Coase, Knight, and the Nexus-of-Contracts Theory of the Firm: A Reflection on Reification, Reality, and the Corporation as Entrepreneur Surrogate

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I. INTRODUCTION

Scholars routinely credit R. H. Coase and his first seminal work—*The Nature of the Firm*[1]—as the progenitor of the nexus-of-contracts theory of the corporation.[2] This account, which has dominated legal scholarship for four decades, describes a corporation as a nexus of contracts between the various claimants to the earnings of the business—shareholders, directors, officers, employees, customers, suppliers, and other factors of production.[3] In this Article, I will argue for a different

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1. R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

2. *See, e.g.*, Stephen Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 9 (2002) ("The dominant model of the corporation in legal scholarship is the so-called nexus of contracts theory. This model's origins fairly can be traced to Nobel Prize laureate Ronald Coase's justly famous article, *The Nature of the Firm*."); *see also* Angus Corbett & Peta Spender, *Corporate Constitutionalism*, 31 SYDNEY L. REV. 147 (2009) ("Since the rediscovery of the Coase Theorem by Jensen and Meckling in the late 1970s, corporate law theory has been dominated by economic analysis which posits that the corporation is a nexus of contracts."); David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 229 (1990) (noting that the nexus-of-contracts theory of the corporation "can be traced to Ronald Coase's 1937 article"); Gregory Sidak, *Mr. Justice Nemo's Social Statics*, 79 TEX. L. REV. 737, 745 (2001) ("Coase's insight that the firm is the nexus of contracts between the owners of various factors of production also has gained widespread acceptance among legal scholars.").

3. The bridge between Coase and the nexus-of-contracts definition of the firm is found in Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976). Jensen and Meckling noted that "[c]ontractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc. . . . " and that "most organizations are simply *legal fictions which serve as a nexus for a set of contracting relationships among individuals*." *Id.* at 310. Contractarian legal scholars have amplified Jensen and Meckling's approach. *See, e.g.*, Jonathan Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1266 (1999) ("The first paradigm, which has its intellectual origins in the work of Ronald Coase, holds that the modern, publicly held corporation is a nexus of contracts among the company's various contributors."); James McConville & Mirko Bagaric, *Opting Out of Shareholder Governance Rights: A New Perspective on Contractual Free-*

understanding of Coase's theory of the firm and its implications for legal research into the nature of the modern corporation. I will argue that nexus-of-contracts scholars' claims to Coase's lineage are based on a misapplication of Coase's central insights and the pursuit of a very different research project than underlay *The Nature of the Firm*.[4] Coase's insights must be understood as an extension of Frank Knight's grand opus—*Risk, Uncertainty, and Profit*[5]—and as an extension of Knight's theory of the entrepreneur.[6] So understood, Coase's theory of the firm supports a very different contractarian account of the corporation than the currently dominant nexus-of-contracts version, and a very different research agenda. So understood, the firm has boundaries and a center. So understood, the corporation and the firm are different phenomena. Properly understood, the corporation and corporation law must be seen as serving the purpose of providing the incorporated firm with a substitute for the entrepreneur who owns and directs the classical firm.

As support for Coase's patrimony, contractarian scholars rely on Coase's terse assertion that "[a] firm . . . consists of the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur."[7] Moving to the modern corporation with

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dom in Australian Corporate Law, 3 DEPAUL BUS. & COM. L.J. 255, 256 (2005) ("[C]ontractarians view the corporation not as a separate and distinct legal entity with its own personality and post office box, but rather as a 'nexus of contracts,' a label representing the series of contracts exchanged and performed between suppliers, creditors, employees, employers and other stakeholders."); David G. Yosifon, *Towards a Firm-Based Theory of Consumption*, 46 WAKE FOREST L. REV. 447, 448–49 (2011) ("The corporation is a 'nexus of contracts' comprised of all those with a stake in the firm's operations, including shareholders, workers, consumers, and the broader social and political community.").

4. On the notion that the nexus-of-contracts theory does not flow from Coase's 1937 article, see David Westbrook, *Corporation Law After Enron: The Possibility of a Capitalist Reimagination*, 92 GEO. L.J. 61, 106 n.277 (2003) ("Although Coase was not influential for many years after its publication, many legal scholars (who call themselves 'contractarians') came to lean on *The Nature of the Firm* as authority for the economic understanding of the firm as a nexus of contracts . . . . [F]or Coase, in the first instance, the firm is *anything but* a nexus of contracts. Instead the firm is a site where the costs of continuous contracting (forming a market) outweigh the costs of forming the entity.").

5. FRANK H. KNIGHT, RISK, UNCERTAINTY, AND PROFIT (1921).

6. For extensive analysis of Knight's theory of the entrepreneur as it relates to corporate law theory, see Ross B. Emmett, *Frank H. Knight on the Entrepreneur Function in Modern Enterprise*, 34 SEATTLE U. L. REV. 1139 (2011); Charles R. T. O'Kelley, *Berle and the Entrepreneur*, 33 SEATTLE U. L. REV. 1141 (2010) [hereinafter O'Kelley, *Berle and the Entrepreneur*]; Charles R. T. O'Kelley, *The Entrepreneur and the Theory of the Modern Corporation*, 31 J. CORP. L. 753 (2006) [hereinafter O'Kelley, *Modern Corporation*].

7. Coase, *supra* note 1, at 393. For scholars explicitly citing this passage as the root of the nexus-of-contracts theory, see Thomas Blackwell, *The Revolution is Here: The Promise of a Unified Business Entity Code*, 24 J. CORP. L. 333, 349–50, 349 n.66 (1999); Alan Meese, *Monopolization, Exclusion, and the Theory of the Firm*, 89 MINN. L. REV. 743, 813–19, 838 n.434 (2005); O'Kelley, *Modern Corporation*, *supra* note 6, at 763; Robert Rhee, *Corporate Ethics, Agency, and the Theory of the Firm*, 3 J. BUS. & TECH. L. 309, 311–13, 323 (2008).

its separation of ownership and control, nexus-of-contracts theorists tell us that the incorporated firm is no more than the larger set of relationships that exist and are made possible by the corporate form. Each of these contractual relationships results from the same type of rational maximizing behavior as is modeled in neoclassical analyses of the price mechanism. In effect, then, the nexus-of-contracts paradigm, as currently formulated, eliminates the distinction between the price mechanism and the firm, and it treats "the firm" and "the corporation" as simply a different kind of market, "which serves as a focus for the complex process in which the conflicting objectives of individuals . . . are brought into equilibrium within a framework of contractual relations."[8] The firm has no center, and the old-fashioned concept and term "the entrepreneur" has no function to play in a theory of the modern corporation.[9] The term "the corporation" is a metaphor—a handy, rhetorical device—connoting the totality of the contractual relations between officers, directors, shareholders, creditors, customers, suppliers, and others involved in the production and sale process.[10] Speaking of the corporation as having any other "reality" involves the sin of "reification."[11]

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8. Jensen & Meckling, *supra* note 3, at 311.

9. *See* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980). Eugene Fama removed the entrepreneur from the center of the firm:

> [S]eparation of security ownership and control can be explained as an efficient form of economic organization within the 'set of contracts' perspective. We first set aside the typical presumption that a corporation has owners in any meaningful sense. The attractive concept of the entrepreneur is also laid to rest, at least for purposes of the large modern corporation.

Id.

10. On "corporation" as metaphor, see Ian B. Lee, *Corporate Criminal Responsibility as Team Member Responsibility*, 31 OXFORD J. LEG. STUD. 755, 766 (2011) ("A corporation is not a thing . . . [and] this insight is captured by the metaphor of the corporation as a nexus of contracts."); Thomas W. Joo, *Contract, Property, and the Role of Metaphor in Corporations Law*, 35 U.C. DAVIS L. REV. 779, 780 (2002) ("The 'nexus of contracts' or 'contractarian' model, a metaphor that attempts to understand corporations in terms of 'contracts,' currently dominates corporations law scholarship."); and Cynthia A. Williams, *Corporate Compliance with the Law in the Era of Efficiency*, 76 N.C. L. REV. 1265, 1377 (1998) ("The nexus-of-contracts view of the corporation that so influenced the ALI Principles and ABA revisions . . . explicitly rel[ies] on a metaphor of private ordering (that of contract law) to describe the corporation . . . .").

11. Jensen and Meckling first asserted this point:

> Viewing the firm as the nexus of a set of contracting relationships among individuals also serves to make it clear that the personalization of the firm implied by asking questions such as "what should be the objective function of the firm," or "does the firm have a social responsibility" is seriously misleading. *The firm is not an individual* . . . . We seldom fall into the trap of characterizing the wheat or stock market as an individual, but we often make this error by thinking about organizations as if they were persons with motivations and intention.

Jensen & Meckling, *supra* note 3, at 311; *see also* Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 971 n.1 (1992) ("The corporate social responsibility literature, however, frequently falls into the reification trap. Reification is useful be-

Working within the nexus-of-contracts model, scholars have struggled to develop a rhetorical paradigm that accurately predicts or describes corporation law. This difficulty flows from twin flaws in the currently dominant model—the equation of the corporation and the firm and the exclusion of the entrepreneur. Coase and his progenitor, Frank Knight, saw the firm as having an "inside" and an "outside" and a distinct central actor—the entrepreneur. Contrary to the allocation of resources by the unconscious processes of the market fundamental to the perfect competition model favored by free-market, nexus-of-contracts theorists, Knight and Coase looked inside the firm and identified the entrepreneur as the central economic actor; it was the entrepreneur who consciously allocated resources within the firm by command. If, following Knight and Coase, we conceive of the corporation as a small inner circle comprised of the relations between officers, directors, and shareholders, and the firm as a larger circle comprised of the relationships between the corporation (acting as entrepreneur–owner) and the employees (and other constituents), then we have the beginning point for a comprehensive theory of the incorporated firm. The rhetorical device that this model suggests is entrepreneur primacy, the claim that corporation law serves to ensure that corporations are operated entrepreneurially.

I develop these points by taking a fresh look at the evolution of the theory of the firm and then detailing how a new account of the incorporated firm is warranted. In Part II of this Article, I outline the research agenda that dominated mainstream economic accounts of the firm prior to Knight and Coase. In Part III, I sketch Knight's seminal account of the entrepreneur. In Part IV, I describe Coase's theory of the firm, placing it in the context of Knight's earlier work and highlighting Coase's important identification of the law's place in a *real world* theory of the firm. Part V explores the implications of Coase's seminal insights for corporation law scholars working to understand the modern corporation and the theory of the corporation that Coase's work suggests for that work. Part VI provides concluding thoughts.

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cause it permits us to utilize a form of shorthand. It is easier to say 'General Motors' ought to do so and so than to describe the complex process that is actually necessary for General Motors to do something. Indeed, it is very difficult to think about large firms without reifying them. Reification, however, can be dangerous. Reification makes it easy to lose sight of the fact that firms do not do things; people do things. The proper focus is thus not on the corporation's obligations, but on the moral obligations and legal duties of the actors who make corporate decisions."); Marc Galanter, *Planet of the APs: Reflections on the Scale of Law and its Users*, 53 BUFF. L. REV. 1361, 1363 (2006) ("In the nexus view, references to corporations as actors is a fiction or reification.").

II. THE BACKDROP FOR THE WORK OF KNIGHT AND COASE: THE PERFECT COMPETITION THEORY AND THE FIRM AS A "BLACK BOX"

What is a "firm" and why does it exist? These questions received little attention prior to, and for forty or so years after, the early-twentieth century seminal contributions of Frank Knight in his book, *Risk, Uncertainty, and Profit*[12] and R. H. Coase in his paper, *The Nature of the Firm*.[13] Instead, beginning in 1776 with the first publication of *The Wealth of Nations*,[14] and continuing for nearly 200 years, the paramount project for mainstream economists was to formalize Adam Smith's insight that central economic planning is largely unnecessary.[15] The product of this effort—the perfect competition model—shows how in a perfectly competitive free-market economy, the maximizing behavior of individual producers and consumers, guided solely by price signals, would result in the best possible allocation of economic resources.[16]

> The intellectual achievement of this model is its complete abstraction from centralized control of the economy. What is modeled is not competition but extreme decentralization . . . . Perfect decentralization is realized theoretically through assumptions guaranteeing that authority, or command, plays no role in coordinating resources. The only parameters guiding choice are those that are given—tastes and technologies—and those that are determined impersonally on markets—prices. All parameters are beyond the control of any of the actors or institutions, so these assumptions effectively deprive authority of any role in allocation.[17]

While the perfect competition model transparently makes the case that political authority should not be used to govern the economy, it also, less obviously, assumes away the existence or importance of managerial authority within firms:

> [The perfect competition] model sets the maximizing tasks of the firm in a context in which decisions are made with full and free knowledge of production possibilities and prices . . . . "Firm" in the theory of price is simply a rhetorical device adopted to facilitate

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12. KNIGHT, *supra* note 5.

13. Coase, *supra* note 1.

14. ADAM SMITH, THE WEALTH OF NATIONS (Random House ed. 1937) (1776).

15. Harold Demsetz, *The Theory of the Firm Revisited*, 4 J. ECON. & ORG. 141, 142 (1988).

16. Under perfect competition, "each individual achieves the goal of rational action, maximizing the want satisfaction procurable with his given resources (whatever they are) in purchasing power, by distributing them among the alternatives according to the law of choice." KNIGHT, *supra* note 5, at 85. This is the best possible allocation of resources achievable by voluntary consent because at equilibrium "no individual will wish to exchange anything in his possession for anything in the possession of anyone else." *Id.*

17. Demsetz, *supra* note 15, at 142.

> discussion of the price system. Tasks to normally be expected of management are given only the most superficial, formal discussion; they are performed without error and costlessly, as if by a free and perfect computer. The real tasks of management, to devise or discover markets, products and production techniques, and actively to manage the actions of employees, have no place in the perfect [competition] model because it assumes that all products, markets, production techniques, and prices are fully known at zero cost.[18]

Thus, if one looked solely to perfect competition theory to determine the nature of the firm, one might conclude that the firm is simply a black box that magically turns price signals into production decisions and outputs.[19]

III. FRANK KNIGHT AND "THE ENTREPRENEUR"

Frank Knight's *Risk, Uncertainty and Profit* provided an important bridge from an economics devoid of interest in the firm to the modern focus on developing a theory of the firm. On one hand, Knight sought to bring coherence to the historic body of theoretical economics thereby completing the classical economists' perfect competition theory project.[20] On the other hand, he sought to go beyond perfect competition theory and provide a coherent theory of imperfect competition—how the free enterprise system actually works. To carry out his sweeping agenda, Knight necessarily focused on the fundamental nature of the economic system and the ways in which actual economic organizations—what Coase later called firms—are different from the economic organizations that would exist under perfect competition.[21]

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18. *Id*. at 143.

19. Brian J. Loasby, *Management Economics and the Theory of the Firm*, 15 J. INST. ECON. 165 (1967). The black box theory of the firm is central to perfect competition theory.

> The crux of microeconomics is the competitive system. Within the competitive model there is a hypothetical construct called the firm. This construct consists of a single decision criterion and an ability to get information from an external world, called the "market." The information received from the market enables the firm to apply its decision criterion, and the competitive system then proceeds to allocate resources and produce output.

Richard M. Cyert & Charles L. Hedrick, *Theory of the Firm: Past, Present, and Future; An Interpretation*, 10 J. ECON. LIT. 398, 398 (1972).

20. KNIGHT, *supra* note 5, at 18–19. Knight explained the project as follows:

> The aim will be to bring out the content of the assumptions or hypotheses of the historic body of economic thought, referred to by the classical writers as "natural price" theory. By this is meant, not the assumptions definitely in the minds of the classical economists, but the assumptions necessary to define the conditions of perfect competition, at which the classical thought was aimed, and which are significant as forming the limiting tendency of actual economic processes.

Id. at 18.

21. *Id*. at 264–312, 349–68.

Knight's central argument was that uncertainty is the most critical factor to abstract from reality in order to produce perfect competition and that uncertainty's presence in the real world explains the existence of the entrepreneur and the firm.[22] Knight's central insight was that when uncertainty is abstracted away, there is no need for a firm or an entrepreneur even when division and specialization of labor are present:[23]

> With uncertainty entirely absent, every individual being in possession of perfect knowledge of the situation, there would be no occasion for anything of the nature of responsible management or control of productive activity. Even marketing activities in any realistic sense would not be found. The flow of raw materials and productive services through productive processes to the consumer would be entirely automatic . . . . There might be managers, superintendents, etc., for the purpose of coordinating the activities of individuals. But under conditions of perfect knowledge and certainty such functionaries would be laborers merely, performing a purely routine function, without responsibility of any sort, on a level with men engaged in mechanical operations.[24]

Knight also asserted the converse point; when uncertainty is present, the existence of the entrepreneur and the firm naturally follows:

> With uncertainty absent, man's energies are devoted altogether to doing things . . . . With uncertainty present, doing things, the actual execution of activity, becomes in a real sense a secondary part of life; the primary function or activity is deciding what to do and how to do it . . . .[25]

With uncertainty present, producers no longer know what consumers want. Instead, they must forecast these wants, which involves predicting the future. Likewise, producers no longer know how best to organize production.[26] As a result, "the work of forecasting and at the same time a

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22. Though Knight did not use the term "a firm," without doubt he would equate that term with an enterprise directed by an entrepreneur. *See* Emmett, *supra* note 6, at 1140; O'Kelley, *Berle and the Entrepreneur*, *supra* note 6, at 1147–50.

23. Prior to Knight, many leading theorists viewed the firm as a natural byproduct of the division of labor. KNIGHT, *supra* note 5, at 398.

24. KNIGHT, *supra* note 5, at 267. Coase, writing later, misunderstood Knight to be using the phrase "managers, superintendents" synonymously with the term "entrepreneur." *See* Coase, *supra* note 1, at 401. Knight clearly was not using the phrases synonymously because he believed that entrepreneurs must be "responsible managers." *See* KNIGHT, *supra* note 5, at 259, 267. I have addressed this point somewhat more comprehensively in a previous article. O'Kelley, *Modern Corporation*, *supra* note 6, at 768 n.103.

25. KNIGHT, *supra* note 5, at 268.

26. Donald J. Boudreaux & Randall G. Holcombe, *The Coasian and Knightian Theories of the Firm*, 10 MANAGERIAL DEC. ECON. 147, 151 (1989) ("Entrepreneurial judgment is the real-world

large part of the technological direction and control of production are still further concentrated upon a very narrow class of the producers, and we meet with a new economic functionary, the entrepreneur."[27]

IV. COASE AND THE NATURE OF THE FIRM

A. Coase and Knight

Coase's *The Nature of the Firm* is clearly one of the most influential articles of the past century, a fact noted to be particularly remarkable since the article originated as a college "term paper."[28] The influence of Coase's paper is also remarkable considering its limited scope in comparison to the sweeping work of Frank Knight.[29] Indeed, *The Nature of the Firm* could be viewed as simply a small extension of Knight's insights in *Risk, Uncertainty and Profit*.[30] Though Coase did not read *Risk, Uncertainty and Profit* until 1933, a year after Coase developed the basic theory set out in *The Nature of the Firm*, he later acknowledged that he undoubtedly was aware of Knight's general ideas from discussions with classmates at the London School of Economics.[31] Thus, Coase was indirectly influenced by Knight's work when he formed his initial thesis, and

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substitute for the hypothetical perfect foresight exercised by producers in static equilibrium models.").

27. *Id.*

28. Steven N. S. Cheung, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1, 1–2 (1983) ("At about twenty years of age and before receiving a bachelor's degree from the London School of Economics, Coase conceived the thesis of that work during a traveling scholarship to the United States in 1931–32. Considering the work started out as the equivalent of an undergraduate term paper one stands in awe of the insights that prompted it.").

29. Upon rereading the article fifty years later, Coase himself found this remarkable: "What strikes me in rereading this article is its extreme simplicity. There is no subtle or complicated argument to tax the brain and no concepts difficult to understand." R. H. Coase, *The Nature of the Firm: Meaning*, 4 J. ECON. & ORG. 19, 20 (1988) [hereinafter Coase, *Meaning*].

30. Bruce Kogut, Book Review, 38 ADMIN. SCI. Q. 503, 504 (1993) (reviewing OLIVER E. WILLIAMSON & SIDNEY G. WINTER, THE NATURE OF THE FIRM: ORIGINS, EVOLUTION AND DEVELOPMENT) (1991) ("The notion of bounded rationality in [Coase's definition of the firm] was clearly already implied by Frank Knight in his distinction of risk and uncertainty.").

31. Fifty years after the publication of *The Nature of the Firm,* Coase reflected on Knight's influence:

> And it is quite certain that I . . . had not read Knight's *Risk, Uncertainty and Profit* before [1933]. A letter to Fowler, written in May 1933, indicates that I had just read Knight (along with Wicksteed, Babbage, and some Marshall). When I put forward my explanation in 1932 for the existence of the firm, I had not examined these alternative explanations . . . . It might of course be argued that Knight's ideas were so much in the air at LSE that I would be exposed to them without reading him. And this is true. Everyone at LSE referred to *Risk, Uncertainty and Profit* whether they had read it or not . . . . Of course, afterwards I read Knight's work with great care, and I have little doubt that in my later writings I have been greatly influenced by him . . . .

Coase, *Meaning*, *supra* note 29, at 23.

the influence was direct by the time Coase transformed *The Nature of the Firm* into its final published version, as is evidenced by the extensive references to and comments about *Risk, Uncertainty and Profit* that Coase ultimately inserted.[32] Importantly, he acknowledged that Knight's book contained the then most widely accepted theory for why firms emerge.[33]

Coase began his inquiry into the nature of the firm by focusing on the difference between firms and markets; while the price mechanism coordinates transactions *between* firms, *within* firms, the entrepreneur consciously organizes and coordinates production.[34] He then posed a broad question: Why, given the theoretical efficacy of prices in allocating resources, do firms—and the corresponding allocation of resources by the entrepreneur's command—come into existence?[35] As Coase conceded, Knight had made a convincing case that the entrepreneur and the firm come to exist as a response to problems created by uncertainty.[36] Coase suggested, however, that Knight's theory did not go far enough. In the real world, we observe *both* market transactions and transactions within firms. If the existence of uncertainty causes *some* transactions to be carried out within firms, why does it not cause *all* transactions to be intra-firm?[37] Why are resources sometimes allocated by the price mechanism and sometimes by an entrepreneur? "Why does the entrepreneur not organise one less transaction or one more?"[38] In other words, Knight's theory fails to answer a fundamental question—What explains whether a *particular* transaction will be organized outside the firm via a market transaction between autonomous producers, or instead, within a firm?[39]

Coase's answer to this puzzle is majestic in its simplicity.[40] On one hand, in the real world, the price mechanism does not work costlessly; instead, the entrepreneur experiences transaction costs in coordinating production, including the costs of discovering relevant prices and entering into myriad separate contracts with factors of production.[41] Accordingly, firms arise when the costs of using the price mechanism increase

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32. *See* Coase, *supra* note 1, at 388, 392, 394, 398–401. Although Coase's article is only nineteen pages in length, "Coase devotes more than six of those pages exclusively to Knight and *Risk, Uncertainty and Profit*." O'Kelley, *Berle and the Entrepreneur, supra* note 6, at 1151 n.50.

33. Coase, *supra* note 1, at 398.

34. *Id*. at 387–89.

35. *Id*. at 387–90.

36. *Id*. at 392 ("It seems improbable that a firm would emerge without the existence of uncertainty.").

37. *Id*. at 394.

38. *Id.* at 393–94.

39. *Id*. at 389.

40. Kogut, *supra* note 30, at 503 ("The article is a tour de force in terms of rhetorical logic.").

41. Coase, *supra* note 1, at 392.

to the point where production can be coordinated at less expense via contracts with factors of production that give the entrepreneur, within limits, the right to direct production.[42] On the other hand, firms do not operate costlessly either.[43] Both methods of allocating resources are subject to various types of transaction costs. When a transaction previously organized by the price mechanism can, at less cost, be organized in a firm, then the price mechanism will be superseded by a new or existing firm.[44] Conversely, when the cost of organizing a transaction within the firm becomes greater than the cost of organizing via the market, then the transaction will be abandoned or avoided by the firm.[45]

B. Coase's Definition of "The Firm"

Coase sought to develop "a definition of a firm . . . which is . . . realistic in that it corresponds to what is meant by a firm in the real world."[46] Further, he sought to explain why a firm comes into existence and why a firm grows or diminishes in size.[47] In doing so, Coase was engaged in prototypical scientific problem solving: describe an actual state of the world and then discover the process that will produce that

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42. *Id*. at 390–92.

43. *Id*. at 394–95, 403.

44. While much of Coase's 1937 article can be seen as an extension of Knight's work, Coase's insights concerning transaction costs may well derive from the influential work of Thorsten Veblen. Consider the following passage from one of Veblen's most influential works:

> The amount of "business" that has to be transacted per unit of product is much greater where the various related industrial processes are managed in severalty than where several of them are brought under one business management. A pecuniary discretion has to be exercised at every point of contact or transition, where the process or its product touches or passes the boundary between the different spheres of ownership. Business transactions have to do with ownership and changes of ownership. The greater the parcelment in point of ownership, the greater the amount of business work that has to be done in connection with a given output of goods or services, and the slower, less facile, and less accurate, on the whole, is the work.

THORSTEIN VEBLEN, THE THEORY OF BUSINESS ENTERPRISE 46–47 (Charles Scribner's Sons ed. 1919) (1904). For Veblen's influence on Frank Knight, see O'Kelley, *Berle and the Entrepreneur*, *supra* note 6, at 1152, 1152 n.53, 1154 n.68. For Veblen's broader influence on scholars working at the time of the Great Depression, see Charles R. T. O'Kelley, *Berle and Veblen: An Intellectual Connection*, 34 SEATTLE U. L. REV. 1317 (2011).

45. Coase, *supra* note 1, at 394–95. "[B]y forming an organisation and allowing some authority (an entrepreneur) to direct the resources, certain marketing costs are saved. The entrepreneur has to carry out his function at less cost . . . because it is always possible to revert to the market." *Id.* at 392.

46. *Id*. at 386.

47. Coase understood that an essential part of a scholar's or scientist's task is identifying precisely the assumptions underlying a particular theory in order "to prevent the misunderstanding and needless controversy which arise from a lack of knowledge of the assumptions on which a theory is based, but also because of the extreme importance for economics of good judgment in choosing between rival sets of assumptions." Coase, *supra* note 1, at 386.

state.[48] Inherent in his definition was his assumption that a firm has boundaries—that there is an outside and an inside to the firm. Accordingly, Coase's definition of the firm can be depicted as a circle with certain relations inside and certain relations crossing the boundary of the firm. Also inherent in his definition was his identification of the firm with the classical entrepreneur, a feature likewise central to the work of Frank Knight.[49]

Coase's definition of the firm can be distilled from the following:

> *Outside* the firm, price movements direct production, which is co-ordinated by a series of exchange transactions on the market. *Within* a firm, these market transactions are eliminated and [replaced by] the entrepreneur-co-coordinator, who directs production . . . .[50]
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> . . . .
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> A factor of production (or the owner thereof) does not have to make a series of contracts with the factors with whom he is co-operating *within* the firm, as would be necessary, of course, if this co-operation were as a direct result of the working of the price mechanism. For this series of contracts is substituted one. At this stage it is important to note the character of the contract into which a factor enters that is employed *within* a firm. The essence of the contract is that it should only state the limits to the power of the entrepreneur. Within these limits, he can therefore direct *the other* factors of production . . . . A firm, therefore, consists of the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur.[51]

Thus, the Coasian firm may be depicted as a circle encompassing the entrepreneur and the other factors of production who have agreed to

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48. Herbert A. Simon, *The Architecture of Complexity*, 106 PROCEEDINGS OF THE AM. PHIL. SOC. 467, 479 (1962) ("'State descriptions' and 'process descriptions' are the warp and weft of our experience. Pictures, blueprints, most diagrams, chemical structural formulae are state descriptions. Recipes, differential equations, equations for chemical reactions are process descriptions. The former characterize the world as sensed; they provide the criteria for identifying objects, often by modeling the objects themselves. The latter characterize the world as acted upon; they provide the means for producing or generating objects having the desired characteristics."). Coase clearly chose and valued problem solving in this scientific tradition:

> The approach which has just been sketched would appear to offer an advantage in that it is possible to give a scientific meaning to what is meant by saying that a firm gets larger or smaller . . . . The question which arises is whether it is possible to give a scientific meaning to what is meant by saying that a firm gets larger or smaller. Why does the entrepreneur not organize one less transaction or one more?

Coase, *supra* note 1, at 393–94.

49. *See* O'Kelley, *Berle and the Entrepreneur*, *supra* note 6, at 1150–57; O'Kelley, *Modern Corporation, supra* note 6, at 758, 766–73.

50. Coase, *supra* note 1, at 388 (emphasis added).

51. *Id.* at 391, 393 (emphasis added).

provide services subject to the entrepreneur's direction. The entrepreneur and employees are *inside* the firm. All factors of production with whom the entrepreneur transacts via the price mechanism are *outside* the firm. The firm—the totality of the circle—is the system of relations between the entrepreneur and other factors of production who have agreed to act as directed by the entrepreneur.[52]

C. The Relationship Between Law and the Definition of the Firm

Does this definition achieve Coase's goal—"a definition of a firm . . . which is . . . realistic in that it corresponds to what is meant by a firm in the real world"?[53] Strikingly, Coase viewed the real world definition of the firm to be intertwined with legal concepts.

We can best approach the question of what constitutes a firm in practice by considering the legal relationship normally called that of "master and servant" or "employer and employee." The essentials of this relationship have been given as follows:

> (1) The servant must be under the duty of rendering personal services to the master or to others on behalf of the master, otherwise the contract is a contract for the sale of goods or the like.
>
> (2) The master must have the right to control the servant's work, either personally or by another servant or agent . . . .
>
> We thus see that it is the fact of direction which is the essence of the legal concept of "employer and employee" just as it was in the [definition of the firm] developed above.[54]

Explicit in Coase's use of agency law as the real world check on his theory of the firm is his understanding that agency law is the institution that gives ultimate authority to the master (the entrepreneur, owner, or employer) to direct the actions of employees. Direction—allocation of resources by the entrepreneur—is the essence of the firm. In the real world, employees and employers experience this relationship between employer and employee as the essence of the firm. Law—particularly the law of

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52. Viewed in isolation, Coase's statement that a "firm . . . consists of the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur" could be interpreted to support a nexus-of-contracts definition of the firm. Under such an interpretation, "the firm" would include relations not only between the entrepreneur and employees but also relationships between and among the entrepreneur, employees, customers, suppliers, and other stakeholders of the firm. But this interpretation would be incompatible with Coase's larger thesis that the firm exists as an alternative to the price mechanism for directing productive resources, and would also be inconsistent with Coase's problem-solving goal—to show why this alternative to market allocation even exists.

53. Coase, *supra* note 1, at 386.

54. *Id.* at 403–04.

master and servant—makes this relationship possible. Thus, the essence of the firm is inextricably intertwined and dependent on the authority that law provides to the entrepreneur.[55]

V. A KNIGHT–COASIAN APPROACH TO THE MODERN CORPORATION AND CORPORATION LAW RESEARCH

A. The "Corporation" as Sole-Proprietor Surrogate

Put in contractarian terminology, the sole proprietor, the classic entrepreneur, is the nexus of contracts in the classic firm.[56] Coase, however, did not address the question posed by the modern corporation: What is the nexus of the firm when ownership and control are separated? Most nexus-of-contracts scholars see shareholders, directors, and officers as occupying the same contractual boat as other corporate constituencies; employees, customers, creditors, suppliers, directors, officers and shareholders each enter into voluntary contractual relationships with the nexus of the firm—the empty and essentially meaningless artificial corporate entity.[57] This depiction eliminates the entrepreneur and the entrepreneur function from the theory of the firm.[58]

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55. Contractarians recoil at the notion that authority (direction of resource by command) is the essence of the firm. The strongest (and most quoted) statement of the contractarian viewpoint is found in Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 777 (1972) ("It is common to see the firm characterized by the power to settle issues by fiat, by authority, or by disciplinary action superior to that available in the conventional market. This is delusion. The firm does not own all its inputs. It has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people."). For a convincing refutation of this contractarian view, see Scott Masten, *A Legal Basis for the Firm*, 4 J.L. ECON. & ORG. 186 (1988).

56. For a much earlier look at the corporation as sole-proprietor-surrogate, see Charles R. T. O'Kelley, *The Theory of the Firm: The Corporation as Sole-Proprietor Surrogate*, *available at* http://ssrn.com/abstract=1858936 (last updated Sept. 30, 2001).

57. As Edward Rock and Michael Wachter powerfully described, the problem with the nexus-of-contracts definition is that it leaves the corporation empty:

> [A]s a motivating theory for corporate law or for business associations in general, a weakness of the nexus of contracts approach is that the firm as an operating unit appears to be without a core and without "insiders," as the term is normally understood . . . . Because the nexus view defines the various constituencies by their contractual rights, the firm is merely the total grouping of those relationships. In one respect, employees, including executive officers, are no more insiders than are individual suppliers, each described by their "contract" with the corporation.

Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1628–29 (2001). Responding to this emptiness, Stephen Bainbridge has generated numerous articles promoting his theory of director primacy. *See, e.g.*, Stephen Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance,* 97 NW. U. L. REV. 547 (2003); Stephen Bainbridge, *Director v. Shareholder Primacy in the Convergence Debate*, 16 TRANSNAT'L LAW. 45 (2002); Bainbridge, *supra* note 2. Like Rock and Wachter, Bainbridge sees that the standard nexus-of-contracts account leaves the firm without the entrepreneurial center provided by Knight and Coase's theory. Bainbridge seeks to fill this void not by

Conceiving of the corporation as the vibrant, entrepreneurial (and nonempty) center of the firm solves this error. So viewed, the corporation is a surrogate for the entrepreneur. Viewed as a circle, the corporation encompasses the contractual and legal relations between, and the contractual and legal responsibilities of, the shareholders, directors, and officers; it is these relations and responsibilities that constitute what we call "the corporation" and that determine how the entrepreneurial role is carried out in an incorporated firm. It is these relationships that are the subject of corporation law. The Coasian firm is a larger circle encompassing the corporation and the relations between the corporation and the firm's employees. Finally, the revised nexus-of-contracts firm is an even larger circle encompassing the corporation and not only employees but also suppliers, customers, and other contractual constituencies.

If we take as a starting point Coase's seminal insight that allocation of resources by the entrepreneur's direction is the essence of the firm, then the central research question posed by the modern corporation follows: How is the entrepreneur function carried out in the modern corporation with separation of ownership functions among multiple roles? For legal scholars, there is a specialized subpart to this research question: How do the corporation and corporation law help solve the problems inherent in the separation of ownership and control famously identified by Knight, and Berle and Means? Viewing the corporation as a surrogate for the entrepreneur, and as encompassing the relations and obligations of the shareholders, directors, and officers, facilitates analysis of this question.

As we have seen, Coase first sought to define the firm and then to illuminate the process that resulted in the firm's existence and determined its boundaries. But the only dimension of the firm that he sought to explain was the allocation of resources pursuant to the hierarchical

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breathing life into the corporation as entrepreneur surrogate, but rather by suggesting that one set of the corporation's constituent actors—the board of directors—is the sole nexus of contracts. Like shareholder primacy theories and Blair and Stout's team production scholarship (Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999)), Bainbridge's insights contribute to a study of relationships and duties within the corporation, but his theory does not support or provide a comprehensive descriptive account of the corporation or corporation law. These points are further elaborated in O'Kelley, *Modern Corporation, supra* note 6, at 772–77.

58. *See* Boudreaux & Holcombe, *supra* note 26, at 154 ("[A] fully adequate theory of the firm cannot be developed within a general-equilibrium setting because one of the key characteristics of a firm is decision-making under uncertainty—i.e. where vectors of outputs and prices are not known by decision makers. By working implicitly within the framework of general equilibrium, contemporary theorists, following Coase, have assumed away some important aspects of the firm's environment. These aspects are the fundamental building blocks of Knight's theory of the firm, and their explicit recognition promises a richer and more complex theory of enterprise and of the firm.").

direction of the entrepreneur. In other words, Coase found the essence of the firm to be the direction of resources pursuant to the entrepreneur's command because his research agenda was to explain why such interfirm allocation of resources via the entrepreneur's command occurs at all, and because it does, why a particular transaction is organized within the firm instead of via the market. Other dimensions of business organizations, such as the nature of capital ownership,[59] or the reasons why some resources are allocated within a sole proprietorship by the entrepreneur–owner and other transactions are coordinated by a more complex corporate hierarchy,[60] were simply not part of Coase's research agenda and therefore not necessary to his definition of the firm.

Fortunately, Coase's insight meshes easily with a revised nexus-of-contracts account. Under this revised account, the corporation is a part of the standard-form contract that shareholders, directors, and officers voluntarily select when they initially choose to organize business relationships as a corporation.[61] Importantly, "the corporation" is not the same thing as "the firm," but rather a by-product of contractual bargaining between a subset of the firm's constituents who voluntarily choose to organize their business relationship by forming a corporation and agreeing to act as the corporation's officers, directors, and shareholders. The corporation is a subset of the relationships that constitute the firm, but a very special subset, because corporation law assigns to the corporation the role of sole-proprietor-surrogate. Thus, a fundamental first purpose of corporation law is to provide "the corporation" and its internal governance rules as a surrogate for the sole proprietor, and to determine how the rights, responsibilities, and rewards of the sole proprietor will be allocated to and among the persons replacing the sole proprietor—the corporation's shareholders, directors, and officers.[62]

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59. For a discussion of the implications of Coase's theory of the firm for corporate finance and the implications of corporate finance for a theory of the firm, see Geoffrey P. Miller, *Finance and the Firm*, 152 J. INSTITUTIONAL & THEORETICAL ECON. 89 (1996).

60. Following in Coase's footsteps, transaction-cost economists continue to refine our understanding of the design and purpose of alternative business organization structures. *See, e.g.*, OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1998); Charles R. T. O'Kelley, *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 NW. U. L. REV. 216 (1992); Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913 (1999).

61. ERIC W. ORTS, SHIRKING AND SHARKING: A LEGAL THEORY OF THE FIRM 265, 299 (1998) ("Firms of more than one person are better described not as a nexus of contracts, but as a *nexus of agency relationship.* In the language of contractarian theory, saying that a 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.").

62. I argue that this first purpose is not morally relativistic—responsibilities and rewards are not allocated or allocable against a value-neutral backdrop. Instead, the fundamental purpose of corporation law is to see that responsibilities and rewards are allocated so as to provide the firm with

The nature of the corporation as sole-proprietor-surrogate is illuminated by considering the nature of the classic firm—a sole proprietorship in which the proprietor is the firm's entrepreneur–manager and owns the firm's means of production.[63] From Coase's viewpoint, the classic firm consists of the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur.[64] Thus, if depicted as a circle, the Coasian firm encompasses the entrepreneur and the employees that she directs. In contrast, from the nexus-of-contracts perspective, the classic firm consists of the relationships between the entrepreneur and not only her employees, but also the firm's suppliers, customers, lenders, lessors, and other constituents. Accordingly, the nexus-of-contracts definition of the classic firm would be captured pictorially by a circle encompassing that wider set of relationships. From both the Coasian and nexus-of-contracts perspectives, however, the terms "the firm" and the "sole proprietorship" denote the same phenomena—the set of relations that are deemed to constitute the firm.

Still, there is another concept to consider in examining the classic firm—the sole proprietor. Where does the sole proprietor fit in the description of the firm? It seems indisputable that the term "the sole proprietor" does not denote the same phenomena as the terms "the firm" and "the sole proprietorship," but rather denotes the role undertaken by one of the individuals involved in the contractual relations within the firm—the entrepreneur. The entrepreneur differs from the other constituents of the sole proprietorship in that she is a party to every contract as well as the owner and provider of the sole proprietorship's equity capital. Thus, the sole proprietorship should be defined as the set of relations between the sole proprietor and the other constituents of the firm and should be depicted as a circle encompassing all of these relations. At the center of this circle is the sole proprietor—the common party to all of the contractual relationships.

Does this understanding of the sole proprietorship make it appropriate to describe "the sole proprietor" as "the owner" of the firm? Not from the nexus-of-contracts perspective:

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the best possible entrepreneurial direction. Put differently, corporation law is not agnostic as to the governance choices made by the corporation's constituents: corporation law is intended to guide corporate constituencies in the direction of entrepreneurial management.

63. Alchian & Demsetz, *supra* note 55, at 783, provide the standard economic definition of the rights attendant to the sole proprietor, the owner and entrepreneur in the classical firm:

> It is this entire bundle of rights: 1) to be a residual claimant; 2) to observe input behavior; 3) to be a central party common to all contracts with inputs; 4) to alter the membership of the team; and (5) to sell these rights, that define the *ownership* (or the employer) of the *classical* (capitalist, free-enterprise) firm.

64. Coase, *supra* note 1, at 386, 394.

> [O]wnership of capital should not be confused with ownership of the firm. Each factor in a firm is owned by somebody. The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs. In this "nexus of contracts" perspective, ownership of the firm is an irrelevant concept.[65]

It is, of course, true that the individual who assumes the role of sole proprietor does not "own" the individuals who assume the role of employee.[66] The sole proprietor, however, does possess a position within the firm and a bundle of property rights that are generally described as the powers and position of an owner. First, the proprietor is the locus of, the common party to, all contracts with the firm's factors of production. Second, the proprietor owns or otherwise controls the firm's productive capital—the means of production. Third, the proprietor has the legal right to determine with whom she associates and for how long, and this legal right of association extends to determining how long and to what extent she will allow other factors of production to have access to the firm's productive assets.[67] Fourth, the proprietor has the rights provided by the law of master and servant and the law of agency to determine, within limits, what employees and other agents will do.[68] Fifth, the law of master and servant substantially lessens the risk that employees will be able to misappropriate the sole proprietor's business assets. It is with refer-

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65. Fama, *supra* note 9, at 290.

66. Alchian & Demsetz, *supra* note 55, make this point rather strongly. The example they use is the customer-grocer relationship:

> [In an market exchange relationship] I can "punish" you only by withholding future business or by seeking redress in the court for any failure to honor our exchange agreement. That is exactly all that any employer can do. He can fire or sue, just as I can fire my grocer by stopping purchase from him or sue him for delivering faulty products . . . . Telling an employee to type this letter rather than to file that document is like my telling a grocer to sell me this bread or tuna rather than that brand of bread.

Id. at 777.

67. The entrepreneur's ability to grant, deny, or terminate access to the firm's productive assets gives the entrepreneur power and makes internal governance structure critically important. *See* Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q.J. ECON. 387 (1998).

68. Of course, this right of association is symmetrical. The other members of the classical firm can also terminate their association with the firm at will, but when they depart they will no longer have access to the productive assets owned by the proprietor. Thus, upon departure, the other members will suffer a loss to the extent that their human capital has value specific to those assets. This explains one aspect of the error in Alchian and Demsetz's claim that the authority of the entrepreneur is no different than the customer's ability to order her grocer to stock a certain type of bread. If the grocer refuses to follow the customer's order, the customer can do no more than "fire" the grocer. But if the employee refuses to follow the employer's directions, the employer may fire the employee, which causes the employee to suffer noncompensable damages equal to the value of the portion of the employee's human capital that is specialized to the employer's assets.

ence to these legal rights that the sole proprietor is termed "the owner" of the classic firm.

When we move to what is colloquially called "a corporation," these insights concerning the sole proprietorship do not translate into an equality of the "the corporation" and "the firm," but rather result in the realization that the term "the corporation" refers to the legal entity that possesses all of the rights that in the classic firm are possessed by the sole proprietor and to the totality of the contractual relationships between and among the shareholders, directors, and officers. Like the sole proprietor, the corporation owns the firm's productive assets and serves as the locus for contractual relations. The corporation also has the legal right to determine who will be employed within the firm and who will provide supplies, and the corporation has the right to terminate these relationships at will. Further, the corporation has the rights provided by the law of master and servant and the law of agency to determine, within limits, what employees and other agents will do. And finally, it is the corporation to whom the employees and agents owe fiduciary duties.

The firm can best be depicted as a circle encompassing the relations between the corporation—the artificial proprietor—and the firm's employees.[69] At the center of the firm is a smaller circle—the corporation. Within the firm, the corporation assumes a position parallel to that which the sole proprietor occupies in the classic firm, and within this corporate circle are the contractual and legal relations and responsibilities assumed by the officers, directors, and shareholders.

B. The Definition in Action

How does the revised Coasian account of the firm that I have sketched above matter? I believe at the very least it facilitates a more accurate descriptive account of corporation law, and it facilitates communication as opposed to apparent communication between scholars of differing viewpoints. For example, the current nexus-of-contracts account appears to support both communitarian and conservative accounts of the corporation.[70] Coase's reality test reveals that both of those accounts cannot be right.

The debate about corporation law's role in protecting the interests of a firm's "other constituents" (constituents other than directors, officers, and shareholders) springs from a mistaken premise—the other con-

69. In the Coasian firm, the corporation takes the role of the sole proprietor, and the only contractual relationships that make up the firm are those between the entrepreneur and the employees. In the nexus-of-contracts firm, the relationships that matter are broadened to include a wider group of stakeholders.

70. *See* O'Kelley, *Modern Corporation*, *supra* note 6, at 765–66.

stituents of the firm are also constituents of the corporation. As the previous section showed, the corporation should be viewed as a surrogate for the sole proprietor. So viewed, the corporation encompasses only the governance relationship between the shareholders, officers, and directors, who are, thus, the corporation's only constituents.

A simple hypothetical illustrates this point. Assume that a sole proprietor, Entrepreneur, hires Techie I, Techie II, Techie III, and Techie IV to work under Entrepreneur's direction in perfecting and bringing to market the Product. Entrepreneur owns and provides the necessary work premises and equipment. Entrepreneur borrows needed capital from Lender and obtains supplies on credit from Supplier. From a Coasian perspective, this classic firm is comprised of the contractual relationships between Entrepreneur and his four employees; from a modern nexus-of-contracts perspective Lender, Supplier, and perhaps other constituents would also be included. If we depicted this firm as a circle, Entrepreneur would be at the center representing her place as the common party to all contractual relations. But Entrepreneur also should be depicted at the center of the firm because she is the owner of the firm as the concept of ownership is commonly understood.

Now consider the plight of the most vulnerable constituents of this classic firm. The employees are subject to the law of master and servant. Thus, they owe fiduciary duties to Entrepreneur, yet she owes no fiduciary duties to the employees. Even though the employees' well-being depends on the efficacy of Entrepreneur's business decisions, the employees have no right to participate in the making of important policy decisions, no right to replace Entrepreneur if she proves unskillful or opportunistic, and no right to sue Entrepreneur for damages that the employees suffer as a result of Entrepreneur's negligent operation of the firm's business.

Now suppose that Entrepreneur incorporates her sole proprietorship under the name Corporation in order to obtain the benefits of limited liability, and she initially allocates to herself all of the corporation's shares and its one authorized directorship. The firm now constitutes the relationships between Corporation and Corporation's employees, Supplier, and Lender. The changes in our description of the firm effected by this reorganization are the following: the firm is now depicted as a circle encompassing the contractual relations between Corporation and the other constituents of the firm; Corporation is located at the center of the firm representing Corporation's place as common party to all contracts and status as owner; Entrepreneur is now depicted as *within* Corporation, representing Entrepreneur's position as the corporation's officer, shareholder, and director. As the only constituent of the corporation, the provisions

of corporation law apply only to Entrepreneur. Importantly, as before incorporation, the employees still owe the proprietor fiduciary duties and must follow the proprietor's directions. As before, the proprietor does not owe fiduciary duties to the employees. The only difference is that the proprietor is now the corporation, Corporation.

Now suppose Techie I and Techie II threaten to quit, and Entrepreneur concludes the firm will fail without their unique skills. At the same time, Lender demands an equity interest in the corporation. Accordingly, the corporation is reorganized so that Techie I, Techie II, Entrepreneur, and Lender each own 25% of the corporation's shares. The board is expanded from one position to three, and the new positions are filled by Techie I and Lender. Entrepreneur continues to serve as the corporation's CEO, and Techie I and Techie II continue to provide services to the corporation as nonexecutive employees.

This change in our hypothetical highlights a flaw in the communitarian analysis of the relative contractual standing of various corporate constituents. In our hypothetical, each individual has bargained for a particular set of contractual rights: Techie I has bargained for share ownership, a director position, and the status of employee; Techie II has bargained for share ownership and the status of employee; Lender has bargained for share ownership and lender status; Techie III and Techie IV have bargained only to be employees; Supplier has bargained only for the contractual relationship of supplier. Some individuals have bargained to have corporation law rights and relationships, some have not. Those who have bargained for corporation law rights and responsibilities as officers, directors, or shareholders, have struck different bargains in terms of their position within the corporation. What is the descriptive basis in the nature of the firm for reordering the bundle of rights and duties for which each party has contracted?[71]

Finally, we can expand this hypothetical to include additional shareholders, employees, directors, and other constituents. Corporation may eventually "go public" and add thousands of individuals to the ranks

71. The point here, is that a descriptive (predictive theory) of the modern American corporation, does not coincide with reality if it shows or predicts that ordinary stakeholders (those playing roles other than as officers, directors, or shareholders) have an entrepreneurial decision-making or risk-taking role in the corporation. There is an enormous body of literature explicitly making *normative* claims for why corporate stakeholders should receive enhanced substantive and procedural rights. For insight into that literature and how it relates to the nexus-of-contracts theory of the firm, see Neil A. Shankman, *Reframing the Debate Between Agency and Stakeholder Theories of the Firm*, 19 J. BUS. ETHICS 319 (1999). Those normative arguments must rise or fall on grounds other than a theory of how corporations are in fact governed.

of its shareholders.[72] Let us also assume that despite having her equity ownership and voting power diluted to 25%, Entrepreneur continues as CEO (though it would not affect our analysis of the firm if she did not). Some of the new shareholders may be nonexecutive employees, some may be key executives and directors, and some may otherwise be strangers to the firm. The legal and contractual rights and duties that flow from these new share issuances will go into the mix of governance and ownership relationships that make up the corporation. Some of these new shareholders will also have relationships, perhaps as nonexecutive employees, that will properly be described as within the firm, but not within the governing corporation. Perhaps some of the buyers of these newly issued shares will have existing or concurrently created relationships with the firm as officers or directors; these relationships too should be viewed as within the corporate circle. And some of these new share owners will have relationships with the firm only as shareholders, and those relationships will fall inside the corporate boundary as well.

These insights lead to the following description of the more complex organization—the modern, publicly traded corporation. The Coasian firm still encompasses the contractual relations between Corporation and its nonofficer employees, and the nexus-of-contracts firm still encompasses not only the relationships with nonofficer employees but also the relationships with other constituencies. Corporation is still the sole-proprietor-surrogate standing at the center of the firm. Corporation, however, now encompasses the myriad relationships between and among the firm's CEO (Entrepreneur) and the other individuals who occupy the status of officer, director, and shareholder.

VI. CONCLUSION

Nexus-of-contracts scholars caution against reifying the corporation.[73] The same caution should be applied to the many other legal and nonlegal concepts that we use in our corporate law scholarship and to use of the concept of reification, a concept we are little trained to under-

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72. Missing from most accounts of the modern corporation is how firms arise and how they (sometimes) become publicly traded corporations with widely dispersed share ownership. Knight's overarching theory provides the vehicle for this type of analysis:

> Knight's discussion facilitates a dynamic perspective on firms, from their entrepreneurial beginnings to their widely held corporate forms. This perspective alerts us to the fact that at the time of a firm's IPO, its ownership rights are already in the possession of the entrepreneur(s), and if we accept the rights of an individual to the ownership and sale of private property, then it is difficult to argue against the entrepreneur's rights to sell his property (i.e. ownership) to investors.

S. Ramakrishna Velamuri & S. Venkataraman, *Why Stakeholder and Stockholder Theories Are Not Necessarily Contradictory: A Knightian Insight*, 61 J. BUS. ETHICS 249, 259 (2005).

73. *See supra* text accompanying note 11.

stand.[74] Terms such as "employer," "director," and "officer" refer to legal roles that may be assumed by human actors, but these roles are not "real" any more than a corporation is "real." Human actors may take on multiple roles within a firm. Some of these roles, and the associated contractual and legal rights and responsibilities, may best be described as belonging within the corporation. Other roles and associated contractual and legal rights may be best described as belonging within the firm but outside of the corporate inner core. Real human actors may occupy multiple roles, some of which are within the corporate circle and some of which are only within the larger circle bounding the firm. And, of course, human actors will occupy many roles outside of the boundaries of the firm. Clarity of thinking and debate in corporate law scholarship would be greatly enhanced if each of us carefully refrained from equating roles and human beings.

That said, viewing the corporation as a nonempty, entrepreneurial center of the firm is not reification. Rather, this model depicts the reality of corporate governance, and the use of this model will promote clear thinking about the nature of the incorporated firm. The power to make entrepreneurial decisions is not an afterthought or a mere economic theo-

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74. Sociologists, anthropologists, and philosophers provide us with a treasure trove of scholarship about reification. Importantly, reification should be understood from both the institutional (holistic) and individualist perspectives:

Reification is:

> The error of regarding an abstraction as a real phenomenon. The source of the error lies in the fact that in analysis it is necessary to simplify the complex phenomena of the real world, and in developing analytic concepts aspects of a given phenomenon must be ignored in order to focus on other aspects. (Modern Dictionary of Sociology)

This general definition includes the more typical individualist charge of reification against holists for the inappropriate application following from "misapprehending a human relationship as a thing." It includes the also the less recognized error of individualists for the inappropriate application of idealized conceptions of people following from "the mental conversion of a person or abstract concept into a thing" (Oxford English Dictionary). Reification in the first instance is the negative consequences from the incorrect imposition of abstract relationships on complex human behavior. Reification in the second instance is the negative consequences from the inappropriate imposition of an abstracted individual on complex human behavior.

. . . .

There is nothing inherently wrong in the abstraction and application of a "guiding imagery." The problem is one of fit between the applied image and actual complex human behavior; whether its application leads us forward. Guiding images are misleading when their imposition distracts from our analyses to overly simple dispositional characteristics, boundaries, and reciprocal interdependencies when the critical issues are understanding very complex interactions, relationships, and orientations.

Richard A. Colignon, *Reification: The "Holistic" and "Individualistic" Views of Organizations*, 18 THEORY & SOC. 83, 83–84 (1989) (footnote omitted); *see also* Ian Ashman & Diana Winstanley, *For or Against Corporate Identity? Personification and the Problem of Moral Agency*, 76 J. BUS. ETHICS 83 (2007); Hanna Fenichel Pitkin, *Rethinking Reification*, 16 THEORY & SOC. 263 (1987).

ry; it is a central organizing feature of the corporation and corporate law. All relations within the incorporated firm are not the same. Some are "more equal" than others: the corporation is a surrogate for the sole proprietor, and the relationships that matter most, and are best described as comprising the corporation, are those pertaining to the roles of shareholders, officers, and directors.