (2017).

believed.[162] Indeed, even shareholders who prioritize wealth maximization may still disagree about what, exactly, that means, the proper timeline, and other issues. And when we expand our gaze to other participants, the guess looks even more off the mark. Employees, for example, care about their wages, but they also care about the long-term health of their companies and their jobs. Customers care about the cost of their products (and, all things considered, like them lower rather than higher), but they also care about the quality of the goods or services they purchase. The normative force of the hypothetical bargain disappears if the bargain is not based on the actual preferences of corporate constituents.

But even if Easterbrook and Fischel are right about the preferences of corporate constituents—even if every last one of them values money above all else—that alone doesn't lend much insight into the hypothetical bargains they would make. Different corporate constituents may want to strike deals that maximize their own group's wealth, not necessarily the overall wealth of the firm. And even if you could convince all constituents that the only way to make a deal is to agree to a system that maximizes the value of the firm, that alone doesn't automatically get you a hypothetical bargain on any particular governance feature. There still exists an argument that a particular governance structure is the right one to achieve that shared goal, which brings you back to the original arguments you were seeking to avoid. Is a structure that gives shareholders alone the right to elect board members the best way to maximize the value of a firm? Maybe or maybe not. But it depends on the particulars of the situation, not on any actual or hypothetical agreements.

At this point, it should be clear that the hypothetical bargain is an empty concept. It's really just an opening that allows contractarians to try to link various governance features, including the exclusive shareholder franchise, to "free choice" and all its normative goodness. The bargain doesn't do any work by itself and may be used to justify virtually any corporate feature. As Jonathan Macey explains, "the analytical framework that the contracting paradigm provides for non-contractual law is not much of a constraint on policymakers, since virtually any decision that a judge makes can be justified as being consistent with the hypothetical bargain."[163] As a justification for the shareholder franchise, the hypothetical bargain ends up being a self-fulfilling prophecy.

Of course, the hypothetical bargain serves the same rhetorical purpose as the nexus of contract theory: it makes the existing arrangements seem like a voluntary agreement among the parties. By viewing corporate law as a mere reflection of what the parties *would* have bargained for, proponents of the hypothetical bargain can achieve a twofer: set corporate law as they desire but then claim that

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162. *Id.*
163. MACEY, *supra* note 150, at 29.

such arrangements represent the will of the participants. Ultimately the whole enterprise seems absurd. But the rhetoric enables these commentators to keep their "private ordering" priors while meddling when the parties do not play the game as expected.

C. *The New Corporate Contract*

The metaphor and rhetoric of contract have enjoyed recent application in discussions surrounding the "corporate contract" between shareholders and the board. Taking the idea behind the general nexus of contracts theory, the corporate contract approach views interactions between shareholders and management as primarily contractual in nature. In this instance, the "corporate contract" analysis has been extended to the specific mechanics of corporate governance: corporate charters and bylaws.[164] Also known as the articles or certificate of incorporation, the corporate charter is the foundational document for the corporation and sets forth the basic structure of its governance, such as the board of directors and the creation and allocation of shares.[165] Bylaws govern interstitial rules of governance that can directly impact specific types of procedural actions or decisions.[166] They both provide tools for these stakeholders to change the rules through which the corporation is governed. Courts and commentators have come to characterize these instruments of governance as the corporate contract.[167] As described in one recent Delaware case, "the bylaws of a Delaware corporation constitute part of a binding broader contract among the directors, officers, and stockholders formed within [the state's] statutory framework."[168]

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164. *Id.* at 18.

165. DEL. CODE ANN. tit. 8, § 102 (2018) (describing the contents of a certificate of incorporation).

166. *Id.* at § 109(b) ("The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees."). In Delaware, the charter is more difficult to amend, as it requires both shareholder and board approval. *Id.* at § 242(b)(1). Bylaws, in contrast, can be created and amended by the board or by shareholders. *Id.* at § 109(a).

167. *See, e.g.*, Airgas, Inc. v. Air Prods. & Chems., Inc., 8 A.3d 1182, 1188 (Del. 2010) (describing bylaws as "contracts among a corporation's shareholders"); Robert Borowski, *Combatting Multiforum Shareholder Litigation: A Federal Acceptance of Forum Selection Bylaws*, 44 SW. L. REV. 149, 150 (2014) (finding that "bylaws are generally treated as contracts between corporations and their shareholders"). *See generally* Verity Winship, *Litigation Rights and the Corporate Contract, in* THE CORPORATE CONTRACT IN CHANGING TIMES: IS THE LAW KEEPING UP? (William Savitt et al. eds.) (forthcoming 2019), https://ssrn.com/abstract=2913745 (describing the corporate contract as "the agreement or set of agreements that articulate the terms of the relationship among shareholders, directors and the corporation itself").

168. Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 939 (Del. Ch. 2013); *see also id.* at 955 ("In an unbroken line of decisions dating back

The idea of the corporate contract is generally used to justify the parties' use of charter amendments or bylaws as part of the rules of the game. Commentators have argued that shareholders should have broad rights to propose and enact bylaws as part of their "contract" with the corporation.[169] With a flurry of activity over bylaws concerning proxy access, forum selection, majority voting, advance notice, and litigation expenses,[170] parties are hotly contesting the degree of deference that courts must provide. In recent cases, Delaware courts have upheld bylaws concerning forum selection[171] and litigation fee-shifting.[172] In these decisions, the courts have leaned heavily on the notion that these bylaws are part of the corporate contract between the shareholders, the board, and the corporation.[173] However, Delaware did find that shareholders lacked the authority to propose a bylaw requiring the corporation to reimburse reasonable proxy solicitation expenses.[174] The Supreme Court found that the bylaw improperly conflicted with the board's broad powers to manage the corporation.[175]

Once again, we find the idea of the corporation as contract being used as a metaphor, and not a very useful one at that. First, charters and bylaws are instruments of governance. There is no need to layer the additional metaphor of "contract" on top of what are clearly mechanisms for managing relations between the parties. The whole point of having a system of governance is to create a mechanism beyond simple contracts that structures the relationships between the parties. As Delaware recognizes, bylaws themselves are supposed to focus on procedural matters rather than substantive business matters.[176] They clearly relate to governance.[177] If the legitimacy of

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several generations, our Supreme Court has made clear that the bylaws constitute a binding part of the contract between a Delaware corporation and its stockholders.").

169. D. Gordon Smith et al., *Private Ordering with Shareholder Bylaws*, 80 FORDHAM L. REV. 125, 127 (2011) (proposing to "empower shareholders in public corporations by facilitating their ability to contract" through bylaws).

170. *See* Fisch, *supra* note 3, for a discussion of these bylaw controversies.

171. *Boilermakers*, 73 A.3d at 939.

172. ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 558 (Del. 2014).

173. *Id.* ("But it is settled that contracting parties may agree to modify the American Rule and obligate the losing party to pay the prevailing party's fees. Because corporate bylaws are 'contracts among a corporation's shareholders,' a fee-shifting provision contained in a nonstock corporation's validly-enacted bylaw would fall within the contractual exception to the American Rule."); *Boilermakers*, 73 A.3d at 955.

174. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 240 (Del. 2008).

175. *Id.* at 232.

176. *Id.* at 236; *Boilermakers*, 73 A.3d at 951 (noting that "bylaws typically do not contain substantive mandates, but direct how the corporation, the board, and its stockholders may take certain action").

177. *See, e.g.*, Brett H. McDonnell, *Bylaw Reforms for Delaware's Corporation Law*, 33 DEL. J. CORP. L. 651, 651–52 (2008) (describing shareholder bylaw proposals as "an increasingly important part of battles over corporate

the particular bylaw is in question, it can be justified through the nature of the democratic process through which it was enacted. There is no need to layer the additional idea of "contract" on top of the system of governance.[178]

Second, the rhetoric of corporate contract has been used inconsistently to support a variety of different approaches to governance. Commentators often cite the corporate contract to advocate for a hands-off or *laissez-faire* approach to shareholder-proposed bylaws.[179] Because the corporation allows shareholders to implement procedural rules in their own interests, corporate law should generally presume their enforceability. Delaware courts, however, have used the corporate contract rhetoric to justify board-enacted bylaws that arguably limit shareholder rights. For example, in *Boilermakers v. Chevron Corp.*,[180] the Chevron and FedEx boards of directors adopted forum-selection bylaws naming Delaware courts as the exclusive forums for shareholder litigation.[181] Shareholders then sued to render the bylaws invalid.[182] The Delaware Chancery Court upheld the bylaws, relying in part on the idea of corporate contract.[183] Then-Chancellor Leo Strine explained:

> In an unbroken line of decisions dating back several generations, our Supreme Court has made clear that the bylaws constitute a binding part of the contract between a Delaware corporation and its stockholders. Stockholders are on notice that, as to those subjects that are subject of regulation by bylaw under 8 Del. C. § 109(b), the board itself may act unilaterally to adopt bylaws addressing those subjects. Such a change by the board is not extra-contractual simply because the board acts

governance" and "a useful way for shareholders to guard against board opportunism without going too far in usurping board authority"); Ben Walther, *Bylaw Governance*, 20 FORDHAM J. CORP. & FIN. L. 399, 404 (2015) (stating that under the bylaw governance model, "shareholders may exert authority over corporate affairs by promulgating bylaws that circumscribe the board's exercise of its authority").

178. At times the language in Delaware opinions seems to be referencing the idea of a "social contract" to justify the governance by the consent of the governed. *See Boilermakers*, 73 A.3d at 955–56 ("Stockholders are on notice that, as to those subjects that are subject of regulation by bylaw under 8 Del. C. § 109(b), the board itself may act unilaterally to adopt bylaws addressing those subjects. Such a change by the board is not extra-contractual simply because the board acts unilaterally; rather it is the kind of change that the overarching statutory and contractual regime the stockholders buy into explicitly allows the board to make on its own.").

179. Fisch, *supra* note 3, at 375 ("The contractual approach has become particularly influential in supporting deference to the participants' agreed-upon governance terms on both autonomy and efficiency grounds.").

180. 73 A.3d 934 (Del. Ch. 2013).

181. *Id.* at 937.

182. *Id.* at 938.

183. *Id.* at 939.

> unilaterally; rather it is the kind of change that the overarching statutory and contractual regime the stockholders buy into explicitly allows the board to make on its own. In other words, the Chevron and FedEx stockholders have assented to a contractual framework established by the DGCL and the certificates of incorporation that explicitly recognizes that stockholders will be bound by bylaws adopted unilaterally by their boards. *Under that clear contractual framework, the stockholders assent to not having to assent to board-adopted bylaws.* The plaintiffs' argument that stockholders must approve a forum selection bylaw for it to be contractually binding is an interpretation that contradicts the plain terms of the contractual framework chosen by stockholders who buy stock in Chevron and FedEx. Therefore, when stockholders have authorized a board to unilaterally adopt bylaws, it follows that the bylaws are not contractually invalid simply because the board-adopted bylaw lacks the contemporaneous assent of the stockholders.[184]

Although acknowledging the argument "that board-adopted bylaws are not like other contracts because they lack the stockholders' assent," the Chancellor dismissed it as "a failure to appreciate the contractual framework established by the DGCL for Delaware corporations and their stockholders."[185]

It is almost a magic trick: take the shareholders' complete lack of power over a forum-selection clause and turn it into a contract.[186] Delaware even seems to allow the board to overturn a bylaw that the shareholders have enacted to restrain the board.[187] If this relationship is contract, it would be an illusory one.[188] There are certainly valid normative reasons for constraining shareholder power and preserving board authority.[189] But, cloaking such policymaking under the guise of corporate contract allows the court to make the shareholders responsible for their own disenfranchisement. A cynic might even add that Delaware inconsistently deploys the contract metaphor to suit its own purposes. Forum-selection bylaws that choose Delaware, as well as loser-pays bylaws, are justified by the

184. *Id.* at 955–56 (emphasis added) (footnotes omitted).

185. *Id.* at 956.

186. One is reminded of Grant Gilmore's astonishment at Oliver Wendell Holmes: "The magician who could 'objectify' *Raffles v. Wichelhaus* . . . could, the need arising, objectify anything." GRANT GILMORE, THE DEATH OF CONTRACT 45 (Ronald K.L. Collins ed., 2d ed. 1995).

187. Fisch, *supra* note 3, at 389 (citing Kidsco Inc. v. Dinsmore, 674 A.2d 483, 492 (Del. Ch. 1995)).

188. *See, e.g.*, Salazar v. Citadel Commc'ns Corp., 2004-NMSC-013, ¶ 9, 135 N.M. 447, 90 P.3d 466 ("Under general New Mexico contract law, an agreement that is subject to unilateral modification or revocation is illusory and unenforceable . . . . The party that reserves the right to change the agreement unilaterally, and at any time, has not really promised anything at all and should not be permitted to bind the other party.").

189. *See, e.g.*, Fisch, *supra* note 3, at 374.

corporate contract; in contrast, bylaws that require corporations to reimburse reasonable proxy solicitation expenses are not.[190]

Ultimately, the corporate contract between shareholders and the corporation is a system of governance, not a contract. The metaphor of contract blurs the picture, rather than illuminating it. Resolving whether shareholders or boards should have the authority to pass certain kinds of bylaws is a governance issue. The answers to these puzzles are not to be found in the realm of offer, acceptance, consideration, and the parol evidence rule.

IV. CORPORATION AS FIRM AND THE SHAREHOLDER FRANCHISE

It is strange to see the amount of intellectual energy poured into the flawed nexus of contracts metaphor, especially when the whole idea of a corporation is to differentiate it from the world of contracts. Yes, the individual participants may contract with one another as part of their relationships within the corporation. But we have the corporate form to distinguish the organization and its set of relationships from the market and from general contractual relations. The corporate form, and its family of other business associations, were created to allow for a sustained approach to joint production.[191]

There is in fact a branch of economics that is devoted to exploring the differences between firms and market-based transactions. This research into the theory of the firm seeks to answer a fundamental question: Why do we even have firms at all? The function of markets is to allocate resources based on the best information available at the time.[192] Firms, however, operate outside of this market structure, standing like "lumps of butter coagulating in a pail of buttermilk."[193] The law reflects this differentiation, as market transactions are generally governed by contract, while firms are created as specific business organizations—partnerships, corporations, LLCs, among others. Why have we created the non-market, non-contractual entities in the first place? Why not just rely on markets and contracts for everything?

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190. *Cf. id.* at 382–83 (noting the inconsistency).

191. William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1521 (1982) (suggesting that "the most useful way to analyze the modern business enterprise is to interpret the terms of the economic arrangements of a firm (partnership, corporation, cooperative) and the terms of the related economic arrangements that should not be analyzed separately from the firm (distributorship, loan agreement, employment contracts) as a series of bargains subject to constraints and made in contemplation of a long-term relationship").

192. Friedrich A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 520 (1945).

193. Coase, *supra* note 7, at 388 (quoting D.H. ROBERTSON, THE CONTROL OF INDUSTRY 85 (1930)).

Early economists did not seek to answer this question, but rather relied on a placeholder to serve their modeling needs.[194] The firm was simply a black box that took in inputs and put out outputs.[195] The first modern effort to inquire into the nature of firms was *The Nature of the Firm*.[196] In that article, Coase framed the issue in this manner:

> Outside the firm, price movements direct production, which is coordinated through a series of exchange transactions on the market. Within a firm these market transactions are eliminated, and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-coordinator, who directs production. It is clear that these are alternative methods of coordinating production. Yet, having regard to the fact that, if production is regulated by price movements, production could be carried on without any organization at all, well we might ask, why is there any organization?[197]

For Coase, the answer is transaction cost economics: organizing production through a market creates transaction costs that a firm can avoid.[198] Since the firm consisted of managers and workers, the heart of the firm was the relationship between these two groups. It was the firm's ability to manage workers outside of a market that solved significant pricing and contracting expenses. As he argued, "it is the fact of direction which is the essence of the legal concept of 'employer and employee'" as well as the concept of the firm itself.[199]

Although the field started slowly, the theory of the firm made significant advancements beginning in the 1970s. Armen Alchian and Harold Demsetz developed a concept of team production that explained the firm not as a way of providing command and control but as a way of pooling disparate inputs into a system of cooperative creation.[200] They defined team production as "production in which (1) several types of resources are used and (2) the product is not a sum of separable outputs of each cooperating resource."[201] Firms are able to coordinate production among various groups without carving the

194. *See* Charles R.T. O'Kelley, *The Entrepreneur and the Theory of the Modern Corporation*, 31 J. CORP. L. 753, 757 (2006); Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1631 (2001).

195. Reza Dibadj, *Reconceiving the Firm*, 26 CARDOZO L. REV. 1459, 1462 (2005) ("The predominant model of microeconomics, neoclassical price theory, assumes simply that the firm is a black box that maximizes profitability.").

196. Coase, *supra* note 7, at 386.

197. *Id.* at 388.

198. *Id.* at 390–92.

199. *Id.* at 404.

200. *See generally* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

201. *Id.* at 779.

relationships into separable contracts.[202] As a result, firms are used when the team method increases productivity, after factoring out the costs associated with monitoring and disciplining the various players.[203] Under Alchian and Demsetz's model, the primary concern of team production is making sure that the team members do not shirk their responsibilities to the team.[204] The inability to measure individual contributions to productivity is what makes the firm useful in the first place, but it is also the firm's central governance problem.[205] As a result, an independent monitor is necessary to ensure that the team members all contribute appropriately and are rewarded appropriately. That central monitor is the firm itself.[206]

Around the same time of Alchian and Demsetz's work, Oliver Williamson was continuing to develop Coase's "transaction-costs" model into a robust field of research. Williamson used the theory of the firm to identify the types of contractual difficulties that are likely to lead to firm governance rather than market solutions.[207] When contributions and compensation are harder to value individually, the parties will be left with incomplete and ambiguous contracts. And these contracts will be insufficient to properly allocate economic power within the relationship, particularly where one or both of the parties must invest significant resources in assets specific to the particular firm, project, or transaction. In order to prevent opportunism in the face of these contracts, some system of governance is necessary to deal with ex ante developments. Firms can provide this governance. By creating legal structures that allocate control between the parties separate and apart from their contractual rights, governments can assist parties in developing relationships that minimize transaction costs and facilitate economic growth.[208]

The property-rights theory of the firm focuses more particularly on the assets that the parties seek to use together. This theory, developed in a series of articles by Grossman, Hart, and Moore, posits that firms serve as a repository of property rights for assets used in joint production.[209] By owning the property outright, the firm prevents the tragedy of the commons[210] (in which no one holds

202. *Id.* at 780.
203. *Id.*
204. *Id.*
205. *Id.* at 779.
206. *Id.* at 794.
207. OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 2 (1985).
208. *Id.* at 18.
209. OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 23 (1995); Grossman & Hart, *supra* note 120, at 716; Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755, 755 (1988); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119, 1121 (1990).
210. Garrett Hardin, *The Tragedy of the Commons*, 162 SCIENCE 1243, 1244–45 (1968).

property rights over valuable assets) as well as the problem of the anticommons (in which property rights are divvied up among too many disparate actors).[211] The Grossman-Hart-Moore model dictates that the firm should be owned by those who contribute the most valuable and most asset-specific property to the joint enterprise.[212] While these types of contributors are crucial to the firm's success, they are also the most vulnerable to hold-up problems as the joint enterprise moves forward in time.[213] Building on the property-rights theory of the firm, Raghuram Rajan and Luigi Zingales have proposed an "access" theory of power within the firm.[214] This model defines a firm "both in terms of unique assets (which may be physical or human) and in terms of the people who have access to these assets."[215] The power of the individuals within and without the firm is based on their relative access to the assets, which Rajan and Zingales define as "the ability to use, or work with, a critical resource."[216] Examples of critical resources include machines, ideas, and people. As Rajan and Zingales make clear, "[t]he agent who is given privileged access to the resource gets no new residual rights of control. All she gets is the opportunity to specialize her human capital to the resource and make herself valuable."[217] Combined with her right to leave the firm, access gives the employee the ability to "create a critical resource that she controls: her specialized human capital."[218] Other research has focused more specifically on the role of human capital. According to the knowledge-based theory of the firm,[219] a firm "develops the knowledge it will use in its production process and the extent that firm can bind this knowledge to its structure will influence its organizational structure."[220] Rather than emphasize the ownership

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211. *See* MICHAEL HELLER, THE GRIDLOCK ECONOMY: HOW TOO MUCH OWNERSHIP WRECKS MARKETS, STOPS INNOVATION, AND COSTS LIVES 1–22 (2008) (describing the gridlock effects of disparate ownership that are characteristic of the anticommons).

212. *See generally* Grossman & Hart, *supra* note 120.

213. In the transaction-cost model, employees may be precisely the vulnerable yet valuable contributors to the joint enterprise who have the most to fear from opportunistic behavior. Indeed, Blair offers the following critique: "The tendency of the transactions costs literature has been to recognize that firm-specific human capital raises similar questions, but then to sidestep the implications of these questions for corporate governance." Margaret M. Blair, *Firm-Specific Human Capital and Theories of the Firm*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 58, 66 (Margaret M. Blair & Mark J. Roe eds., 1999).

214. Raghuram Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q.J. ECON. 387, 387 (1998).

215. *Id.* at 390.

216. *Id.* at 388.

217. *Id.*

218. *Id.*

219. Érica Gorga & Michael Halberstam, *Knowledge Inputs, Legal Institutions and Firm Structure: Towards a Knowledge-Based Theory of the Firm*, 101 NW. U. L. REV. 1123, 1139–40 (2007).

220. *Id.* at 1140.

of physical assets, which can be fungible and non-specific, the knowledge-based theory focuses on the need to produce, distribute, and ultimately retain valuable knowledge-based assets within the firm. Similarly, another approach known as the capability-based theory of the firm focuses on firm-specific knowledge and learning that can be translated into joint production.[221]

These theories of the firm do not lead to the inarguable conclusion of shareholder primacy. In fact, Alchian and Demsetz specifically question the very idea of shareholder governance:

> In sum, is it the case that the stockholder-investor relationship is one emanating from the *division* of *ownership* among several people, or is it that the collection of investment funds from people of various anticipations is the underlying factor? If the latter, why should any of them be thought of as the owners in whom voting rights, whatever they may signify or however exercisable, should reside in order to enhance efficiency? Why voting rights in any of the outside, participating investors?[222]

The transaction costs and property rights theories do lend themselves to a concern for shareholder protection. Both identify vulnerable groups among those who provide inputs and attempt to create structures that protect them from hold up or exploitation. But compelling cases could also be made for employees, suppliers, and customers as the parties who—in various types of situations—would be the most vulnerable or most in need of protection from other players.[223]

The nexus of contracts theory is something of an "anti-theory" of the firm. It explains why firms are not necessary, rather than why they exist. Unlike Alchian and Demsetz's firm—which plays a real role in shaping, executing, and enforcing contracts with input providers—the "nexus" at the center of Jensen and Meckling's firm is a mere legal fiction that is "*not an individual*" and has no real independent existence.[224] Jensen and Meckling's model focuses on agency costs created by the upper-level managers who are tasked to do the bidding of principals. Their theory defines agency costs as the costs associated with monitoring by the principal, bonding expenditures by the agent, and the residual loss.[225] The monitoring they describe looks a lot like the "control" that Coase focused on as

221. Thomas F. McInerney, *Implications of High Performance Production and Work Practices for Theory of the Firm and Corporate Governance*, 2004 COLUM. BUS. L. REV. 135, 136 (2004).

222. Alchian & Demsetz, *supra* note 200, at 789 n.14.

223. *See generally* Blair, *supra* note 213; David G. Yosifon, *Consumer Lock-In and the Theory of the Firm*, 35 SEATTLE U. L. REV. 1429 (2012) (arguing for governance rights for customers, based on sunk costs and concerns over opportunism).

224. Jensen & Meckling, *supra* note 105, at 311.

225. *Id.* at 308.

the key element in defining the firm.[226] But Jensen and Meckling turn their attention to the relationship between shareholders (principals) and management (agents), rather than the relationship of employees to the firm. Their model joins the financial structure of the firm with the management structure of corporate governance.

As other commentators have pointed out, the nexus of contract theory is thus not really a theory of the firm at all. Rather, it is a theory of agency costs within a certain type of firm—namely, the corporation.[227] And upon close examination, it falls apart, at least as a theory of the firm, or as a justification for the corporation in the first place. If a corporation is really no more than a nexus of contracts, then there should be no need for corporations or corporate law. For if firms are not necessary, there is no need for the law to create and support them. As has been repeatedly recognized, the nexus of contracts approach is not a theory of the firm because it "says nothing about why firms exist or what kind of activity is undertaken by a certain firm."[228]

Stephen Bainbridge has drawn upon the theory of the firm and public choice literature in creating his "director primacy" theory of the corporation.[229] Bainbridge's model splits the theory of the firm question into two components: What are the ends for which the

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226. And indeed, Jensen and Meckling observe in a footnote: "As it is used in this paper the term monitoring includes more than just measuring or observing the behavior of the agent. It includes efforts on the part of the principal to 'control' the behavior of the agent through budget restrictions, compensation policies, operating rules etc." *Id.* at 308 n.9.

227. Oliver Hart, *Incomplete Contracts and Control*, 107 AM. ECON. REV. 1731, 1735 (2017); Michael J. Meurer, *Law, Economics, and the Theory of the Firm*, 52 BUFF. L. REV. 727, 732 (2004); Edward B. Rock & Michael L. Wachter, *Norms & Corporate Law: Introduction*, 149 U. PA. L. REV. 1607, 1624 (2001); David A. Westbrook, *Corporation Law after Enron: The Possibility of a Capitalist Reimagination*, 92 GEO. L.J. 61, 105 n.277 (2003) ("So for Coase, in the first instance, the firm is *anything but* a nexus of contracts. Instead the firm is a site where the costs of continuous contracting (forming a market) outweigh the costs of forming the entity. Ironies abound in the legal academy's appreciation of the great economist.").

228. Meurer, *supra* note 227, at 731–32 (citing Harold Demsetz, *The Theory of the Firm Revisited*, *in* THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT (Oliver E. Williamson & Sidney G. Winter eds., 1991)).

229. Bainbridge's theory was developed over time through a series of articles on the subject. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U.L. REV. 547, 573 (2003) [hereinafter Bainbridge, *Director Primacy*]. *See generally* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006) [hereinafter Bainbridge, *Voting Rights*]; Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) [hereinafter Bainbridge, *Shareholder Disempowerment*]; Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791 (2002) [hereinafter Bainbridge, *Primacy in Takeovers*]. He has synthesized his research into a book on the subject. *See generally* STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE (2008).

corporation exists, and what are the means of achieving those ends?[230] For the theory of shareholder primacy, shareholders represent both the ends and the means of governance.[231] Bainbridge agrees that the goal of the corporation should be shareholder wealth maximization.[232] He believes, however, that control of the corporation rests not with the shareholders but rather with the board of directors who serves as the "Platonic guardian" of the firm.[233]

Bainbridge's theory is thus an amalgam of shareholder primacy and nexus of contracts theory but with important differences. Rather than saying that the firm is itself a nexus of contracts, he argues that the firm has a nexus of its contracts, and that the board is that nexus.[234] According to Bainbridge, the defining characteristic of a firm is "the existence of a central decision-maker vested with the power of fiat."[235] Rather than being participatory democracies, firms provide for hierarchies that can direct the allocation of resources through command.[236] Bainbridge bases his theory on Coase's differentiation between markets and firms, as well as the notion that "firms arise when it is possible to lower these sets of costs inherent to team production by delegating to a team member the power to direct how the various inputs will be utilized by the firm."[237] Drawing upon Arrow's *The Limits of Organization*,[238] Bainbridge contrasts consensus-based decision-making structures with authority-based structures, and argues that the corporation fits Arrow's model of an authority-based system.[239] The board of directors serves as the ultimate seat of authority—the central decision-maker that contracts with all other players and directs them within the firm.

Bainbridge uses the theory of the firm literature to establish the basics of his model (as a combination of contracts and hierarchy) and then to defend its particular configuration of authority and purpose. It is arguably a continuation of Coase's original insight regarding firms, further elaborated with the hypothetical bargain used in law and economics analyses. Ultimately, however, Bainbridge fails to flesh out his theory sufficiently to justify the near absolute control he provides to the board. He repeatedly relies on Arrow's contrast between consensus and authority to resolve any questions of power

230. Bainbridge, *Director Primacy*, *supra* note 229, at 547–50.

231. *Id.* at 573 ("[S]hareholder primacy embraces two principles: (1) the shareholder wealth maximization norm . . . and (2) the principle of ultimate shareholder control.").

232. *Id.* at 563.

233. Bainbridge, *supra* note 13, at 33; Bainbridge, *Director Primacy*, *supra* note 229, at 550–51, 560 (also referring to the board as a "*sui generis* body").

234. Bainbridge, *Director Primacy*, *supra* note 229, at 554–60.

235. *Id.* at 555.

236. *Id.*

237. *Id.* at 556 (citing to the "Coasean theory of the firm").

238. *See generally* KENNETH J. ARROW, THE LIMITS OF ORGANIZATION (1974).

239. Bainbridge, *Director Primacy*, *supra* note 229, at 557–58.

allocation in favor of stronger authority. This move—characterized by Brett McDonnell as Bainbridge's "Arrowian moment"—is the crux of his model.[240] But as McDonnell points out, Arrow's description of the tradeoff between authority and accountability does not resolve all policy questions in favor of authority.[241] Ultimately, Arrow's dichotomy—and by extension, the director primacy model—is "not able to tell us whether reform in favor of somewhat more accountability at the expense of some, but far from total, loss in authority is a good idea or not."[242]

Moreover, there is nothing in Bainbridge's theory that requires the exclusive shareholder franchise. Shareholder wealth maximization is built into his model, but director primacy itself does not need shareholders to be the only members of the electorate. If we take the nexus of contracts model seriously, then any of the contractual partners should have the right to bargain for participation in the election of directors. Only by relying on the hypothetical bargain can the shareholder franchise be justified. And as noted above, this fictional agreement fails to justify the shareholder franchise independently.

Margaret Blair and Lynn Stout drew extensively from the theory of the firm literature in developing their "team production" theory of corporate law.[243] Like nexus of contract and director primacy theories, the team production model views the firm as a series of relationships between various constituencies.[244] These relationships result in the joint production of goods or services. And as in director primacy theory, the board of directors serves as the ultimate authority when it comes to assigning responsibilities, mediating disputes, and divvying up the profits.[245] Unlike Bainbridge or shareholder primacy theorists, however, Blair and Stout do not argue that shareholder wealth maximization should be the goal of the corporation. Instead, the corporation consists of all stakeholders who are responsible for the business of the enterprise, and the directors owe a duty to all of these participants in the corporate enterprise.[246] According to the model, these stakeholders contribute their resources to the enterprise with the implicit bargain that the enterprise itself will fairly apportion the responsibilities and rewards. The board is

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240. Brett H. McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of* The New Corporate Governance in Theory and Practice, 34 DEL. J. CORP. L. 139, 143 (2009).

241. *Id.* at 161. McDonnell considers various arguments for Bainbridge's allocation of power but ultimately finds none of them to solve the dilemma. *See id.* at 162–85.

242. *Id.* at 143.

243. Blair & Stout, *supra* note 87, at 313.

244. *Id.* at 254 (stating that the team production approach is "consistent with the 'nexus of contracts' approach").

245. *Id.* at 251.

246. *Id.* at 253.

hired by these stakeholders to serve as the apportioning body. The board thus serves the stakeholders' interests as a group, but it must have authority over them in order to carry out its function.[247]

Blair and Stout's team production model draws extensively on the theory of the firm literature. Their analysis opens with the question, "Why do firms exist?"[248] and discusses the principal-agent and property-rights approaches on its way to developing the team production model.[249] In focusing on the lateral interactions between different stakeholders, Blair and Stout draw extensively upon the work of Alchian and Demsetz in conceptualizing the firm as a method for coordinating production.[250] At the same time, they criticize that model for taking "a potentially rich story about economic gains from horizontal interaction among team members and, by reducing the team members to interchangeable parts that make no firm-specific investment, reformulat[ing] the team production problem as a vertical principal-agent problem."[251] They then move on to consider the works of Bengt Holmstrom,[252] Jean Tirole,[253] and Rajan and Zingales[254] in developing their own "team production" model of corporate law. Their model emphasizes that the team in effect hires the board, rather than the other way around, and that the team members all plan to share in the fruits of the joint production. As Blair and Stout describe it, "the public corporation is not so much a 'nexus of contracts' (explicit or implicit) as a 'nexus of firm-specific investments,' in which several different groups contribute unique and essential resources to the corporate enterprise, and who each find it difficult to protect their contribution through explicit contracts."[255] The board serves as a group of "mediating hierarchs" who manage the relationships of various corporate constituencies.[256]

Like Bainbridge, Blair and Stout endeavor for their model to serve both descriptive and normative purposes.[257] They argue that the team production model better mirrors the law's approach to the corporation, as, in practice, directors are largely left alone to manage the affairs of the corporation.[258] Unlike director primacy, however, the team production model requires the board to serve all

247. *Id.* at 280–81.

248. *Id.* at 257.

249. *Id.* at 257–61; *see also id.* at 261–65 (developing a "grand-design principal-agent model," which represents the conventional model of the firm).

250. *Id.* at 265 (citing Alchian & Demsetz, *supra* note 200).

251. *Id.* at 267.

252. *See generally* Bengt Holmstrom, *Moral Hazard in Teams*, 13 BELL J. ECON. 324 (1982).

253. Jean Tirole, *Hierarchies and Bureaucracies: On the Role of Collusion in Organizations*, 2 J.L. ECON. & ORG. 181, 181 (1986).

254. Rajan & Zingales, *supra* note 214.

255. Blair & Stout, *supra* note 87, at 275.

256. *Id.* at 250.

257. *Id.* at 289.

258. *Id.* at 287–319.

stakeholders, rather than shareholders alone. They argue that this is both a better description—as, in practice, boards balance concerns among various constituencies—and a superior normative approach. The team production model offers incentives for all members of the team to participate, and thereby "more accurately captures the fundamental contracting problem corporation law attempts to resolve."[259]

Lynn Stout has developed another approach to the corporate firm with coauthor Tamara Belinfanti using systems theory.[260] Stout and Belinfanti argue that systems theory—a design and performance assessment methodology used in engineering, biology, computer science, and management science—better models the operation and function of business entities. Rather than limiting the firm to one undifferentiated whole, systems theory recognizes that independent subparts interlock together to create the larger unit. These subparts are distinct yet interconnected, and they operate together as a unit over time to serve a given function or purpose.[261] Studying a system is thus comprised of an acknowledgement of the many subsystems (and subsystems of subsystems) that make up the larger whole. A subsystem may have a specific sub-purpose but still be committed overall to the organization's ultimate goals. Systems theorists would be wary of a single metric that purported to demonstrate the success of the entire organization—say, for example, share price.

Systems theory sounds a bit like a nexus of contracts; both involve interwoven and overlapping layers of relationships between various parties. Systems theory, however, recognizes that the firm is not just a set of independent relationships; it is rather a set of independent parts or groups that work together to serve a larger whole. These parts may not "naturally" come together, as does an agglomeration of contracts: there must be an overall structure that works to harmonize the subsystems. Rather than trusting that individual contracts will create a private order of maximal efficiency, systems theory looks to understand how successful organizations structure themselves to achieve that success.

Ultimately, these theories of the firm all fail to provide independent support for the exclusive shareholder franchise. Coase supports the idea of an internal hierarchy; Alchian and Demsetz demonstrate the need for a central bargaining agent. Hart and Moore, Rajan and Zingales, McInerney, and Gorges and Halberstam

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259. *Id.* at 328. *See* Grant Hayden & Matthew T. Bodie, *Shareholder Democracy and the Curious Turn Toward Board Primacy*, 51 WM. & MARY L. REV. 2071, 2115–16 (2010), for a critique of the exclusion of non-shareholder representatives on Blair & Stout's board of directors.

260. *See generally* Tamara Belinfanti & Lynn Stout, *Contested Visions: The Value of Systems Theory for Corporate Law*, 166 U. PENN. L. REV. 579 (2018).

261. *Id.* at 599. The management system "holacracy" applies an analogous approach. BRIAN J. ROBERTSON, HOLACRACY: THE NEW MANAGEMENT SYSTEM FOR A RAPIDLY CHANGING WORLD 158–59 (2015).

all puzzle through the importance of assets to the firm, and the firm's role in managing these assets. Blair and Stout and Bainbridge focus on the role of the board in mediating the relationships between the various stakeholders. But in none of these theories is the exclusive shareholder franchise a critical part of what makes the corporation a firm, and vice versa. Rather than justifying the shareholder franchise, the theory of the firm literature is at best agnostic.

V. CONCLUSION

American corporations are the most powerful economic actors in the modern world. They involve a coming together of labor, capital, and a host of other stakeholder groups to produce most of the world's goods and services in ways that generate—and distribute—enormous amounts of wealth. Their decision-making structures, then, are of crucial importance. Most all of them share the same system of governance, where shareholders elect directors who appoint officers, and other constituents are restricted to more limited participation rights through contract. This basic organizational structure, in which shareholders alone ultimately control firm decision-making, both reinforces and is reinforced by the doctrine of shareholder primacy, and has become so entrenched in modern thinking about corporations that it bears no mention in corporate law scholarship.

Over the years, this basic structure and the exclusive shareholder franchise has been propped up by several different arguments, including, most notably, the argument from the residual and the argument from Arrow's theorem. But over the past decade, as those arguments have fallen by the wayside, corporate law scholars have been forced to circle back to a final argument for the special voting status of shareholders—that this fundamental feature of corporate governance is the product of the set of freely-bargained-for agreements among all corporate constituents. And because it reflects the preferences of all parties to the corporate contract, it should be viewed as the best way to structure the corporation.

This argument, though, has always been a slippery one, drifting from reality to metaphor, bolstered by visions of hypothetical bargains that always seem to do a better job reflecting the views of particular groups of scholars than the desires of actual corporate constituents. Does anyone really believe that workers think the best way to structure a corporation is to hand over the entirety of firm decision-making to shareholders? The whole notion of the corporation as a nexus of contracts has been a theatrical production of dodges, feints, and posturing designed to rationalize and justify the existing order of things and used by corporate governance theorists to create the kind of rhetorical space they need to advocate for their own particular policy positions.

The nexus of contracts theory, it turns out, is both descriptively wrong and normatively hollow, and as such provides a poor foundation for the exclusive shareholder franchise. The corporation is neither a contract nor a set of contracts. Business organizations (including corporations) are state law entities that have their own legal personality and internal governance structure. Reducing corporations to contractual components makes absolutely no theoretical sense, literally, metaphorically, or otherwise. This final argument for shareholder voting, and shareholder primacy more generally, is built on a house of sand.

It is time now to do the hard work of starting over and determining what the ideal structure or structures might be for organizations that bring together capital and labor in a process of joint production. The modern corporation has, in fact, achieved amazingly powerful advances in technology and productivity. At the same time, workers' wages are stagnant, and the divide in income inequality grows ever wider. Freed from the constraints of false theories, it is time to reconsider the possibilities for our economic organizations and the society that they help to shape.

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