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THE UNCORPORATION AND THE UNRAVELING OF “NEXUS OF CONTRACTS” THEORY

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The Rise of the Uncorporation. By *Larry E. Ribstein*. New York: Oxford University Press. 2010. Pp. xvi, 277. \$65.

Introduction

A corporation is not a contract. It is a state-created entity. It has legal personhood with the right to form contracts, suffer liability for torts, and (as the Supreme Court recently decided) make campaign contributions.¹ However, many corporate law scholars have remained wedded to the conception—metaphor, model, paradigm, what have you—of the corporation as a contract or “nexus” of contracts.² The nexus of contracts theory is meant to point up the voluntary, market-oriented nature of the firm and to dismiss the notion that the corporation owes anything to the state.³ It is also used as a justification for preserving the corporate law status quo. Since the corporation is contractual in nature, the argument goes, corporate structure reflects what the participants have freely chosen.⁴ The basic corporate structure—shareholders vote for the board of directors, who then appoint the officers—is seen not as the decision of state legislatures, but as the free choice of investors, directors, boards, and indeed all of those who are involved with the corporation.⁵ To question this structure is to dispute the market choices of those who are, presumably, in the best position to make these decisions.

In *The Rise of the Uncorporation*, Larry Ribstein⁶ paints an alternative picture. It is a picture not of organizational perfection but of political inter-

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1. *Citizens United v. Fed. Election Comm’n*, 130 S.Ct. 876, 913 (2010).

2. Jonathan R. Macey, *Corporate Governance: Promises Kept, Promises Broken* 22 (2008) (“It has long been recognized . . . that the corporation . . . should be viewed as a ‘nexus of contracts’ or set of implicit and explicit contracts.”).

3. Of course, no one disputes that the corporation does owe incorporation fees and taxes to the state of incorporation. As of 2002, Delaware earned roughly \$500 million a year in corporation franchise fees and taxes. Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 *Stan. L. Rev.* 679, 724 (2002). These revenues are approximately 17 percent of Delaware’s budget. Mark J. Roe, *Delaware’s Shrinking Half-Life*, 62 *Stan. L. Rev.* 125, 130 (2009).

4. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 6–7 (1991); *see also* Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 *Nw. U. L. Rev.* 542 (1990) (answering “yes”).

5. Easterbrook & Fischel, *supra* note 4, at 66–70.

6. Mildred Van Voorhis Jones Chair in Law and the Associate Dean for Research, University of Illinois College of Law.

meddling. Rather than claiming that the corporation is the efficient result of market forces, Ribstein depicts it as a large, insensate beast, blundering about the business landscape and leaving destruction in its wake. For most of the twentieth century, corporations were the only option for firms looking for limited liability, and as a result they were used far more frequently than they should have been. It was not until the birth of the limited liability company (“LLC”) that a new era—that of the “uncorporation”—came into being. Now that businesses are truly free to choose amongst business organizational forms, Ribstein argues, the unincorporation will continue to gain popularity, and the corporation’s presence will shrink down to a more appropriate size.

Ribstein’s narrative is a fascinating one. It takes the traditional law and economics story of the corporation and turns it on its head. Instead of seeing the corporation as the hero of our political economy, Ribstein casts it as the villain—or at least, Frankenstein’s monster: a brutish creature that means well but cannot help itself from wreaking havoc. And Ribstein is quite clear that this creature was not the result of market adaptation through private agreements. No, this monster is a creation of the state—if anything, the market was forced to adapt to what the government had wrought. Now that the unincorporate hero has arrived on the scene, the economic potential of free organizational forms will be unleashed.

The rise of “uncorporations”—a set of business entities that differ in significant respects from the standard corporate model—requires a reconsideration of many of the core principles of corporate law. As Ribstein himself points out, many of the facets of the corporation that we take for granted—a board of directors, shareholder voting, capital lock-in, fiduciary duties—are not necessary for a successful business organization (pp. 67–72). LLCs, LLPs, trusts, and other business forms have been growing exponentially in the last twenty years. The popularity of these business forms demonstrates that many parties prefer an alternative to the corporation. Their success should also prompt a reconsideration of corporate theory.⁷

This Review evaluates the contractual approach to the corporation in light of the rise of the unincorporation. It argues that state corporate law, rather than contractual decisions, frames the structure of the modern corporation. Even when it was possible to deviate from this structure, corporate law did not encourage such deviation. And once federal securities and tax laws are factored in, the current corporate structure becomes something close to mandatory. The development of unincorporations highlights this corporate inflexibility. Many unincorporate forms, for example, provide for a mix of labor, management, and capital in the governance regime. With their diversity of ownership structures, unincorporations should provide additional impetus for the reexamination of the corporate governance structure. More-

7. This Review is part of an overall project reexamining the basic principles of corporate governance. The project aims to strip away the doctrine and history of corporate law and get to the theoretical core of the corporate form and its governance. For earlier pieces of the project, see Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity*, 30 *Cardozo L. Rev.* 445, 445–505 (2008); Grant Hayden & Matthew Bodie, *Arrow’s Theorem and the Exclusive Shareholder Franchise*, 62 *Vand. L. Rev.* 1217 (2009); Grant Hayden & Matthew T. Bodie, *Shareholder Democracy and the Curious Turn Toward Board Primacy*, 51 *Wm. & Mary L. Rev.* 2071 (2010).

over, they might signal the final gasp of the nexus of contracts theory—at least in its descriptive guise. *Requiescat in pace.*

I. Corporation as Contract

The nexus of contracts theory, generally attributed to Jensen and Meckling's *Theory of the Firm*, holds that the firm—and by extension the corporation—is merely a central hub for a series of contractual relationships.⁸ Jensen and Meckling emphasize that the firm is a “legal fiction;” it is “not an individual” and has no real independent existence.⁹ Their approach seeks to disaggregate our notion of the corporation as an entity and break it down into its component parts.¹⁰ These parts are the contractual relationships between the various parties involved with the firm: executives, directors, creditors, suppliers, customers, and employees. The corporation itself doesn't really exist; it is merely the nexus (or connection or link) amongst these various corresponding relationships.¹¹ To view the corporation as an entity is to confuse the legal fiction for reality. Instead, corporate law should merely be an extension of contract law and should focus on facilitating these interrelationships in the most efficient manner.¹²

The nexus of contracts theory has been extremely influential in shaping corporate law theory over the past three decades.¹³ But despite its dominance, there is still confusion over whether the theory is a descriptive model,

8. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976). The nexus of contract theory is thus not really a theory of the firm at all, but rather a theory of agency costs within a certain type of firm. See, e.g., Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 Colum. L. Rev. 1757, 1759 (1989) (“Principal-agent theory . . . fails to answer the vital questions of what defines a firm and where the boundaries of its structure are located.”); 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, 137–38 (“Scholars working in this paradigm do not offer theories of the firm so much as theories of who controls the firm.”); Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. Pa. L. Rev. 1619, 1624 (2001) (“Jensen and Meckling, despite the title, did not really offer a full-fledged theory of the firm. Rather, they offered a theory of agency costs within firms . . .”). Thus, the nexus of contracts model in a sense assumes the existence of the corporation and then goes on to tackle a problem within the corporate model. See Rock & Wachter, *supra*, at 1629 (“This [nexus of contracts theory] leaves corporate law focused entirely on financial transactions that are cut off from the primary strategic operating transactions of the corporation.”).

9. Jensen & Meckling, *supra* note 8, at 310–11 (italicization omitted).

10. See, e.g., William W. Bratton, Jr., *The “Nexus of Contracts” Corporation: A Critical Appraisal*, 74 Cornell L. Rev. 407, 415 (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”).

11. See Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 Colum. L. Rev. 1416, 1426 (1989) (describing the “nexus of contracts” theory as “a shorthand for the complex arrangements of many sorts that those who associate voluntarily in the corporation will work out among themselves”).

12. See *id.* at 1444.

13. Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 Iowa L. Rev. 1, 9 (2002) (“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) (“[T]he 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 . . .”).

a normative prescription, or some combination of both.¹⁴ Jensen and Meckling presented a positive theory of the corporation and its concomitant relationships.¹⁵ That thread has been picked up in the legal literature, with Easterbrook and Fischel cementing the concept in place.¹⁶ But even at the most basic of levels, the “corporation as contract” claim is simply incorrect. Corporations are not creatures of contract. One cannot contract to form a corporation.¹⁷ 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.¹⁸

The fallback position of contractarian scholars is that the nexus of contracts model is not a literal claim.¹⁹ But it’s often difficult to determine when the theory crosses the line from abstract metaphor to description of reality.²⁰ To say that we should conceive of the firm as a nexus of contracts for certain purposes is different than saying that corporations actually are simply a nexus of contracts.²¹ Yet both characterizations are used interchangeably.²²

14. 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.”).

15. Jensen & Meckling, *supra* note 8, at 310–11.

16. Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. Corp. L. 779, 780 n.4 (2006) (describing Easterbrook and Fischel as “the primary expositors of the contractarian theory”).

17. This fact is acknowledged by contractarian theorists. See Easterbrook & Fischel, *supra* note 11, at 1417–18, 1444–45 (acknowledging that statutory corporate law is necessary to create a corporation).

18. Cf. Bratton, *supra* note 10, 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.”).

19. 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). 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.”).

20. 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., Macey, *supra* note 2, at 22 (“It has long been recognized . . . that the corporation . . . should be viewed as a ‘nexus of contracts’ or 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”).

21. For a discussion of the uses and misuses of models in corporate law theory, see G. Mitu Gulati, William A. Klein & Eric M. Zolt, *Connected Contracts*, 47 UCLA L. Rev. 887, 889–93, 943–48 (2000); see also Daniel J.H. Greenwood, *Introduction to the Metaphors of Corporate Law*, 4 Seattle J. Soc. Just. 273 (2005) (discussing the use of metaphors in corporate law).

22. Bill Bratton has described how Easterbrook and Fischel moved over time from a strong version of the theory to a weaker one. William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 Nw. U. L. Rev. 180, 184 (1992) (“Easterbrook and Fischel are so astute that they keep a safe distance from the assertion that the corporation is a nexus of contracts. The book delimits and subordinates this once foundational proposition.”).

Moreover, contractarians often seek to minimize the role of the state to such a degree that it becomes vestigial. Easterbrook and Fischel, for example, claim that when it comes to the corporation, “what is open to free choice is far more important to the daily operation of the firm, and investors’ welfare, than is what the law prescribes.”²³ Corporate law thus becomes a way of facilitating the other aspects of the corporation—the more important, contractually based ones. As they claim:

Why not just abolish corporate law and let people negotiate whatever contracts they please? The short but not entirely satisfactory answer is that corporate law is a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting. 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, enabling the venturers to concentrate on matters that are specific to their undertaking.²⁴

Thus, contractarians have two competing sets of positive claims, with two sets of normative takeaways.²⁵ These claims intersect and overlap, to varying degrees, in the various instantiations of the nexus of contract approach. First, contractarians argue that the corporation is primarily contractual, and as such it represents terms that the parties have freely chosen for themselves. Since the terms have been freely chosen, we can presume they are efficient.²⁶ This claim leads to the normative perspective that since the corporation is merely an intersection of voluntary agreements, corporate law should facilitate freedom of contract and eschew mandatory rules.²⁷ The second set of claims, however, suggests that corporate law does provide default or even mandatory terms in situations where the terms are approximations of the will of the parties, or (more controversially) would lead to more efficient results.²⁸ The case is easier to make with default rules, of course, as they can be trumped by explicit terms to the contrary. However, some default terms are “sticky” enough that they become something close to mandatory. In such cases, the imposed term must be something that

23. Easterbrook & Fischel, *supra* note 11, at 1418. They continue: “For debt investors and employees, everything (literally) is open to contract; for equity investors, almost everything is open to choice.” *Id.* Easterbrook and Fischel presumably are only speaking of state corporate law here, as there are significant regulations placed on debt and employment contracts.

24. *Id.* at 1444.

25. See Klausner, *supra* note 16, 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.”).

26. A more nuanced version of this argument would be: having the parties choose their terms is the system most likely to lead to an efficient result over time.

27. Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 Cornell L. Rev. 856, 860 (1997) (book review) (“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) (“[Corporate law contractarians argue] that the contractual view of the corporation implies that the parties involved should be totally free to shape their contractual arrangements.”).

28. See Macey, *supra* note 2, at 22 (“[B]usiness law, including corporate law, exists to economize on transaction costs by supplying sensible ‘off-the-rack’ rules that participants in a business can use to economize on the costs of contracting.”).

“almost everyone will want to adopt.”²⁹ The contractarian must be careful here, as an emphasis on the efficiency of sticky defaults will slide over into noncontractarianism. But the concern for these near-mandatory terms is mitigated because there is choice amongst the fifty states as to the laws of incorporation.³⁰

Larry Ribstein is a contractarian. At least, his work has demonstrated agreement with the descriptive and the normative aspects of the nexus of contracts theory. His most direct discussion of the theory is “Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians,” an article he wrote with Henry Butler.³¹ Butler and Ribstein define contractarian theory as the view that “the corporation is a set of contracts among the participants in the business, including shareholders, managers, creditors, employees and others.”³² They argue that private ordering is the best way to arrange these relationships.³³ Like Easterbrook and Fischel, however, they view state corporation law as an extension of the contract.³⁴ And they are quick to move to the “policy implication” that “private parties to the corporate contract should be free to order their affairs in whatever manner they find appropriate.”³⁵

“Opting Out” criticizes anti-contractarians on both descriptive and normative grounds. The authors point to the “demise” of concession theory, based on the notion that “[t]hroughout the nineteenth century, under the onslaught of increasingly permissive general incorporation statutes, state creation gradually yielded to private formation of the corporation and private ordering of the corporate relationship.”³⁶ They concede that “modern corporate statutes do include many mandatory terms, including voting rules, fiduciary duties and legal capital rules.”³⁷ However, they argue that these mandatory terms are, in most cases, better characterized as some form of avoidable placeholder. Some seemingly mandatory rules may be strong default rules that can nevertheless be contracted around.³⁸ Other mandatory rules, such as shareholder voting on mergers, can be avoided by restructuring the underlying transaction.³⁹ Moreover, parties can avoid the mandatory

29. See Easterbrook & Fischel, *supra* note 11, at 1444.

30. See, e.g., Erin A. O'Hara & Larry E. Ribstein, *The Law Market* 107–31 (2009); Roberta Romano, *The Genius of American Corporate Law* 32–51 (1993).

31. Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 Wash. L. Rev. 1 (1990).

32. *Id.* at 7.

33. *Id.* (“The corporate contract also specifies the extent to which the parties rely on the competitive pressures from capital, product, and managerial labor markets as well as internal incentive structures such as corporate hierarchy, boards of directors and managerial compensation contracts, to force agents to act in their shareholders’ best interests.”). Their focus, like Jensen and Meckling’s, is on agency costs.

34. *Id.* (“The terms of the agency contract include the provisions of state law, which are regarded as a standard form that can be accepted by the parties or rejected either by drafting around the provision or by incorporating in another state.”).

35. *Id.* at 7–8.

36. *Id.* at 9.

37. *Id.* at 10.

38. *Id.* (discussing the close-corporation buyout rules from *Donohue v. Rodd Electrotape Co. of New England, Inc.*, 328 N.E.2d 505, 515 (Mass. 1975)).

39. *Id.*

rules from a particular state by incorporating in another state or choosing another organizational form.⁴⁰ They conclude:

In sum, truly “mandatory” provisions are the exception rather than the rule in the law of business associations. The most important mandatory provisions are the federal securities laws and state provisions that are imposed on existing investors in firms. While these provisions are not trivial, they do not establish the non-contractual nature of the corporation.⁴¹

Interestingly, Butler and Ribstein also criticize Easterbrook and Fischel for not being sufficiently committed to the contractual model. They argue that Easterbrook and Fischel use the concept of a “hypothetical bargain” to impose certain terms upon the corporate contract.⁴² Calling this approach “inconsistent with the contract theory of the corporation,” Butler and Ribstein contend that “it is one thing to propound a default rule to cover situations not covered in the parties’ contract, and another thing to state a general rule applicable irrespective of contract.”⁴³ A true contractualist, in their view, would favor a default approach, one that allows parties to contract in accord with their preferences.⁴⁴

The debate between two sets of committed contractarians over the proper approach to the corporate rules is indicative of the nexus of contract theory’s unsettled state—drifting between reality and metaphor, description and normative judgment.⁴⁵ In this Review, we will focus on the extent to which the theory is a positive endeavor, and not on the normative ramifications.⁴⁶ We endeavor to show, with the unincorporation’s help, that the theory does not correspond with a realistic picture of the corporation, even at the level of metaphor.

II. The Corporation, the Uncorporation, and the Struggle for Contractual Freedom

The Rise of the Uncorporation is a story.⁴⁷ It tracks the developments of two broad types of business organization: the corporation (in both public and private forms) and the “uncorporation,” a collective term for a variety of partnership-like organizations, primarily partnerships and LLCs (p. 1). Ribstein tracks the history of these forms as two inversely related lines: un-

40. *Id.* at 11.

41. *Id.* at 11–12 (footnote omitted).

42. *Id.* at 16–17.

43. *Id.* at 17.

44. *Id.* They discuss the example of management responses to hostile corporate takeovers. Easterbrook and Fischel support rules requiring management passivity, while Butler and Ribstein would impose default rules.

45. *Cf.* Eisenberg, *supra* note 14, at 836 (“[The nexus of contract theory] can be understood in either a very weak or a very strong sense.”).

46. For a broad attack on the normative underpinnings of the nexus of contracts approach to corporate law, see Grant M. Hayden & Stephen E. Ellis, *Corporate Law and the Cult of Efficiency*, 5 Va. L. & Bus. Rev. (forthcoming 2010).

47. Ribstein makes this refreshingly clear. P. 10 (“As indicated by the title, this book has a sort of a plot in tracking the increasing importance of unincorporations in modern business.”); p. 11 (discussing “[t]he story so far” and “an alternative narrative”). He has evinced a keen interest in the role of narrative in other work. *See, e.g.*, Larry E. Ribstein, *Imagining Wall Street*, 1 Va. L. & Bus. Rev. 165 (2006).

corporations predominated up until the latter nineteenth century, at which point the corporation took off and achieved a century of dominance. Although the corporation remains the primary form of business organization, the unincorporation is catching up, constituting almost a third of all tax-reporting business entities (p. 3). As the title of the book suggests, the corporation is poised to plummet as the unincorporation begins its ascent.

As we said earlier, Larry Ribstein is a contractarian. We read *The Rise of the Unincorporation*, however, as a refutation of the descriptive part of the nexus of contracts theory, at least as applied to the twenty-first century corporation. To be sure, Ribstein is committed to nexus of contract theory in its normative instantiation; he believes that individual participants in a business organization should be left free to construct that organization as they see fit. But the new organizational hero for contractarians, in Ribstein's telling, is the unincorporation. The unincorporation, unlike pretenders before it, is actually something close to the pure nexus of contracts. To make his case, Ribstein uses a foil, and that foil is the corporation.

A. *Where Corporation Trumps Contract*

Much of *Rise* should be strangely familiar to anti-contractarian corporate scholars, many of whom have battled with Ribstein in the past. Here, he documents the many ways in which the corporation is *not* a creature of contract and is instead overlain with a slew of mandatory rules and strong default terms. There are two parts to the story. The first involves situations where corporate law trumps contract and imposes mandatory requirements on the incorporating parties (pp. 65–75). These areas are somewhat familiar fodder for the debate. But this part of the story is incomplete, because it doesn't explain why parties would agree to incorporate and thus subject themselves to such contractual limitations in the first place. The second part of the story is that corporate law provides benefits for corporations and their participants—principally, limited liability—that contract law could not provide on its own (p. 138). According to Ribstein, these two parts of the story, taken together, explain the rise of the corporation despite its noncontractual features.

1. *Mandatory Terms in Corporate Governance*

On a fundamental level, corporations all share the same governance characteristics. 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. This board is elected by shareholders. The shareholders⁴⁸ share in the profits of the corporation through dividends and can sell their shares on the open market. This same basic structure—shareholders elect directors who appoint officers—can be found in every public corporation.⁴⁹

Why is this tripartite power dynamic so uniform across corporations? Is it because corporate law requires this structure, or because this structure is

48. The distinction between different groups of common shareholders, as well as the difference between common and preferred shareholders, will be taken up more specifically in this Section.

49. The same is true of closely held corporations, although the roles overlap to a great extent.

the most efficient and therefore freely chosen? Contractarians would point to the default nature of corporate law statutes as evidence that this structure is optimal. For example, §141 of Delaware General Corporation Law 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.”⁵⁰ Thus the board—the central feature of corporate governance—appears to be merely a default rule. Similarly, the Model Business Corporation Act states:

All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32.⁵¹

Perhaps corporations could really be arranged in almost any possible fashion.⁵²

However, this apparent flexibility is belied by the actual structure of most corporations and the presence of other mandatory requirements. In practice, for example, corporate charters are extremely homogenous.⁵³ The diversity that one might expect from a collection of firms with heterogeneous governance needs is nowhere apparent.⁵⁴ Moreover, the apparent flexibility of corporate law on paper is undercut by a more complex reality. The textual openness of § 141(a), for example, masks a fairly rigorous defense of managerial power. Shareholders’ power to amend the corporation’s bylaws under § 109(b) of the Code takes a back seat to the more free-ranging power of § 141(a).⁵⁵ In addition, many provisions of federal securities law, particularly SEC Rule 14a-8⁵⁶ and the Sarbanes-Oxley Act,⁵⁷ assume the existence of certain governance mechanisms, such as the board and shareholder meetings, before adding additional requirements.⁵⁸

50. Del. Code Ann. tit. 8, § 141(a) (2001).

51. Model Bus. Corp. Act § 8.01(b) (2008).

52. Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. Pa. L. Rev. 667, 669 (2003) (“Delaware law accordingly treats board governance as a default rule that can be ‘bargained around’ in the corporate charter.”). See generally Henry Hansmann, *Corporation and Contract*, 8 Am. L. & Econ. Rev. 1, 2 (2006) (“Even more than is commonly realized, virtually all of corporate law today consists of default rules rather than mandatory rules.”).

53. Klausner, *supra* note 16, at 784, 786–91.

54. *Id.* at 783–84.

55. 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 Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 Tul. L. Rev. 409, 428–44 (1998).

56. 17 C.F.R. § 240.14a-8 (2010).

57. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

58. For example, Rule 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,

Ribstein argues that 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” (p. 67). He contends that “only a corporation *must* have a board of directors that is separate from the executives and appointed directly by the owners” (p. 67). Shareholder voting is part of the “legally mandated corporate governance structure;” it is so critical that it is considered “sacred space” (p. 69). In addition, Ribstein points to transferable shares, fiduciary duties, and capital lock-in as other essential “governance” elements of the corporation (pp. 68–75). Each of these is essentially required as part of the corporate form.⁵⁹

Ribstein does not spend a great deal of time defending his characterization of these corporate characteristics as mandatory. This is a critical point, as some contractarians have depicted the modern corporation as the product of market forces rather than state law.⁶⁰ It is somewhat surprising to see this article of contractarian faith being dismissed so cavalierly by a contractarian. But the mandatory nature of these governance “requirements” is necessary for Ribstein to tell his political economy story. Each of these factors, to a greater or lesser degree, plays a critical role in the government’s regulation of and control over the modern corporation.

As Ribstein describes it, “The corporate form represents a *quid pro quo*: big firms get corporate features, and government gets an opportunity to regulate governance” (p. 66). Thus, the board of directors is not just an efficient way of centralizing authority, as others have argued.⁶¹ It also plays a “politically legitimizing role” and has the opportunity to “help constrain corporations to act consistently with the objectives of lawmakers rather than solely those of investors” (p. 68). The shareholder meeting is “not simply a way to ensure that managers are running the firm in the shareholders’ interests, but also a mechanism for admitting *vox populi* into the running of these powerful institutions” (p. 70). Given the power that large corporations can use for good or evil, Ribstein argues, lawmakers sought to introduce internal limitations on their governance (pp. 86–87). Of course, tax was an issue as well. The corporate tax—characterized as “double taxation,” since dividends are taxed as well—was “in a sense a fee for incorporating” (p. 99). All of these restrictions on corporate freedom can be traced back to regulatory motives.

2. *The Benefits of Incorporation*

Given the corporate tax, as well as the regulation of corporate governance, why did the great majority of businesses choose the corporation as their organizational form? Ribstein’s answer is, largely, the promise of limited liability. The role of limited liability has long been a *bête noire* for contractarians, since it is clearly an aspect of the corporation that is not con-

which are subcommittees of the board. Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1 (2006).

59. In an earlier piece, Ribstein (with Butler) argued that fiduciary duties were not outside of the realm of contract law and thus should not be counted as evidence of an anti-contractarian approach. Butler & Ribstein, *supra* note 31, at 28–32.

60. See, e.g., Hansmann, *supra* note 52, at 1–2.

61. Bainbridge, *supra* note 13.

tractual. Its importance has been minimized, overlooked, and disputed.⁶² In *Rise*, however, Ribstein decisively argues that the corporation's monopoly on limited liability was the key to its organizational popularity (pp. 72, 76, 79–84, 95–97).

Limited liability is the reason why the corporation succeeded where the partnership failed. 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” (p. 76). As he makes clear, limited liability is distinctly anticontractarian: “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” (p. 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 (p. 79). And limited liability is not window dressing. As Ribstein concedes, “This feature is basic because . . . it is the one that parties cannot replicate by private contract. . . . [W]hether a statutory form provides for limited liability therefore will dominate parties’ choice of form” (p. 138). Control over liability is what gave lawmakers the upper hand in directing organizational choice. It was the carrot that states used to get businesses into the corporate form.

The trade-off between limited liability, on the one hand, and the tax and regulatory treatment of the corporation, on the other, is critical to Ribstein’s political economy narrative: “As lawmakers could control access to limited liability, they could extract a quid pro quo for it by channeling limited liability firms into the corporate form and then taxing and regulating corporations.”⁶³ The delay in the development of the unincorporation stems from legislators’ desire to maintain the limited availability of this quid pro quo. Ribstein contends, “Government has jealously guarded the prerogative of creating limited liability and sought to channel limited liability into the regulated corporate form” (p. 139).

The importance of limited liability is a theme Ribstein turns to over and over again in the book (pp. 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). For example, the closely held corporation makes no sense to Ribstein as an organizational form, as it imposes a structure on small firms that is much more suitable to larger companies (pp. 95–96). In Ribstein’s view, “[c]losely held firms’ widespread use of the corporate form indicates that the benefits of limited

62. See, e.g., Easterbrook & Fischel, *supra* note 4, at 40–47 (arguing that limited liability is a misnomer, as well as touting the societal benefits of limited liability); Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 Wash. & Lee L. Rev. 1423, 1428–32 (1993) (justifying limited liability as a default rule necessary to overcome high transaction costs).

63. P. 79. Ribstein believes:

The normative basis for the quid pro quo is unclear. Limited liability could not be considered a subsidy to firms to the extent that creditors adjust their credit charges for the greater risk. Even to the extent that limited liability shifts risks to tort creditors who cannot demand compensation for the additional risk, society arguably gains because investors are attracted to socially productive ventures. However, it is not clear why limited liability firms should “pay” for this social benefit by being subjected to extra constraints on their operations.

Pp. 79–80 (footnotes omitted).

liability outweighed firms' costs of having to accept the other aspects of the corporate form along with it" (p. 95).

This basic equation started to shift, however, as tax reform in the 1980s made the corporate tax more onerous (p. 101). Businesses started to push for organizational forms that avoided the corporate tax without many of the drawbacks of partnership. For a time, the *Kintner* regulations⁶⁴ drew the line as to which firms would be taxed as corporations. Because firms with limited liability were considered corporations, "the tax classification rules effectively forced firms to pay a tax to the federal government for complete limited liability."⁶⁵ However, as businesses grew increasingly dissatisfied with the strictures of the corporate form, pressure grew for an alternative. The limited liability company, originally a modest vehicle for oil and gas companies, threaded the needle by getting classified as a partnership for tax purposes,⁶⁶ despite having limited liability (pp. 120–21). This leak in the dam ultimately drove the IRS to adopt a "check the box" rule allowing firms to choose whether they wanted to be taxed as partnerships or corporations.⁶⁷ "Check the box" opened the door for the full flowering of the "uncorporation," as limited liability was allowed to coexist with favorable tax treatment.

Ribstein tells a story of contractual desires ultimately breaking free of a regulatory scheme that sought to channel businesses into one particular form. Certainly one could tell a different story: how the corporation carefully balanced costs and benefits amongst businesses and society until interest groups finally succeeded in cracking the tax code. This is not Ribstein's narrative, but it is consistent with his version of events. More importantly, both stories emphasize the importance of the government and of organizational law to the choice of organizational form. The corporation is not simply a nexus of contracts. It is an organizational form with a set of state-given benefits (primarily limited liability) along with a set of taxes and mandatory governance rules. The state plays a much larger role in the story than contractarians have ever before allowed.

B. *Uncorporation and Contractual Freedom*

Of course, it is Ribstein's normative commitment to contractarianism that draws him to the unincorporation in the first place. The unincorporation offers the contractual flexibility that the corporation lacks. Indeed, "uncorporation" itself is merely a label put on a variety of different organizational forms, offering an assortment of organizational approaches. The flexibility represented by these forms, both internally and as a group, allows for greater specialization and even "idiosyncratic arrangements" (p. 157). For example, Ribstein notes that Delaware corporate shareholders cannot waive the fiduciary duties of loyalty and good faith, whereas that

64. Treas. Reg. § 301.7701-2(a) (as amended in 2005). The regulations were promulgated in the wake of *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954).

65. P. 100. The S-corporation was an exception. See I.R.C. §§ 1361–1379 (2006). Ribstein characterizes the S-corporation as a "kind of political safety valve by which Congress hoped to head off both demands to eliminate the corporate tax and state efforts to provide for the partnership with limited liability . . ." P. 113.

66. Rev. Rul. 88–76, 1988-2 C.B. 360.

67. P. 121. See Treas. Reg. § 301.7701-3 (as amended in 2005).

state offers much more flexibility for limited partnerships and LLCs (pp. 169–70, 175, 177–78). Uncorporation owners also have “greater access to the firm’s cash through distributions or the power to demand liquidation or buyout” (p. 139). This access, in his view, provides much greater market discipline against the type of managerial agency costs that have plagued the public corporation in the last decade (pp. 209–12).

However, Ribstein acknowledges that all is not completely contractual, not even in the unincorporate world. For example, “uncorporations have adopted the partnership approach [of] restricting transferability of management rights” (p. 182). In addition, most LLC statutes do not provide for a default right to disassociate, in order to accommodate tax-law requirements about the liquidity of estate assets.⁶⁸ And although LLCs have more flexible governance requirements than corporations, most statutes provide only a “binary choice between manager- and member-management” (p. 153).

Moreover, complete contractual freedom may not always provide the most efficient result. Flexibility can lead to confusion or divergent understandings. Standardization may be appropriate “to clarify the expectations of the many people with which the corporation deals” (p. 149). Once again, fiduciary duties provide an example. Despite his admiration for Delaware’s freedom to waive such duties, he acknowledges that “[a]s LLCs increasingly become the new default entity, many undoubtedly are being formed with plain-vanilla certificates and no detailed agreements” (p. 178). As a result, restrictions on waivers in other states’ LLC statutes may make sense as long as Delaware remains an option for sophisticated LLCs. Ribstein argues: “This illustrates how distinctiveness can be as important among different statutory versions of the same business associations as it is among different types of business associations.”⁶⁹

Rather than minimizing the role of government in the unincorporation, Ribstein’s analysis highlights it. *Rise* is rife with discussions of the inefficiencies of legislative drafting (pp. 155–56), the importance of tax policies such as the *Kintner* factors and “check the box” (pp. 100, 131–32), and the significance of regulatory arbitrage (pp. 184–86, 192). One is constantly reminded of the state’s heavy hand in creating corporations and unincorporations, in all their permutations. This approach suits Ribstein’s normative agenda, which is to identify and eliminate market impurities introduced by legislative meddling.⁷⁰ But in his criticism of government, he must not only acknowledge that states hold the cards and control the game, but also that

68. Pp. 179–80. Ribstein argues that this has had “the perverse secondary effect of forcing lawmakers to provide a backup exit right” in the form of judicial dissolution. P. 180. However, Delaware does allow parties to contract out of this dissolution remedy. *R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, No. 3803-CC, 2008 WL 3846318, at *8 (Del. Ch. Aug. 19, 2008); see also pp. 180–81.

69. P. 178. Ribstein also notes the confusion surrounding whether interests in LLCs are securities. Pp. 186–89; see also *Robinson v. Glynn*, 349 F.3d 166, 174 (4th Cir. 2003) (holding that the determination must be made case by case, since “LLCs lack standardized membership rights or organizational structures” and thus “can assume an almost unlimited variety of forms”). He notes that state lawmakers might consider offering clear management alternatives, rather than a spectrum of flexible management possibilities, in order to create more certainty when it comes to securities regulation. P. 189.

70. *E.g.*, p. 185 (“[L]awmakers could minimize total social costs by designing tax and regulatory statutes that take into consideration business association coherence as well as other statutory objectives.”).

they sometimes get it right (e.g., LLCs and check the box). Entities are state creations—a fact that is abundantly clear after reading *Rise*.

At the end of the book, Ribstein cites the possibility of the un-business association—the “fully customized firm” (p. 256). Although he doesn’t frame it exactly this way, one gets the sense the un-business association would be Ribstein’s favorite when it comes to organizational forms, as it would allow for complete contractual flexibility. Of course, at least one non-contractual element would still be necessary. As Ribstein describes it, an un-business association statute would allow parties to “enter into a customized contract, but still have limited liability—a sort of ‘contractual entity’” (p. 256). Such an entity might still be vulnerable to the regulatory overreach that felled the corporation. But a man can dream.

III. The Final Contractual Twist

The unincorporation seems to be the undoing for the nexus of contracts theory, at least as a positive description. The corporation is not simply a point at which myriad contracts intersect. It is instead a governmentally created organizational body that imposes specific constraints on participants. Conceiving of the corporation as a simple agglomeration of private agreements—even metaphorically—is deeply misleading. As the unincorporation demonstrates, the corporation has many specific features that could be considered either mandatory or quasi-mandatory. These features distinguish the corporation not only from the realm of contract but from the unincorporation as well.

A contractarian might, at this point, turn the diversity in organizational choice around on us and argue that the variety demonstrates a different kind of contractual freedom. After all, as Ribstein argues, having a multitude of organizational choices allows parties to pick and choose the organizational form that best suits their needs (Chapter Six). Businesses are no longer stuck with the corporation; they are now free to choose from a variety of unincorporations instead. Because parties are still using the corporation, even in the midst of organizational plenitude, that must mean that parties prefer the corporation. It is the choice of the majority of businesses; it must therefore have advantages that other organizational forms do not. In other words, we can say that the corporation is like a nexus of contracts, in that it is freely chosen by the parties as the best organizational delivery system for their relationships. Even if not literally a contractual nodule, it represents the parties’ free choice.⁷¹

This is not the argument Ribstein makes in *Rise*. He argues instead that the unincorporation is a superior vehicle for addressing the problems of contemporary organizational structure (p. 193). Arguing that the corporation is “far from ideal” as a governance structure, Ribstein claims that “the unincorporation provides potentially more efficient ways to control the agency costs of centralized management” (p. 193). He argues that the traditional corporate tools for restraining managers—shareholder voting, boards of directors,

71. See Butler & Ribstein, *supra* note 31, at 11 (“[T]he parties to a firm can opt out of terms that are mandatory for all corporations simply by choosing among different investment and organizational forms. For example, the ‘mandatory’ requirement of at least majority shareholder voting on significant corporate transactions can be avoided by disincorporating into a limited partnership.”) (footnotes omitted).

fiduciary duties, and takeovers—have failed to provide the proper market discipline (pp. 195–207). Instead, the unincorporation’s combination of greater managerial freedom and stronger mandate for distributions provides a better approach, in his view, for reducing managerial costs.⁷² Although “the unincorporation is unlikely to push the corporation off the main stage,” Ribstein sees a role for the unincorporation in a variety of different contexts, including for firms at the beginning and at the end of their life cycles (p. 246).

If the unincorporation is a superior organizational form, why is it only gaining popularity now? Ribstein provides only a brief direct answer, citing the increased salience of agency costs, greater financial complexity, and advances in organizational development (p. 194). His narrative, however, describes how the unincorporation has only recently been freed of its regulatory shackles, with “check the box” allowing unincorporations to have both favorable tax treatment and limited liability. It is state lawmakers and federal bureaucrats who created the LLC revolution. These political forces originally entrenched the corporation; now they have created an opening for the unincorporation (pp. 193–95). To the extent the unincorporation does face challenges to its growing role, Ribstein sees those challenges largely coming from the government (pp. 238–46). This is not a story of firms adapting to organizational demands through contract. It is a story of government facilitating growth (or not) through the organizational forms it provides:

The large unincorporation’s story is still unfolding. Courts, regulators, and tax authorities may decide that large firms should be subject to corporate rules whatever business form they have chosen. On the other hand, policy makers may see that the crisis in the governance of large firms demands a fresh approach rather than just tinkering with an increasingly unsatisfactory model. Understanding the distinct mechanisms of unincorporations and giving them room to operate may be a key to this fresh approach. (pp. 194–95)

In other words, it is up to government to develop the organizational forms necessary for efficient private ordering.

It is hard to know, at this point in time, how controversial such a statement is. Law and economics scholars such as Henry Hansmann and Michael Klausner have moved away from the descriptive form of the nexus of contracts theory by suggesting that government does need to play a role in creating the corporate “contract.”⁷³ Easterbrook and Fischel have touted a hypothetical bargain to be used contemporaneously with the actual bargain of the parties.⁷⁴ And, of course, anti-contractarians have long believed in the importance of government regulation to the nature of the firm.⁷⁵ Ribstein’s

72. Pp. 207–17. Unincorporations cannot rely on the market for control, as their governance rights are generally difficult to transfer. P. 218. Although the market for corporate control has long been a critical aspect of imposing economic discipline on corporations, Ribstein believes this market is not necessary for unincorporations. Pp. 218–19.

73. Hansmann, *supra* note 52, at 10 (discussing the government’s role in structuring long-term relational contracts); Klausner, *supra* note 16, at 793–96 (blaming learning and network externalities for the dearth of contractual innovation at the corporate level).

74. Easterbrook & Fischel, *supra* note 11, at 1444–46.

75. Bratton, *supra* note 10, at 442 (“Freedom of contract is freedom to ask the sovereign to confer power constraining your freedom on another party.”); *id.* at 445 (noting that “the sovereign

approach is in many ways unremarkable. But it signals that, to the extent there was a debate about the positive version of nexus of contracts theory, that debate is over.

So where does this leave us with respect to the proper normative approach to organizational form? The normative side of the nexus of contracts theory relies on an extended version of the following argument: corporations are contracts; contracts reflect Pareto improvements; Pareto improvements, by their very nature, promote the good; therefore, corporations promote the good. Ribstein clears the table by removing the first premise of the argument. Without it, there is no natural feature of corporations that maximizes the good. Once the nexus of contracts and its Panglossian view of the corporation are done away with, we can think more broadly about the most desirable way to structure a firm. And this is clearly what Ribstein wants us to do.

While he may have delivered a mortal blow to the first premise, Ribstein is quick to replace the corporation-as-contract with the unincorporation as a closer approximation of the contractual ideal (and being a contractarian, he leaves the rest of the argument alone). But his concessions to the anti-contractarians may ultimately give away too much to pull off this switcheroo. Sure, the unincorporation allows a few more degrees of freedom with respect to organizational structure. But against the backdrop of federal regulations and state dispensations of limited liability that he's articulated, it is far from clear that we're anywhere close to the firm as a purely contractual relationship. The state looms large either way, and the relationships between the firm's many constituents are largely framed and directed by the exercise of government power.

Conclusion

Perhaps we are headed toward a radically decentralized future, in which we participate in an economy of small, privately held firms, each tailored to the needs of its own participants. There is much that might be attractive about such a future, and *The Rise of the Unincorporation* does a nice job of selling the benefits of "un." But as the book acknowledges, we are far away from such a world. The nexus of contracts model does not represent the reality of the modern corporation, and it has misled us for too long. It's time to follow Larry Ribstein and the unincorporation back to the real world where organizational forms—and the governments that create them—truly do make a difference.

presence persists" in corporate law); Eisenberg, *supra* note 14, at 823–25 (discussing mandatory rules).