

January 2005

## Competing Concepts of the Corporation (a.k.a. Criteria - Just Say No)

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### Recommended Citation

Stephen M. Bainbridge, *Competing Concepts of the Corporation (a.k.a. Criteria - Just Say No)*, 2 BERKELEY BUS. L.J. 77 (2005).  
Available at: <http://scholarship.law.berkeley.edu/bbj/vol2/iss1/8>

### Link to publisher version (DOI)

<http://dx.doi.org/https://doi.org/10.15779/Z38B00G>

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# Competing Concepts of the Corporation

## (a.k.a. Criteria? Just Say No)

Stephen M. Bainbridge<sup>†</sup>

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**Abstract:** This essay was written for a festschrift in honor of my UCLA School of Law colleague, co-author, and friend Professor William A. Klein. The conference is organized around Bill’s claim that corporate law scholarship would benefit if scholars were more explicit about the normative criteria that motivate their analyses and policy recommendations. In pursuit thereof, Bill’s “Criteria Project” identifies four broad categories of “criteria for good corporate laws”: (1) fairness; (2) efficiency; (3) legitimacy and accountability; and (4) administrability. Within each broad category, one then finds a number of specific criteria. Scholars are then asked to identify those criteria that inform their work.

In this essay, I argue that the Criteria Project lacks an overall conception of the corporation. I further argue that one’s selection of evaluative criteria cannot be appraised in isolation from the concepts of the corporation informing that selection. Hence, I echo a call made two decades ago by Professor Roberta Romano for scholars to be more explicit in setting out their “normative theory of the corporation and its place in the polity.”

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<sup>†</sup> Professor, UCLA School of Law. I thank Mitu Gulati, Mark Ramseyer, and the participants who attended a faculty workshop at the University of Indiana law school for their very helpful comments.



# Competing Concepts of the Corporation (a.k.a. Criteria? Just Say No)

Stephen M. Bainbridge

## INTRODUCTION

The organizers of this festschrift invited us to reflect back not upon the work of Bill Klein, in whose honor the symposium was held, but rather on our own prior work in hopes that we might identify the normative criteria by which we evaluate corporate law. At first blush, this may seem an odd request. Yet, I believe it is a peculiarly appropriate way to honor Bill. Like all good academics, Bill is intensely interested in ideas. Unlike some academics, however, Bill is especially interested in *other people's* ideas. If I had the proverbial nickel for every time Bill has asked me what I thought about some question of law, politics, books, or, especially, religion, I could buy dinner at a very upscale Los Angeles restaurant.

Bill's "Criteria Project" (as I have come to think of it over the eight years during which we have argued about it, off and on) makes two basic moves. First, Bill identifies four broad categories of "criteria for good corporate laws": (1) fairness; (2) efficiency; (3) legitimacy and accountability; and (4) administrability.<sup>1</sup> Within each broad category, one finds a number of specific criteria.<sup>2</sup> Second, he argues that corporate law scholars should be quite explicit about which criteria motivate their analyses and policy recommendations:

For example, some people advocating director concern for stakeholders may be doing so in the interests of *ex ante* economic efficiency, while others may be doing so as part of a strategy of redistribution, helping the poor, or protecting the environment. Identification of the goal may not resolve conflict but might well improve the quality of the discussion.<sup>3</sup>

My assigned task in this project therefore seems to be one of discussing why my work tends to emphasize efficiency and accountability rather than fairness and administrability. Presumably, I should also explain why promoting "effective shareholder control" is a terrible way of promoting accountability, and so on. Regretfully, however, I must decline this assignment.

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1. William Klein, *Criteria for Good Laws of Business Association*, 2 BERKELEY BUS. L.J. 13, 15-16 (2005).

2. See *infra* Table 1.

3. Klein, *supra* note 1, at 16.

**Table 1. Klein's Criteria of Good Corporation Law**

Fairness	Efficiency	Accountability	Administrability
Enforcement of private bargains	Facilitation of exchange	Promote effective shareholder control	Objectivity
Avoidance of harshness	Macro efficiency	Promote public involvement	Self enforcement and private enforcement
Fairness and fair dealing	Micro efficiency	Limitations on specific action	Limit the costs of private compliance
Protections of expectations (other than bargains)	Liquidity	Legitimate the role of management and its exercise of power	Old laws are good laws
Redistribution	Specific Goals	Limit the use, and prevent the abuse, of power	
Protection of the weak	Predictability	Allocation of power	
Allocation of cost of harmful conduct to the proper person	Caveat emptor		
Maximization of individual freedom & autonomy			
Evenhandedness & objectivity			
Full Disclosure			

Over the years that we have been discussing it, I have developed some serious reservations about Bill's Criteria Project. On the one hand, the Criteria Project seems to assume that there are neutral normative priors against which one may evaluate a scholar's selection of criteria. As I shall argue herein, I do

not believe this to be the case. On the other hand, the Criteria Project lacks an overall conception of the corporation. What is this entity we are studying? As I will demonstrate, Bill and I approach the corporation with a very different understanding of the entity, which leads us to apply very different metrics to evaluating corporate law and scholarship. Our selection of evaluative criteria cannot be appraised in isolation from the concepts of the corporation informing that selection. Hence, I have decided to come at the problem from a somewhat different angle than that proposed by our hosts.

Part I summarizes my critique of the Criteria Project, emphasizing the importance of developing an overarching theory of the firm rather than simply a set of evaluative criteria. Competing conceptions of the firm will affect both our choice of criteria and the content we give them. In Part II, I turn to the competing concepts of the corporation reflected in my work and that of our honoree. As we shall see, my model emphasizes the board of directors' role as a central decision-making nexus exercising command-and-control functions, while Bill's emphasizes studying actual bargains struck among individuals. Within the constraints of the short essay format, I shall attempt to demonstrate that my model does a better job of explaining and predicting corporate law.

## I. CONCEPTS VERSUS CRITERIA

Two decades ago, Roberta Romano observed:

A survey of the literature suggests that the last major work of original scholarship was Adolf Berle and Gardiner Means' *The Modern Corporation and Private Property*. . . . An essential difference between Berle and contemporary corporate law reformers is that he had a normative theory of the corporation and its place in the polity, whereas many advocates of reform are uninterested or unwilling to articulate the vision of the good society that informs their policy package.<sup>4</sup>

Romano's complaint captures several important flaws in the Criteria Project. First, the Criteria Project fails adequately to engage the normative implications of competing theories of the firm or the broader question of what constitutes "the good society."<sup>5</sup> Second, as we shall see in Part II, Bill and I bring to bear very different theories about the corporation. Yet, nothing in the Criteria Project captures (or even implicates) those important differences.

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4. Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 923-24 (1984).

5. I have come closest to responding to Romano's request for "the vision of the good society that informs [my] policy package" in my articles on the relationship between corporate law, Catholic social thought, and conservative political theory. See, e.g., Stephen M. Bainbridge, *Catholic Social Thought and the Corporation*, 1 J. CATHOLIC SOC. THOUGHT 595 (2004); Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856 (1997).

### A. Norms and Criteria

If explicitly normative discussion is to be truly useful, the non-neutral priors driving the scholar's selection of specific criteria must be disclosed. Indeed, it is those priors rather than evaluative criteria upon which the normative issue should be joined:

In disputes over cherished ideals, the prospects for obtaining agreement are dim because basic judgments can be only loudly asserted and never proven. But by clarifying the differences in the visions of corporate law reformers and joining the debate, we at least begin to determine where the dispute involves value choices and where it founders on the acquisition of more information.<sup>6</sup>

Yet, one's selection among Bill's criteria obviously will not be based on neutral normative priors.<sup>7</sup>

Many of the criteria identified by Bill, moreover, have sharply contested meanings. Most scholars likely would agree that efficiency is relevant to evaluating corporate law. Yet, efficiency has several potential meanings. Are we to use Kaldor-Hicks or Pareto superiority as our metric?<sup>8</sup> Again, this choice cannot be made on the basis of neutral priors, as demonstrated by the sharp disagreements over the validity of Kaldor-Hicks efficiency as a guide to public policy.<sup>9</sup> Accordingly, once again, identification of specific criteria is inadequate. There also must be disclosure of the normative priors by which one selects and gives content to those criteria.

Significantly, however, one cannot ask whether the shareholder wealth maximization norm is Kaldor-Hicks efficient, for example, unless one has an overarching vision of how that norm fits into corporate law as a whole. Indeed, without such a vision, one cannot really say that the Kaldor-Hicks inquiry is important or even relevant. In turn, one's overarching vision of corporate law cannot be defended absent an articulation of its relationship to a "vision of the good society." In this sense, the Criteria Project calls to mind (or, at least, to

6. Romano, *supra* note 4, at 1016.

7. In light of David Hume's famous point that "ought" claims cannot be derived from "is" statements, of course, there may be no such thing as truly neutral priors. See generally JOHN FINNIS, *NATURAL LAW AND NATURAL RIGHTS* 36-42 (1980) (discussing Hume).

8. In order to satisfy the Pareto superiority definition of efficiency, a transaction must make at least one person better off and no one worse off. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 13 (4th ed. 1992). Kaldor-Hicks efficiency does not require that no one be made worse off by a reallocation of resources. Instead, it requires only that the resulting increase in wealth be sufficient to compensate the losers. Note that there does not need to be any actual compensation, compensation simply must be possible. *Id.* at 13-14.

9. See RICHARD A. POSNER, *THE ECONOMICS OF JUSTICE* 91-94 (1981); Bruce Chapman, *Trust, Economic Rationality, and the Corporate Fiduciary Obligation*, 43 U. TORONTO L. REV. 547, 554-55 (1993). Of particular relevance to my work on the role of the corporation in Catholic social thought, important strains of natural law thought are clearly inconsistent with Kaldor-Hicks efficiency. The Lockean strain, for example, precludes the use of others as means to our own ends. J. BUDZISZEWSKI, *WRITTEN ON THE HEART: THE CASE FOR NATURAL LAW* 106 (1997). The modern strain associated with Catholic thinkers such as John Finnis and Germain Grisez likewise proscribes doing evil that good may result. *Id.* at 198. Because the Kaldor-Hicks standard permits uncompensated wealth transfers, it runs afoul of these precepts.

my mind) poet John Godfrey Saxe's fable *The Blind Men and the Elephant*.<sup>10</sup>

Hence, the Criteria Project is incomplete. Debate as to the selection of appropriate evaluative criteria in any given case is inextricably intertwined with the same debates for whose resolution those criteria purportedly are invoked. Put another way, in order both to give content to specific evaluative criteria and choose among those criteria, one must first have a positively and normatively viable conception of the entity being studied.<sup>11</sup>

### *B. On the Necessity of Models*

One function of legal analysis is to determine whether a particular rule makes sense—in other words, to identify relevant evaluative criteria and test the rule for compliance with those criteria. It is toward this aspect of legal scholarship that the Criteria Project seems most obviously directed. Yet, as Romano's reference to Berle's "normative theory of the corporation" suggests, legal analysis has additional functions. One is to make predictions about how people will behave under a given legal regime. Another is to provide a model that allows one to make predictions about legal outcomes: How is a court likely to rule in a given case? Both of the latter functions require more than just lists of evaluative criteria; they require an overarching theory of the firm.

Nobel laureate economist Milton Friedman famously argued that a model is properly judged by its predictive power with respect to the phenomena it purports to explain, not by whether it is a valid description of an objective reality.<sup>12</sup> As such, "the relevant question to ask about the 'assumptions' of a theory is not whether they are descriptively 'realistic,' for they never are, but

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10. For the sake of brevity, I have collapsed the stanzas:

It was six men of Indostan/To learning much inclined,/Who went to see the Elephant/(Though all of them were blind),/That each by observation/Might satisfy his mind

The First approached the Elephant,/And happening to fall/Against his broad and sturdy side,/At once began to bawl:"God bless me! but the Elephant/Is very like a wall!"

The Second, feeling of the tusk,/Cried, "Ho! what have we here/So very round and smooth and sharp?/To me 'tis mighty clear/This wonder of an Elephant/Is very like a spear!"

The Third approached the animal,/And happening to take/The squirming trunk within his hands,/Thus boldly up and spake:"I see," quoth he, "the Elephant/Is very like a snake!"

The Fourth reached out an eager hand,/And felt about the knee."What most this wondrous beast is like/Is mighty plain," quoth he;"'Tis clear enough the Elephant/Is very like a tree!"

The Fifth, who chanced to touch the ear,/Said: "E'en the blindest man/Can tell what this resembles most;/Deny the fact who can/This marvel of an Elephant/Is very like a fan!"

The Sixth no sooner had begun/About the beast to grope,/Than, seizing on the swinging tail/That fell within his scope,"I see," quoth he, "the Elephant/Is very like a rope!"

And so these men of Indostan/Disputed loud and long,/Each in his own opinion/Exceeding stiff and strong,/Though each was partly in the right,/And all were in the wrong!

11. Hence, for example, my model of the corporation suggests that Bill's accountability criteria should be the trump card. Because my model also places great emphasis on respect for the authority of the board of directors, however, the content of the accountability criteria would have to be informed by that respect.

12. Milton Friedman, *The Methodology of Positive Economics*, in *ESSAYS IN POSITIVE ECONOMICS* 23, 27 (1985).

whether they are sufficiently good approximations for the purpose in hand.”<sup>13</sup>

Applying these guidelines to corporate law scholarship, it seems clear that the chief task for any model of the corporation must be the model’s ability to predict the separation of ownership and control, the formal institutional governance structures following from their separation, and the legal rules responsive to their separation.<sup>14</sup> Shareholders, who are said to “own” the firm,<sup>15</sup> have virtually no power to control either its day-to-day operation or its long-term policies. Instead, the board of directors and subordinate managers, whose equity stake is often small, control the firm.<sup>16</sup>

In Part II of this essay, I will argue that my model of the corporation does a better job of explaining the separation of ownership and control than does the model used by Bill. Whether or not one is persuaded by my argument on that score, however, it should become clear that it is our competing conceptions of the corporation that are critical to accomplishing this central task of corporate law scholarship, not how we pick and choose among evaluative criteria.

## II. COMPETING CONCEPTS

In Part I of this essay, I endorsed Roberta Romano’s argument that corporate law scholarship requires “a normative theory of the corporation and its place in the polity.”<sup>17</sup> Put another way, corporate law scholarship requires a model of the corporation upon which one may make predictions about how corporate actors will behave under a given legal regime and about how courts should rule in particular cases. In this part, I demonstrate that Bill and I come at the corporation with rather different models in mind.<sup>18</sup>

If Bill’s approach to corporation law has a single defining characteristic, it doubtless would be his longstanding insistence that the corporation is neither a person nor even a thing capable of being owned. The very first edition of his *Business Organization and Finance* text explained that:

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13. *Id.*

14. See Patrick Bolton & David S. Scharfstein, *Corporate Finance, the Theory of the Firm, and Organizations*, 12 J. ECON. PERSP. 95, 96 (1998) (arguing that “a fully satisfactory theory of the firm” must account for the separation of ownership and control). This Article focuses on the latter test of a model’s predictive power, i.e., its ability to make useful predictions about the content of corporate law.

15. Although I follow convention in using the term “separation of ownership and control,” ownership is not a particularly useful concept in the corporate context. See Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1427-28 (1993) (arguing against applying ownership concepts to the corporation).

16. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 84-89 (1932).

17. See *supra* text accompanying note 4 (quoting Romano).

18. I worry somewhat that this section overstates the differences in our models. For example, I suspect Bill will acknowledge that hierarchy does have some evolutionary survival benefit in large firms, while I will concede that networks are an important phenomenon. For the sake of exposition, however, I have chosen to present the differences as starkly as possible while being true to the source material.

## Competing Concepts of the Corporation (a.k.a. Criteria? Just Say No)

In legal theory, the corporation, with few qualifications, is reified. It is conceived of as having an existence separate from that of its employees, customers, suppliers, and so forth—but mainly, from its shareholders. Sometimes, to be sure, the corporation is called a “fictional” entity—in apparent recognition of the abstract and potentially misleading nature of the concept. Still, there is the basic notion of a barrier, a psychological wall, between the shareholders (and other participants in the venture) and the corporation. . . . Sometimes the process goes a step further. The fictional (conceptual) entity becomes a putative person—capable, for example, of committing a crime or appealing the burden of a tax. In other words, reification sometimes leads to anthropomorphism.<sup>19</sup>

Bill went on to argue that while reification has some utility, it ultimately can prove a source of serious error:

Reification is a useful device; it allows us to manage complexity. . . . In law, the idea of the separate entity serves the further, more mundane, function of symbolizing a set of important legal rules or doctrines, such as limited liability of shareholders. . . . Still, reification is a device for making something that is in fact complex seem simple and that can be dangerous. The fact is that only individuals enjoy the benefits,<sup>20</sup> or bear the burdens and the responsibilities, of actions affecting other individuals.<sup>20</sup>

The most recent (ninth) edition makes the same point in essentially identical language.<sup>21</sup>

So far so good. Bill’s persistent refusal to treat the firm as a black box is not necessarily inconsistent with the contractarian approach to the firm,<sup>22</sup> which is the model used in my scholarship and, moreover, is generally regarded as the dominant model in legal scholarship.<sup>23</sup> In this model, the corporation is viewed not as an entity but rather as an aggregate of various factors of production. Capital is provided by creditors and shareholders. Labor is provided by employees. Labor is supervised and monitored by management, which also coordinates the activities of all the firm’s other inputs. The corporation, in turn, is the nexus of explicit and implicit contracts establishing rights and obligations among these various factors of production.<sup>24</sup> The contractarian model thus seemingly avoids reifying the firm, instead focusing on individual inputs, as Bill commands.

Hence, Bill’s approach to the corporation seemingly could be squared with the standard nexus of contracts account of the business firm without much difficulty. Curiously, however, Bill has criticized the contractarian account. He

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19. WILLIAM A. KLEIN, *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 98 (1980).

20. *Id.*

21. WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 117-18 (9th ed. 2004).

22. See generally Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 318-28 (1993).

23. As no less an authority than former Delaware Chancellor William Allen has acknowledged, contractarianism is now the “dominant legal academic view.” William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993).

24. As I explained elsewhere in detail, I think it is more useful to describe the firm as “having” a nexus than as “being” a nexus, but the latter seems to be the dominant usage in the legal literature. See Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1 (2002).

claims, for example, that it is “incomplete” because it fails “to consider the legitimate conflicting interests of individual parties to an economic arrangement.”<sup>25</sup>

This line of criticism likely is a corollary of Bill’s longstanding interest in actual bargains struck by participants in economic ventures. As long ago as 1982, Bill was arguing that:

[T]he most useful way to analyze the modern business enterprise is to interpret the terms of the economic arrangements of a firm (partnership, corporation, cooperative) and the terms of the related economic arrangements that should not be analyzed separately from the firm (distributorship, loan agreement, employment contracts) as a series of bargains subject to constraints and made in contemplation of a long-term relationship.<sup>26</sup>

Two decades later he was still inviting attention to:

[C]ooperation, conflict, competition, and compromise among equity investors, lenders, managers, workers, suppliers, customers, and all others who contribute to an economic endeavor—all those people or groups of people who acquire rights and obligations and who affect and are affected by the rights and obligations of all other participants.<sup>27</sup>

Bill thus wants us to focus directly on “the various devices for dealing with allocation and specification of control over the various aspects of relationships among the participants and economic venture.”<sup>28</sup> Specifically, Bill argues, business entities should be understood as a series of bargains over four basic deal points: risk of loss, return, control, and duration.<sup>29</sup>

In recent work, Bill has gone further by questioning the utility of the very concept of a firm. He argues, for example, that it is often “futile to try to map out the boundaries of the firm.”<sup>30</sup> Indeed, he has gone so far as to assert that in his model “there is no . . . *firm*.”<sup>31</sup> Instead, there is simply a set of contracts among the enterprise’s various constituencies.<sup>32</sup>

This perspective presumably stems from Bill’s increasing interest in hybrid forms of economic organization that lie somewhere in the middle of the spectrum that runs from pure spot market transactions to true firms. From the outset of his work in corporate law, Bill has resisted the tendency to draw a bright line between firms and markets. Instead, he has focused on economic interactions having “varying degrees of ‘firmishness.’”<sup>33</sup> Indeed, as he recently

25. G. Mitu Gulati, William A. Klein & Eric M. Zolt, *Connected Contracts*, 47 UCLA L. REV. 887, 893 (2000).

26. William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1521 (1982).

27. Gulati et al., *supra* note 25, at 895.

28. *Id.* at 891.

29. Klein, *supra* note 26, at 1563.

30. Gulati et al., *supra* note 25, at 897.

31. *Id.* at 947 (emphasis added).

32. *Id.* at 894-95 (defining the term “connected contracts”).

33. Klein, *supra* note 26, at 1523.

put it, his approach “bypasses the firm” entirely.<sup>34</sup> Hence, for example, his *Connected Contracts* article focuses on such examples as internet start-ups, the construction industry, and the motion picture industry.<sup>35</sup> Economic organization in those industries, he claims, is “characterized by contracts and subcontracts among many individuals and small firms.”<sup>36</sup> He further asserts that the nexus of the contracts model fails “to capture the complex relationships between and among the participants” in such industries.<sup>37</sup>

Granted, these phenomena are important and worthy of study. There does seem to be a “trend today toward disintegration, outsourcing, contracting out, and dealing through the market rather than bringing everything under the umbrella of the organization.”<sup>38</sup> It is with respect to such arrangements that Bill’s connected contracts model seems most useful.<sup>39</sup>

In a review of such ventures, however, the *Economist* concluded that “the idea that the basic agent in the modern economy is ceasing to be the firm and becoming the network is unconvincing.”<sup>40</sup> Interestingly, evidence for that proposition can be found in Bill’s own work. In his most recent major article, Bill (along with our mutual friend Mitu Gulati) studied a major commercial construction project in Los Angeles. He explains:

The construction team has been described as a “quasi-firm,” which means that it (and its counterpart, the virtual firm) is not a firm at all. Rather, it is a network of relationships and contracts. Most notably, it lacks the characteristic of hierarchical control. . . . [Instead, there is a] “culture of collaboration.” A construction project requires teamwork and a willingness and ability to adjust to changing needs and circumstances without hierarchical control. . . . This phenomenon of collaboration seems to trivialize (at least in this context) the distinction between firms and markets and between separable and nonseparable tasks. It is true, to be sure, that in the end there is one person or entity that has the legal, and perhaps even the practical, right to exercise control—to decide by fiat. But the premise of this study is that there is much to be learned from a focus on complexity, on networks, and on collaboration, as contrasted with hierarchy and fiat, and that this focus may provide useful insights into the distinction between firms and markets.<sup>41</sup>

Fair enough, but note that the vast majority of the individuals who come together to form the construction team are themselves members of a firm. The architects work for an architectural firm. The plumbers work for a plumbing

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34. Gulati et al., *supra* note 25, at 891.

35. *Id.* at 896.

36. *Id.* at 896 n.31.

37. *Id.* at 896.

38. Bengt Hölmstrom & John Roberts, *The Boundaries of the Firm Revisited*, 12 J. ECON. PERSP. 73, 80 (1998).

39. See Gulati et al., *supra* note 25, at 896 n.31 (discussing the “virtual” firm).

40. *The Future of the Company: A Matter of Choice*, *ECONOMIST*, Dec. 20, 2001.

41. William A. Klein & Mitu Gulati, *Economic Organization in the Construction Industry: A Case Study of Collaborative Production under High Uncertainty*, 1 *BERKELEY BUS. L.J.* 137, 139-42 (2004). Note that this passage seems to retreat from the strong view expressed in *Connected Contracts* that “there is no . . . firm.” See *supra* text accompanying note 31.

firm. And so on. Indeed, from a legal perspective, the construction team would seem to be a network of firms related to one another by contract, rather than an aggregate of individuals.

In any event, despite his emphasis on virtual firms and related concepts, Bill contemplates broader applications for the connected contracts model. He notes, for example, the model's potential utility with respect to such paragons of hierarchy as General Motors and Ford Motor Company.<sup>42</sup> In addition, he asserts the model can be "useful in thinking about more traditionally organized economic activities and might open new possibilities for legal rules."<sup>43</sup> It is therefore fair to test his model's predictive powers with respect to the legal and institutional features of the species of economic firm to which we have both devoted so much professional attention; namely, the corporation.<sup>44</sup>

As I have explained elsewhere, the corporation is properly understood as "a legal fiction characterized by six attributes: formal creation as prescribed by state law; legal personality; separation of ownership and control; freely alienable ownership interests; indefinite duration; and limited liability."<sup>45</sup> For present purposes, the separation of ownership and control is the most salient of these characteristics:

Corporations differ from most other forms of business organizations in that ownership of the firm is formally separated from its control. Although shareholders nominally "own" the corporation, they have virtually no decisionmaking powers—just the right to elect the firm's directors and to vote on an exceedingly limited—albeit not unimportant—number of corporate actions. Rather, management of the firm is vested by statute in the hands of the board of directors, who in turn delegate the day-to-day running of the firm to its officers, who in turn delegate some responsibilities to the company's employees.<sup>46</sup>

Fiat thus emerges as the defining characteristic of the corporation. Indeed, corporate governance should be understood as a series of rules and practices by which *ex post* command and control is substituted for bargaining (both *ex ante* and *ex post*).<sup>47</sup>

Bill's approach to thinking about firms does not engage this central institutional feature of the corporation. To the contrary, he questions—and

42. Gulati et al., *supra* note 25, at 897; Klein & Gulati, *supra* note 41, at 142-43.

43. Gulati et al., *supra* note 25, at 897.

44. See *supra* Part I.

45. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 2 (2002) (footnotes omitted).

46. *Id.* at 8-9 (footnotes omitted).

47. See generally Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) (explaining how corporate law vests the power of fiat in the board of directors). To be sure, there is a limited amount of bargaining in corporate governance. Much of this bargaining occurs *ex ante*, of course, as potential constituencies such as labor and capital negotiate the terms on which they will provide services to the corporation. Bill thus correctly acknowledges that his model does not assume that economic actors necessarily engage in actual bargaining. To the contrary, due to transaction cost barriers that preclude negotiation, much economic organization results from bargains (that is, outcomes often struck from "take it or leave it" offers) rather than actual bargaining (in the sense of a negotiation process). Klein, *supra* note 28, at 1522.

arguably denies—the relevance of fiat and hierarchy to the study of corporations. As Bill describes it, his model claims “there is no primacy, no core, no hierarchy, no prominent participant, no firm, no fiduciary duty.”<sup>48</sup> Instead, or so we gather, the corporation is a mere legal fiction describing the space within which a set of contracts is worked out among factors of production. Bill thus echoes the claim made by Armen Alchian and Harold Demsetz that the firm “has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people.”<sup>49</sup> Hence, they argued, an employer’s control over its employees does not differ from the power of a consumer over the grocer with whom the consumer does business.<sup>50</sup> Bill likewise questions “the assumption . . . that in general, in business organizations, there is a common and identifiable model of hierarchical control, with dominating employers and compliant employees.”<sup>51</sup>

As Coase explained long ago, however, firms emerge when it is efficient to substitute entrepreneurial fiat for the price mechanisms of the market.<sup>52</sup> In markets, resources are allocated by the price system, while in firms resources are allocated by authoritative direction.<sup>53</sup> Hence, Coase’s fundamental insight: “If a workman moves from department *Y* to department *X*, he does not go because of change in relative prices, but because he is ordered to do so.”<sup>54</sup>

Coase’s central decisionmaker need not be an authoritarian, as is illustrated by the informal decision-making processes of partnerships and other small firms. The importance of collaboration in the construction project Bill studied further confirms that decision making may be affected by consensus even in fairly large and complex economic organizations. Before concluding that Coase’s dictum does not hold in the hybrid entities that have captured Bill’s interest, however, note that the construction project he studied had a client with the power to make decisions by fiat.<sup>55</sup> Instructively, moreover, even within many types of the virtual firms Bill has studied, so-called “governance contracts” that allocate highly nuanced ownership-like decision rights are a common feature.<sup>56</sup>

In any event, there can be no serious doubt that Coase’s dictum holds for true firms.<sup>57</sup> Command-and-control is the norm in virtually all corporations.<sup>58</sup> As

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48. Gulati et al., *supra* note 25, at 947.

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

50. *Id.*

51. Klein & Gulati, *supra* note 41, at 143 n.20.

52. See Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* (N.S.) 386, 389 (1937) (arguing that “the distinguishing mark of the firm is the suppression of the price mechanism”).

53. *Id.*

54. *Id.* at 387.

55. See *supra* text accompanying note 41.

56. Hölmstrom & Roberts, *supra* note 38, at 85.

57. Indeed, we might conclude that true firms and markets are chiefly distinguished by the

a major sociological study of the American workplace concluded, workers generally accept hierarchical authority and perceive obedience to authority as an integral part of their job: “for the majority, disobedience is unthinkable.”<sup>59</sup> My work on employee involvement in corporate governance and decision making shows that this remains generally true.<sup>60</sup>

Why? What survival value does fiat have that ensures its triumph (or, at least, persistence)? Answering that question requires us to shift our attention from Coase to Kenneth Arrow’s work on organizational decision making. All organizations must have some mechanism for aggregating the preferences of the organization’s constituencies and converting them into collective decisions. Arrow identified two basic mechanisms for carrying out this task: “consensus” and “authority.”<sup>61</sup> Consensus is utilized where each member of the organization has identical information and interests, which results in preferences that are easily aggregated and thus permits relatively easy collective decision making.<sup>62</sup> In contrast, authority-based decision-making structures arise where group members have different interests and amounts of information. Because collective decision making is impracticable in such settings, authority-based structures are characterized by the existence of a central agency to which all relevant information is transmitted and which is empowered to make decisions binding on the whole.<sup>63</sup>

Decision-making systems in small business firms typically resemble Arrow’s consensus model. The default rules of American partnership law, for example, are a virtually ideal exemplar of a consensus-based decision-making mechanism.<sup>64</sup> As firms grow in size, however, consensus-based decision-making systems become less practical.

In the modern public corporation, the use of consensus-based decision-making mechanisms is effectively impossible. Consider the problems faced by shareholders, who are usually assumed to be the corporate constituency with the best claim on control of the decision-making apparatus. At the most basic level, the mechanical difficulties of achieving consensus amongst thousands of decision makers impede shareholders from taking an active role. Yet, even if

existence of a boundary within which the firm’s decisionmaker has power to exercise fiat.

58. See Joseph E. Stiglitz, *Incentives, Risk, and Information: Notes Toward a Theory of Hierarchy*, 6 BELL J. ECON. 552, 553 (1975) (“The employer is allowed to assign the workers different tasks . . .”).

59. JOHN F. WITTE, *DEMOCRACY, AUTHORITY, AND ALIENATION IN WORK: WORKERS’ PARTICIPATION IN AN AMERICAN CORPORATION* 38 (1980).

60. See, e.g., Stephen M. Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 DEL. J. CORP. L. 979 (1998) (explaining how hierarchy remains the dominant characteristic of corporate governance).

61. KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* 68-69 (1974).

62. *Id.* at 69-70.

63. *Id.* at 68.

64. See Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 466-68 (1992) (comparing partnership and corporate law).

those mechanical obstacles could be overcome, active shareholder participation in corporate decision making would still be precluded by the shareholders' widely divergent interests and distinctly different levels of information.

Although neoclassical economics assumes that shareholders come to the corporation with wealth maximization as their goal, and most presumably do so, once uncertainty is introduced it would be surprising if shareholder opinions did not differ on which course maximizes share value. More prosaically, shareholder investment time horizons are likely to vary from short-term speculation to long-term buy-and-hold strategies, and that variation in turn is likely to result in disagreements about corporate strategy. Even more prosaically, shareholders in different tax brackets are likely to disagree about such matters as dividend policy, as are shareholders who disagree about the merits of allowing management to invest the firm's free cash flow in new projects.

As to Arrow's information condition, shareholders lack incentives to gather the information necessary to participate actively in decision making. A rational shareholder will expend the effort necessary to make informed decisions only if the expected benefits of doing so outweigh its costs.<sup>65</sup> Given the length and complexity of corporate disclosure documents, the opportunity cost entailed in making informed decisions is both high and apparent. In contrast, the expected benefits of becoming informed are quite low, as most shareholders' holdings are too small to have significant effect on the vote's outcome. Corporate shareholders thus are rationally apathetic. Instead of exercising their voting rights, disgruntled shareholders typically adopt the so-called Wall Street Rule—it is easier to switch than fight—and sell out.

In sum, it is hardly surprising that the modern public corporation's decision-making structure precisely fits Arrow's model of an authority-based decision-making system. All state corporate codes provide for a system of nearly absolute delegation of power to the board of directors, which in turn is authorized to further delegate power to subordinate firm agents.<sup>66</sup> This must be so, because neither shareholders, employees, nor any other constituency have the information or the incentives necessary to make sound decisions on either operational or policy questions. Overcoming the collective action problems that prevent meaningful involvement by the corporation's various constituencies would be difficult and costly. Under these conditions, Arrow predicts, it is "cheaper and more efficient to transmit all the pieces of information to a central place" and to have the central office "make the collective choice and transmit it rather than retransmit all the information on which the decision is based."<sup>67</sup>

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65. See generally ROBERT C. CLARK, CORPORATE LAW 390-92 (1986) (discussing shareholder incentives).

66. See MODEL BUS. CORP. ACT ANN. § 8.01 cmt. (1995) (reviewing statutes).

67. ARROW, *supra* note 61, at 68.

Accordingly, the corporation's constituencies will prefer to delegate irrevocably decision-making authority to the board of directors and its management subordinates.

In large corporations, the desirability of authority-based decision-making structures is enhanced by the division of labor that it makes possible. Bounded rationality and complexity, as well as the practical costs of losing time when one shifts jobs, make it efficient for corporate constituents to specialize. Managers specialize in the efficient coordination of other specialists. In order to reap the benefits of managerial specialization, all other corporate constituents should prefer to specialize in functions unrelated to decision making, such as risk bearing (shareholders) or labor (employees), delegating decision making to managers. This natural division of labor between capital and management, however, requires that the chosen managers be vested with discretion to make binding decisions. Separating ownership and control by vesting decision-making authority in a centralized entity distinct from the corporation's various constituencies thus is what makes the large public corporation feasible.

In light of this analysis, Bill's insistence on de-emphasizing the role of fiat and hierarchy strikes me as most curious. After all, there is no necessary contradiction between a theory of the firm characterized by command-and-control decision making and Bill's preference for examining bargains. The set of contracts making up the firm consists in very large measure of implicit agreements, which by definition are both incomplete and unenforceable. Under conditions of uncertainty and complexity, we cannot expect the parties to execute a complete contract; accordingly, many decisions must be left for later contractual rewrites imposed by fiat. In turn, it is precisely the lack of enforceability of implicit corporate contracts that makes it possible for the central decision maker to rewrite them more-or-less freely. The parties to the corporate contract presumably accept this consequence of relying on implicit contracts because the resulting reduction in transaction costs benefits them all. It is thus possible to harmonize Coasean and bargain-based models without having to reject a theory of the firm in which management has the power to direct its workers or in which the corporation is characterized by bureaucratic hierarchies. Instead, the firm's employees (and other constituencies) voluntarily enter into a relationship in which they agree to permit the board of directors to make managerial decisions by fiat, while reserving the right to disassociate from the firm.

### III. CONCLUSION

I have doubtless somewhat overstated the extent to which Bill and I diverge in how we think about the corporation. I freely concede that there are hybrids having characteristics of both firms and markets in which collaboration and consensus are the norm. I suspect Bill would agree that there are entities as to

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which hierarchy and fiat are dominant. Our disagreements tend to be mainly a matter of emphasis.

Because our emphases differ so radically, however, it is difficult to see how much the Criteria Project—standing alone—would add to our debates. Merely exposing the criteria by which we evaluate corporate policies does not provide the reader with a complete picture unless we have first laid out a “normative theory of the corporation and its place in the polity.”<sup>68</sup> Once we do so, moreover, the Criteria Project still may have us comparing apples and oranges.

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68. See *supra* text accompanying note 4.

