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The Entrepreneur and the Theory of the Modern Corporation

Charles R.T. O'Kelley
University of Georgia School of Law, okelley@uga.edu

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I. INTRODUCTION

The third quarter of the nineteenth century was the golden age of economic and political liberalism and the entrepreneur.[1] The last quarter of the nineteenth century and the first three decades of the twentieth century witnessed the decline of political and economic liberalism, the demise of the entrepreneur in favor of the modern corporation, and the rise of competing systems built on ideologies[2] either partially or completely at odds with a pure free market economy.[3] The First World War marked the breakdown of

* M.E. Kilpatrick Chair, University of Georgia School of Law.

1. *See* ERIC HOBSBAWM, THE AGE OF CAPITAL, 1848–1875 1-4, 29-68 (Vintage Books 1996) (1975).

2. "Ideologies are, by definition, attempts to say that what is contingent and constructed by the participants in the society, the grandest of all hermeneutic circles, is in fact natural, a part of the nature the mind is supposed to be able to mirror, and thus to legitimate the power that ideology bestows on selected individuals." John Henry Schlegel, *The Ten Thousand Dollar Question*, 41 STAN. L. REV. 435, 449 (1989) (book review).

3. *See* ERIC HOBSBAWM, THE AGE OF EMPIRE, 1875–1914 (Vintage Books 1989) (1987). "One way or another, after 1875, there was growing skepticism about the effectiveness of the autonomous and self-correcting market economy, Adam Smith's famous 'hidden hand,' without some assistance from state and public authority. The hand was becoming visible in all sorts of ways." *Id.* at 54; HOBSBAWM, THE AGE OF CAPITAL, *supra* note 1, at 155-69.

nineteenth century western civilization.[4] The Great Depression confirmed that economic liberalism and free market capitalism had failed.[5] Whether collectivism, fascism, or some form of heavily-government-regulated capitalism would become the world's dominant political and economic philosophy was a question slowly and painfully answered and re-answered thereafter.[6]

In America, however, the answer seemed clear early on. Classic liberalism[7] and the ideology of free markets and the individual entrepreneur gave way to the New Deal[8] and a philosophy that strongly preferred government regulation to promote the general welfare over protection of private property rights in the means of production.[9] The New Deal ideology reflected widespread fear and distrust of the modern corporation and its economic and political power.[10] In corporation law, the governing ideology concerning the corporation crystallized in the Berle-Means Paradigm and its identification of separation of ownership and control as the central problem of the modern corporation.[11] For nearly fifty years thereafter, this description of the corporation provided the theoretical framework for mainstream corporation law scholarship[12]—a paradigm far more powerful than simple fear of the modern corporation and its entrenched, unrestrained managers.

Around 1980, the governing-ideology pendulum unexpectedly swung the other way. Advocates of free markets, individualism, and elimination of government regulation recaptured political and intellectual control in America, England, and, within a decade, most of the first-world countries.[13] Within corporation law, a similar ideological shift

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> As capitalism and bourgeois society triumphed, the prospects of alternatives to it receded, in spite of the emergence of popular politics and labor movements. These prospects could hardly have seemed less promising in, say 1872-3. And yet within a very few years the future of the society that had triumphed so spectacularly once again seemed uncertain and obscure, and movements to replace it or overthrow it had once again to be taken seriously.

Id.

4. ERIC HOBSBAWM, THE AGE OF EXTREMES 6 (Pantheon Books 1995) (1994). Hobsbawm describes that civilization and its liberal nature: "This civilization was capitalist in its economy; liberal in its legal and constitutional structure; bourgeois in the image of its characteristic hegemonic class; glorying in the advance of science, knowledge and education, material and moral progress . . . ." *Id.*

5. *Id.* at 102-08.

6. *Id.* at 6-17.

7. *Id.* at 54-499.

8. *Id.* at 105.

9.

> The New Dealers answered the old Constitution's account of economic liberty with a new one. They held that all Americans had rights to decent work and livelihoods, social provision, and a measure of economic democracy, including rights on the part of wage-earning Americans to organize and bargain collectively with employers.

William E. Forbath, *The New Deal Constitution in Exile*, 51 DUKE L.J. 165, 166 (2001).

10. Dalia Tsuk, *From Pluralism to Individualism: Berle and Means and 20th-Century American Legal Thought*, 30 LAW & SOC. INQUIRY 179, 185-96 (2005).

11. William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 739-40, 753-59 (2001).

12. *Id.* at 737.

13. HOBSBAWM, THE AGE OF EXTREMES, *supra* note 4, at 403-18.

occurred.[14] Disciples of the Chicago School of Law and Economics controlled the agenda. Their swift rise to dominance coincided with the ascendancy in corporation law of a new hegemonic paradigm, founded on the view that the corporation is a nexus-of-contracts—a consensual ordering of relations generally to be governed by private ordering and not government regulation.[15]

This most recent era of free market ideological dominance has seen a rekindling of the cult of the entrepreneur primarily in the form of the modern CEO.[16] One example of the exalted status that the modern CEO has enjoyed post-1980 should suffice:

> The average CEO made $6.7 million more in 2003 than in 1980, when they made $1.4 million, adjusted for inflation. The average full-time production and non-supervisory worker made $31,928 in 2003 and $31,769 in 1980, adjusted for inflation—a gain of $159. CEOs often spend more than that on dinner.
>
> CEO pay skyrocketed 480% during 1980-2003, adjusted for inflation, while domestic corporate profits rose 145%, worker productivity rose 61% and worker pay stalled. If CEO and worker pay had increased at the pace of worker productivity, CEOs would have made $2.3 million in 2003 and workers $51,148.[17]

However, the reign of the CEO, the modern personification of the swashbuckling entrepreneur of the 19th century, has not been reflected in corporation law's version of free market ideology—the nexus-of-contracts model of the corporation. For the last two decades of the twentieth century, nexus-of-contracts scholars overwhelmingly agreed that corporation law can best be understood by reference to shareholder primacy—the predictive (and normative) maxim that the defining purpose of corporation law is shareholder wealth maximization.[18] Recently, there have been two provocative,

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14. William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1471, 1476-77 (1989).

15. *See* Steven M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 858 (1997) (discussing the nexus-of-contracts theory of the firm). The law and economics movement remains the most successful example of intellectual arbitrage in the history of corporate jurisprudence. It is virtually impossible to find serious corporate law scholarship that is not informed by economic analysis. Even those corporate law scholars who reject economic analysis spend most of their time responding to those of us who practice it.

16. *See* Jeswald W. Salacuse, *Corporate Governance, Culture, and Convergence: Corporations American Style or With a European Touch?*, 9 LAW & BUS. REV. AM. 33, 56 (2003).

> [T]he position [of] the CEO in the modern American corporation is like that of a third-world autocrat. Indeed, like political systems dominated by the "cult of the leadership personality," it is not unfair to say that most American corporations manifest "a cult of the CEO." It is almost an article of faith of American business that the CEO, and the CEO alone, is responsible for the rise or fall of the corporation's fortunes. Popular and managerial opinion in the United States considers that Lou Gerstner single handedly turned around IBM, that Jack Welch built GE into a modern force all by himself, and that Sandy Weill alone created Citigroup. CEOs not only manage. They write books. They appear regularly on television. They are the superstars of American corporate culture.

Id.

17. Holly Sklar, *Outsource CEOs, not Workers*, COMMON DREAMS NEWS CENTER, Apr. 30, 2004, http://www.commondreams.org/views04/0430-06.htm.

18. The dominant view at the turn of the century was aptly summarized by Henry Hansmann & Reinier

alternative accounts of corporation law, each of which touts a version of director primacy—the maxim that the defining purpose of corporation law is to promote centralized decision-making within the corporation.[19] However, neither of these models is completely satisfactory because they predict shareholder or director primacy in important circumstances where, in fact, the law favors the CEO.[20] My intuition, which I am testing here and elsewhere, is that these anomalies are explained by what I call the theory of entrepreneur primacy—the proposition that corporation law may be understood as a mechanism to support private ordering intended to provide the modern corporation with a surrogate for the classic entrepreneur—the entrepreneur exalted in free market ideology as it existed immediately prior to the Great Depression.

The foremost description of the classic entrepreneur, immediately prior to the Great Depression and now, was presented by Frank Knight in his seminal work, *Risk, Uncertainty, and Profit*.[21] In this Article, I will explicate Knight's theory of the entrepreneur and show how it relates to both the Berle-Means Paradigm and the nexus-of-contracts theory of the corporation. My effort here is in part intellectual history and in part the tentative beginnings of a new positive account of the corporation. In the latter regard, this Article takes only the first step in what may prove a quite exhaustive effort to re-plow the field of corporation law.

Part II describes capitalist ideology, and the central place therein of the entrepreneur, as it was understood at the nascence of the New Deal. Part III examines the Berle-Means view of the modern corporation, how that view depended on, and was fueled by, the "death" of the classical entrepreneur, and how the study of corporation law thereafter focused on the problems presented by separation of ownership and control. As Part III notes, economists working in the tradition of Adam Smith (unlike corporation law scholars) continued to give the entrepreneur a central place in their study and defense of capitalism long after the birth of the New Deal. Part IV examines the development of the

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Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 468 (2001).

> The triumph of the shareholder-oriented model of the corporation over its principal competitors is now assured, even if it was problematic as recently as twenty-five years ago . . . . The standard model has never been questioned for the vast majority of corporations. It dominates the law and governance of closely held corporations in every jurisdiction . . . . [T]he standard model of shareholder primacy has always been the dominant legal model in the two jurisdictions where the choice of models might be expected to matter most: the U.S. and the U.K.

Id.

19. Margaret Blair and Lynn Stout argue that corporate power is lodged in the board of directors so that it may serve as a mediating hierarchy, refereeing the competing claims of shareholders and other corporate constituencies involved in the team production of the corporation's product. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) [hereinafter Blair & Stout, *Team Production Theory*]; Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. CORP. L. 743 (1999) [hereinafter Blair & Stout, *Team Production*]; Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403 (2001) [hereinafter Blair & Stout, *Director Accountability*]. Stephen Bainbridge asserts that directors are the locus of all corporate power, controlled only by the principle that the proper end to which their decision should aim is shareholder wealth maximization. *See* Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1 (2002); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003).

20. *See infra* Part VI.

21. FRANK H. KNIGHT, RISK, UNCERTAINTY, AND PROFIT (Midway Reprint ed. 1985) (1921).

Nexus-of-Contracts theory of the corporation, and how one of its central assumptions—the study of the classical entrepreneur—is irrelevant and misleading if one hopes to understand the modern corporation. Part IV then describes my counterview: corporation law can be understood, at least in important part, as intended to ensure that the modern corporation has an effective surrogate for the classical entrepreneur. Part V revisits the work of Frank Knight to develop an understanding of the central characteristics of the classic entrepreneur, and why it is reasonable to assert that the modern corporation generally does have an adequate surrogate for the classic entrepreneur. Part VI tests the predictive power of entrepreneur primacy in comparison to the predictive power of two versions of director primacy. The Article concludes with a brief look ahead.

II. THE ROLE OF PRIVATE PROPERTY AND THE INDIVIDUAL ENTREPRENEUR IN TRADITIONAL "FREE MARKET" IDEOLOGY

Beginning in 1776 with the publication of *The Wealth of Nations*[22] and continuing for nearly 200 years, classical and then neo-classical economic theorists elaborated on the work of Adam Smith to provide theoretical justification for a political and economic system supportive of the individual entrepreneur's wealth and power, a system featuring strong legal protection of the entrepreneur's right to own and control his business assets and strict limits on the power of government to regulate or control economic activity.[23] One product of this effort—the perfect competition model[24]—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.[25]

The "black box" that is the firm in perfect competition theory may represent a solo producer,[26] but it does not betoken an entrepreneur. Perfect competition theory assumes omniscient actors—everyone in the market knows everything about prices, demand, and product quality. There is no role for an entrepreneur. Each individual involved in the perfect market is effectively an automaton.[27] When we move to the real, imperfect world, free market ideology viewed the individual entrepreneur—the sole proprietor who owned and managed her own firm—as the primary motor driving the economy from the producer side of the equation. In turn, private property in the means of production was justified as central to a system depending on the voluntary actions of each market participant. Private property in the means of production allows and creates incentives for the entrepreneur to use her talents and capital in an effort to maximize her own wealth

22. ADAM SMITH, THE WEALTH OF NATIONS, 421-24 (Random House 1937) (1776).

23. Harold Demsetz, *The Theory of the Firm Revisited*, *in* THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 159, 159-60 (Oliver E. Williamson & Sidney G. Winter eds., 1993).

24. *Id.* at 160 (stating that "[t]he intellectual achievement of this model is its complete abstraction from centralized control of the economy. What is modeled is not competition but extreme decentralization").

25. 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 21, 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 any one else." *Id.*

26. A producer who has no employees.

27. KNIGHT, *supra* note 21, at 268.

and happiness. The entrepreneur's selfish use of her property—her effort to make a profit and accumulate wealth—results in the best possible allocation of resources and the maximization of all citizens' wealth and happiness. Berle and Means called this the traditional logic of profits.

> By carrying on enterprise [the entrepreneur] would employ his energy and wealth in such a way as to obtain more wealth. In this effort he would tend to make for profit those things which were in most demand. Competition among countless producers could be relied upon in general to maintain profits within reasonable limits while temporary excessive profits in any one line of production would induce an increase of activity in that line with a consequent drop of profits to more reasonable levels. At the same time it was supposed that the business man's effort to increase his profits, would, in general, result in more economical use of the means of production, each enterprise having to compete with others for the available economic resources. Therefore, it has been argued that by protecting each man in the possession of any profits he could make from its use, society would encourage enterprise and thereby facilitate the production and distribution of goods desired by a community at reasonable prices with the economic use of labor, capital, and business enterprise.[28]

As Frank Knight put it, the entrepreneurs are "the individuals with superior managerial ability (foresight and capacity of ruling others) . . ." who, because they have "confidence in their [own] judgment . . . 'back it up'" by guaranteeing the wages of their employees and putting their own capital at ultimate risk.[29] It is the entrepreneur who carries out two key functions: she manages—that is, she determines what to do and how to do it—and she assumes the risk of her decisions—that is, she puts her personal wealth at risk as a means of guaranteeing to her employees that even if the venture fails, they will receive the compensation for which they bargained.[30] This unification of ownership is the defining characteristic of the classic entrepreneur and is essential to the proper working of the free market system.[31]

III. THE ENTREPRENEUR AND THE MODERN CORPORATION; LAW AND ECONOMICS DIVERGE

Frank Knight's prototypical entrepreneur, the "responsible" manager who owns and controls her business,[32] was fundamental to free market ideology. For most of the latter

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28. ADOLPH A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 340-41 (The MacMillan Company 1933) (1932).

29. KNIGHT, *supra* note 21, at 270.

30. *Id.* at 269-76. Though not often acknowledged, Knight's theory of the entrepreneur recognized the essential elements of what Alchian and Demsetz later described as the metering problem endemic to team production. *Compare id.* at 275-76, *with* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 778-81 (1972).

31. KNIGHT, *supra* note 21, at 308.

32. *Id.* at 271.

half of the nineteenth century, the real-world economy was reasonably congruent with this theoretical imperative.[33] Sole proprietors dominated American industry.[34] By 1930, ownership of American industry was fundamentally transformed—the ownership of a large and ever growing share of American industry and the means of industrial production had passed from the classical sole proprietor to the large publicly-traded corporation.[35]

This shift from widely dispersed ownership of industrial wealth to a large-corporation dominated economy was not discovered by Berle and Means. It did not happen overnight, and did not go unobserved by others.[36] As will be discussed fully below,[37] it was well understood by Frank Knight, who argued that the apparent separation of control observed in the modern corporation was illusory. Nor did Berle and Means first argue that the ascendancy of the publicly-traded corporation posed challenges to the relevancy of free market ideology.[38] Well before the Great Depression, a growing number of intellectuals and policy makers believed that "an economy increasingly dominated by huge corporations made nonsense of the term 'perfect competition.'"[39] "One did not have to be a Marxist, or show an interest in Marx, to observe how unlike the economy of nineteenth century free competition . . . capitalism [of that period] was."[40] What Berle and Means did do was identify the extent to which the publicly-traded corporation had achieved hegemony, document the extent to which share ownership and management power were already held in separate hands, and accurately predict that this concentration of ownership would steadily envelope a greater share of industrial property and wealth.[41] They also provided the intellectual framework—often called the Berle-Means Paradigm—that would dominate corporation law scholarship for nearly fifty years.[42]

It is at this point that corporation law ideology and the microeconomic study of markets and firms diverge. Economists working in the microeconomic tradition extant prior to the Great Depression continued to study the classic entrepreneur to gain insights into the workings of the modern corporation.[43] Law and public policy makers seeking to reform the modern corporation trod in the footsteps of Berle and Means, believing the

33. *See* HOBSBAWM, THE AGE OF CAPITAL, *supra* note 1, at 214.

34. There were also corporations and partnerships, of course, but most of them were closely-held so that the separation of ownership and control was relatively insignificant. *See* BERLE & MEANS, *supra* note 28, at 4, 334.

35. By 1930, as Berle and Means documented, corporations controlled 78% of America's business wealth, and the 200 largest companies controlled 38% of America's business wealth. *Id.* at 31. The 200 largest companies were growing at more than twice the rate of all other non-financial corporations. *See id.* at 40. As a result, power over the American economy was increasingly in the hands of a relatively small number of very large corporations. *Id.* at 44.

36. HOBSBAWM, THE AGE OF EXTREMES, *supra* note 4, at 103.

37. *See infra* Part V.

38. HOBSBAWM, THE AGE OF EMPIRE, *supra* note 3, at 10, 45.

39. HOBSBAWM, THE AGE OF EXTREMES, *supra* note 4, at 103.

40. *Id.*

41. ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, at xxix-xxx, 317-59 (rev. ed., Harcourt 1967) (1932).

42. William W. Bratton, *Berle And Means Reconsidered At The Century's Turn*, 26 J. CORP. L. 737, 737 (2001).

43. Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289-90 (1980).

classic entrepreneur of little relevance.

I will defer until Part V, a detailed consideration of the views of Frank Knight and the relevance of those views to a better current understanding of corporation law. It is enough at this point to note that as early as 1916,[44] Frank Knight understood that "[t]he typical form of business unit in the modern world is the corporation. Its most important characteristic is the combination of diffused ownership with concentrated control."[45] Knight argued that the separation of ownership and control in the modern corporation did not mean that responsibility had been wholly separated from control. Careful study would reveal, he asserted, that a reasonable approximation of the classical entrepreneur will be found in control of the typical modern corporation.[46]

Knight's view did not predominate, even within the field of microeconomics, where study of the entrepreneur remained relevant, not because it was deficient as a theoretical construct, but because it was not consonant with how the vast majority of citizens and policymakers *perceived* "the facts on the ground." The ascendancy of the large corporation, the horror of the First World War (coming after nearly a century free from widespread warfare), and the communist revolution in Russia, all played a role in shaping popular sentiment.[47] The Great Depression then "confirmed intellectuals, activists and ordinary citizens in the belief that something was fundamentally wrong with the world they lived in."[48]

Berle and Means asserted that the corporation, as used to organize relations within large publicly-traded firms, was a totally new form of property whose characteristics threatened the legitimacy of the free enterprise system of economic organization.[49] It had long been possible for an individual entrepreneur "to incorporate his business even though it still represents his own investment, his own activities, and his own business transactions; he has in fact merely created a legal *alter ego* by setting up a corporation as the nominal vehicle."[50]

The use of the corporation to own and operate large, publicly-traded firms created a fundamentally different entity—"the quasi-public corporation . . . in which a large measure of separation of ownership and control has taken place through the multiplication of owners."[51] In the quasi-public corporation, management exercises control, while the passive, geographically dispersed shareholders who make up the investing public are powerless.[52] "No longer are the individuals in control of most of the companies the dominant owners. Rather, there are no dominant owners, and control is

44. Though not published until 1921, "*Risk, Uncertainty and Profit* was Knight's doctoral thesis, completed in 1916." George Stigler, *Foreword* to FRANK H. KNIGHT, RISK, UNCERTAINTY, AND PROFIT, at ix (Midway Reprint ed. 1985).

45. KNIGHT, *supra* note 21, at 291.

46. *Id.* at 291-312.

47. HOBSBAWM, THE AGE OF EXTREMES, *supra* note 4, at 6-8, 54-58, 73-74.

48. *Id.* at 102.

49. BERLE & MEANS, *supra* note 28, at 7-9.

50. *Id.* at 4.

51. *Id.*

52. *Id.* at 5. Berle and Means found that in more than half of the 200 largest publicly-traded corporations, management's stock ownership constituted such a small percentage of the voting stock as to be irrelevant in the election of directors. *Id.* at 94, 114, 117.

maintained largely apart from ownership."[53]

In Berle's and Means's view, the quasi–public corporation, with its separation of ownership and control, threatened the theoretical underpinnings of the free enterprise system.

> It has been assumed that, if the individual is protected in the right both to use his own property as he sees fit and to receive the full fruits of its use, his desire for personal gain, for profits, can be relied upon as an effective incentive to his efficient use of any industrial property he may possess.
>
> In the quasi-public corporation, such an assumption no longer holds. As we have seen, it is no longer the individual, himself, who uses his wealth. Those in control of that wealth, and therefore in a position to secure industrial efficiency and produce profits, are no longer as owners entitled to the bulk of such profits . . . . The explosion of the atom of property destroys the basis of the old assumption that the quest for profits will spur the owner of industrial property to its effective use.[54]

Berle and Means asserted that the quasi-public corporation, and the corporate system of which it was a part, were new institutions that compete with and threaten to supplant the modern state as the dominant form of social organization because "[they] involve[] a concentration of power in the economic field comparable to the concentration of economic power in the mediaeval church or of political power in the modern state."[55] Significantly, Berle and Means concluded that the corporation should now be analyzed as a social organization, and with a view to determining how managers' power shall be constrained for the public good.[56]

Berle and Means categorized three types of possible responses to the economic power of the quasi-public corporation and its managers. Society could seek to bend the quasi-public corporation and their managers to the will of the shareholders, recreating the traditional understanding of property. Alternatively, society could recognize that corporate managers have absolute power, constrained only by their sense of morality and public duty. A third possibility would be to treat the interests of both managers and shareholders as subordinate to the paramount claims of the community, leading to the evolution of managers who are "a purely neutral technocracy."[57]

From the New Deal onwards, law and policy makers chose to pursue the third approach—subordinating private property in the means of production to the legitimate claims of the larger society.[58] The institution of private property that had given the

53. BERLE & MEANS, *supra* note 28, at 117.

54. *Id.* at 8-9.

55. *Id.* at 352.

56. *Id.* at 353-57.

57. *Id.* at 356.

58. In one of its most criticized decisions, Lochner v. New York, 198 U.S. 45 (1905), the [Supreme] Court embraced substantive due process and constitutionalized private property and freedom of contract. The Lochner doctrine enshrined laissez-faire, and for approximately thirty years led the Court to strike down state economic and social laws, such as minimum wage maximum hours laws, designed to promote the general welfare and which were often supported by sizeable democratic majorities . . . . [T]he Lochner doctrine was repudiated

entrepreneur almost total control over his business—the right to hire and fire whomever he wanted for whatever reason, the right to set wages and working conditions, the right to pollute air and water rather than incur costs for less environmentally harmful methods of production—would yield to competing interests within the larger society.[59]

Over the years, corporation law scholars writing within the Berle-Means Paradigm offered numerous proposals for corporation law reform designed to better achieve certain of these larger social goals.[60] However, to the extent this so-called "corporate social responsibility" scholarship sought to use corporation law to further regulate corporations, it did not bear fruit: lawmakers would in every significant case choose to achieve these larger social goals through legal institutions, both statutory and regulatory, other than state or federal corporation law.[61]

The role of corporation law would have been much greater during this period if law and policy makers also had decided to pursue the first possibility for regulating the corporation noted by Berle and Means—bending the corporation to the will of the shareholders so as to reunite ownership and control. However, instead of choosing to make shareholders "real owners" and suitable surrogates for the classical entrepreneur, law and policy makers chose to view shareholders as holders of a new type of property that did not provide them with the legal rights that the classic entrepreneur enjoyed. Shareholders as a class were treated as having chosen to provide capital to the corporation knowing that the law requires shareholders to submit to the managers' judgment as to what is in the best interest of the corporation, including whether and in what amount to pay a dividend.[62]

The only significant role left for state corporation law was providing the institution of fiduciary duty, mainly to check unfair self-dealing or other insider use of corporation funds that could not possibly be justified as in the best interest of the shareholders or the corporation.[63] Federal corporation law was never allowed to develop.[64] *Erie v.*

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during the New Deal.

Michel Rosenfeld, *The Rule of Law and the Legitimacy of Constitutional Democracy*, 74 S. CAL. L. REV. 1307, 1340 (2001).

59. The New Deal always recognized that a more equitable distribution of income and opportunities, not to be confused with socialism or a drab egalitarianism which militates against incentives, is indispensable to the improved functioning of the entire economy. Many New Deal programs and policies were directed toward, and substantially accomplished, improved distribution of income and opportunity. These included spending and tax policies in general, the early public employment and relief acts, the wage and working condition provisions of the National Industrial Recovery Act (N.I.R.A.), and minimum wage legislation. Other measures include the huge reduction in interest rates and the cost of credit, the early housing reforms, the farm price supports, the original Social Security Act, the Tennessee Valley Authority Act, labor legislation protecting collective bargaining including section 7(a) of the N.I.R.A. and the Wagner Act, and the early banking and security exchange reforms. *See* Leon H. Keyserling, *The New Deal and Its Current Significance In Re National Economic and Social Policy*, 59 WASH. L. REV. 795, 801 (1984).

60. For a concise summary of the history of corporate social responsibility scholarship, see C.A. Harwell Wells, *The Cycles Of Corporate Social Responsibility: An Historical Retrospective For The Twenty-First Century*, 51 U. KAN. L. REV. 77 (2002).

61. Henry Hansmann & Reinier Kraakman, *The End Of History For Corporate Law*, 89 GEO. L.J. 439, 440-41 (2001).

62. BERLE & MEANS, *supra* note 28, at 277.

63. Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1661-63 (2001).

Tompkins[65] killed the federal common law of corporations that federal courts had been developing in a straightforward manner.[66] The Burger Court killed the lower federal courts' later effort to create a federal common law of corporations through the backdoor of Rule 10b-5.[67] As the era of the Berle-Means Paradigm's hegemony came to a close, corporation law scholarship, if not "dead," was certainly viewed as an intellectual backwater.[68] Cutting-edge scholarship was the province of other fields. The typical Corporations or Business Associations casebook was filled with many tired, old cases.[69] As the 1970s came to a close, into this stagnant field came the Nexus-of-Contracts Paradigm and its primarily Chicago-style, microeconomic-trained missionaries. They met little resistance, but they were not welcomed as liberators.[70]

IV. THE NEXUS-OF-CONTRACTS PARADIGM AND THE ENTREPRENEUR; LAW AND ECONOMICS MEET AGAIN

Though it is impossible to date precisely, the Nexus-of-Contracts Paradigm achieved dominance in the field of corporation law near the end of the 1970s.[71] It was modernly rooted in Jensen and Meckling's 1976 article on the theory of the firm,[72] and Eugene Fama's 1980 article on the same subject.[73]

The foundation upon which Jensen and Meckling built was R.H. 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."[74] Expanding on Coase's insights, Jensen and Meckling emphasized that a "firm" or "corporation" is not a real individual or entity. Instead, "the firm [is] the nexus of a set of contracting relationships among individuals . . . ."[75] Thus, a "firm" is "only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor,

64. Of course, federal law intrudes on corporate governance, and has done so since the enactment of the Securities Act of 1933. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 600-15 (2003). Clearly there has been more intrusion as a result of Sarbanes-Oxley. *See* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859 (2003); Roberta S. Carmel, *Realizing the Dream of William O. Douglas: The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79 (2005).

65. Erie R.R. Co. v. Tompkins, 304 U.S. 64, 78 (1938).

66. "[A] federal law of corporations now exists. But it has always existed–since the passage of the Securities Act of 1933." Arthur Fleischer, *Federal Corporation Law: An Assessment*, 78 HARV. L. REV. 1146, 1179 (1965).

67. E. Norman Veasey & Michael P. Dooley, *The Role of Corporate Litigation in the Twenty-First Century*, 25 DEL. J. CORP. L. 131, 144 (1999).

68. *See* Bayless Manning, *Shareholders Appraisal Remedy: Essay on Frank Coker*, 72 YALE L.J. 223, 245 n.37 (1962).

69. Robert W. Hamilton, *The State of State Corporation Law: 1986*, 11 DEL. J. CORP. L. 3 n.16 (1986).

70. *See* Fred S. McChesney, *Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg*, 89 COLUM. L. REV. 1530, 1530 (1989).

71. Brett W. King, *The Use of Supermajority Voting Rules in Corporate America: Majority Rule, Corporate Legitimacy, And Minority Shareholder Protection*, 21 DEL. J. CORP. L. 895, 915 (1996).

72. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

73. Fama, *supra* note 43.

74. Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA, NEW SERIES 386, 394 (1937).

75. Jensen & Meckling, *supra* note 72, at 310.

material and capital inputs and the consumers of the output."[76]

Following Jensen and Meckling, Eugene Fama completed the Contractarian assault on the underpinnings of traditional corporate theory, and at the same time, dismissed the classic entrepreneur from any role in the developing theory of the modern corporation.

> [S]eparation of 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 set aside, at least for the purposes of the large modern corporation. Instead, the two functions usually attributed to the entrepreneur, management and risk bearing, are treated as naturally separate factors within the set of contracts called a firm . . . .
>
> [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.[77]

The Nexus-of-Contracts Paradigm led a sweeping reconsideration of the nature and purpose of corporation law, yielding profoundly important insights. However, with the benefit of 20-20 hindsight, it is possible to identify two serious flaws in the way the Paradigm was understood and communicated, particularly as it relates to the interconnection between the study of corporation law and an understanding of the role played by the classical entrepreneur.[78] As I have examined extensively in a separate paper,[79] the first error lies in the Nexus-of-Contracts definition itself, which equates the firm and the corporation.[80] The second flaw, which I will set out in some detail below, is traceable to the acceptance of Eugene Fama's view[81] that a positive account of the modern corporation would not benefit from continued study of the classical entrepreneur.

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76. *Id.* at 311.

77. Fama, *supra* note 43, at 289-90.

78. As transported to law, a typical explication of the nexus-of-contracts paradigm is that of Professor Jon Macey:

> [O]ne should view the corporation as nothing more than a set of contractual arrangements among various claimants to the product and earnings generated by the business. The group of claimants includes not only shareholders, but also creditors, employee managers, the local communities in which the firm operates, suppliers, and, of course, customers. The core insight of the nexus-of-contracts paradigm is that contract defines each participant's rights, benefits, duties, and obligations in the corporate endeavor. This insight, in turn, implies that one should not give any class of claimants preference over any other. Instead, each claimant or a group of claimants deserves to receive only the exact benefits of the particular bargain that it has struck with the firm, no more and no less.

Jonathan Macey, *Obligations to Nonshareholder Constituencies From a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1266-67 (1999).

79. Charles R.T. O'Kelley, The Corporation as Sole-Proprietor Surrogate, Presented at Georgetown-Sloan Project on Business Institutions Conference on Corporations as Producers and Distributors of Rents 4, 23-28 (Oct. 2001) (unpublished manuscript, available from author on request).

80. *Id.* at 26.

81. *See supra* text accompanying note 78.

Looking many years back, it is now clear that the triumph of the Nexus-of-Contracts Paradigm was but a part of the re-emergence of economic liberalism and its emphasis on individualism, private property in the means of production, and free markets, as the governing ideology not only in American society, but also in large parts of the world.[82] However provident or inevitable that triumph may now seem, it was unexpected at the time.[83] Thus, the original debate between Contractarians and those defending the older paradigm focused on whether the corporation should be viewed primarily in contractual terms as the product of voluntary choices made by individuals, or, at least in part, as a social organization that must be regulated to protect the interests of both shareholders and society as a whole.[84] Within the world of corporation law scholarship, there was no post-Fama consideration of why the Nexus-of-Contracts definition failed to follow Coase in locating the entrepreneur at the center of the firm.

It is here, I believe, that the governing ideology got off track as a descriptive theory of corporation law. The initial proponents of the Nexus-of-Contracts theory wanted to, and to a large extent did, cancel out the Berle-Means thesis and its focus on the corporation as a social organization. But in their zeal to reestablish individualism and contractarian analysis, they also threw out the "classical entrepreneur." Just as having a theoretical understanding of the classic entrepreneur was important to proper comprehension of mid-to-late-19th century free markets in action, so too does that understanding have substantial positive, predictive ability for the current era.

Following Coase, the firm should have been conceived as involving two sets of differently bounded contractual relations. Within one set of relations, which we can depict as bounded by a circle, are the relations between and among shareholders and managers. The relations so bounded constitute the corporation, and these relations are the primary subject of corporation law.[85]

The corporation, viewed as the sum of these contractual relations between and among shareholders and managers, is a surrogate for the entrepreneur in the classic sole proprietorship. To depict the firm, we must draw a larger circle, at the center of which is the corporation. The firm, viewed in Coasian terms, is the relation between the corporation (acting as entrepreneur) and the other constituents of the firm.[86]

The failure to view the corporation and the firm as involving entirely different sets of contractual relations has led to inordinate confusion and communication difficulties

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82. Just as the Berle and Means Paradigm achieved hegemony not as a free-standing theory, but as a part of the ideological shift from liberalism to managed capitalism that occurred in this country in the 1930s. *See supra* text accompanying notes 2-12.

83. Indeed, many of us who lived through that transformation would agree with Eric Hobsbawm's dismay and disbelief (even without the advantage of his personal memory of the Great Depression):

> Those of us who lived through the years of the Great Slump still find it almost impossible to understand how the orthodoxies of the pure free market, then so obviously discredited, once again came to preside over a global period of depression in the late 1980s and 1990s, which, once again, they were equally unable to understand or deal with.

HOBSBAWM, THE AGE OF EXTREMES, *supra* note 4, at 103.

84. To get the flavor of this debate, see Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989); PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed., 1995).

85. *See* Coase, *supra* note 74, at 394; O'Kelley, *supra* note 79, at 23-26.

86. *See* Coase, *supra* note 74, at 391; O'Kelley, *supra* note 79, at 26, 30.

between Contractarians and Progressives.[87] Progressives have seen the apparent *ex ante* equality of shareholders, managers, employees and other constituents of the firm as supporting their view that corporation law should address the concerns of this larger group of constituents.[88] Moreover, to some extent Progressives view, or at least describe, their other constituency arguments as not only normative, but descriptive.[89] Properly differentiating the firm and the corporation prevents that confusion. So clarified, the Nexus-of-Contracts definition of the firm directly makes the positive claim that corporation law applies only to relations between and among shareholders and managers, because the corporation, *by definition*, only includes those relations.[90] Put another way, the corporation (the set of relations between the shareholders and managers) *is* the artificial *sole proprietor* that owns and manages the incorporated firm.[91]

This definitional clarification leads to, and perhaps partially explains, the second error in the Nexus-of-Contracts Paradigm. If the corporation is a set of relations that collectively replace the entrepreneur, then we should be intensely interested in how, if at all, corporation law is designed to promote, support, or ensure that this surrogate entrepreneur functions as a reasonable substitute for the entrepreneur in the classic firm. To understand this, we must understand how the modern corporation, in theory, can be organized so as to include a person or persons who carry out the functions of the classic entrepreneur in a manner consistent with the assumptions that underlie traditional free market ideology.

V. THE CLASSICAL ENTREPRENEUR WITHIN THE MODERN CORPORATION—FRANK KNIGHT REVISITED

Frank Knight, progenitor of the theory of the classic entrepreneur,[92] disagreed with the proposition that ownership and control are separated in the modern corporation, a proposition unchallenged even by Contractarians.[93] As he cryptically noted: "Whenever we find an apparent separation between control and uncertainty-bearing, examination will

87. As Professor Stephen Bainbridge aptly described:

> Contractarians and noncontractarians no longer have much of interest to say to one another; indeed, they barely speak the same language. To shift metaphors, those who adhere to the nexus of contracts model pass those who do not like so many ships in the night, with only an occasional exchange of broadsides to enliven the proceedings.

Steven M. Bainbridge, *Community and Statism: a Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856 (1997).

88. Cynthia A. Williams, *Corporate Social Responsibility in an Era of Economic Globalization*, 35 U.C. DAVIS L. REV. 705, 777 & n.33 (2002).

89. *See* Peter C. Konstant, *Team Production and the Progressive Corporate Law Agenda*, 35 U.C. DAVIS L. REV. 667, 668-70 (2002); Blair & Stout, *Team Production Theory*, *supra* note 19, at 287-89 (1999).

90. O'Kelley, *supra* note 79, at 29.

91. *Id.* at 27-28.

92. It may well be that Frank Knight should be viewed as the father of modern Contractarianism: his book RISK, UNCERTAINTY, AND PROFIT, *supra* note 21, anticipates much of what has since been worked out by theorists in the principal-agent, property rights, and transaction cost economics branches of general economic theory.

93. Fama, *supra* note 43, at 289-90.

show that we are confusing essentially routine activities with real control."[94] Market forces normally will cause the modern corporation to be organized so that control is exercised by one or more persons who are effective surrogates for the classical entrepreneur. To understand why this is so, we must understand the relationship between entrepreneurship and uncertainty. We must understand why decisions made by non-owner employees that appear to involve wide discretion, never involve *entrepreneurial* risk or control. We must appreciate why the person actually exercising decision-making authority at the pinnacle of the corporation will usually be motivated to manage in the best interest of the corporation and its constituents, whether or not she owns a controlling bloc of the corporation's stock.

Knight's central thesis was that uncertainty is the most critical factor to abstract from reality to produce perfect competition, and that uncertainty's presence in the real world explains the existence of the entrepreneur and the firm.[95] "Chief among the simplifications of reality prerequisite to the achievement of perfect competition is . . . the assumption of practical omniscience on the part of each member of the competitive system."[96] With perfect knowledge and foresight, producers know not only what consumers now want, but what they will want in the future. Thus producers know what they need to do to maximize the value of their productive resources, and how to go about doing it.[97]

In the world of perfect competition theory, every producer is assumed to have perfect understanding of her own talents, knowledge, integrity, and leadership ability. These attributes are treated as unchanging, as are all other features of this hypothetical world. Needs and wants are known and unchanging. There are no new resources to exploit, current resources are available without fear of exhaustion; there are never any scientific resources, inventions, wars or plagues.[98] Through a process of adjustment and experimentation, each person would determine the highest and best use of her talents and time.[99] To the extent production were to prove more efficient via coordinated efforts involving specialization of function, such adjustments would occur through each person providing to the market that product or service that maximizes his or her utility.[100] Finally, equilibrium would be reached and the economy would work like a clock thereafter.[101]

Therefore, when uncertainty is abstracted away, there is no need for a firm or an entrepreneur even when division and specialization of labor are present.[102]

> 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

94. KNIGHT, *supra* note 21, at 298.
95. *Id.* at 20-21.
96. *Id.* at 197.
97. *Id.* at 268.
98. *Id.* at 266.
99. KNIGHT, *supra* note 21, at 267.
100. *Id.* at 106-07.
101. *Id.* at 107-08.
102. Prior to Knight, many leading theorists viewed the firm as a natural by-product of the division of labor. *Id.* at 398.

> 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.[103]

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."[104] 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. As a result, "the work of forecasting and at the same time a 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."[105]

Importantly, the entrepreneur is selected in the same competitive process that determines how other productive resources are allocated; the entrepreneur is a function or product of the rational, self-interested choices of the entrepreneur and those who choose whether or not to work for her and whether or not to buy her products. Some individuals have superior knowledge and skill at estimation of consumer wants, superior ability to control and direct the actions of others, greater confidence that their business estimates—business judgments—will prove correct.[106] As joint production groups form and specialize in particular activities, they seek "individuals with the greatest managerial capacity of the requisite kinds and [place] them in charge of the work of the group, submitting the activities of other members to their direction and control."[107] Likewise, individuals compete for positions as entrepreneurs or for other positions within the group.[108] Self-interest causes each individual to select and be selected for the role that

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103. *Id.* at 267. Coase, writing later, misunderstood Knight's insight:

> Finally, it seems important to notice that even in the case of an economic system where there is no uncertainty Professor Knight considers that there would be co-ordinators, though they would perform only a routine function. He immediately adds that they would be "without responsibility of any sort," which raises the question by whom are they paid and why?

Coase, *supra* note 74, at 401.

Apparently Coase thought Knight was using the term "managers, superintendents" synonymously with the term "entrepreneur." Knight clearly was not, since, for him, entrepreneurs must be "responsible managers." *See* KNIGHT, *supra* note 21, at 259, 267. Properly understood, Knight and Coase had identical views about how a world without firms would operate. Compare Knight's description, above, with R.H. Coase, *The Nature of the Firm: Influence*, *in* THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 61, 65 (Oliver E. Williamson & Sidney G. Winter eds., 1991).

104. KNIGHT, *supra* note 21, at 268.

105. *Id.*

106. *Id.* at 270.

107. *Id.* at 269.

108. *Id.* at 273-74.

maximizes the value of her talents, taking into account her willingness to assume the risk of the business judgments on which the group's fortunes will depend.[109]

In the real world, individuals differ in numerous important ways, including intelligence, training, leadership ability, integrity, physical strength, endurance, and so on. In the real world, producing goods and service involves a multitude of interrelated tasks that differ markedly in the requisite skills and knowledge required for their accomplishment. Men and women specialize in these tasks, one of which is serving as an entrepreneur. The classic entrepreneur is someone with both "superior managerial ability (foresight and capacity of ruling others)"[110] . . . and enough confidence in her ability that she is willing to "'back it up' [and] specialize in risk-taking."[111]

In larger enterprises, the various components that go into producing and marketing a product or service, involve innumerable "problems" that must be solved at every level of the firm. The problem may be no more difficult than to decide how to move a ton of coal from spot A to spot B, or it may involve writing a security program to protect a firm's computer system from destructive breaches. To solve each of these problems a certain amount of knowledge, judgment and skill is required. The solution to each of these problems involves a certain amount of uncertainty, and determining how to solve each problem requires someone to exercise judgment. Someone must decide what to do, and then decide whether to do it herself, or delegate the task to one or more persons under her control in the firm's hierarchy.

The entrepreneur cannot do all of these tasks herself, nor can she know how best to solve the problem presented by each sub-task involved in carrying out the business of the firm. What the successful entrepreneur must do is put the right people in charge of the right task of management at the level in the hierarchy immediately below her own. These managers must then assign men and women to solve the sub-tasks that fall within the area of responsibility delegated to them by the entrepreneur. These men and women may, in turn, control other men and women further down the hierarchy, and so on.[112]

Knight's seminal insight was that uncertainty colors the decision of whether to become an entrepreneur or an employee. Once a person decides to become an entrepreneur, uncertainty affects her decision of who to hire (or attempt to hire) and what to offer as wages.[113] Likewise uncertainty affects the person deciding whether to accept a particular offer of employment. Each of these decisions involve judgments about men and women, their skills, knowledge, and integrity—about their ability to perform the task that they are being asked or are offering to perform.[114]

The employee is someone who lacks the confidence, skills, knowledge, or capital to be an entrepreneur. However, in agreeing to become an employee, she agrees to accept the entrepreneur's direction and control in return for a promised wage.[115] The prospective employee must have confidence that the entrepreneur can fulfill the wage promises made to her, that the entrepreneur's confidence in herself is well-placed, yet she

109. KNIGHT, *supra* note 21, at 269.
110. *Id.* at 270.
111. *Id.*
112. *Id.* at 297.
113. *Id.* at 269-70.
114. KNIGHT, *supra* note 21, at 291-93.
115. *Id.* at 270.

will necessarily be unable to *know* that the entrepreneur will be successful in the planned venture.[116] Consequently, she will be unlikely to accept the entrepreneur's offer of employment unless the entrepreneur will put her own capital at risk to provide a substantial guarantee that the wages will, in fact, be paid. In other words, the prospective employee's uncertainty about the entrepreneur's ability to perform is ameliorated by the entrepreneur's confidence in herself, demonstrated by the equity capital the entrepreneur puts at risk. Ownership (risk-taking) and control must be united in the entrepreneur, or the firm will be unable to attract the best possible employees.[117]

Given Knight's theory of the criticality of unification of ownership and control in a classic entrepreneur, how can the modern corporation be viewed as an efficient, socially useful, economic organization? Knight answers counter to received wisdom: the *apparent* separation of ownership and control is usually illusory.[118]

The first step necessary to understanding the distribution of control and responsibility in modern business is to grasp this fact: what we call "control," consists mainly of selecting someone else to do the "controlling." Business judgment is chiefly the judgment of men and women.[119]

Control is exercised at every level in the firm by a superior choosing whether to perform a particular task (solve a particular problem) or, instead, to assign part or all of the task to someone below her in the hierarchy, which itself may require judgment as to whether to self-perform some or all of the assigned task or pass it down to someone else. Each decision involves a judgment by the decider about her own abilities and a judgment about the abilities of those whom she directs. To the extent someone who is being directed is doing something that is not routine, that is not within their expected competence, they are expected to appeal to their superior for assistance. Thus, each person in the hierarchy below the entrepreneur makes only routine judgments, because the only entrepreneurial judgment is what task to assign and what decisions require decision by the higher authority.[120] As Knight puts it, "[t]he true uncertainty in organized life is the uncertainty in the estimate of human capacity, which is always a capacity to meet uncertainty."[121] Since each person lower in the hierarchy has been judged and told what tasks to perform and what problems to pass back to a superior for guidance if encountered, no subordinate is exercising control, because they are doing only the task they have been assigned. Only the entrepreneur, exercising the ultimate decision about what to make, how to make it, who to hire as seconds-in-command, and what tasks to delegate to them, is actually exercising control.[122]

The other consideration in locating a classic entrepreneur within the modern corporation, presumably in the person of the CEO, is how to overcome the view that has been so long dominant, that almost by definition a CEO cannot be the equivalent of the classic entrepreneur when her shareholdings constitute far less than a majority of the

116. *Id.*
117. *Id.* at 271.
118. *Id.* at 297.
119. KNIGHT, *supra* note 21, at 291.
120. *Id.* at 296-99.
121. *Id.* at 309.
122. *Id.* at 297.

voting equity.[123] The long-held assumption is that there is a significant wealth loss attributable to the agency costs that managers can be expected to impose on the corporation, including the costs of the optimal amount of bonding or monitoring, and that those costs increase as the CEO's percentage of company equity declines. The most significant of the presumed losses flows from the claim made in the principal-agent literature that "as the manager's ownership claim falls, his incentive to devote significant effort to creative activities such as searching out new profitable ventures falls."[124]

Focusing on the disincentive effects that principal-agent theory expects when a CEO owns substantially less than 100% of a company's equity, highlighting the fundamental way in which entrepreneurs differ from the 'normal' risk-averse actor. The archetypal entrepreneur is by nature an optimist, a doer, a dreamer—not a carefully, calculating wealth maximizer. Knight captured this essential point in his concluding explanation of why separation of ownership and control is illusory:[125]

> Most [shareholders in the modern corporation] do not regard themselves and are not regarded as owners of the business. In form they are owners, but in substance they are merely creditors, and both they and the insiders count upon the fact. The great companies are really owned by small groups of men who generally know each other's personalities, motives and policies tolerably well.[126]

In other words, Knight, like Berle and Means, claims as an empirical fact that managers maintain themselves in office, not by virtue of share ownership, but by virtue of control of friendly boards. However, unlike Berle and Means, Knight firmly believes that these entrenched managers are motivated to act as real entrepreneurs and in the best interest of the corporation.

Principal agent theorists, and many conservative or Chicago-style contractarians, join Berle and Means in assuming that a CEO (manager) will not act as a classic entrepreneur, but instead will act in a rational and calculating manner in pursuit of his own self-interest so that "as the manager's ownership claim falls, his incentive to devote significant effort to creative activities such as searching out new profitable ventures falls."[127] Moreover, because his share of ownership is less than 100%, the rational CEO may "avoid such ventures simply because it requires too much trouble or effort on his part to manage or to learn about new technologies."[128]

Knight presents a compelling counter account: "The conventional view is, of course, to regard risk-taking as repugnant and irksome and to treat profit as the 'reward' of assuming the 'burden' . . ."[129]; "it appears [however] that risk-taking is the opposite of

123. *See* Jensen & Meckling, *supra* note 72, at 312-13.

124. *Id.* at 313.

125. This account anticipates Fama, *supra* note 43, with regard to the fact that shareholders cannot be viewed as owners in any meaningful sense, and that the "problem" of separation of ownership and control is not a "problem" but a naturally occurring and efficient ownership structure. Fama differs from Knight only in failing to see the value in identifying the CEO as a substitute for the classic entrepreneur.

126. KNIGHT, *supra* note 21, at 359.

127. Jensen & Meckling, *supra* note 72, at 313.

128. *Id.*

129. KNIGHT, *supra* note 21, at 362.

irksome . . . . [That is to be doubted];"[130] "[entrepreneurs] are not the critical and hesitant individuals, but rather those with restless energy, buoyant optimism, and large faith in things generally and themselves in particular . . ."[131]; "Most human motives tend on scrutiny to assimilate themselves to the game spirit. It is little matter, if any, what we have set ourselves to do . . . . But once having set ourselves to achieve some goal it becomes imperative to achieve it."[132]

> For it is clear that the 'personal' interests which our rich and powerful business men work so hard to promote are not personal interests at all . . . . The real motive is the desire to excel, to win at a game, the biggest and most fascinating game yet invented, not excepting even statecraft and war.[133]

One's view of human nature determines whether one believes that a CEO with a relatively small equity stake will be naturally motivated to shirk or naturally motivated to act as a classic entrepreneur in the corporation's best interest. Trying to further explore relative merits of either position is far beyond the scope of this paper. Therefore, I will make behavioral assumptions in my concluding comments to illustrate in a very preliminary and incomplete fashion, how a theory of entrepreneur primacy might contribute to the evolving positive theory of the modern corporation.

VI. DOES THE THEORY OF ENTREPRENEUR PRIMACY CONTRIBUTE TO A DESCRIPTIVE ACCOUNT OF THE CORPORATION?

Does the theory of entrepreneur primacy add to our descriptive understanding of the corporation and corporation law? That is a question I plan to address more fully in later articles. I will conclude this effort with a simple example of how entrepreneur primacy adds to our knowledge.

For purposes of this example, I will assume that a majority shareholder who serves as her corporation's CEO constitutes an adequate surrogate for the classic entrepreneur.[134] Thus, I will totally avoid for now grappling with the facially more difficult proposition that CEOs with relatively small equity stakes will, under appropriate conditions, operate as satisfactory substitutes or surrogates for the classic entrepreneur.

The proposition I will explore below is this: It is descriptively accurate to view corporation law as designed to promote or support the ownership and management prerogatives of a majority-shareholder CEO so that she may be expected to function as the corporation's classic entrepreneur.

I will compare the predictive power of my model with the predictions that flow from two versions of director primacy—one advocated by Stephen Bainbridge, the other by Lynn Stout and Margaret Blair. The case I will use to illustrate why this proposition

130. *Id.* at 367.

131. *Id.* at 366.

132. *Id.* at 53.

133. *Id.* at 360.

134. Studies of CEO compensation lend support to this assumption; majority-shareholder CEOs receive significantly less remunerative salary and incentive-based compensation than CEOs with non-controlling shareholdings. *See* Brian R. Cheffins & Randall S. Thomas, *The Globalization (Americanization?) of Executive Pay*, 1 BERKELEY BUS. L.J. 233, 252-54 (2004).

appears to add value is *Adlerstein v. Wertheimer.*[135] The case involves a dispute between Joseph Adlerstein (the CEO, Board Chair, and controlling stockholder of Spectrumedix, Inc., a Delaware corporation) and the other two members of the company's board of directors—Stephen Wertheimer and Judy Mencher.

Adlerstein was a scientist and entrepreneur who had been involved in funding and managing a number of start-up technology companies. In 1992, he founded SpectruMedix. In 1997, SpectruMedix went public, but it quickly burned through all its cash.[136] At all relevant times prior to July 1, 2000, Adlerstein held stock providing him with a majority of the votes in any election of directors.[137]

Beginning in January 2000, as the corporation's financial condition deteriorated, Adlerstein expanded the board of directors of which he had been the sole member, to three by adding two new directors—Wertheimer, an investment banker and Mencher, a money manager with expertise in distressed investments.[138] Soon after joining the board, Wertheimer and Mencher became concerned about Adlerstein's management style. One employee alleged that Adlerstein had sexually harassed her.[139] On at least one occasion, Adlerstein lied to the board, claiming that sales were "in the pipeline" which were not.[140] Wertheimer and Mencher decided that they must find funds to keep the company afloat. The situation reached crisis proportions on July 2, 2002, when a management consultant hired by the board concluded:

> Adlerstein was "the central problem" at the Company, because "he is totally lacking in managerial and business competence and has demonstrated an unwillingness to accept these shortcomings." [The consultant] further opined: "For SpectruMedix to have any chance, [Adlerstein] must be removed from any operating influence within the company."[141]

Wertheimer and Mencher contacted a potential investor, Ilan Reich. Reich agreed to invest needed funds, but only if the board would issue to him dual-class common stock with sufficient weighted voting power to make Reich the controlling shareholder. Wertheimer and Mencher agreed to this demand.[142]

Around July 5, 2001, Wertheimer and Mencher orally informed Adlerstein that a special meeting of the board would be held on July 9, but they did not tell him the purpose of that meeting.

At the special meeting, while Adlerstein remained silent, Wertheimer and Mencher approved the transaction with Reich, and issued the new control bloc of stock to him effective immediately. They then removed Adlerstein as CEO for cause and replaced him with Reich. After the meeting, Reich, acting by written consent, removed Adlerstein from the board.[143] Subsequently, Adlerstein filed suit challenging the legitimacy of these actions.

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135. Adlerstein v. Wertheimer, No. Civ.A.19101, 2002 WL 205684 (Del. Ch. Jan. 25, 2002).
136. *Id.* at *1-2.
137. *Id.* at *2.
138. *Id.* at *1.
139. *Id.* at *2.
140. *Adlerstein*, 2002 WL 205684, at *3.
141. *Id.* at *4.
142. *Id.* at *6.
143. *Id.* at *7.

The Chancery Court held that Mencher and Wertheimer had breached the fiduciary duty they owed to Adlerstein, thereby invalidating the actions taken at the July 9, 2000, directors' meeting. I will now evaluate that decision under "Bainbridge-style" Director Primacy, under "Stout-Blair-style" Director Primacy, and under the Entrepreneur Primacy theory discussed in this Article.

A. "Bainbridge-Style" Director Primacy

In a series of articles, Steven Bainbridge has developed a coherent and comprehensive theory of Director Primacy.[144] Simply put, "Bainbridge-style" Director Primacy places the board of directors at the center of the firm. It is both a normative and predictive theory: Directors should manage and control the corporation; directors do manage and control the corporation.[145] The only check on the directors' power is an essentially unenforceable "contractual obligation to maximize the value of the shareholders' residual claim."[146] If the directors do not hew to this norm, neither the judiciary nor shareholders have any power to intervene, save in extraordinary circumstances.[147]

Under "Bainbridge-style" Director Primacy, the Delaware Court of Chancery should have ruled in favor of the actions taken by the majority of the board of directors. Neither Mencher nor Wertheimer had any material financial interest riding on the decision to oust Adlerstein and facilitate Reich's assumption of control. Rather, they were acting in the belief that if they did not do so the corporation would go bankrupt. In such circumstances, "Bainbridge-style" Director Primacy would describe the directors' use of their powers as an appropriate attempt to maximize shareholder wealth.

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself [or] to the reduction of profits . . . .[148]

If Mencher and Wertheimer had acquiesced in Adlerstein's continued management of SpectruMedix, they would have been acting contrary to their contractual obligation to maximize shareholder wealth. Put another way, if Mencher and Wertheimer had backed Adlerstein's continued management of the corporation, they would have been favoring Adlerstein's personal desire to continue as an officer and director over their own

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144. See the following articles by Stephen M. Bainbridge: *Director v. Shareholder Primacy in the Convergence Debate*, 16 TRANSNAT'L LAW. 45 (2002); *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1 (2002); *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791 (2002); *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003); *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. CORP. L. 1, 27-37 (2003); *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 87-109 (2004).

145. Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 7-8, 29-32 (2002).

146. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 551 (2003).

147. Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 805 (2002).

148. Bainbridge, *supra* note 146, at 575.

considered judgment as to the course of action most likely to maximize shareholder wealth. So doing would violate the norms explicit in "Bainbridge-style" Director Primacy.

B. "Blair-Stout-style" Director Primacy

In a series of articles, Lynn Stout and Margaret Blair have developed a different version of Director Primacy.[149] Like Bainbridge, "Blair-Stout-style" Director Primacy is both a positive and normative theory. Like Bainbridge, "Blair-Stout-style" Director Primacy places the board of directors at the center of the firm and blesses the board's near-total discretion to manage the business and affairs of the corporation.[150] However, under the Blair-Stout theory, the directors do not have a contractual or ethical obligation to measure their decisions against the norm of shareholder wealth maximization; nor do they have an obligation to respond to the claims of employees or any other corporate constituency ahead of the interests of shareholders.[151] Instead, they act as a "mediating hierarchy," refereeing disputes between shareholders, managers, employees, creditors and other constituents who are involved in the team production of the corporation's product.[152] A neutral referee is needed because team production is complex, and the value of each team member's contribution is difficult to measure and verify.[153]

As a mediating hierarchy, the board's goal is to advance the interests of the corporation as a whole, even if shareholders wealth is diminished.[154] Blair and Stout assert:

> [u]sing team analysis, the "firm" can be understood as a nexus of firm-specific assets that have been invested by a variety of groups, including most obviously shareholders, bondholders, managers, and employees. The board of directors acts as a fiduciary for the firm, meaning that it seeks to maximize the total *value* of these combined economic interests.[155]

Importantly, Blair and Stout assert that the majority of the board should not be under any greater obligation to consider the interests of the CEO than the interests of any other constituency.[156]

Under "Blair-Stout-style" Director Primacy, the Delaware Court of Chancery should have ruled in favor of the actions taken by the majority of the board of directors. Mencher and Wertheimer are empowered as a majority of the board to take into account and balance the interests of all corporate constituents. In fact, the board's decision to oust Adlerstein appears grounded not only in a desire to protect shareholder interest, but also a

149. *See* Blair & Stout, *Director Accountability*, *supra* note 19; Blair & Stout, *Team Production Theory*, *supra* note 19; Blair & Stout, *Team Production*, *supra* note 19.

150. Blair & Stout, *Team Production Theory*, *supra* note 19, at 252; Blair & Stout, *Director Accountability*, *supra* note 19, at 434-35.

151. Blair & Stout, *Team Production Theory*, *supra* note 19, at 254.

152. Blair & Stout, *Director Accountability*, *supra* note 19, at 250-51.

153. *Id.* at 419.

154. *Id.* at 436; Blair & Stout, *Team Production Theory*, *supra* note 19, at 271-76.

155. Blair & Stout, *Director Accountability*, *supra* note 19, at 425.

156. *Id.* at 435 n.93.

desire to protect creditors and employees.[157] Adlerstein is a shoddy manager, he has not been truthful with the board, and an independent expert has concluded that the firm will soon be bankrupt unless Adlerstein is deposed. This is clearly a case where the directors, acting as a neutral mediating hierarchy, would resolve the dispute between Adlerstein and other corporate constituents—employees, the other shareholders, customers, and suppliers—in favor of the other corporate constituents.

C. Entrepreneur Primacy

While both versions of Director Primacy point to a decision in favor of the SpectruMedix board, Entrepreneur Primacy points to a decision protecting Adlerstein's right to control the corporation. The essence of classic entrepreneurship is direction and control by the entrepreneur, backed up by the entrepreneur committing his equity as security for the claims of employees and other corporate constituents.[158] If corporation law is to support the contractual view of the corporation, and support the majority-shareholder-CEO's private right to control the corporation and its means of production, then the court must not interfere, or allow corporate fiduciaries to interfere, with the entrepreneur's management decisions, *even if* a majority of the board strongly believes that the majority-shareholder-CEO's decision or, in this case, continued management of the firm, is not in the corporation's best interests. Under Entrepreneur Primacy, ownership and control must be united, or Berle's and Means' fears about the modern corporation will be realized.[159] Allowing the board to take control away from the majority-shareholder-CEO, even in dire circumstances, would mean that ultimate control resided in the board, rather than the entrepreneur.

Interestingly, Stephen Bainbridge concedes the following regarding his version of Director Primacy:

> Director primacy works less well for those firms for which the default rules of corporate law are often a poor fit. In closely held corporations, for example, ownership of the equity claim and de facto control of the enterprise typically are joined. Shareholders of such firms commonly opt out of those default corporate law rules that effect director primacy. Similarly, director primacy does not work well with respect to wholly-owned subsidiaries or publicly held corporations with controlling shareholders. Again, in both settings, ownership of the equity claim and de facto control tend to be united.[160]

In other words, Bainbridge essentially concedes that his theory is non-predictive in the very circumstance where share ownership and control are united in an effective entrepreneur.[161]

In contrast, Entrepreneur Primacy does predict the result in *Adlerstein* and does

157. Adlerstein v. Wertheimer, No. Civ.A. 19101, 2002 WL 205684, at *11 (Del. Ch. Jan. 25, 2002).

158. *See supra* text accompanying notes 116-18.

159. *See supra* text accompanying notes 51-55.

160. Bainbridge, *supra* note 145, at 33-34.

161. Professor John Coates has asserted that Blair and Stout's version of director primacy is also non-predictive where a controlling shareholder serves as CEO. John C. Coates IV, *Measuring The Domain Of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 838-40 (1999). Blair & Stout seem to agree. *See* Blair & Stout, *Director Accountability*, *supra* note 19, at 447.

support the limited proposition that this Article addresses: it is descriptively accurate to view corporation law as designed to promote or support the ownership and management prerogatives of a majority-shareholder CEO so that she may be expected to function as the corporation's classic entrepreneur.

Finally, Entrepreneur Primacy explains the very limited reach of *Adlerstein* and similar cases. Vice Chancellor Lamb is not asserting that a board must always give the CEO notice of the purpose of a directors' meeting called for the purpose of removing the CEO from office:

> Here, the decision to keep Adlerstein in the dark about the plan to introduce the Reich proposal was significant because Adlerstein possessed the contractual power to prevent the issuance of the Series C Preferred Stock by executing a written consent removing one or both of Wertheimer and Mencher from the board. He may or may not have exercised this power had he been told about the plan in advance. But he was fully entitled to the opportunity to do so and the machinations of those individuals who deprived him of this opportunity were unfair and cannot be countenanced by this court.[162]
>
> .... The outcome in this case flows from the fact th[at] Adlerstein was *both a director and a controlling stockholder*, not from either status individually .... [T]here is no authority to support the argument that Adlerstein's stockholder status entitled him to advance notice of actions proposed to be taken at a meeting of the board of directors.[163]

This analysis suggests that not only does Entrepreneur Primacy predict the result in *Adlerstein*, but that Vice Chancellor Lamb consciously decided the case with a similar principle in mind.

VII. CONCLUSION

One example does not a theory make, and much work must be done to test the predictive power of a theory of Entrepreneur Primacy. To that end, I plan in subsequent articles to flesh out this theory. What I hope to show is that many troubling features of corporation law are better explained by my theory than by other accounts of the corporation. I do not expect, nor do scholars who have developed other theories claim as to their theories, that my theory will predict every facet of corporation law better than any other theory. It will be enough if it predicts important aspects of corporation law, such as the business judgment rule, better than other models.

Thus, I will next attempt to test a much broader proposition than tested in Part VI, *supra*. The proposition to be tested is this: corporation law may be understood as a mechanism to support private ordering intended to provide the modern corporation with a surrogate for the classic entrepreneur, even if the CEO owns only a small percentage of the corporation's voting stock. In other words, I will attempt to show that Knight was right and Berle and Means were wrong in their analysis of separation of ownership and control in the modern corporation.

162. *Adlerstein*, 2002 WL 205684, at *9.

163. *Id.* at n.28 (emphasis added).

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