The Conception That the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm

Melvin A. Eisenberg

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The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm

Melvin A. Eisenberg*

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I. INTRODUCTION

In 1976 Michael Jensen and William Meckling first formulated the conception that the corporation is a nexus of contracts in their famous article The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure.¹ Since that time, the conception has dominated the law-and-economics literature in corporate law.² The

* Koret Professor of Law, University of California at Berkeley; Justin W. D’Atri Visiting Professor of Law, Business, and Society, Columbia Law School. In 1998, Jonathan Macey and I jointly led break-out sessions on Law and Economics at an AALS Conference on Business Associations in Washington, D.C. We had several conversations before the workshop, and essentially we led the break-out sessions by continuing these conversations. One of the topics of the conversations and the break-out sessions was the nexus-of-contracts conception of the corporation. Jonathan and I pushed one another to refine and clarify our respective thoughts on this issue. Eventually, two papers resulted: a paper by Jonathan entitled Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective, 84 CORNELL L. REV. (forthcoming 1999) and the present paper. Jonathan, with his usual graciousness, dedicated his paper to me. I return the favor and dedicate this one to him. I also thank Stephen Bainbridge, Stephen Choi, Aaron Edlin, Jesse Fried, and Omri Yadlin for their extremely valuable comments on earlier drafts of this paper.


validity of this conception, however, cannot be established by economic analysis. That does not make the conception invalid, but it does mean that its validity must be examined along other dimensions. In this Article, I will examine the conception along several such dimensions, including its descriptive validity, its bearing on important problems of corporate law, and its intellectual coherence. I will show that the nexus-of-contracts conception is unsatisfactory as a positive—that is, descriptive—matter, in part because the corporation has a dual nature: In one aspect, it consists of reciprocal arrangements; in another, it is a bureaucratic hierarchy. The nexus-of-contracts conception captures only one of these two aspects of the corporation. I will also show that the conception lacks intellectual coherence and often gets in the way of clear thinking by substituting conclusory assertions for careful analysis.

II. A BRIEF INTELLECTUAL HISTORY

It is useful to begin by reviewing the intellectual history of the Jensen and Meckling article. That history begins with Ronald Coase's landmark paper, *The Nature of the Firm*. In that paper, Coase characterized the boundaries of the firm as the range of exchanges over which the market system was superseded and resource allocation was accomplished instead by authority and direction:

In economic theory we find that the allocation of factors of production between different uses is determined by the price mechanism. The price of factor \( A \) becomes higher in \( X \) than in \( Y \). As a result, \( A \) moves from \( Y \) to \( X \) until the difference between the prices in \( X \) and \( Y \), except insofar as it compensates for other differential advantages, disappears. Yet in the real world, we find that there are many areas where this does not apply. If a workman moves from department \( Y \) to department \( X \), he does not go because of a change in relative prices, but because he is ordered to do so.


My own view is that the firm is a network of individuals, organizations, and assets, dedicated to making profits through production and organized by rules. These rules fall into two categories: substantive and constitutive. Substantive rules govern the way in which the firm's property, personnel, and inputs are put to use, and the way in which its outputs are distributed. Constitutive rules govern the way in which the firm's substantive rules are made, and determine the rights, powers, and duties of the firm's owners and the organs or persons who comprise the firm's control-structure. For an earlier version of this view, see Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989). The critique of the nexus-of-contracts conception in the present article does not depend on the validity of my own view of the firm.

The Conception That the Corporation is a Nexus of Contracts

... 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.4 Coase argued that activities will be included within a firm when the costs of using markets—that is, contracts—are greater than the costs of direction by authority.5 The essential issue in the theory of the firm, therefore, was why some economic activity takes place within firms, so that the activity is directed by authority, while other economic activity takes place across markets, so that the activity is determined by contract.

Coase did not explicitly define the firm in his paper. Implicitly, however, he defined the firm to consist of the activities under the direction of the entrepreneur, who in turn was defined as the person or persons who take the place of the price mechanism in the direction of resources.6 Coase stated that the question what constitutes a firm can be approached in practice by considering the relationship of employer and employee.7 One of the essentials of this relationship, he said, is that the employer must have the right to control the work of the employee.8 "We thus see," he concluded, "that it is the fact of direction which is the essence of the legal concept of employer and employee"—and, by extension, of the firm.9

In their paper Production, Information Costs, and Economic Organization,10 Armen Alchian and Harold Demsetz objected to the Coasian conception of the firm, and emphasized instead the role of team production within the firm and the role of agreement and monitoring in team production. It is a "delusion," they said, "to see the firm characterized by the power to settle issues by fiat, by authority, or by disciplinary action superior to that available in the conventional market."11 Rather,

[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. [In the case of a contract between me and you,] I can "punish" you only by withholding future business or by seeking redress in the courts for any failure to honor our exchange agreement. That is exactly all that any employer can do. He can fire or sue, just as I can fire my grocer by stopping purchases from him or sue him for delivering faulty products. What then is the content of the presumed power to manage and assign workers to various tasks? Exactly the same as one little consumer's power to manage and assign his grocer to various tasks. The single consumer can assign his grocer to the task of

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4. Id. at 387-88.
5. The major costs identified by Coase concerned the discovery and negotiation of prices. This part of Coase's argument was developed and augmented in Steven N.S. Cheung, The Contractual Nature of the Firm, 26 J. L. & ECON. 1, 6-10 (1983).
7. Id. at 404.
8. Id. at 404-05.
9. Id. at 404.
11. Id. at 777.
obtaining whatever the customer can induce the grocer to provide at a price acceptable to both parties. That is precisely all that an employer can do to an employee. To speak of managing, directing, or assigning workers to various tasks is a deceptive way of noting that the employer continually is involved in renegotiation of contracts on terms that must be acceptable to both parties. Telling an employee to type this letter rather than to file that document is like my telling a grocer to sell me this brand of tuna rather than that brand of bread. . . . Wherein then is the relationship between a grocer and his employee different from that between a grocer and his customers? It is in a team use of inputs and a centralized position of some party in the contractual arrangements of all other inputs. It is the centralized contractual agent in a team productive process—not some superior authoritarian directive or disciplinary power.¹²

Jensen and Meckling applauded Alchian and Demsetz’s objection to Coase’s theory of the firm, but concluded that Alchian and Demsetz had not gone far enough in rejecting Coase:

Alchian and Demsetz . . . object to the notion that activities within the firm are governed by authority, and correctly emphasize the role of contracts as a vehicle for voluntary exchange. They emphasize the role of monitoring in situations in which there is joint input or team production. We sympathize with the importance they attach to monitoring, but we believe the emphasis which Alchian-Demsetz place on joint input production is too narrow and therefore misleading. Contractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc.¹³

Jensen and Meckling therefore substituted, for Coase’s conception of the firm, the competing conception that the firm was a nexus of contracts—and, more particularly, “that most organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals. . . .”¹⁴

III. THE MEANING OF THE NEXUS-OF-CONTRACTS CONCEPTION

Before proceeding further, it is necessary to clarify the meaning of the nexus-of-contracts conception. The conception neither can nor does mean what it literally says. In ordinary language, the term contract means an agreement. In law, the term means a legally enforceable promise. Pretty clearly, however, the nexus-of-contracts conception does not mean either that the corporation is a nexus of agreements or that it is a nexus of legally enforceable promises. Instead, the conception means that the corporation is a nexus of reciprocal arrangements. But then why is the term contracts, rather than the term reciprocal arrangements, used in the nexus-of-contracts conception?

One possible explanation is that the term nexus of contracts was coined by economists, and “Economists tend to view contracts as relationships characterized by

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¹² Id. at 777-78.
¹³ Jensen & Meckling, supra note 1, at 310-11.
¹⁴ Id.
reciprocal expectations and behavior."\textsuperscript{15} It also seems relevant, however, that the term \textit{contracts} connotes markets, and conceiving the corporation as a nexus of contracts therefore connotes that a corporation is simply the product of market forces. As stated by David Campbell, "the central feature of [the nexus-of-contracts conception] is that the determinate empirical features of the company as a legitimately non-market institution are eroded to allow the purely hypothetical market to govern the company, from which, indeed, it cannot be distinguished."\textsuperscript{16} Thus the inaccurate term \textit{nexus of contracts} may have persisted, even among legal academics, because it carries connotations that nexus-of-contracts theorists find normatively or strategically appealing. Whatever the explanation, in this Article I will use the term \textit{nexus of contracts} in the way it is meant, that is, a nexus of reciprocal arrangements.

\textbf{IV. THE PROBLEM OF MANDATORY LEGAL RULES}

A central issue raised by the nexus-of-contracts conception is how to deal with the rules of corporate law. Clearly, these rules are basic to the constitution of the corporation. Equally clearly, they are not reciprocal arrangements; in particular, some important rules of corporation law, such as the federal laws that govern insider trading and tender offers, are mandatory.

Some commentators deal with this issue by taking the position that none of the rules of corporation law are really mandatory. Roberta Romano, for example, argues that "The rules that are identified as 'mandatory' in practice have very little in common with the ordinary understanding of that term. They are either easily—and legally—sidestepped, or they pose nonbinding constraints because there is no burning demand to deviate from them."\textsuperscript{17} The first branch of this argument—that the mandatory rules of corporate law are easily and legally sidestepped—is factually incorrect. For example, one cannot trade on inside information while easily and legally side-stepping Rule 10b-5,\textsuperscript{18} or launch a takeover of a publicly held corporation while easily and legally side-stepping the Williams Act.\textsuperscript{19} The second branch of the argument—that a rule is not mandatory if there is no burning demand to deviate from the rule—is conceptually incorrect. Under this argument the rules against theft would not be mandatory, because there is no burning demand to deviate from them.

The strategy of denying that there are mandatory rules of corporate law is not only untenable; it is unnecessary. Nothing in the nexus-of-contracts conception requires a denial that there are mandatory corporate rules. After all, even real contracts are governed by a number of mandatory rules, such as the rules that concern consideration, unconscionability, and good faith. Accordingly, the nexus-of-contracts conception could be interpreted to mean that the corporation is a nexus of reciprocal arrangements made

\begin{footnotesize}
\begin{enumerate}
\item[16.] Campbell, \textit{supra} note 2, at 361.
\item[18.] Rule 10b-5, 17 C.F.R. § 240.10b-5 (1999).
\end{enumerate}
\end{footnotesize}
within a framework of mandatory legal rules, just as many other reciprocal arrangements, like contracts, trusts, and marriages, are made within a framework of mandatory legal rules.

Unfortunately, it has proved easy to confuse the positive proposition that the corporation is a nexus of reciprocal arrangements with the normative proposition that the persons who constitute a corporation should be free to make whatever reciprocal arrangements they choose, without the constraints of any mandatory legal rules. For example, Stephen Bainbridge states that "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." In fact, however, insofar as the nexus of contracts is a positive conception, it has no implications for the proper role of mandatory legal rules. To reason from the nexus-of-contracts conception to a rejection of mandatory legal rules is to mistakenly reason from is to ought.

Whether any rules of corporation law should be mandatory, and if so, what those rules should be, are important and difficult questions. Contracts—real contracts—should normally be respected and legally enforced. Under appropriate conditions, so should certain other forms of private ordering. In the corporate context, however, contracts and other forms of private ordering are subject to special problems. For example, there are a number of potential limits on the force of shareholder consent to corporate actions. The consent may be fictitious—as when the approval is given in part by nonshareholders with power to vote, like brokers who hold stock in street name. The consent may be tainted by a conflict of interest—as when a majority of the approving shareholders benefit from the approval in a way that other shareholders do not. The consent may be coerced—as when the shareholders are threatened that unless they approve a proposal, management will refuse to take some action that is in the shareholders' interests, like the payment of dividends. The consent may be impoverished—as when shareholders approve an action they deem second best because management's control of the agenda prevents them from voting on an action they deem first best, or when the shareholders have only a weak, incomplete, or nonexistent idea of a proposal for which they vote.

Furthermore, the respect that is normally due to contracts and other forms of private ordering is significantly diminished when the contract or private ordering creates adverse third-party effects—negative externalities. The possibility of such effects is especially salient in the corporate context, because of the frequent interdependence of individuals and groups who are interested in a corporation but are not parties to a given arrangement. For example, a shareholders' agreement between two of three shareholders in a close corporation may have a significant negative effect on the third shareholder. A contract between the board and the chief executive officer may have a significant negative effect on the shareholders as a group. A restructuring of the corporation initiated by the board and approved by the shareholders may have a significant negative effect on bondholders.

Given the special problems of contract and private ordering in the corporate context, whether any particular rule of corporate law should be mandatory must be examined on a

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rule-by-rule basis in light of the extent, if any, to which the power to contract around the given rule may implicate one or more of these problems. One of the defects of the nexus-of-contracts conception is that it too easily leads to a substitution of conclusory thinking for careful rule-by-rule analysis.

V. THE PROBLEM OF OWNERSHIP

Under the nexus-of-contracts conception, the body of shareholders is not conceived to own the corporation. Rather, shareholders are conceived to have only contractual claims against the corporation. This denial of shareholder ownership is critical to the nexus-of-contracts conception, because if the corporation is owned by the shareholders it would not be simply a nexus of contracts: Both law and social practice draw sharp distinctions between ownership or property rights on the one hand, and contract rights on the other.

The claim that the shareholders do not own the corporation is not limited to proponents of the nexus-of-contracts conception. For example, communitarians often make the same claim. Nor is the claim implausible. On balance, however, the claim is unpersuasive. As A. M. Honore has pointed out, one way to determine the proper characterization of an interest is by comparing the incidents of the interest with the standard incidents of ownership, such as the rights to possess, use, and manage, and the rights to income and to capital. From this perspective, the body of shareholders appears to own the corporation. Although shareholdership does not carry all the standard incidents of ownership, it has never been thought that an interest is not a property right unless it carries every such incident. For example, life interests, remainder interests, and easements are property rights, not contractual rights, even though they lack some of the standard incidents of ownership. The body of shareholders has most of the incidents of ownership except direct control, and it has at least indirect control through its rights to elect and remove directors and to collectively sell all or a majority of the corporation’s shares to a single bidder.

Nor are the shareholders disqualified as owners on the ground that they do not manage the corporation. The nobility and landed gentry of eighteenth- and nineteenth-century England did not manage their estates; they hunted, rode to hounds, gambled, and visited. Did they then not own their estates? Is a party with a fee interest in a hotel not the owner of the hotel if he has hired a management company to manage the hotel? In short, shareholdership is a property right of the kind that Honore calls “split ownership”—that


is, ownership in which the standard incidents are divided between two or more persons. As Honoré states, "splitting may serve the purpose of specialization, by separating management from the enjoyment of income. . . . In this . . . class fall such devices as . . . incorporated companies." Another way to determine whether a given type of interest constitutes an ownership or property interest, on the one hand, or a contractual interest, on the other, is by adverting to social conventions. From this perspective, shareholders are the owners of a corporation because they are taken to be the owners under such conventions. This result is reached not simply because social conventions are entitled to weight as such (although they may be), but because what constitutes property is to a significant extent a matter of social convention.

There is also a welfare reason for considering the shareholders to be the owners of the corporation. If it is believed that the social interest is best served by orienting the corporation to the maximization of wealth, it is desirable to treat shareholders as owners as a means to legitimizing and reinforcing that end.

Finally, the position that shareholders are not owners involves enormous and probably insuperable problems of distinguishing (i) between corporate and noncorporate business enterprises, and (ii) between different types of corporate enterprises. If noncorporate business enterprises are owned, there is insufficient reason to conclude that corporations are not owned. Certainly the corporation cannot be distinguished from other kinds of business enterprise in this regard on the ground that the corporation has more than a single putative owner. If that were so, it would mean that two persons who held the fee interest in a commercial building in joint tenancy would not own the building, and that three partners would not own their partnership. Furthermore, many corporations, including wholly-owned subsidiaries, have only one shareholder. Is such a corporation not owned by its shareholder? If it is owned, does it become not owned when a second person becomes a shareholder? If a corporation is 51% owned by a parent and 49% by the public, is half of the corporation owned and half not owned?

Against the weight of the reasons why shareholders should be treated as owners of the corporation, the only argument made by proponents of the nexus-of-contracts conception is that it follows from the nexus-of-contracts conception that the shareholders are only contractual claimants, not owners. Thus, Jonathan Macey states:

> [O]nce we accept the view that the firm is not an entity at all, but a set of contracts or series of bargains, the organization decomposes "into a group of identifiable participants—e.g., investors, managers, creditors, employees, and suppliers—who negotiate an equilibrium position among themselves. An implication of this perspective is to deny that any one class of participants (i.e.,

25. Id. at 107, 143.
26. Id. at 142.
27. Cf. Lon Fuller & Melvin A. Eisenberg, BASIC CONTRACT LAW 1018 (6th ed. 1996) (in determining whether a type of interest is an interest in land for purposes of the Statute of Frauds, the law looks to how the interest is generally viewed).
the shareholders) have a natural right to view themselves as the owners of the firm.28

Of course, it is true that if the nexus-of-contracts conception is descriptively accurate, then the shareholders do not own the corporation. But whether the nexus-of-contracts conception is descriptively accurate is the conclusion that needs to be proved. One of the elements of such a proof is a showing that the shareholders do not own the corporation. Whether the shareholders own the corporation is not a question free from difficulty, but it is a question that must be investigated on its own merits, as a predicate to establishing that the corporation is a nexus of contracts—not by reasoning backwards from that conclusion to one of its necessary predicates. Once again, therefore, the nexus-of-contracts conception too easily leads to a substitution of conclusory thinking for careful analysis.

VI. THE DUAL NATURE OF THE FIRM

Recall that Coase's conception of the firm turned on the entrepreneur's authority (that is, his power) to direct his subordinates through rules and orders.29 Recall too that in contrast, Alchian and Demsetz argued that the concept of authority in the firm was a delusion.30 "The firm," they said, "has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people."31 Accordingly, they said, there is no difference between the employer-employee relationship and the grocer-customer relationship:

To speak of managing, directing, or assigning workers to various tasks is a deceptive way of noting that the employer continually is involved in renegotiation of contracts on terms that must be acceptable to both parties. Telling an employee to type this letter rather than to file that document is like my telling a grocer to sell me this brand of tuna rather than that brand of bread.32

This analysis, in turn, is a lynchpin of Jensen and Meckling's nexus-of-contracts conception.

This analysis is not exactly wrong. But neither is it exactly right. It catches half the truth, but only half. To begin with, many or most of the contracts in a corporation are sticky. It is usually easy to switch grocers, but it is usually not easy to quit jobs. Consider, for example, an employee with firm-specific skills, or with great seniority, unvested stock options, or other benefits that will be lost if he resigns.

Much more important, the position that there is no difference between contracting to do an act and being ordered or directed to do an act lacks all correspondence with reality. Corporations are hierarchical organizations. Anyone who has worked in a hierarchical organization knows that the way in which directions are experienced by supervisors and

29. See text accompanying supra notes 3-9.
30. See supra text accompanying notes 10-12.
32. Id.
subordinates is entirely different from the way in which contracts are experienced by contracting parties. To use Alchian and Demsetz’s example, both an employer and an employee will experience the employer’s direction to type a letter very differently than a customer and a grocer will experience the grocer’s trying to sell tuna rather than bread.

This difference is qualitative, not merely quantitative. When a consumer needs to decide whether to buy bread or tuna, his decision will be based on whether bread or tuna is the best choice (by whatever metric of best he employs), all things considered—that is, considering, on the merits, all the reasons for and against each alternative. In contrast, when a subordinate is given a direction by a superior, the fact of the direction normally excludes the subordinate from considering any reason for action except the direction. Thus a subordinate normally follows a direction more or less reflexively, whether he likes the direction or not, and whether or not he considers the direction best, all things considered. As Bainbridge has observed, “there is a sharp disconnect between Alchian and Demsetz’s argument and the real world of work. Command-and-control is the norm in most workplaces. Workers generally accept hierarchical authority and perceive obedience to authority as an integral part of their job: ‘for the majority, disobedience is unthinkable.’”

An analogue is provided by H.L.A. Hart’s distinction between the external and the internal points of view toward legal rules: Hart pointed out that rules can be viewed from the perspective of either a mere “observer who does not himself accept them, or [of] a member of the group which accepts and uses them as guides to conduct.” He called these two perspectives the external and internal points of view. As Hart noted, a person who observes rules from the external point of view may be content merely to record the regularity with which rules are followed, and the responses to deviations from the rules:

His view will be like the view of one who, having observed the working of a traffic signal in a busy street for some time, limits himself to saying that when the light turns red there is a high probability that the traffic will stop. He treats the light merely as a natural sign that people will behave in certain ways, as clouds are a sign that rain will come. In so doing he will miss out a whole dimension of the social life of those whom he is watching, since for them the

33. I draw here on the concept of exclusionary reasons developed by Joseph Raz. See JOSEPH RAZ, PRACTICAL REASONS AND NORMS 37-45 (1975). An exclusionary reason is a reason for action that excludes other reasons for an action. For example, suppose that A wants to decide whether to do X. He will then do X if all things considered—all the relevant reasons considered—X is best, by whatever metric of “best” that A employs. But suppose now that A has been authoritatively directed to do X. In that case, the direction serves as an exclusionary reason, that is, it excludes all the other reasons that A would have taken into account in the absence of an authoritative direction.

34. Bainbridge, Participatory Management Within a Theory of the Firm, 21 J. CORP. L. 657, 663-64 (1996) (quoting JOHN F. WIhE, DEMOCRACY, AUTHORITY, AND ALIENATION IN WORK: WORKERS’ PARTICIPATION IN AN AMERICAN CORPORATION 38 (1980); see also Flanagan, supra note 2, at 119 & n.48: (E)mployees do not refuse to accept direction. They do what is asked of them, and they do so for very good reasons. . . First, there are substantial costs involved in obtaining new employment, which employees will not incur simply to demonstrate their ultimate personal autonomy. Second, the value of their labour capital is often greatest to their current employer. Third, they make personal investments in co-workers and neighbours.


36. Id. at 88-89.
red light is not merely a sign that others will stop: they look upon it as a signal for them to stop, and so a reason for stopping in conformity to rules which make stopping when the light is red a standard of behaviour and an obligation.

What the external point of view, which limits itself to the observable regularities of behaviour, cannot reproduce is the way in which the rules function as rules in the lives of those who normally are the majority of society.

Similarly, the nexus-of-contracts conception captures only the external view of rules and directions, not the internal view. It fails to capture the way in which rules and directions function in the lives of those who are members of hierarchical organizations, such as corporations.

All this is of great psychological and sociological importance, because most people work in hierarchical organizations. But it is of economic importance as well, precisely because it is of psychological and sociological importance. Just as a subordinate experiences getting a direction differently than making a real contract, so too does a superior experience giving a direction differently than making a real contract. There are costs to inducing action by making real contracts, and there are costs to inducing action by giving directions. Firms exist in part when the cost of inducing action through giving directions is less than the cost of inducing action by making real contracts.

Furthermore, a corporation—or more generally, a firm—is not only a hierarchical organization; it is a bureaucratic hierarchical organization. That means, among other things, that much of the activity in a corporation is organized by established bureaucratic rules that are not open to continued reexamination, let alone negotiation. To paraphrase a remark of Benjamin Klein, an organization is embedded in its human capital, but is greater than the sum of its parts. Employees come and go, but the organization maintains the memory of how things are done.

More generally, an organization consists not only of assets, persons, and relationships among persons, but of the rules that organize those assets, persons, and relationships. Some of those rules are contractual, but most are bureaucratic in the sense that they are hierarchically adopted and persist over time as persons, assets, and relationships come and go.

To put this differently, the corporation has a dual nature. In the first quarter of the twentieth century, it was discovered that light, theretofore described and understood as a wave (a portion of the electromagnetic spectrum), can alternatively be described and understood as a particle (a photon) and that, correspondingly, the building-blocks of atoms, such as electrons, theretofore described and understood as particles, can alternatively be described and understood as waves. So too the firm can be described and understood either as a set of reciprocal arrangements or as a bureaucratic hierarchical organization. To describe and understand firms purely as bureaucratic hierarchical

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37. Id. at 90.
organizations misses the voluntary element of many of the arrangements that constitute a firm. To describe firms purely as a set of reciprocal arrangements misses the extent to which firms are organized by bureaucratic rules and operate by hierarchical directions issued by superiors to subordinates.

VII. THE PROBLEM OF INTELLECTUAL COHERENCE

I turn now to whether the nexus-of-contracts conception is intellectually coherent, taken on its own terms. Assume for this purpose that the corporation is comprised in some way of reciprocal arrangements. The question then arises, exactly what reciprocal arrangements constitute any given corporation? The answer of the nexus-of-contracts conception is, those reciprocal arrangements that have a nexus. But what does that mean? The term *nexus* normally means a core, or a tie, link, or means of connection. So one possible meaning of the nexus-of-contracts conception is that a corporation is the core or node at which relevant reciprocal arrangements intersect or overlap. But a corporation could not consist only of the core at which relevant reciprocal arrangements intersect or overlap, because most of the reciprocal arrangements that are relevant to a corporation do not intersect or overlap. For example, the contract of a steel supplier will not overlap with the contract of an advertising agency, and so forth.

Suppose we take the alternative definition of nexus and say that a corporation consists of all relevant reciprocal arrangements that are linked to one or more other relevant reciprocal arrangements. It must then be determined, what are the relevant reciprocal arrangements? Hundreds of thousands of reciprocal arrangements in the world are linked to other reciprocal arrangements, either directly or indirectly. If a corporation is a nexus of reciprocal arrangements, then any particular corporation must consist of only *some* of the reciprocal arrangements in the world. But which ones? Presumably, a particular corporation consists of all and only those reciprocal arrangements that are linked not just to each other, but to *something*. But to what?

Surely the corporation cannot consist of all the reciprocal arrangements that are linked to the corporation, because that would make the nexus-of-contracts conception circular: It would be like saying that a zebra is a nexus of stripes linked to a zebra. Suppose the conception is recast to mean that a corporation consists of reciprocal arrangements linked to a specific firm. But then we would have to formulate a conception of the firm that does not itself use the nexus-of-contracts conception. If this could be done, the nexus-of-contracts conception would be superfluous.

In short, the conception that the corporation is a nexus of contracts lacks intellectual coherence, because it cannot mean either that the corporation consists of the core at which reciprocal arrangements overlap, or that the corporation consists of all reciprocal arrangements that are linked to each other or to something. It is therefore impossible, under this conception, to determine which reciprocal arrangements in the world constitute any given corporation.

Some recent reformulations of a contractarian conception of the firm avoid the term *nexus*, and therefore might seem to avoid as well the problem of incoherence. For

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40. See RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1296 (2d ed. 1993). The term *nexus* can also mean a connected series or group. *Id.* However, that definition can be put aside for purposes of this article, because the inquiry here is what connects reciprocal arrangements.
example, Jean-Jacques Lafont and David Martimort define the firm as "a set of bilateral contracts between each stakeholder... and the manager, or common agent." A comparable reformulation has been advanced by Henry Hansmann, who defines the firm as "the common signatory of a group of contracts." He continues, "In small firms organized as sole proprietorships, the individual proprietor signs these contracts. In a corporation or a partnership, the party that signs the contracts is a legal entity."

If these reformulations worked, they might provide close cousins to the nexus-of-contracts conception that were at least intellectually coherent. However, these reformulations are also subject to fatal problems.

Under the Lafont and Martimort reformulation, the firm is defined as contracts entered into with the manager or common agents. But how do we know that an individual is the manager or common agent of a firm unless we have a prior conception of the firm? Furthermore, most contracts that are linked to a corporation are not made between a manager and others. Rather, they are made between the corporation and others; that is, managers do not enter into these contracts on their own behalf, but only on behalf of the corporation. Moreover, the contracts that a corporation makes are executed on its behalf, not by "the manager, or common agent," but by individuals sprinkled throughout the corporation, like raisins in a pudding. The board executes some contracts; the CEO executes some contracts; but most contracts are executed by purchasing agents, salesmen, and other low-level folks—in short, by nonmanagerial employees.

The general part of Hansmann's reformulation, which defines the firm as the common signatory of a group of contracts, is subject to comparable objections. Because many contracts in the world have common signatories, it would remain to be determined which of the contracts that have common signatories constitute a particular firm. Hansmann partially addresses that problem in the special part of his reformulation, which states that in a corporation or a partnership the party that signs the contracts is a legal entity. However, this reformulation is noncontractarian to the extent that it is centered on a legal entity that is presumably not itself a nexus of contracts. It also fails to account for firms that are not legal entities, like partnerships under the Uniform Partnership Act or, historically, joint stock associations.

Finally, both the Hansmann and the Lafont and Martimort reformulations are subject to other, even more fundamental objections. For one thing, they fail to account for shareholder ownership. For another, they fail to account for such basic voluntary arrangements as certificates of incorporation, by-laws, board resolutions, shareholder resolutions, shareholder agreements, and hierarchical rules, none of which is either a contract to which a manager or the corporation is a signatory or a bilateral contract between managers and stakeholders.

42. HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 18 (1996). Although Hansmann avoids the term nexus in his formulation of the conception of the firm, the section in which this formulation appears is called "The Firm as a Nexus of Contracts." Id. at 16.
43. Id. at 18.
VIII. THE PROBLEM OF BOUNDARIES

Still another problem with the intellectual coherence of the nexus-of-contracts conception is that although this conception is generally thought of as a theory of the firm, in fact the conception is incapable of drawing boundaries between what is inside the firm and what is outside the firm.

Recall that Coase’s enterprise was to determine why certain economic activity occurred on the market—that is, by contract—while other economic activity occurred within a firm. This enterprise simultaneously assumed a boundary between the market—that is, contracts—and firms, and sought to determine the reason for and location of this boundary.

In contrast, the nexus-of-contracts conception denies that the firm has any boundaries. As stated by Jensen and Meckling, “Viewed [as a nexus for contracting relationships], . . . it makes little or no sense to try to distinguish those things which are ‘inside’ the firm (or any other organization) from those things that are ‘outside’ of it.”

But if it makes little sense to distinguish those things that are inside the firm and those things that are outside the firm, then there is no firm. Accordingly, at bottom the nexus-of-contracts conception is not a theory of the firm: It is a theory of why there are no firms. This explains why Jensen and Meckling conclude that under this conception it makes little or no sense to try to distinguish those things which are inside the firm from those things that are outside of it. This also explains why Jensen and Meckling conclude that only individuals, not organizations, are real, so that a contract that purports to be between two corporations really consists of contracting relationships among individuals. These conclusions logically follow from the nexus-of-contracts conception, but they leave us in a world without firms, and conflict with reality as it is normally understood.

IX. THE PROBLEM OF SHAREHOLDER PRIMACY

Most (although by no means all) corporate scholars subscribe to the norm of shareholder primacy, under which the objective of the corporation’s management should be to increase shareholder wealth, within the constraints of law and morality. This view is not uncontroversial. In particular, many corporate scholars take a communitarian view, under which the board should manage the corporation in the interests of all actors who have an interest in or reciprocal arrangements with the corporation, including not only shareholders but employees, creditors, customers, suppliers, and the community.

44. Jensen & Meckling, supra note 1, at 310-11.
45. Id.
46. In an essay written in 1987, in connection with a conference to celebrate the fiftieth anniversary of the publication of The Nature of the Firm, Coase remarked that “A number of economists have said in recent years that the problem of the firm is essentially a choice of contractual arrangements. I have never thought otherwise.” Ronald Coase, The Nature of the Firm: Meaning, in THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 48, 56 (Oliver E. Williamson & Sidney G. Winter eds., 1993). This remark is somewhat ambiguous, especially because a few passages later Coase contrasts “long-term contracts” with “integration.” Id. at 57-58. Certainly nothing in the 1987 essay suggests that Coase no longer believes that there are differences between the market and a firm. On balance, Coase’s remark is best interpreted to reflect what I refer to in the conclusion of this article as the very weak sense of the nexus-of-contracts conception.
The Conception That the Corporation is a Nexus of Contracts

It is commonly thought that the nexus-of-contracts conception is connected in some fundamental way to the concept of shareholder primacy. It isn’t. Just as contract law does not give primacy to either buyers or sellers, contractors or owners, so the nexus-of-contracts conception does not give primacy to any single group. On the contrary, taken in isolation, that conception, like contract law, would specify an equal footing for all groups with an interest in the corporation. Accordingly, as Margaret Blair and Lynn Stout have shown, the nexus-of-contracts conception is connected in a fundamental way, not to shareholder primacy, but to a communitarian conception of the corporation in which all groups with an interest in the corporation are put on an equal footing.

In an attempt to explain shareholder primacy on a contractarian basis, it is sometimes argued that shareholder primacy is a contractual default rule. If so, it is a very odd kind of default rule, because in the real world it cannot be contracted around. At least in publicly held corporations, in practice it is virtually impossible to get consent from the shareholders and all the other relevant groups to vary the rule of shareholder primacy.

Even if shareholder primacy is a default rule, however, it is not a contractual rule. The standard methodology for establishing the content of a default rule is that the rule should have the content that the affected parties would have agreed upon if they had costlessly negotiated on the matter. Some commentators argue that this methodology makes default rules contractual. It does not. Default rules are rules that are applied only in the absence of contract. No one can know what rule the parties to any given relationship—with individual differences in bargaining power, information, risk-aversion, and the like—would have agreed to if they had addressed the relevant issue. Even under the what-the-parties-would-have-agreed-to algorithm, therefore, the content of default rules is established not by contract, but by collective action—that is, by government decision.

Even so, if it could be confidently predicted that if all the groups with an interest in a given issue addressed the issue and negotiated costlessly, they would agree upon a given rule in all or nearly all cases, then that rule might be justified on the ground that its adoption saves the transaction costs of negotiation. In the case of shareholder primacy, however, it is difficult to confidently make a prediction of this sort. Indeed, many corporation statutes have negated shareholder primacy, or at least put it into substantial question, by the adoption of “other-constituency” provisions. For example, section 1715 of the Pennsylvania statute provides that:

In discharging the duties of their respective positions, the board of directors . . . [may] consider to the extent they deem appropriate . . .

The effects of any action upon any or all groups affected by such action including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located . . .

. . . The board of directors . . . shall not be required, in considering the best interests of the corporation or the effects of any action, to regard any

48. See, e.g., Bainbridge, supra note 22, at 1428-31.
corporate interest or the interests of any particular group affected by such action as a dominant or controlling interest or factor. . . .

Similarly, section 718 of the New York statute provides that "In taking action . . . a director shall be entitled to consider . . .":

(ii) the corporation's current employees;

(iii) the corporation's retired employees and other beneficiaries receiving or entitled to receive retirement, welfare or similar benefits from or pursuant to any plan sponsored, or agreement entered into, by the corporation;

(iv) the corporation's customers and creditors; and

(v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise to contribute to the communities in which it does business.

In light of statutes like these, it is not easy to confidently predict that parties who bargained costlessly would always or almost always agree upon a rule of shareholder primacy. Indeed, if one accepts the teaching of public-choice theory that statutes are legislative bargains, it might be confidently predicted that the relevant parties often or even usually would not bargain to a rule of shareholder primacy, because they have bargained to very different rules in other-constituency states. At the least, the widespread adoption of other-constituency provisions requires agnosticism concerning what rule the parties would agree upon if they bargained costlessly on the issue.

A variety of arguments have been made to show why shareholders are in need of primacy, or why other groups are better able to protect themselves contractually than shareholders, or the like. These arguments, if correct, might justify shareholder primacy on welfare grounds, but they are irrelevant to showing that shareholder primacy can be justified as a contractual rule. Furthermore, as Jonathan Macey has shown, most of these arguments cannot stand scrutiny. For example, shareholders are at least as able, if not more able, than other groups to protect themselves contractually, simply by writing shareholder primacy into the certificate of incorporation and ensuring that the board inserts shareholder-primacy provisions into bond indentures, collective-bargaining agreements, and other significant contracts. There are good reasons, based on welfare considerations, for shareholder primacy, but the rule of shareholder primacy is not contractual, and the welfare reasons for the rule are not contractarian.

Of course, even though the nexus-of-contracts conception does not itself support shareholder primacy, it is possible to place a shareholder-primacy overlay on that conception, just as it is possible to place an overlay of mandatory legal rules on that conception. However, insofar as the nexus-of-contracts conception connotes a contractual view of the corporation, it supports a view in which all groups with an interest in the corporation bargain from an equal footing, not a view in which the law places its weight behind one of these groups before bargaining even begins.

49. PA. CONS. STAT. ANN. tit. 15, § 1715(a), (b) (West 1995).
50. N.Y. BUS. CORP. § 717(b) (McKinney Supp. 1998).
51. Many of these arguments are reviewed in Bainbridge, supra note 22, and Macey, supra note 22.
52. Macey, supra note 22.
X. THE PROBLEM OF LOYALTY

The corporate system operates most efficiently where corporate actors act loyally—that is, deal fairly and in a trustworthy manner—and are perceived to do so. One way to achieve loyalty is by legal sanctions. This way is very expensive and probably has limited effectiveness, taken alone, because of the difficulty of detecting breaches of the duty of loyalty and the cost of legal enforcement. A second way to achieve loyalty is to install intracorporate monitoring and bonding systems. This way is somewhat more effective than a legal regime alone, but it is also very expensive—and the more effective it is to be, the more expensive it must be.

A third way to achieve loyalty is through the operation of the social norm of loyalty. This way is very inexpensive. Of course, if the loyalty norm is adhered to only because the actor fears reputational sanctions, the problem of detection remains significant. Drawing on terminology used by Bruce Chapman, I will refer to loyalty that is based on an internalized norm—particularly a norm that shapes character—as authentic, and to loyalty that is based on reputational concerns as instrumental. Instrumental loyalty is good, but authentic loyalty is better. Instrumental loyalty will be forthcoming only when disloyalty is easy to observe. Authentic loyalty will be forthcoming even when disloyalty is difficult to observe.

To put the extreme case, if all corporate actors fully internalized the social norm of loyalty and gave full effect to that norm, the costs of both legal sanctions and monitoring-and-bonding systems would be unnecessary, and the levels of loyalty would be much higher than those sanctions and systems can achieve. Accordingly, whatever the law does to increase the force of the social norm of loyalty, and further its internalization, will lead to greater efficiency. Whatever the law does to diminish the force of the social norm of loyalty, and lessen its internalization, will lead to diminished efficiency.

Authentic loyalty can run to an organization, or at least to the group of individuals that inhabit an organization, but it is not likely to run to a set of contracts. Accordingly, the critical role of the norm of loyalty in the success of the corporate system would be significantly undermined if the nexus-of-contracts conception held social sway. As Bruce Chapman has stated:

[C]orporate contracting cannot achieve all that this [contractual] view . . . promises unless it is aided by the very value that a contractual understanding of the fiduciary obligation denies, namely, the duty of loyalty and trust. Trust plays an essential role in all modern economies, and without it, or without the coordination that is provided by institutional loyalty, even efficient wealth-maximizing corporate contracting can make us all worse off. . . . Nor can the concept of trust be very easily accommodated into the contractual model of the corporation. Properly interpreted, the concepts of trust and loyalty present a deep challenge not only to that contractual model, but also the very conventions of instrumental rationality upon which the model is based.54

54. Cf. Campbell, supra note 2, at 354 ("The . . . 'fiduciary' quality of the fiduciary duty does not survive its [contractual] description.").
In short, the norm of loyalty serves the interest of efficiency, and the ideology of the nexus-of-contracts conception undermines the norm of loyalty. Accordingly, adoption of that ideology by the legal profession would threaten to undermine efficiency.

XI. CONCLUSION

What is at stake here? What difference does it make whether the nexus-of-contracts conception is accurate or inaccurate, coherent or incoherent?

At one level, what is at stake is simply getting things right; making sure that we employ a descriptive apparatus that is correct as a positive matter. At a deeper level, more is involved. The conception that the corporation is a nexus of contracts can be understood in either a very weak or a very strong sense. In its very weak sense, the conception means only that the corporation is by and large a product of private ordering, including not only reciprocal arrangements, but property rights, bureaucratic rules, and directions by superiors to subordinates. In this very weak sense, the conception has few positive implications and no normative implications.

If the rhetoric of corporate-law scholarship was restricted to this very weak sense, the nexus-of-contracts conception would not be objectionable. Typically, however, the nexus-of-contracts conception is used in a very strong sense, to mean that the corporation consists of, and only of, contracts and other reciprocal arrangements. This sense of the term is both descriptively inaccurate and intellectually incoherent. Furthermore, it gets in the way of clear thinking and directs attention away from the dual nature of the firm and the important fact that firms are utilized when the cost of inducing action by giving directions is less than the cost of inducing action by making real contracts. Moreover, this very strong sense, although nominally only descriptive, is often made to carry heavy normative freight. Logically, the freight cannot be carried—that is, the nexus-of-contracts conception, as a positive description, has no normative implications. Nevertheless, the conception is commonly, although fallaciously, used for normative purposes. Because the very strong sense of the nexus-of-contracts conception is untenable on positive grounds and misused on normative grounds, and because the very weak sense of the conception is so easily confused with the very strong sense, it would be best to drop the conception entirely, and to instead recognize the dual nature of the corporation.