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The Post-Revolutionary Period in Corporate Law: Returning to the Theory of the Firm

Matthew T. Bodie[*]

I. INTRODUCTION

Corporate law academia has an established story about the transformation of the field—a revolution, in fact—that took place in the 1970s and 1980s. According to the traditional narrative, what was once a swampy doctrinal backwater became a vibrant hub of intellectual activity through the new methodology of law and economics.[1] Economic theory introduced such concepts as agency costs, the market for corporate control, and shareholder primacy—concepts that in turn became the dominant framework for the corporate law and theory of today. Some scholars have characterized this revolution as the "end of history" of corporate law: namely, an international consensus on the corporation's basic structure and principles.[2]

The consensus on corporate law theory has narrowed the field's doctrinal and methodological foci. Although the vibrancy of shareholder primacy has at times been called into question as a matter of law,[3] both boardrooms and courts have taken the normative call for shareholder wealth maximization increasingly to heart. There is little doubt that the revolution has not only substantially affected legal theory but also legislation,[4] court decisions,[5] and corporate behavior.[6] It achieved a level of

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1. Roberta Romano, *After the Revolution in Corporate Law*, 55 J. LEGAL EDUC. 342 (2005).

2. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001) (arguing that the shareholder-centered model has achieved dominance "among the business, government, and legal elites in key commercial jurisdictions").

3. D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 284–88 (1998); Lynn A. Stout, *Why We Should Stop Teaching* Dodge v. Ford, 3 VA. L. & BUS. REV. 163, 168–72 (2008).

4. *See, e.g.*, 26 U.S.C. § 162(m) (2011) (limiting the corporate deduction for nonincentive-based executive pay to $1 million); DEL. CODE ANN. tit. 8, § 112 (2009) (expressly authorizing corporations to provide bylaw provisions that would permit proxy access and to impose any lawful condition on the access provision).

success unusual for an academic discipline; it not only transformed the field but also the world.

We now find ourselves in the post-revolutionary period. For some academics, it is time to refine the revolutionary principles and attend to the subsidiary issues that are left to be worked out.[7] But for me, it is time to look forward to the next revolution. This Essay argues that corporate law academics should look to the economic literature on the theory of the firm in taking those next steps. The fundamental question about corporate law is not how to manage the relationships between shareholders, directors, and executives; instead, it is why we have created and sustained corporations in the first place. In going back to basic principles, we need to ask ourselves the following question: Why do we have firms, rather than markets? And how do corporations serve our needs for firms? Can the model be improved? Are there other models to consider?

Fortunately, we have a robust existing literature seeking to answer at least some of these questions. The question of firms versus markets was famously posed by Ronald Coase in *The Nature of the Firm*,[8] and the economic literature on the theory of the firm has grown (in fits and starts) over time to flesh out his work. Although the law and economics revolution gave lip service to this literature, in fact, it has largely been marginalized.[9] It is time to begin incorporating this body of research more directly into corporate law, and to start a new revolution that reexamines many of the basic principles of the earlier law and economics upheaval.

Part II of this Essay explores the law and economics revolution and discusses the different levels of attention to the finance and theory of the firm literatures. Part III sets out the basics of the theory of the firm literature. Part IV discusses how several significant strands of corporate law scholarship have already incorporated the theory of the firm literature.

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5. *See, e.g.*, Dynamics Corp. of Am. v. CTS Corp., 805 F.2d 705, 708 (7th Cir. 1986) ("[W]hile the board of directors of a corporation that is a target or potential target of hostile tender offers has the power to adopt a poison pill, the particular poison pill it adopts must be reasonably related to the goal of shareholder wealth maximization."); eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 34 (Del. Ch. 2010) ("Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders.").

6. *See* Matthew T. Bodie, *AOL Time Warner and the False God of Shareholder Primacy*, 31 J. CORP. L. 975, 985–89 (2006) (discussing the importance of stock price to the stock options mania of the late 1990s).

7. Romano, *supra* note 1, at 355–56 (describing how empirical research based on established economic models is now more important than new efforts at modeling).

8. R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937), *available at* http://onlinelibrary.wiley.com/doi/10.1111/j.1468-0335.1937.tb00002.x/pdf.

9. *See, e.g.*, Michael J. Meurer, *Law, Economics, and the Theory of the Firm*, 52 BUFF. L. REV. 727, 732 (2004) ("[T]he theory of the firm has played a minor role in law and economics.").

Finally, Part V explores two potential avenues for inquiry and connection moving forward: the role of employees in corporate law, and connections with business and organizational theory academics.

II. THE LOPSIDED LAW AND ECONOMICS REVOLUTION IN CORPORATE LAW SCHOLARSHIP

Sadly, it is unusual for academics to offer stand-alone chronicles of the changes within their field.[10] Roberta Romano's *After the Revolution in Corporate Law,*[11] on the other hand, takes up this task with zest and incisiveness. Her article opens:

> Corporate law is a field that underwent as thorough a revolution in the 1980s as can be imagined, in scholarship and practice, methodology and organization. The term "revolution" is invoked all too often in popular culture, but as this article will suggest, it is entirely apt in this case. The revolution in corporate law has been so thorough and profound that those working in the field today would have considerable difficulty recognizing what it was twenty-five to thirty years ago.[12]

Much of Romano's history is familiar rhetorical ground: the "ossified, stagnant" state of corporate law in the 1960s;[13] the early work of pioneers such as Henry Manne[14] and Ralph Winter;[15] and the wave of law and economics scholarship that transformed the field in the 1980s. Rather than a simple string of successive cites, however, her article seeks to single out the specific aspects of the revolution that were critical to its success. She identifies three distinct "strands" to this transformation: modern finance theory, work on the theory of the firm, and the boom in hostile takeovers in the 1980s. The first strand imported concepts such as the efficient capital market and the capital asset pricing model (CAPM) into business law theory and doctrine.[16] The second strand introduced transaction cost economics and agency costs theory to corporate law, building on the earlier work of Berle and Means.[17] Finally, the relevance

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10. The exception is the critical legal studies movement, which may have overanalyzed itself into dissolution. *See, e.g.*, Peter Gabel & Duncan Kennedy, *Roll Over Beethoven*, 36 STAN. L. REV. 1 (1984).

11. Romano, *supra* note 1.

12. *Id*. at 342.

13. *Id.* at 343.

14. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

15. *See* Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

16. Romano, *supra* note 1, at 344–46.

17. *Id.* at 347. Berle and Means famously suggested that the modern corporation experienced a separation of ownership (shareholders) from control (management) because of, among other things,

of these theories was demonstrated in practice when buyouts and other novel transaction techniques exploded across the business landscape. These three strands—finance, firm, and takeover mania—created the new law and economics approach to corporate law and theory.

Romano goes into significant detail on the role of modern finance theory in shaping the transformation. The portfolio theory of investment decision-making, irrelevance theories of firm capital structure and valuation, and CAPM provided the intellectual architecture for the notion that the corporation represented a somewhat fungible mass of investment signals.[18] And those signals were relatively straightforward to study. Romano notes that finance "differs from many other fields of economics because it has a decidedly empirical focus."[19] Through event studies, which measured the effect of certain "events" on share prices, scholars could study the efficiency of state governance statutes, federal legislation, and international regulatory regimes.[20] Thus, finance brought together a theory having a relatively straightforward normative agenda—namely, the overall maximization of share price—with a methodology for testing results against that agenda.

Romano also cites to the importance of the theory of the firm to the corporate law revolution but spends considerably less of her discussion on it. Romano discusses the advances in the economics of the firm and specifies two lines of research in this regard: transaction cost economics and agency cost theory.[21] Citing to Williamson for the former[22] and Jensen and Meckling for the latter,[23] Romano argues that these two developments had a "lasting impact on the thinking of corporate law academics."[24] She acknowledges that agency costs theory stemmed from Berle and Means's work on the separation of ownership and control, but argues that the theory was redeveloped from the corporate finance literature and was later "mathematicized and refined by economists."[25]

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the weakness of the proxy voting system. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 3–7 (1932).

18. Romano, *supra* note 1, at 344–46.

19. *Id.* at 346.

20. *See, e.g.*, Kate Litvak, *Sarbanes-Oxley and the Cross-Listing Premium*, 105 MICH. L. REV. 1857 (2007) (studying the impact of Sarbanes-Oxley on share prices).

21. Romano, *supra* note 1, at 347.

22. *Id.* (citing OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975)).

23. Romano, *supra* note 1, at 347 (citing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976)).

24. Romano, *supra* note 1, at 347.

25. *Id.*

Although the theory of the firm research is important enough to Romano that she lists it as a coequal strand with finance theory, her program for the future better demonstrates her actual balance on the two subjects.[26] She suggests that aspiring corporate law professors would be better served by a background in finance than a background in economics. Graduate economics programs focus more on theory and formal modeling, while finance tends to use empirical tools. These empirical tools, argues Romano, were more likely to "facilitate the sorting out of theories" than would further research based on modeling.[27] Noting that empirical work depended on a consensus on the ends of a particular policy or regulatory scheme, she claims that most corporate law scholars agreed that the objective of publicly held corporations was to maximize the overall wealth of shareholders.[28] Given these ends, event studies could be employed to determine which policies increased share prices and thereby maximized shareholder wealth.

Finance has indeed become the most important outside discipline in the contemporary study of corporate law. Sophisticated number crunching of stock prices has become a critical—perhaps even the dominant—analytical tool for today's corporate law scholar.[29] Academics have employed event studies to address some of the thorniest issues in corporate law theory, such as the efficiency of state corporate law,[30] staggered boards,[31] federal securities and state derivative suit litigation,[32] independ-

26. Indeed, Romano referred to both when discussing the focus of the law and economics reforms. *See id.* at 348 ("Modern finance and the new economic theories of the firm provided the analytical tools for understanding the new deals transforming corporate law practice in the 1980s . . . ."); *id.* at 351 ("As takeovers flourished, those deals set the teaching and research agenda, and finance and the theory of the firm provided the tools for analyzing the deals and the novel legal issues they raised."); *id.* ("Modern finance and the theory of the firm offered plausible theories of investor and manager behavior and therefore quickly came to be pervasive in analyses of corporate law.").

27. *Id.* at 356.

28. *Id.*

29. *See* Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 639 (2006) (citing Randall S. Thomas, *The Increasing Role of Empirical Research in Corporate Law Scholarship*, 92 GEO. L.J. 981, 982–83 (2004)).

30. *Compare* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001) (finding that Delaware firms had higher value than firms incorporated elsewhere), *with* Guhan Subramanian, *The Disappearing Delaware Effect*, 46 J.L. ECON. & ORG. 32, 57 (2004) (failing to find higher value).

31. *See, e.g.*, Lucian Ayre Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002).

32. Stephen J. Choi, *Do the Merits Matter Less in Private Securities Litigation Reform Act?*, 23 J.L. ECON. & ORG. 598 (2007); Stephen J. Choi, *Motions for Lead Plaintiff in Securities Class Actions*, 40 J. LEGAL STUD. 205 (2011).

ent directors,[33] and executive compensation.[34] Legislation such as the Sarbanes-Oxley Act[35] and the Dodd-Frank Act[36] has been judged based on its grounding (or lack thereof) in empirical research.[37] Even the courts have gotten into the act; the D.C. Circuit has referred to the empirical literature in addressing whether the SEC had demonstrated sufficient support for its independent mutual fund chairpersons and proxy-access rules.[38]

This growing use of empirical study of stock prices in answering corporate law's questions has generated a growing level of criticism. First, the efficiency of market prices has been called into question by a roller-coaster ride of share prices, particularly the calamitous drop in late 2008. Market stalwarts such as Alan Greenspan admitted that the models for efficient capital markets did not accurately reflect reality.[39] Although corporate law scholars have emphasized the need to focus on long-term shareholder value,[40] the reliance on short-term event studies contradicts that caution. Second, the notion that share value represents overall societal efficiency has been questioned not only by progressive scholars but

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33. Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002). Roberta Romano has criticized the requirements of audit-committee independence within the Sarbanes-Oxley Act based on her review of the existing empirical literature. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1529–33 (2005). For an overview of this issue, see Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1469 (2007).

34. For a review of the empirical evidence, see LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE (2004).

35. Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of the U.S.C.).

36. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S.C.).

37. Stephen M. Bainbridge, *Dodd-Frank: Quack Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1796–1819 (2011) (criticizing Dodd-Frank for lack of empirical support); Romano, *supra* note 33 (criticizing Sarbanes-Oxley for lack of empirical support).

38. Bus. Roundtable v. SEC, 647 F.3d 1144, 1150–51 (D.C. Cir. 2011) (finding that the SEC relied on "insufficient empirical data" in formulating its proxy-access rule and pointing to an analysis of event studies as contrary evidence to the proposed rule); Chamber of Commerce v. SEC, 412 F.3d 133, 142–44 (D.C. Cir. 2005) (noting the SEC's dismissal of empirical research on the value of independent chairpersons on mutual fund performance).

39. Brian Knowlton & Michael M. Grynbaum, *Greenspan "Shocked" that Free Markets Are Flawed*, N.Y. TIMES, Oct. 23, 2008, http://www.nytimes.com/2008/10/23/business/worldbusiness/23iht-gspan.4.17206624.html ("I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms." (quoting former Federal Reserve chairman Alan Greenspan)).

40. Hansmann & Kraakman, *supra* note 2, at 439 ("There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.").

by more mainstream academics as well.[41] Proponents of stakeholder theory have jousted with shareholder primacy for some time.[42] But the failures of companies such as Enron and WorldCom, and transactions such as the AOL-Time Warner merger, called the shareholder primacy ethos into doubt.[43] The 2008 financial crisis compounded this doubt. Although shareholder primacy is not dead by any stretch, it has suffered a series of blows that render it open to serious question.

Research on the theory of the firm, on the other hand, has been relatively unplumbed in corporate law. Although Romano asserts that the economics on the theory of the firm has had "a lasting impact" on corporate law scholars, it is really only the literature on agency costs analysis that has had any substantial development. Certainly, Jensen and Meckling's *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure* shaped much of the subsequent literature on the corporation and the roles of shareholders, managers, and directors within the corporation.[44] Their article developed the nexus-of-contracts theory, which argues that the firm is merely a central hub for a series of contractual relationships. As discussed later in the paper,[45] however, this approach is not a theory of the firm, but rather a theory of agency costs within the firm.[46] The nexus-of-contracts paradigm isolates corporate law, as it "leaves corporate law focused entirely on financial transactions that are cut off from the primary strategic operating transactions of the corporation."[47]

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41. *See* Fisch, *supra* note 29, at 638 (challenging "the foundations of using the shareholder primacy norm to judge corporate law").

42. *See, e.g.*, LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT (2001) (arguing that the "main problem with American corporations—the main cause of their irresponsibility—is their drive to maximize short-term stock prices"). *See generally* PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed., 1995).

43. Bodie, *supra* note 6.

44. Jensen & Meckling, *supra* note 23, at 308.

45. *See infra* Part IV.A.

46. *See* Thomas McInerney, *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."); Meurer, *supra* note 9, at 728 (noting "some confusion" about the difference between agency theory and the theory of 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, 1624–25 (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 . . . ."); *see also* Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757, 1764 (1989) ("[T]he nexus of contracts approach does less to resolve the questions of what a firm is than to shift the terms of the debate. In particular, it leaves open the question of why particular 'standard forms' are chosen. Perhaps more fundamentally, it begs the question of what limits the set of activities covered by a 'standard form.'").

47. Rock & Wachter, *supra* note 46, at 1629.

So there is much left to explore when it comes to the economic theory of the firm. The next section endeavors to sketch (with broad strokes) an overview of this literature.

III. THE THEORY OF THE FIRM IN BRIEF

The 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.[48] Firms, however, operate outside of this market structure, standing like "lumps of butter coagulating in a pail of buttermilk."[49] 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?

Early economists did not seek to answer this question, but rather relied on a placeholder to serve their modeling needs. The firm was simply a black box that took in inputs and put out outputs. The first modern effort to inquire into the nature of firms was *The Nature of the Firm*.[50] 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?[51]

For Coase, the answer is transaction cost economics: organizing production through a market creates transaction costs that a firm can avoid.[52] 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

48. F. A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945).

49. Coase, *supra* note 8, at 388 (quoting D. H. ROBERTSON, THE CONTROL OF INDUSTRY 85 (1930)).

50. *Id.*

51. *Id.*

52. *Id.* at 390–92.

the essence of the legal concept of 'employer and employee'" as well as the concept of the firm itself.[53]

Although the field started slowly, the theory of the firm made significant advancements beginning in the 1970s. Alchian and 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.[54] 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."[55] Firms are able to coordinate production among various groups without carving the relationships into separable contracts. 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. 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. 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. 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.[56]

Around the same time of Alchain 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.[57] 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, gov-

53. *Id.* at 404.

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

55. *Id.* at 779.

56. *Id.*

57. OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985); Jeffrey T. Macher & Barak D. Richman, *Transaction Cost Economics: An Assessment of Empirical Work in the Social Sciences*, 10 BUS. & POL. 1 (2008).

ernments can assist parties in developing relationships that minimize transaction costs and facilitate economic growth.[58]

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.[59] By owning the property outright, the firm prevents the tragedy of the commons (in which no one holds 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). 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. 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.[60]

Building on the property-rights theory of the firm, Rajan and Zingales have proposed an "access" theory of power within the firm.[61] 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."[62] 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."[63] 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."[64] Combined with her right to leave the firm, access

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58. WILLIAMSON, *supra* note 22.

59. OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 23 (1995); Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986); Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755 (1988); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119, 1121 (1990).

60. 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 66 (Margaret M. Blair & Mark J. Roe eds., 1999).

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

62. *Id.* at 390.

63. *Id.* at 388.

64. *Id.*

gives the employee the ability to "create a critical resource that she controls: her specialized human capital."[65] Control over this critical resource is a source of power. Rajan and Zingales argue that "[s]ince the amount of surplus that she gets from this power is often more contingent on her making the right specific investment than the surplus that comes from ownership, access can be a better mechanism to provide incentives than ownership."[66] Given the importance of access, the role of the firm is to allocate access efficiently among the firm's agents.

Other research has focused more specifically on the role of human capital. The macroeconomic shift from manufacturing to service and creative industries led one set of scholars to develop a knowledge-based theory of the firm.[67] According to the knowledge-based theory, "The way the 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."[68] Rather than emphasize the ownership 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.[69]

These theories of the firm do not lead to the inarguable conclusion of shareholder primacy. In fact, they seem to point elsewhere. First, it is important to remember that the "firm" means something different than corporation. Firms may take one of many different organizational forms: corporation, partnership, LLPs, LLCs, cooperatives, and non-profits.[70] In fact, these legally created organizational forms should look to the theory of the firm for justification why they even exist in the first place. But given the importance of the corporate form to twentieth-century firms, it

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65. *Id.*

66. *Id.*

67. 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 (2007).

68. *Id.* at 1140.

69. McInerney, *supra* note 46.

70. For a discussion of these forms, see HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (1996). Organizational forms must justify their existence in a world of contractual obligation. Of the organizational forms, partnership comes closest to contract, as it places upon the parties the obligations they would generally assume from a contractual agreement. Partnership law, however, is an effort to shape these relationships by assigning certain rights and duties even in the face of uncertainty about the parties' intentions. The corporation—with its need for state approval, its particularized form, and its limited liability for shareholders—is perhaps the least contractual. *See* Grant M. Hayden & Matthew T. Bodie, *The Uncorporation and the Unraveling of the "Nexus of Contracts" Theory*, 109 MICH. L. REV. 1127, 1141–42 (2011).

would seem appropriate for the theory of the firm to speak to the purpose of corporations, as an important subcategory. Coase focuses on the employer–employee relationship and does not mention shareholders or the corporate form. Alchian and Demsetz place the firm at the center of team production, with shareholders as one of the many groups providing inputs. 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?[71]

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. The transaction-costs school has focused on incomplete contracts and the need for firm governance to resolve the ex post distributional difficulties. The property-rights school has focused on the property at the core of the firm, and those who hold it, as the most likely of the groups to need control rights. Both of these approaches could justify placing shareholders at the center of the firm, in order to permit them to gain corresponding economic advantage in the face of contractual uncertainty and property-rights weakness. 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.[72]

The economic literature on the theory of the firm should be attractive to scholars looking to push into new frontiers in corporate law because it has the imprimatur of the current corporate law establishment, and yet is relatively underexplored. Perhaps more fundamentally, the theory of the firm asks foundational questions—primarily, why we have legally created firms in the first place. As Jill Fisch has persuasively argued, empirical scholars who base their studies on share-related value "have not yet made the case" that societal efficiency is best reflected in

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71. Alchian & Demsetz, *supra* note 54, at 789 n.14.

72. *See* Blair, *supra* note 60; *see also* 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).

the maximization of shareholder wealth.[73] The best opportunity for delving into these fundamental premises lies with the theory of the firm literature.

IV. THE THEORY OF THE FIRM IN CORPORATE LAW

Many scholars have used the theory of the firm literature in their discussions of corporate law, and citations to Coase, Alchian and Demsetz, and Williamson are fairly abundant. But three examples of this research have developed distinct theories of the firm that have garnered substantial traction within the academy: the nexus-of-contracts theory, the director primacy theory of Stephen Bainbridge, and the team production model of Margaret Blair and Lynn Stout.[74] These examples use the theory of the firm research in a sustained effort to develop a model of the corporation. These three explorations are discussed further below.

A. Nexus of Contracts

The nexus-of-contracts theory has been extremely influential in shaping corporate law theory over the past three decades.[75] It has driven corporate law theorists to emphasize the non-mandatory nature of corporate law—both as a descriptive and a normative manner—and it has counseled against changes to the status quo based on the contractual nature (and arguable Pareto optimality) of that status quo.[76] However, as

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73. Fisch, *supra* note 29, at 640.

74. Andrew Gold has used shareholder primacy, director primacy, and team production as three examples of theories of the firm in corporate law. Andrew S. Gold, *Theories of the Firm and Judicial Uncertainty*, 35 SEATTLE U. L. REV. 1087 (2012). This Essay focuses on nexus of contracts rather than shareholder primacy, as that theory is more closely associated with the theory of the firm literature.

This focus on the three theories is not meant to exclude the other insightful works of scholarship that have analyzed corporate law using the theory of the firm literature. Many of them have been cited already within this Essay. *See, e.g.*, Gorga & Halberstam, *supra* note 67; McInerney, *supra* note 46; Meurer, *supra* note 9. While these works constitute the literature upon which I hope scholars will draw more substantially in the future, they have not yet attained the same level of recognition within the field, nor (in some cases) do they purport to develop a new theory of the corporation. I am partial to the employee primacy model of the firm proposed by Brett McDonnell, but I leave it for the "future developments" portion of this Essay. *See* Brett H. McDonnell, *Employee Primacy, or Economics Meets Civic Republicanism at Work*, 13 STAN. J.L. BUS. & FIN. 334, 335 (2008) ("I challenge shareholder primacy as the appropriate model for corporate law, arguing instead for employee primacy in corporate decision-making.").

75. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1–39 (1991) (discussing the corporate contract); 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."); Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 318–27 (1993) (discussing the importance and impact of the nexus-of-contracts theory).

76. Ulen *supra* note 75, at 322–23 (discussing the overall impact of the theory).

noted earlier, 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 & Meckling's firm is a mere legal fiction that is "*not an individual*" and has no real independent existence.[77] 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.[78] The monitoring they describe looks a lot like the "control" that Coase focused on as the key element in defining the firm.[79] 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.[80] 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. Recognizing this fact,[81] proponents of the nexus-of-contract theory make two arguments to salvage the theory as both a descriptive matter and a normative prescrip-

77. Jensen & Meckling, *supra* note 23, at 311.

78. *Id.* at 308.

79. 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.

80. Hart, *supra* note 46, at 1763–65; Meuer, *supra* note 9, at 732; Rock & Wachter, *supra* note 46, at 1624; 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.").

81. *See* EASTERBROOK & FISCHEL, *supra* note 75, at 1417–18, 1444–45 (acknowledging that statutory corporate law is necessary to create a corporation); Fred S. McChesney, *Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg*, 89 COLUM. L. REV. 1530, 1537 (1989) ("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.").

tion.[82] First, contractarians argue that the corporation is primarily contractual, and therefore, it represents terms that the parties have freely chosen for themselves. Moreover, because the terms have been freely chosen, we can presume they are efficient.[83] This claim leads to the normative perspective that because the corporation is merely an intersection of voluntary agreements, corporate law should facilitate freedom of contract and eschew mandatory rules.[84] But such a norm—taken to its logical extreme—would eliminate corporate law, at least in terms of any mandatory rules. Therefore, some contractarians suggest that corporate law should provide default or even mandatory terms in situations when the terms are approximations of the will of the parties—or more controversially, where the terms would lead to more efficient results.[85]

Thus, the nexus-of-contract theory has taken on a life of its own outside of the theory of the firm and has served as both a descriptive model and a normative prescription for corporate law scholars. As has been repeatedly recognized, however, the nexus-of-contracts approach is not a theory of the firm because it "says nothing about why firms exist or

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82. *See* Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 783 (2006) ("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.").

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

84. 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) ("[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.").

85. For example, Easterbrook and Fischel argue:

> Thus, the purpose of corporate law is to fill in or even require certain provisions within the corporate contract, as long as those provisions are our best guess as to what the parties would have contracted for *ex ante*, had they the information and foresight to do so. 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.

Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1444 (1989). For a critique of this approach as "inconsistent with the contract theory of the corporation," see Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 17 (1990) (contending 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").

what kind of activity is undertaken by a certain firm."[86] Ultimately, other developments in the theory of the firm literature have more to add when it comes to these foundational topics.

B. Director Primacy

Stephen Bainbridge has drawn upon the theory of the firm and public choice literature in creating his director primacy theory of the corporation.[87] Bainbridge's model splits the theory of the firm question into two components: What are the ends for which the corporation exists, and what are the means of achieving those ends?[88] For the theory of shareholder primacy, shareholders represent both the ends and the means of governance.[89] Bainbridge agrees that the goal of the corporation should be shareholder wealth maximization.[90] 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.[91]

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.[92] According to Bainbridge, the defining characteristic of a firm is "the existence of a central decision-maker vested with the power of fiat."[93] Rather than being participatory democracies, firms provide for hierarchies that can direct the allocation of resources through command.[94] Bainbridge bases his theory on Coase's differentiation between markets and firms, as well as

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86. Meurer, *supra* note 9, 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)).

87. 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 also* Bainbridge, *supra* note 75; 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 synthesized his research into a book on the subject. STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE (2008).

88. Bainbridge, *Director Primacy*, *supra* note 87, at 547–50.

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

90. *Id.* at 563.

91. *Id.* at 550–51, 560 (also referring to the board as a "*sui generis* body"); Bainbridge, *supra* note 75, at 33.

92. Bainbridge, *Director Primacy*, *supra* note 87, at 554–60.

93. *Id.* at 555.

94. *Id.*

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."[95] Drawing upon Arrow's *The Limits of Organization*,[96] he contrasts consensus-based decision-making structures with authority-based structures, and argues that the corporation fits Arrow's model of an authority-based system.[97] 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.

The director primacy theory has both positive and normative components.[98] As a matter of description, Bainbridge contends that the director-centered model of the firm matches both modern corporate practice and the structure of most state law (particularly Delaware, the dominant model).[99] As a normative matter, he argues that director primacy is superior to shareholder control because shareholders lack the information necessary to make informed decisions about the firm, as well as the financial interest in obtaining such information.[100] According to Bainbridge, "Active investor involvement in corporate decision-making seems likely to disrupt the very mechanism that makes the widely held public corporation practicable: namely, the centralization of essentially non-reviewable decision-making authority in the board of directors."[101] He also argues that shareholder wealth maximization has become the dominant norm in business and in law, and that this norm is optimal because it reflects the hypothetical bargain that the parties would achieve in a world without transaction costs.[102] The other stakeholders would be willing to pay less for control, according to the hypothetical bargain, because they are better protected by contracts and welfare legislation. As a result, shareholders would efficiently bargain to be the sole recipients of the residual profits of the firm.[103]

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

96. KENNETH J. ARROW, THE LIMITS OF ORGANIZATION (1974).

97. Bainbridge, *Director Primacy*, *supra* note 87, at 557–58.

98. *Id.* at 591–92; *see* Charles R. T. O'Kelley, *The Entrepreneur and the Theory of the Modern Corporation*, 31 J. CORP. L. 753, 774 (2006) (describing director primacy as "both a normative and predictive theory: Directors should manage and control the corporation; directors do manage and control the corporation").

99. Bainbridge, *Director Primacy*, *supra* note 87, at 568–74. For an extensive discussion of the role of director primacy within the law, see BAINBRIDGE, *supra* note 87, at 105–53.

100. BAINBRIDGE, *supra* note 87, at 202–03, 233–35. Bainbridge also argues that shareholder control can lead to rent-seeking by certain shareholders. *Id.* at 228–32.

101. Bainbridge, *Shareholder Disempowerment*, *supra* note 87, at 1749.

102. Bainbridge, *Director Primacy*, *supra* note 87, at 577–83.

103. *Id.*

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 allocation in favor of stronger authority. This move—characterized by Brett McDonnell as Bainbridge's "Arrowian moment"—is the crux of his model.[104] 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.[105] 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."[106]

Bainbridge's use of Coase, Arrow, and the theory of the firm moves the ball significantly when it comes to our conceptions of the modern corporation.[107] His director primacy theory has been influential in academic, practitioner, and judicial circles.[108] His insightful but limited use of theory of the firm principles demonstrates the opportunity for their further development in corporate law.

C. Team Production

Margaret Blair and Lynn Stout drew extensively from the theory of the firm literature in developing their team production theory of corporate law.[109] Like nexus-of-contract and director primacy theories, the team production model views the firm as a series of relationships be-

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104. 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).

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

106. *Id.* at 143.

107. *Id.* at 142 (noting that Bainbridge's "extensive reliance" on Arrow is "on its own, a great service").

108. *See, e.g.*, *In re* Transkaryotic Therapies, Inc., 954 A.2d 346, 367 n.94 (Del. Ch. 2008) (citing Bainbridge, *Director Primacy*, *supra* note 87, for the proposition that "the law requires and encourages director involvement"); Wayne O. Hanewicz, *Director Primacy,* Omnicare*, and the Function of Corporate Law*, 71 TENN. L. REV. 511, 514 (2004) ("For the most part, director primacy is descriptively accurate and offers a compelling normative justification for why the board, and not the shareholders or the courts, should be the institution that decides what a corporation does.").

109. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 313 (1999).

tween various constituencies.[110] 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.[111] 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.[112] 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 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.[113]

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?"[114] and discusses the principal-agent and property-rights approaches on its way to developing the team production model.[115] In focusing on the lateral interactions between different stakeholders, Blair and Stout draw extensively on the work of Alchian and Demsetz in conceptualizing the firm as a method for coordinating production.[116] 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."[117] They then move on to consider the work of Holmstrom,[118] Tirole,[119] and Rajan and Zingales[120] in developing their own team production model of corporate law. Their model emphasizes that the team in effect hires the board, rather than the

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

111. *Id.* at 251.

112. *Id.* at 253.

113. *Id.* at 280–81.

114. *Id.* at 257.

115. *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).

116. *Id.* at 265 (citing Alchian & Demsetz, *supra* note 54).

117. *Id.* at 267.

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

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

120. Rajan & Zingales, *supra* note 61.

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."[121] The board serves as a group of "mediating hierarchs" who manage the relationships of various corporate constituencies.[122]

Like Bainbridge, Blair and Stout endeavor for their model to serve both descriptive and normative purposes.[123] 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.[124] Unlike director primacy, however, the team production model requires the board to serve all 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."[125]

Blair and Stout's team production model, rooted in the work of Alchian and Demsetz, and Rajan and Zingales, can be seen as the foundational work for a new school of corporate law and economics based on the theory of the firm. But as important as this work is, it would be a mistake to think that the team production model represents the alpha through omega in terms of the contributions that the theory of the firm can make. I would prefer to think of it as the alpha. The following Part explores where we might be headed.

V. THE FUTURE OF THE THEORY OF THE FIRM IN CORPORATE LAW

The theory of the firm is firmly engrained in the corporate law literature. Now is not the time to shunt it aside in favor of event studies. Instead, corporate law scholars should explore additional opportunities to delve into this research. Two ideas regarding the potential for further exploration are discussed below: the role of employees in corporate law,

121. Blair & Stout, *supra* note 109, at 275.

122. *Id.* at 250.

123. *Id.* at 289.

124. *Id.* at 287–319.

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

and the potential for further connections between legal scholars and interdisciplinary research.

A. Employees and the Theory of the Firm

Employees play a central role in the theory of the firm literature. Although the neoclassical firm was largely undefined, employees and capital assets were considered to be inside the firm, while customers and suppliers were outside.[126] In *The Nature of the Firm*, Ronald Coase singled out the relationship between the firm and its employees as the firm's defining feature.[127] The firm-based (as opposed to market-based) transactions described by Coase involve the purchase of labor for a particular endeavor or ongoing concern. In explaining these transactions, Coase states: "If a workman moves from department Y to department X, he does not go because of a change in relative prices, but because he was ordered to do so."[128] The firm's reason for existing outside of the market is the relationship between the entrepreneur-coordinator and the employee. Coase finds empirical support for this conclusion in the law, as he argues that "[w]e can best approach the question of what constitutes a firm in practice by considering the legal relationship normally called that of 'master and servant' or 'employer and employee.'"[129] He then quotes at length from a treatise concerning the common law "control" test, which provides that "[t]he master must have the right to control the servant's work, either personally or by another servant or agent."[130] He concludes: "We thus see that it is the fact of direction which is the essence of the legal concept of 'employer and employee,' just as it was in the economic concept which was developed above."[131]

Although the subsequent theory of the firm literature has not been as explicitly employee-centric, it has generally concurred regarding the importance of employees to the firm. Alchian and Demsetz, for example, define the purpose of the firm as team production that is "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."[132] Given the difficulty of measuring individual contributions to productivity in joint production, the core problem of the firm is to make sure contributors do not shirk their responsibilities to the team. Such concerns obviously apply to

126. *See* Rock & Wachter, *supra* note 46, at 1631.
127. Coase, *supra* note 8, at 387, 403–05.
128. *Id.* at 387.
129. *Id.* at 403.
130. *Id.* at 404.
131. *Id.*
132. Alchian & Demsetz, *supra* note 54, at 779.

employees. In the transaction-costs model, firms are designed to prevent or mitigate ex post opportunism by the parties. The value that employees contribute to the firm—often described as "human capital"—may be transferable, such as education or general skills, or may be specific to the firm. To the extent an employee has invested in firm-specific skills, she is subject to opportunistic behavior because she has little leverage to get the full value of those skills.[133] The property-rights model is also concerned with the relationship of employees to the firm. Although the property rights discussed in the model are generally nonhuman assets, the assets are "the glue that keeps the firm together."[134] Thus, the property-rights theory of the firm is designed in part to explain why the firm's employees remain with the firm.[135]

Recent scholarship has taken the role of human capital even further. Gorga and Halberstam's knowledge-based theory of the firm is based on "[t]he way the 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."[136] The knowledge-based theory focuses on the need to produce, distribute, and ultimately retain valuable knowledge-based assets within the firm. The primary generators of this knowledge are employees. Similarly, McInerney's capability-based theory of the firm focuses on firm-specific knowledge and learning that can be translated into joint production, emphasizing the role of employees as holders of the firm's capabilities.[137] Rajan and Zingales's "access" model of power within the firm 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."[138] An employee uses her access to these

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133. As Margaret Blair has pointed out, "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." Blair, *supra* note 60, at 66.

134. HART, *supra* note 59, at 57.

135. Hart poses the following hypothetical: if firm 1 acquires firm 2, what is to stop workers at former firm 2 from quitting and forming a new entity?

> For firm 1's acquisition of firm 2 to make any economic sense, there must be some source of firm 2 value over and above the workers' human capital, i.e. some 'glue' holding firm 2's workers in place. The source of value may consist of as little as a place to meet; the firm's name, reputation, or distribution network; the firm's files, containing important information about its operations or its customers; or a contract that prohibits firm 2's workers from working for competitors or from taking existing clients with them when they quit . . . . [W]ithout something holding the firm together, the firm is just a phantom.

Id. *But cf.* Rajan & Zingales, *supra* note 61, at 388 ("The property rights view does not consider employees part of the firm because, given that employees cannot be owned, there is no sense in which they are any different from agents who contract with the firm at arm's length.").

136. Gorga & Halberstam, *supra* note 67, at 1140.

137. McInerney, *supra* note 46, at 139.

138. Rajan & Zingales, *supra* note 61, at 390.

unique assets to "specialize her human capital to the resource and make herself valuable."[139] Rajan and Zingales argue that "[s]ince the amount of surplus that she gets from this power is often more contingent on her making the right specific investment than the surplus that comes from ownership, access can be a better mechanism to provide incentives than ownership."[140] The role of the firm is to allocate access efficiently among the firm's agents.[141]

The focus of the theory of the firm literature on the firm as a whole, and especially its focus on employees within the firm, stands in stark contrast to corporate law where employees are nowhere to be found. The primary players in corporate law are shareholders, directors, and officers, sometimes described as "management".[142] More recently, gatekeepers such as accountants, lawyers, and compensation consultants have taken on more specific and significant roles in the structure of corporate governance. Employees, however, have remained off the corporate law radar.[143] As someone who believes that employees can and should play meaningful roles in corporate governance,[144] the theory of the firm literature supports the notion that employees are critical to our definition of the firm. Their importance to the firm, and relative unimportance to corporate law, is the source of some dissonance that needs to be addressed.

B. Making New Connections

As Romano noted in *After the Revolution in Corporate Law*, the law and economics movement in corporate law produced "one of the more interdisciplinary fields of law."[145] Although the interdisciplinary study of law has a hoary tradition,[146] it is perhaps even more popular than ever before.[147] The injection of a rigorously produced methodology into the formerly staid confines of corporate law is, according to Romano, the reason for the field's transformation. Rather than simply relying on doc-

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139. *Id.* at 388.

140. *Id.*

141. *Id.* at 391.

142. ROBERT C. CLARK, CORPORATE LAW 93 (1986).

143. Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283, 283 (1998).

144. *See, e.g.*, Matthew T. Bodie, *Workers, Information, and Corporate Combinations: The Case for Nonbinding Employee Referenda in Transformative Transactions*, 85 WASH. U. L. REV. 871 (2007).

145. Romano, *supra* note 1, at 342.

146. *See, e.g.*, Richard A. Posner, *The Decline of Law as an Autonomous Discipline: 1962–1987*, 100 HARV. L. REV. 761 (1987).

147. *See* David A. Hollander, *Interdisciplinary Legal Scholarship: What Can We Learn from Princeton's Long-Standing Tradition?*, 99 LAW LIBR. J. 771, 773 (2007) ("The increasingly interdisciplinary nature of law scholarship and law practice is both long and well documented.").

trine developed through case law and doctrinal analysis, law and economics scholars could apply a new form of analysis that had the support of complex theory and empirical findings. It enabled the new breed of scholars to speak with authority and, at times, contempt for those unfamiliar with the new approach.[148] This interdisciplinary approach was the key to the revolution.

At this point in the revolution, however, the interdisciplinary approach has become somewhat constrained. Romano's view is that the field has become less a "law and economics" collaboration than a law and finance one. She counsels prospective business law scholars to pursue a law and finance PhD rather than an economics PhD, because graduate economics programs have focused too much on theory and mathematical modeling. Romano also contends that "there is a consensus on ends, as there is among most U.S. corporate law scholars . . . (a consensus that the objective of public, for-profit corporations is to maximize shareholder wealth)."[149] This constricted view of interdisciplinarity is, in fact, evidence that the field is ripe for another transformation. Finance continues to contribute significantly to corporate law. But it seems counter to the original interdisciplinary spirit of the revolution to circumscribe corporate law so narrowly. The tunnel vision of the law and finance approach threatens to return corporate law to the "ossified, stagnant field" that law and economics scholars themselves transformed.

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148. *See, e.g.*, Romano, *supra* note 1, at 343–44 (describing the preexisting doctrinal approach as "an ossified, stagnant field" and "intellectual vacuousness"). Fred McChesney used a colonization metaphor to describe this strategic advantage for those proficient in law and economics:

> As American history demonstrates, the colonization of one territory by inhabitants of another creates at least two problems. First, the colonizers and colonized usually do not speak the same language, and thus must learn to communicate. Ordinarily, the language of the colonizers comes to dominate, a development rarely pleasing to the colonized. Second, patterns of property ownership will likely be disrupted, as colonizers acquire (often by force) rights previously held by the colonized.
>
> The colonization of some fields of law by economic analysis fits this historical pattern. Economics provides a powerful "tool kit" with which to analyze law. It has proven difficult, however, for some adherents of more traditional approaches to law to come to understand the different form of analysis that the use of economic methods entails. Moreover, the economic approach has reduced the value of lawyers' more traditional but less powerful methods of legal analysis. Not surprisingly, many lawyers have objected to the intrusion of economic analysis into law on both grounds.

McChesney, *supra* note 81, at 1530.

149. Romano, *supra* note 1, at 356; *see also* Fisch, *supra* note 29, at 639 (noting the "explosion of empirical analysis" and finding that "[e]mpirical scholars have embraced the [shareholder] primacy norm").

There is a wealth of new avenues for exploration in law through the social sciences.[150] But the different social science disciplines—economics, psychology, sociology, anthropology—are increasingly borrowing from one another and bleeding into each other's work. This should not be surprising, as at root, these disciplines are about examining and explaining human behavior. But with the blending will come conflict and confusion. Law represents an ideal melting pot for many of these concepts.[151] Law relies on an understanding of human behavior to develop a legal system that regulates and motivates individuals within a social structure. It thus need not cling to and defend a particular social science methodology; it can instead select the best approaches and even combine insights across disciplines.

Economics revolutionized the study of corporate law. It is now time to continue and extend the revolution. We should branch out beyond finance to further consider the insights of the theory of the firm. Rather than limiting the connections to finance departments, corporate law scholars should look to management, strategy, and organization scholars located in business schools, as well as in economics and sociology departments. Obviously, these connections have already begun in earnest, as the Berle III Symposium demonstrates.[152] But Romano's narrative threatens to marginalize this stream of research. The contributions of finance should not be allowed to overwhelm the continuing advances developed through the theory of the firm.

As noted earlier, with interdisciplinary cooperation comes the potential for conflict and confusion. This seems particularly likely when working in the theory of the firm, which lacks a degree of the rigorous border enforcement that financial economics has maintained. The ecumenical quality of the discipline can be a weakness if one is intent on creating a coherent approach. Of course, it is also a strength, as it allows for a variety of insights from a broad band of scholars. But if the theory of the firm is to take root in corporate law beyond its current footholds, academics across departments and graduate schools may need to commit to stronger methodological assumptions or shared terminologies in order

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150. Jeremy A. Blumenthal, *Law and Social Science in the Twenty-First Century*, 12 S. CAL. INTERDISC. L.J. 1, 1 (2002) (discussing the "growing trend" and "increasing number" of law review articles that use "social science—[and] psychology in particular—to inform legal theory").

151. For example, the behavioral law and economics movement is at root an effort to import key insights from social psychology into standard law and economics models. Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998).

152. Beyond the subject of the conference itself, it includes the work of business school scholars. *See, e.g.*, Richard Marens, *We Don't Need You Anymore: Corporate Social Responsibilities, Executive Class Interests, and Solving Mizruchi and Hirschman's Paradox*, 35 SEATTLE U. L. REV. 1189 (2012).

to provide more continuity between projects. In order to convince others to wade into new pools of research, it is helpful first to provide some common ground. Otherwise, the exercise can seem boundless. One of the reasons for the success of law and economics in corporate law is its uniform name, as well as its approachable and common concepts such as agency costs, nexus of contracts, and shareholder primacy. These ideas were complex enough to provide a competitive advantage to insiders, while being simple enough to be used by a wide range of academics, practitioners, and courts. Legal scholars interested in a theory of the firm approach to corporate law may need to address this issue self-consciously and be careful to coalesce around common terms and concepts, so the literature and discipline may grow more harmoniously and efficiently.

Some of this dialogue is happening, particularly outside of law schools. But my hope is that the work on the theory of the firm will become more accessible and commonplace to the average U.S. corporate law scholar—beyond Jensen and Meckling. One possibility includes closer ties with new institutional economics (NIE).[153] As a matter of nomenclature, I confess to some confusion about the differences between new institutional economics, transaction-cost economics, and the theory of the firm, as the term "new institutional economics" is attributed to Williamson, the progenitor of the transaction-costs theory of the firm.[154] Regardless, the International Society for New Institutional Economics (ISNIE) would appear to be a congenial place for corporate law scholars to convene with academics working on the theory of the firm at business schools and social science departments.[155]

It is the potential for interdisciplinary connections that provides perhaps the most excitement for corporate law academics contemplating the theory of the firm literature. The wealth of scholarship upon which the field can draw provides a potent contrast to the narrowness of the current corporate law literature, resting as it does primarily on empirical financial research. Moreover, in an era where the traditional corporate

153. The field is described as "an interdisciplinary enterprise combining economics, law, organization theory, political science, sociology and anthropology to understand the institutions of social, political and commercial life." Peter G. Klein, *New Institutional Economics*, *in* 1 ENCYCLOPEDIA OF LAW AND ECONOMICS 456, 456 (Boidewijn Bouckaert & Gerrit De Geest eds., 2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=115811.

154. *See id.* at 457 (citing WILLIAMSON, *supra* note 22).

155. ISNIE's mission statement is as follows: "ISNIE encourages rigorous theoretical and empirical investigation of these topics using approaches drawn from economics, organization theory, law, political science, and other social sciences. The Society makes a special effort to encourage participation from scholars around the world, with membership from over 46 countries. ISNIE is committed to young scholars as well as those from developing and transitional economies." *About ISNIE*, ISNIE, http://www.isnie.org/about.html (last visited May 15, 2012).

law has become more federalized, and alternatives to the corporation are becoming more popular,[156] it makes sense to reexamine the root question as the base of our system of corporate law: Why firms? The theory of the firm promises the best opportunity to begin this inquiry in earnest.

VI. CONCLUSION

The Berle III Symposium demonstrates the potential for corporate law scholars to engage with the theory of the firm on broader and deeper levels. My contribution to the conference is simply an extended argument for this engagement to continue. Empirical research into the effects of laws, regulations, and corporate governance practices on stock prices offers important insights into corporate law's financial ramifications. But much remains to be mapped in our thinking about the social and legal construction of organizations, particularly business organizations. The theory of the firm literature offers a terrific base for legal scholars to start and extend their explorations.

156. LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION (2010).