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DEMYSTIFYING THE 'NEXUS OF CONTRACTS' THEORY THROUGH RIBSTEIN'S 'UNCORPORATION' CRITIQUE

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ABSTRACT

In traditional legal theory, the fundamental notion of a 'corporation' was solely contractual. Many legal scholars buttressed the idea that a 'corporation' is merely a legal fiction borne out of the simultaneous intersection of contracts. This notion was forwarded by Jensen and Meckling's 'Theory of the Firm' hypothesis and later established by Easterbrook and Fischel in their seminal work 'The Corporate Contract'.

However, modern corporations don't perfectly fit into the 'Nexus of Contract' (hereinafter "NoC") model for it is difficult to handle corporate operations only through multiple differential contracts. In response to this, Larry Ribstein advanced the idea of 'Uncorporation'; an evolutionary corporate setup based on the NoC that is more autonomous and flexible than the traditional conception of corporation.

Part I of this paper attempts to bring conceptual precision in this discourse through a descriptive study of the NoC. Part II tries to critically evaluate the corporate status quo to check the veracity of NoC. Part III deals with Ribstein's 'Uncorporation' hypothesis and examines its claims and the model advanced by it. Consequentially, Part IV presents the proposition that NoC has finally crumbled, and is no more a relevant theory of corporation.

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CORPORATION AS THE 'NEXUS OF CONTRACTS' THEORY: AN INTRODUCTION

A corporation is not a contract; it is a legal entity created by the state. It has legal personhood with the option to frame and enter into contracts, suffer liability for torts arising therefrom, languish responsibility over misdeeds, and make a lawful case for itself.[155] Nonetheless, numerous scholars of corporate law have stayed loyal to the notional allegory, model, worldview which perceives a corporate as an extension or "nexus of contracts".[156] The 'Nexus of Contracts' hypothesis is intended to propel the financial and independent nature of the Corporation and to pardon the possibility that it owes anything to the state.[157] It is likewise utilized to buttress or preserve the corporate status quo as opposed to dynamical state policy. The theory contends that the corporation reflects what the parties to a contract have uninhibitedly intended.[158] The fundamental corporate model wherein investors and creditors choose the top administrative staff, who then deal with the arrangement of the supporting staff and authorities isn't viewed as the decision of the state. It is the result of free determination of corporate chiefs, board of directors, creditors, and different partners of the corporate arrangement. To debate this design is to scrutinize the market choices of the people who are, evidently, in the best place and shape to make these decisions.[159]

This standard supposition by Micheal Jensen and William Meckling, presenting a positive theory of corporation, has been at the helm of developmental corporate theory for decades. The Nexus of Contracts hypothesis, by and large, ascribes to Jensen and Meckling's "Theory of the Firm" which holds that the firm (or the corporation as an extension) is just a product of simultaneous contractual agreements.[160] Jensen and Meckling stress that the corporate is

[155]Grant M. Hayden and Matthew T. Bodie, *The Uncorporation and the Unraveling of Nexus of Contracts Theory*, 109 MICH. L. REV. 1127 (2011) [*hereinafter* "Hayden"].
[156]*Id.*
[157]Henry N. Butler, *The Contractual Theory of the Corporation,* 11 GEORGE MASON LAW REVIEW 99-123 (1989).
[158]Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, in* A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS AND ORGANIZATIONAL FORMS (Michael C. Jensen ed., Harvard University Press 2000) [*hereinafter* "Jensen"].
[159]Hayden, *supra* note 1.
[160]Jensen, supra note 4.

merely a "legal fiction" devoid of a legal personality or autonomous presence of its own. This hypothesis tries to reconceptualize the traditional notion of the corporate as a solitary unit and disaggregates it into its segment parts. These segments are identified through legally binding contracts amongst different stakeholders engaged with the corporate: creditors, directors, executives, suppliers, employees, and customers. That is to say, the existence of the corporate is redundant in itself.[161] Ergo, corporate law should simply be an expansion of law of contracts and should concentrate on encouraging these interrelationships in the most proficient way.

On parallel lines, Frank Easterbrook and Daniel Fischel reinforced the contractarian nature of the corporation.[162] They opined that the fundamental nature of laws for corporate governance is useless as "divergence between private and social interest is rare".[163] Ergo, it doesn't matter what objectives are sought by the Corporate: social welfare, profit-making, or charitable purposes. It also didn't make a difference whether companies operated for a long-term or temporarily. In light of the notion that a corporate was essentially a mesh of 'private contracts' these suppositions do not hold much value. The objectives of corporate law were already accomplished in the law of contracts, or the law of torts, or explicit legislations outside corporate law. Corporate law itself was only a sub-class or an extension of contractual law where the main aim is to uphold and enforce private deals. Frequently, the express terms of the 'corporate agreement' runs out regularly. Thereafter, corporate law makes default rules or individual contracts for unique situations. Thenceforth, in the event that you impertinently enquired about the fundamental idea of corporate law, the answer was exactly: "Who cares?" [164]

This argument of Frank H. Easterbrook and Daniel R. Fischel lays on the possibility of the "nexus of Contracts". The aforementioned theory infers that, a typical investor has a little stake - little in contrast with the huge size of the venture. Then again, the board of directors of the concerned corporate know about the complexities of the business. This established notion describes an entity that is in actuality not present but is more akin to a legal fiction made up of

[161]Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUMBIA LAW REVIEW 1449-460 (1989) [*hereinafter* "Kornhauser"].
[162] Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUMBIA LAW REVIEW 1416 (1989) [*hereinafter* "Easterbrook and Fischel"].
[163]Easterbrook and Fischel, *supra* note 8.
[164]Ewan McGaughey, *Ideals of the Corporation and the Nexus of Contracts*, 78 MODERN LAW REVIEW 1057-1090 (2015).

several constituent parts, which are the contractual obligations between different parties.[165] Along these lines, corporate law, ought to be an augmentation of law of contracts which administers with more accuracy, the connections comprising the foundation of the corporate organization itself. One of the proponents of the Uncorporation theory, Stephen Bottomley, vehemently argues that:

"Why not just abolish corporate law and let people negotiate whatever contracts they please? The short but not entirely satisfactory answer is that corporate law is a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting. There are lots of terms, such as rules for voting, establishing quorums, and so on, that almost everyone will want to adopt. Corporate codes and existing judicial decisions supply these terms 'for free' to every corporation, enabling the venturers to concentrate on matters that are specific to their undertaking." [166]

The "Nexus of Contracts" theory has been essential in the development of Statute of corporate regulation. Nonetheless, despite its academic strength, there is still confusion over - whether hypothesis is a normative theory or a descriptive idea, or a mix of both.[167] Jensen and Meckling introduced a "positive theory of the corporation" and its interrelations. That string has been acknowledged in the legal academia, with Easterbrook and Fischel solidifying the idea advanced. But even at the most basic of levels, the "Corporation as Contract" claim is ambiguous.

Corporations don't perfectly fit the NoC theory.

THE STATUS QUO STUDY OF MODERN 'CORPORATION' VIS-À-VIS 'NEXUS OF CONTRACTS'

Since contractarians have vehemently explained corporations solely as a product of multiple contracts, it seems only plausible that, by inductive reasoning, every functioning corporation must therefore readily fit into the theory of Nexus of Contracts. However, as it will be apparent from the discussion below, this does not seem to be the conclusion.

[165]A. Schwartz, and R.E. Scott, Contract Theory and the Limits of Contract Law, 113 YALE LJ 541 (2003) [*hereinafter* "Schwartz"].
[166]STEPHEN BOTTOMLEY, RETHINKING CORPORATE GOVERNANCE, 99 (1st ed, Taylor and Francis 2016)
[167]Melvin A. Eisenberg, *The Conception That the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819 (1999).

Corporations have long suffered from the prevalence of high corporate taxes and strict corporate governance, but despite these pitfalls, a large majority of businesses have adopted the traditional form of the corporation as the default organisational structure by the majority of businesses.[168] This behaviour can be satisfactorily explained by focusing on the lucrative opportunity to avail a limited liability which, only the corporations used to offer to businesses. Now, although this is a plausible explanation, the fact remains that 'limited liability' is not, in any way a feature or product of Nexus of Contract, which according to contracterians is the basis of corporations. Surprisingly, Ribstein agrees that it was the promise of low risk and limited liability, which only the corporation provided, that attracted so many proponents.[169] It is this particular reason why the partnership structure of organization paled in comparison to the corporation. Nevertheless irrespective of the actual reason, limited liability is not a product of Nexus of contract, therefore, the very fact that it is this feature that has led to the widespread adoption of corporations, casts serious doubts on the basic presumption that corporations are by nature a product of the intersection of contracts.[170]

The aforementioned proposition already reveals cracks in the NoC model. But Ribstein teething to dodge the implication explains this phenomenon by arguing that it was the lawmakers who grasped onto the benefit that limited liability provides, and channelled this benefit into the corporation structure so that a quid pro quo can be extracted in return of availing the benefit.[171] Ribstein also claims that this was one of the reasons for the late rise of 'uncorporations'. And in a final attempt to defend the Nexus of contract, Ribstein posits that parties valued the benefit offered by limited liability, over increased taxation and state regulation imposed by the government, and adopted the corporation as the preferred model of the business framework.[172]

Additionally, the notion that one can simply produce a corporation out of a connexion of contracts is also not entirely without blemishes. Furthermore, the idea that state intervention is absent in the formation of a corporation which is strictly a product of contractual obligation between parties, is also merely another superficial allegation. Because, no matter the

[168]Marco Becht, Patrick Bolton, and Ailsa Röell, *Corporate Governance and Control*, *in* HANDBOOK OF THE ECONOMICS OF FINANCE 93-109 (1st ed., Elsevier 2003).
[169]LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 1 (1st ed., Oxford University Press 2010) [*hereinafter* "RIBSTEIN"].
[170]Kornhauser, *supra* note 7.
[171]S. Levmore, *Uncorporations and the Delaware Strategy*, 45 U. ILL. L. REV. 195 (2005).
[172]*Id.*

contractual basis, the state is still required to grant permission for the establishment of the entity, the mere fact that states readily grants said permissions does not erase the requirement for the permission and does not in any form imply the absence of influence on the part of the state. Minimal obstructions cannot be construed as the absence of impediments altogether. Although there does exist the counter-argument that the theory of NoC is merely a model, it is however not solid, since it has never been confirmed whether the theory is a normative prescription or just a descriptive idea.[173] Additionally, the theory heavily propounds the contractual nature of corporations to such a degree that it invariably leads to the conclusion that, parties have an extremely high degree of, if not complete, freedom to be able to choose the terms of the contract that form the corporation, and therefore, the governing corporate law should in actuality be an extension on contract law which functions as a facilitator of free markets and freedom of contracts, and governs the minute intricacies of interpersonal contracts of the parties all the while shunning completely all compulsory regulations.[174] This simply isn't true, since, the corporate code in almost every state is an "enabling" statute and an empowering statute enables administrators and investors to set up frameworks of administration without substantive intervention and larger hindrances on corporate administration. As is evident by now, there are plenty of loopholes in the proposition of the contractarians, and attempts to elucidate any general model of the corporation as a product of the theory of NoC does not often, if not all the time, result in a perfect fit.[175]

UNCORPORATION: THE TRUE EMBODIMENT OF THE 'NEXUS OF CONTRACTS'

The rise of the Uncorporation is more of a narrative than a theory. The rise points towards a paradigm shift that has taken place in the business world. This paradigm shift is now gradually destabilising the long-held theories of contractarians and refuting the proposition of contracts being the basis of corporations.[176] In the aforementioned narrative, Ribstein vehemently tracks the growth and prevalence of both the corporations and the uncorporations throughout history. He carefully plots the periods of dominance of uncorporations, their eventual demise and the

[173]Charles RT O'Kelley, *Coase, Knight, and the Nexus-of-Contracts Theory of the Firm: A Reflection on Reification, Reality, and the Corporation as Entrepreneur Surrogate*, 35 SEATTLE UL REV. 1247 (2011).
[174]Richard L. Langlois, The Corporation Is Not a Nexus of Contracts. It's an iPhone, (July 2016) (Unpublished PhD thesis, The University of Connecticut)(On file with author).
[175]Kenneth Ayotte and Henry Hansmann, *A Nexus of Contracts Theory of Light Entities*, 42 INT'L REV. L & ECON. 5 (2015) [*hereinafter* Ayotte and Hansmann].

[176]*Id.*

rise of corporations with the advent of the 19th century, and finally the resurgence the previously dormant uncorporations.[177] As to the nomenclature, it is of no surprise that Larry Ribstein himself being a stout contractarian, choose to name these other entities as 'Uncorporations'.

It must be made clear at the behest that Ribstein remains through and through a contractarian, but is unable to ignore the changes in the corporate structures where the 'uncorporations' are now in the dominance. However, it is here that the narrative is introduced to a rather interesting twist. Ribstein in an attempt to uphold the contractarian theories posits that these 'Uncorporations' do after all follow the theory of NoC. He proceeds to explain that the Uncorporations are an evolution of the corporation itself and represent a much purer embodiment of, closer resemblance to, the original nexus of contract idea; even more so than the corporations ever have.[178] Ribstein also claims that, "Uncorporations provide a fundamental alternative to the corporation in addressing the central problems of business organization: how to minimize the costs of delegating power over investments to non-owner managers and controlling owners."[179] The highly specialized nature of Uncorporation(s) is indeed the manifestation of the interest and intention of parties to have more freedom in contracting business framework. And it is as a result of these endeavours that the Uncorporation(s) have started to dominate again. [180]

Irrespective of the current resurgence, it remains a fact that corporations have dominated the organisational framework of businesses for years, so shouldn't this be adequate proof of the effectiveness of the NoC theory of corporations? No. The initial rise of the corporations can simply be explained by the fact that corporate law, as opposed to contract law, provides various benefits to the incorporated entities which would otherwise be unavailable.[181] On the other, it remains a matter of fact that corporate law also imposes some mandatory requirements on the parties to the corporation which would otherwise be absent in contract. This raises serious doubts as to the actual reason for wide-scale adoption by parties, who, imbibed with the ideals of a free economic construct agree to a regime of compulsory obligations via a process of free

[177]RIBSTIEN, *supra* note 15.
[178]John R Boatright, *Contractors as Stakeholders: Reconciling Stakeholder Theory with Nexus-of-Contracts Firm*, 26(9) J. BANK. FINANC. 1843, 1837-1852 (2002) [*hereinafter* 'Boatright'].
[179]RIBSTIEN, *supra* note 15.
[180]Boatright, *supra* note 24.
[181]Joseph A McCahery et al., *A Primer on the Uncorporation*, 14 EUR. BUS. LAW REV. 331, 305-342 (2013).

contracting (as proposed by the NoC theory). Especially, when the very idea of a corporation made up of contracts, is to be able to choose any and all terms that are imposed on the parties on their own consent.[182]

Another observation is that the basic structure of a corporation has remained the same even for markedly different businesses. This structure of governance always invariably comprises of shareholders, a board of directors elected by the shareholders and a right provided to the shareholders to be able to sell their shares in the market for further profits. It is this basic organisational structure which is found across all corporations which once again is completely sardonic on the face of the theory that, if corporations are the result of free contracting between parties, then having the same basic structure for every corporation makes little sense if at all, and defeats the very purpose of the system. As is evident by now, the NoC theory is packed to the brim with similar doubts and cracks that have not been satisfactorily resolved by the proponents of the theory. This invariably leads to the failure of the theory of "Nexus of Contracts".[183]

UNCORPORATION & CONTRACTUAL FREEDOM: NOT TRULY FREE

The liberal or the free, or the laissez-faire economy is not an economy of freedom but an economy of license. The planned economy is not rational, it is an economy of restraint. This implies that free enterprise must be defined as a contrast to both laissez-faire and planned economy because real liberty is defined as much by its difference from license as by its difference from restraint.[184]

The greatest advantage that the Uncorporations have over traditional corporations is the flexibility in terms of contractual obligation that they offer. In fact, "Uncorporations differ from corporations in terms of their ability both to choose contract terms that suit the particular firm and to modify terms to adjust to changes in the firm or its business environment."[185] After all, the term 'Uncorporation' is merely a tag Ribstein put on all other forms of business frameworks

[182] *Id.*
[183] Marcel Clément, *From "Laissez-Faire Entreprise" To Free Enterprise*, 67 BULLETIN DES RELATIONS INDUSTRILLES 33 (2011).
[184] Ayotte and Hansmann, *supra* note 22.
[185] *Id.*

that were dissimilar to that of the corporation. The flexibility that these Uncorporations offer results in a far more specialised arrangement for parties, which then enables them to mould the structure to fit the various idiosyncratic objectives they might fester. In fact, owners of Uncorporations tend to have a greater admittance to assets of the business, and can demand further liquidation or buyout to suit their specialised needs[186]. It is this increased access that offers parties fortification against managerial costs that have historically beleaguered traditional corporations. However, even though Ribstein considers Uncorporations as being more 'contractual' in spirit than corporations, he is weary to admit that not all are fully contractual even in the world of Uncorporations. For example, it is typical to have Uncorporations where the right to transfer management rights have been handicapped to some extent to preserve the structure and overall functionality of the said Uncorporations. Lastly, Ribstein also admits that complete and total flexibility might not always be the most efficient answer. He denotes that standardization is in fact, at times necessary "to clarify the expectations of the many people with whom the corporation deals."[187]

WHY 'NEXUS OF CONTRACTS' THEORY STARTS TO CRUMBLE?

At this point, the aforementioned deliberations have conclusively unravelled the frail and untenable foundations of the proposition that the corporation is the direct product of a Nexus of Contracts. As discussed previously, the initial rise of corporations eventually started to witness some major shifts due to the change in tax laws across the world, these tax reforms were introduced with the objective of providing nation-states with leverage to compete in the increasingly globalised economy that was emerging towards the end of the twentieth and the start of the twenty-first century. Corporations and firms all over the world were now being 'double taxed', subjected increasingly strict scrutiny and regulation.[188] As a result of which businesses were forced to start the search for other organisational structures to avoid paying the newly imposed corporate taxes, and escape the stringent government regulations. Therefore the troubled businesses finally started to settle on the idea of 'limited liability companies'. And as a result, LLCs and LLPs started becoming more and more prevalent.[189] This phenomenon warranted the reconsideration of various traditional theories of the corporation.[190] This rise of the uncorporations, and their continued success also meant that the traditional components of

[186]RIBSTIEN, *supra* note 15, at 139.
[187]RIBSTIEN, *supra* note 15, at 149.
[188]Kornhauser, *supra* note 7.
[189]RIBSTIEN, *supra* note 15, at 120-121.
[190]*Id.*

the corporation, i.e. the shareholder voting, fiduciary duties, directors etc. are not indispensable parts of a successful business venture. This development also highlights that state corporate law, and not contract law is responsible for structuring and re-structuring of modern-day business organisations.[191]

This shift is not only a reflection of how corporations and businesses responded to the changing times but also is the inception of the deterioration of the NoC theory. Especially with the push for a more laissez-faire oriented global economy, transitioning businesses were able to judiciously juggle operational costs and profits until they were able to finally escape the tax conundrum.[192] Ribstein however, does not side with this narrative. Instead, he is adamant on insisting that the real object behind this paradigm shift is that the "contractual desires" of businesses and the pressures of the new age commerce were at last able to break out of the traditional framework which was forcing businesses to morph themselves into one specific structure irrespective of their varied objectives. Nevertheless, regardless of the differences between Ribstein's narrative and the one proposed above, it is undeniable that in both the narratives, there exists a common appreciation for the importance of the state and corporate law in shaping the organisational arrangement of even these "uncorporations".[193]

Finally, notwithstanding the arguments and counters, the definitive inference at the end of this lengthy discourse is that, the corporation, as was previously hypothesised by contractarians, is in fact not just a nexus of contracts. It is, as it turn out, a fluid organisational structure that is constructed on top of various state sponsored benefits, along with some mandatory regulations and guidelines. This implies that the state does in fact plays a much larger and prominent role in the formation of the corporations and/or uncorporations alike. This is in direct contrast to the ideals advocated by the proponents of the Nexus of Contract theory.[194]

[191]Hayden, *supra* note 1.
[192]*Id.*
[193]Schwartz, *supra* note 11.
[194]Kornhauser, *supra* note 7.

CONCLUSION

Ribstein seems to have finally accepted uncorporations as the downfall of the Nexus of Contract theory, albeit as a positive description. As it appears, the corporation is after all not a central vertex at which myriad contracts superimpose. Instead, it is an entity created with the active sanction of the government containing certain obligations and restraints on the parties to the business. This seems to be the price to be paid by a specialised business entity, for it to be able to thrive in the globalised open economy of the 21st century. This suggests that the takeover of the uncorporation is a global phenomenon and is there to stay. After all, in affirmation to Ribstein's beliefs, the uncorporation is indeed an evolution of the corporation forced by the demands of the modern economy. But, as opposed to Ribstein and other contractarians, even the uncorporations are not truly made up of a free nexus of contracts and are in the end at the mercy of state sanctions.

Maybe we are advancing towards a profoundly decentralized future in which we would witness and participate in a market held by small corporates, each customized to the requirements of its customers. Such a future is undoubtedly appealing and lucrative, and 'The Rise of the Uncorporation' makes appreciable efforts in selling the advantages of an "Uncorporation." But as Ribstien himself recognizes, we are far away from such a world. The "Nexus of Contracts" theory doesn't mirror or even acknowledge the realities of a modern corporate. It's an ideal opportunity to follow Larry Ribstein back to this present reality where hierarchical structures and the legislatures that make them-genuinely make a conspicuous difference.

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