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THE NEW NEXUS OF CONTRACTS: THE MARKET PRODUCTION OF CORPORATE GOVERNANCE

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Abstract

In this article we present a new framework for thinking about the governance of firms. The key insight of the framework is that there are two production functions that must be analyzed when looking at a firm: (1) the production of the good or service that the firm introduces to the market and (2) the production of the governance or control under which the firm operates. We demonstrate that the first is produced within a Coasean hierarchy, and that the second is produced in an open market, often influenced by complex and overlapping networks of formal and informal relationships. We suggest that this framework has important implications for laws of corporate governance and finance.

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INTRODUCTION

Conventional theories of firms and governance generally fall into one of three camps: shareholder primacy, director primacy, or pure contractarian.[2] None of these theories adequately describes or predicts what goes on in modern business firms. This is true primarily because they try to explain too much. Virtually every theory of corporate governance attempts to explain the function that produces goods and serves and the function that produces governance within one unified theory. This is a mistake.

The organization of production of goods or services sold on the market (we will call this the "revenue function"[3]) is radically different from the organization of production of control over the stakeholders who come together to create a firm (we will call this the "governance function").

For example, imagine the following group of people comes together to sell widgets on the market: two investors, one experienced executive, one widget designer, and one manufacturing expert. Let's say the investors and the executive enter a detailed partnership agreement to set up a firm to produce widgets. The agreement allocates profits among the investors and the executive and includes specific provisions that cover all decisions about who controls the firm and who decides its big-picture business strategy. The executive is put in charge (as the managing partner and

[2] A fourth category might be labeled managerialism, which focuses on executive officers rather than directors or shareholders. Theories under this label have gone out of favor and have been labeled "passé" by the leading theorist of director primacy. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. L. REV. 547, 561 (2003). For our purposes, we can lump manager-primacy theories in with director-primacy theories.

[3] The production of goods or services creates the revenue that sustains the firm.

CEO) and hires the designer and the manufacturing guru to start the widget production.

In this scenario, there are two production functions. The revenue function is the direct combination of factors of production (the designer, the manufacturing expertise, and an other labor and supplies) to produce a widget. This function is taking place within a firm under the guidance of the executive. This is a traditional Coasean firm.[4] It looks like this:

[INSERT DIAGRAM]

The executive directs the activities of the designer and the manufacturer by fiat.[5] From the perspective of the designer and the manufacturer, they are working for a widget firm. They have no default property rights. If the designer has a dispute with the manufacturer about the quality of widgets, she does not take the manufacturer to court. Rather she goes to the hierarch – here, the executive.

The governance function, however, is entirely different. The governance function *creates* the revenue function. It takes market inputs and then provides the rules within which the hierarch must operate. Significantly, those rules are produced from outside the firm. The function that produces them has no hierarchy. Inputs come together and create a governing set of rules, but they do so in an open market, without a manager. In our example, the function that produces the rules of the game is a contractual[6] arrangement between the investors and the executive. It looks like this:

[INSERT DIAGRAM]

If the inputs have a dispute about the rules (or the production of the rules) that govern the firm (and by firm we mean the revenue function), fiat has no sway. They look to

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

[5] We simplify here by assuming the full power to direct an employee by fiat. Fiat power over assets that are owned is more clear cut than the power over an employee. We discuss this in more detail below.

[6] We use the word contractual here in the board sense that others writing about these issues have used it to include formal and informal market transactions. *See* G. Mitu Gulati, William A. Klein & Eric M. Zolt, Connected Contracts, 47 UCLA L. REV. 887, 894 (2000).

their contract, which is enforceable by going to court or by resort to other (formal or informal) market forces.

Thus, governance produces the parameters for the revenue function. Put together, this is how firms are organized:

[INSERT DIAGRAM]

In this framework, the revenue function *is* the firm while the governance function *defines* the firm. And that is why governance has to be external to the firm. The rules of the function cannot be set by the function itself.[7]

All firms – be they partnerships, corporations, or some other form – have this structure. In this way, we are suggesting that corporate governance scholarship should return to Coasean roots. Coase posited that some things were being produced in hierarchies and others were being produced in the market. Attempts to collectively address questions of internal organization, managerial agency costs, and capital structure have led scholars to conflate these questions and try to answer them with one theory of the firm.

As a result, the conventional theories all run into contradictions when they are applied to real world cases. Hierarchical theories of team production or director primacy, which place directors at the top of a unified production function, cannot explain the governance power that creditors and other stakeholders exert over directors, officers, or even over other stakeholders. Nor can they explain how and why these stakeholders exert pressure to replace boards altogether. On the other hand, leading pure contractarian

[7] Various metaphors can be constructed to make this point. Computer programming is an apt one. The governance is the code and thus it comes from an external source: the programmer. The program or game then collects inputs according to its code and a user (the hierarch) can direct those inputs within the parameters set by the code. But neither the user nor the program itself can change the underlying code parameters. As we will see, our main argument (and our main departure for traditional models) is our claim that there is not one centralized programmer. Rather general market forces fill the role of the programmer without hierarchical direction. Traditional theories, on the other hand, might view the directors or shareholders as the programmer and the CEO as the user.

theories do not fully account for the deference that directors are given on questions of internal corporate affairs and the day-to-day allocation of resources. And shareholder-primacy models cannot explain basic events like the filing of bankruptcy by an insolvent debtor.[8]

A theory that separates the revenue function from the governance function does not run into these contradictions. This may seem semantic, but the difference matters in understanding the power and control dynamics between stakeholders and in setting default rules of governance. A view that directors are the prime governors of all stakeholders (the traditional director-primacy and team-production view) is vastly different from our view that directors are the governors only of internal decisions aimed at revenue production and they act only within the parameters set by much stronger market forces. This difference has important consequences for policy questions ranging from the validity of takeover defenses to default fiduciary duties and the rights of any given group of stakeholders to sue for "governance" violations.

The remainder of this article proceeds as follows. Part I reviews the leading theories of firms and corporate governance. Part II introduces the framework for the market production of corporate governances. Part III discusses the legal policy implications of the framework. Part IV concludes.

I. BACKGROUND LITERATURE

The literature on firms and corporate governance is mired in two debates. The first concerns what a firm is and the other second concerns who controls the firm. Pure contractarians argue that there is no firm. There is simply a web of contracts and relationships that produce economic activity.[9] Thus, the firm *is* the web of contracts and relationships and it is *governed by* those contracts and relationships.[10] On the other extreme, those in the

[8] *See, e.g.,* Douglas G. Baird & M. Todd Henderson, Other People's Money, 60 STAN. L. REV. 1309 (2008).

[9] Gulati, et al.; Cheung, The Contractual Nature of the Firm, 26 J.L. & ECON. 1, 8 (1983).

[10] Gulati, et al.

shareholder-primacy camp argue that a firm is a hierarchy owned (and therefore governed) by its shareholders.[11]

There are many variations between these two extremes. Three groups of theories are most notable: nexus-of-contracts theories, director-primacy theories,[12] and team-production theories.[13] Nexus theories—at least as they are most commonly understood—posit a hub-and-spokes model for firm activity.[14] The firm is the hub collecting the relationships with various other actors in the economy such as employees, investors, customers and so on. The various actors do business with the firm rather than engaging in endless multilateral transactions with each other.[15]

Director-primacy and team-production theories might be viewed as more specific sub models of the nexus-of-contracts theory. The leading director-primacy model labels the board of directs as the nexus, which then governs the firm.[16] Under this model, the board is a "Platonic guardian" whose powers arises from the contracts of the firm as a whole.[17] The directors craft the firm and they design the contractual web in the interest of the various stakeholders.[18] The team-

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[11] Lucian Arye Bebchuk, The Case for Increasing Shareholder Power, 118 HARV. L. Rev. 833 (2005).

[12] Bainbridge (2003); Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 Iowa L. Rev. 1 (2002).

[13] Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 VA. L. REV. 247 (1999). We have provided a critique of the team-production theory in a prior essay. Much of what we say here about theory is derived from our earlier analysis. Casey & Henderson.

[14] The dictionary definition of "nexus" suggests something more web like. But the common use of nexus implies a hub and spokes. See Gulati et al (explaining the prevailing views of nexus-of-contracts theories and distinguishing them from their web-like model of connected contracts); see also Bainbridge (2003) & (2002) (embracing the hub-and-spokes model as a nexus-of-contracts theory).

[15] Alchian & Demsetz; Williamson; etc.

[16] Bainbridge (2002).

[17] Bainbridge (2002) at 8.

[18] Bainbridge (2002) & (2003). Bainbridge notes that the directors bring together the other factors of production and govern the relationships with them. In this way, he implies a special role of the directors as the master of the nexus rather than as the hired monitors as team-production theorists describe. Based on this distinction Bainbridge

production model similarly views the board of directors as the nexus of the contractual relationship. For that model, the board of directors is a "mediating hierarch" for all the various relationships that form the firm.[19] All relationships go through the board, which calibrates and coordinates the obligations and entitlements of the stakeholders to maximize their collective welfare.

These theories have their strengths. But they also have significant limitations.

A. Team Production

Blair's and Stout's team-production model was an important improvement on shareholder-centric concepts of firms. They pointed out that where conventional scholarship equated ownership with rights of control in all contexts, the truth for publicly trade firms was more complex. They demonstrated that, as a matter of first principles, nothing about equity's investment privileged it (over other stakeholder classes) to exclusive control rights.[20]

This was an important insight. Legal scholarship about corporate governance had become obsessively focused on the problem of agency costs between owners and managers. Positing that the shareholders owned firms, the literature assumed that shareholders should be controlling them as well. From that vantage point it was puzzling that shareholders ceded so much power to managerial agents with quite divergent incentives. They framed this as a stark principal agent problem that arose from the separation of ownership and control.[21] Blair and Stout and those that followed them, pushed the literature beyond that point, showing that it was possible that there was no owner-manager agency problem. There was rather a vast network of stakeholders doing business through a platform. This

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reaches normative conclusions that grant more discretion to directors. For our critique of this view see below at ___.

[19] Blair & Stout.

[20] Blair & Stout.

[21] For the classic accounts see ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1932) and Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 3 J. FIN. ECON. 305 (1976).

story had the appeal of more accurately reflecting reality. As Blair and Stout put it, "If control is the economically important feature of 'ownership,' then to build a theory of corporations on the premise that ownership (and hence, control) lies with shareholders grossly mischaracterizes the realities of public corporations."[22]

At the same time, the team-production model has its own limitations. As we have pointed out elsewhere, the team-production model does not provide a satisfactory story of the way that creditors exercise control over firms.[23]

The last decade of academic literature has revealed compelling evidence that lenders and other creditors are a critical part of the governance function of firms.[24] Lenders govern firms through covenants, through market forces, through reputation, and through other forms of direct and indirect control.[25] These creditors can dictate who runs a firm, how she runs it, and when control shifts from one hierarch to another. They can put in place covenants that control big-picture decisions when things are going well or that control day-to-day operations when the firm is in distress.[26]

A contradiction arises under the team-production model, all stakeholders deposit residual control in the team leader. If we count creditors as stakeholder (as any useful model must), then it follows that creditors should deposit residual control with the board and follow its lead.[27] But that is not the way that boards and lenders do business. In exercising

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[22] Blair & Stout at 260-61

[23] Anthony J. Casey & M. Todd Henderson, *The Boundaries of "Team" Production of Corporate Governance*, 38 SEATTLE L. REV. 365, 372 (2015).

[24] Douglas G. Baird & Robert K. Rasmussen, Private Debt and the Missing Lever of Corporate Governance, 154 U. PA. L. REV. 1209 (2006); Baird & Henderson; Sufi et al; Frederick Tung, Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance, 57 UCLA L. REV. 115 (2009); see also Barry E. Adler, An Equity-Agency Solution to the Bankruptcy-Priority Puzzle, 22 J. LEGAL STUD. 73 (1993).

[25] Id.

[26] Sufi, et al.

[27] Blair and Stout suggest that creditors do this. Blair & Stout at 253.

their levers of control, these creditors do not answer to boards of directors. In many cases, the creditors dictate the rules to the directors. To the extent anyone or anything exerts residual control over lenders, it is not the board of directors but other lenders and the finance industry as a whole.[28]

This creates a paradox for a team-production theory (and also for director-primacy theories). If the directors are team leaders, the team does not include the lenders. But a team that does not include the lenders leaves out too many crucial decisions to be a useful model of the governance function.

We cannot solve the puzzle by merely suggesting a creditor-centric model. That would go to far in the other direction. Creditors do not have fiat power over boards and they do not mediate the interests of other stakeholders. Rather they assert as much control as the market allows and accept as much command as the market dictates. In any event, a creditor-centric model would ignore the role of other powerful stakeholders like trade associations, large consumer groups, and suppliers. None of these stakeholders is commanded and controlled by the creditors. But neither are any of them under the command and control of the board (or any other stakeholder).

Thus, we have suggested that there is no team governing this function "but rather a collage of groups contracting on the market – some that are independent and others that are overlapping."[29]

Some have noted other limitations inherent in the team-production model. For example, Bainbridge and Coates have suggested that the "model fares poorly when there is a dominant shareholder."[30] In those cases, the directors look more like captured agents than like mediating hierarchs.[31]

Bainbridge raises two other critiques, but Blair and Stout have the stronger ground on these. First, Bainbridge

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[28] No one lender controls another. But there are industry relationships and norms that can have a strong influence on lender behavior. Id.

[29] Casey & Henderson, at 373.

[30] Bainbridge; Coates.

[31] Id.

suggests that team production is unrealistic because it suggests that the stakeholders hire the directors when, in fact, directors hire the factors of production. This is a weak criticism for two reasons. First, there is nothing in the team-production model that requires the board to evolve in a certain order. Directors may hire the factors of production but still become instruments to mediate the relationship between those factors. Powerful financiers, critical suppliers, or high-profile employees, may all come to wield power over the team leaders who hired or brought them in the first place. Indeed, contractarian capital market theories of governance assume that those running a firm will adopt the strategy that the market demands. It is perfectly consistent with a team-production model to assume that boards evolve into their role for this very reason.

Moreover, the way firms reach a given organization structure can vary. Companies that go through venture capital or private equity funding may have their board determined by investors at the equity or preferred equity level. Firms that go through Chapter 11 reorganization will almost certainly push stakeholders through a grand bargain to determine who owns and controls the firm as it emerges. Bainbridge's "empirical impression" that a board displaces the original promoters and then hires factors of production is accurate for firms in certain points in their life cycle,[32] but this ignores all the various ways that those factors of production can influence the board's role and composition at other points in the firm's life cycle.

B. Director-Primacy

The director-primacy model suggests that the board of directors is the center of governance power. It controls the firm for the benefit of shareholders but with great discretion and power.[33] In this way the board can be viewed as the nexus of contracts.

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[32] Bainbridge (2003) (ssrn version, and version quoted by Bainbridge at http://www.professorbainbridge.com/professorbainbridgecom/2015/01/the-case-against-blair-stouts-team-production-model.html).

[33] Bainbridge (2003) at 551 ("[T]he director primacy theory embraces the shareholder wealth maximization norm even as it rejects the theory of shareholder primacy.").

Just as the team-production model fares poorly when there is a dominant shareholder, the director-primacy model (with its focus on shareholder wealth) fairs poorly when there is a dominant creditor or other non-equity stakeholder. The director-primacy model and the shareholder-primacy model do a good job of explaining how large public firms are governed when things are going well. But they tell us little about firms in their infancy or firms in distress. Venture capital structures often govern infant firms in ways that look nothing like what any board-centric model would predict. Likewise, creditors routinely govern (directly and indirectly) firms in distress.[34] Those creditors have enormous influence over who runs the firm, how it is run, and often over who sits on the board of directors.[35] Models that focus on the board and the shareholders do very poorly in predicting legal rules when they encounter the decisions of insolvent firms.[36]

Even if we ignored the shareholder wealth maximization part of director primacy, and just focused on the board's role in maximizing anything, the model fairs poorly. When creditors exercise their influence it is not through the board as their agent or as there Platonic guardian. The creditors exercise power on the firm itself – sometimes through the managers, sometimes through pressure on equity, sometimes through pressure on other creditors, sometimes by taking control or possession of the board, of equity, or a key asset. To put it simply, creditors (and other powerful stakeholders) do not act through the board. They act on stakeholders and on internal components of the firm, which sometimes include the board.[37] A theory that directs the observers attention to the board will misdirect in times of critical change and times of control struggles. The observer will be watching the board, while power is shifting between

[34] Sufi, et al.

[35] Id.

[36] *See, e.g.,* Baird & Henderson.

[37] Often when they do deal with the board that is just formality required by the vestigial requirement that all firms of a certain type have a board. This is one of the great difficulties of any claim about director primacy. It is empirically untestable in a world in which boards are required by any firm that wants to opt for the corporate form. We do not know whether firms opt for that form because of or despite the requirement of the board.

a set of stakeholders that is entirely separate from the board.[38]

C. Pure Contractarian Models

The more extreme contractarian views do better along some of these metrics of the governance function. But they do poorly in describing the revenue function. Indeed, they essentially ignore the Coasean firm altogether.

Gulati, Klein, and Zolt present a connected-contracts model of firms. They reject the hub-and-spokes foundation of the nexus-of-contracts theories of the firm.[39] They propose a conception of the firm that has no boundaries and no firm hierarchy.[40] They contend (we think accurately) that the various traditional hierarchical models of firms will "fail to capture the complex relationships" between stakeholders in many forms of firms.[41] They show that traditional models of firms that suggest that directors, managers, or shareholders are the ones making investment decisions are inconsistent with reality. And they argue that the boundaries these models propose do not map well against boundaries of relationships in many firms.

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[38] We provide some examples in Casey & Henderson. One apt one is the bankruptcy of the Texas Rangers Baseball team. Id. 393 (detailing the control battle between JPMorgan, Nolan Ryan, and MLB that played itself out in the bankruptcy court and noting that the board was irrelevant).

[39] Gulati, et al. note that a "nexus" might be viewed as a web that is consistent with their idea of connected contracts. But in common usage the "nexus of contracts" describes the firm (or the board) as the central place where the contracts come together. The corporation is viewed as the nexus or meeting place of the various contracts. They reject this concept and suggest rather that there is simply a large web of connections with no center and no boundaries. Gulati, Klein, and Zolt at 895. In turn they reject the notion that the firms relationships are governed in a hierarchy. Id. at 896.

[40] Bainbridge criticizes Gulati, Klein, and Zolt for suggesting that it is "futile to try to map out boundaries of the firm." Bainbridge (2002) at 12 (quoting Gulati et al at 897). At some points they do allow for the usefulness of drawing boundaries under a standard hierarchical model, Gulati, Klein, and Zolt at 907; but they suggest that the boundaries of a corporate core tend to be arbitrary and do not accurately portray the bargain where stakeholders negotiate for various rights of control. Id. at 908, 916.

[41] Id. at 897 (using the internet venture to demonstrate the limits of traditional models).

While Gulati, Klein, and Zolt use an internet venture as a motivating example, they importantly note that traditional models fail to explain even the structure of firms like General Motors and Ford Motor Company, "which are often thought of as the paradigms of the traditional hierarchical structure." [42] Those firms have boundaries that can be difficult to demarcate and have even been referred to as "virtual firms."[43] They also argue convincingly that concepts of "ownership" are misleading. They show convincingly that ownership distinctions between equity and debt are largely imagined.

At the same time, their model goes too far in eliminating all conceptual boundaries. [44] As Bainbridge points out,

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[42] The GM hierarchy and its historical moves to integrate have been used as quintessential case studies in economic literature on the theory of the firm. This has been quite controversial. See, for example, Baird, In Coase's Footsteps (recounting the misunderstandings of the GM vertical integration decisions, Coase's critiques of those who tried to explain the integration, and other issues with this literature).

[43] Gulati, et al. at 897 (collecting sources).

[44] At times Gulati, Klein, and Zolt make a more limited claim focusing on allocation of control—that it is produced by a web of connected contracts. See, e.g., Gulati, et al. at 916 ("At the very least, control, and the devices by which the allocation of control is accomplished, seem to deserve more attention than they have received."). Our analysis builds on that insight and connects it with a Coasean theory of the revenue function over which that control is exercised.

In that sense, our view is less a critique and more a further development of Gulati, Klien, and Zolt. At other times, however, their model seems to go further and distances itself from any hierarchical view of the revenue function, implying that the connected contracts metaphor might be applied all the way down. And critics have certainly interpreted their analysis to include this stronger claim. See Bainbridge (2002).

From this stronger claim, we depart. Any suggestion that connected contracts govern all activity of production cannot be squared with observations of how firms operate. By separately analyzing the revenue function, we aim to show the error of the broader claim that connected contracts (meaning market relationships generally) govern all the way down, while salvaging the point that connected contracts do allocate control (and, we suggest, set all the various parameters of that control). We argue that reality presents both a Coasean revenue function and a connected contracts governance function.

Our separation of the analysis of the two functions allows for a more complete theory that stands up to the criticisms that director-primacy theorists level against pure contractarian models.

evidence shows "that real consequences follow from conducting economic activity within firms rather than across markets."[45] There are boundaries that matter. And they matter because within the firm the "decisionmaker has the power to exercise fiat."[46]

The fiat point is, of course, a Coasean one.[47] As Coase suggested, if there was nothing important about fiat, then we would expect all transactions to be conducted on the spot market. We do not see that. Rather, we see the bulk of economic activity occurring within a firm.[48] And when the activity occurs within the firm, it is directed by fiat.[49] Thus, there must be something important about activity of that sort.[50]

Thus, Gulati, Klein, and Zolt make a convincing argument that traditional models go too far in assigning ownership to equity or full control to directors and in suggesting that all business and investment decisions are made within the firm. But they go too far, themselves, to the extent they suggest that there is no meaningful boundary within which intrafirm activity takes place or can be measured.[51]

As discussed below, recognizing the two separate functions has important policy implications that differ from those suggested by contractarian like Gulati, Klein, and Zolt.

[45] Bainbridge (2002) at 12.

[46] Id. at 13.

[47] Bainbridge explores this in detail at id. 18-23.

[48] As we will suggest below, this activity falls under the label of revenue function.

[49] Bainbridge at 15 ("Even in high-tech firms, it is still a Dilbert world.").

[50] To understand what that "something" is we must first define what that makes activity within the firm different. Another way to put it, we must define what a firm's boundary is. We discuss these questions in more detail in the next section.

[51] Kelli Alces presents a similar model that suggests that a firm is really a network of stakeholder contracts. Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783 (2011). Like other contractarians she takes her model one step too far suggesting that all decisions are market based and denying the importance of the internal hierarchy. Because she also views the board of directors as an impediment to market forces she advocates for its ultimate demise and replacement by the network of contracts that Gulati, Klein, and Zolt

To summarize, we can identify a common thread in these leading theories of corporate governance: Theories that accurately describe the hierarchical structure by which management directs day-to-day matters inaccurately describe the way that big picture investment and strategic planning decisions are made and the way that external forces like trade associations and creditors interact with each other and with a firm's managers. These theories suggest that directors or shareholders have power over forces that basic observation tells us they do not have.[52]

Conversely, theories that accurately describe the decentralized relationship between investors, industry networks, governments, and the like tend to ignore the importance of the Coasean hierarchy and fiat in the day-to-day operation of firms. They cannot, in fact, distinguish intra-firm activity from market activity in a meaningful and realistic way.

The contradiction then lies in the attempt that these theories make to explain two separate production functions with the same theory. To correct for this, we present our bifurcated model of firms and corporate governance in the next section.

II. Separating the Revenue Function from the Governance Function

Our framework identifies two separate production functions that are at the core of analyzing firms and corporate governance. We have labeled these the revenue function and the governance function. The revenue function

describe. For the same reasons we noted above with regard to Gulati, Klein, and Zolt, her proposal fails to recognize the importance of fiat and of the boundaries of the firm for determining when the fiat will control decisions. Id. at 813. We have provided a more detailed critique of Alces's proposal elsewhere. See Casey & Henderson at 374-75.

[52] Bainbridge answers this criticism by saying that limits on directorial fiat power are merely contractual limitations. Bainbridge (2002) at 24. But that begs the questions and conflates things. As we explain below, the limitations on the power of fiat *are* the rules of corporate governance. And those rules limiting the power of fiat cannot, by definition, come from that very same fiat. If the limitations that set the rules of governance are coming from contracts in the market, then it is appropriate to say that governance rules are produced through those market contracts rather than through the fiat of the manager.

is the process that results in a good or service that an economic actor sells on the market to generate revenue. When the economic actor that produces the widget is a firm, it will be governed by a hierarchy. The governance function is the function that produces control over the firms that engage in the revenue function—or to put it another way, it produces the hierarchy.

In this way, the firm *engages in* the revenue function and *is the product of* the governance function.[53] But where does the governance come from? In the revenue function, a hierarch directs the factors of production within the firm by fiat to achieve the goal of producing a widget and generating revenue. The governance function, on the other hand, produces a grand set of rules that dictate the specifics of that hierarchy. The governance function chooses the hierarch, defines the scope of the hierarch's power, and dictates various standards and rules to be followed by the hierarch when she exercises her fiat power. In setting the power of the hierarch, the governance function may set specific parameters or allow for considerable discretion. Thus, it may be the case that the governance rules restrict the hierarchy such that the revenue function must produce cars, guns, or legal services; or it may be that the revenue function must produce goods within a certain industry or risk profile; or it may be that the hierarch has wide discretion to choose the object of the revenue function.

Our main analytical point is that while the revenue function often occurs within a firm[54] and the governance function occurs on the open market. There will be some instances in a firm's life cycle when multiple aspects of the

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[53] In cases of subsidiaries, a parent firm may itself be governing another firm. In that sense, the widget that the parent firm is producing is the governance of the subsidiary. In those cases, the governance of interest is the governance of the parent and there our framework tell us to look to the market to find the production of that governance. See below at __.

[54] Of course any one aspect of the revenue function can be outsourced. A firm that makes automobiles may outsource tire-production to the market. See Coase. That point is well established and not of critical import to our analysis. The firm is a hierarchy that has integrated multiple aspects of the revenue production function. The decision to outsource some parts of that production turns on the transaction costs in the market. The governance function on the other hand, will always be external to that hierarchy

governance firm are concentrated in the hands of one stakeholder. A dominant shareholder of a closely held company, who is self financed, and is also the founder and CEO will exercise extreme governance power. As the firm grows or shrinks, however, the founder will cede power to lenders, suppliers, or critical employees. Thus, it is the market and the interaction of those forces that set the parameters of that founder's fiat power.

To see this we must first understand where a firm ends and where a market begins. Once we have that understanding we can start to identify which things are occurring inside and which are occurring outside the firm.

In this Part, we begin with a definition of the boundaries of the firm and the market. We then present our base model of the revenue function and our base model of the governance function.

A. The boundaries of the firm

Our working definition of the firm is Coasean. For the purposes of our analysis we define the firm as the unit in which non-market hierarchy controls the factors of production. As anyone who is familiar with the literature on firms knows, this definition is controversial. What makes the fiat of the manager non-market when an employee can quit or demand a raise? This question alone has produce voluminous literature. Some have proposed that residual ownership of property defines the fiat power.[55] Others have suggested that there is no such thing as a non-market transactions and no real line between firms and contracts. Firms are just collections of long-term contracts.[56]

We do not necessarily have to answer existential questions of whether firms are separate beings or simply the amalgamation of certain types of contracts or relationships. If those relationships produce behavior that is meaningfully different from behavior that occurs in their absence (and they do), then where we can identify those relationships,

[55] Grossman, Hart, Moore.

[56] Cheung.

there is an important distinction that we can label as the "Firm."[57]

There is indeed such a distinction that has particular importance for law scholars.[58] In most market disputes the backstop authority is legal. That is to say when negotiation fails, the parties will resort to legal enforcement. In the open market, if one party wants to take possession of a good that is in the possession of another party it has essentially two choices: a negotiated resolution or the legal enforcement of its right.

If seller withholds goods because she claims that buyer breached their contract, buyer can attempt to settle the dispute or buyer can seek a judicial remedy. Of course, most disputes are negotiated to settlement and do not ultimately lead to a full judicial remedy. But it has long been understood that the shadow of that remedy influences the negotiation.

There may be intermediary steps. Parties may, for example, agree to third-party arbitration. Moreover, alternative informal enforcement mechanisms may take the place of formal legal sanctions. In this way, networks and norms can govern behavior as powerfully as formal law.[59]

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[57] See Casey & Henderson at 391 ("Equating a covenant in a credit facility with a board or a CEO's direction for a firm to undertake a new marketing campaign is to ignore Coase's fundamental insight about the boundaries of firms altogether. While these two things may be reduced to contractual sources if we abstract enough, one cannot seriously maintain that a contract with an outsider and a directive from a manager are the same thing.").

[58] The distinction we set out here has been suggested separately by Margaret Blair and by Anup Malani and Richard Holden. Blair; Malani & Holden; see also Casey and Henderson (discussing the importance of this legal theory of firms).

[59] Robert Axelrod, *The Evolution of Cooperation* (1984); Lisa Bernstein, *Opting out of the Legal System, Extralegal Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992); ROBERT ELLICKSON, ORDER WITHOUT LAW (1991); Stewart Macauley, *Non-contractual Relations in Business: A Preliminary Study*, 28 AMER. SOC. REV. 55 (1963); *generally* Lisa Bernstein, *Private Ordering, Social Capital, and Network Governance in Procurement Contracts: A Preliminary Exploration* (Feb. 2015) (unpublished manuscript); *See* Candace Jones, William S. Hesterly, & Stephen Borgatti, *A General Theory of Network Governance: Exchange Conditions and Social Mechanisms*, 22 ACAD. MGM'T. REV. 911 (1997).

Alternatively, in relationships that we will label intra-Firm, disputes are resolved through managerial fiat. When two employees or two divisions within a firm have a dispute about how to apply factors of production, they do not go to a court. They lack legal standing to even bring such a suit. A division of a firm has no legal identity. And an employee has no ownership of the factors in question.[60]

This can be demonstrated by modifying Coase's motivating example only slightly: Let us say that the question is whether we move machine A from department x to y. No employee will have standing to challenge that decision on that matter externally. The only remedy for a dissatisfied employee is to complain to the hierarch. When this holds true, we can say that the decision to locate the asset is one that is within the firm and the employee is within the firm with regard to that decision.

In Coase's prototypical example it was an employee being moved from department x to y. Employees complicated things a bit. An employee may have a legal remedy if her contract provides her a right to stay in x or if external employment law prohibits the transfer. In that case, the decision about her placement is effectively outside the firm; it has been outsourced. Or as we shall see below, the market has limited the hierarch's discretion over that decision and has dictated that that decision is not within the fiat power.

Employees are also complicated because they can exert external force through a threat to quit. This is why many have suggested that employees can never be truly integrated into a firm[61]. In this way, key employees or employee unions have market power over the firm. (And that is a form of governance power). Employees who are easily replaceable do not.

Key employees gain power from their threat to walk away. As a condition of submitting to the fiat of the hierarch, they demand certain concessions. They place parameters on that fiat. If the market allows, a critical employee can set a governance rule that says that she will never be transferred

[60] Here the resulting lack of standing can be traced back to property rights, suggesting that this theory is in ways consistent with the Grossman, Hart, and Moore property-rights theory.

[61] Grossman, Hart, Moore.

from division x to y. She could alternatively demand, like many lenders do, that the firm maintain a certain debt-to-equity ratio. In doing so, she is negotiating terms for the investment of her firm-specific human capital just as a lessor of critical asset might dictate terms of a lease.

The comparison of an employee to a lessor is useful. Full integration of an asset occurs when a firm buys the asset outright. The property rights that come from that purchase are complete – the asset is fully integrated.[62] The seller (assuming the transaction was on a one-off cash deal) retains neither property or contract rights over the firm. The firm has fiat power over what to do with that asset. If an asset is leased instead, then the lessor retains ownership. And the firm (the lessee) only has the rights provided for in the lease. An employee's labor is provided in a similar fashion.

But there is an additional nuance. The lessor now has power over the firm. Imagine that a certain asset is critical to the firm's going concern value. The firm can buy it outright, the firm can lease it, or the firm can obtain financing to buy it. If the firm opts for a lease, then the lessor has gained significant power over the firm as part of that deal. First the contract may provide the lessor with specific rights of fiat over the firm or over constituents of the firm. Second, the lessor has a withdrawal threat.[63] Under certain circumstances it can remove the asset from the firm and destroy going concern. For example, if the firm defaults and files for bankruptcy, lessors can remove assets from the going concern unless the firm makes them whole. This threat affects more than just the firm. It affects all of the firm's stakeholders. Indeed, stakeholder's withdrawal right may be more threatening to another stakeholder than it is to the firm itself.

In this way the lessor's relationship with the firm gives it power to influence the fiat power of the directors of the firm and to influence the various relationships between the firm and its other stakeholders. The power of the lessor can be limited by the initial transaction. Instead of a lease, the firm can purchase the asset with financing and grant a lender a

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[62] Id.

[63] See Douglas G. Baird & Anthony J. Casey, No Exit? Withdrawal Rights and the Law of Corporate Reorganizations, 113 COLUM. L. REV. 1 (2013)

security interest. This structure shifts power to the bank granting who provides the financing. But the power is different. A security interest does not include the robust withdrawal rights that a lease does. These are just two examples of how the stakeholders can obtain control rights and of how those rights can be indirectly influenced by the rights of other stakeholders.

The employee is unique because outright purchase is not an option. The relationship will always include withdrawal rights and so employees always retain that lever of control. But like any other stakeholder, the employee's rights will be subject to and influenced by the rights of other stakeholders. She will only be able to demand what the market as a whole deems appropriate.[64]

Ultimately, though, the various stakeholders play out their bargains, things shake out in the market and a hierarchy emerges where day-to-day operations are run by fiat. And the law formalizes this relationship. When there are disputes that are not governed by market relationships, the hierarch is the final authority. It is only the firm that has the legal personhood and standing to assert the legal rights that make up the firm. The firm is, in this way, meaningfully different from employees and divisions.[65]

Here, the team production theory is exactly right. The stakeholders interact in the market to deposit a set of control rights into the firm, and the hierarch (be it a board, a CEO, or something else) exercises those rights. But the set of rights deposited is not universal. And contrary to what the team-production model suggests, the does not retain residual rights. Rather the market produces a set specific parameters of within which the governance of the firm (the revenue function) can operate. And *the market stakeholders retain* all residual rights. If they did not, they would not be stakeholders. Someone who sells an asset outright to the firm no longer has a relationship with it. But most interactions are not one-off outright sales. They are leases, financed sales or purchases, or long term relationships that

[64] There is nothing radical in this analysis. These issues have all been explored at length in the foundational literature on firms. Alchian & Demsetz; Williamson, Grossman, Hart.

[65] Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 VA. L. REV. 515 (2007).

include a string of transactions building on each other. In those cases specific rights are transferred through the transaction. Neither party is granted residual rights of control over the relationship. Things not specified by the terms of the transaction, are gaps that must be filled. The market power of one party over another, or the norms of business in an industry, or the biases of the court system, will determine that party's ability to exercise control and influence the other party. And the power to influence a counterparty firm is the power to influence that firm's other stakeholders. A lender calls a default on Ford, can shut down Ford's suppliers, lenders to those suppliers, or even GM because they rely on the same suppliers and lenders.[66] who can shut the That is to say that market forces, negotiation, and contract interpretation (not hierarchical fiat) will fill gaps where they arise. The firm's leaders decide and resolve the matters when the market has deposited the power to so with the firm. The market decides the rest in arm's-length transactions.

B. Locating the two separate function

This legal definition of the firm provides a useful distinction that we explore in this section. The legal firm is defined as the powers given to it by the market. All other powers are reserved to the traditional resolution mechanisms (usually courts and market negotiation). This definition separates the rights that can be influenced by outsiders from those that are completely within the directors' fiat powers. And it provides a boundary for us to study. As we will see, things can flow across that boundary. Decisions can be brought within the fiat powers and decisions can be extracted from them. This process of defining the powers is, we will argue, the core of corporate governance. Corporate governance is the mechanism by which a firm's operation parameters are set. And that mechanism always operates in a market. We can now define each function precisely.

a. The revenue function

[66] This potential ripple effect has been well documented in the auto industry with its complicated overlapping supply network. See, e.g., Austan Goolsbee and Alan Krueger A Retrospective Look at Rescuing and Restructuring General Motors and Chrysler (forthcoming).

The revenue function can occur inside or outside of a firm. This was Coase's essential point. Some transactions occur between individual economic actors on the spot market. Others occur within hierarchies under the direction of managerial fiat.

When we examine a formal business association, we examine a legal firm. The business form – be it a corporation, limited liability company, limited partnership, or the like – creates a legal boundary of the type discussed above. Within one business association, there may be many subsidiary legal forms, which pose interesting questions for any theory of firms or governance. We address those below; but for now we assume one legal entity that creates a legal hierarchy.

The legal entity has hierarchs in the form of directors, managers, or officers who make the decisions on how the firm will be operated. Decisions to increase or reduce production, to hire or fire employees, to increase marketing, or retool equipment are generally made by these hierarchs.

In this way, they direct the production of the widgets and revenue. Of course, aspects of that production may be outsourced. If widget production combines inputs A, B, and C, the hierarch may direct the production of A and B within the firm while procuring C from the market. This is the classic make-or-buy decision. By purchasing C on the market, the hierarch subjects the decisions about C's production entirely to market forces. Disputes about that production will be negotiated or litigated. Disputes about the production of A and B will be decided by fiat.[67]

A more complex model includes the possibility of leasing, secured financing, and long term relationships which all between full integration (ownership) and full outsourcing. When a firm makes something internally it has full ownership of the factors of production. Everything that goes into making the asset is subject to fiat. When it purchase the good from a one-off market transaction, the firm has no fiat

[67] As noted above and studied extensively by Grossman, Hart, and Moore there is a sense in which the human capital inputs can never be fully integrated into a firm. This means that fiat has its limits in directing human capital inputs and at some point external forces will always provide the ultimate governing power with regard to human capital. For all others inputs integration can be more complete.

authority over the production inputs. Alternatively, the firm could own input A outright, lease input B, own input C subject to a security interest, own input D subject to contractual obligations, and own input E subject to industry norms of sharing. The lessor of B, the financier of C, the counterparty for D, and the industry for E, all have control rights that affect the fiat power of the firm's hierarch.[68]

One might say that the firm has ultimate fiat power over input A. But that ignores that A is only useful when combined with B, C, D, & E. As a result all of the stakeholders have power and influence over how the firm uses input A. Likewise, the lessor of B has influence over the use of C, D, & E and over the financier, the counterparty and the industry. The relationship looks like this:

[Insert diagram]

The hierarch's power is defined by this total relationship. After accounting for the various relationships with and among all of the stakeholders, the hierarch is left with a set of powers over A, B, C, D, & E.[69] Within that set, the hierarch exercise fiat power to combine the inputs to produce the widget. That set is the firm, everything else is outside the firm.

We can then say that the firm encompasses all control rights that, according to the specific market relationships, fall under the fiat power of the managers. That set of decisions will be some subset of the total control decisions that go into the revenue function. An extreme example would be an entrepreneur already in possession of all factors of production. She could produce the widget from scratch with no external inputs. She would represent the fully integrated firm. No such firm actually exists. But it is useful

[68] The firm will conversely have power over those firms as well because of the rights it can asset against them.

[69] Stakeholders can strategically influence the rights of others indirectly. For example, a manager or director can negotiate a poison put with a lender that grants power to the lender, but then increases the manager or directors power over shareholders. See below at __ on poison puts. There are all sorts of ways that one stakeholder can improve relationship relative to one party by binding itself to obligations to a third party.

to keep this fully integrated firm in our mind as a baseline example as we move forward.[70]

The inquiry about which aspects of the revenue function are moved into the market bleeds into the inquiry about where the governance function takes place. We turn now to presenting our framework for those inquiries.

b. The governance function

Imagine that our fully integrated entrepreneur runs out of input A. At this point she must go to the market to obtain input A. The production of input A has now been moved to the market. But little else has changed.

But now let us assume that Entrepreneur cannot obtain input A without some financing arrangement with Bank. Let us also assume that Bank has strict guidelines for how its borrowers behave. Bank demands covenants requiring Entrepreneur to maintain certain debt-to-equity ratios, and to hit certain revenue targets. Bank even requires that Entrepreneur source all supplies of A from Supplier1.

Nothing has changed about the revenue function. Entrepreneur sources A on the market and produces everything else internally. Entrepreneur still directs the use of all factors within the firm. If she has employees, they still take orders from her. But the rules governing the method of production have changed dramatically. She is now restrained in the orders she can give. She can no longer command that input A be sourced from Supplier2. To be sure, if she made such a command, the employees would likely be required to follow it. But Entrepreneur might quickly find herself ousted by Bank as a result of defaulting of the loan agreement.

Bank has effectively changed the scope of Entrepreneur's fiat powers. Bank has redefined the rules that govern the revenue function. That is the quintessential nature of governance – it sets the rule under which the governed operate.

One response is to say that Entrepreneur can push back on Bank or seek other financing. Perhaps. But that is the point. There will come a point at which Entrepreneur has to obtain financing (or some other resource) and she can

[70] On the difficulty in classifying employees, see above at __.

negotiate for the best terms the market will provide—but no better. Thus, Bank does not set the terms of governance (if it did Bank would take all power). But neither does Entrepreneur. Rather the market sets the terms. Neither Bank nor Entrepreneur can demand more power than is competitively feasible.[71]

To complicate matters a bit, imagine that our fully integrated entrepreneur brought her widgets to market and was told by her largest customer that the use of input A somehow offended the customer's sensibilities. If the market power of the customer were great enough, this would cause Entrepreneur to substitute input B for input A. The fiat power of Entrepreneur has a new limit. The governance of the firm has new parameters.

The point here is that forces that are outside the firm define how the firm is governed.[72] This governance function produces a set of rules within which the revenue function plays out. Director-primacy and shareholder-primacy theories cannot be universally applied because they consider only one governance variation among many that occur—the broad fiat power that a director of a large solvent public corporation holds—and suggest that it is a broad theory of corporate governance. In reality, director primacy is simply the rule that the market produces for that specific case.[73] For other cases (internet startups, distressed firms, small LLCs, private equity portfolio companies, firms within the GM and Ford supply chain, etc.) the specific rules will be different. But the *mechanism* for producing those rules, that is to say the instrument of corporate governance, is the same.[74]

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[71] Moreover, Bank will incur regulatory costs with ever marginal increase in power, and so it will weigh those costs against the marginal value that demanding such power will bring.

[72] In practice, the firm cannot integrate these forces. It could integrate by purchasing a stakeholder. But that only moves the boundary. Now the control forces come from the stakeholders of that stakeholder.

[73] To use our computer programming analysis, there is a parameter for "if x, then y" where x is a solvent publicly held firm with certain characteristics and y is director management with some deference to shareholder welfare. The directors do not set that parameter. They merely react to it.

[74] The computer code does not change. Only the inputs do.

Limitations on fiat are precisely the rules that govern a corporation. The revenue function is governed by the instruction of the manager. That was Coase's insight. He said nothing about limits on the manager must behave because that was a not a question that was answered within the hierarchy. The manager says: asset A must move from division x to division y. That is management by hierarchical fiat over the production of the widget.

But what is the scope of the manager's power. Can the manager create a new division z? Can the manager move the employee from x to y in order to benefit her own bank account rather than the welfare of the firm? Those questions are about how the hierarchy is to be run – about how the fiat is to be exercised. Those are questions about how the firm will be governed. The answers cannot come from the hierarchy itself. The manager cannot define the scope of fiat power by fiat (this would obviously be circular and provide for unlimited authority). The rules for governing the firm cannot come from the firm itself. They will come from a combination of external forces, which interact to create the force governing the firm. Ultimately, and this is where law comes in, formal law (through courts) and informal rules (through norms of industries and network) provide the governing force that backstops the governance function.

The forces that produce the rules that limit fiat power are the ones that govern the firm. To see this, we only need recognize how vast is the universe of contractual limits that can be put on fiat power. With one important exception to be discussed below, the market can impose virtually any limitation on the manager's power.[75]

We do not suggest an unlimited power of any given stakeholder to impose these limits. Rarely will one stakeholder have that sort of influence. A shareholder who demands absolute veto over a director's decisions will learn that her share is not as valuable as she believes. Similarly, a

[75] The one constraint on the market's power is the legally imposed concept of the fiduciary out. This is a defining characteristic of the law of corporate governance, but it is not a defining characteristic of the firm. It is a controversial doctrine. Our framework suggests that this doctrine is problematic, which is why the market continually tries to skirt it. See below at ___.

lender can demand vast control rights, but when those start encroaching on the rights of other stakeholders the market will balk at the lender's demands. This is partly why lenders reserve control rights that are proportional to the risk of their stake – they are not willing to pay the market rate for control rights that affect stakes that are not their own. Thus, the rules that govern the fiat power of a director or manager result from a vast serious of market transaction and relationships. There is no one contract; there is no nexus; there is just a market force that produces governance rules.

This looks likes the connected contracts version of the firm. But the hierarch then operationalizes things. In keeping with the dictates of the market governance, the director, partner, managing member, or whomever the market has designated, directs the factors of production within the firm to produce the widgets. Within a set scope of operation, the hierarch directs the firms activities by fiat. This is what makes it a firm. If instead 'the widget was also produced by a connection of contracts, then we would say there is no firm at all. In our example, there is a firm, but it performs only the revenue function.

Of course, those outside forces can be more or less concentrated. A large customer can also provide the primary financing for operations or employees can be the equity investors. On the other hand, there may be several different union forces, multiple layers of bank debt, funds with large bond holdings, and industry groups all exercising power over a firm's governance. The important characteristic is that the governance is coming from outside the firm and not from the entrepreneur or from the board of directors.

C. Locating the board of Directors

The recognition that the governance function is being produced externally leads to reduced emphasis on the board of directors.[76] The board is merely one mechanism for internally managing the hierarchy. In a world where the market produces governance, it may be a particularly useful mechanism for gathering the market information. But it has no existential role in any model of governance. A good CEO, management committee, or a board of directors can all serve

[76] Casey & Henderson.

the same function. If they gauge the market correctly and negotiate with stakeholder they will succeed. If they ignore market pressures, violate contracts, or trample on expectations and norms they will be replaced or the firm will fail.

Theories that place special emphasis on the board have difficulty justifying that move. Some of these label the board as mere agents of shareholders.[77] But the realities on the ground belie these theories. For closely held corporations, some venture capital firms, and private equity portfolio companies, the board might be highly responsive to equity. But in those cases the directors are often identical to the equity principals.

It is not clear what function the board is serving other than a formality that must be adhered to for formality's sake for those principals to run their business.[78] As we noted in an earlier article "it is difficult to know if the boards serve any purpose or are just a means to comply with a meaningless formal requirement."[79] The "board room" might be a metaphorical "bargaining table" at which the stakeholders come together and bargain over governance.[80] But when the stakeholders are few in number, it is not clear that they need a formal default mechanism to facilitate that bargaining.[81] Sophisticated investors are pretty good at setting up their own bargaining spaces.

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[77] Bainbridge is essentially in this camp. He views the directors as Platonic guardians of the shareholder interest. Another way to put this is that they are agents of the shareholders with very broad discretion to act paternalistically to do what is best for the shareholders even if the shareholders want them to do something else.

[78] Casey & Henderson, Robert P. Bartlett, Shareholder Wealth Maximization as Means to an End, 38 SEATTLE U. L. REV. 255 (2015).

[79] Id.

[80] See Robert P. Bartlett, Shareholder Wealth Maximization as Means to an End, 38 SEATTLE U. L. REV. 255 (2015).

[81] The default mechanism may also carry significant costs with it. Courts tend to import notions of public company fiduciary duties into all boardrooms. Thus, the principles of free contract between sophisticated parties can be undermined when non-waivable fiduciary duties creep into the default structure of private bargaining spaces. See Casey & Henderson.

Paradoxically, the role of the board as an agent of shareholders is weakest when the shareholders are most in need of an agent. For large publicly held corporations, shareholders have little power and the deference rules of corporate governance provide few tools for them to enforce duties upon the directors. Moreover, when the potential for conflict between shareholders and other stakeholders are greatest, the duties of the directors to shareholders are weakest. Perhaps the most destructive thing a director can do to the value of equity is to file for bankruptcy when equity still has option value, but few would question the right of directors to do just that. And a claim that the directors did so to benefit the creditors at the expense of shareholders will fail (at least in the absence of a conflict of interest).[82] At best, shareholders have preferential standing to bring claims that the directors did not protect the value of the firm as a whole, but they will fail in claims that directors protected the value of the firm rather than equity's option value.

Other theories, like the team-production model, label the board as an agent of other stakeholders. These theories fail to capture the relationship between the directors and external forces. Stakeholders outside the firm do not deposit residual control with the directors. Nor do they follow the command and control of directors. Nor do they use the directors as their agent.[83]

The board of directors is only agent of the external stakeholder in some cases. Stakeholders act on the board, through the board, and often around the board. They regularly circumvent the board because it is an impediment to their control rights. The board is merely one of many potential counterparties. Thus, while the board does, in many settings, manage the internal hierarchy, the hiearch's

[82] Compare Credit Lyonnias, Production Resources, Gheewalla, Trados, and Quadrant (holding that while creditors may not have the right to sue for violations of duties in a zone of insolvency, directors may be protected from suit by shareholders for favoring creditors in such instances; it is often said that the duty to creditors is a shield protecting the directors but not a sword for the creditors); see also Buccola. Generally courts will say that there is a duty to maximize the value of the firm not the value of shareholders. Gheewalla; Baird & Henderson.

[83] See above at __

organization as a board is not an essential characteristic.[84] The CEO and the board have a nuanced relationship that directs the firms operations according to market parameters. It is difficult to see exactly where the power in that relationship lies. But the CEO could serve both functions. The board could serve both functions. An internal management committee could serve one or both functions. A managing partner could serve one or both functions and so on.

Moreover, changes in the makeup of a board and the control that it possesses are common. These changes have to come from somewhere and when we identify that somewhere we have identified corporate governance at its source.

D. This is a nexus-of-contracts theory

Before discussing the policy implications, it is worth noting that ours is, in the broad technical sense, a nexus-of-contracts theory. The stakeholders enter into contracts and market relations that ultimately govern the firm. In dictionary sense the market is a nexus (or web) of contracts and that is where governance comes from.

Those relationships manifest themselves as parameters within which the firm operates. But the pathway of that manifestation is not as clean as traditional theories suggest. Directors do not mediate the stakeholders' influence and they do not negotiate all control allocations. Often they are bypassed and must simply comply with that influence.

Neither the firm nor the directors in our framework is a hub. The directors are simply one form of hierarch. And the firm is the product of governance function. That function is the true the nexus of contracts.

This diagram illustrates the analysis so far:

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[84] Casey & Henderson at 374 ("To a large degree, the role of the board is irrelevant. It is just one means of centralizing decisions that occur within the firm. If the board was removed, a firm's internal decisions would be produced by a management committee or a lone CEO (the equivalent of a one-person board). These considerations are peripheral to the main inquiry.

The specific organization of internal decisions is of little importance when compared to the question of which things happen internally and which happen in the market.").

[insert diagram]

III. Implications for Governance Law

A. Gap Filling

Our framework draws into question one of the main implications that Easterbrook and Fischel's saw in the nexus of contracts theory. It may be more difficult or impossible to use the concept of a hypothetical contract to fill the gaps of corporate governance law. To predict what the "parties" to the relevant hypothetical contract would have bargained for requires one to identify all parties to that contract and the impacts of terms on those parties, and to identify how the terms of the contract tie in with the goals with which they enter the relationship.[85]

The opaqueness of parties' identities and interests might counsel in favor of judicial restraint and limitations on notions of fiduciary duties and implied covenants. The idea here is that if the courts have no ability to adequately fill gaps they should simply abstain from the process to encourage clarity from the parties. This bifurcation highlights the important of developing a legal theory that can distinguishes those things that are inside the firm from those that are outside.[86]

The upshot is that the current state of fiduciary duty as a gap filler is entirely backwards. Relationships that are outside of the hierarchy should be governed by strict contract law with no extraneous fiduciary gap filling. The courts do not have the information to understand what a hypothetical governance contract would look like because they do not have the information to even know who the parties to that contract are. The best they can do is look at the actual contract they have before them.

This means that the court would apply traditional contract principles in interpreting loan agreements, bylaws, charters, and all other supplier, investor, or external

[85] Lewis Kornhauser brought a similar critique to their proposal in *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel,* 89 Col. L. Rev. 1449 (1989)

[86] See Holden and Malani.

stakeholder relationships. They wild not overlay a special fiduciary duty or implied covenant to fill gaps.

Comparing the two possibilities, the fiduciary gap-filling story goes likes this: Equity investor and directors enter into an agreement. That agreement is vague and the courts must decide what terms they should use to fill the gaps. Because directors are either agents of equity, platonic guardians of equity, or mediating hierarchs of equity's relationship with other stakeholders, the court (and legislatures) should devise default rules that will create the best incentives to maximize the welfare of the equity investor or of the stakeholders generally. Thinking about it this way gives us a whole set of rules: 1) strict duties of care and loyalty (including good faith),[87] 2) wide discretion for directors acting within those duties, 3) the requirement that all agreements have fiduciary outs,[88] 4) specific duties regarding takeovers[89] (Unocal, etc) and asset sales,[90] 5) controlling shareholder duties,[91] and 6) specific rules on management conflicts.[92]

The alternative goes like this: The court has no way of knowing who has bargained for what part of control and so it cannot conceptualize the hypothetical contract. Instead it can just look at the actual relationship between the parties. It can fill gaps based on general rules of contractual interpretation. The contract before it is no different than any other. The parties have other interests that may affect them, but those are too opaque for the court to take into account. It looks at the language of the contract and fills the gaps to make that contract coherent, not to match expectations parties may hold based on their larger conception of who owns or controls a firm. The contract must be interpreted as if it were any other contract with no special consideration for the fact that it impacts corporate governance.

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[87] Smith v. van Gorkum, etc.

[88] Time Warner, QVC, Omincare, etc.

[89] Unocal, etc.

[90] Revlon, etc.

[91] Southern Peru

[92] Statutory and Case law.

The following sections provide some explicit examples of this.

B. Takeover Defenses

The debate about takeover defenses is mired in two camps: those in favor of greater shareholder power, personified most recently by Professor Lucian Bebchuk, and those in favor of greater board power, a position most often associated with lawyer Martin Lipton. Our very preliminary view is that our analysis, while not a board-centric model, begins to present something of a defense of the Lipton response to the shareholder model proposed by Easterbrook & Fischel, Bebchuk, and others.

Recent evidence suggests that takeover defenses produce value by committing equity to longer-term strategies that managers undertake.[93] Managers (and other stakeholders) may know that short-term losses can produce long-term gains. Shareholders may desire that managers undertake those projects. But the managers fear that when there is a reported short-term loss, they may be ousted by investors. Takeover defenses that combine poison pills and staggered boards provide a "an ex ante commitment device of the shareholders to evaluate directors over longer periods of time."[94]

This view of takeover defenses is consistent with our framework and provides evidence of the difficulty in judging a contract provision, bylaw, or charter provision under the traditional law-and-economics view of the hypothetical investor contract. The Easterbrook and Fischel model simply sees a relationship between shareholders and their agents (the directors), and posits that shareholders must want directors to be passive salespersons who maximize their return.

This view ignores the market concerns of the managers, and the nuances of market behavior of equity. It also ignores other stakeholders. Indeed, it may not even be the managers who care about the takeover defenses. After all, if equity cannot commit to a long-term view, managers' will just shift their behavior and seek short-term returns. And ghey will

[93] K.J. Martin Cremers, Lubomir P. Litov, Simone M. Sepe, Staggered Boards and Firm Value, Revisited.

[94] Id.

demand compensation for any increased risk. Management is not a great deal worse off. But creditors, other employees, suppliers and other stakeholders who do repeat business with the firm have a strong incentive to demand structures and operations that maximize long-term vale. They have an incentive to demand governance parameters that mutually bind the firm and its network of stakeholders to a long-term view of things. Thus creditors may be the ones who prefer staggered boards, poison pills, or—more obviously and more directly—poison-put provisions in loan agreements.

[**more on this—Revlon--Paramount cases]**

C. Fiduciary outs

One of the most inconsistent rules in corporate governance is the rule of the fiduciary out. The basic principle posits something like the following: Directors and officers cannot enter agreements with third parties that bind them to do something that breaches their fiduciary duty. Thus, any agreement must have a clause that allows the directors to back out if they find that compliance would violate their fiduciary duty.

This doctrine, which was developed famously in canonical mergers and acquisitions cases, continues to have force in many contexts. Most recently we have seen the debate resurface with regard to stand still agreements and the so-called "don't ask, don't waive" provisions.

The illogic of the rule lies in its temporal uncertainty. Directors cannot, it seems, bind themselves to a path of action that seems wise at the time of contracting if it may turn out to be unwise later. If a firm is on the brink of collapse and someone offers to buy it, the buyer may say, "We will pay $100 to buy the firm in 6 months, but the deal has to be final. We need a lockup agreement. You cannot go and shop around for better offers." If this is the only offer on the table, the directors may want to take the deal to avoid a 90% chance of collapse. But a 90% chance of collapse suggests a 10% change of success. And once a firm offer is made, the dynamics change collapse becomes less likely (the creditors can be stalled from tearing the firm apart). And so collapse does not materialize and the firm turns out to be worth more than $100.

Not surprisingly, new buyers will materialize once it is certain that the firm is worth more than $100. If the original buyer gets the firm at $100, the ex post view of things looks like the directors did not get the best deal. But if the parties had not agreed to the lockup in the first place, then the firm would have collapsed and the subsequent bidders would have never showed up. From an ex ante perspective, the lock-up creates value.

Cases like Omnicare suggest that true lock-ups are prohibited. There must be some fiduciary out. The don't-ask don't-waive cases also suggest a prohibition on strong lock-up provisions. That said, Omnicare is an extreme case and subsequent cases suggest that some less extreme level of lock-ups are permissible.

The inconsistency of judging a lock-up provision ex post rather than ex ante is not the only temporal problem with fiduciary out doctrine. Separately, any fiduciary out must expire at some point. No one suggests that a closed sale should have a fiduciary out that allows the directors to undo the sale if the market turns around and the firms performance recovers. So fiduciary outs expire somewhere before the sale closes.

But when? Courts can justify any time frame if they point to a hypothetical bargain and the duties that it implies for directors to maximize shareholder wealth. They could go as far as to say that all contracts should be viewed as mere term sheets. Or they could justify very early expirations. To maximize the willingness of buyers to come to the bargaining table they could go as far as to say that fiduciary outs are not only not necessary but they are not allowable – courts could enforce terms sheets that were even expressly unenforceable. On the other side of the equation, if the courts care about other stakeholders they can cite entirely different rational for setting fiduciary outs expirations early or late – creditors bear the down side risk of a deal falling through more than equity and they reap the upside of a higher deal less than equity.

In the end, there is no determinacy and no principled way to set a mandatory time period for fiduciary outs that is anything other than the period agreed to by the parties.[95]

D. [To be added later: Outside Forces Government ***[hubbard templton, diagram, nonstakeholder stuff]***

E. [To be added later: Corporate Groups]

IV. CONCLUSION

Integration means something. Things can be brought within the firm. Other things can be left out. While purely contractarian models suggest that all things are created in the market, our model recognizes the meaningful distinction between what is inside and what is outside the firm. It allows for the existence of hierarchal management of production and of internal capital markets. But it also recognizes that the rules within which those internal functions operate are set by external market relationships.

If the limitations on the fiat power come from contract or market relationships, then it is accurate to say that corporate governance is produced by those contracts, by that market relationship. The directors enjoy power not because they say so. The directors enjoy power because the market says so.

This is important to understand in crafting a theory of corporate governance. If one hopes to preserve or alter corporate governance rules, one must know the source of that governance—how it is created and how to change it.

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[95] There is an important connection between the market production analysis of takeover defenses and of fiduciary outs. For the same reason that a bidder wants to lock up a deal, a manager may want to lock out a deal. A bidder is being asked to make a relationship specific investment in due diligence, financing arrangements, and market exposure. To avoid being held up, the bidder demands a lock-up and a break-up fee. A fiduciary out undermines that bargain. Similarly, managers are making relationship specific investments in running a firm. They want to lock out takeover attempts that will destroy that value, so they demand takeover defenses. Rules prohibiting those defenses undermine that bargain. Thus, one should expect lock-ups and takeover defenses to be defended on the same grounds.

A theory that recognizes this can provide insights into the management of business associations of all forms and during the all life cycles of those business associations without the inherent contradictions and limitations of conventional theories.