

Shirking and Sharking: A Legal Theory of the Firm

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INTRODUCTION

Shirking and sharking, in all their many varieties, have been sown broadcast by the ill-fated cause; and even those who have contemplated its history from the outermost circle of such evil, have been insensibly tempted into a loose way of letting bad things alone to take their own bad course, and a loose belief that if the world go wrong, it was, in some off-hand manner, never meant to go right.¹

This Article reexamines economic theories of the firm from a legal perspective. These theories are said to have “dominated” and produced a “revolution” in legal scholarship in recent years,² particularly in the field of enterprise organization.³ In this Article, I accept the insights of this

1. CHARLES DICKENS, *BLEAK HOUSE* 21-22 (J.M. Dent & Sons 1901) (1852).

2. Jason Scott Johnston, *The Influence of The Nature of the Firm on the Theory of Corporate Law*, 18 J. CORP. L. 213, 213 (1993); see also Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657, 659 (1996) (describing the economic theories of the firm as “now the dominant paradigm in corporate law”); Aleta G. Estreicher, *Beyond Agency Costs: Managing the Corporation for the Long Term*, 45 RUTGERS L. REV. 513, 515 (1993) (arguing that analysis based on agency costs “still reigns supreme in the academic literature”). For some leading examples of this genre, see Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); William J. Carney, *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, 1988 WIS. L. REV. 385; Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986); and Saul Levmore, *Monitors and Freedivers in Commercial and Corporate Settings*, 92 YALE L.J. 49, 59-80 (1982).

3. I use the term “enterprise organization” to include legal agency, employment, partnerships, and corporations. For a casebook written along these lines, see ALFRED F. CONARD ET AL., *ENTERPRISE ORGANIZATION* (4th ed. 1987). See also Eric W. Orts, *The Future of Enterprise Organization*, 96 MICH. L. REV. — (1998) (book review) (arguing in favor of this broad conceptual approach). The term also includes nonprofit associations. Cf. *Developments in the Law—Nonprofit Corporations*, 105 HARV. L. REV. 1578 (1992). Although some of the analysis offered here may be applied to nonprofit organizations, the topic is left outside the scope of this

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scholarship, but recommend a significant expansion of its theoretical premises. In contrast to most economic accounts, I argue that legal theory is needed for an accurate description of the business firm. In particular, I contest economic theories of the firm that fail to appreciate the importance of legal relationships of agency authority, power, and hierarchy.

My main claim is that a recovery of traditional legal principles helps to clarify some problems in economic theories of the firm. These problems include omissions of both a descriptive account of how authority, power, and hierarchy are created within firms⁴ and a prescriptive discussion of how this authority, power, and hierarchy may be misused.⁵ A legal perspective can also help to resolve the conundrum in economics of distinguishing between firms and markets.⁶ The legal theory of the firm and its boundaries offered here brings together elements of various economic theories within a unified framework.⁷

My analytic style is the reverse of the usual article in "law and economics." Most law-and-economics scholarship begins with a legal problem and then applies economic analysis to find a solution. Instead, I begin with an economic problem—namely, conflicting theories of the firm—and use legal analysis to overcome conceptual difficulties.⁸

In this endeavor, some problems of conflicting terminology become apparent. Economists and lawyers often use the same terms differently. I argue for a precise use of terms such as "agency" and "contracts" that have legal origins and meanings. At the same time, any discussion of the "firm" must include an understanding of how economists have used the term given the roots of the idea in economic theory. The debate is not only semantic. A combination of legal *and* economic analysis opens the door for other disciplines besides economics to describe the social nature of the entities called firms.⁹

Article. The focus here is on the business firm.

4. See *infra* Parts I, II, IV.

5. See *infra* Part VI.

6. See *infra* Part III.

7. See *infra* Parts IV, V.

8. This methodology is consistent with a recent recommendation for a synthesis in legal scholarship to include "the microanalysis of institutions." Edward L. Rubin, *The New Legal Process, the Synthesis of Discourse, and the Microanalysis of Institutions*, 109 HARV. L. REV. 1393 (1996). Rubin describes a willingness to recognize the importance of noneconomic factors as characteristic of a "Post-Chicago School of Law and Economics." *Id.* at 1404; cf. RICHARD A. POSNER, *OVERCOMING LAW* 426-43 (1995) (describing the "new institutional economics" and its relation to neoclassical law and economics). For another useful approach employing both economic and legal analysis to firms, though with a different emphasis, see HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* (1996).

9. My interdisciplinary account is limited to law and economics (and perhaps a social theory combining them), but other social sciences are also helpful in studying firms. See, e.g., John C. Coffee, Jr., *The Folklore of Investor Capitalism*, 95 MICH. L. REV. 1970, 1982, 1988-89 (1997) (reviewing MICHAEL USEEM, *INVESTOR CAPITALISM: HOW MONEY MANAGERS ARE*

The Article proceeds as follows. Part I reconstructs two building blocks for a theory of the firm: legal agency and agency costs. In contemporary market economies, the law of agency gives individuals the power to enter into relationships that result in the construction of firms. The economics of agency gives a partial explanation (in addition to other economic reasons) for the ever-changing variety of these organizations.

Part II recommends an amendment to the economic conception of agency costs to include not only the costs of agents or *shirking* but also the costs of principals or *sharking*. Expanding on Dickens' description of the "many varieties" of "shirking and sharking" in *Bleak House*, the idea of sharking refers to the costs of principals who abuse their positions of authority and power within firms to act self-servingly. Sharking also refers to the costs of *quasi-principals* or "superior agents" who act with the authority of principals regarding lower-level agents under their direction.¹⁰ Because economists do not ordinarily focus on the relationships of authority, power, and hierarchy in legal agency, they have tended to overlook the costs of sharking.¹¹

Parts III and IV then turn to examine economic theories of the firm more broadly. Part III examines the difficulty that economic theory has in distinguishing between firms and markets. An analytical focus known in economics as "methodological individualism"¹² runs into a paradox when confronted with the existence of both firms and markets. To resolve this paradox, I distinguish between *consumer markets* for goods and services and *organizational metamarkets* of business firms.¹³ Economic success in consumer markets, deriving in part from efficiency in organizational metamarkets, drives a Schumpeterian process of "creative destruc-

CHANGING THE FACE OF CORPORATE AMERICA (1996)). Ethics is also important—a dimension that is discussed in the conclusion of this Article.

10. In other words, the concept of quasi-principals refers to people who are technically legal agents of the firm but who exercise authority as de facto principals for certain purposes. The most important example is the chief executive officer of a public corporation. The alternative term, "superior agent," is used in an initial draft of a new *Restatement of Agency*. RESTATEMENT (THIRD) OF AGENCY § 1.09 cmt, cmt c, illus. 1 (Preliminary Draft No. 1, 1997). For further discussion, see *infra* Section II.B.

11. This is beginning to change, however. For recent economic accounts of authority and power in the firm, see Phillip Aghion & Jean Tirole, *Formal and Real Authority in Organizations*, 105 J. POL. ECON. 1 (1997); and Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, — Q.J. ECON. (forthcoming).

12. Kenneth J. Arrow, *Methodological Individualism and Social Knowledge*, 84 AM. ECON. ASSOC. PAPERS & PROC. 1, 1 (1994).

13. The term *metamarket* describes a "higher or second-order" market for organizational forms that occurs above but not separate from consumer markets for goods and services. See THE CONCISE OXFORD DICTIONARY 745 (1990) (defining the Greek root); cf. Jane S. Schacter, *Metademocracy*, 108 HARV. L. REV. 593 (1995). This organizational metamarket is distinguished from consumer markets for analytical purposes only. In practice, both metamarkets and consumer markets operate together in the market-writ-large of everyday life. This distinction is further described *infra* Section III.B.

tion” of business firms in capitalist society.¹⁴ Part IV considers economic theories of the firm in addition to those that emphasize agency costs. Competing economic theories see transaction costs, contracts, property, and employment to be essential. I conclude that each of these models contributes to understanding the nature of the business firm, but none of them gives an adequate descriptive account of the role of law.

The theory of the firm advanced in Part V complements economic theories by collecting their fundamental insights under a legal umbrella. Legal forms of business enterprise called “firms” range from one-person *pure sole proprietors* to *relational firms* of corporate groups.¹⁵ Firms of more than one person are described as *a nexus of agency relationships*. Legal boundaries of the firm are drawn along the lines of control, ownership, and employment.

A number of areas of law recognize the importance of boundaries.¹⁶ Describing the boundaries of business firms, however, has been mostly left to economists. The question “What is a firm?” has generated an enormous amount of economic theory, beginning with Nobel laureate Ronald Coase’s *The Nature of the Firm*¹⁷ and continuing vigorously today.¹⁸ This Article contributes to the debate by advancing a theory of the firm that draws as heavily on law as on economics. It speaks to both lawyers and economists in arguing that firms cannot be understood in terms of either law or economics alone. A combination of both, with neither dominating the other, is required for an adequate descriptive account.¹⁹

14. JOSEPH SCHUMPETER, *CAPITALISM, SOCIALISM, AND DEMOCRACY* 83 (5th ed. 1976) (“The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers’ goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates. . . . This process of Creative Destruction is the essential fact about capitalism.”).

15. A common understanding of the “firm” is “a business concern” characterized by “a group of persons working together.” *THE CONCISE OXFORD DICTIONARY* 441 (1990). The account offered here departs from this definition in recognizing one-person firms and groups of firms. See *infra* Section III.B and Part V.

16. See Symposium, *Surveying Law and Borders*, 48 *STAN. L. REV.* 1037 (1996). Legal boundaries are not only “spatial” but conceptual, including those “that separate different value systems.” William Ian Miller, *Sanctuary, Redlight Districts, and Washington, D.C.*, 48 *STAN. L. REV.* 1235, 1246 (1996).

17. R.H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* (n.s.) 386 (1937), reprinted in R.H. COASE, *THE FIRM, THE MARKET, AND THE LAW* 33 (1988).

18. Two leading economists have recently published book length treatments of the firm. See HAROLD DEMSETZ, *THE ECONOMICS OF THE BUSINESS FIRM* (1995); OLIVER HART, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE* (1995); see also *THE ECONOMIC NATURE OF THE FIRM: A READER* (Louis Putterman & Randall S. Kroszner eds., 2d ed. 1996) (collecting articles on the subject); *THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT* (Oliver E. Williamson & Sidney G. Winter eds., 1991) (same).

19. Coase’s original work strongly supports this view emphasizing economics and law. See *infra* Section IV.B. In his 1991 Alfred Nobel Memorial Prize Lecture in Economic Sciences, Coase emphasized that “the rights which individuals possess, with their duties and privileges, will be to a large extent, what the law determines. As a result the legal system will have a pro-

Describing firms as legal entities also yields a more balanced normative approach to their regulation than strictly economic theories. Part VI argues that legal constraints should aim to reduce the costs of shirking and sharking as well as to enforce contractual bargains within firms.²⁰ Recognizing the importance of agency and principal costs helps to explain, for example, the need for mandatory fiduciary duties. The lesson with respect to classical agency costs or *shirking* is well known.²¹ Principal costs or *sharking* also support the judicial enforcement of fiduciary duties, rather than whittling them away.²² Four illustrations are given of situations in which principal costs may appear in corporations: majority shareholder “oppression” of minority shareholders,²³ excessive executive compensation, noncontractual but unjustified harm to debt-holders, and financial reengineering of capital structure designed solely to benefit one group of participants in a firm at the expense of others.

I. AGENCY LAW AND AGENCY COSTS

Let every eye negotiate for itself
And trust no agent²⁴

Shakespeare’s advice to distrust agents does not apply to all agency relationships.²⁵ The law of agency recognizes that some people act on behalf of others, and the business world would be radically different if it did not. In part because the law recognizes and enforces these relationships, it is possible to trust agents—within limits. Through agency law,

found effect on the working of the economic system, and may in certain respects, be said to control it.” Ronald H. Coase, *The Institutional Structure of Production*, 28 OCCASIONAL PAPERS FROM THE U. CHI. L. SCH., May 1992, at 9-10, quoted in Herbert J. Hovenkamp, *Market Efficiency and the Domain of the Firm*, 18 J. CORP. L. 173, 174 (1993).

20. Cf. William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1521 (1982) (emphasizing regulatory constraints to moderate the “conflicting interests and goals” among business participants as well as contractual bargains).

21. See *infra* Section I.B.

22. For examples of the currently popular argument for reducing mandatory fiduciary duties, see FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 90-108 (1991); Frank H. Easterbrook & Daniel R. Fischer, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 429-32 (1993); and Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1126-30 (1981). For opposing arguments favoring continuing enforcement of fiduciary duties in various circumstances, see, for example, Alison Grey Anderson, *Conflicts of Interest: Efficiency, Fairness, and Corporate Structure*, 25 UCLA L. REV. 738 (1978); Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595 (1997); and Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1 (1975).

23. The term “oppression” refers to the problem of protecting the “reasonable expectations” of minority shareholders in the absence of a contractual remedy. 2 JAMES D. COX ET AL., *CORPORATIONS* § 14.13 (1995).

24. WILLIAM SHAKESPEARE, *MUCH ADO ABOUT NOTHING*, act 2, sc. 1.

25. The context of the quotation is “the office and affairs of love,” *id.*, the agency implications of which lie outside the scope of this Article.

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principals are liable for contracts entered and torts committed by their agents.²⁶ Trusting agents is fundamental to any economic system.²⁷ At the same time, Shakespeare rightly advises against trusting agents too much.²⁸ Economic theories of agency costs provide a formal account of the tendency of agents to act for themselves rather than their principals. A problem in economic theory is to account for the agency relationships that nevertheless prevail in all walks of life.²⁹

When one considers both legal and economic accounts of agency, it becomes apparent that lawyers and economists do not fully understand one another. Lawyers often fail to appreciate the complexity of economic theories, and economists often overlook the complexity of the law of agency and enterprise organization. This Article aims to improve mutual understanding by bringing together both legal and economic conceptions of agency.

A. *Legal Agency: Authority, Power, and Hierarchy in the Firm*

Agency law enables individuals to create relationships of authority and power among themselves. In this sense, agency provides an example of what H.L.A. Hart calls “power-conferring” rules.³⁰ “The principles of agency have made it possible for persons to utilize the services of others

26. In contracts, even “undisclosed” principals may be held liable for contracts entered by their agents. RESTATEMENT (SECOND) OF AGENCY §§ 186, 194 (1958). In torts, principals are vicariously liable for the harmful acts of their agents who are servants under the doctrine of respondeat superior. *See id.* § 219(1) (“A master is subject to liability for the torts of his servants committed while acting in the scope of their employment.”); *id.* § 220 (defining servant). For further discussion of vicarious liability as forming one of the legal boundaries of the firm, see *infra* Subsection V.B.2.

27. Cf. KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 23 (1974) (“Trust is an important lubricant of a social system. It is extremely efficient; it saves a lot of trouble to have a fair degree of reliance on other people’s word.”); FRANCIS FUKUYAMA, TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY 152 (1995) (“We often take a minimal level of trust and honesty for granted and forget that they pervade everyday economic life and are crucial to its smooth functioning.”); TRUST IN ORGANIZATIONS: FRONTIERS OF THEORY AND RESEARCH (Roderick M. Kramer & Tom R. Tyler eds., 1996) (collecting recent research on the importance of trust); Lawrence E. Mitchell, *Trust, Contract, Process*, in PROGRESSIVE CORPORATE LAW 185, 185 (Lawrence E. Mitchell ed., 1995) (“Trust is one of the most important institutions binding our society. . . . Trust enables us to give others the power to manage our money and to run our businesses.”). For critical accounts of the role of trust in modern society, see also ADAM B. SELIGMAN, THE PROBLEM OF TRUST (1997); Daryl Koehn, *Should We Trust in Trust?*, 34 AM. BUS. L.J. 183 (1996).

28. This is perhaps especially true in matters of love, the context of Shakespeare’s play, see *supra* note 25, but it is also true in business.

29. In economic terms, the benefits of agency relations must often exceed their costs. *See, e.g.*, DEMSETZ, *supra* note 18, at 11; *see also* Hovenkamp, *supra* note 19, at 184 (“The fact that much of our economy is dominated by firms suggests that the degree of market imperfection in a world when such firms could not exist must be very large indeed.”).

30. H.L.A. HART, THE CONCEPT OF LAW 40-41 (1972); *see also* Eric W. Orts, *Positive Law and Systemic Legitimacy*, 6 RATIO JURIS 245, 246-47 n.3 (1993) (analyzing Hart’s distinction between power-conferring and duty-imposing rules and collecting sources).

in accomplishing far more than could be done by their unaided efforts," observes the *Restatement of Agency*.³¹ Legal agency is ubiquitous,³² and businesses of all sorts "depend for their existence on agency principles."³³ No wonder Oliver Wendell Holmes calls agency one of the "great departments of the law."³⁴

Agency principles expressed in law are needed to account for firms because the essential feature of the firm is not the agreement of individuals through contracts—which also characterize transactions in markets—but the creation of legal authority and power, often in a hierarchical form.³⁵ Hierarchy is not always necessary. The default rule in partnerships, for example, creates equal authority and power in each partner to bind the other in the market.³⁶ Even general partnerships of equal authority, however, usually have employees, and employment is usually hierarchical.³⁷

31. RESTATEMENT (SECOND) OF AGENCY § 8A cmt. a (1958).

32. See CONARD ET AL., *supra* note 3, at 3 (describing agency as "embracing all the people who work for somebody else (or have somebody working for them)"); JOSEPH L. FRASCONA, AGENCY at ix (1964) (arguing that agency "is as integral a part of activity in society as anything one can think of").

33. RESTATEMENT (SECOND) OF AGENCY § 8A cmt. a (1958); see also CONARD ET AL., *supra* note 3, at 3 (observing that the primary function of agency law is to make possible the commercial enterprise which could not exist otherwise).

34. Oliver Wendell Holmes, *Agency—Part I*, 4 HARV. L. REV. 345, 348 (1891) (agency and torts); see also Oliver Wendell Holmes, *Agency—Part II*, 5 HARV. L. REV. 1 (1891) (agency and contracts). Today, many introductory casebooks in enterprise organization neglect the law of agency. For exceptions to the rule, see CONARD ET AL., *supra* note 3, at 181-327; DEBORAH A. DEMOTT, FIDUCIARY OBLIGATION, AGENCY AND PARTNERSHIP: DUTIES IN ONGOING BUSINESS RELATIONSHIPS 67-346 (1991); MELVIN A. EISENBERG, AN INTRODUCTION TO AGENCY AND PARTNERSHIP 1-27 (2d ed. 1995); WILLIAM A. KLEIN & J. MARK RAMSEYER, BUSINESS ASSOCIATIONS: AGENCY, PARTNERSHIPS, AND CORPORATIONS 11-81 (3d ed. 1997). A new *Restatement of Agency* sponsored by the American Law Institute may restore agency law to its rightful place. See RESTATEMENT (THIRD) OF AGENCY (Preliminary Draft No. 1, 1997).

35. See Geoffrey P. Miller, *Finance and the Firm*, 152 J. INSTITUTIONAL & THEORETICAL ECON. 89, 91 (1996) ("[M]any scholars have resisted the impulse to reduce relationships among participants in a firm to a series of actual or implied market contracts. Hierarchies do exist in firms, and even if relations within firms can be characterized in a sense as contracts, they may not easily be assimilated into a simple contractual framework."); see also *supra* note 11 and accompanying text.

36. See UNIF. PARTNERSHIP ACT § 9(1) (1994) ("Every partner is an agent of the partnership for the purpose of its business, and the act of every partner . . . for apparently carrying on in the usual way the business of the partnership of which he [or she] is a member binds the partnership . . ."). It is also true that small groups of individuals may organize work "cooperatively, without formal internal organization or direction." Lee E. Preston & James E. Post, *The Third Managerial Revolution*, 17 ACAD. MGMT. J. 476, 477 (1974). But the development of hierarchical organization—perhaps first in military, political, or religious forms—stands as an important "revolution" in business and economics. See *id.* at 477-78.

37. However, it is possible for employees to own and participate in the management of firms. For discussion of the law and economics of employee ownership, see HANSMANN, *supra* note 8, at 66-119; Bainbridge, *supra* note 2; Henry Hansmann, *Worker Participation and Corporate Governance*, 43 U. TORONTO L.J. 589 (1993); Henry Hansmann, *When Does Worker Ownership Work?*, 99 YALE L.J. 1749 (1990); Alan Hyde, *In Defense of Employee Ownership*, 67 CHI.-KENT L. REV. 159 (1991); Marlene A. O'Connor, *The Human Capital Era*, 78 CORNELL L.

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Law explains the relationships of authority, power, and hierarchy in firms. The prominent economic theory of the firm that maintains 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”³⁸ is therefore incorrect.³⁹ The essence of agency is authority, power, and hierarchy.

It is important to emphasize that the legal relationships that compose firms are not simply contracts. Some economists adopt a contractarian model of law when thinking about firms.⁴⁰ Although legal agency is most often created through a special kind of contract, it is something more.⁴¹ A contract alone does not create the open-ended relationships of agency authority characteristic of most business firms. For example, a business that hires an employee creates an agency relationship that extends beyond the explicit terms of the employment contract.⁴² In corporate law, to take another example, agency authority inheres in the board of directors even for participants who join after the corporation is formed.⁴³ Firms are more than a matter of contracts because of the importance of the relationships of authority and power among principals and agents organized within a business entity.

A schematic illustration may help to make the point. In the simplest contract, there are two parties, *A* and *B*. In the simplest agency relation-

REV. 899 (1993). Employment is further discussed *infra* Section IV.D and Subsection V.B.2.

38. Armen Alchian & Harold Demsetz, *Production, Information Costs and Economic Organization*, 62 AM. ECON. REV. 777 (1972), reprinted in HAROLD DEMSETZ, OWNERSHIP, CONTROL, AND THE FIRM: THE ORGANIZATION OF ECONOMIC ACTIVITY 119, 119 (1988).

39. See Bainbridge, *supra* note 2, at 663 (observing “a sharp disconnect between Alchian and Demsetz’s argument and the real world of work”). The exception is the one-person firm without internal agency relationships. See *infra* Sections III.B, V.A.

40. For further description and criticism of the contractarian theory of the firm, see *infra* Section IV.B.

41. Legal agency is often formed by contract, but not always. Creating an agency requires only “the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other to so act.” RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958). Because “agency does not depend upon the intent of the parties to create it, nor their belief that they have done so . . . , there must be an agreement, but not necessarily a contract, between the parties” *Id.* § 1(1) cmt. b; see also HAROLD GILL REUSCHLIEN & WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP § 12, at 31 (2d ed. 1990) (“The [agency] relationship is most often thought of as being contractual though it is not necessary that the relationship arise out of a contract.”). Unlike most contracts, agency does not require consideration. See RESTATEMENT (SECOND) OF AGENCY § 16 (1958); see also REUSCHLIEN & GREGORY, *supra*, § 12, at 31. Gratuitous agents are possible. See RESTATEMENT (SECOND) OF AGENCY § 16 cmt. b (1958). Also unlike contracts, agency does not impose a minimum age of capacity. Compare E. ALLAN FARNSWORTH, CONTRACTS 214-20 (2d ed. 1990) (discussing rule in contracts that agreements made by minors under the age of 18 are voidable), with RESTATEMENT (SECOND) OF AGENCY § 21(1) (1958) (“Any person has capacity to hold a power to act on behalf of another.”).

42. See *supra* note 26 and accompanying text. The employment relationship is also discussed *infra* Section IV.D and Subsection V.B.2.

43. The authority structure of the corporation is further discussed *infra* Section V.D.

ship, there are three: the principal *A*, the agent *B*, and a third-party *C*.⁴⁴ In a contractual relationship between *A* and *B*, a third-party may hold *A* liable only through contract or tort theories that go to *A*'s own actions, such as the third-party beneficiary doctrine in contracts⁴⁵ or negligence where *A* should have known that a danger to a third-party may result.⁴⁶ In contrast, an agency relationship between *A* and *B* raises the possibility that *C* may hold *A* directly liable for the actions of *B*. This sort of vicarious liability characterizes the firm.⁴⁷ The origin of a business "entity" of more than one person thus lies in agency law. Firms do not arise from contracts alone.

Although legal agency explains the existence of firms involving more than one person, agency law is not sufficient to determine the boundaries of firms.⁴⁸ Because legal agency appears outside as well as within firms, a description of the firm relying purely on agency law would be overinclusive. A good example is a client's decision to retain a lawyer. Although the lawyer acts as an agent for the client as a principal, a business firm is not thereby created.⁴⁹

Legal agency relationships are one foundation of business organizations. Without legal agency, business firms of any complexity are impossible. By the same token, agency law alone cannot explain the nature of

44. See 1 FLOYD R. MECHEM, A TREATISE ON THE LAW OF AGENCY § 27, at 14-15 (1914) (noting that an agency relationship contemplates at least three persons: a principal, an agent, and a third-party to whom the relation of agency matters or makes relevant). The six possible combinations of duties and liabilities that result compose the six divisions of the law of agency. See *id.*

45. See FARNSWORTH, *supra* note 41, at 709-44 (discussing contract beneficiaries). Efforts to clarify the law of third-party beneficiaries have focused on the need for *A* to have "intended" to benefit *C* in the contract with *B*. RESTATEMENT (SECOND) OF CONTRACTS § 302(1) (1979) (describing "intended beneficiary"). For a critical analysis of this approach, see Melvin Aron Eisenberg, *Third-Party Beneficiaries*, 92 COLUM. L. REV. 1358 (1992). Eisenberg proposes a similar test limited by "the contracting parties' performance objectives." *Id.* at 1385.

46. See RESTATEMENT (SECOND) OF TORTS § 324A (1965) ("One who undertakes . . . to render services to another which he [or she] should recognize as necessary for the protection of a third person or his [or her] things, is subject to liability to the third person for physical harm resulting from his [or her] failure to exercise reasonable care . . .").

47. See *supra* note 26 and accompanying text; see also *infra* Subsection V.B.2 (discussing employment relationships and vicarious liability for torts).

48. The various legal types of firms are described in more detail in Part V.

49. There are exceptions. For example, a corporate general counsel hired as a full-time employee would be counted a part of a firm.

One commentator on a draft of this Article suggested that a lawyer-client relationship might be considered a "project firm" of relatively short duration, but this approach would define any contractual or agency relationship as creating a firm. The description offered here is narrower in part because of the usefulness of maintaining an analytical distinction between firms and markets. See *infra* Part III. The usual lawyer-client relationship is best described as an independent contractor relationship that falls outside the boundaries of the firm on a number of grounds, including lack of common financial ownership in the enterprise and lack of direct control on the part of the principal client over the agent lawyer. For further discussion of the legal boundaries of the firm, see *infra* Part V.

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firms. Economic considerations also determine the sizes and shapes of firms.

B. Agency Costs: Classical Shirking

The internal costs of organization known in the economic literature as agency costs provide one important theoretical explanation for limitations on the size of firms. Firms respond to economic pressures both externally in consumer markets and internally. The importance of consumer markets for goods and services is addressed in Part III. Here, the internal costs of organization are emphasized.

In contrast to the ancient ancestry of agency law,⁵⁰ economic theories of agency costs are relatively recent.⁵¹ As a term of art, “agency costs” describe the inevitable risks that agents will act for themselves rather than their principals.⁵² In other words, theories of agency costs start from the assumption that people will act in their own self-interests. From this premise, these theories must then explain two facts about the world: (1) agency relationships exist in great numbers despite their costs, and (2) agents often act on behalf of their principals.

Agency costs theory explains this empirical reality in terms of two measures by which a principal can reduce agency costs. First, the principal may devise mechanisms of *monitoring* the agent.⁵³ For example, in a lawyer-client relationship, the client as principal may scrutinize the lawyer’s bill to make sure it is accurate. Or the client may insist on a flat or fixed fee for the lawyer’s services rather than the usual hourly-rate

50. Agency appears in its rudimentary form in Blackstone’s *Commentaries* and in Roman law. See 1 MECHEM, *supra* note 44, §§ 11-21, at 5-10 (discussing Blackstone’s treatment of the law of “master and servant”); P.W. DUFF, *PERSONALITY IN ROMAN PRIVATE LAW* (1938) (noting Roman concepts of legal personality that would be translated today into principles of agency). The first English treatise on agency law is William Paley’s *Principal and Agent* published in 1812. See 1 MECHEM, *supra* note 44, § 23, at 10. Agency in its modern form developed after the Industrial Revolution in the “commercial age.” *Id.* § 10, at 5 (“A non-commercial society, while it might have much use of servants, would have little need of agents.”).

51. See, e.g., Stephen A. Ross, *The Economic Theory of Agency: The Principal’s Problem*, 62 AM. ECON. REV. 134 (1973); see also Norman E. Bowie & R. Edward Freeman, *Ethics and Agency Theory: An Introduction*, in ETHICS AND AGENCY THEORY 3, 4 (Norman E. Bowie & R. Edward Freeman eds., 1992) (describing Ross’s article as one of the first “influential” contributions to “modern agency theory”).

52. One influential economic theory defines an agency relationship as “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.” Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976); see also Daniel Levinthal, *A Survey of Agency Models of Organizations*, 9 J. ECON. BEHAV. & ORG. 153, 155 (1988) (articulating a similar definition derived from literature survey).

53. See Jensen & Meckling, *supra* note 52, at 308 (“The *principal* can limit divergences from his [or her] interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent.”).

method of billing.⁵⁴ Second, the principal and agent may agree that the agent will share in the principal's risk and reward to encourage the agent to act in the principal's best interest. This is called *bonding*.⁵⁵ In the lawyer-client example, contingency fees illustrate bonding.⁵⁶

Monitoring and bonding are then combined to define agency costs as the combination of:

- (1) the monitoring expenditures by the principal,
- (2) the bonding expenditures by the agent, [and]
- (3) the residual loss.⁵⁷

"Residual loss" refers to the economic costs suffered by the principal due to the self-interested behavior of the agent. According to this theory, principals will enter into agency relationships when the sum of these costs are outweighed by (1) the net gains achieved through monitoring and bonding and (2) the other economic gains that agency relationships make possible, including increased efficiency allowed by specialization and "team production."⁵⁸

The classical agency costs approach to the firm emphasizes the need to monitor and bond agents in order to prevent them from *shirking*.⁵⁹ It is a funny word, *shirking*, but it is meant seriously. The assumption is that agents—whether they are employees beholden to managers, or managers

54. It will pay the client to monitor the lawyer if the risks of legal agency costs are large enough, though economists are also quick to point out the costs of monitoring (e.g., paying someone to review the lawyer's bills, haggling over a fixed fee, and risking a lower quality of service if the usual rates are not paid). For a review of current fixed fee billing methods, as well as a list of the "Top 10 Reasons [Legal] Bills Are Unpaid," see Barry Solomon & Rachel Gibbons, *Coming to Terms with New Billing Methods*, NAT'L L.J., Nov. 23, 1992, at S4.

55. See Jensen & Meckling, *supra* note 52, at 308 ("In addition [to monitoring] in some situations it will pay the agent to expend resources (bonding costs) to guarantee that he [or she] will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he [or she] does take such actions.").

56. For a description and criticism of these arrangements, see, for example, LESTER BRICKMAN ET AL., *RETHINKING CONTINGENCY FEES* (1994).

57. Jensen & Meckling, *supra* note 52, at 308 (citation omitted).

58. Economic theories have emphasized the benefits of specialization and the division of labor in many historical variations. For three well-known examples, see FRANK KNIGHT, *RISK, UNCERTAINTY, AND PROFIT* 271 (Augustus M. Kelley 1964) (1921) (emphasizing the "manifold specialization of function" in business enterprise); 1 KARL MARX, *CAPITAL: A CRITIQUE OF POLITICAL ECONOMY* 368-94 (Samuel Moore & Edward Aveling trans., 1909) (1859) (describing the division of labor and specialization in capitalist manufacturing); and ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* 3-12 (The Modern Library 1934) (1776) (including the famous example of specialization in pin-making). For an economic account of "team production" emphasizing agency costs, see Alchian & Demsetz, *supra* note 38, at 121-24. Other economic theories present competing accounts of the benefits of agency relationships organized within the legal structure of firms. An overview of these theories is given *infra* Part IV.

59. One of the best descriptions of shirking is given in Alchian & Demsetz, *supra* note 38, at 123, 124-26, 131-33, 137; see also Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375 (1983), reprinted in DEMSETZ, *supra* note 38, at 187, 191-97.

beholden to the corporate enterprise—will shirk their responsibilities when given half a chance. In other words, if not sufficiently monitored or bonded, agents will be lazy or irresponsible—or at least not entirely selfless in their motivations.⁶⁰

Agency costs theory has been criticized for assuming an overly pessimistic view of human nature, and there is some weight in this criticism.⁶¹ Ethical norms, including altruism, may influence people more than some economists admit.⁶² Agency costs theory has also been criticized for “its narrow view of rationality.”⁶³ It is probably not realistic to assume that agents always want to shirk or “slack off.” Often agents *like* to work.⁶⁴ Still, it remains true that employees and other agents often find themselves tempted not to work as hard as they should. As a result, a theory of agency costs has descriptive power as long as many people act in a self-interested fashion much of the time. Because any realistic theory of the firm must account for the tendency of people to act self-servingly, the concept of agency costs is helpful in understanding the economics of firms.⁶⁵ The economics of agency helps to determine whether a firm con-

60. See also *infra* Section III.A (discussing neoclassical assumptions of selfishness and methodological individualism).

61. For a collection of essays criticizing economic agency theories on ethical grounds, see ETHICS AND AGENCY THEORY, *supra* note 51. For an analysis of ethical problems posed under a contractual theory of the firm, see John R. Boatright, *Business Ethics and the Theory of the Firm*, 34 AM. BUS. L.J. 217 (1996). The contractual theory of the firm, which is related to agency costs theory, is discussed and criticized *infra* Section IV.B.

62. A connection between law and norms is taken for granted in this Article without elaboration. For a recent collection of articles on the topic, see Symposium, *Law, Economics & Norms*, 144 U. PA. L. REV. 1643 (1996). For an argument that norms are as important as legal constraints in corporate law, see Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997).

63. Levinthal, *supra* note 52, at 154 (“As with neoclassical theory more generally, agency theory can be criticized from a behavioral perspective for its narrow view of rationality and its assumptions regarding economic agents’ cognitive abilities.”). Behavioral economics has not yet been widely influential in the legal literature. For exceptions applying behavioral economics to federal securities regulation, see Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Misperceive Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997); and Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627 (1996).

64. For a criticism of the assumption in agency-costs theory that agents will always have a disutility for effort, see Bengt Holmstrom & Joan Richart Costa, *Managerial Incentives and Capital Management*, 101 Q.J. ECON. 835 (1986).

65. For the most important expositions of economic theories of agency costs as they relate to theories of the firm, see Alchian & Demsetz, *supra* note 38; Demsetz, *supra* note 59; Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980), reprinted in THE ECONOMIC NATURE OF THE FIRM, *supra* note 18, at 315; Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Jensen & Meckling, *supra* note 52; and Benjamin Klein, *Contracting Costs and Residual Claims: The Separation of Ownership and Control*, 26 J.L. & ECON. 367 (1983). For critical surveys of the literature, see Kathleen M. Eisenstadt, *Agency Theory: An Assessment and Review*, 14 ACAD. MGMT. REV. 57 (1989); and Levinthal, *supra* note 52.

tinues, changes, or disappears.⁶⁶

Although agency costs help to explain the economic dynamics of firms, they are not sufficient to explain the existence of firms and their boundaries. Whether it makes economic sense to enter into a firm with a legal agency structure depends on other economic costs and benefits, as well as agency costs.⁶⁷ In addition, agency costs cannot explain *how* rather than *why* some work is internalized in firms rather than contracted for across markets. In other words, economic theories cannot explain the mechanisms by which people bind themselves together into firms rather than dealing with each other as individuals in markets.⁶⁸ Only in combination with legal principles can economic theories, including those that emphasize agency costs, provide a conceptual foundation for understanding what business firms are and where they come from.

II. PRINCIPAL COSTS

Shark: to prey like a shark upon; to victimize, sponge upon, swindle; to oppress by extortion.⁶⁹

Economic theory tends to see the costs of agency relationships from the principal's perspective—hence *agency* costs. But this tells only half the story. The costs that principals impose on agents should also be considered.

Take, for example, the lawyer-client relationship. In economic theory, the agency costs of the relationship are borne by the client as principal. The client bears the risk that the lawyer will shirk. In economic terms, Dickens' description of the never-ending case of Jarndyce and Jarndyce is a story of the agency costs of lawyers.⁷⁰ Perhaps even the legal system

66. Agency costs also exist in agency relationships that do not cohere into firms. For example, in the lawyer-client relationships discussed above, *see supra* Section I.A, clients may incur agency costs. A good example is a lawyer in a class action who may tend to act contrary to the best interests of the class of plaintiffs. *See, e.g.,* John C. Coffee, Jr., *Rethinking the Class Action: A Policy Primer on Reform*, 62 IND. L.J. 625, 633 (1987) (describing the agency costs of plaintiff class action attorneys).

67. Other economic costs and benefits of firms are described *infra* Parts II, III, IV.

68. This puzzle and a proposed solution are further discussed *infra* Part III.

69. 9 THE OXFORD ENGLISH DICTIONARY 634 (1933). *Shark* used in this fashion shares its etymology with *shirk*. Both words trace their origins to the old German *schurke*, which is now used to refer generally to a "scoundrel or villain." *Id.* at 633.

70. Dickens' description of "shirking and sharking," *see supra* text accompanying note 1, refers to "the ill-fated cause" of this self-perpetuating and "perennially hopeless" litigation. DICKENS, *supra* note 1, at 21, 52. As Dickens further describes the case:

The Lawyers have twisted it into such a state of bedevilment that the original merits . . . have long disappeared from the face of the earth. It's about a Will, and the trusts under a Will—or it was, once. It's about nothing but Costs, now. We are always appearing, and disappearing, and swearing, and interrogating, and filing, and cross-filing, and arguing, and sealing, and motioning, and referring, and reporting, and revolving about the Lord Chancellor and all his satellites, and equitably waltzing ourselves off to

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as a whole conspires to increase the costs of doing business.⁷¹ But the lawyer as agent also bears risks in the relationship. The client may fail to pay for the lawyer's services, or the client may exploit the lawyer's expertise or reputation in a fraudulent scheme. To look at agency only from the principal's perspective ignores the agent's risks.

An agency costs theorist may respond that this is only the flip-side of the same problem. Choosing to look at the costs of agency only from the principal's perspective, however, privileges the principal in a manner that obfuscates the total economic costs of agency. One of the first and most important contributions in agency costs theory is subtitled *The Principal's Problem*.⁷² It reveals a bias that tends to focus on the opportunism of agents rather than principals. Principals may also take advantage of agents, and these costs of organization should be included in a theory of the firm.

A. Sharking Defined: Opportunism of Principals Within Firms

Recognizing that agency is a two-way street, J. Gregory Dees urges "an attempt to correct the biases" in agency theory "by refining and enriching principal-agent models" to include the agent's perspective.⁷³ The theory of the firm advanced here responds to this concern about *the agent's problem*. Like principals, agents face risks in agency relationships. Trust in agency cuts both ways.

A complete theory of agency and principal costs should expand the

dusty death, about Costs.

Id. at 122.

71. In this regard, Dickens' *Bleak House* illustrates that there is nothing new about lawyer-bashing:

The one great principle of English law is, to make business for itself. There is no other principle distinctly, certainly, and consistently maintained through all its narrow turnings. Viewed by this light it becomes a coherent scheme, and not the monstrous maze the laity are apt to think it. Let them but once clearly perceive that its grand principle is to make business for itself at their expense, and surely they will cease to grumble.

DICKENS, *supra* note 1, at 509; *see also* Max Radin, *The Ancient Grudge: A Study in the Public Relations of the Legal Profession*, 32 VA. L. REV. 734 (1946) (tracing antilawyer sentiment to classical Greece).

72. *See* Ross, *supra* note 51.

73. J. Gregory Dees, *Principals, Agents, and Ethics*, in *ETHICS AND AGENCY THEORY*, *supra* note 51, at 25, 49. As Dees observes:

Principal-agent models focus on the principal's problem, from the principal's point of view. The principal's interests drive the model and determine the shape of the contract that results. The contract must protect the principal from the agent's opportunism. Yet it may fail to adequately protect the agent from the principal's opportunism. This can be a serious problem for prescriptive uses of principal-agent analysis.

Id. "More work should be done," Dees concludes, "on the development of reciprocal principal-agent models to capture situations in which both sides are vulnerable to opportunism." *Id.*

vocabulary used to describe different kinds of opportunism in agency relationships. The well-known term *shirking* characterizes the principal's problem. *Sharking* captures the reverse possibility that principals may take undue advantage of their positions of power and authority to the detriment of the interests of their agents.

Some economists recognize the costs of opportunism in general to be important.⁷⁴ The general concept of opportunism is too broad to be useful in advancing a theory of the firm, however, because it does not distinguish between principals and agents. Adding law to the theoretical picture reveals a long-standing concern with this distinction.⁷⁵ In addition, the general problem of opportunism appears outside the boundaries of the firm as well as inside. Opportunistic behavior occurs in arms-length bargaining in open-market contracts as well as within the legal agencies of firms. For an account of organizational costs *within* firms, the costs of *opportunism in markets* must be distinguished from the costs of *opportunism in the agency relationships that compose firms*. Broad accounts of economic opportunism may be useful for other purposes, but the more limited concepts of shirking and sharking are used here to refer to the costs of opportunism of agents and principals within firms.

B. Agency Chains: Quasi-Principals and Superior Agents

In addition to the two-way costs of opportunism, agency relationships in firms also become complex in other ways. Contrary to the simplifying assumptions of some economic theories that conceive only of principals and agents, many firms create what may be called *agency chains* in which the same individuals may sometimes act as "agents" and sometimes "principals" depending on the circumstances. Legal theory is more adept than economics in capturing the nature of these relationships.

74. An account of opportunism figures largely, for example, in the economic theory advanced by Oliver Williamson. See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* 47-49, 64-67 (1985). He broadly defines "opportunism" as "self-interest seeking with guile," which includes "more blatant forms, such as lying, stealing, and cheating" and "more subtle forms of deceit." *Id.* at 47. Opportunistic behavior of principals as well as agents also appears in theories that emphasize the "influence costs" of "individuals within an organization seeking to influence its decisions for their private benefit." Paul Milgrom & John Roberts, *Bargaining Costs, Influence Costs, and the Organization of Economic Activity*, in *THE ECONOMIC NATURE OF THE FIRM*, *supra* note 18, at 162, 163. Another account of the perils of opportunism of those acting within the firm is described by the "gains of position" that members of the executive group in a corporation may be able to make[.] . . . gains that are not made in fulfillment of the entrepreneurial 'function' but can be made by those who fill this function." JOSEPH A. SCHUMPETER, *HISTORY OF ECONOMIC ANALYSIS* 897 n.12 (1954) (quoting ROBERT A. GORDON, *BUSINESS LEADERSHIP IN THE LARGE CORPORATION* 272 (1945)).

75. For example, an entire chapter of the *Restatement (Second) of Agency* is devoted to the various duties and responsibilities which principals owe to agents, as well as vice versa. *RESTATEMENT (SECOND) OF AGENCY* ch. 14 (1958).

Consider the following example: *A* is a chief executive officer, *B* is a middle manager, and *C* is a rank-and-file employee. *A* acts as an agent of the firm as a whole but also has the authority of what the *Restatement of Agency* calls a “superior agent” with respect to *B* and *C*.⁷⁶ *B* answers as an agent with respect to *A*’s authority but acts as a superior agent to *C*. Whether an individual in a firm acts with the authority of a “principal” or answers to others as an “agent” depends on the circumstances and the relative place of a person in an agency chain.

The most important contemporary example of the ambiguity of principal and agent relations in corporations is the chief executive officer and the chair of the board of directors. Although the two positions are sometimes separated, one person holds both titles in most corporations in the United States.⁷⁷ In this case, the CEO and chair of the board wears “two hats” as both an agent of the corporation and its de facto principal. On one hand, the chair of the board is a high-level agent of the corporation and its shareholders.⁷⁸ On the other, a CEO or president usually exercises powers akin to a principal in having the authority (nominally delegated from the board) to act as the corporation in most ordinary transactions, including most contracts with lower-level employees. In other words, cases have held that the chief executive of a corporation exercises “inherent agency power.”⁷⁹

Another example of principal-agent ambiguity is a general partnership in which the partners hire an employee agent.⁸⁰ With respect to em-

76. RESTATEMENT (THIRD) OF AGENCY § 1.09, cmt., cmt. c, illus. 1 (Preliminary Draft No. 1, 1997).

77. See Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 914 & n.85 (1996) (revealing that more than three-quarters of CEOs in the U.S. also chair the board). In contrast, the two positions are usually split in Great Britain. See Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2022 (1994). For a recent recommendation for reform that would require companies listed on the New York Stock Exchange and NASDAQ to disclose whether they have a separate chair or “lead director” of the board, see Constance E. Bagley & Richard H. Koppes, *Leader of the Pack: A Proposal for Disclosure of Board Leadership Structure*, 34 SAN DIEGO L. REV. 149 (1997).

78. See, e.g., *Bayer v. Beran*, 49 N.Y.S.2d 2, 5 (Sup. Ct. 1944) (“Directors are agents; they are fiduciaries. . . . Those obligations apply with equal force to the humblest agent or broker and to the director of a great and powerful corporation. They lie at the very foundation of our whole system of free private enterprise and are as fresh and significant today as when they were first formulated. . . .”).

79. See RESTATEMENT (THIRD) OF AGENCY § 1.08 cmt. (Preliminary Draft No. 1, 1997) (“Case law for the most part supports the proposition that a corporation’s president (especially a president who is also the chief executive officer . . .) presumptively has powers that may be exercised independently from the control of the corporation’s board of directors. . . . The power is inherent in the president’s appointment to a particular position.”). *Id.* cmt. b (collecting cases).

80. See RESTATEMENT (SECOND) OF AGENCY § 20 cmt. f (1958) (“A number of persons, such as members of a partnership, may act jointly in the authorization of an agent . . .”).

ployee agents or third parties, each partner acts as a principal. With respect to each other, however, the partners are agents.⁸¹ Likewise, it is common in business enterprise to hire a number of agents who owe fealty to different principals or owners.⁸² The law of agency allows for the complexity in practice of “dual agents” and “ambiguous principals.”⁸³

Many of the most powerful individual actors in contemporary society are characterized in law as agents of others. “In a world thought to be more egalitarian,” writes one scholar, “the agents now governed by corporate law are those who might individually have been principals in pre-modern eras.”⁸⁴ For these modern princes, including corporate CEOs, the term *quasi-principal* may be coined to capture their double lives—agents for others (their corporations and shareholders) and de facto principals who hold vast authority and power.⁸⁵

III. FIRMS AND MARKETS

[T]he broader history of the theory of the firm . . . reveals the major shaping role of conjunctions of circumstances that . . . do not reflect the internal logic of the subject matter. . . . Without demeaning the contributions that any of us have made, I think we must acknowledge that the present state is one of incoherence. If we ask, “What does economics have to say about the role of the business firm in a market economy?” the response will be silence followed by an excited babble of significantly conflicting answers—an interesting babble, but a babble nonetheless.⁸⁶

81. See REVISED UNIF. PARTNERSHIP ACT § 301(1) (1994) (“Each partner is an agent of the partnership for the purpose of its business.”).

82. See, e.g., RESTATEMENT (SECOND) OF AGENCY § 41 (1958) (allowing for the creation of “joint” principals and agents acting for a “joint account”). For an economic discussion of “multi-agent models,” see Levinthal, *supra* note 52, at 174-77. These more complex economic models of agency have not yet been fully developed.

83. RESTATEMENT (SECOND) OF AGENCY § 313 (1958) (stating that a dual agent must be disclosed to both principals); *id.* § 14L (discussing the duties of an ambiguous principal). This legal account casts doubt on recent claims that the law of enterprise organization should always prevent situations where an agent “serves two masters.” The argument is advanced by some scholars who promote a strict shareholders-only view of the fiduciary duties of corporate managers and directors. See, e.g., EASTERBROOK & FISCHER, *supra* note 22, at 38 (“[A] manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither.”). “Thou shalt not serve two masters” may be true as a matter of theology, but not law. Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121, 158 (1991) (quoting *Matthew* 6:24 (King James)); see also WARREN A. SEAVEY, HANDBOOK OF THE LAW OF AGENCY § 147 (1947) (“If a dual agency is disclosed to both principals, an agent ‘can properly represent competing or even antagonistic interests’”).

84. JOSEPH VINING, FROM NEWTON’S SLEEP 321 (1995).

85. As in the days of Machiavelli, “prince” remains the operative term. Only a handful of CEOs of major corporations are women. See, e.g., Kristen Downey Grimsley, *Avon Calling . . . On a Man*, WASH. POST, Dec. 12, 1997, at G1 (citing statistics from Catalyst, a group that advocates promotion of women in business, that show “top jobs” are “still overwhelmingly male”).

86. Sidney G. Winter, *On Coase, Competence, and the Corporation*, in THE NATURE OF THE FIRM, *supra* note 18, at 179.

From the description of legal agency and agency costs given in Parts I and II, I turn now to consider other leading economic theories of the firm in Parts III and IV. From a legal perspective, I discuss what these theories leave out and what they get wrong. In this Part, I argue that economic theories tend to confuse the difference between firms and markets. Making a distinction between *consumer markets* for goods and services and *organizational metamarkets* of firms avoids this confusion.

A. The Paradox of Methodological Individualism

Most contemporary economic theories proceed on a strong assumption of the individual actor as the unit of analysis. They adhere to “methodological individualism,”⁸⁷ which asserts that “it is necessary to base all accounts of economic interaction on individual behavior.”⁸⁸ Although economic theories of the firm have undergone significant changes in the past few decades, most do not depart substantially from this assumption. As a result, they have not arrived at a consistent and coherent theory of the firm.⁸⁹ In particular, economic theories have had difficulty in describing the boundaries of the firm.⁹⁰

The confusion begins in a failure to recognize that a firm is both an *aggregate of individuals* and an *entity*. On one hand, the firm is an aggregate of individuals who carry on a business together. These individuals share reciprocal rights and duties within the firm defined by legal relationships of agency, contract, and property. On the other hand, the firm is an independent entity that acts in competition with other firms and individuals. In both economic and legal terms, firms are entities acting in markets.

87. *Id.* at 181.

88. Arrow, *supra* note 12, at 1.

89. See *supra* text accompanying note 86; see also Bo Gustafson, *Foreword to THE FIRM AS A NEXUS OF TREATIES* at vii (Masahiko Aoki et al. eds., 1990) (“It is doubtful if there is yet general agreement among economists on the subject matter designated by the title ‘theory of the firm’ . . .”).

90. See, e.g., HART, *supra* note 18, at 18 (“Principal-agent theory . . . leaves unresolved the basic issue of firm boundaries.”). One recent contribution has even argued that new information and communication technology including computers and the internet will result in the “fading” or “disintegration” of the boundaries of the firm. Arnold Picot et al., *The Fading Boundaries of the Firm: The Role of Information and Communication Technology*, 152 J. INSTITUTIONAL & THEORETICAL ECON. 65, 65-66, 77 (1996). It is true that changing technology in many areas (and not only information and communications) leads to changes in the organizational structure of firms and relations among firms. However, organizational change does not mean that firm boundaries “dissolve” or “disintegrate.” *Id.* at 65-66. Instead, it is more accurate to see the boundaries of firms changing in response to the economics of changing technologies. As one commentator remarks, the economic approach to determining the boundaries of the firm would be improved through “more attention to institutional detail.” Ronald J. Gilson, *The Fading Boundaries of the Firm: Comment*, 152 J. INSTITUTIONAL & THEORETICAL ECON. 80, 83 (1996). In particular, greater legal detail helps to clarify the boundaries of the firm. See *infra* Part V.

Economic theory has had difficulty embracing this paradox.⁹¹ In legal theory as well, the conflict between competing views of firms as aggregates of individuals or entities remains unresolved.⁹² The treatment offered here sheds light on this debate. The short answer is that firms are *both* aggregates of individuals and entities, depending on the question being asked.⁹³ From the point of view of their internal organization, firms are aggregates of individuals (with the exception of single-person firms). From the point of view of the markets in which they act as purchasers and sellers, firms act as entities.

Orthodox economic theory treats business firms exclusively as entities participating in markets. Like individuals, firms are subject to the "price mechanism" of markets for their goods and services.⁹⁴ This conception, however, presents a "blatant affront" to methodological individualism⁹⁵ because orthodox economics sees firms as "organizations not individuals."⁹⁶ In other words, the firm is a "black box"⁹⁷ or "a monad."⁹⁸

91. See, e.g., WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 18 (6th ed. 1996) ("Economists . . . worry about the question of why activities are sometimes organized across markets and sometimes within the firm, about what seem to be the most important characteristics of the firm, and about how firms operate. These issues have proved to be surprisingly intractable.").

92. Whether to consider different kinds of business firms, such as partnerships and corporations, as entities or aggregates of individuals informs a long tradition of legal debate. An example is the debate about the nature of partnerships. See REVISED UNIF. PARTNERSHIP ACT § 201 (1994) ("A partnership is an entity distinct from its partners."); *id.* cmt. (discussing "ambivalence on the nature of partnerships" under the Uniform Partnership Act with respect to "the entity theory"); A. Ladru Jensen, *Is a Partnership Under the Uniform Partnership Act an Aggregate or an Entity?*, 16 VAND. L. REV. 377 (1963); Donald J. Weidner, *Three Policy Decisions Animate Revision of Uniform Partnership Act*, 46 BUS. LAW. 427, 428-35 (1991) (discussing the rationale for "the move to the entity theory" of partnership). For an account of business organizations that emphasizes the agreements made by an aggregate of individuals as participants, see, for example, KLEIN & COFFEE, *supra* note 91, at 67-68, 108-13. For further discussion of the entity or personality theories of corporations, see, for example, ALFRED A. CONARD, *CORPORATIONS IN PERSPECTIVE* 416-45 (1976); John Dewey, *The Historic Background of Corporate Legal Personality*, 35 YALE L.J. 655 (1926); Gregory A. Mark, Comment, *The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441 (1987); and Michael J. Phillips, *Reappraising the Real Entity Theory of the Corporation*, 21 FLA. ST. U. L. REV. 1061 (1994).

93. Cf. Eric W. Orts, *The Complexity and Legitimacy of Corporate Law*, 50 WASH. & LEE L. REV. 1565, 1567-1612 (1993) (extending H.L.A. Hart's analysis of the corporation along these lines); cf. also Dewey, *supra* note 92, at 669 ("As far as the historical survey implies a plea for anything, it is a plea for disengaging specific issues and disputes which arise from entanglement with any concept of personality which is other than a restatement that such and such rights and duties, benefits and burdens, accrue and are to be maintained and distributed in such and such ways, and in such and such situations.").

94. See, e.g., Alchain & Demsetz, *supra* note 38, at 187, 189. For a seminal treatment of prices, see Friedrich Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945).

95. Winter, *supra* note 86, at 181.

96. Arrow, *supra* note 12, at 4.

97. Jensen & Meckling, *supra* note 52, at 306-07 (describing "black box" theories of the firm). On the neoclassical economic theory of the firm, see HART, *supra* note 18, at 15-17.

98. Oliver E. Williamson, *The Firm as a Nexus of Treaties: An Introduction*, in *THE FIRM AS A NEXUS OF TREATIES*, *supra* note 89, at 8.

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In part, the orthodox view is correct. Firms act as entities in the market for goods and services because they have the legal authority to do so. The law of agency and enterprise organization specifically provide for the creation of this kind of authority. Law enables individuals to bind together into a firm that has legal personality. A firm organized in any legal form—whether a partnership, limited liability company, or corporation—is empowered to bind itself as an entity to third parties in the market.⁹⁹

Although orthodox economists recognize firms as entities, other economists maintain that “the *ultimate* unit of analysis is always the individual.”¹⁰⁰ This methodological commitment leads revisionist economists to deconstruct the firm into its component parts, namely, its human participants. This approach, which informs an analysis based on agency costs outlined above,¹⁰¹ focuses on the relationships of individuals within firms rather than firms acting in markets. The role of prices illustrates the difference between the two perspectives. Unlike the orthodox view that sees firms subjected to the price mechanism when they participate in markets,¹⁰² revisionist theories claim that “the distinguishing mark of the firm is the suppression of the price mechanism.”¹⁰³

Choosing between the orthodox and revisionist economic theories will not resolve the paradox of the firm, namely, the difference between individuals composing firms and firms acting in markets. Revisionist economists dare to look inside the black box of the firm, but they see only individuals.¹⁰⁴ Orthodox economists treat firms as entities, but they do not fully appreciate how law binds individuals together within firms. Adding legal principles to a theory of the firm resolves the paradox by showing how both orthodox and revisionist economic theories are correct, depending on one’s perspective. The revisionist view is correct from the internal perspective within the firm, and the orthodox view is correct from the external perspective of firms acting in markets. Legal agency

99. See REVISED UNIF. PARTNERSHIP ACT § 201 (1995) (describing a partnership as “an entity distinct from its partners”); *id.* § 301 (stating that each partner may act to bind the partnership); UNIF. LTD. LIAB. CO. ACT § 201 (1995) (“A limited liability company is a legal entity distinct from its members.”); *id.* § 301(a)(1)-(b)(1) (stating that LLC members and managers act “for the purpose of its business”); REVISED MODEL BUS. CORP. ACT § 3.02 (1984) (stating that a corporation has “the same powers as an individual” to “carry out its business and affairs”).

100. Geoffrey Brennan & Gordon Tullock, *An Economic Theory of Military Tactics: Methodological Individualism at War*, 3 J. ECON. BEHAVIOR & ORG. 225, 225 (1982).

101. See *supra* Section I.B.

102. See *supra* note 94 and accompanying text.

103. COASE, *supra* note 17, at 36.

104. Behavioral economics also challenges the orthodox view of firms as entities rather than as aggregates of individuals. Compare Fritz Machlup, *Theories of the Firm: Marginalist, Behavioral, Managerial*, 57 AM. ECON. REV. 1 (1967) (defending the neoclassical view of the firm as an entity for many purposes of economic analysis), with Richard M. Cyert & Charles L. Hedrick, *Theory of the Firm: Past, Present, and Future; An Interpretation*, 10 J. ECON. LIT. 398 (1972) (arguing for a behavioral account of firms through empirical observation).

enables aggregations of individuals in firms to act as entities in markets "as if" they were "legal persons."¹⁰⁵ Both orthodox and revisionist economic theories are correct because legal agency gives individuals the power to bind themselves together in firms *and* allows firms to act as entities in markets.

B. Consumer Markets and Organizational Metamarkets

Legal analysis can resolve the economic paradox of the firm because it allows for a social theory of the firm rather than one that insists on a myopic individualism. Legally, firms are social entities found at an intermediate level of organization.¹⁰⁶ On a continuum stretching from sole proprietorships to large multinational corporations, firms occupy a space in the social structure between natural individuals and larger collective entities known as political states.¹⁰⁷ Economics explains *why* individuals enter and leave firms in pursuit of their own ends. Law explains *how* individuals bind themselves together in firms.

With a conception of firms at an intermediate level in society between autonomous individuals and law-creating states, the paradox of the firm in economics can be resolved by making a conceptual distinction between two types of markets: *consumer markets* and *organizational metamarkets*.¹⁰⁸ Firms act as entities competing with each other to supply consumer markets for goods and services. At the same time, firms are aggregates of individuals in how they are organized and change composition in a constant struggle to create efficient organizational forms.

First, both individuals and firms participate in consumer markets for goods and services. For example, both individuals and firms purchase legal services. Second, consumer markets are usefully distinguished from metamarkets that organize production of the goods and services to be

105. See *supra* Section I.A; cf. VINING, *supra* note 84, at 319-20 (describing corporate law as involving "the creation of authority in organized activity" and "the recognition of entity"). For an introduction to the concept of legal personality, see Dewey, *supra* note 92.

106. Cf. James S. Coleman, *Constructed Organization: First Principles*, 7 J.L. ECON. & ORG. 7 (1991); Oliver E. Williamson, *Economic Institutions: Spontaneous and Intentional Governance*, 7 J.L. ECON. & ORG. 159 (1991). In addition to business firms, there are many other forms of associations at the level of civil society. For the classic treatment, see 2 ALEXIS DE TOQUEVILLE, *DEMOCRACY IN AMERICA* 106 (Phillips Bradley ed., 1948) (1840) (describing "associations of a thousand other kinds, religious, moral, serious, futile, general or restricted, enormous or diminutive"). These associations are outside the scope of this Article.

107. Some business firms have in fact become larger in terms of size and influence than many political states. For critical discussion, see RICHARD J. BARNET & JOHN CAVANAGH, *GLOBAL DREAMS: IMPERIAL CORPORATIONS AND THE NEW WORLD ORDER* (1994); EDWARD M. GRAHAM, *GLOBAL CORPORATIONS AND NATIONAL GOVERNMENTS* (1996); Eric W. Orts, *The Legitimacy of Multinational Corporations*, in *PROGRESSIVE CORPORATE LAW*, *supra* note 27, at 247.

108. On the term "metamarket," see *supra* note 13.

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sold.¹⁰⁹ Harold Demsetz describes the firm as “a specialized production unit.”¹¹⁰ Firms in organizational metamarkets respond to the demands of consumer markets, but they are also subject to other variables, such as the costs of organization emphasized in revisionist economic theory.

Entities and collections of individuals act in both consumer markets and organizational metamarkets. In consumer markets, individuals get together to purchase goods and services. The black box of “the household” appears at this level.¹¹¹ Cooperative consumer organizations also act as entities in the consumer market.¹¹² Firms participate as consumers as well as producers.¹¹³ For example, both firms and individuals purchase legal services. Firms also purchase “inputs” for production. Whether a firm acts as a consumer or a metamarket producer depends on the circumstances of a particular transaction, whether the firm is a buyer or seller.¹¹⁴ For instance, a law firm participates in the consumer market when it buys paper, computers, and supplies, but it competes in the organizational metamarket as a supplier of legal services.

This distinction between consumer markets and organizational metamarkets is not without complications. It does not capture problems of “in-the-household” production and “on-the-job” consumption.¹¹⁵ Unpaid labor, such as housework and in-the-home child care, is not included in the production model of organizational metamarkets.¹¹⁶ The model of consumer markets does not account for “perks” and other benefits of managers, owners, and employees in firms that are not accounted for in overt compensation payments.¹¹⁷

109. Cf. DEMSETZ, *supra* note 18, at 6-9.

110. *Id.* at 8.

111. *Id.* A household, such as a family, is a group of individuals who live together and make joint purchases.

112. For an account of the economic importance of “customer-owned enterprise,” see HANSMANN, *supra* note 8, at 149-223.

113. In this respect, my account of firms as entities that act as consumers as well as producers differs from Demsetz’s view. See *supra* notes 109-110 and accompanying text.

114. One commentator on an early version of this Article said that this theory of the firm bears a resemblance to theories of light in physics: Whether light is a particle or a wave depends on how one looks at the issue. Similarly, a firm acts as a consumer when it purchases goods or services and as a producer when it makes and sells them. Cf. Eugene Volokh, *Computer Media for the Legal Profession*, 94 MICH. L. REV. 2058, 2084 (1996) (“Most laypeople, very much including me, would be out of place at a physicists’ conference, where we’d probably say things like ‘Light is a particle *and* a wave? That makes no sense!’ Law can be as technical as physics . . .”).

115. DEMSETZ, *supra* note 18, at 8.

116. See, e.g., Ann Laquer Estin, *Love and Obligation: Family Law and the Romance of Economics*, 36 WM. & MARY L. REV. 989 (1995); Katherine Silbaugh, *Turning Labor into Love: Housework and the Law*, 91 NW. U. L. REV. 1 (1996).

117. Demsetz distinguishes between two types of on-the-job consumption: “explicitly negotiated on-the-job consumption” which is accounted for within the firm’s compensation structure and “implicit” on-the-job consumption which is not. DEMSETZ, *supra* note 18, at 24-25.

The distinction between consumer markets and organizational metamarkets is nevertheless useful because it clarifies the second-order level of competition among different business forms. Organizational metamarkets respond to the demand in consumer markets, but other factors also affect them. The structure of the metamarket of firms is determined not only by the prices of factors of production, but also by variables difficult to quantify, such as savings on organizational costs (agency and principal costs),¹¹⁸ transaction costs,¹¹⁹ specialization,¹²⁰ the organization of technical knowledge and information,¹²¹ and economies of scale and scope.¹²²

Business firms exist to supply the needs of consumer markets for goods and services. This answers an initial problem in economic analysis to explain why firms exist. Why do people band together in organizations if they tend to be selfish and serve themselves? The answer is that significant economic gains can be obtained from coordinated specialization and teamwork within legal structures of agency relationships.¹²³

The distinction between consumer markets and organizational metamarkets allows for clarification of the different kinds of business firms. At one extreme, a single individual entrepreneur may compete in the organizational metamarket. An example is an individual lawyer equipped with his or her own personal computer and other supplies. Without a partner, secretary, or paralegal, the sole practitioner may

118. See *supra* Parts I, II.

119. Transaction costs may be defined as the costs of markets when using the price mechanism. These costs include negotiating, contracting, and the opportunity costs of not being able to focus on doing something else. For further discussion of transaction costs theories of the firm, see *infra* Section IV.A.

120. See *supra* note 58 and accompanying text. For a leading treatment of specialization of risk-taking and management, see KNIGHT, *supra* note 58, chs. 8 & 9.

121. See Bruce Kogut & Udo Zander, *Knowledge of the Firm, Combinative Capabilities, and the Replication of Technology*, 3 ORG. SCI. 383, 396 (1992) (describing the firm as "a repository of capabilities"); Bruce Kogut & Udo Zander, *What Firms Do? Coordination, Identity, and Learning*, 7 ORG. SCI. 502, 503 (1996) (describing the firm as "a social community specializing in the speed and efficiency in the creation and transfer of knowledge"). For a recent economic account that emphasizes access to information as an important source of power within the firm, see Aghion & Tirole, *supra* note 11.

122. See, e.g., ALFRED D. CHANDLER, *SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM* 17 (1990) (defining "economies of scale" as "those that result when the increased size of a single operating unit producing or distributing a single product [or service] reduces the unit costs of production or distribution" and "economies of scope" as "economies of joint production or distribution" that result "from the use of processes within a single operating unit to produce or distribute more than one product [or service]").

123. See *supra* notes 29, 58, 118-122 and accompanying text. Some theories of the firm, however, then go on to ask why specialization and team production should be coordinated within firms rather than across markets. In other words, specialists could exist independently and coordinate production through a series of market transactions that do not cohere into a firm. Theories that emphasize transaction costs and the organization of technical knowledge in firms provide helpful analysis along these lines. See *supra* notes 119, 121 and accompanying text; see also *infra* Part IV (discussing economic theories of the firm).

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compete with other more complex law firms to provide legal services to consumers. This “one-person unit” qualifies as a firm because it competes in the metamarket of production of legal services.¹²⁴ A one-person business, according to this approach, qualifies as the simplest type of firm, which is called a *pure sole proprietorship*. Larger firms including partnerships and corporate groups also compete in organizational metamarkets.¹²⁵

This approach resolves the paradox of firms and markets. As an entity, the firm participates in consumer markets. As an aggregate of individuals, the firm competes in organizational metamarkets with other firms to supply consumer markets. Firms as entities and aggregates competing in markets and metamarkets describe two sides of the same economic coin.

IV. ECONOMIC THEORIES OF THE FIRM

The economic literature on theories of the firm has grown enormous, and it is not possible to do justice to all the various approaches here. However, it is useful to classify economic theories of the firm into four types that emphasize transaction costs, contracts, property, and employment. Each of them is briefly reviewed through a legal lens.

A. *Transaction Costs*

The original version of a transaction costs theory of the firm is given by Ronald Coase. He claims broadly that firms exist because the mechanisms of market trading are not free. In other words, firms exist because people engaged in business may in some circumstances save transaction costs (such as negotiating, drafting contracts, and other costs of using markets) by internalizing production within a single organizational form.¹²⁶ When the costs of transacting business across markets exceed the costs of organizing the same transactions within firms, then firms exist and will increase in size as long as an economic differential can be realized.¹²⁷ Agency and principal costs, both shirking and sharking, impose

124. DEMSETZ, *supra* note 18, at 9.

125. The different kinds of firms are canvassed below in Part V.

126. See COASE, *supra* note 17, at 35-36 (“Outside the firm, price movements direct production, which is co-ordinated 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.”); see also Robert Flannigan, *The Economic Structure of the Firm*, 33 OSGOODE HALL L.J. 105, 113-17 (1995).

127. The difference between the costs of markets and firms is not readily identifiable, however, because there is no market “price” for the transaction costs of markets. See *supra* note 103 and accompanying text.

organization costs on firms. An economic equilibrium results between the transaction costs of markets and the organization costs of firms.¹²⁸

Oliver Williamson further develops the concept of transaction costs.¹²⁹ His project is to “operationalize” Coase’s theory of the firm.¹³⁰ Because Williamson adopts a “contractual approach,” his transaction costs theory is closely related to the contractarian theories of the firm that I discuss next.¹³¹ According to Williamson, the firm is “a governance structure rather than a production function.”¹³² By governance structure, he means one version or another of an explicit or implicit contract.¹³³

Despite his use of the concepts of governance and contracts, however, Williamson does not develop a sophisticated legal account of firms in tandem with his complex economic theory.¹³⁴ Little of the law of agency

128. This equilibrium in transaction costs theory corresponds to my distinction between consumer markets and organizational metamarkets of firms described *supra* Section III.B.

129. See Flannigan, *supra* note 126, at 122 (describing Williamson’s work as “a capacious analytical framework purporting to have application to a variety of diverse phenomena”).

130. *Id.* at 121 (citing Oliver E. Williamson, *The Vertical Integration of Market Production: Market Failure Considerations*, 61 AM. ECON. REV. 112 (1971), and Oliver E. Williamson, *Markets and Hierarchies: Some Elementary Considerations*, 63 AM. ECON. REV. 316 (1973)).

131. OLIVER E. WILLIAMSON, *ECONOMIC ORGANIZATION: FIRMS, MARKETS AND POLICY CONTROL* 174 (1986) (“Transaction economics adopts a contractual approach to the study of economic organization.”).

132. Oliver E. Williamson, *Economics and Organizations: A Primer*, CAL. MGMT. REV., Winter 1996, at 131, 131, 133 (describing the view of the firm in traditional neoclassical theory as a “production function” and the view derived from transaction costs as a “governance structure[]”). As described above, Demsetz sees the firm rather as “a specialized production unit.” See *supra* note 110 and accompanying text.

133. See, e.g., WILLIAMSON, *supra* note 74, at 43-84 (discussing views of “contractual man” and “the governance of contractual relations”). For an introduction to Williamson’s theory, see OLIVER E. WILLIAMSON, *THE MECHANISMS OF GOVERNANCE* 3-20, 54-87, 219-49, 349-75 (1996); Oliver E. Williamson, *The Logic of Economic Organization*, 4 J.L. ECON. & ORG. 65, 66-67, 72-88 (1988); Oliver E. Williamson, *The Economics of Governance: Framework and Implications*, 140 J. INSTITUTIONAL & THEORETICAL ECON. 195 (1984).

134. Williamson’s economic theory cannot be summarized here. There are several basic concepts, however, which are important in his theory of the firm. First, like theorists of agency costs, Williamson emphasizes the costs of *opportunism* in firms. See *supra* note 74 (giving Williamson’s definition of opportunism); see also WILLIAMSON, *supra* note 74, at 64-67 (discussing the importance of opportunism in economic organization). This open-ended concept is consistent with the analysis of shirking and sharking developed above. See *supra* Section I.B & Part II. Second, following Herbert Simon, Williamson highlights *bounded rationality* and *uncertainty* as factors influencing the choice of individuals to create and join in firms. See, e.g., Williamson, *supra* note 98, at 11-12 (citing HERBERT SIMON, *ADMINISTRATIVE BEHAVIOR* (2d ed. 1961)); Williamson, *The Economics of Governance*, *supra* note 133, at 203-06. Firms are useful because “human beings are limited in knowledge, foresight, skill, and time.” Williamson, *supra* note 98, at 11 (quoting SIMON, *supra*, at 199). Third, Williamson develops the concept of *asset specificity*, which refers to the tendency of investments in property and human skills to become tied to a particular firm. See WILLIAMSON, *supra* note 74, at 52-56 (describing different kinds of asset specificity and emphasizing that “the importance of asset specificity to transaction cost economics is difficult to exaggerate”); Williamson, *supra* note 98, 11-12 (defining asset specificity as “the degree to which an asset can be redeployed to alternative uses and by alternative users without sacrifice of productive value”). As discussed below, asset specificity refers to the important role of ownership and property rights in firms. See *infra* Section IV.C and Part V. Together, these elements of transaction costs, opportunism, bounded rationality, and asset specificity help

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or enterprise organization appears in his voluminous work.¹³⁵ For example, in his treatment of corporations, Williamson notes only two “key legal features”—limited liability and the transferability of ownership in shares—and then moves on.¹³⁶ “Failure to discuss them [as well as other legal principles] does not,” he says, “reflect a judgment that they are either irrelevant or uninteresting.”¹³⁷ More than this, I believe including a more comprehensive understanding of law—especially the law of agency and business forms—would clarify and strengthen Williamson’s theory because it is precisely the availability of legal organizational forms that enables the transaction costs of markets to be saved. Firms are creatures of law as well as transaction costs.

B. Contracts

Transaction costs theory also shares a fault of another theory that employs a simple model of the firm as involving mostly contracts. “Contractual relations are the essence of the firm,” according to this influential theory,¹³⁸ and the “firm is simply one form of *legal fiction which serves as a nexus for contracting relationships*.”¹³⁹ From a legal perspective, however, the view that “*all relationships that make up a firm are*

to explain the economic nature of firms.

For a recent debate about transaction costs theory, compare Sumantra Ghoshal & Peter Moran, *Bad for Practice: A Critique of Transaction Cost Theory*, 21 ACAD. MGMT. REV. 48 (1996), with Oliver E. Williamson, *Economic Organization: The Case for Candor*, 21 ACAD. MGMT. REV. 48 (1996). Ghoshal and Moran argue that Williamson’s theory is open to criticism on the same grounds as other theories that pursue an approach of methodological individualism. See *supra* Section III.A. Ghoshal and Moran open their argument with the following joke:

In business circles, a story is often told of two hikers who wake up one night to find a tiger lurking near their tent. One of the hikers immediately reaches for his running shoes. On being reminded by his partner that he could not possibly outrun the tiger, he responds that all he has to do is to outrun his partner.

Ghoshal & Moran, *supra*, at 13. Williamson responds that such “toy problems” are not convincing, but he seems to miss the point when he answers that hikers should think about whom to go hiking with beforehand and go only with those with “good” reputations. Williamson, *Economic Organization*, *supra*, at 53-54.

135. See, e.g., WILLIAMSON, THE MECHANISMS OF GOVERNANCE, *supra* note 133, at 10, 57, 333 (demonstrating a truncated view of contract law and failing to refer to legal agency principles).

136. WILLIAMSON, *supra* note 74, at 274.

137. *Id.*

138. Jensen & Meckling, *supra* note 52, at 310.

139. *Id.* at 311. These theorists note that the firm “is characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals.” *Id.* at 311 (emphasis omitted). This observation relates to the “property rights” view of the firm discussed below. See *infra* Section IV.C. These theorists also note: “By legal fiction we mean the artificial construct under the law which allows certain organizations to be treated as individuals.” Jensen & Meckling, *supra* note 52, at 310 n.12. This comment relates to legal ideas of “entity” and “personality,” but the economists do not develop a sophisticated view of this “fiction” that through legal recognition has a very real existence. See *supra* notes 92-93 and accompanying text.

'contractual'" is wrong.¹⁴⁰ Among other things, asserting that business firms are essentially contractual obscures the importance of legal agency.¹⁴¹

Contractarian theorists recognize implicitly that contract law is insufficient to account for agency authority in firms when they refer to "implicit,"¹⁴² "incomplete,"¹⁴³ or even "non-binding"¹⁴⁴ contracts. Although this loose conception of contracts may prove useful for some forms of economic analysis, it is imprecise from a legal perspective.¹⁴⁵ Vague references to implicit or incomplete contracts often substitute for a proper recognition of a different kind of legal relationship, namely agency. Implicit or incomplete contracts also often refer to normative agreements or ethical obligations that are *not* legally enforceable as contracts. At the least, this use of the concept of "contracts" in economics is confusing.

Scott Masten criticizes the broad use of the term "contract" in eco-

140. Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in *PRINCIPLES AND AGENTS: THE STRUCTURE OF BUSINESS* 61 (John W. Pratt & Richard J. Zeckhauser eds., 1991). According to Clark, the contractarian view is "extreme," "almost perverse," and "likely to blind us" to the features of firms that are most "distinctive, puzzling, and worth exploring." *Id.* at 60. For criticism of the legal adoption of contractarian economic theory along similar lines, see William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 *NW. U. L. REV.* 180 (1992); William W. Bratton, *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 *CORNELL L. REV.* 407 (1989); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 *COLUM. L. REV.* 1403 (1985); John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 *BROOK. L. REV.* 919 (1988).

141. For example, Jensen and Meckling recognize the "important role which the legal system and the law play in social organizations," but they do not fully appreciate its complexity when they describe this role largely in terms of contracts. Jensen & Meckling, *supra* note 52, at 311 n.14.

Statutory laws sets [sic] bounds on the kinds of contract into which individuals and organizations may enter without risking criminal prosecution. The police powers of the state are available and used to enforce performance of contracts or to enforce the collection of damages for non-performance. The courts adjudicate conflicts between contracting parties and establish precedents which form the body of common law. All of these government activities affect both the kinds of contracts executed and the extent to which contracting is relied upon. This in turn determines the usefulness, productivity, profitability and viability of various forms of organization. Moreover, new laws as well as court decisions often can and do change the rights of contracting parties *ex post*, and they can and do serve as a vehicle for redistribution of wealth.

Id. In this account, note the almost exclusive focus on contracts as if all other law were only a gloss on contracts.

142. EASTERBROOK & FISCHER, *supra* note 22, at 12 (referring to the corporation as "a set of implicit and explicit contracts").

143. WILLIAMSON, *THE MECHANISMS OF GOVERNANCE*, *supra* note 133, at 9-10, 56, 131 (referring to "incomplete contracts").

144. Lars A. Stole & Jeffrey Zwiebel, *Intra-Firm Bargaining Under Non-Binding Contracts*, 63 *REV. ECON. STUDIES* 375, 375-77 (1996) (referring to "non-binding contracts" in employment-at-will bargaining).

145. As Clark observes, using the term "contracts" in this sense is "metaphorical" rather than legally descriptive. Clark, *supra* note 140, at 61.

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conomic theories of the firm.¹⁴⁶ Recognizing that lawyers use the term *contract* more restrictively than economists, he recommends an expanded consideration of the true “legal basis for the firm.”¹⁴⁷ “Ironically,” he notes, “economists have either downplayed or rejected outright the role of the law in defining the firm.”¹⁴⁸ It is even more ironic that many legal academics uncritically embrace contractarian theories of the firm. The fervor of their attachment may justify an ideological label of “contractarianism,”¹⁴⁹ and Victor Brudney may correctly identify their

146. Scott E. Masten, *A Legal Basis for the Firm*, 4 J.L. ECON. & ORG. 181, 184 (1988).

147. *Id.* at 181. As Masten notes, most lawyers mean “contract” to refer to “a formal, legal commitment to which each party gives express approval and to which a particular body of law applies.” *Id.* at 184. Masten argues that agency relationships in employment should be recognized as central in a theory of the firm. *See id.* at 185-94. In this Article, I agree with Masten but extend his approach to include other agency relationships in addition to employment. *See infra* Part V.

148. *Id.* at 185 (citing Jensen & Meckling, *supra* note 52, at 310-11, referring to the firm as a “legal fiction”).

149. For an expression of a leading contractarian account of corporate law, see EASTERBROOK & FISCHER, *supra* note 22, at 12 (“[W]e often speak of the corporation as a ‘nexus of contracts’ or a set of implicit and explicit contracts. This reference . . . is shorthand for the complex arrangements of many sorts that those who associate voluntarily in the corporation will work out among themselves.”); Easterbrook & Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) (“The corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy.”). For critical reviews of their approach, see Lyman Johnson, *Individual and Collective Sovereignty in the Corporate Enterprise*, 92 COLUM. L. REV. 2215 (1992) (book review essay); Lawrence E. Mitchell, *The Cult of Efficiency*, 71 TEX. L. REV. 217 (1992) (book review). For a critical review within the law-and-economics tradition, see Robert M. Daines & Jon D. Hanson, *The Corporate Law Paradox: The Case for Restructuring Corporate Law*, 102 YALE L.J. 577 (1992) (book review essay); *see also* sources cited *supra* note 140.

Another recent approach refers to the firm as a “network of contracts.” Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995). This approach does not “question the usefulness of contractual metaphor in characterizing the firm.” *Id.* at 765. It seeks only to expand the metaphor to include “network externalities,” which have been argued to be important in product markets. *Id.* at 763 & n.15 (citing sources in the economics literature). Like agency costs, network externalities help to explain the boundaries of firms, but they do not account for the basic legal machinery that creates firms themselves. For a criticism of the use of the “network” concept in legal analysis, see Richard M. Buxbaum, *Is “Network” a Legal Concept?*, 149 J. INSTITUTIONAL & THEORETICAL ECON. 698 (1993).

Yet another alternative focuses on the “bargains” made among the actual individual participants in firms. William Klein gives the leading account of a bargaining theory of the firm. *See* Klein, *supra* note 20, at 1521 (describing a “series-of-bargains model” of “the economic arrangements of a firm”). One recent variation of this theory uses agency costs “as a springboard.” Manuel A. Utset, *Towards a Bargaining Theory of the Firm*, 80 CORNELL L. REV. 540, 550 (1995) (expanding on Klein’s bargaining theory). However, most bargaining theories of the firm remain tied to an essentially contractarian model of the firm, which is expanded metaphorically (like other contractarian models) to refer to “implicit, tacit bargaining.” Utset, *supra*, at 584. Bargaining theories therefore remain incomplete. A focus on contractual bargaining tends to emphasize the role of individual participants at the expense of relationships of authority that allow firms to act as entities in markets. *See supra* Parts I, III.

motivation as political.¹⁵⁰ More charitably, the simplicity of contractarian theory may seduce those who are strongly influenced by an individualistic view of the world.¹⁵¹ Contractarian theories overemphasize contracts and oversimplify the law, however, because they do not account for organizational complexity and its legal foundations in agency relationships of authority, power, and hierarchy.¹⁵²

Interestingly, this mistake is not made by Ronald Coase, the progenitor of economic theories of the firm. In *The Nature of the Firm*, Coase draws directly on principles of agency law.¹⁵³ Adding law to the theoretical mix does not detract from the economic reasons firms come into existence. As discussed above, these reasons include transaction costs, specialization, organization of knowledge and information, and the ability of firms to achieve economies of scale and scope.¹⁵⁴ Firms are flexible in “deciding what to do and how to do it.”¹⁵⁵ If the *motivation* for creating firms is economic, however, the *mechanism* by which firms are established is legal. Coase recognizes the importance of legal agency when he writes that the “best approach” to “what constitutes a firm in practice” is to consider “the legal relationship normally called that of ‘master and servant’ or ‘employer and employee.’”¹⁵⁶ For Coase, “it is the fact of direction which is the essence of the legal concept” of the firm.¹⁵⁷

150. See Brudney, *supra* note 140, at 1404 (noting that a contractarian theory of the firm “serves the ideological function of legitimating substantially unaccountable managerial discretion”).

151. A contractarian worldview comports with the neoclassical economic starting point of a world of individuals competing in markets. Contracts specify the transactions among the individuals. The world of enterprise organization and its legal structure, however, cannot be described so easily in terms of “simple rules.” See RICHARD A. EPSTEIN, *SIMPLE RULES FOR A COMPLEX WORLD* 247 (1995) (“On internal corporate matters, the sound approach only requires using the standard common law rules of property, contract, and tort.”). For criticism of Epstein’s “simple rules,” see Heidi Li Feldman, *Law and Economics: Libertarianism with a Twist*, 94 MICH. L. REV. 1883 (1996) (book review); Eric W. Orts, *Simple Rules and the Perils of Reductionist Legal Thought*, 75 B.U. L. REV. 1441 (1995) (book review).

152. See *supra* Section I.A and *infra* Part V.

153. Coase begins with the following question: Given neoclassical economic assumptions about efficient markets, “why is there any organization?” COASE, *supra* note 17, at 36. Why does the economist look at the world and find “islands of conscious power in this ocean of unconscious cooperation like lumps of butter coagulating in a pail of buttermilk?” *Id.* at 35 (quoting D.H. ROBERTSON, *CONTROL OF INDUSTRY* 85 (1925)). As discussed in the text, the answers lie in the legal mechanisms of agency and enterprise law.

154. See *supra* notes 118-122 and accompanying text.

155. COASE, *supra* note 17, at 49 (quoting KNIGHT, *supra* note 58, at 268).

156. COASE, *supra* note 17, at 53-54. The importance of employment in theories of the firm is also discussed *infra* Section IV.D.

157. *Id.* In later reflections on *The Nature of the Firm*, Coase agrees with economists who say “the firm is essentially a choice of contractual arrangements.” Ronald H. Coase, *The Nature of the Firm: Meaning*, in *THE NATURE OF THE FIRM*, *supra* note 18, at 56. However, he emphasizes that contracts are “greatly reduced” in firms “by the use of a special kind of contract” and recalls that these special contracts “correspond closely to the legal concept of the relationship of employer and employee.” *Id.* Coase credits this insight about the importance of agency relationships to FRANCIS R. BATT, *THE LAW OF MASTER AND SERVANT* (1929), which he studied

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In a footnote in *The Nature of the Firm*, Coase recognizes also—though somewhat vaguely—that the employer-employee relationship is not the only important agency relationship in firms. In addition, the *property* and *financing* of the firm are critical.¹⁵⁸ Later theorists pick up on the importance of property, ownership, and the financing of the firm. They develop the property theories of the firm discussed next. The point here is to emphasize that Coase recognized the importance of legal agency in his original theory of the firm, though he did not spell it out precisely.¹⁵⁹

C. Property

Economic theories of the firm that emphasize property focus on the control of employment relationships enabled by ownership. They point out the weakness of contractarian theories in explaining the center of gravity of a firm and argue that the ownership of property in the firm should be seen as fundamental. A leading version of a property theory of the firm is given by Oliver Hart.¹⁶⁰ According to Hart, “the firm’s non-human assets . . . represent the glue that holds the firm together.”¹⁶¹ Without property, “the firm is just a phantom.”¹⁶² Firms arise where contractual relationships fail and “where the allocation of power and control is therefore important.”¹⁶³ Hart criticizes contractarian theories for fail-

in “one of my law courses at LSE,” thus providing an object-lesson in favor of interdisciplinary studies of law by economists and vice versa. Coase, *supra*, at 56.

158. See COASE, *supra* note 17, at 53 n.48 (“The legal concept of ‘employer and employee’ and the economic concept of a firm are not identical in that the firm may imply control over another person’s property as well as over their labor.”).

159. It is interesting also to note that Coase’s article had “little or no influence for thirty or forty years after it was published,” and its initial reception was “complete lack of interest.” R.H. Coase, *The Nature of the Firm: Influence*, in *THE NATURE OF THE FIRM*, *supra* note 18, at 61; see also Bruce Kogut, *Book Review*, 38 ADMIN. SCI. Q. 503 (1993) (stating that “it took 40 years before the economics profession seriously returned” to Coase’s question concerning why firms exist). Perhaps recovering an understanding of Coase’s original emphasis of legal as well as economic principles in his theory of the firm has required a similar period of gestation.

160. See HART, *supra* note 18, at 29-72; see also Sanford J. Grossman & Oliver Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990); Oliver Hart, *An Economist’s Perspective on Theories of the Firm*, 89 COLUM. L. REV. 1757 (1989). For other theories emphasizing a property approach, see STEPHEN R. MUNZER, *A THEORY OF PROPERTY* 317-79 (1990) (advancing a theory of corporations as an extension of theories of property); D. Bruce Johnsen, *The Quasi-Rent Structure of Corporate Enterprise: A Transaction Cost Theory*, 44 EMORY L.J. 1277 (1995) (extending the “measurement branch” of transaction costs theory, which emphasizes a property-rights approach, to advance a financial valuation theory of firms).

161. HART, *supra* note 18, at 57.

162. *Id.*

163. *Id.* at 1. For a recent economic approach that usefully expands on the importance of power and the access to power enabled by property rights of ownership in the firm, see Rajan & Zingales, *supra* note 11.

ing to explain “the source of an employer’s authority over an employee,”¹⁶⁴ and he emphasizes that “control over nonhuman assets leads to control over human assets.”¹⁶⁵ Ownership of capital assets puts a person in a position to organize production through the purchase of economic factors, including labor.¹⁶⁶

The property theory of the firm represents an advance from contractarian theories. Property or capital explains the economic leverage required for the creation of relationships of authority in firms, usually through contracts. Only through legal agency, however, is the nature of these relationships fully explained. Residual control rights are ordinarily retained by the holders of equity ownership interests in the firm.¹⁶⁷ Property theorists recognize that residual rights may be delegated within a firm according to law, for example, from equity shareholders to the board of directors in a corporation.¹⁶⁸ This analysis does not go far enough, however, to account for the importance of legal mechanisms in creating firms.

Like economists who focus too closely on contracts in firms, property theorists emphasize the rights of “ownership” and downplay other legal relationships.¹⁶⁹ In fact, firms are a complex mixture of contracts and property, and the mixture coheres through the law of agency and enterprise organization. Both contractarian and property rights theories are important for understanding the economic and legal nature of the firm. Standing alone, however, neither theory offers a complete picture. A legal theory of the firm shows how agency, contracts, and property work together.

D. Employment

As discussed above, Ronald Coase recognizes that employment con-

164. HART, *supra* note 18, at 57.

165. *Id.* at 58 (emphasis omitted).

166. This point is related to Williamson’s emphasis of asset specificity in firms. *See supra* note 134.

167. “According to the property rights approach,” Hart writes, “the owner of an asset has *residual control rights* over that asset: the right to decide all usages of the asset in any way not inconsistent with prior contract, custom, or law.” HART, *supra* note 18, at 30. On the importance of “the residual control argument” and its relationship to human capital and controlling opportunism within firms, see Flannigan, *supra* note 126, at 125-31.

168. *See* HART, *supra* note 18, at 30 n.3. Depending on economic and social circumstances, equity ownership in a firm may be held primarily by employees or customers, as well as investors. For an interesting analysis along these lines, see HANSMANN, *supra* note 8, at 66-119, 149-81.

169. For example, Hart relies on Oliver Wendell Holmes’s definition of “ownership” but overlooks Holmes’s work in agency law. *See* HART, *supra* note 18, at 30 n.4 (citing OLIVER WENDELL HOLMES, *THE COMMON LAW* 193 (1963)). For a discussion of Holmes’s writings on agency see *supra* note 34 and accompanying text (referring to Holmes’s writings on agency).

stitutes an essential element that distinguishes firms from markets.¹⁷⁰ Employment is not present in all kinds of firms. There are one-person firms and multiple-person partnerships without employees.¹⁷¹ The vast majority of firms, however, use employment agency relationships.

A growing number of economists focus on the employment dimension of firms from a microeconomic perspective.¹⁷² In addition, various methods of profit-sharing and employee ownership are increasingly seen as important in the productivity of firms.¹⁷³ Theorists also emphasize the importance of “human capital” invested in a firm’s employees and risks borne by them.¹⁷⁴

Employment theories of the firm differ widely in their prescriptions for how employees should be treated within firms. Some commentators advocate employee representation in managerial decisionmaking, in-

170. See *supra* notes 156-157 and accompanying text. Scott Masten also makes this point. See *supra* note 147.

171. See *supra* text accompanying notes 124-125 and *infra* Sections V.A, V.B.

172. See, e.g., Alchian & Demsetz, *supra* note 38, at 121-24 (emphasizing “team production”); Samuel Bowles & Herbert Gintis, *Contested Exchange: New Microfoundations for the Political Economy of Capitalism*, 18 POL. & SOC’Y 165, 167 (1990) (arguing that “contested exchange” between labor and capital “gives rise to a well-defined set of power relations among voluntarily participating agents” in firms); Bengt Holmstrom & Paul Milgrom, *The Firm as an Incentive System*, 84 AM. ECON. REV. 972 (1994) (offering principal-agent model examining employment incentives); Bengt Holmstrom & Paul Milgrom, *Multi-Task Principal-Agent Analysis: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24 (1991) (same); Harvey Liebenstein, *The Prisoners’ Dilemma in the Invisible Hand: An Analysis of Intrafirm Productivity*, 72 AM. ECON. REV. 92 (1982) (examining legal and non-legal “conventions” for worker productivity); Louis Putterman, *Ownership and the Nature of the Firm*, 17 J. COMP. ECON. 243, 244 (1993) (focusing on the “separation of ownership and work” as “the basic cause of the familiar agency problem between employer and employee”).

Note that my distinction between consumer markets and organizational metamarkets, see *supra* Section III.B, does not conflict with a large and important body of scholarship that analyzes “internal labor markets” within firms. See, e.g., Edward B. Rock & Michael L. Wachter, *The Enforceability of Norms and the Employment Relationship*, 144 U. PA. L. REV. 1913 (1996) (focusing on norms of internal labor markets and the law of employment); Oliver Williamson et al., *Understanding the Employment Relation: The Analysis of Idiosyncratic Exchange*, 6 BELL J. ECON. 250 (1975) (examining “internal labor markets” in firms). The laws of economics are not suspended within firms and apply to employment as well as goods and services. This analytical approach to employment, however, is not my focus here.

173. See, e.g., PAYING FOR PRODUCTIVITY: A LOOK AT THE EVIDENCE (Alan S. Blinder ed., 1990) (collecting essays on incentive pay structures, profit-sharing, employee ownership, and other approaches to increasing employee productivity within firms); see also *supra* note 37 (listing sources on employee ownership and participation in governance of firms).

174. See, e.g., MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 238 (“Employees . . . inevitably bear many of the risks associated with certain kinds of investments, especially investments in ‘human capital.’ Hence, when investments in highly specialized human capital are important to the way that a firm creates wealth, employees . . . are likely to be residual claimants and, therefore, residual risk-bearers.”); O’Connor, *supra* note 37, at 965 (arguing that concern with human capital and efficiency in firms should drive reform of corporate and labor law). For a general treatment distinguishing between firm-specific and general human capital, see GARY S. BECKER, HUMAN CAPITAL: A THEORETICAL AND EMPIRICAL ANALYSIS 19-20, 26 (2d ed. 1975).

cluding representation on corporate boards of directors,¹⁷⁵ and others argue for broadening fiduciary duties of employers to include employees.¹⁷⁶ Most argue for the status quo of employment contracts with some constraints imposed by statutes.¹⁷⁷ At a minimum, scholars who examine the role of employees in firms have established that this relationship is a key component of any viable theory of the firm. In the theory of the firm advanced here, employment is included as a necessary element.

V. A LEGAL THEORY OF THE FIRM AND ITS BOUNDARIES

The introduction of insights grounded in microeconomic analysis has enhanced the intellectual rigor of corporate legal scholarship. The complexity of the behavior and organizations to which corporate law lends formal legal structure belies the explanatory force of any one intellectual discipline, however As a result, although the theoretical future might look less tidy than some would wish, its longevity will be enhanced. In short, like a shark, corporate law scholarship requires motion for its survival.¹⁷⁸

Deborah DeMott's estimation of the merits of economic analysis is confirmed by the analysis of theories of the firm presented above.¹⁷⁹ These theories are complex, untidy, and often conflicting, yet they have explanatory force. This Part advances a legal theory of the firm intended to complement these various economic theories.¹⁸⁰ It pulls together dis-

175. See, e.g., J.E. PARKINSON, *CORPORATE POWER AND RESPONSIBILITY: ISSUES IN THE THEORY OF COMPANY LAW* 397-434 (1993) (arguing for a "democratic imperative" of employee participation in corporate decisionmaking); RALPH NADER ET AL., *TAMING THE GIANT CORPORATION* 118-76 (1976) (arguing for "constituency directors" including representatives of employees). Some European states have legislated a requirement for employee representation on corporate boards or "codetermination." See Klaus J. Hopt, *Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Integration in Europe*, 14 INT'L REV. L. & ECON. 203 (1994); Klaus J. Hopt, *New Ways in Corporate Governance: European Experiments with Labor Representation on Corporate Boards*, 82 MICH. L. REV. 1338 (1984).

176. See David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 227, 248-52, 255-70 (1991); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 630-39 (1992); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts*, 69 N.C. L. REV. 1189, 1234 (1991); Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45, 47, 70-71 (1991).

177. Statutory restrictions include prohibitions on employment discrimination on the basis of age, ethnicity, religion, sex, or sexual orientation, as well as recognition of rights of employees to organize themselves in unions for collective bargaining. See also *infra* note 222 and accompanying text.

178. Deborah A. DeMott, *Trust and Tension Within Corporations*, 81 CORNELL L. REV. 1308, 1337 (1996) (reviewing *PROGRESSIVE CORPORATE LAW* (Lawrence E. Mitchell ed., 1995)).

179. See *supra* Parts I-IV.

180. This approach accords with recommendations from several leading academics in both law and economics. Robert Clark argues that a "closer focus on actual rather than presumed legal doctrines and concepts might do much to refine our current theory of the firm." Clark, *supra* note 140, at 55. Similarly, Harold Demsetz and Scott Masten agree that legal analysis may help to clarify the confusion among economic theories. See Harold Demsetz, *The Theory of the*

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parate economic elements within a legal understanding, and outlines the boundaries of “what a firm is and what it is not.”¹⁸¹

Firms of more than one person are better described not as a nexus of contracts, but as a *nexus of agency relationships*. In the language of contractarian theory, saying that the firm is a nexus of contracts leads one to ask: What creates the nexus? Only a legal theory of the firm can answer the question: agency and the legal recognition of specific forms of organization.¹⁸²

Individuals with different skills and resources fill different roles within economic organizations. The analysis that follows distinguishes three specialized roles in firms: *control*, *ownership*, and *employment*. These attributes of the firm combine insights gained from economic theories—including the importance of contracts, property, and employment—with a recognition of the essential mechanisms of legal agency that establish relationships of authority and power.¹⁸³ In these terms, I describe a number of types of firms ranging from the *pure sole proprietorship* to the *relational firm* of a large corporate group. In each case, I also discuss the legal boundaries of the firm,¹⁸⁴ which appear against the background of competitive markets in which firms act¹⁸⁵ and shift according to the question being asked.¹⁸⁶ In general, the boundaries of the firm are drawn along the lines of control, ownership, and employment.

Firm Revisited, 4 J.L. ECON. & ORG. 141, 155 (1988) (“[Economists] have no clear notion of firm-like contractual arrangements, especially since we now recognize the difficulty of distinguishing between coordination achieved ‘across markets’ and coordination achieved ‘within firms.’ It might be useful to adopt legal notions of what a firm is and what it is not.”); Masten, *supra* note 146, at 181 (arguing that a “legal basis for the firm” should be pursued).

181. Demsetz, *supra* note 180, at 155.

182. Another conceptual approach to contracts within firms that is consistent with the nexus-of-agencies analysis focuses on the “legal personality” created by the recognition of the ability of “the firm” to enter various contracts with its participants, including its owners, managers, employees, suppliers, distributors, customers, and others. See *supra* notes 92-93, 105 and accompanying text (discussing legal personality and collecting sources). This approach is not purely contractarian because the legal recognition of “the firm” as an abstract “entity” or “person” with the capacity to enter contracts and own property requires a different kind of law, namely, the law of agency and enterprise organization. I thank Henry Hansmann for e-mail correspondence which recommended this alternative approach.

183. See *supra* Section I.A and Part III. Another scholar describes control as “the essential defining attribute of the firm.” Flannigan, *supra* note 126, at 106. Emphasizing legal conceptions of control, however, should not ignore economic reality and complex structures of “specialization, diversification, and discretion.” Klein, *supra* note 20, at 1544. The synthesis offered here balances an account of the legal authority and control necessary to create firms with an appreciation of the economic complexity of ownership and employment patterns. See *infra* Figure 1 at page 313 (illustrating the vertical dimension of agency authority and the horizontal dimension of ownership in firms).

184. As in other areas of law, the conceptual boundaries of the firm are important. See *supra* note 16 and accompanying text.

185. See *supra* Part III.

186. See *supra* note 93 and accompanying text.

A. Control: Enterprise-Organizing and the Sole Proprietor

In the beginning, for a legal theory of the firm in free societies, is the *enterprise-organizer*.¹⁸⁷ Once an economic, legal, and political system has been established that recognizes a free market in enterprise organization as well as goods and services, each person becomes able to go into business independently—at least in theory.¹⁸⁸ In practice, one also needs the skill or good fortune to have the necessary capital. Given the economic means, each individual has the legal capacity to act as a firm (or to join one) as well as to be an individual consumer.¹⁸⁹ One person acting as the enterprise-organizer is a *sole proprietor*.¹⁹⁰

If the sole proprietor acts alone without any employees, partners, or financial contributors, then the legal enterprise may be called a *pure sole proprietorship*. It combines the functions of a business in one individual. It is self-directed, self-owned, self-employed, and self-financed. A pure sole proprietorship is a unique type of firm because it does not involve an internal agency relationship. With neither legal agency nor agency costs, it is an exception to the rule that firms are composed of agencies.¹⁹¹ It makes sense to include pure sole proprietorships as firms, however, be-

187. The term “enterprise-organizer” is adapted from CONARD ET AL., *supra* note 3. Coase refers instead to the “entrepreneur-coordinator.” COASE, *supra* note 17, at 58. Similarly, Alchian and Demsetz refer to “entrepreneur-organizer.” Alchian & Demsetz, *supra* note 38, at 140 n.14. I prefer *enterprise-organizer* because the term is broader. The term encompasses managers as well as entrepreneurs, and it covers the general responsibility of organizing a business, including not only coordinating and overseeing, but also reorganizing the entire structure of a firm. See *infra* Subsection VI.B.4 (discussing “financial reengineering”).

188. Some societies with a tradition of state socialism, such as those in Eastern Europe, have found this basic principle difficult to accept. For example, an early proposal for post-revolutionary Russian law would have required every business, no matter what the legal form and including sole proprietorships, to register with the state. See American Bar Association, Central and East European Law Initiative, Analysis of Draft Law of the Russian Federation on Business and Business Activity (Mar. 29, 1993) (appendix, comment of Eric W. Orts, Mar. 22, 1993). Thankfully, this approach was abandoned. Cf. Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996) (describing new version of Russia’s corporate statute drafted by the authors).

189. This freedom to organize as well as to consume parallels the conceptual distinction between organizational metamarkets and consumer markets introduced above in Section III.B.

190. A familiar example of an enterprise-organizer is the child who sets up a lemonade stand. See Theresa Gabaldon, *The Lemonade Stand: Feminist and Other Reflections on the Limited Liability of Corporate Shareholders*, 45 VAND. L. REV. 1387, 1388-89 (1992). Supplies are provided by a well-meaning parent. But the enterprise, that is, the making of the lemonade, marketing it with a sign, serving it to customers, and making money from the sales—all of the basic business functions that can become very complex in large firms—are carried out in the business of a lemonade stand by one person. See also KLEIN & COFFEE, *supra* note 91, at 5 (defining “sole proprietorship” as “a business owned directly by one individual”). Klein and Coffee state that because sole proprietorships have “no formal elements of co-ownership” they are not “usually thought of as a ‘business organization’ in the legal sense.” *Id.* For the reasons given above, however, I count sole proprietorships as the most basic kind of firm. See *supra* text accompanying notes 124-125.

191. See *supra* Part I. Nevertheless, even pure sole proprietors often rely on external agencies that lie outside of the boundaries of the firm in conducting business.

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cause they compete in organizational metamarkets with other types of firms in supplying the needs of consumer markets.¹⁹²

A pure sole proprietorship may acquire *limited liability* for its single owner.¹⁹³ Limited liability draws a line between the “entity” of the one-person corporation or limited liability company and the individual who is recognized for certain legal purposes as separate from the business. Close questions along this boundary of the firm inform the jurisprudence of “disregarding the corporate entity.”¹⁹⁴

Otherwise, the boundaries of the pure sole proprietorship coincide with the individual person who runs the business. Pure sole proprietorships, however, are rare. Much more commonly, sole proprietors share internal agency relationships with other owners or employees.

B. Ownership and Employment: Horizontal and Vertical Firms

Except in the case of pure sole proprietorships, firms are created in two directions when more than one person is involved. First, firms expand *horizontally* in the sense of sharing control and ownership of a business with another party. Second, firms expand *vertically* by creating hierarchical relationships of control through ownership structures and employment. Both of these dimensions involve the creation of legal agency relationships; hence *the nexus of agency relationships* that characterizes most firms.

An example of a *horizontal* firm is the general partnership with equal rights of control and ownership. An example of a *vertical* firm is the sole proprietorship with employees. In practice, purely horizontal or vertical firms are rarely encountered. Most actual firms combine horizontal and vertical agency relationships of control, ownership, and employment.

1. Horizontal Ownership

Often a business functions more effectively when enterprise-organizers join forces. When this is done on a relatively equal basis, a

192. See *supra* Part III.

193. A debate once raged about this issue, but it has been resolved in favor of recognizing one-person corporations and, more recently, one-person limited liability companies. See REVISED MODEL BUS. CORP. ACT § 2.01 (allowing that “[o]ne or more persons” may incorporate); UNIF. LTD. LIAB. CO. ACT § 202 (“One or more persons may organize a limited liability company, consisting of one or more members”); Twelfth Council Directive 89/667 on single-member private limited-liability companies, 1989 O.J. (L 395) 40 (requiring all member states in the European Community to recognize one-person companies but allowing special legislation to provide safeguards to protect third-parties).

194. For a comprehensive treatment, see STEPHEN B. PRESSER, *PIERCING THE CORPORATE VEIL* (1991).

general partnership is created.¹⁹⁵ Enterprise-organizers agree to pool their capital and labor (or, in the extreme case, one partner provides only capital and the other only labor). The distinguishing feature is that partners share the right of control, risk of loss, and any profits.¹⁹⁶

Those who enter into a partnership become legal agents of each other.¹⁹⁷ This *horizontal* agency relationship is a defining characteristic of the firm. Each partner has legal authority to bind the other in the business, and each is liable for partnership debts.¹⁹⁸ As agents, general partners also owe one another mutual fiduciary duties of trust and loyalty.¹⁹⁹ The mutual obligations of partners can be altered by agreement, but only within legal limits.²⁰⁰

Other organizational forms also expand horizontal ownership of a firm. In limited partnerships, for example, limited partners have ownership rights to a share of profits and losses, though only general partners exercise control rights.²⁰¹ Limited liability companies (LLCs), limited liability partnerships (LLPs), and corporations also allow for an increase in the number of equity owners, while limiting their liability to the capital invested in the business.²⁰²

Limited liability influences the shape and selection of business firms. Because of the costs of liability and tax consequences, limited liability is obviously important from an economic perspective.²⁰³ However, limited

195. See UNIF. PARTNERSHIP ACT § 6(1) (1994) (“[P]artnership is an association of two or more persons to carry on as co-owners a business for profit.”); REVISED UNIF. PARTNERSHIP ACT § 202(a) (1995) (“association of two or more persons to carry on as co-owners a business for profit forms a partnership”).

196. See KLEIN & COFFEE, *supra* note 91, at 61 (stating that partnership exists when two or more people have agreed to engage in a business and share in profits and control).

197. See UNIF. PARTNERSHIP ACT § 9 (1994) (discussing partners as agents of partnership business); REVISED UNIF. PARTNERSHIP ACT § 301 (1995) (same).

198. See UNIF. PARTNERSHIP ACT § 15(b) (1994) (stating that partners are liable for “debts and obligations of the partnership”); REVISED UNIF. PARTNERSHIP ACT § 306 (1995) (stating similar rule though recognizing the limited liability partnership option).

199. See UNIF. PARTNERSHIP ACT § 21 (1994) (stating that partners are accountable as fiduciaries); REVISED UNIF. PARTNERSHIP ACT § 404 (1995) (stating that are partners subject to fiduciary duties of care and loyalty); see also Deborah A. DeMott, *Our Partners’ Keepers? Agency Dimensions of Partnership Relationships*, LAW & CONTEMP. PROBS., Spring 1995, at 109 (describing law of partnership in terms of agency law and fiduciary obligations).

200. See REVISED UNIF. PARTNERSHIP ACT § 103(a) (asserting that partnerships are “governed by the partnership agreement” with exceptions including the right to inspect books and records, mandatory fiduciary duties, and rights to end the partnership). There is a debate about the extent to which the RUPA allows partners to contract out of fiduciary duties and the wisdom of this departure from the UPA. For a recent collection of essays on the topic, see Symposium, *The Future of the Unincorporated Firm*, 54 WASH. & LEE L. REV. 439 (1997).

201. See, e.g., KLEIN & COFFEE, *supra* note 91, at 98-101 (describing limited partnerships).

202. See *id.* at 101-03 (giving a basic description of these alternatives); see also Symposium, *LLCs, LLPs, and the Evolving Corporate Form*, 66 U. COLO. L. REV. 855 (1995) (collecting articles on the topic). For further description of the corporate firm, see *infra* Section V.D.

203. See, e.g., William A. Klein & Eric M. Zolt, *Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?*, 66 U. COLO. L. REV. 1001 (1995).

liability does not change the underlying importance of agency relationships in firms. Firms would continue to exist even if the benefits of limited liability were eliminated because firms allow individual participants to capitalize on the economic benefits of organization.²⁰⁴ Nevertheless, the contested scope of limited liability describes an important boundary of the firm with respect to ownership and control.²⁰⁵

A related boundary of the firm along the dimension of horizontal ownership involves inadvertent partnership. Because partners share in the liabilities of the business, boundary cases arise when a person who did not want to be considered a partner is later sued by a third-party for business debts or other liabilities. Purported creditors, employees, limited partners, or LLC members may face claims of inadvertent partnership and liability on the basis of their participation in profit-sharing and legal control.²⁰⁶

2. Vertical Authority

The hierarchical organization of ownership and control in firms refers to the economic concept of “vertical integration.”²⁰⁷ Governance of partnerships, LLCs, and corporations usually occurs through hierarchical or *vertical* authority structures. In corporate groups of parents and subsidiaries, vertical ownership structures become more complex, but they also involve the establishment of agency control. The issue of legal control of business entities raises important boundary questions for vertically integrated firms. In securities law, for example, liability often turns on

204. See *supra* notes 118-122 and accompanying text (recounting some of the economic benefits of firm organization).

205. See also *supra* notes 193-194 and accompanying text. For the legal debate about the desirability of limited liability, see Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387 (1992); Richard A. Booth, *Limited Liability and the Efficient Allocation of Resources*, 89 NW. U. L. REV. 140 (1994); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565 (1991); Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1 (1994).

206. Several classic teaching cases illustrate the point. See, e.g., *Frank v. R.A. Pickens & Son Co.*, 572 S.W.2d 133 (Ark. 1978) (discussing the line between profit-sharing employment and partnership); *Holzman v. De Escamilla*, 195 P.2d 833 (Cal. Ct. App. 1948) (warning that limited partners are liable as general partners when they exert control of the business); *Martin v. Peyton*, 158 N.E. 77 (N.Y. 1927) (exploring the line between creditors and partners).

207. For economic treatments of vertical integration, see WILLIAMSON, *supra* note 74, at 85-130; WILLIAMSON, *supra* note 131, at 85-100; Grossman & Hart, *supra* note 160; Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978); Benjamin Klein, *Vertical Integration as Organizational Ownership: The Fisher Body-General Motors Relationship Revisited*, 4 J.L. ECON. & ORG. 199 (1988). Essentially, these accounts attempt to explain in economic terms when, to achieve particular objectives, it is cheaper or more efficient to organize vertically as a firm than to make horizontal contracts in the market.

whether a firm exercises effective "control" over a subsidiary or agent.²⁰⁸ The question of effective legal control of firms also arises in antitrust law.²⁰⁹

A different kind of vertical or hierarchical relationship is created when employees are hired. For general employees who work at a contractual wage, an owning or controlling "boss" usually directs the work. Employment is distinguished from multiple-ownership arrangements by hierarchical authority. Compensation usually does not include profit-sharing, though emerging trends toward employee ownership plans and incentive pay structures combine the *vertical* authority of employment with an interest in the *horizontal* ownership of the enterprise.²¹⁰ Even with profit-sharing or modest levels of employee ownership in the firm, however, the employer retains legal agency authority to direct the work of a general employee.²¹¹ This remains true in firms that follow the recent trend toward "flattening" the organizational structure of a business to devolve greater responsibility to lower levels of employees.²¹² Someone with authority in the firm makes the decision to "flatten."²¹³

In vertical employment relationships, an important boundary of the firm is drawn between a general employee and an independent contractor. An employee subject to the general authority of the employer is usually considered "inside" the firm, and an independent contractor is usu-

208. See, e.g., LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 369-81 (3d ed. 1995) (discussing various concepts of "control" under securities statutes); *id.* at 1085-89 (discussing secondary liability of "controlling persons").

209. See, e.g., Phillip Areeda, *Monopolization, Mergers, and Markets: A Century Past and the Future*, 75 CAL. L. REV. 959, 959-63 (1987) (discussing problem of ascribing intention to "control price" to firms in antitrust analysis); Milton Handler, *Reforming the Antitrust Laws*, 82 COLUM. L. REV. 1287 (1982) (reviewing various problems of control in antitrust law).

210. Profit-sharing with employees is becoming increasingly popular. See, e.g., Martin L. Weitzman & Douglas L. Kruse, *Profit Sharing and Productivity*, in *PAYING FOR PRODUCTIVITY*, *supra* note 173, at 95. In particular, employee stock ownership plans (ESOPs) have become increasingly large and significant. See JOSEPH R. BLASI & DOUGLAS L. KRUSE, *THE NEW OWNERS: THE MASS EMERGENCE OF EMPLOYEE OWNERSHIP IN PUBLIC COMPANIES AND WHAT IT MEANS FOR AMERICAN BUSINESS* (1991); see also *supra* note 37 and accompanying text.

211. See *supra* Section I.A; see also RESTATEMENT (SECOND) OF AGENCY §§ 383, 385 (1958) (discussing agent's duty to act as authorized and duty to obey).

212. See, e.g., Thomas A. Kochan, *The American Corporation as an Employer*, in *THE AMERICAN CORPORATION TODAY* 242, 252 (Carl Kaysen ed., 1996) (describing "the movement to decentralize decision making and flatten organizational structures").

213. See Edward H. Bowman & Michael Useem, *The Anomalies of Corporate Governance*, in *REDESIGNING THE FIRM* 21, 31 (Edward H. Bowman & Bruce M. Kogut eds., 1995) ("If a new set of practices was pushed down the firm's hierarchy, few new practices were pushed up. Empowerment, decentralization, and flexibility became the new 'best practices' below the chief executive, but they found little application above."). Authority structures to direct employees are also present in "employee-owned" firms of a size large enough to require coordination of work other than through face-to-face consensus. Examples in the United States include Weirton Steel and United Airlines. For a useful discussion of the costs of governance in employee-owned firms, see HANSMANN, *supra* note 8, at 89-119.

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ally “outside.”²¹⁴ For example, employees may act as agents to bind their firms to contracts, and firms may be held vicariously liable for tortious harm caused by their agent-employees.²¹⁵ The talismans for vicarious liability are whether the employee acted as a “servant” and whether the action at issue was within “the scope of employment.”²¹⁶

The boundaries of vicarious liability of the firm are not easily drawn, but courts do so when asked.²¹⁷ The recent phenomenon of “downsizing” employees and replacing them by “outsourcing” independent contractors illustrates the practical importance of this boundary of the firm. Because independent contractors are considered “outside” the firm for some kinds of vicarious liability, as well as for tax and other reasons, this strategy saves the firm organizational costs by exploiting its own “blurred boundaries.”²¹⁸ The phenomenon of downsizing shows how the legal background rules concerning the boundaries of firms can have significant social effects.²¹⁹

214. In agency law, this boundary is usually described as one between a “servant” and an independent contractor. Although there are important technical differences, I adopt the simplifying assumption here that for most practical purposes the general employee and legal servant are the same. See RESTATEMENT (SECOND) OF AGENCY § 2 cmts. a-d (1958) (distinguishing servants, nonservant agents, independent contractors, and employees).

215. See *supra* notes 26, 44-47 and accompanying text; see also RESTATEMENT (SECOND) OF AGENCY §§ 228-31 (1958) (describing scope of employment and noting that “forbidden” and “criminal” acts may also lie within the scope of an agent’s employment); Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231, 1231 (1984) (“Hierarchy and delegation are so pervasive in modern business relationships that a staggering number of legal disputes directly or indirectly involve rules of vicarious liability.”).

216. See RESTATEMENT (SECOND) OF AGENCY § 219 cmt. a (1958) (“The conception of the master’s liability to third persons appears to be an outgrowth of the idea that within the time of service, the master can exercise control over the physical activities of the servant. From this, the idea of responsibility for the harm done by the servant’s activities followed naturally. The assumption of control is a usual basis for imposing tort liability when the thing controlled causes harm.”); Alan O. Sykes, *The Boundaries of Vicarious Liability*, 101 HARV. L. REV. 563 (1988) (analyzing “scope of employment” rule). For a recent debate on the justification of vicarious liability, compare Gary T. Schwartz, *The Hidden and Fundamental Issue of Employer Vicarious Liability*, 69 S. CAL. L. REV. 101 (1996), with Stephen P. Croley, *Vicarious Liability in Tort: On the Sources and Limits of Employee Reasonableness*, 69 S. CAL. L. REV. 1705 (1996); see also Gregory C. Keating, *The Idea of Fairness in the Law of Enterprise Liability*, 95 MICH. L. REV. 1266 (1997).

217. See, e.g., CONARD ET AL., *supra* note 3, at 86-88 (collecting cases and references); Sykes, *supra* note 216, at 581-93 (describing “scope of employment” rule and its exceptions).

218. Kochan, *supra* note 212, at 253-55, 262 (discussing rationale of firms using independent contractors and problems associated with increasing numbers of “contingent workers” in labor force); see also Clyde W. Summers, *Contingent Workers in the United States*, 18 COMP. LAB. L.J. 503 (1997) (discussing increasing use of part-time, temporary, and detached employment to reduce labor costs and collecting sources).

219. See, e.g., Lester Thurow, *Almost Everywhere: Surging Inequality and Falling Real Wages*, in THE AMERICAN CORPORATION TODAY, *supra* note 212, at 386 (documenting the downsizing of more than two million workers in the United States from 1990 to 1994); Richard Waters, *Return of the Downsizers*, FIN. TIMES, Dec. 19, 1997, at 13 (documenting another wave of thousands of job cuts in 1997). By most accounts, “downsizing has been devastating” for employees, most of whom do not get equivalent-paying new jobs. Thurow, *supra*, at 388. A series of articles in *The New York Times* focused attention on this issue. See THE NEW YORK TIMES,

Like partners, employees and employers owe one another different kinds of fiduciary duties under the law of agency.²²⁰ Also like partners, employees and employers may waive or alter most of their fiduciary duties by contract.²²¹ In firms with labor unions, collective bargaining enters at this employment boundary of the firm. At this boundary also, state and federal statutes condition the terms of employment and restrict discriminatory practices.²²²

C. Property: Ownership of the Firm's Capital

Another important characteristic of a firm is the ownership of its financial capital and other property. In addition to its economic importance, ownership structure is essential for determining the legal control of firms.²²³ The capital structure of firms is commonly divided into categories of debt and equity, though various hybrid instruments fudge this distinction in practice.²²⁴ Sometimes debt is considered purely financial, without control rights, and equity is considered to represent true "ownership." But reality is not this simple.

THE DOWNSIZING OF AMERICA (1996) (collecting news articles and editorial responses); see also DAVID M. GORDON, *FAT AND MEAN: THE CORPORATE SQUEEZE OF WORKING AMERICANS AND THE MYTH OF MANAGERIAL DOWNSIZING* 51-60 (1996) (arguing that downsizing hit blue-collar workers hardest, contrary to emphasis in the media on firings of white-collar middle managers).

220. Unlike partnerships and in keeping with the hierarchical authoritative nature of employment relationships, employer and employee fiduciary duties are not equal and mutual. Nevertheless, in addition to whatever duties the employment contract specifies, an employee owes an employer a general "duty of care and skill," a duty of "good conduct," a duty to convey relevant information about the business, a duty to account for any profits, and a duty not to act adversely to the interests of the employer in a transaction not known to the employer. RESTATEMENT (SECOND) OF AGENCY §§ 379-80, 388-89 (1958). An employer owes an employee duties to provide an opportunity to perform the work, to refrain from undue interference in the work, to provide necessary information, to keep and render accurate accounts, and to indemnify the employee for certain losses incurred in the business. See *id.* §§ 433-36, 438-39. The employer is also subject to a general duty of "good conduct," as well as a duty to pay compensation. *Id.* §§ 437, 441.

221. See *id.* § 376 ("The existence and extent of the duties of the agent to the principal are determined by the terms of the agreement between the parties, interpreted in light of the circumstances . . ."). The phrase "unless otherwise agreed" often appears in the *Restatement*. See *id.* Scope Note, at 4.

222. See *supra* note 177 and accompanying text. Some scholars argue that fiduciary duties to employees should be expanded to be enforceable against managers in situations such as unjustifiable downsizing or plant relocations. See *supra* notes 176, 219 and accompanying text. However, reforming employment and labor law may offer a more promising avenue for policing the employment boundary of the firm. See, e.g., PAUL WEILER, *GOVERNING THE WORKPLACE: THE FUTURE OF EMPLOYMENT AND LABOR LAW* (1990); Symposium, *The Changing Workplace*, 74 TEX. L. REV. 1485 (1996); Clyde Summers, *Effective Remedies for Employment Rights: Preliminary Guidelines and Proposals*, 141 U. PA. L. REV. 457 (1992).

223. See *supra* Sections IV.C, V.A and Subsection V.B.1.

224. This Article follows the traditional legal distinction between "debt" referring to creditors and "equity" referring to shareholders. In contemporary practice, this distinction is blurred. For an introduction, see KLEIN & COFFEE, *supra* note 91, at 288-97 (describing preferred stock, convertible bonds, and other "hybrids" and "derivatives").

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1. Debt

Very commonly, an enterprise-organizer obtains capital from an outside provider who agrees to supply financing in return for a promise to repay the principal with interest.²²⁵ Because debt relationships are primarily contractual, creditors usually stand “outside” the agency relationships of a firm.²²⁶ In certain situations, however, credit financing implicates elements of control and ownership. Secured creditors, for example, have a direct right in the event of nonpayment to seize the property of a firm that provides the “security.”²²⁷ In the event of insolvency, creditors can step into control and ownership of the enterprise under bankruptcy law.²²⁸ Fiduciary duties may also owe to creditors when the corporation is “in the vicinity of insolvency.”²²⁹ In these kinds of situations, which usually arise when the firm falls on hard times, creditors become involved in running the firm.

Given that creditor relationships may give rise to rights of control and ownership in adverse economic situations, creditors should be included in a legal theory of the firm, even if peripherally. In ordinary circumstances when the firm is a “going concern,” the interests of creditors in the governance and direction of the firm are often minimal. In situations of default on secured debt, insolvency, or bankruptcy, however, what may be called *springing rights of control and ownership* in the firm become active

225. For an introduction to the various forms of debt and its attributes, see *id.* at 225-56.

226. In ordinary circumstances, the creditor cannot act to bind the firm in the market, and the firm is not liable for torts of the creditor. Even in the simplest situations, however, a creditor must take care not to become a “partner” inadvertently by (1) exercising too much control over the direction and management of the business with the enterprise-organizers and (2) sharing in the profits of the enterprise. If a court finds a creditor to be in fact a “partner” or “principal” of a business, the creditor is liable for its obligations. See *supra* note 206 and accompanying text; see also *A. Gay Jensen Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285 (Minn. 1981) (illustrating a lender’s risk of exercising control and thereby becoming liable as a principal in agency law).

227. For an introduction, see Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625 (1997).

228. For an account of governance issues in bankruptcy reorganizations, see, for example, Daniel J. Bussel, *Coalition-Building Through Bankruptcy Creditors’ Committees*, 43 UCLA L. REV. 1547 (1996); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993).

229. See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 W.L. 277613, at n.55 (Del. Ch. Ct. 1991); see also Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 115-22 (1992) (discussing this exception to the no-fiduciary-duty rule for creditors and possible statutory support for it). But see Laura Lin, *Shift of Fiduciary Duty Upon Insolvency: Proper Scope of Directors’ Duty to Creditors*, 46 VAND. L. REV. 1485 (1993) (arguing that cases in fact should be read as applying “extra-contractual” rather than fiduciary duty to creditors); C. Robert Morris, *Directors’ Duties in Nearly Insolvent Corporations: A Comment on Credit Lyonnais*, 19 J. CORP. L. 61 (1993) (arguing that creditors are entitled only to contractual protection); Dale B. Tauke, *Should Bonds Have More Fun? A Reexamination of the Debate over Corporate Bondholder Rights*, 1989 COLUM. BUS. L. REV. 1 (arguing that creditors deserve only contractual protection but analysis should be expansive).

for creditors. In addition, even when things are going well, debt financing of the firm can provide structural discipline by putting pressure on managers and equity owners to make relatively high interest payments, rather than allowing them to rely on the "cushion" of retained earnings.²³⁰ Creditors may also strongly influence the governance of the firm through detailed provisions in the loan agreements.²³¹

Like the boundary separating a firm's employees and independent contractors, the boundary determining when creditors are "inside" or "outside" the firm is not always sharp. In general, it is described by (1) the right of creditors to control or assert ownership in assets of a firm in adverse economic situations and (2) the structural power of creditors to negotiate governance provisions in loan agreements. For purposes of the theory of a firm advanced here, it is sufficient to recognize the general outlines of creditor relationships as a boundary of the firm without a comprehensive examination of its contours.²³²

2. Equity

Recall that an enterprise-organizer may acquire additional capital by teaming up with another in a partnership and agreeing to share profits and losses.²³³ More complex business forms, such as corporations, raise capital by splitting equity ownership rights into "shares."²³⁴ Shareholders exercise control rights of owners through voting, but these rights are conditioned by the legal structure of corporations.²³⁵

In close corporations, ownership and control are often unified because the majority shareholders and managers are identical. Large public corporations, however, are usually characterized by a separation of own-

230. Particularly in more complex forms of business enterprise such as corporations, see *infra* Section V.D, debt can provide an efficient structural alternative or supplement to equity capital financing. For an economic account of debt financing and capital structure in a property theory of the firm, see HART, *supra* note 18, at 93-155. For an account emphasizing the legal control that debtors can exert in firms that they finance, see George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073 (1995). Empirical evidence suggests that managers may not leverage firms as much as most shareholders prefer in the absence of an event that "disciplines" managers, such as a threatened takeover. See Philip G. Berger et al., *Why CEOs Use Insufficient Debt*, WHARTON J., Oct. 27, 1997, at A2.

231. For an introduction to various common types of covenants in debt contracts, see KLEIN & COFFEE, *supra* note 91, at 240-44.

232. Part VI returns to consider one aspect of this boundary of the firm with respect to possible fiduciary duties owing to creditors in certain situations. See *infra* Subsection VI.B.3.

233. See *supra* Subsection V.B.1.

234. In economic terms, shareholders "collectively own the residual or equity interest in the corporation." KLEIN & COFFEE, *supra* note 91, at 118.

235. Because the legal structures of corporations, partnerships, and LLCs place restrictions on residual control, the economic theory of the firm that emphasizes property is incomplete from a legal perspective, though this economic theory correctly points out the source of bargaining power with employees in the ownership of the assets of the firm. See *supra* Section IV.C.

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ership and control. Everyday operational control settles in a centralized management.²³⁶ Shareholders retain rights to vote by proxy for the board of directors, to sell shares into a tender offer, and to hold directors and managers to their fiduciary duties through the possibility of shareholder derivative suits.²³⁷ The primary interest of public shareholders, however, is that of an investor in the financial capital of the firm. To account for the various rights and responsibilities of shareholders and other participants in corporations, a legal theory of the firm is needed.

D. Complex Firms: The Corporation

The corporate form embraces complex structures of control and capital ownership. Beginning with control, enterprise-organizers may retain full ownership of the business and simply incorporate or form an LLC to obtain the legal benefit of limited liability. But equity financing also provides a mechanism to raise outside capital rather than relying solely on retained earnings and debt financing. This alternative of investing in the ownership of a business through the purchase of corporate shares attracts investors seeking higher levels of risk and return.²³⁸ As a result of this

236. For an introduction to the basic legal structure of public corporations and the “master problem” of accountability created by the separation of ownership and control, see JESSE H. CHOPER ET AL., *CASES AND MATERIALS ON CORPORATIONS* 1-10, 22-23, 24 (4th ed. 1995). There is a debate, as yet unsettled, about whether the rise of institutional investors will help to close this gap between shareholders and managers. For a discussion and references to the relevant literature, see Orts, *supra* note 3.

237. Procedural hurdles to derivative shareholder suits alleging fiduciary duty violations, however, have grown higher in recent years. With respect to the duty of care, one commentator questions whether it “entails a useful norm of behavior” given that the “level of care required . . . is low, and the quality of [business] judgment is even lower.” Brudney, *supra* note 22, at 599 & n.12. Forgiving standards of review, state exculpation statutes allowing directors and managers to be immunized from liability, and strict procedural requirements involving the demand requirement and the use of special litigation committees have effectively eliminated the enforcement of fiduciary duties of care in the corporate context, except perhaps for directors in financial institutions. See, e.g., *id.* at 600 n.12. For an overview of the law of derivative shareholder litigation, see DEBORAH A. DEMOTT, *SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE* (1994); KLEIN & COFFEE, *supra* note 91, at 195-201. Another partial exception appears in the “enhanced” standard of review applied in some hostile takeover situations. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985). A similar trend is evident in “increasingly slack” enforcement of “restrictions on self-dealing” under the fiduciary duty of loyalty. Brudney, *supra* note 22, at 629.

238. Again, the conceptual line between “equity” shareholders and “debt” creditors is not always clearly drawn in practice. See *supra* note 224 and accompanying text. Some stock, for example, is nonvoting and therefore without direct control rights. Preferred stock is usually best treated as a type of debt. See, e.g., Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (and Why We Should Care About It)*, 51 *BUS. LAW.* 443, 444 (1996) (“[T]he preferred stockholder ought not think of himself or herself as a stockholder at all and should plan to rely exclusively on his or her contract as the source of rights. . . .”). At the same time, certain kinds of debt may be convertible into equity with voting rights. Debt known as “high-yield” or “junk” bonds may also provide for high risk and high return similar financially to common stock. For an introduction, see KLEIN & COFFEE, *supra* note 91, at 238-40, 293-94. Given this complexity, a determination of the relative weight of “equity” or “debt” for any particular financial instrument often depends on the circumstances.

process in which shares are widely distributed, most large corporations have centralized control in professional managers and established complex financing arrangements that include retained earnings, outside creditors, and shareholder investors.

Traveling with the difference in the capital structure of corporations is also a fundamental change in agency relationships. Economic theories of the firm often cast the board of directors as an "agent" of shareholders,²³⁹ but this characterization is not correct as matter of law.²⁴⁰ Although board members "resemble agents in that they act on behalf of others and are fiduciaries owing duties of loyalty and care," they owe these duties "to the corporation itself rather than to the shareholders individually or collectively."²⁴¹ Because the board has statutory authority to "manage" the corporation,²⁴² descriptions of corporate directors as simply the agents of shareholders are legally flawed.²⁴³

A realistic theory of the firm must account for the different legal agency structures in the corporation. In partnerships, owners are principals. In corporations, shareholders are equity owners but not always directors or managers, especially in large public corporations. Shareholders do not act as principals in the everyday management of public corporations, even though they participate in a manner similar to principals when

239. See Bowman & Useem, *supra* note 213, at 23, 29, 32 (describing the assumptions in applications of principal-agent theory to corporations and arguing that they do not accurately portray reality); Dennis C. Mueller, *The Corporation and the Economist*, 10 INT'L J. INDUS. ORG. 147, 157-58 (1992) (advancing similar critical description of principal-agent theories of the corporation).

240. See RESTATEMENT (SECOND) OF AGENCY § 14C (1958) ("Neither the board of directors nor an individual director of a business is, as such, an agent of the corporation or of its members.").

241. *Id.* § 14C cmt. a. This distinction continues to be important in shareholder lawsuits to enforce violations of fiduciary duties of directors or managers. They must be brought "derivatively" in a representative capacity on behalf of the corporate entity. See *supra* note 237 and accompanying text.

242. See, e.g., REVISED MODEL BUS. CORP. ACT § 8.01(b) (1984) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized [by the shareholders in advance]"). Although most state corporate statutes now allow this sort of "opting out" of a board of directors, most large corporations have boards and, when they do, the board has authority to act for the corporation in most instances.

243. Robert Clark describes this difficulty as follows:

To an experienced corporate lawyer who has studied primary legal materials, the assertion that corporate managers are agents of investors would seem odd or loose. The lawyer would make the following points: (1) corporate officers like the president and treasurer are agents of the corporation itself; (2) the board of directors is the ultimate decision-making body of the corporation . . . ; (3) directors are not agents of the corporation but are *sui generis*; (4) neither officers nor directors are agents of the stockholders; but (5) both officers and directors are "fiduciaries" with respect to the corporation and its stockholders.

Clark, *supra* note 140, at 56; see also *supra* Section II.B.

electing board members and sharing in profits.²⁴⁴ Like chief executive officers, shareholders in large corporations are more accurately described as *quasi-principals* because they sometimes exercise the prerogatives of ownership and control, and sometimes they do not—sharing ownership with the rights of creditors (and the corporate entity itself), and sharing authority and control with corporate directors and officers.²⁴⁵ For most practical purposes, managers are the enterprise-organizers in corporations with their authority delegated from the board. Shareholders exercise power over the board through voting at annual or special meetings²⁴⁶ and through shareholder derivative lawsuits.²⁴⁷ They also, of course, receive dividends (when they are declared) and can sell their shares (at a profit or loss). Only in these senses do shareholders act as “principals” of corporations. In legal terms, the relationship between shareholders and directors/managers is not a direct agency, but rather a special form of quasi-agency governed by an overlay of state corporate law.

The complex structure of corporations allows for significant flexibility in terms of financing and organization. Agency and fiduciary relationships become elongated. Contracts define the financial, managerial, and employment arrangements within a corporation, but they occur within the *nexus of agency relationships* that describes the legal structure. In the corporate firm, a new set of boundaries forms within this web of agency relationships.²⁴⁸ Shareholders act as residual owners, yet in public corporations they are also investors who may exit the firm in an electronic flash. Managers are high-level employees of the corporation, yet they are also delegated considerable authority to act on behalf of the firm—often as if they were principals.²⁴⁹ The board has formal authority to act as the principal decision-making body, yet its members are also elected by the shareholders and often covertly selected by the managers.²⁵⁰ The

244. See DeMott, *supra* note 199, at 109 (“The baseline assumptions about the corporate form are that the corporation itself, not its owners, is the principal, that management is centralized into a hierarchical structure of directors, officers, and nonofficer managerial employees, and that shareholders risk no individual liability for corporate debts, beyond the amount they invested.”).

245. See *supra* Sections I.A, II.B, V.C. For an account of the divided rights of ownership and control in the corporation, see John Kay & Aubrey Silberston, *Corporate Governance*, in 2 PERSPECTIVES ON COMPANY LAW 49, 52-56 (Fiona Macmillan Patfield ed., 1997).

246. Another option is the shareholder consent solicitation. See, e.g., 8 DEL. CODE § 228 (West 1997).

247. See *supra* note 237 and accompanying text.

248. Cf. John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986).

249. See *supra* Section II.B (describing corporate executives as both agents and quasi-principals).

250. See James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, LAW & CONTEMP. PROBS., Summer 1985, at 83; see also MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 139-48

boundaries of these various relationships within the corporation shift in various circumstances—such as when shareholders sue, directors deliberate, managers are fired, or the ownership of the corporation changes hands.²⁵¹

E. Complex Groups: Relational Firms

Including sole proprietors, partnerships, limited liability companies, and corporations as firms should meet with the common knowledge of most lawyers familiar with the basic law of enterprise organization. The borderline cases of pure sole proprietorships, employment relations, and the role of creditors may prove more controversial, but they remain within the ken of traditional legal understandings of business firms. A last type of firm that competes with others in organizational metamarkets steps further outside traditional forms to include “relational contracts” made between or among simpler firms to act in unison.²⁵²

This type of *relational firm* acts as one entity for certain purposes and at the same time retains separate boundaries of smaller firms within it. One example is the corporate group with “subsidiary” corporations organized under a corporate “parent.” Corporate groups act as one entity for some purposes (such as financial control), but they are also composed of subsidiary entities for other purposes (such as separate governance or limited liability).²⁵³ Other examples include joint ventures, franchises, distributorships, and other arrangements that do not fit the model of a single, integrated firm.²⁵⁴

(1976) (describing the “captured board” syndrome).

251. Given the complexity of the ownership structure of many corporations, change of ownership often means more precisely that enough ownership assets are acquired by a new person or group of persons to enable a transfer of effective control of the enterprise (i.e., ownership of sufficient shares to elect a new CEO).

252. I use the term “relational contract” to refer to governance arrangements between two firms or among a group of firms described previously in this Part which have the effect of unifying the efforts of the resulting “relational firm” in the organizational metamarket. Cf. WILLIAMSON, *supra* note 74, at 68-84; George Baker et al., *Relational Contracts and the Theory of the Firm* (Harvard Business School Working Paper, Dec. 29, 1997) (copy on file with author); G.B. Richardson, *The Organization of Industry*, 82 *ECON. J.* 883 (1972). This usage is not the sense of the term “relational contracts” used in either the broad social sense, see, for example, Ian R. Mcneil, *Relational Contract: What We Do and Do Not Know*, 1985 *WIS. L. REV.* 483, or the broad economic sense of “relational exchange,” see, for example, Victor Goldberg, *Relational Exchange: Economics and Complex Contracts*, 23 *AM. BEHAVIORAL SCIENTIST* 337 (1980).

253. For an introduction to the law of corporate groups, including the multinational enterprise, see PHILIP I. BLUMBERG, *THE MULTINATIONAL CHALLENGE TO CORPORATION LAW* (1993). Some legal systems recognize and regulate corporate groups more directly than in the United States. Most notable in this regard are the German rules governing *Konzernrecht* (“related companies”). See, e.g., ERIC STEIN, *HARMONIZATION OF EUROPEAN COMPANY LAWS: NATIONAL REFORM AND TRANSNATIONAL COORDINATION* 89, 105-07, 468 (1971).

254. In distributorships and franchises, “when the sales and distribution component of a venture is legally independent of the manufacturing or service-supplying component, . . . the

The boundaries of the firm become difficult to ascertain in these kinds of relational firms. Whether a relational firm is considered one entity or a group of entities will depend, again, on the question that is asked. If the question is one of limited liability, the answer will focus on the lines of demarcation between the corporate entities that compose relational firms. If the question is whether a relational firm is acting as a unit in competing with other firms in markets, the answer will focus on the lines of authority that enable it to act as a single entity.

Relational firms highlight the analytical difficulty in defining the boundaries of the firm. From an economic perspective of the organizational metamarkeet, complex relational firms compete with other kinds of firms to supply goods and services to consumer markets. From a legal perspective, the boundaries of relational firms are dynamic and shift in response to different questions about different elements of organization.²⁵⁵

F. The Legal Boundaries of the Firm

The legal theory of the firm advanced here does not provide a simple account with clear-cut boundaries. Instead, the boundaries of the firm fluctuate in the key areas of control, ownership, and employment. My purpose has been to outline these legal boundaries, rather than to describe them in detail.

In general, the “black box” of the firm has the following legal

two components can be thought of as parts of a single organization,” if each depends on the other. Klein, *supra* note 20, at 1533. On joint ventures, see Steven R. Salbu & Richard A. Brahm, *Strategic Considerations in Designing Joint Venture Contracts*, 1992 COLUM. BUS. L. REV. 253. On franchises, see Robert W. Emerson, *Franchising and Collective Rights of Franchisees*, 43 VAND. L. REV. 1503 (1990).

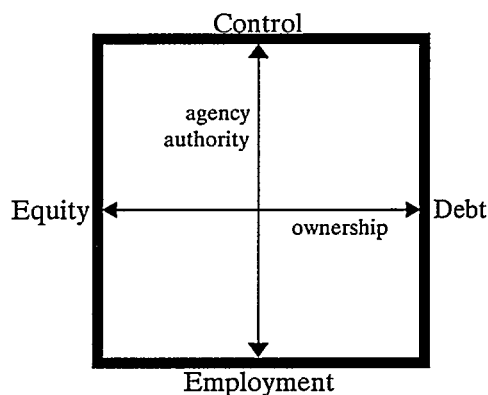
Price-fixing or other collusive arrangements that raise issues of antitrust law might also be described as creating relational firms. A touchstone in antitrust analysis is often control. See *supra* note 209 and accompanying text. From the larger theoretical perspective suggested above, the general problem of antitrust law might be redescribed as regulation of the organizational metamarkeet of firms to assure competition in the supply of consumer markets. See *supra* Section III.B. In any event, the law of antitrust certainly affects the size of firms. See, e.g., Tony Freyer, *Legal Restraints on Economic Coordination: Antitrust in Great Britain and America, 1880-1920*, in COORDINATION AND INFORMATION: HISTORICAL PERSPECTIVES ON THE ORGANIZATION OF ENTERPRISE 183 (Naomi R. Lamoreaux & Daniel M.G. Raff eds., 1995) (arguing that the enforcement of antitrust laws in the United States led ironically but beneficially to the growth of large-scale corporate enterprises through mergers).

255. Difficult hybrid cases lying in a gray area between relational firms and markets remain. These cases usually involve relatively long-term contractual relationships between firms legally organized in one of the forms described above. Often these intermediary arrangements are for supplies, marketing, or distribution. See *supra* note 254 and accompanying text; see also *supra* note 252 (describing “relational contracts” and “relational exchange”). In terms of the theoretical perspective offered here, these relationships would be described as either relational firms or market contracts between firms, depending on the extent of integrated control, ownership, and employment.

boundaries which fluctuate according to size and firm structure.²⁵⁶ The boundaries of the firm include the vertical dimensions of legal control and employment, and the horizontal dimensions of equity and debt ownership and financing. (See Figure 1.) One-person firms shrink these dimensions to a single dot. Complex relational firms multiply the number of boxes. The thick lines indicate that the boundaries are not sharp. As discussed above, various boundary problems include the following: limited liability, inadvertent ownership, the line separating employees and independent contractors, whether and when creditors should be considered in the firm, the conflicting and ambiguous roles of principals and agents, and two or more smaller firms acting as one relational firm.²⁵⁷

Figure 1

The Legal Boundaries of the Firm



256. *Cf. supra* note 97 and accompanying text (referring to the orthodox economic description of the firm as a “black box”).

257. The fact that the boundaries of the firm pose difficult cases, however, is not an argument against drawing lines. Consider, as an analogy, the idea that the United States has boundaries. There are lines drawn on a map, but what do they mean? The border is not always strictly enforced. If the United States is its economy, many noncitizens participate in it. If the United States is its citizens, many live outside the geographical territory of the United States. If the United States is its government, constitutional federalism raises complications. Like firms within relational firms, the states are political entities within a larger national entity. Nevertheless, there is an underlying truth and usefulness in referring to “the United States.” So also it is useful to outline the boundaries of firms.

VI. SHIRKING, SHARKING, AND FIDUCIARY DUTIES

“There ain’t no clean way to make a hundred million bucks,” Ohls said. “Maybe the head man thinks his hands are clean but somewhere along the line guys got pushed to the wall, nice little businesses got the ground cut from under them and had to sell out for nickels, decent people lost their jobs, stocks got rigged on the market, proxies got bought up like a pennyweight of old gold, and the five per centers and the big law firms got paid hundred-grand fees for beating some law the people wanted but the rich guys didn’t, on account of it cut into their profits. Big money is big power and big power gets used wrong. It’s the system.”²⁵⁸

Having described a legal theory of the firm and its boundaries, I turn now to consider a prescriptive application of this theory in legal practice. As first suggested above in Part II, the costs of *sharking* by principals and quasi-principals in positions of what Chandler’s character calls “big power” in a firm often prove as large as the costs of *shirking* by agents. If so, constraining both kinds of behavior in firms is important.²⁵⁹ Some constraints appear at the various legal boundaries of the firm sketched in Part V in the form of securities and antitrust law, labor and employment law, and the law of enterprise organization. Other constraints include those of environmental law and the criminal prohibition of fraud, theft, and extortion.²⁶⁰ This Part focuses on only one piece of the larger picture of legal constraints on the behavior of individuals in firms. It examines the relationship between the law of fiduciary duties and the costs of shirking and sharking within business corporations.²⁶¹

A. *Constraining Shirking*

As described above in Part I, shirking refers to the costs of all agents in a firm who choose to further their own self-interests at the expense of the collective interests of the firm. In the context of the corporate firm,

258. RAYMOND CHANDLER, *THE LONG GOODBYE* 227 (1953).

259. Cf. Klein, *supra* note 20 (recognizing the importance of legal constraints as well as contractual bargaining).

260. See Joseph Vining, *Corporations, Criminal Law, and the Color of Money*, MICH. L. QUADRANGLE NOTES, Spring 1997, at 87 (“The application of the criminal law to business corporations has one overriding function. It counters, as can nothing else, the temptation to define the purpose of the corporate entity as the maximization of money profit.”).

261. As a practical matter, it makes sense to focus on corporations. Although the most recently available statistics indicate that there are quantitatively more sole proprietorships and partnerships than corporations (16.3 million of the former compared to 3.7 million corporations in the United States in 1990), corporations account for more than 90 percent of total sales and receipts. The 7000 largest corporations (each with assets of \$250 million or more) make up more than half of all sales and receipts of businesses. See Carl Kaysen, *Introduction and Overview*, in *THE AMERICAN CORPORATION TODAY*, *supra* note 212, at 3, 5. Similar arguments with respect to fiduciary duties may apply to other business firms, but they are left outside the scope of this Article.

shirking refers to the agency chain of command.²⁶² Managers watch over and seek to motivate employees. Shareholders watch over and seek to motivate the board of directors and, through the board, the managers. The direction of the analysis of shirking is generally “downward” in terms of the vertical and hierarchical structure of the firm.²⁶³ The punishment of agents is usually a self-help remedy, such as firing employees or replacing managers or directors.

Because of the complex authority structures of large corporations,²⁶⁴ self-help remedies to police the shirking of top managers or the board of directors are not directly available to shareholders, except in relatively rare situations when a proxy fight or tender offer aims to replace ineffective, incompetent, lazy, or greedy management. Shareholder derivative lawsuits developed historically to allow shareholders to police violations of the fiduciary duties of managers or board members. Today, cases that allege violations of the duty of care—in other words, some degree of negligence by managers or directors—usually run into procedural problems and, even when they do not, judicial review is usually governed by a forgiving “business judgment rule” that protects the discretion of directors and managers in most situations.²⁶⁵ More substantive judicial review governs claims that agents have secretly diverted assets from the firm to themselves.²⁶⁶ In corporate law, this problem of diverting assets is handled by duty of loyalty restrictions on self-dealing (as well as criminal prohibitions against theft and fraud).²⁶⁷ These restrictions also include prohibitions against the misappropriation of corporate opportunities and insider trading.²⁶⁸

Legal intervention as well as self-help by owners and enterprise-organizers is often required to minimize the costs of shirking by agents. This approach is well recognized in the economic and legal literature, though debate continues about whether and when extra-contractual fiduciary duties should be enforced.²⁶⁹ The theoretical contribution here is to recognize that efforts should also be made to reduce the costs of shirking

262. See *supra* Section II.B.

263. See *supra* Sections I.B, V.B, V.D.

264. See *supra* Sections II.B, V.D.

265. See *supra* note 237 and accompanying text. For a description of the business judgment rule and its limits, see 1 COX ET AL., *supra* note 23, §§ 10.1 to 10.10.

266. See Brudney, *supra* note 140, at 1406 (referring to management’s “temptation to shirk in its performance or to divert corporate assets to itself”).

267. For an overview of the current law dealing with the duty of loyalty and self-dealing, see 1 COX ET AL., *supra* note 23, §§ 10.11 to 10.18, 11.1 to 11.10.

268. For an overview of these two particular problems, see ROBERT CHARLES CLARK, CORPORATE LAW chs. 7 & 8 (1986). On the law against insider trading, see also DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT AND PREVENTION (1996); WILLIAM K.S. WANG & MARK I. STEINBERG, INSIDER TRADING (1996).

269. See *supra* note 22 and Section I.B.

by principals and quasi-principals in firms. As with shirking, contractual self-protection alone is often not enough.

B. Constraining Shirking

As described above in Part II, economic theories of the firm usually do not distinguish between “downward” and “upward” opportunism. The direction depends on who within the firm is acting, with what authority, and through what means. Traditional agency costs theory is justly criticized for its preoccupation with the “downward opportunism” of agents.²⁷⁰ Focusing only on the principal’s problem of controlling the behavior of agents overlooks the opportunism of principals and quasi-principals. The misuse of authority and power by principals and quasi-principals within firms is called *sharking* to distinguish it from classical agency costs.²⁷¹ The term is colorful, but not more so than shirking. Unlike shirking, which describes laziness, incompetence, or theft by agents, sharking refers to the use of authority by principals and quasi-principals to redistribute assets within the firm. Sharking can occur laterally against other powerful players in the firm. More often, it is used in a direction of “upward opportunism” to the advantage of principals and quasi-principals (such as shareholders or corporate management) against the interests of other principals or agents (such as minority shareholders, creditors, or even rank-and-file employees).²⁷²

For purposes of illustration, this Part briefly discusses four general situations that may involve sharking within corporations: conflicts between majority and minority shareholders, executive compensation, downgrading of creditors, and financial reengineering of capital structure. Each of these situations of potential interfirm opportunism by principals or quasi-principals is discussed in turn. The illustrations do not provide full-fledged arguments describing proper legal standards to constrain the various forms of sharking described. Each problem may call for regulatory responses not only in corporate law, but in other areas such as securities, tax, or bankruptcy. A common normative prescription, however, is to reinvigorate fiduciary duties (along with the procedural means to enforce them) to address some of these kinds of problems.

270. See Gregory K. Dow, *The Function of Authority in Transaction Costs Economics*, 8 J. ECON. BEHAV. & ORG. 1 (1987); see also *supra* Section II.A.

271. See *supra* Section II.A.

272. For an early recognition in terms of game theory of the problem of sharking, see John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495 (1990). In addition to the examples given below, the downsizing phenomenon discussed *supra* Subsection V.B.2 may sometimes involve sharking against rank-and-file employees.

1. *Oppression of Minority Shareholders*

A well-known problem in corporate law is the misuse of the authority of a controlling majority of shareholders to “oppress” minority shareholders.²⁷³ The problem often arises in close corporations when controlling shareholders engage unfairly in a “freezeout” or “squeezeout” of a minority.²⁷⁴ This kind of situation cannot be accounted for in agency theory as a species of shirking. Instead, controlling shareholders and managers use their power and authority as quasi-principals to dilute or eliminate the interests of minority shareholders who are also quasi-principals.²⁷⁵ Wronged minority shareholders may recover against the majority for this sort of behavior, but the intervention of courts is usually necessary, such as in proceedings for an appraisal or claims for equitable relief for oppression.²⁷⁶ Although *ex ante* contracting can protect shareholders who foresee the risk of oppression, self-help remedies alone are not sufficient.²⁷⁷

273. See *supra* note 23 and accompanying text; see also Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699 (1993) (providing a general discussion of remedies for oppression of minority shareholders in close corporations). For comparative analysis, see Deborah A. DeMott, *Oppressed But Not Betrayed: A Comparative Assessment of Canadian Remedies for Minority Shareholders and Other Corporate Constituents*, LAW & CONTEMP. PROBS., Summer 1993, at 181, 191; Sandra K. Miller, *Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French “Close Corporation Problem”*, 30 CORNELL INT’L L.J. 381 (1997).

274. See, e.g., CLARK, *supra* note 268, at 499-530 (discussing general legal principles of “freezeouts and buyouts”). A freezeout is a transaction in which the minority interest is involuntarily eliminated, for example, through a short-form statutory merger. See *id.* at 499 (describing a freezeout); *id.* at 502 (describing a short-form merger). A squeezeout is a transaction that does not directly eliminate the minority shareholder but “has the purpose and practical effect of making his situation so unrewarding that he is virtually disinvested or so unpleasant that he will inevitably sell out on the insider’s terms.” *Id.* § 12.1, at 500.

275. As discussed *supra* Sections II.B and V.D, neither corporate shareholders nor managers exercise the full powers of a “principal” in agency law. They are better described as quasi-principals.

276. For discussion of the purposes of and difficulties with the appraisal remedy, see Hideki Kanda & Saul Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429 (1985); Alexander Khutorsky, *Coming in from the Cold: Reforming Shareholders' Appraisal Rights in Freeze-Out Transactions*, 1997 COLUM. BUS. L. REV. 133; Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223 (1962). For sources on equitable remedies for oppression, see *supra* notes 23, 273. For a comprehensive discussion of judicial remedies for minority shareholders, see F. HODGE O'NEAL & ROBERT B. THOMPSON, *O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS* (1994).

277. Some commentators argue that this problem should be resolved entirely by *ex ante* contracting. See, e.g., EASTERBROOK & FISCHER, *supra* note 22, at 228-52. If minority shareholders are not smart enough to foresee the risk of the majority later taking advantage of them, then too bad. Shareholders will learn the lesson and either negotiate appropriate buyout clauses or refuse to invest. This position is not persuasive, however, for several reasons. First, the future is not easily foretold in business. When things turn out differently than shareholder investors anticipated—due, for example, to the unfolding of a major dispute within a family corporation—allowing minority shareholders to bear the full brunt of changed circumstances is unfair. Second, because minority shareholders represent an ownership interest in the firm, allowing a majority to eliminate or significantly reduce the value of this interest violates the basic property

Mistreatment of minority shareholders along these lines may occur in sale-of-control transactions. In the United States, majority shareholders have a right to sell control and retain a “control premium.”²⁷⁸ However, this rule is subject to exceptions under both federal securities regulation and state corporate law.²⁷⁹ Transactions in corporate control undertaken by majority shareholders pose the risk of what one commentator calls “insider imperialism.”²⁸⁰ This is not to say all control transactions that freezeout minority shareholders are unfair or inefficient. Many transactions in corporate control are both fair to minority shareholders and economically beneficial. The legal problem is to distinguish “a transaction that creates wealth from one that merely transfers it.”²⁸¹

A theory of the firm that includes principal costs recognizes the risk that some transactions may involve unfair wealth transfers from minority shareholders. Although oppression of minority shareholders is a long-standing problem,²⁸² it does not fit the standard economic account of agency costs. The theory of the firm advanced here is broad enough to

rights of equity ownership. Affording minority shareholders no legal protection against abuse by the majority would be tantamount to recognizing simple theft of the minority’s investment interest. Third, a lack of protection for minority shareholder interests would provide a disincentive for any investor to take such a position, thus at least potentially decreasing the amount of capital raised for business enterprise.

278. See John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359, 360 (1996) (discussing “the widely prevailing rule that a controlling shareholder may receive a control premium for its shares” but noting this “consensus” is “surprising” because “the United States stands virtually alone in failing to accord minority shareholders any presumptive right to share in a control premium” as compared to other countries).

279. Federal securities law requires that tender offers must be open to all holders at the same price. See *id.* at 371-76 (discussing Rule 14d-10 and its judicial applications). Going private transactions that employ a tender offer and then a second step freezeout must treat minority shareholders to a portion of any control premium. See *id.* at 377-78 (discussing Rule 13e-3). State corporate law protects minority shareholders in control transactions in the following situations: (1) when a controlling shareholder suspects that an acquirer may “loot” the corporation, (2) when a sale of control involves the sale of a “corporate office,” (3) when a sale of control diverts a corporate opportunity, or (4) when a controlling shareholder discriminates against minority shareholders in the payment of dividends or other benefits that should be shared equally by all. See *id.* at 378-85; Einer Elhauge, *The Triggering Function of Sale of Control Doctrine*, 59 U. CHI. L. REV. 1465, 1467-81 (1992). Statutory appraisal remedies also sometimes provide a remedy to protect minority shareholders from unfair treatment at the hands of a majority in a squeezeout or freezeout. See Coffee, *supra* note 278, at 385-87. On appraisal rights generally, see CLARK, *supra* note 268, § 10.6, at 443-58; Kanda & Levmore, *supra* note 276; Manning, *supra* note 276.

280. CLARK, *supra* note 268, at 499.

281. Coffee, *supra* note 278, at 369; see also Elhauge, *supra* note 279, at 1466 (asserting that the problem in “sale of control” cases is to determine in each case “whether the control transfer is likely to be harmful or productive”).

282. For an historical account of early U.S. cases in this area, see D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 310-15 (1998). It is also possible that minority shareholders may exploit legal mechanisms designed to protect them at the expense of majority shareholders. For a recent exploration of the minority shareholder “holdout” problem, see A. Richard Blaiklock, Note, *Fiduciary Duties Owed By Frozen-Out Minority Shareholders in Close Corporations*, 30 IND. L. REV. 763 (1997).

include this risk of sharking by majority shareholders, and it provides a basis for the development of legal standards to govern this behavior.²⁸³

2. *Excessive Executive Compensation*

Overcompensation of executives is a recurring problem in corporate law.²⁸⁴ The issue traces at least to the 1930s in the United States.²⁸⁵ Recently, it has returned to prominence for several reasons. First, other countries pay much lower levels of executive compensation.²⁸⁶ Second, the gap between compensation levels of executives and the rest of the workforce is increasing.²⁸⁷ Third, levels of executive compensation have significantly outpaced gains in corporate revenues and profits.²⁸⁸

The legal problem arises from the undue influence that executives may exert on the board of directors, including any compensation committee. The influence of corporate executives in choosing the members of the board has been observed for some time.²⁸⁹ Recently, various meas-

283. Working out exactly what the standard of review for this area should be lies outside the scope of this Article. For a good introduction to the current debate, compare Coffee, *supra* note 278, with Elhaage, *supra* note 279. A theory of the firm that recognizes this sort of sharking also helps to justify securities regulation in this area. See *supra* note 279 and accompanying text.

284. For the case against current levels of executive compensation, see DEREK BOK, *THE COST OF TALENT: HOW EXECUTIVES AND PROFESSIONALS ARE PAID AND HOW IT AFFECTS AMERICA* 95-118 (1993); GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS* (1992); Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 *IND. L.J.* 59 (1992); Carl T. Bogus, *Excessive Executive Compensation and the Failure of Corporate Democracy*, 41 *BUFF. L. REV.* 1 (1993). For defense of current practices, see Richard A. Booth, *The Other Side of the Management Compensation Controversy*, 22 *SEC. REG. L.J.* 22 (1994); Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 *U. CIN. L. REV.* 713 (1995); Kevin J. Murphy, *Top Executives Are Worth Every Nickel They Get*, *HARV. BUS. REV.*, Mar.-Apr. 1986, at 125.

285. See *Rogers v. Hill*, 289 U.S. 582, 591-92 (1933) (holding that payments to executives with "no relation" to services provided amounted to "misuse and waste"); Detlev Vagts, *Challenges to Executive Compensation: For the Market or the Courts?*, 8 *J. CORP. L.* 231, 245-47, 252-68 (1983) (discussing history and leading cases).

286. See, e.g., CRYSTAL, *supra* note 284, at 205-07 (noting that average compensation of CEOs in 1989 was \$2.8 million in the United States compared with \$735,000 in Germany and \$310,000 in Japan); see also Johannes M. Pennings, *Executive Reward Systems: A Cross-National Comparison* 105 (Wharton School Management Dep't Working Paper No. 105, 1991) (comparing executive pay in the United States, France, and the Netherlands).

287. One commentator figures the ratio of executive pay to that of rank-and-file employees to be 120:1 in the United States compared with 21:1 in Germany and 16:1 in Japan. See CRYSTAL, *supra* note 284, at 27, 207-09; see also Thurow, *supra* note 219, at 383-85 (showing that while CEO pay rose significantly from 1973 to 1993, median real wages for most workers fell significantly even though GDP increased).

288. See David Cay Johnston, *Executive Pay Increases at a Much Faster Rate than Corporate Revenues and Profits*, *N.Y. TIMES*, Sept. 2, 1997, at D4 (reporting that between 1980 and 1995 executive pay rose 182% compared to increases in corporate profits of 127% and corporate revenues of 129.5%).

289. See *supra* note 250 and accompanying text; see also SONNY KLEINFELD, *STAYING AT THE TOP: THE LIFE OF A CEO* 145 (1986) ("Why do executives make such seemingly scandalous sums of money? Easy. They are the ones who decide how they should be compensated. Boards of directors do no more than offer pro forma blessings (and directors pretty much serve

ures have been adopted to address executive compensation, such as requiring disclosure in federal securities filings²⁹⁰ and eliminating corporate tax deductions for compensation in excess of one million dollars annually which is not tied to stock performance.²⁹¹ However, these measures have been judged to have had “no effect.”²⁹² In fact, executive pay rose even faster after these provisions were adopted.²⁹³

In the past, corporate law provided for substantive review of inordinate executive compensation.²⁹⁴ Since at least 1960, however, most courts have been hostile to substantive challenges to executive compensation in large public corporations. Approval by compensation committees composed of disinterested directors acting in good faith is sufficient to prevent substantive judicial review of even the most outrageously generous compensation deals.²⁹⁵ In the absence of this procedure, however, a compensation plan may run into trouble, especially if it does not assure that a corporation gets a benefit for its money, such as in a plan involving stock options to be exercised in the far-distant future.²⁹⁶

Legal scholars have taken a number of different approaches to this issue. One approach is to say: Don't worry—labor markets for executive compensation are working correctly.²⁹⁷ Agency costs theorists argue that

at the pleasure of the chief executive.)”); Johnston, *supra* note 288, at D4 (“[C]hief executives are paying themselves. . . . They have all this diaphanous language about performance and all these committee reports on how pay was determined, but the simple truth is that executives are setting their own pay.”) (quoting Robert Monks).

290. See Regulation S-K, Item 402.

291. See I.R.C. § 162(m) (West Supp. 1997).

292. See Johnston, *supra* note 288, at D4 (quoting Michael Graetz).

293. See *id.* (reporting that executive compensation increased at a 29% faster rate after the tax law change). For a skeptical view of the effectiveness of securities disclosure and tax approaches before these figures proved him right, see Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1885-96 (1992) (reviewing GRAEF CRYSTAL, *IN SEARCH OF EXCESS* (1991)); see also Murphy, *Politics, Economics, and Executive Compensation*, *supra* note 284, at 739 (predicting that tax changes for executive compensation under § 162(m) would result ironically in higher levels of compensation).

294. See *supra* note 285 and accompanying text. In addition, executive salaries were held in check after the stock market crash in 1929 by economic conditions, wartime salary stabilization, and progressive income taxation. See Barris, *supra* note 284, at 62.

295. See, e.g., *Beard v. Elster*, 160 A.2d 731, 738 (Del. 1960) (upholding a stock option compensation package against challenge when it had been approved by disinterested directors); *Heller v. Boylan*, 29 N.Y.S.2d 653, 679 (Sup. Ct. 1941) (“Yes, the Court possesses the *power* to prune these payments, but openness forces the confession that the pruning would be synthetic and artificial rather than analytic or scientific. Whether or not it would be fair and just, is highly dubious.”), *aff'd mem.*, 32 N.Y.S.2d 131 (Sup. Ct. 1941); see also Barris, *supra* note 284, at 75 (“So long as full disclosure is made and the compensation is approved by disinterested directors, it will be reviewed under the business judgment standard with only a cursory review, if any, for fairness to the corporation.”).

296. See, e.g., *Byrne v. Lord*, Fed. Sec. L. Rep. (CCH) [1995-1996 Transfer Binder] ¶ 98,987, at 93,800-02 (Del. Ch. Nov. 9, 1995) (striking down a stock option plan not shown to provide a benefit to the corporation for the bargain).

297. See, e.g., *Booth*, *supra* note 284, at 51-52 (arguing that “nothing but the market should regulate the process” of setting compensation and “executives should get their due”). This view

executive compensation is not excessive as long as payment of executives is tied to stock performance.²⁹⁸ Another approach argues for vigorous board oversight of executive pay and encourages tying the pay of board members to stock price.²⁹⁹

The legal theory of the firm advanced here, however, casts doubt on approaches to thinking about the problem of executive compensation as a bilateral one between shareholders as principals and top-level managers as agents.³⁰⁰ Conceiving executive compensation to be a problem of principal costs or sharking suggests that a return to a "reasonableness" test under the law of fiduciary duties may be in order, at least in some circumstances.³⁰¹ Excessive executive compensation is not simply a kind of shirking because in some cases the executives are arguably overreaching their authority as quasi-principals in setting their own salaries.³⁰² Excessive executive compensation involves a type of self-dealing that involves not a secret diversion of assets, but rather an abuse of authority. A judicial determination that a compensation package results from overreaching by executives, rather than due deliberation by disinterested directors, would show it more likely to represent opportunism than reason-

is consistent with what Charles Yablon calls the "financial zeitgeist" of the 1980s and early 1990s. Yablon, *supra* note 293, at 1881. With salaries for sports figures, movie stars, and other entertainers in the stratosphere compared to most people, the argument that corporate executives are overpaid is difficult to sustain. *See id.*; *see also* Barris, *supra* note 284, at 65 (discussing "the ballplayer analogy").

298. *See* Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138; Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990); Geoffrey S. Rehnert, Note, *The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs*, 37 STAN. L. REV. 1147 (1985).

299. *See, e.g.*, Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937 (1993). A problem with this approach is that it assumes that a significant amount of an average board member's compensation derives from board memberships. In fact, many of them are CEOs themselves with their own lucrative compensation deals. *See supra* notes 250, 289 and accompanying text; *see also* Barris, *supra* note 284, at 76 ("It is not unusual for chief executives to sit on one another's compensation committees in the capacity of outside directors. These CEOs may approve increases for friends because they expect the favor will be returned, or simply because the corporate environment in which they operate approves of lavish spending on top executives. So much for impartiality.").

300. *See supra* Part II and Section V.D; *see also* Teresa A. John & Kose John, *Top-Management Compensation and Capital Structure*, 48 J. FIN. 949, 952 (1993) ("In the design of managerial contracts, an optimally structured compensation system depends not only on the agency relationship between shareholders and managers, but also on the other agency relationships that constitute the firm.").

301. For arguments along these lines, *see* Vagts, *supra* note 285, at 276 ("[C]ourts can and should carefully scrutinize compensation that is substantially out of the line and prune off the abnormal amount when not justified by special risks run by the executive recipients or special contributions made by them."); Yablon, *supra* note 293, at 1899 (arguing for a "proportionality" standard of review of the "reasonableness" of executive compensation). Much of the case law regarding "reasonableness" of executive compensation comes from close corporation cases and tax law. *See* Barris, *supra* note 284, at 81-88 (collecting and discussing cases); Vagts, *supra* note 285, at 257-61 (same).

302. *See supra* notes 250, 289, 299 and accompanying text.

able business judgment.³⁰³

3. *Downgrading Creditors*

As discussed above, creditors lie on a contested boundary of the firm.³⁰⁴ Sharking captures the possibility of opportunism by enterprise-organizers against their creditors. In other words, corporate managers and shareholders may exercise their authority as principals and quasi-principals to transfer wealth inappropriately from creditors to themselves. To use another metaphor, they may “scalp” their creditors.³⁰⁵

The classical response to this problem is to say that creditors never deserve extra-contractual protection. Creditors execute contracts, and their contracts express the limit of any obligation owed to them by managers or shareholders.³⁰⁶ In most situations, this answer is sufficient. A fundamental feature of the structure of the corporate firm lies in the tension between residual owners (shareholders) and creditors. This tension is resolved primarily through contractual bargaining.

In some situations, however, this strict view of no extra-contractual duties proves unsatisfactory. If creditors are never owed non-contractual protection, then managers and shareholders have an incentive to take

303. I do not intend to propose what a “reasonableness” test under a fiduciary duty for the review of executive compensation would look like. I mean only to suggest a theoretical justification for a fiduciary duty analysis that may proceed along these lines. Closer analysis of the executive compensation problem may recommend another approach, such as the reestablishment of a progressive income tax. *See, e.g.*, BOK, *supra* note 284, at 275-80 (recommending a move to progressive taxation as a remedy for excessive executive compensation). For other arguments favoring progressive taxation, see Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 (1987); Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952). My point is only to identify executive compensation as one area that illustrates how sharking costs may reduce the efficiency of the firm in the absence of appropriate legal constraints, which may include the vigorous enforcement of fiduciary duties.

304. *See supra* Subsection V.C.1.

305. It is also true that creditors may behave opportunistically against their debtors. *See, e.g.*, Mann, *supra* note 227, at 663-68 (explaining opportunistic behavior of creditors as a reason for the relative scarcity of secured credit). One might describe this tendency as the sharking of creditors against the firm, but I prefer to restrict the term to the opportunism of principals and quasi-principals acting within the firm as defined above. Ordinarily, creditors are outside the boundaries of the firm, but a sharking analysis could be extended to secured creditors and creditors involved in bankruptcy reorganizations. This analytical extension, however, remains outside the scope of this Article. *See supra* Section II.A (defining sharking).

306. *See, e.g.*, EASTERBROOK & FISCHER, *supra* note 22, at 36 (“For most firms the expectation is that the residual risk bearers have contracted for a promise to maximize long-run profits of the firm, which in turn maximizes the value of their stock. Other participants contract for fixed payouts—monthly interest, salaries, pensions, severance payments, and the like.”); *id.* at 37 (“Each investor must live with the structure of risks built into the firm. Equity claimants lose out to debt claimants when times are bad and are not thereby entitled to some additional compensation. It is all a matter of enforcing the contracts. And for any . . . investor other than the residual claimant, that means the explicit, negotiated contract.”); *see also* sources cited *supra* note 229.

every advantage of new circumstances or contractual ambiguity.³⁰⁷ Again, one can adopt a hard-line position and say that creditors in these situations should have known better or at least will learn to protect themselves contractually in the future.³⁰⁸ However, this approach ignores significant harm that results to creditors given the relative unpredictability of the future, the continual invention of new financial instruments, and the creative legal interpretation of contracts, especially when the stakes are high. In addition to unfairness, willingness to risk loaning capital may decline, which would harm the economy as a whole.³⁰⁹ At least partially as a result, a number of extra-contractual legal provisions protect creditors from sharking by debtor corporations.³¹⁰ A theory of the firm that

307. See William W. Bratton, *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667, 704 ("Bondholder expectations persistently outpace contract protections and are frustrated by remote risks."). A few recent examples of corporate reorganizations designed to benefit shareholders through sharp practices that harm creditors illustrate the point. Several years ago, Marriott Corporation spun-off a part of the corporation, which put the remaining bondholders at much greater risk, and the value of their bonds declined dramatically. Although the reorganization benefited shareholders, it arguably should have been illegal if the sole motivation was to transfer wealth from creditors to shareholders. For a more detailed discussion of this transaction, see Orts, *supra* note 93, at 1606-11; F. John Stark et al., "*Marriott Risk*": A New Model Covenant to Restrict Transfers of Wealth from Bondholders to Stockholders, 1994 COLUM. BUS. L. REV. 503, 586 (discussing Marriott and concluding "[b]oth traditional legal remedies and the traditional form of bond indenture are inadequate" to protect bondholders from "event risk" and calling for judicial reform). A similar story can be told about the RJR Nabisco leveraged buyout, which hurt bondholders who failed to negotiate "event change" covenants in the bond indentures. See *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989). Another type of problem known as "bondholder coercion" occurs when managers use the threat of bankruptcy or adverse indenture amendments to force creditors to agree to a change in contractual terms. See John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207 (1991); see also Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821 (1992) (discussing strategic behavior of debtors working to deny bondholders truly volitional consent). But see Lewis S. Peterson, Note, *Who's Being Greedy? A Theoretical and Empirical Examination of Holdouts and Coercion in Debt Tender and Exchange Offers*, 103 YALE L.J. 505, 509 (1993) (finding that "the coercion problem has been overrated" and "the more serious problem of holdouts derailing apparently good offers demands increased attention").

308. See *supra* note 306 and accompanying text. For an argument along these lines with respect to the development of "event risk" covenants, see Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment*, 40 UCLA L. REV. 931 (1993).

309. See, e.g., Triantis & Daniels, *supra* note 230, at 1073, 1081 (emphasizing importance of "the role of lenders" in corporate governance and supporting "rules that prevent one stakeholder from benefiting at another stakeholder's expense in situations where it is likely that conflicts of interests among stakeholders outweigh the benefits arising from the signals sent by stakeholder action").

310. See Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 689 (1996) (discussing various legal sources in addition to explicit contracts imposing duties to creditors and arguing for a "unified theory of a corporate debtor's obligation to creditors"). Various provisions of bankruptcy law are, of course, designed to protect creditors. The law prohibiting fraudulent conveyances is another example of a substantial body of non-contractual law favoring creditors. See CLARK, *supra* note 268, at 40-52; J.B. Heaton, *Debt Capacity and Fraudulent Conveyance Law* (1997) (unpublished manuscript, on file with author). Creditors receive greater legal protection in some other countries, such as in Germany.

recognizes the danger of sharking provides a rationale for this kind of legal protection, which in some extraordinary circumstances includes fiduciary duties.³¹¹

4. *Financial Reengineering*

A fourth type of sharking refers to the possibility that certain kinds of corporate reorganizations or recapitalizations sponsored by controlling shareholders or managers may achieve changes in capital structure and control that may harm other corporate participants without an appropriate business purpose. This type of sharking is a variant of the temptation to use a reorganization to freezeout minority shareholders unfairly.³¹² Shareholders and executives of a public corporation may also use a reorganization or recapitalization to enrich themselves at the expense of other interests, such as creditors.³¹³ What may be called *financial reengineering* often yields benefits in terms of enabling firms to compete efficiently in organizational metamarkets, but it can also be misused.³¹⁴

For example, the management-led leveraged buyout (MBO) raises the possibility that managers may act self-interestedly in seeking ownership as well as control.³¹⁵ In these transactions, shareholders may not be

See, e.g., Harold Herrmann, *Creditor's Protection as Help for Self-Protection: A Comparative Study of Quasi-Equity in German and United States Law* (1994) (unpublished manuscript, on file with author).

311. As discussed above, a fiduciary duty to creditors may arise in "near insolvency" situations. *See supra* note 229 and accompanying text. Also in bankruptcy reorganizations, corporate directors may owe fiduciary duties to creditors as well as shareholders. *See, e.g.,* Harvey R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467, 1467 (1993); *see also supra* note 228 and accompanying text. An alternative to recognizing fiduciary duties to creditors in various situations is to expand contractual principles of "good faith" or "unconscionability" which may serve as the functional equivalent. *See, e.g.,* Brudney, *supra* note 22, at 652-53; *see also* Tauke, *supra* note 229, at 79-80 (arguing that an expansive "modern approach" to interpretation of contracts tends to achieve "fairness" to bondholders and "shares substantial common ground with the concept of fiduciary duty").

312. *See supra* Subsection VI.B.1.

313. *See supra* Subsection VI.B.3. It is also possible that a recapitalization may have a negative impact on majority as well as minority shareholders. *See* Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 3 (1988) (citing empirical evidence that dual class recapitalizations have a "negative impact on shareholder wealth" and supporting legal restrictions).

314. For discussion of the salutary effect that increased debt obligations can have in motivating and disciplining managers, *see supra* note 230 and accompanying text. Courses in "Financial Engineering" are taught at leading business schools (including the Wharton School). My criticism of financial reengineering in the text is limited to cases that involve wealth transfers within the firm without a redeeming economic justification from the point of view of the firm as a whole.

315. For a recent analysis of the standards of review applied to MBOs in the Delaware courts, *see* Rock, *supra* note 62, at 1022-63 (reviewing cases); *see also* Scott V. Simpson, *The Emerging Role of the Special Committee—Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest*, 43 BUS. LAW. 665 (1988). For criticism of current standards of review of MBOs,

treated fairly, managers may be motivated to aggrandize themselves, or the reorganization may harm other participants in the firm including creditors. At present, the standards of review for MBOs are relatively lax.³¹⁶

This is not to say that all leveraged buyouts, recapitalizations, or reorganizations should be legally impermissible. My point is only to illustrate the potential problem of sharking by the principals and quasi-principals who promote these transactions. Recognizing the danger may support stricter legal standards of review to show the economic worth of these transactions for the enterprise as a whole. An enhanced fiduciary duty analysis may be employed toward this end.

The usual justification for a free market in transactions that result in a change of corporate control and capital structure is that the market fairly prices the "ownership" of the company and that paying a premium for the shares over the market price is an adequate indication of the fairness of the transaction. The theory of the firm outlined here, however, recognizes important roles played in the firm by participants other than majority shareholders. Greater scrutiny should be given to changes of control or financial structure of a firm when these changes threaten significant harm to other interests. In fact, the law provides greater scrutiny in many instances. Evidence of diversions of wealth from one group of corporate participants to another is often sufficient to enjoin a proposed transaction of this type or to award damages for harm the transaction causes to other groups.³¹⁷ Courts should continue to scrutinize corporate reorganizations and recapitalizations for potential sharking.

see Louis Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730 (1985), and James R. Reppetti, *Management Buyouts, Efficient Markets, Fair Value, and Soft Information*, 67 N.C. L. REV. 121 (1988). For defenses of a lax standard of review, see Richard A. Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U. L. REV. 630 (1985), and J. Robert Brown, Jr., *In Defense of Management Buyouts*, 65 TUL. L. REV. 57 (1990). For general discussion, see Kenneth B. Davis, Jr., *Approval By Disinterested Directors*, 20 J. CORP. L. 215 (1995); Deborah A. DeMott, *Directors' Duties in Management Buyouts and Leveraged Recapitalizations*, 49 OHIO ST. L.J. 517 (1988); Dale A. Oesterle & Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207 (1988); and Bill Shaw, *Resolving the Conflict of Interest in Management Buyouts*, 19 HOFSTRA L. REV. 143 (1990).

316. See sources cited *id.*

317. See, e.g., 3 COX ET AL., *supra* note 23, §§ 23.1 to 23.4 (1995); see also Jay W. Eisenhofer & John L. Reed, *Valuation Litigation*, 22 DEL. J. CORP. L. 37, 56 (1997) ("The fiduciary duty of loyalty forbids corporate fiduciaries, including directors, officers, and controlling stockholders, from considering or acting to protect interests other than those of the corporation when making business decisions. For example, a fiduciary cannot use his or her position in the corporation to promote a transaction between the corporation and an entity in which he or she has a substantial economic interest, unless that transaction is substantively fair to the corporation.").

CONCLUSION

The separation of ownership from management, the development of the corporate structure so as to vest in small groups control over the resources of great numbers of small and uninformed investors, make imperative a fresh and active devotion to [the fiduciary] principle if the modern world of business is to perform its proper function.³¹⁸

Justice Harlan Stone's advice, given over half a century ago in the depths of the Great Depression, remains apt today even as business enterprise and capital markets grow increasingly large and global. As in the time of Dickens and Shakespeare,³¹⁹ the shirking and sharking of agents and principals will continue, and the discipline of markets alone will prove an insufficient remedy. Law should evolve with the ever-changing forms of business organization to constrain the opportunism of both agents and principals within firms. Traditional fiduciary duties should be continually updated to constrain the costs of shirking and sharking, and legal procedures should permit substantive claims made with reasonable evidence to go forward.

Economic theories of the firm contribute analytical clarity to thinking about the structure of business organization. However, they tend to employ oversimplified models of the legal structure of business. The law of agency and enterprise organization—including partnerships, limited liability companies, and corporations—provides an essential extension to economic theories of the firm. The boundaries of the firm are formed not only by relationships of ownership and contracts, but also agency authority and power.

The theory of the firm advanced here is descriptive in seeking to clarify the role of law. Legal agency enables the formation of authority, power, and hierarchy among individual participants in business. Once the importance of legal agency is recognized, a focus on agency costs is revealed as too narrow; principal costs must also be included. Legally, a business firm of more than one person is a nexus of agency relationships in which (1) vertical authority provides the means to compete as an organized entity in markets and (2) horizontal ownership facilitates the aggregation of financial capital.

The organizational structures of firms enable feats of economic productivity unimaginable without them. At the same time, these organizational structures present temptations for their participants to shirk and shark against one another's interests. In other words, the authority and power in business firms explain the efficiency gains they achieve, but this

318. Harlan F. Stone, *The Public Influence of the Bar*, 48 HARV. L. REV. 1, 8 (1934).

319. See *supra* notes 1, 24 and accompanying text.

very authority and power open avenues for potential abuse. As a supplement to economics, a legal theory of the firm provides a descriptive foundation from which to inquire into normative issues of whether the current regulation of business enterprise achieves an appropriate balance between (1) the economic flexibility that markets need to function efficiently and (2) the legal constraints on the abuse of authority and power in firms needed to establish norms of social trust for economic stability and progress.³²⁰

Abuse of authority and power in the firm also has a normative dimension beyond economic analysis. Ethics as well as economics should set the ground rules of contemporary business civilization. In considering the concept of agency from an ethical point of view, Amartya Sen distinguishes between ethical calculations of self-interested "well being" and other-related "agency."³²¹ An individual enters agency relationships in order to pursue goals, commitments, and values through organization.³²² Neoclassical economic models mistakenly assume an "exclusively self-interested motivation."³²³ Restoring the importance of law in understanding business firms broadens the policy debate in the law of enterprise organization to include ethical dimensions of agency responsibility

320. In 1992 in the United Kingdom, the Cadbury Committee on Financial Aspects of Corporate Governance expressed the need for a similar balance between two basic principles of corporate governance: "They [i.e., managers and directors] must be free to drive their companies forward but exercise that freedom within a framework of effective accountability." JONATHAN P. CHARKHAM, KEEPING GOOD COMPANY: A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES 4 (1994) (quoting the Cadbury Committee's report). On the economic importance of promoting trust, see *supra* note 27 and accompanying text.

321. AMARTYA SEN, ON ETHICS AND ECONOMICS 41 (1987).

322. *See id.* This is not to say that one's actions as an agent do not have an effect on one's well-being. One's role as an agent can have either a positive or negative effect on well-being. *See* Amartya Sen, *Well-being, Agency and Freedom: The Dewey Lectures 1984*, 82 J. PHIL. 169, 187 (1985). "Even when the impact is positive," however, "the importance of the *agency aspect* has to be distinguished from the importance of the *impact of agency on well-being.*" *Id.* This theme relates to philosophical discussions about agency, ethics, and organizations, but application along these lines is outside the scope of this Article. *See, e.g.,* Boatright, *supra* note 61; Thomas W. Dunfee, *On the Synergistic, Interdependent Relationship of Business Ethics and Law*, 34 AM. BUS. L.J. 317 (1996); Guangwei Ouyang & Roger A. Shiner, *Organizations and Agency*, 1 LEGAL THEORY 283 (1995); Dennis P. Quinn & Thomas M. Jones, *An Agent Morality View of Business Policy*, 20 ACAD. MGMT. REV. 22 (1995). On moral responsibility in corporations, see, for example, THOMAS DONALDSON, CORPORATIONS AND MORALITY (1982); PETER A. FRENCH, COLLECTIVE AND CORPORATE RESPONSIBILITY (1984); and PATRICIA H. WERHANE, PERSONS, RIGHTS AND CORPORATIONS (1985). For a legal discussion of theories of organization, see Richard B. Stewart, *Organizational Jurisprudence*, 101 HARV. L. REV. 371 (1988) (reviewing MEIR DAN-COHEN, RIGHTS, PERSONS AND ORGANIZATIONS: A LEGAL THEORY FOR BUREAUCRATIC SOCIETY (1986)).

323. SEN, *supra* note 321, at 41. For another economic argument emphasizing that "market forces [can] do many things well—but not everything"—and concluding that "[m]any forms of human motivation cannot be reduced to the market model of man," see ROBERT KUTTNER, EVERYTHING FOR SALE: THE VIRTUES AND LIMITS OF MARKETS 3, 6 (1996). For a collection of legal essays developing similar themes, see CASS R. SUNSTEIN, FREE MARKETS AND SOCIAL JUSTICE (1997).

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as well as economic efficiency. By imposing appropriate standards of behavior on participants in firms, including fiduciary duties, legal regulation can improve overall economic efficiency and promote ethical norms of good business practice. In this endeavor, the costs of sharking by those in authority are as significant as the costs of shirking by the firm's more lowly stationed agents.

