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The Merging of Ownership and Control

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The Merging of Ownership and Control

Tomer S. Stein[*]

What if shareholders controlled every decision their company makes? This seemingly simple idea threatens to upend the modern corporation.

Shareholders own the corporation and directors and officers manage the corporation—a "separation of ownership and control" that has become a defining characteristic of our modern economy. As per conventional wisdom, the law enables separation of ownership and control by not prohibiting owners and employees from exercising their contractual freedom to hire and work for one another.

This Article demonstrates that this widely held view is incomplete and detrimental to the economy. Much of the economic activity that utilizes the corporate form has relied on a legal mandate, rather than permission, to establish the separation between ownership and control.

While ordinary employer-employee contracts, such as an agreement between a store owner and store clerk, rely on the parties' ability to contract for and alter fiduciary arrangements on an ongoing basis, many shareholders pool their money together to hire directors for the exact opposite reason. They rely on the mandatory separation of ownership and control in order to effectively combine their assets under the direction of a fiduciary who answers only to the firm, and not any individual investor. Absent the ability to rely on a legally mandated independent director, such shareholders would not be able to coordinate and combine their assets. The shareholders' various competing interests and rights would be too conflicting and complex to organize contractually.

Yet, an amendment signed into law in July 2024 is set to unravel this economically essential legal mechanism—it promises to merge ownership and control. This legislation was able to pass at least partly because extant scholarship lacks a theory to explain why a mandatory separation of ownership and control is an indispensable mechanism. This Article fills this gap and calls for the repeal of this watershed amendment.

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Introduction

When Ken Moelis, the founder, CEO and Chairman of the Board of Moelis & Company, organized his large investment bank as a public corporation, he also made the corporation enter into a shareholder agreement that effectively forced the board to get his consent for anything the board may do.[1] Not long thereafter, shareholders who felt harmed by this managerial chokehold, represented by the West Palm Beach Firefighters' Pension Fund, sued, and the Delaware Chancery Court deemed much of the shareholder agreement invalid.[2] The court held that the contract interfered with the statutory power of corporate managers to manage the corporation.[3] This decision drove market participants and legislatures into a frenzy.[4] The Delaware State Bar quickly proposed

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[1] *See* W. Palm Beach Firefighters' Pension Fund v. Moelis & Co., 311 A.3d 809, 817-18 (Del. Ch. 2024) (describing the events).

[2] *Id.* at 881 (holding that the "Pre-Approval Requirements, the Recommendation Requirement, the Vacancy Requirement, and the Size Requirement" are invalid contractual limitations on the board's statutory power to manage the corporation).

[3] *Id.*

[4] While Delaware is a small state, the wide industry response is due to Delaware's prominence as the preferred state of incorporation. For discussion of the industry response *see, e.g.*, Erin Mulvaney & Theo Francis, *Battle Over Shareholder Pacts Strains Delaware's Business Courts*, THE WALL STREET JOURNAL (July 14, 2024 11:00 PM), https://www.wsj.com/business/shareholder-agreements-delaware-corporate-law-b083e768 ("Delaware's lawmakers pushed the measure forward after complaints from companies and others that several

legislation designed to enable a "freedom of contract" approach to the managerial power to manage the corporation.[5] Shortly thereafter, other lodestar decisions, including a suit alleging a breach of fiduciary duty by Meta's Mark Zuckerberg, have chipped away at the decision mandating managerial independence.[6] The cases tried to draw a distinction between corporate charters, which would allow contracting around the manager's power to manage, and bylaws and shareholder agreements, which would not.[7] The Delaware legislature, in turn, responded in record speed. The law enabling the assumption of control by corporate owners (or "prospective shareholders") was controversially passed, and is to become effective on August 1st, 2024.[8]

This legal reform has generated much controversy, with objectors claiming that shareholders should be able to interfere with the judgment of directors only if the corporate charter, rather than a shareholder agreement, allows them to do so.[9] This objection is

of the Chancery Court's decisions threatened to undermine the validity of existing stockholder agreements."). For evidence of Delaware's dominance over corporate law *see* About the Division of Corporations, DEL. DIV. OF CORPS., https://corp.delaware.gov/aboutagency/ ("More than 66% of the Fortune 500 have chosen Delaware as their legal home.").

5 Proposed Amendments, THE COUNCIL OF THE CORPORATION LAW SECTION OF THE DELAWARE STATE BAR ASSOCIATION (March 28, 2024), https://www.skadden.com/-/media/files/publications/2024/04/2024-dgcl-amendments-bill-form.pdf?rev=335dffdd1c9049b399730371ad23f59d&hash=61C300C0B253F38344FE42FEBFA97C86.

6 McRitchie v. Zuckerberg, 315 A.3d 518, 574-77 (Del. Ch. 2024) (explaining that charter provisions provide the exclusive means to interfere with the director power to manage the corporation).

7 *Id.*

8 *See* Senate Bill 313, DELAWARE GENERAL ASSEMBLY, https://legis.delaware.gov/BillDetail/141480 ("Shall become effective on August 1, 2024 . . . signed by Governor."). For the as enacted text, *see id.* at https://legis.delaware.gov/json/BillDetail/GenerateHtmlDocument?legislationId=141480&legislationTypeId=1&docTypeId=2&legislationName=SB313.

9 *See, e.g.*, Joan Heminway, *Comment Letter*, BUSINESS LAW PROF BLOG (June 19,2024),https://lawprofessors.typepad.com/business_law/2024/06/i-also-write-letters.html ("Both proponents and critics of proposed § 122(18) concur that the stockholder agreements that would be authorized by that provision can currently be accomplished in a corporation's certificate of incorporation—the corporate charter."). Scholarly work addressing shareholders agreements and preceding the proposed law has also argued for charter primacy. *See* Jill E. Fisch, *Stealth Governance: Shareholder Agreements and Private Ordering*, 99

procedural rather than substantive, as it shares a common assumption with the proposal—corporate owners should be able to, somehow, interfere with corporate control.[10] Scholars and practitioners supporting either the proposal or its objection only disagree about the contractual method for attaining the desired seize of control.[11]

This Article argues that this consensus rests on a flawed understanding of the firm, and that directors' managerial independence must be an immutable right. Thus far, the corporate form (unlike close corporations, LLCs, and others) has been the only business association that offered the option to hire directors with mandatory managerial independence—an essential form of organization whose elimination is bound to engender dire economic consequences.[12] Undoing the separation of ownership and control would unravel one of the most ubiquitous forms of organization in today's economy: the pooling of assets under a fiduciary who answers to the firm rather than to individual investors.

WASH. U.L. REV. 913, 914 (2021) ("This Article argues that stealth governance is inappropriate for corporations and instead advocates a uniform structural approach to corporate law that would limit private ordering to the charter and bylaws.").

[10] Indeed, some scholars responded that this procedural point is, in their opinion, the most important aspect of the debate. *See* Sarath Sanga & Gabriel Rauterberg, *Proposed Amendments to DGCL on Stockholder Contracting Would Create More Problems Than They Purportedly Solve*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (April 5, 2024), https://corpgov.law.harvard.edu/2024/04/05/proposed-amendments-to-dgcl-on-stockholder-contracting-would-create-more-problems-than-they-purportedly-solve/ ("The harder question here is not so much whether a corporation should be able to contract around a given statutory or common law rule—but how.").

[11] *Id.*

[12] Limited liability corporations were purposely designed to be different from corporations in that they have maximal contractual freedom. *See* Del. Code Ann. tit. 6, § 18-1101 (2013) ("It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."). Close corporations were explicitly separated from corporations by creating "*special provisions*" enabling contracting around managerial rights. *See* Del. Code Ann. tit. 8, § 351 (2023) ("The certificate of incorporation of a close corporation may provide that the business of the corporation shall be managed by the stockholders of the corporation rather than by a board of directors.").

Whether managing independently or subject to the owners' instructions, a manager (a fiduciary employee) works on behalf of another. This bilateral and voluntarily formed decision to hire and work for another person is the fundamental starting point of understanding the *formation of the firm* for economists and legal scholars alike.[13]

Accordingly, the economic and legal disciplines have joined forces to develop and refine two distinct, yet complimentary, theories to understand the legal and market conditions for establishing owner-employee arrangements.[14] These theories are undeniably important and illuminating in their own right. But both tackle this project with what is best described as "fiduciary essentialism"—a pre-commitment to the idea that all employees, regardless as to whether they are agents, trustees, officers, or directors, can be treated as a functionally equivalent alternative to contracting for a one-off service (a *contractor).*[15] The failure to appreciate the mandatory separation of

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[13] The first scholarly work to pave this path in both law and economics is Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937) [hereinafter Coase, *The Nature of the Firm*]. For instance, Coase notes that "We can best approach the question of what constitutes a firm in practice by considering the legal relationship normally called that of . . . 'employer and employee.'" *Id.* at 408.

[14] The economic theory of the firm is championed by seminal works such as Oliver E. Williamson, *Hierarchical Control and Optimum Firm Size*, 75 J.P.E. 123 (1967) (modeling the limits of the firm as the increase in transaction costs as the firm increases in size); Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986) (theorizing firm ownership as stemming from contracts between residual claimants and agents) [hereinafter Grossman & Hart, *The Costs and Benefits of Ownership*]; and Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990) (expounding on residual claimants as those with bifurcated, rather than lumped, control over both assets and agents). The legal theories of the corporation have been pioneered by works such as FRANK H. EASTERBROOK &DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, 90–144 (1991) (advancing an understanding of the corporation as a response to the problem of incomplete contracts and the duty of loyalty) [hereinafter EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW], and Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (theorizing fiduciary duties as contractual agreements) [hereinafter Easterbrook & Fischel, *Contract and Fiduciary Duty*].

[15] *See, e.g.*, Easterbrook & Fischel, *Contract and Fiduciary Duty*, supra note 14,

ownership and control in the corporate form stems from this hitherto hidden and unquestioned fiduciary essentialism assumption—an assumption this Article disproves.

As per the conventional wisdom shared among law scholars, the most important hiring decision a person makes is between hiring a contractor and a vertically integrated fiduciary (for instance, an employee, agent, director, officer, or trustee).[16] To make that decision properly, a person must examine whether it is more expedient—that is, cheaper and easier—to execute a one-off contract in the market with a contractor who will deliver a specified job, or to hire a fiduciary for a prolonged period of time and under a very general job description.[17] When the latter is preferable, the law is sometimes forced to intervene to fill gaps in incomplete hiring contracts.[18] For instance, an agent who was hired to "manage a convenience store" cannot decide whether to buy Coca-Cola or Pepsi products by referencing the contract. The agent must consider the instructions they receive, however narrow in application they may be, and then make a decision using their best judgment. If the principal is unhappy with the decision after the fact, the principal may sue the agent and ask the court to decide whether the agent made a reasonable judgment. When judges adjudicate such matters, they are filling contractual gaps; and the main tool for filling such gaps, as per the legal tradition, is by imposing fiduciary duties on the hired person.[19] Hence the insistence that the choice between a contractor and a

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at 426 ("One party to the contract may desire an objective (maximum income investment, a favorable outcome to litigation) but have neither an idea nor much concern how the objective is to be achieved. Specialists in achieving this objective (trustees, managers, lawyers) agree to lend their efforts . . . a detailed contract would be silly . . . the agent assumes a duty of loyalty in pursuit of the objective and a duty of care in performance."); Grossman & Hart, *The Costs and Benefits of Ownership*, *supra* note 14, at 694 ("For example, in insurance retailing a firm may use its own employees as commissioned agents or use independent agents. The important difference between the two forms of retailing is that the employee-agent does not own the list of his clients, while the independent agent does own the list.").

[16] Coase, *The Nature of the Firm*, *supra* note 13, at 402–03.

[17] *Id.* at 390–91.

[18] *See* Easterbrook & Fischel, *Contract and Fiduciary Duty*, supra note 14, at 429 ("That objective calls for filling gaps in fiduciary relations the same way courts fill gaps in other contracts.").

[19] *Id.*

fiduciary is the essential choice in the formation of firms.[20] Legal scholars and practitioners who follow this commitment to fiduciary essentialism understand fiduciary duties as contractual in nature.[21] The content of fiduciary duties is what the parties would have bargained for had they been able to formulate a fully specified hiring agreement.[22]

This contractual understanding is also the basis for the economic "property rights" theory of the firm.[23] Given that fiduciary contracts are incomplete, we have to assign a default person who will exercise the right to decide how an asset is to be managed when the contract is silent.[24] Accordingly, when an employer-employee contract does not mention who has a right to sell or use, say, the office desks, it is a right that belongs to the employer.[25] In other words, after we account for all the contractual provisions in a given hiring contract, there will still be a number of remaining, or "residual," claims over the control of the assets that properly belong to the owner or the "claimant."[26] The concept of "residual claimant" thus forms the focal point of fiduciary essentialism—the defining feature of the theory of the firm ubiquitously shared in both legal and economic scholarship.[27]

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[20] *Id.*; *see also* Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON L. REV. 99, 110 (1989) ("The corporation is based on voluntary contract, and the realities of the corporate agency relationship dictate that the corporation's managers select the contractual terms that are then offered to potential investors."); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1261 (1982) ("Because of the costs associated with separately negotiating each of these contracts, the entrepreneur may choose an alternative to a series of market exchanges-the firm.").

[21] *See* Easterbrook & Fischel, *Contract and Fiduciary Duty*, supra note 14, at 429–32; Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779 (2006).

[22] *See* Easterbrook & Fischel, *Contract and Fiduciary Duty*, supra note 14, at 429–31.

[23] Grossman & Hart, *The Costs and Benefits of Ownership*, *supra* note 14, at 692 (theorizing firms as the contract for the purchase of residual rights in the firm).

[24] *Id.* at 700–09 (modeling the benefits of assigning a bearer of residual rights).

[25] *Id.* at 696 ("The noncontractibility of q creates the need to allocate residual rights of control since, if it is not specified how q will be chosen, there must be some implicit or explicit default that allows some party to choose the relevant components of q in the second period.").

[26] *Id.*

[27] *See* discussion *infra* Part I as well as sources cited *supra* note 14.

Yet, fiduciary essentialism is false. Scholars and policymakers who commit to this theory fail to understand that the distinction among the different types of fiduciaries—agent, director, and trustee—is a primary decision that carries enormous significance, and not a secondary clerical legal choice.[28]

First, while the defining characteristic of fiduciary relationships such as agency and trust is the existence of a residual claimant (for instance, the principal), the essence of the directorship arrangement is the director's unique position and functioning as a *residual obligor*.[29] When a director has to make a managerial decision regarding an asset, they first consult the relevant contractual commitments.[30] For instance, in deciding whether to issue dividends to the company's shareholders, the directors may first determine whether there are any lenders entitled to interest payments.[31] If there are no relevant

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[28] In other words, the distinction among directors, agents, and trustees is a drastic economic distinction. The broad treatment of this distinction as a mere clerical choice is entrenched in both law and theory. *See, e.g.*, *In re* Sears Hometown & Outlet Stores, Inc. Stockholder Litig., 2019-0798-JTL, 2024 WL 262322, at *29 (Del. Ch. Jan. 24, 2024) ("directors and officers are not agents of the stockholders, nor are the stockholders their principals . . . The principal-agent problem uses the language of economic theory, not the language of legal relationships.").

[29] In agency, the residual claimant structure is reflected in the principal's right to provide the agents with instructions that are not contractually accounted for. *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006). In trust, the residual claimant structure is reflected in the settlor's default retention of all rights not contractually given to the trustee. *See* John Morley, *The Common Law Corporation: The Power of the Trust in Anglo-American Business History*, 116 COLUM. L. REV. 2145, 2195–96 (describing the historical development of trustee fiduciary duties in the context of settlor default ownership rights).

[30] *See, e.g.*, Halifax Fund, L.P. v. Response USA, Inc., CIV.A.15553, 1997 WL 33173241, at *2 (Del. Ch. May 13, 1997) ("First, there is no Delaware case that holds that the management of a Delaware corporation has a fiduciary duty that overrides and, therefore, permits the corporation to breach, its contractual obligations."). Importantly, however, that directors must consult the firm's contractual commitments does not entail that any application of contract doctrines such as efficient breach are rendered inapplicable. *See* Frederick Hsu Living Tr. v. ODN Holding Corp., CV 12108-VCL, 2017 WL 1437308, at *24 (Del. Ch. Apr. 14, 2017) ("Even with an iron-clad contractual obligation, there remains room for fiduciary discretion because of the doctrine of efficient breach.").

[31] N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007) ("While shareholders rely on directors acting as fiduciaries to

contractual commitments, however, the shareholders are still not entitled to receive or control the direction of the cash.[32] Instead, the directors must investigate their fiduciary obligations, not the shareholder's claims or desires, in order to determine how to best utilize the cash from the perspective of the firm.[33] If the directors have not delegated these decisions away to agents they hired or to third parties they pre-committed to, it is the directors' obligations alone that determine the fate of the asset.[34] In other words, the directorship fiduciary arrangement is one in which any residual obligation not contracted away resides with the director. To be sure, directors have beneficiaries,[35] but it is their residual obligation to the firm—not any shareholder's claim—that will direct the fate of the assets. This managerial format of decision-making is diametrically opposed to the claim-based nature of agency or trust.

The second defining characteristic of directorships is the existence of a *strong-form separation of ownership and control*.[36] The basic notion

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protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights.").

[32] *See* Paramount Commc'ns. Inc. v. QVC Network Inc., 637 A.2d 34, 41–42 (Del. 1994) (explaining that shareholders cannot interfere with the directors' managerial judgment).

[33] *Id.*

[34] Directors may delegate certain obligations to others. *See, e.g.,* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 943 (Del. 1985) ("The realities of modern corporate life are such that directors cannot be expected to manage the day-to-day activities of a company. This is recognized by the provisions of 8 Del. C. § 141(a) that the business and affairs of a Delaware corporation are managed "by or under the direction" of its board.").

[35] Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. Ch. 1939) ("While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders.").

[36] The chief economic work investigating this phenomenon is Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (modeling the firm as a distribution of rights in response to the costs of separating ownership and control). The pioneering legal works examining the separation of ownership and control include Adolf A. Berle, Jr. & Gardiner C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) (examining the separation of ownership and control in the context of dispersed ownership); Lucian A. Bebchuk & Christine M. Jolls, *Managerial Value Diversion and Shareholder*

of this separation is intuitive: when hiring a fiduciary, one has delegated the control over the asset to that fiduciary while still maintaining ownership of the asset. For example, hiring a dog sitter relinquishes the dog-owner's control over the dog for the hired period, but the dog owner, as their name suggests, retains their ownership over the dog. However, not all separations of ownership and control are born equal. Indeed, the separation of ownership and control exhibited by directorships is essentially different from the separation of ownership and control exhibited by agents and trustees. While both agents and trustees are entrusted with control by the principal and settlor, respectively, the principal and settlor still enjoy the ability to fully control the decisions and actions of the agent and trustee.[37] Under an agency arrangement, the principal maintains the right to provide the agent with interim instructions throughout the business relationship.[38] Under trust, the settlor can insert into the trust contract their instructions as to the management of the entrusted asset.[39] Put differently, while agents and trustees enjoy control over the relevant assets, their control rights are weak as they are always subordinated to the owner's instructions. For agents, these instructions can be given after the relationship is formed (ex post), whereas for trustees, instructions are received at the onset of the relationship (ex ante). Before the amendment and recent court decisions criticized by this Article, directors have never been subject to such instructions.[40] Corporate owners that appoint a director—as

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Wealth, 15 J.L. ECON. & ORG. 487 (1999) (theorizing that costs stemming from the separation of ownership and control cannot be fully internalized away by managerial compensation); and Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV 767 (2017) (arguing that the separation of ownership and control calls for the balancing of agency and principal costs) [hereinafter Goshen & Squire, *Principal Costs*].

[37] *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("An essential element of agency is the principal's right to control the agent's actions . . . a principal has the right to give interim instructions or directions to the agent once their relationship is established."); RESTATEMENT (THIRD) OF TRUSTS § 4 (2003) ("As shall be seen throughout this Restatement, many (but not all) of trust law consists of 'default rules,' as opposed to mandatory or restrictive rules, and is therefore subordinate to the terms (or 'law') of the trust.").

[38] RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

[39] RESTATEMENT (THIRD) OF TRUSTS § 4 (2003).

[40] DEL. CODE ANN. tit. 8, § 141 (2023); Paramount Commc'ns. Inc. v. QVC Network Inc., 637 A.2d 34, 42 (Del. 1994) ("Under normal circumstances,

opposed to an agent or a trustee—could neither use the contract nor interim instructions to subordinate the judgments of the director on how to control the asset.[41] Admittedly, the current debates attempt to question this descriptive point (what *is* the law)—arguing that managerial independence could always be contracted away via the charter.[42] Those who adopt this descriptively questionable standpoint must still address whether shareholders should be able to provide managerial instructions on normative grounds (what the law *should* be). Indeed, this Article's principal contribution is normative: I argue that mandatory managerial independence brings substantial social benefits that should not be foregone. Whether understood descriptively or normatively, or both, directorships properly understood are characterized by a strong-form separation of ownership and control—a feature both essential and unique to directors.

The strong-form separation of ownership and control, coupled with the directors' position as residual obligors, is the essence of directorships. Firms that employ directors emerge because it is cheaper and easier to blur the property rights of owners and price the clear control rights of directors. These firms separate themselves

neither the courts nor the stockholders should interfere with the managerial decisions of the directors.").

[41] *Id.*; *see also* CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 232 (Del. 2008) ("Therefore, the shareholders' statutory power to adopt, amend or repeal bylaws . . . is limited by the board's management prerogatives under Section 141(a)."); Jones Apparel Grp., Inc. v. Maxwell Shoe Co., Inc., 883 A.2d 837, 846 (Del. Ch. 2004) ("Although § 141(a) does not explicitly prohibit charter provisions affecting the board's authority that are 'contrary to the laws of this State,' a fair reading of that statute in conjunction with § 102(b)(1), as well as the fact that privately adopted charter provisions are by definition hierarchically inferior to mandatory aspects of the positive law of the State, make it clear that the ability to adopt charter provisions is not unlimited."). Recent caselaw has called this precedent into doubt, making the point that charters could be made to interfere with managerial independence, *See* New Enter. Associates 14, L.P. v. Rich, 295 A.3d 520, 556-57 (Del. Ch. 2023) (arguing, in dicta, that private ordering through the charter is broader than commonly understood, and that it can interfere with the board's managerial power, but only providing examples in statutory close corporations or statutory public benefits corporations); and McRitchie v. Zuckerberg, 315 A.3d 518, 574-77 (Del. Ch. 2024) (Explaining that charter provisions can interfere with the director authority to manage the corporation).

[42] *Id.*

from agent or trustee-led firms that emerge when it is cheaper and easier to price the clear property rights of the owners (the "residual claimants").

Remove mandatory director independence in the corporation, and many firms will not be formed, as shareholders would not be able to coordinate. First, when multiple joint owners can give orders to directors, they are bound to overuse the firm's assets until the firm is devoid of assets and cash.[43] For example, multiple joint owners of the firm may force out dividend payments whenever they find themselves in personal need of cash, without regard to the impact on the firm. With each investor fearing that other investors will pull cash first, they would be racing to extract value to the firm's ultimate demise. Second, joint owners very often cannot prevent such draining of the firm's assets contractually. With many investors holding a valid claim on the firm's assets, coordinating the various property rights effectively is often too costly a task. As Professor Michael Heller famously noted, "when too many people own pieces of one thing, nobody can use it."[44]

This Article proceeds in three parts to establish the necessity of managerial independence. Part I explains the current understanding of fiduciary arrangements and the nature of the firm. This Part sets up the legal and economic contexts for understanding the prevalent commitment to fiduciary essentialism. Part II dismantles fiduciary essentialism. The choice among agents, trustees, and directors is a critical decision: making this decision prudently calls for a revision to the theory of the firm. This Part shows that the essence of directorships lies in the establishment of firms with residual obligors and a strong-form separation of ownership and control. Part III draws out the policy implication of this theory—that corporate managerial independence must be immutable. A short Conclusion follows.

I. Fiduciary Essentialism

Whether directors could be made subject to the instructions of shareholders is understood as a consequential corporate law debate, impacting the effectiveness of corporations, but not as a fundamental

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[43] *See infra* Section II.B.

[44] Michael Heller, *The Tragedy of the Anticommons, A Concise Introduction and Lexicon*, 76 MOD. L. REV. 6 (2013).

economic question impacting the formation of firms in the first place.[45] This is false. This Part shows that this false belief emerged from an unquestioned commitment to fiduciary essentialism—the idea that choosing between hiring a contractor and hiring a fiduciary is the only fundamental step in business organization and the formation of firms. This conceptual commitment assumes that all fiduciary relationships—agency, trust, and directorship—are functionally equal and can be reduced to one economic model. After presenting the legal and economic theories that brought forth this assumption, and the resulting legal landscape, Part II shows why it is false.

Modern societies are abound with firms—people are not only exchanging goods and services individually, they also organize and coordinate with other people in order to exchange in coalitions and under the direction of an owner.[46] The question is why. To answer this question, the accepted wisdom points out that firms begin with vertical integration.[47] To fully understand what we mean by "vertical integration," consider the following question: If people are able to purchase goods and services from one another in the open market, how come some people instead choose to hire employees to complete varying tasks on an ongoing basis?[48] In other words, can we explain why people sometimes choose to hire people to work "under" their direction rather than to contract for discrete tasks with various contractors in the open market?[49] Ronald Coase famously asked and

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[45] Going further than a matter of principle are exceptions to the directorship requirement provided in statutory variants of corporations such as the close corporation. *See* DEL. CODE ANN. tit. 8, § 351 (2023) ("The certificate of incorporation of a close corporation may provide that the business of the corporation shall be managed by the stockholders of the corporation rather than by a board of directors.").

[46] *See, e.g.*, Taisu Zhang & John D. Morley, *The Modern State and the Rise of the Business Corporation*, 7 YALE L.J. 1970 (2023) (describing the rise of the business corporation).

[47] *See* Coase, *The Nature of the Firm*, *supra* note 13, at 402–03; Benjamin Klein, Robert G. Crawford, and Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. L. & ECON. 297 (1978). For a modern account of how vertical integration developed in law see Herbert Hovenkamp, *The Law of Vertical Integration and the Business Firm:* 1880–1960, 95 IOWA L. REV. 863 (2010).

[48] Coase, *The Nature of the Firm*, *supra* note 13, at 388.

[49] *Id.*

answered these questions in his seminal work, *The Nature of the Firm*.[50] His answer remains the backdrop of both economic and legal analyses of firms to this very day: individuals sometimes choose to hire and work for another person because there are efficiency gains and cost-saving benefits to having an owner-entrepreneur organize and price the exchange of goods and services between people.[51] As the argument goes, vertical integration is beneficial, up to a certain point, when the owner-entrepreneur is a better pricing authority, for all involved, than the free market.[52] The owner-entrepreneur receives benefits because they get to save the transaction costs of having to negotiate and enter into an inordinate number of contracts for each task they need to complete.[53] They also benefit from economies of scope: the synergies of having multiple skill sets under one roof.[54] The employee benefits from the ability to receive a long-term and committed purchaser of their skills, without suffering the risks and costs of continuously having to locate discrete customers.[55]

This beneficial exchange is the first ingredient for the formation of firms.[56] But notice that the market does not disappear, nor does it become subsumed under one gigantic firm.[57] This is because the benefits of transacting within a firm are limited by the economic conditions in which they are present.[58] Sometimes it makes more financial sense to act as a contractor.[59] This is a fact that we are well familiar with in our daily lives. For instance, musicians usually prefer

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[50] *Id.*
[51] *See* Easterbrook & Fischel, *Contract and Fiduciary Duty*, *supra* note 14, at 426–27; Grossman & Hart, *The Costs and Benefits of Ownership*, *supra* note 14,at 693–95; Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1419–20 (1989).
[52] *See* Williamson, *supra* note 14, at 123–25.
[53] *See* Stephen G. Marks, *The Separation of Ownership and Control*, in 3 ENCYCLOPEDIA OF LAW AND ECONOMICS: THE REGULATION OF CONTRACTS 694–95 (Boudewijn Bouckaert & Gerrit de Geest eds., 2000).
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] *See* Williamson, *supra* note 14, at 123–25.
[58] *Id.*
[59] *See* Eric A. Posner, *The Economic Basis of the Independent Contractor/Employee Distinction*, 100 TEX. L. REV. 353, 353–59 (2021) (providing a model for the distinction and tradeoffs between contractors and employees).

to have various contracts with multiple venues and events while investment professionals tend to work for banks or private investment firms.[60]

The Coasean answer initiates our understanding of the firm, but it does not explain everything. Coase shows us why we see owner-entrepreneurs hire employees, and why employees choose to work for owner-entrepreneurs.[61] Yet, there remain a few elements of the firm that this explanation leaves unresolved. Subsequent works in both economics and law embarked on identifying many of these elements. First, notice that the vertical integration identified by Coase works "downstream." While we understand why entrepreneurs hire employees, we still need to understand why entrepreneurs recruit investors to become new owners, and, conversely, why we see non-entrepreneur owners invest in others' entrepreneurial projects.[62] In other words, "upstream" vertical integration must also be explained. Second, we must also understand why owner-entrepreneurs sometimes choose to jointly pursue economic projects with other owner-entrepreneurs.[63] Stated visually, we must also understand lateral or "horizontal" integrations. In sum, these upstream and downstream vertical integrations, together with any horizontal integrations, comprise the coordinate system of the firm as currently understood and reflected in the law.[64] The following paragraphs present the contemporary understanding of these remaining integrations.

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[60] *See, e.g.,* Thomas M. Murray, *Independent Contractor or Employee? Misplaced Reliance on Actual Control Has Disenfranchised Artistic Workers Under the National Labor Relations Act*, 16 CARDOZO ARTS & ENT. L.J. 303, 339 (1998) (describing the typicality of musicians facing the contractor arrangement); Mark J. Roe, *Structural Corporate Degradation Due to Too-Big-to-Fail Finance*, 162 U. PA. L. REV. 1419 (2014) (providing a comprehensive analysis of "too-big-to-fail" financial firms).

[61] Coase, *The Nature of the Firm*, *supra* note 13, at 402–03.

[62] *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 532 (8th ed., 2011) (discussing the separate problem of raising capital in firms as a decision among the different kinds of firms).

[63] *See* Valeria Gattai & Piergiovanna Natale, *A New Cinderella Story: Joint Ventures and The Property Rights Theory of The Firm*, 31 J. ECON. SURV. 281 (2014) (providing a comprehensive survey of the economic literature discussing co-ownership in the firm).

[64] *Id.*

Enter the separation of ownership and control. The second ingredient in the formation of the modern firm is the economic and legal ingenuity that allows owner-entrepreneurs to sell parts of their ownership stake to investors, in exchange for capital investments in the firm.[65] This upstream integration comprises a beneficial exchange for both the entrepreneur and the investor.[66] In a nutshell, the entrepreneur benefits from being able to pursue projects they otherwise would not have had the money to pursue, and they also enjoy the spreading of the risk in case the business fails.[67] The investor, for their part, benefits from the possibility of deriving profits from businesses they otherwise would not have been able to pursue, and without having to do any of the work of managing a business.[68] For example, imagine a house construction company. If the owner of the house construction company decides to stop subcontracting their cabinet work to others, and instead hire a cabinet specialist into the fold, they would be engaged in downstream vertical integration.[69] If the owner also realizes that the cost of raw materials and salaries hinders their ability to take on more customers, the owner may decide to bring in an investor as a co-owner. This move also reduces the ownership risk: there is now another person on the line for any liabilities and losses that the business may incur.[70] The integration of the investor into the company is an upstream vertical integration. Notice that this upstream vertical integration creates a feature that is unique to firms—a separation of ownership and control.[71] There is now at least one investor with ownership rights who does not simultaneously control and manage the firm's affairs.[72]

Part II shows that the degree to which we can properly describe some as having "ownership rights" and others as having "control rights" is not always clear.[73] At this juncture, however, it is sufficient to say that ownership rights without control rights come in a variety of different

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[65] *See* Henry Hansmann, *Ownership of the Firm*, 4 J.L. ECON. & ORG. 267, 269–72 (describing the various models of investment in the firm).
[66] *See* POSNER, *supra* note 62, at 536–44.
[67] *Id.*
[68] *Id.*
[69] *See supra* notes 53–55 and accompanying discussion.
[70] *See* POSNER, *supra* note 62, at 532–33.
[71] *See* Jensen & Meckling, *supra* note 36, at 305–08.
[72] *Id.*
[73] *See* discussion *infra* Section II.A.

expressions. One such expression is fundamental and important to address at this stage: the ability to raise debt investments in the firm.[74] It is a commonplace and essential feature of the firm that businesses are able to borrow money as the firm itself, and that lenders are able to recover assets from the firm itself.[75] If a flooring company borrows money from the bank, the bank is the lender and the company itself is the debtor. If the loan is not repaid, the bank may recover the assets of the flooring company, but not the assets of those who own the company. This economic and legal technology allows us to treat the firm as a separate entity, whose personal lenders (for instance, the flooring company's bank lender) have priority over the lenders of the firm's owners (for instance, any bank who funds a mortgage for the flooring-company owner's home).[76] This partitioning of assets between firms and owners allows the market to develop lenders who have ownership rights over the cashflows of the firm (for example, by a right to have the loan repaid) but no control rights over the management of the firm.[77] Upstream vertical integrations thus brings about a few iterations of the separation of ownership and control that allow the modern firm to attract capital investments into its business ventures.

Both forms of vertical integration—upstream and downstream— bring about another elementary feature of the firm: noncontractibility.[78]

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[74] Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 390 (2000) (theorizing this feature as the essential role of organizational law).

[75] *Id.* at 393 ("The separation between the firm's bonding assets and the personal assets of the firm's owners and managers—is the core defining characteristic of a legal entity, and establishing this separation is the principal role that organizational law plays in the organization of enterprise.").

[76] *Id.* at 394–95; *see also* Henry Hansmann, Reiner Kraakman, and Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1335, 1336 (2006) (coining the term "entity shielding" as the function of protecting firm assets form personal creditors).

[77] In practice, these lines are blurred when lenders acquire contractual mechanisms that de facto control the firm across various dimensions. *See* Tomer S. Stein, *Debt as Corporate Governance*, 74 HASTINGS L.J. 1281, 1290–1303 (2023) (theorizing the role of debt investors and contracts in corporate governance).

[78] *See* Grossman & Hart, *The Costs and Benefits of Ownership*, *supra* note 14, at 696–97 (modeling noncontractibility); William W. Bratton, *Dividends, Noncontractibility, and Corporate Law*, 19 CARDOZO L. REV. 409, 421–24

When an owner-entrepreneur either hires an employee or brings in an investor, there are many future events and contingencies that may or may not occur.[79] As a result, the contracting parties are unable to predict and specify how their contractual arrangement should ensue in all possible iterations of the future world.[80] This is true both because not all information about the future is available and because the cost of drafting contractual provisions for every known future event would be prohibitively high and time consuming.[81] We can thus observe that contractual relations within the firm exhibit noncontractibility.[82] In other words, a firm is a business arrangement under incomplete contracts.[83] As a result, parties to this arrangement must abide by a secondary set of norms that will tell them how to run the firm and manage its assets when the contract does not stipulate how to do so.[84] That is, the default rules of the firm—identified as either agency, partnership, or corporate law—must pick up what the firm's contracts

(1997) (explaining noncontractibility in the context of agency costs and capital structure).

[79] This problem is not exclusive to hiring contracts. For a general assessment of this problem see Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CAL. L. REV. 2005 (1987).

[80] *See, e.g.*, Victor P. Goldberg*, The Law and Economics of Vertical Restrictions: A Relational Perspective*, 58 TEX. L. REV. 91, 95–96 ("If parties were omniscient and saintly, the structuring of their relationship would present no difficulty. But, in fact, they must make their decisions in a world in which information is imperfect and improvable only at a price, and in which people behave strategically or opportunistically.").

[81] *See* Tomer S. Stein, *Rules vs. Standards in Private Ordering*, 70 BUFF. L. REV. 1835, 1853–54 (2022) (modeling the costs of formulating detailed contractual provisions).

[82] Easterbrook & Fischel, *Contract and Fiduciary Duty*, *supra* note 14, at 426–27; Grossman & Hart, *The Costs and Benefits of Ownership*, *supra* note 14, at 696–97.

[83] Jonathan R. Macey, *Corporate Law and Corporate Governance A Contractual Perspective*, 18 J. CORP. L. 185, 186 (1993) ("Now it seems clear that the role of corporate law is to reduce the costs of entering into business relationships, and the primary way in which this is done is by crafting standard-form contracts which greatly reduce the costs of organizing a business venture to the various parties, shareholders, entrepreneurs, and managers. It would be incalculably costly for the various parties to such a long-term relationship to specify all of the terms and conditions of that relationship in a single agreement, because future conditions are complex and uncertain.").

[84] *See, e.g.*, *id.*; Grossman & Hart, *The Costs and Benefits of Ownership*, *supra* note 14, at 696.

have left unregulated.[85] Under the current wisdom, these laws ought to identify the person who shall have the default or residual authority to make decisions when the firm's contracts do not expressly confer this authority to another individual.[86] For example, if the contract between our home builder and cabinet manufacturer does not specify who has the right to decide on the color of the cabinets, this decision will be left in the hands of the person who has the residual claim over the home-building process. Fittingly, the right to make this decision is referred to in the literature as the residual right.[87] The accepted wisdom holds that residual rights sit with the entrepreneur-owner, and that is precisely what makes the owner an owner.[88] Put differently, ownership of a firm is defined by the ability to direct the firm when the contract does not.[89] Formally, owners in a firm are those who have both contractual and residual rights—they are the residual claimants.[90]

The property rights theory of the firm models the distribution of residual rights in this manner to helpfully recast the upstream and downstream vertical integrations explained above.[91] Because owners of firms emerge in response to their effective pricing advantage over the market, it makes economic sense to recognize them as the residual rightsholders of the firm as well.[92] This theory also helps us understand why some firms have multiple owner-entrepreneurs, or why some firms exhibit horizontal integration.[93] Separately from the firm's ability to subsume investors and employees, firms also exhibit the feature of joint ownership and control.[94] Many firms derive great benefits from the ability of entrepreneurs to pursue joint ventures

85 Macey, *supra* note 83, at 186.

86 *Id.*

87 *See, e.g.*, Posner, *supra* note 59, at 361.

88 *Id.* at 362 ("The parties will assign the property interest (that is, car ownership) to the party whose use of residual control is more likely to maximize the surplus of their interaction.").

89 Grossman & Hart, *The Costs and Benefits of Ownership*, *supra* note 14, at 696.

90 *Id.* at 716 ("Ownership is the purchase of these residual rights of control.").

91 *Id.*

92 *Id*; *see also* Philippe Aghion & Richard Holden, *Incomplete Contracts and the Theory of the Firm: What Have We Learned over the Past 25 Years?*, 25 J. ECON. PERSP. 181 (2011) (synthesizing the relevant literature).

93 *See, e.g.*, Gattai & Natale, *supra* note 63, at 281–83 (examining the phenomenon and relevant literature).

94 *Id.*

under joint ownership and control.[95] This feature, identified as horizontal integration, comprises the last feature in the modern theory of the firm.[96]

If two or more coventurers provide roughly equal contributions to the business, it may not be a desirable result for only one of them to be the residual claimant or rightsholder.[97] For example, imagine that Jack, a printer expert, and John, an ink expert, decide to work together in order to open a printing shop in a nearby college town. Should Jack hire John or should John hire Jack? The answer, in many circumstances, is neither. Can John and Jack specify all of their rights and obligations in a contract? The answer is, almost always, no.[98] If so, what is the solution to this problem of noncontractibility? Since both Jack and John are about equally vital to the firm's success, and both should be incentivized to flexibly improve the firm's performance over time, Jack and John may be best off running the firm as co-owners, with each bearing a portion of the residual rights over the firm.[99] The noncontractibility and residual claimant phenomena thus also explain horizontal integration in the firm.[100]

These elementary building blocks of firm integration do not only describe how firms are formed. They also provide the first step towards normative recommendations for the improvement and subsistence of the firm. Chief amongst these recommendations comes from the well-known problem of agency costs.[101] If vertical integration creates a separation of ownership and control, what incentive does the controller have to properly manage the firm? After all, the controller is not an owner: they are managing other people's money.[102] Imagine hiring a house sitter for the weekend. Can you trust

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[95] *Id.*
[96] *Id.*
[97] *See, e.g.*, Christoph Lulfesman, *Research Collaborations with Sequential Investments*, 71 ECONOMICA 241, 242–54 (2004) (modeling scenarios where joint ownership outperforms single residual-claimant structures).
[98] *See supra* notes 78–82 and accompanying discussion.
[99] *See* Lulfesman, *supra* note 97, at 242.
[100] Gattai & Natale, *supra* note 63, at 282.
[101] *See* Jensen & Meckling, *supra* note 36, at 305–08 (modeling agency costs).
[102] ADAM SMITH, THE WEALTH OF NATIONS 700 (Edwin Cannan ed., 1937) (describing this misalignment in managerial incentives); *see also* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288,

them to water your plants exactly in the intervals you prescribed? Sometimes, yes, but other times, no. Maybe your house sitter is more incentivized to continue watching their favorite Netflix show than they are to get up and quench your beloved lily's thirst. This problem—the agency costs problem—is the focal point of normative and legal interventions in the firm.[103] Since the preferences and incentives of the owners and the controllers do not always align, the law should be designed to alleviate these agency costs: the costs incurred by the controllers' management of the firm's assets.[104] On the flip side, recall that the reason for the separation of ownership and control in the first place is that it is beneficial to many owners to have a controller who is an expert in running the firm's business.[105] It is therefore critical to not regulate agency costs too strongly: tight regulations might eliminate the controllers' ability to make expert decisions that benefit the firm.[106] The seesaw that is the normative theory of the firm thus features a constant struggle to balance agency costs and managerial expertise.[107]

This theory of the firm is center stage in today's most divisive business law issues. Should corporate law be modified to allow shareholders to contract for the control of the director's dividend decisions through shareholder agreements, the charter, or the bylaws?[108] Should corporate boards be allowed to execute share buyback plans?[109]

288–89 (1980) (reconfiguring the agency cost problem in the context of modern capital markets).

[103] *See, e.g.*, Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine*, 121 COLUM. L. REV. 2563, 2574 (2021) ("Normative overlay of what constitutes 'good' corporate governance swiftly emerged and came to dominate debates in law and business. Scholars imported economic concepts into corporate law and added a normative lens, mixing the term corporate governance with the principal-agent model.").

[104] *Id.* 2577–78 (describing the historical dominance of this understanding of the corporation).

[105] Goshen & Squire, *Principal Costs*, *supra* note 36, at 796–98.

[106] *Id.* at 826–27.

[107] *See, e.g., id.*; Nixon v. Blackwell, 626 A.2d 1366, 1378 (Del. 1993) ("While the court is not expected to substitute its business judgment for that of the directors in areas where particular business expertise is an ingredient of the decision, the reasonableness of the business judgment of the conflicted directors' decision must be examined searchingly through a principled and disciplined analysis.").

[108] *Id.*

[109] *See generally* Jesse M. Fried & Charles C.Y. Wang, *Are Buybacks Really*

Should these boards be able to unilaterally dispel takeover and shareholder activist campaigns?[110] Should Wall Street's managers be allowed to ignore corporate social responsibility concerns?[111] Should 401(K) providers, or the so-called institutional investors, be trusted with the people's corporate voting rights?[112] Would any of these reforms be economically viable or efficient?

Shortchanging Investment?, HARV. BUS. REV., (March–April 2018) (arguing that shareholder payouts are not as excessive as commonly believed); Nitzan Shilon, *Stock Buyback Ability to Enhance CEO Compensation: Theory, Evidence, and Policy Implications*, 25 LEWIS & CLARK L. REV. 303 (2021) (arguing that buybacks create distorted incentives and conflicted compensation schemes).

[110] *See generally* Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (arguing for a comprehensive reform to the rights of shareholders of public corporations); John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. Corp. L. 545, 548 (2016) (providing an explanation for the rise of shareholder activism); Zohar Goshen & Reilly S. Steel, *Barbarians Inside the Gates: Raiders, Activists, and the Risk of Mistargeting*, 132 YALE L.J. 411, 464–80 (2022) (arguing that shareholder activists are more likely to be harmful than corporate raiders).

[111] *See generally* Jill E. Fisch & Steven D. Solomon, *Should Corporations Have a Purpose?*, 99 TEX. L. REV. 1309 (2021) (advocating for an instrumental understanding of the corporate purpose); Kevin V. Tu, *Socially Conscious Corporations and Shareholder Profit*, 84 GEO. WASH. L. REV. 121 (2016) (exploring the merits of benefit corporations as a mechanism for socially conscious corporations); Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91 (2020) (arguing against stakeholderism); Sarah C. Haan, *Corporate Governance and the Feminization of Capital*, 74 STAN. L. REV. 515 (2022) (demonstrating the impact of gender politics on corporate governance theory and practice).

[112] *See generally* Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders be Shareholders*, 100 B.U. L. REV. 1753 (2020) (advocating for the voting rights of institutional investors and modeling their benefits); Jill E. Fisch, Assaf Hamdani & Steven D. Solomon, T*he New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17 (2019) (developing a comprehensive theory of passive institutional investors); John D. Morley, *Too Big to Be Activist*, 92 S. CAL. L. REV. 1407 (2019) (arguing that institutional investors are not likely to be active corporate governance players); Lucian A. Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721 (2019) (modeling the expected growth of institutional investors); Lawrence A. Cunningham, *The Case for Empowering Quality Shareholders*, 46 B.Y.U.L. REV. 1, 3 (2020) (arguing for the empowerment of quality shareholders rather than a binary and narrow decision

These questions, and many others like them, are important. Yet, the theory of the firm as currently formulated and understood is not equipped to provide adequate answers. Specifically, this theory is deficient in that it treats *all* agents, trustees, and directors as bringing to the table a similar package of rights, obligations, and agency costs and benefits. Treating all agents, trustees, and directors as economic equals is misguided. This conflation, tagged as "fiduciary essentialism," hampers the existing recommendations for improving business law and its effect on society. The following Part fully explains the shortcomings of "fiduciary essentialism" and offers a novel account of directorships and, correspondingly, a revision of the theory of the firm, as a solution.

II. Why Fiduciary Essentialism is Wrong: The Case of Directorships

Part I explained the emergence of firms without specifying the type of entity involved (for instance, corporation, partnership, or limited liability company) and the type of fiduciary hired (agent, trustee, or director).

Why so? The answer is that, under the accepted wisdom, selection of entity and fiduciary are considered to be secondary choices. As an illustration, imagine a landscaping firm. Utilizing the theoretical tools presented in Part I, we can describe the emergence of the firm by explaining the entrepreneur's decision to hire an employee responsible for soil and an employee responsible for flowers as a choice that beats paying outside contractors for these lines of work.[113] We can further describe the entrepreneur's decision to bring in an investor as a reflection of their realization that business expansion requires an additional source of capital.[114] Whether the landscaper should organize as a corporation or as a limited liability company, and whether they should hire agents, directors, or trustees (or a mix of all three) is a mere secondary and follow-up choice that presents itself once we know about the landscaper's decision to operate as a firm. While this understanding of the firm is entrenched in both legal and

between time-bound investors).

[113] *See supra* notes 48–52 and accompanying discussion.

[114] *See supra* notes 65–70 and accompanying discussion.

economic theory, it suffers from a serious flaw. This understanding could only hold true if this so-called secondary choice did not fundamentally change the nature of the firm—but it does.

This Part of the Article demonstrates that hiring directors, as opposed to agents and trustees, profoundly affects the nature of the firm. Directorships fundamentally differ from both agency and trust relationships. Directors, agents, and trustees are all fiduciaries, but not all fiduciaries are created equal. Bringing the existing fiduciary relationships under a common roof—a reductionist methodology identified here as fiduciary essentialism—is consequently a mistake.[115]

[115] It is important to distinguish the theory presented in this Article from two exceptionally important and influential theories that do not commit to fiduciary essentialism. First is the "team production model" pioneered by Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (theorizing that corporations are best understood as the result of productive activities by two or more individuals or groups in the corporate "team"). While team production may be a useful economic analogy to how corporations sometimes de facto operate, this theory does not purport to explain the directorship as an independent economic organizational form that explains the emergence of firms. Also, this theory understands directors as product of contracts and control by non-owner stakeholders such as employees. Second is the "director primacy" theory developed by Stephen Bainbridge in works such as Stephen M. Bainbridge, Director Primacy: *The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) (arguing that directors rather than shareholders control the corporation, but that directors do so for the benefit of shareholders) and Stephen M. Bainbridge, *Why A Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1 (2002) (advancing an understanding of boards of directors as desirable groups of decisionmakers). The theory proposed in this Article differs from Bainbridge's director primacy theory first because it explains directors as maximizing the value of the firm, not any set of shareholders, and that blurring ownership rights by investors is precisely why directorships emerge, and second because it does not view group decisionmaking as an important part of the directorship arrangement. As an initial matter, corporate law allows boards of one director. *See* DEL. CODE ANN. tit. 8, § 141 (b) (2023) ("The board of directors of a corporation shall consist of 1 or more members, each of whom shall be a natural person."). Further yet, directors bear their fiduciary duties individually and not as a group. Directors may be sued individually and even if the remaining board members are not sued. *See, e.g.*, *In re* Tyson Foods, Inc., 919 A.2d 563, 587 (Del. Ch. 2007) ("The only directors for which sufficient conflicts are alleged . . . ."). Conceptually, in order to understand the functioning of the board, one first needs to articulate the singular owner-director relationship. The owner's subsequent hiring of multiple directors is no different from hiring multiple contractors, agents, or trustees and requiring them to consult and vote as a

Directorships embody two characteristics that are both fundamental and unique. These characteristics, not present in agents and trustees, are the directors' status and functioning as the firm's residual obligors and the strong-form separation of ownership and control. In subsections A and B, I develop these characteristics and evaluate their impact on voluntary organization. Subsequently, Part III demonstrates that the new law merging ownership and control promises to undo these features and thus be economically catastrophic.

A. Directors as Residual Obligors

The first essential feature of directorships is the employment of a residual obligor. Other fiduciary arrangements, such as a principal-agent relationship, are defined by the existence of a residual claimant and the distribution of residual rights.[116] Directorships turn this around. In directorships, it is the distribution of residual duties and obligations, not rights or claims, that define the content of the fiduciary arrangement. A careful examination of the residual claimant phenomenon shows why this is the case and why both the legal and the economic theories that study the nature of the firm have missed this all-important point.

Let us start with the phenomenon of residual claimant as understood in the legal tradition. To do so, it is important to first examine the rights framework employed by the law of business associations and the people who theorize and practice it. To begin, the totality that is the ownership of an asset is often understood and described as a "bundle of rights."[117] The analytical point depicted by this imagery is that the concept of a "right" to an asset can be fragmented down to

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group.

[116] *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("An essential element of agency is the principal's right to control the agent's actions . . . a principal has the right to give interim instructions or directions to the agent once their relationship is established."); RESTATEMENT (THIRD) OF TRUSTS § 4 (2003) ("As shall be seen throughout this Restatement, many (but not all) of trust law consists of 'default rules,' as opposed to mandatory or restrictive rules, and is therefore subordinate to the terms (or 'law') of the trust.").

[117] For one of the seminal works employing this depiction see WESLEY N. HOHFELD, FUNDAMENTAL LEGAL CONCEPTIONS AS APPLIED IN JUDICIAL REASONING AND OTHER LEGAL ESSAYS 67 (Walter W. Cook ed., 1923).

particular manifestations.[118] For instance, in real property, one can have a "right to access" a property but not a "right to sell" a property.[119] The same holds true in the context of firm ownership.[120] In this context, the right to a firm is often bifurcated to two general categories of a right—control rights and cash-flow rights.[121] Control rights are rights that allow its bearer to direct an asset and decide how it is used.[122] Cash-flow rights are rights that entitle its bearer to receive certain quantities of value (for example, dollars) that the asset may generate.[123] The reason that the directorship's use of the residual obligor feature was missed in favor of the residual claimant feature is due to a misunderstanding of how control and cash-flow rights are distributed in the corporate form.

Owners of a corporation are typically denoted as the equity holders, stockholders, or shareholders of the corporation.[124] As the typical story unfolds, shareholders of a corporation have weak cash-flow rights.[125] This is because shareholders are not entitled to receive any cash from the firm. While shareholders may earn cash or other valuable assets in the form of a dividend payment from the corporation, this is an entirely contingent and discretionary event that is up to the judgment of the corporate directors.[126] The weakness of the shareholders' cash-

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[118] Jeanne L. Schroeder, *Chix Nix Bundle-O-Stix: A Feminist Critique of the Disaggregation of Property*, 93 MICH. L. REV. 239 (1994) (providing useful presentation of this model and compelling critique thereof).

[119] *See, e.g.*, Morton v. State, 104 N.H. 134, 138, 181 (1962) ("It seems to us clear that McKee did have such easements and that his right of access included not only his right to go to and from his land, but also to have his premises accessible to others.").

[120] *See, e.g.*, CML V, LLC v. Bax, 28 A.3d 1037, 1043 (Del. 2011) ("Ultimately, LLCs and corporations are different; investors can choose to invest in an LLC, which offers one bundle of rights, or in a corporation, which offers an entirely separate bundle of rights.").

[121] *See, e.g.*, Lucian A. Bebchuk, Reinier Kraakman & George G. Triantis, *Stock Pyramids, Crossownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP 445 (Randall K. Morck ed., 2000) (discussing mechanisms for separating cash-flow and control).

[122] Goshen & Squire, *Principal Costs*, *supra* note 36, at 775–76.

[123] *Id.*

[124] *See* Stockholders in WEST'S TAX LAW DICTIONARY § S3600 (2023).

[125] *See* Stein, *supra* note 77, at 1295.

[126] Baron v. Allied Artists Pictures Corp., 337 A.2d 653, 659 (Del. Ch. 1975) ("Before a court will interfere with the judgment of a board of directors in

flow rights is particularly pronounced in the event of a bankruptcy.[127] When a corporation files for bankruptcy, the corporate assets must be distributed.[128] But since claims for entitlement over assets may outweigh the value of the assets, the law also dictates the order in which the various claimants are entitled to recover assets from the corporation.[129] In other words, the law ranks priority between claims for corporate assets. Shareholders are last in line.[130] The shareholders may attempt to make a claim for a corporate asset only after all other lenders, and other parties who have a contractual right to the asset, have satisfied their claims.[131] This is the first sense in which legal scholars and practitioners invoke the notion of a "residual claimant" in the corporate and directorship context.[132] The idea here is that since shareholders can only make a claim to corporate assets after all other claims have been satisfied, their right is best described as a claim to any residual assets of the firm.[133]

But notice that this notion of a residual claimant does not translate to a right to control the assets of the corporation when the business is still in existence. Quite the opposite, it is only in the narrow legal case where the law forces the liquidation of the corporation, and ends the directorship, that the shareholders have a residual claim to the asset.[134] It is a mistake to conflate this weak cash-flow right with a strong control right. This bankruptcy use of "residual claimant," while

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refusing to declare dividends, fraud or gross abuse of discretion must be shown.").

[127] *See* Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CAL. L. REV. 745, 754 (2020) ("Accordingly, for the modern firm, the debt-equity conflict is driven by the firm's financial circumstances and solvency at any given point in time.").

[128] 11 U.S.C. § 726.

[129] *See, e.g.*, *id.*

[130] *Id.*

[131] *See, e.g.*, Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 218 (1941).

[132] *See, e.g.*, Ian B. Lee, *Efficiency and Ethics in the Debate About Shareholder Primacy*, 31 DEL. J. CORP. L. 533, 538 (2006) ("Shareholders are 'residual claimants' in the sense that they are entitled to whatever corporate assets are left once the 'fixed claims'—contractual obligations to creditors, employees, customers, and other participants in the corporation-have been met.").

[133] *Id.*

[134] *See* Miguel García-Posada, *Insolvency Institutions, Pledgeable Assets, and Efficiency*, 50 J. LEGAL STUD. 331, 337 (2021) (modeling legal modes of liquidation).

helpful enough, does not mean that shareholders have any right to direct the assets of the corporation otherwise. Indeed, outside of bankruptcy, shareholders never have the right to direct the fate and use of an asset.[135] During ordinary business times, shareholders cannot intervene in the management of the corporate assets even after all other contractual obligations of the corporation have been satisfied.[136] In other words, this invocation of the residual claimant feature has nothing to do with the directorship relationship.[137] Shareholders have no claim over the directors' management of the asset until both the firm and the directorship arrangements are in the process of terminating.[138]

The bankruptcy context is not the only instance in which legal scholars and practitioners invoke the notion of a residual claimant when describing corporate directorships. Shareholders as residual claimants is also invoked in justificatory and normative accounts of enumerated shareholder rights.[139] Shareholders of a corporation do enjoy many rights, but asset control is not one of those rights. Other shareholder rights include: the right to vote on the certificate of incorporation and bylaws of the corporation;[140] the right to vote on the hiring and firing of directors;[141] the right to vote on events that end or fundamentally change the corporation's existence (for instance, acquisitions and sales of "all or substantially all" of the corporate

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[135] *See* sources and discussion in *supra* notes 40–41.

[136] *Id.*

[137] *Id.*

[138] *Id.*

[139] *See, e.g.*, EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, *supra* note 14, at 38 ("One reason is obvious: a manager told to serve two masters . . . has been freed of both and is answerable to neither . . . far better to alter incentives by establishing rules that attach prices to acts . . . while leaving managers free to maximize the wealth of residual claimants subject to social constraints."); *see also* Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

[140] *See, e.g.*, DEL. CODE ANN. tit. 8, § 242(b)(1) (2023) (delineating the stockholder vote requirement for the certificate of incorporation); DEL. CODE ANN. tit. 8, § 109(a) (2023) (delineating the stockholder vote requirement for the bylaws).

[141] *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(d), (j)–(k) (2023) (delineating the director hiring and removal procedures).

assets);[142] the right to inspect the corporation's books and records;[143] the right to sue for the enforcement of these enumerated shareholder rights;[144] and the right to sue on behalf of the corporation under exceptional circumstances.[145] Since these rights both entrust the shareholders with the appointment and firing of directors, and the right to vote on the most major documents and events of the firm, normative accounts of the corporation have analyzed whether that is a good way to structure corporate governance.[146] In an effort to justify that the answer is, indeed, yes, these accounts point to the nature of the shareholders as residual claimants.[147] As the argument goes, since shareholders, as residual claimants, have the most to lose in the event that the corporation goes bankrupt, it makes sense to place the burden of regulating directors on them—the shareholders have the strongest incentive to detect and address ill-performing directors.[148]

While this invocation of shareholders as residual claimants is compelling, if not simply correct, it too does not entail that shareholders have any control rights over the assets of the corporation. It does show that shareholders have "appointment rights" over the composition of the board of directors and "governance rights" over the corporation's document and events of disposition (certain acquisition and liquidation events), but neither of

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[142] *See, e.g.*, DEL. CODE ANN. tit. 8, § 251–258 (2023) (delineating mergers and acquisitions procedures); DEL. CODE ANN. tit. 8, § 271 (2023) (delineating asset sales procedure).

[143] *See, e.g.*, DEL. CODE ANN. tit. 8, § 220 (2023) (outlining the books and records right).

[144] *See, e.g.*, Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1033 (Del. 2004) (putting forth the test for determining whether a shareholder has a right to bring a direct lawsuit).

[145] *See, e.g.*, United Food & Com. Workers Union & Participating Food Indus. Emps. Tri-State Pension Fund v. Zuckerberg, 404, 2020, 2021 WL 4344361 (Del. Sept. 23, 2021) (providing the latest doctrinal understanding of derivate shareholder litigation).

[146] *Compare Bebchuk supra* note 139*, with* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006).

[147] *See, e.g.*, EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, *supra* note 14, at 66-89 (discussing residual claimant governance in the context of shareholder voting rights.).

[148] *Id.* at 68 ("As the residual claimants, shareholders have the appropriate incentives (collective choice problems notwithstanding) to make discretionary decisions.").

these rights amounts to substantive asset management control. Regarding appointment rights, even though shareholders have the right to appoint and replace directors, it does not provide asset management rights in any important sense. This is because the same right also exists in a contractor arrangement.[149] People have a right to hire, fire, and replace their contractors as well.[150] This means that while shareholders do indeed have these so-called appointment rights, they do not render the shareholder-director arrangement as more akin to a principal-agent relationship than to a customer-contractor arrangement. It is simply a fact of a hirer-hiree arrangement. The shareholders' governance rights also do not amount to substantive asset management rights. First, regarding the shareholders' right to adopt and amend the corporate charter and bylaws, it is essential to note that, at least absent the current legal change, neither document can be used to dictate how the corporation's assets are to be managed.[151] As a matter of mandatory law, neither document was

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[149] Firing a contractor may amount to a breach of contract, but so could firing a fiduciary. *See* Rocha v. Keka Const., Inc., CIV.A. 04A-07-002ESB, 2005 WL 791362, at *9 (Del. Super. Ct. Mar. 31, 2005) (discussing how a right to fire a contractor exists but may be a breach of contract); E.I. DuPont de Nemours & Co. v. Pressman, 679 A.2d 436, 444 (Del. 1996) ("Dislike, hatred or ill will, alone, cannot be the basis for a cause of action for termination of an at-will employment.").

[150] Rocha v. Keka Const., *supra* note 149, at *9.

[151] Both the rules governing the charter and the bylaws are limited by a provision requiring compliance with "laws of this State," or "law," respectively. *See* DEL. CODE ANN. tit. 8, § 121(b)(1) and DEL. CODE ANN. tit. 8, § 109(b). As per the caselaw, these laws include the law granting directors the power to manage the corporation. *See* CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 232 (Del. 2008); Jones Apparel Grp., Inc. v. Maxwell Shoe Co., Inc., 883 A.2d 837, 846 (Del. Ch. 2004); DEL. CODE ANN. tit. 8, § 141 ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors."). Admittedly, recent caselaw seems to have understood the charter restriction, but not the bylaw restriction, more loosely. *See* New Enter. Associates 14, L.P. v. Rich, No. 2022-0406-JTL, 2023 WL 3195927, at *26 (Del. Ch. May 2, 2023); and *McRitchie v. Zuckerberg*, 2022-0890-JTL, 2024 WL 1874060, at *38-42 (Del. Ch. Apr. 30, 2024) (both cases, as also explained above, are making the point that the charter can interfere with managerial independence). *But see* DEL. CODE ANN. tit. 8, § 135 (explicitly providing the power to contract around managerial independence in close corporations, which suggests the provision was needed to be there as compared to the general corporate statute); and *Bebchuk*, *supra* note 110, at 890 ("Support for the view that the statute does not permit an arrangement that

permitted to contain substantive provisions that interfere with the directors' obligation and authority to manage the corporate assets.[152] Second, regarding the shareholders' right to vote on certain sales of the company or its assets, it is essential to understand that these votes are only relevant after the directors have provided their stamp of approval.[153] The shareholder vote is needed in order to effectuate these transactions, but only if the directors have already decided that they are in support of using the corporate assets in this manner.[154] More fundamentally, these voting mechanisms are in play only in acquisition and asset liquidation events that mark the end of the corporation and the directorship arrangement as it stands.[155] In other words, these shareholder voting rights are not a central feature of the directorship arrangement during the ordinary course of the business arrangement.[156]

While the legal concept of shareholders as residual claimants is less determinative than typically understood, it does not render it entirely false. To be clear, there is merit to describing shareholders as residual claimants in both the bankruptcy and normative iterations described above. For argument's sake, we may also concede that shareholders as residual claimants have some fringe abilities to substantively direct assets, at least in those extraordinary and firm-ending events where shareholder votes are required. The important point is, however, that we cannot rely on this notion of residual claimants as a main and defining feature of the directorship arrangement. During the life of the firm, directors have sole discretion over the assets, and any residual-claimant arrangement cannot be invoked to describe or direct the fate of the assets. This is diametrically opposed to both the agency and the trust arrangement.

The same can also be shown from within the economic tradition. Recall that in the law and economic tradition, the notion of

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confers initiative power on shareholders can be found in section 351 of the Delaware Code.").

[152] *Id.*

[153] *See, e.g.*, DEL. CODE ANN. tit. 8, § 251–258 (2023) (delineating mergers and acquisitions procedures); DEL. CODE ANN. tit. 8, § 271 (2023) (delineating asset sales procedure).

[154] *See* sources cited *supra* note 153.

[155] *Id.*

[156] *Id.*

shareholders as residual claimants is invoked in the context of noncontractibility.[157] Since an employer and a fiduciary cannot specify and predict how their arrangement should unfold in all future possibilities of the world, fiduciary duties are imposed in order to fill unavoidable contractual gaps.[158] Stated in the terms of the economic property rights theory of the firm, residual claims are distributed because contractual claims can only take us so far.[159] We need second order norms, or norms other than contractual norms, to prescribe the management of the asset when all relevant contracts fail to do so, and assigning a residual claimant is the solution.[160] While this is a good description of how trust and agency arrangements work, it is not a good description of how directorships work. As shown above, even if we can depict shareholders as residual claimants, it does not do any substantial work to fill the contractual gaps or otherwise direct the corporate assets during the life of the firm.[161] The shareholders' rights are plentiful, but they are enumerated rather than open-ended, and as importantly, they do not concern the firm's assets outside of specific, narrow, and firm-altering circumstances.[162] Missing this descriptive point leads to missing the hidden wisdom and normative prowess of the directorship arrangement.

Enter residual obligation. It is an assumption to transition from noticing that fiduciary contracts are incomplete to concluding that all fiduciary arrangements solve this problem in the same way. While agency and trust fiduciary relationships are solved by assigning residual claimants, directorships provide an alternative solution. This solution is the status and functioning of directors as residual obligors. While directorships, like other fiduciary arrangements, are incomplete contracts in need of second order norms to guide assets, directorships adopt a different kind of norm—residual obligation. When a firm's asset is not contractually committed to others (for instance, the firm's cash is not committed to lenders by form of an interest payment) and the control of the asset has not been delegated

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[157] Grossman & Hart, *The Costs and Benefits of Ownership*, *supra* note 14, at 696–97.

[158] Easterbrook & Fischel, *Contract and Fiduciary Duty*, supra note 14, at 426–27.

[159] Grossman & Hart, *The Costs and Benefits of Ownership*, *supra* note 14, at 697.

[160] *Id.*

[161] *See* discussion and sources in *supra* notes 141–151.

[162] *Id.*

to others (for example, when the firm's cash is not placed in the hands of officers who have been given the discretion to use the cash for business expenses), it is the sole obligation of the directors to utilize the asset appropriately. In other words, after all contractual obligations are satisfied, any firm obligation not vested in others is placed with the directors. Must this obligation heed the directives of the firm owners? The answer is, of course, and as a matter of law described above, no.[163]

When assessing the director's fiduciary duties, we must therefore appeal to the residual obligation structure. This feature fills the missing contractual gaps in the firm. If, for instance, the firm is receiving cash, and no other party is entitled to it (e.g., lenders) or has the directive to manage it (e.g., officers), the directors' obligation to utilize their duties of care and loyalty has been triggered. It is by appeal to this obligation, and not any shareholder desire to receive a dividend or invest the cash in another corporate project, that we can determine the fate of this asset. If, as another example, no contract specifies who has the responsibility of supervising any assigned officers, it is a duty that rests with the directors as well. In a nutshell, contractual gaps in the corporation are filled by appeal to the residual obligations of directors and not by appeal to the residual claims of the shareholders. Put differently, while shareholder rights are enumerated, director obligations are open-ended. Voluntarily undertaking the director position is an assumption by the director of any and all obligations that may arise in the firm, if not contractually transferred to others.

Analyzing this residual obligation structure and designing the legal systems that best utilize its features is a project that can unfold under both moral and economic theories of private law. Under moral accounts, we can understand the directorship arrangement as a deontological relationship. Deontological accounts of law or ethics are those in which obligations are depicted by appeal to conceptions of duties rather than by appeal to rights or the utility consequences of actions.[164] In the same way, those committed to moral accounts of

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[163] *See supra* note 151 and accompanying discussion.

[164] *See, e.g.*, Benjamin Porat, *Deciding Between Contradicting Norms: Rights-Based Law vs. Duty-Based Law and Their Social Ramifications*, 70 AM. J. COMP. L. 399, 401 (2022) (discussing differences between duty-based and

private law can structure the obligations of directors by appeal to the various conceptions of their residual obligations. If, for instance, the firm has not contractually specified who has the responsibility of ensuring a safe and inclusive work environment, it is an obligation that we can, by default, impose on the directors.

Under economic accounts, we can analyze the directorship arrangement utilizing a duty-based economic analysis of law. Per this analysis, the status of the directors as the residual obligors is put in place because the duty of the directors is a more efficient tool for the management of assets than is the market for the selling and buying of control rights over the assets. In other words, under certain circumstances, it is easier and cheaper to appoint a director with open-ended obligations than it is to maintain a clear ownership structure with a residual claimant with open-ended claims over assets. This reveals yet another hidden advantage of directorships: the directorship is the only business arrangement that replaces the residual claimant feature with the residual obligor feature, thereby providing the market with a substitute contractual default strategy for the problem of noncontractibility in the firm. Pricing residual obligors can sometimes outperform pricing residual claimants and contracting in the free market.

It is thus the status of directors as residual obligors, and not the status of shareholders as residual claimants, that defines the directorship arrangement. It is residual obligation that fills the contractual gaps and solves the directorship's noncontractibility problem. This elementary feature has been, thus far, entirely unacknowledged. Further yet, internalizing this feature is consistent with and helpful for both moral and economic accounts of the firm. Part III also shows that the implications of this feature provide concrete practical advantages in law that provide indispensable benefits to the economy. Prior to doing that, however, there is another novel feature of directorships that must be theorized and understood—the strong-form separation of ownership and control.

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rights-based law); Kenneth W. Simons, *Deontology, Negligence, Tort, and Crime*, 76 B.U.L. REV. 273, 276 (1996) (providing a deontological account of tort law).

B. Bifurcating the Separation of Ownership and Control

If directorships are business arrangements defined by the feature of residual obligation rather than claim, why do shareholders volunteer their own assets in a manner that relinquishes rights in this way? After all, couldn't shareholders choose to instead use agents or trustees and thereby maintain a strong right of control over their assets? Part of the answer is explained at the end of the previous Section: shareholders do so because it reduces transaction costs—director obligations are sometimes easier to discern and price than shareholder asset claims.[165] The other part of the answer comes from the directorship's ability to generate a strong and beneficial separation between ownership and control. While all fiduciary arrangements (agency, trust, and directorship) have some separation of ownership and control, the separation of ownership and control in agency and trust takes a weak form while the separation of ownership and control in directorships takes a strong form. This Section theorizes, models, and explains the tradeoffs between these two differing ways of separating ownership and control. Part of the reason directorships are adopted by shareholders is that it is the only business arrangement that allows for the strong-form separation of ownership and control. Together with residual obligation, these two directorship characteristics render the directorship arrangement a unique and fundamental juncture of firm formation.

To begin, imagine a convenience store owner who must sometimes devote their weekends to taking care of their children, and even, at times, make room for a vacation. To do so while still maintaining an open business, the store owner decides to hire an experienced store clerk to work over the weekends. This act alone, referred to in Part I as downstream vertical integration, introduces a separation of ownership and control.[166] During the weekends, the store clerk controls the convenience store while the store owner maintains ownership of it. Similarly, if the store owner separately decides to bring in a silent investor into the store, this upstream vertical integration will create another separation of ownership and control—the owner and the clerk will each have their turn controlling the store,

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[165] *See* discussion *supra* Section II.A.

[166] *See supra* notes 50–68 and accompanying discussion.

but the silent investor never does.[167] Why do we see this separation of ownership and control? As also explained in Part I, it is because this exchange is beneficial for both sides of the contract.[168] The hirer receives a person with time and expertise in managing a store, as well as the ability to pursue other objectives with the time saved, and the hiree receives a paying purchaser of their skills.[169]

Does this arrangement only provide benefits, or does it also impose costs? The answer is that it does, indeed, impose a robust set of costs. The literature refers to these costs, also outlined in Part I above, as "agency costs."[170] Agency costs are the costs associated with the misalignments in interest between those in control and those with ownership rights, as well as the risk of incompetent decisions on the part of those with control.[171] In our convenience store example, costs stemming from the misalignments in interest between the clerk and store owner may look as follows: since the store owner pays the store clerk a fixed salary, the store clerk does not care if the store makes, say, ten thousand or twenty thousand dollars in profits. Either way, the store owner's salary will stay the same. As a result, the clerk may sometimes choose to ignore customers in favor of, for instance, playing a game on their phone. This is a cost as it reduces the revenue of the store. To be sure, we may still expect the clerk to worry about profitability to the extent it may either increase their chances of being fired or receiving a raise, but we would not be able to rely on the clerk's self-interest for any revenue result in between.[172] Costs stemming from the clerk's possible incompetent decisions may manifest in, for example, the clerk accidently providing a customer with extra change, or in the clerk negligently ordering an inferior product to stock the shelves.[173] This is not the end of the story. Those who hire those in control, the owners, impose costs as well.[174] These

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[167] *Id.*
[168] *Id.*
[169] *Id.*
[170] Jensen & Meckling, *supra* note 36, at 305–08 (providing the predominate model of agency costs).
[171] Goshen & Squire, *Principal Costs*, *supra* note 36, at 783–84 (theorizing the totality of agency costs, and principal costs, as the sum of conflict and competence costs, respectively, and coining the relevant terms).
[172] *See, e.g.*, *id.* at 793–94 (describing agent conflict costs).
[173] *See, e.g.*, *id.* at 788 (describing agent competence costs).
[174] *Id.* at 796–808 (theorizing principal costs).

costs, too, may be the result of conflict or incompetence.[175] To illustrate via our ongoing convenience store example, conflict costs on the part of the owner may manifest in decisions that are better for the store owner but not the silent investor or the store itself. For instance, if the store owner decides that they are in immediate need of cash, the store owner may force out a liquidation of the store's assets even though those assets would have produced more cash had they remained invested for long-term returns. Owner competence costs may manifest in situations where the owner interjects with their inexpert opinions. For instance, if the owner intervenes and pressures the clerk to change how they greet the weekend customers, but it turns out that the clerk knew exactly how the weekend crowd prefers to be addressed, it may reduce revenues due to an ill-informed owner intervention. This sort of cost is even more pronounced in complex businesses that hire highly skilled managers.[176] For example, imagine a startup shareholder that forces their engineer CEO to change the development plan, despite the engineer's learned judgment.

The fiduciary arrangement thus brings about a separation of ownership and control that creates both costs and benefits.[177] Some of these costs and benefits are imposed by the hirer and some by the hiree.[178] One of the most important functions of the laws concerning fiduciaries is thus the balancing of these costs and benefits—a difficult task that judges have been incrementally developing through common law for many decades.[179] It is at this juncture that fiduciary essentialism falls short yet again—not all separations of ownership and control are equal. In fact, while the agency and trust arrangements take a similar approach to this all-important balancing act, directorships take the polar opposite approach. Agency and trust attempt to address this balancing act by tilting the scales in favor of the hirer's judgment, while directorships do so by tilting the scales in favor of the hiree's judgment. By putting the law's thumb on the

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[175] *Id.*

[176] *Id.* at 783 (describing expertise as one of the main drivers of managerial value).

[177] Jensen & Meckling, *supra* note 36, at 305.

[178] Goshen & Squire, *Principal Costs*, *supra* note 36, at 767–68.

[179] *In re* Netsmart Techs., Inc. S'holders. Litig., 924 A.2d 171, 207 (Del. Ch. 2007) ("By this means, our law seeks to balance the interest in promoting fair treatment of stockholders and the utility of avoiding judicial inquiries into the wisdom of business decisions.").

hirer's scale-end, the law creates only a weak form of the separation of ownership and control in the case of trust and agency. By moving the law's thumb to the hiree's side of the scale, the law creates a strong form of separation between ownership and control in the case of directorships.

In agency law, while the principal-owner relinquishes control to their hired agent, they always maintain the right to interject and provide the agent with interim instructions.[180] In trust, the settlor-owner that sets up the trust is free to insert any and all specifications and instructions into the trust agreement.[181] Agency and trust thus take a similar approach to the separation of ownership and control: both legal relationships are ones in which the hirer can interject and override the hiree's judgment as to the management of assets.[182] The two only diverge as to the method for doing so—while in agency the principal-owner may interject both before and after the commencement of the relationship, in trust the settlor-owner must do it contractually and at the time of forming the relationship.[183] Regardless as to whether the hirer's interjection right is limited to ex ante contractual instructions, or also carries the right to provide ex post interim instructions, it is a weak form of the separation of ownership and control. It is a weak iteration of this separation as the hiree's control rights are entirely subordinated to the owner's wishes.[184]

In directorships, however, at least absent the this latest legal change undoing managerial independence, the owner never has a right to interfere with the director's judgment.[185] That is true for both ex ante

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[180] RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("An essential element of agency is the principal's right to control the agent's actions . . . a principal has the right to give interim instructions or directions to the agent once their relationship is established.").

[181] RESTATEMENT (THIRD) OF TRUSTS § 4 (2003) ("As shall be seen throughout this Restatement, many (but not all) of trust law consists of 'default rules,' as opposed to mandatory or restrictive rules, and is therefore subordinate to the terms (or 'law') of the trust.").

[182] *Id.*

[183] *Id.*

[184] *Id. See also* Morley, *supra* note 29, at 2195–96 (describing the flexibility of trust settlors in setting up trusts as an essential feature).

[185] *See* sources and discussion *supra* notes 41 and 151 (showing the statutory and caselaw foundations of this legal autonomy on the part of corporate directors).

contractual provisions and ex post interim instruction.[186] Admittedly, there is some descriptive uncertainty regarding whether the charter has always been a permitted means for subordinating the substantive judgment of directors. Suffice it to say, for our purposes, that those who don't agree it is a proper description of the law can treat this point as normative, and those who do think it is a proper description can treat this point as both descriptive and normative.[187] Under this understanding, as a matter of law, neither the certificate of incorporation nor the bylaws may contain substantive provisions that interfere with the director's authority and obligation to manage the corporation.[188] The caselaw has first made that point when it provided a substance-procedure distinction for shareholder bylaws: shareholder bylaws may never interfere with the director's franchise by containing provisions that attempt to substantively guide the management of the firm.[189] Only procedural bylaws may be adopted by the shareholders.[190] The certificate of incorporation statute contains, at least arguably, the same limitation, and also adds a closed list of provisions that exactly delineates what must, may, or may not be contained in the certificate.[191] A fortiori, and also as matter of law, shareholder agreements, which must be subordinated to the certificate of incorporation and bylaws, cannot intervene with the director's management power either (again, prior to the passage of the very law this Article criticizes).[192] Additionally, and also as a matter of

[186] *Id.*

[187] *Id.*

[188] *Id.*

[189] CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 235 (Del. 2008) ("Such purely procedural bylaws do not improperly encroach upon the board's managerial authority under Section 141(a).").

[190] *Id.*

[191] DEL. CODE ANN. tit. 8, § 102 (provision (a) sets forth what must be contained in the charter, while provision (b) sets forth what may be contained in the charter).

[192] Abercrombie v. Davies, 35 Del. Ch. 599, 608 (1956) ("This means that our corporation law does not permit actions or agreements by stockholders which would take all power from the board to handle matters of substantial management policy."); New Enter. Assocs. 14, L.P. v. Rich, No. 2022-0406-JTL, 2023 WL 3195927, at *38 (Del. Ch. May 2, 2023) (discussing the limitation of not overtly intervening with the board's authority); *W. Palm Beach Firefighters' Pension Fund v. Moelis & Co.*, 311 A.3d 809, 829-444 (Del. Ch. 2024) (explaining that shareholder agreements cannot interfere with the director power to manage the corporation).

law, neither the shareholders nor any other party may provide the directors with interim instructions.[193] The directors are free to act as they deem appropriate, subject only to their fiduciary obligations.[194] This renders the separation between ownership and control in directorships a strong and novel arrangement. Directorships enjoy a strong-form separation of ownership and control because the hiree's (i.e., the directors') control rights are never subordinated to the owner's wishes.

The natural question that follows is why, and under what circumstances, do hirers prefer to utilize the strong-form separation of ownership and control over the more flexible weak-form separation of ownership and control. To answer this question, we must distinguish between situations in which we have just one owner considering the hiring of a director and situations in which we have many potential owners.

In the single owner circumstance, the benefit of the directorship's strong-form separation of ownership and control comes from the robust reduction in owner-imposed costs. Since the director will never be subject to intervention by the owner, the director is free to act as they see most prudent.[195] In agency, however, the hiree will always have to consider the possibility that their expert judgment will not be received well by the hirer, and, subsequently, that it will be curtailed.[196] This could potentially reduce the value of the firm as it

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[193] Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 41–42 (Del. 1994) ("Under normal circumstances, neither the courts nor the stockholders should interfere with the managerial decisions of the directors.").

[194] *Id.* For recent scholarship that has broken new grounds in analyzing the desirability of allowing private ordering governance in the corporation. *See generally* George S. Geis, *Ex-Ante Corporate Governance*, 41 J. CORP. L. 609, 610 (2016) (arguing that contract law is not a good vehicle for facilitating corporate governance by private ordering); Jill E. Fisch, *supra* note 9(providing a comprehensive analysis of shareholder agreements and arguing for legal limitations thereof); Gabriel Rauterberg, *The Separation of Voting and Control: The Role of Contract in Corporate Governance*, 38 YALE J. REG. 1124 (2021) (demonstrating the prevalence and impact of shareholder agreements).

[195] *See supra* notes 41 and 151.

[196] RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("An essential element of agency is the principal's right to control the agent's actions . . . a principal has the right to give interim instructions or directions to the agent once their relationship is established.").

will sometimes hinder the effectuation of the most thoughtful and desirable courses of action.[197] In trust, the trustee's expert judgment will be curtailed by the limiting contractual provisions that were put in place at the formation of the relationship.[198] It may be objected, at this juncture, that the trust could mimic the directorship's benefits of strong-form separation of ownership and control by including highly trustee-enabling contractual provisions.[199] Even if we concede that this possibility exists, it will require high transaction costs, as it will demand not only highly creative contracting but also significantly more time spent contracting on the front-end. And even if not particularly expensive, this only shows that sometimes trust arrangements are better off converted into de facto directorships. But even more fundamentally, as shown below, this contracting around is precisely what is not feasible in multiple owner circumstances.

Prior to addressing the unique benefits that the strong-form separation of ownership and control provides multi-owner firms, it is important to note that the single-owner benefits of the strong-form separation of ownership and control do not cease to exist simply because we transitioned from a single owner firm to a multiple owner firm. It is still the case that the strong-form separation of ownership and control provides the multiple owners with a very strong reduction in owner-imposed costs. This reduction in costs may be even more pronounced in the multi-owner circumstance because the various owners may bring additional conflict costs and increase the chances of having at least one ill-informed owner.[200]

The directorship's strong-form separation of ownership and control provides unique benefits to multiple-owner firms under two general circumstances. First are circumstances in which having too many owners with control rights will lead to an uncoordinated depletion of

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[197] *See* Goshen & Squire, *Principal Costs*, *supra* note 36, at 796–808.

[198] RESTATEMENT (THIRD) OF TRUSTS § 4 (2003) ("As shall be seen throughout this Restatement, many (but not all) of trust law consists of 'default rules,' as opposed to mandatory or restrictive rules, and is therefore subordinate to the terms (or 'law') of the trust.").

[199] For a recent discussion and critique of highly enabling trusts see Hanoch Dagan & Irit Samet-Porat, *What's Wrong with Massively Discretionary Trusts*, 138 L. Q. REV. 629 (2022).

[200] *See* Goshen & Squire, *Principal Costs*, *supra* note 36, at 791–93.

the firm's assets, or a "Tragedy of the Commons."[201] Second are circumstances in which many would-be owners of the firm are unable to coordinate and form a firm because, although it would be beneficial for all, it is contractually impractical due to the inordinate volume and complexity of the various property rights involved. In other words, the second set of circumstances denotes a "Tragedy of the Anticommons."[202]

Imagine a rich and public pasture surrounded by many farmers with large herds. If all the farmers were to selfishly extract as much feed time from the pasture as possible, they would quickly destroy the pasture indefinitely.[203] If, however, they were able to coordinate and take turns prudently, the pasture may survive and provide feed time for all, and for a long period of time.[204] This coordination problem and example is famously dubbed the "Tragedy of the Commons."[205] The same sort of problem occurs in the firm context. Imagine a technology company competing for market share of the fully autonomous vehicle category. If all the shareholders were to selfishly pull dividends out of the corporation whenever they were in need of cash, the corporation will not be able to sustain the long-term investment and patience required to develop winning products in this slowly emerging market. If, however, the shareholders were able to coordinate a system that effectively distributed dividends and long-term asset investments, the firm will have a fair chance to succeed in the market and provide even greater value in the future. This is precisely where the directorship's strong-form separation of ownership and control comes into play and provides a solution. By depriving shareholders of the ability to force the directors' hands and provide them with the interim instructions to, for instance, pay dividends as they please, the directors enjoy the control rights necessary to effectively coordinate the firm's assets. The strong-form separation of ownership and control provides the controllers—the

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[201] Garrett Hardin, *The Tragedy of the Commons*, 162 SCIENCE 1243 (1968) (coining the term and defining the concept "tragedy of the commons").

[202] Michael A. Heller, *The Tragedy of Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621, 622 (1998) (coining the term and defining the concept "tragedy of the anticommons").

[203] Hardin, *supra* note 201, at 1244.

[204] *Id.*

[205] *Id.*

directors—with the necessary freedom and discretion to coordinate the firm's assets effectively. But for the directors enjoying this discretion, the various shareholders will tend to abuse their rights in the firm, and eventually destroy its value.

The strong-form separation of ownership and control also provides a solution to the "Tragedy of the Anticommons."[206] A natural objection to the analysis of directors as a solution to the tragedy of the commons reveals why that is the case. It may have been objected that while directors could indeed act as a coordination mechanism that solves the problem of overusing the firm's assets, the shareholders could have just solved it amongst themselves. Extrapolating on this objection, can the shareholders just agree to craft contractual provisions that would prevent them from misusing firm assets? Why is it that shareholders can agree to the hiring of a director but not just agree to use the firm assets prudently? The answer is that, under many circumstances, it would be contractually infeasible to do so. Without the introduction of the directorship, there will be an inordinate number of property rights over the firm's assets that will compete for control of the assets. Even the most detailed contractual arrangements could not solve the fundamental contractibility problem of having multiple residual claimants over firm assets. In essence, it is never possible to specify how assets should be managed in all future contingencies that may occur, at which point the various residual claimants will be placed in an unresolvable coordination problem with one another. Boiled down to its fundamental elements, this problem is rather intuitive—"when too many people own pieces of one thing, nobody can use it."[207] As an illustration, consider the problem encountered by Michael Heller, the first scholar to discover the tragedy of the anticommons.[208] Heller was approached by a drug company that potentially discovered a solution to Alzheimer's, but could not develop the treatment because there were too many patent holders that they would have to coordinate with.[209] In other words, a firm that could produce a solution to Alzheimer's could not emerge due to the problem of too many property rights holders to

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[206] Heller, *supra* note 202, at 622.

[207] Michael Heller, *The Tragedy of the Anticommons, A Concise Introduction and Lexicon*, 76 MOD. L. REV. 6 (2013).

[208] *Id.*

[209] *Id.*

contractually coordinate with.[210] To begin solving this problem, as explained in Section A of this Part, the unreasonable cost of competing residual claimants is avoided by using the directorship's residual obligation structure.[211] The various entrepreneurs can coordinate around the anticommons problem by not negotiating and coordinating their property rights, and instead relinquishing their status as residual claimants in favor of appointing a residual obligor. Together with the strong-form separation of ownership and control, the directors are also able to remain undisturbed as they prudently organize and consider the various owners in their management of the firm. In other words, the directorship's strong-form separation of ownership and control allows the various property holders to intentionally commit themselves and pool their assets together, blur their individual property rights, and hire a residual obligor, a director, with faithful but uninterrupted control over the firm's assets.

Fiduciary essentialism is therefore a false and misleading theoretical commitment because it fails to acknowledge that not all fiduciaries are the same. Directorships are essentially different from other fiduciaries. Failure to acknowledge these differences has left a gaping hole in the current theory of the firm that this Article resolves. Directorships both replace the usage of the residual claimant structure with a residual obligor structure, and offer a strong-form of separation between ownership and control. Together, directorships provide an organizational solution that, under the prescribed circumstances, dramatically reduces the costs of ownership and enables the formation of firms that would otherwise not occur or sustain. The following Part transitions from theory to policy—it shows that fully internalizing the virtues of directorships requires that managerial independence be treated as an immutable right.

III. The Law of Management Rights

The prior Part showed that residual obligors with a strong-from separation of ownership of control are a necessary organizational form. It follows, therefore, that rules that subordinate the directors' managerial judgment are harmful, as they would disable a significant

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[210] *Id.*

[211] *See* discussion *supra* Section II.A.

volume of productive economic activity. This Part builds on this insight to argue that the law set to merge corporate ownership and control on August 1st, 2024 should be repealed. Specifically, Section III.A first shows that both the law itself and its common objections misguidedly attempt to treat corporate managerial independence as a default rather than mandatory rule, and that they differ as to "altering rules" only—the rules that govern how contracting parties can deviate from the established default.[212] Second, Section III.B explains why, to the contrary, the rules regarding the ability to specify the corporate purpose in the charter and the ability to opt into corporate variants and other entities with contractual freedom (e.g., limited liability companies and close corporations), do not run afoul of the need for mandatory managerial independence.

A. Mandating Managerial Independence

Delaware's Vice Chancellor Laster, in two recent and profound decisions, articulated the view that Delaware law does not allow shareholder agreements to circumvent the director's managerial rights but that the charter does (henceforth, the *judicial approach*).[213] The Council of the Corporation Law Section of the Delaware State Bar Association, on the other hand, offered a proposal that would allow shareholder agreements to intervene in the manager's business judgments as well (henceforth, the *legislative approach*).[214] In what has been described as a fast and furious amendment process, the legislative approach was officially adopted, and is set to become

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[212] Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 Yale L.J. 2032, 2036 (2012) ("Altering rules are the necessary and sufficient conditions for displacing a default legal treatment with some particular other legal treatment.").

[213] *See W. Palm Beach Firefighters' Pension Fund v. Moelis & Co.*, 311 A.3d 809, 829-444 (Del. Ch. 2024) (explaining that shareholder agreements cannot interfere with the director power to manage the corporation) and *McRitchie v. Zuckerberg*, 2022-0890-JTL, 2024 WL 1874060, at *38-42 (Del. Ch. Apr. 30, 2024) (explaining that charter provisions can interfere with the director power to manage the corporation).

[214] The Council of the Corporation Law Section of the Delaware State Bar Association, March 28, 2024 proposed amendment, available here: https://www.skadden.com/-/media/files/publications/2024/04/2024-dgcl-amendments-bill-form.pdf?rev=335dffdd1c9049b399730371ad23f59d&hash=61C300C0B253F38344FE42FEBFA97C86.

effective on August 1st, 2024.[215] Under this new law, shareholder agreements could, for instance, "covenant that the corporation or one or more persons or bodies will take, or refrain from taking, actions specified in the contract . . . which persons or bodies may include the board of directors."[216]

Since both the judicial and legislative approaches would allow contracting (whether through the charter or through shareholder agreements) to replace or restrict the director's right to manage the corporation, they both agree that the managerial independence should be treated as a default rather than a mandatory or immutable right. The two approaches differ only as to the method for doing so. Academia's response to both approaches, from both proponents and detractors of the legislative approach, has echoed the same commitment.[217] Rules that govern how to deviate from a default rule are "altering rules."[218] And to be sure, which altering rule to use is not a trivial or clerical decision.[219] As Professor Ayers shows, there are important tradeoffs to consider when designing and choosing altering rules.[220] That said, the debate implied by the disagreement between the judicial and legislative approaches is premature because it skips over whether managerial independence should be immutable to begin with.

To address the immutability point, it is important to first disentangle the descriptive and normative points. As a matter of describing positive law, and as explained above,[221] I agree with Vice Chancellor Laster's position that shareholder agreements may not interfere with the director's statutory grant to manage the corporation. But as also alluded to in Section II, I do not agree, even as a matter of description, that the charter may do so.[222] Admittedly, and as shown in the cases cited above, there is some inconsistency in the caselaw about this point.[223] And as Vice Chancellor Laster masterfully shows

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[215] *See supra* note 8.
[216] *Id.*
[217] *See* sources cited *supra* notes 9-10.
[218] *Ayers*, supra note 212, at 2046-49.
[219] *Id.*
[220] *Id.*
[221] *See supra* note 192 and accompanying discussion.
[222] *See supra* note 41 and accompanying discussion.
[223] *Id.*

in his decision in *McRitchie v. Zuckerberg*, Delaware statutory law is at best unclear about that point as well.[224] Indeed, Vice Chancellor Laster specifically outlines three sperate methods for contracting around managerial independence in the charter: provisions limiting the purpose of the corporation, provisions limiting the director's powers, and provisions changing the director's duties.[225] As the aim of this Article is to address the normative point, the descriptive debate is outside the scope of this argument. Suffice it to say that, as shown in explicit quotes from Delaware cases, it is at best unclear whether charter provisions limiting director powers and duties can interfere with the grant of managerial rights to directors.[226] It is also important to note that examples cited by Vice Chancellor Laster include close corporations and public benefit corporations, which are in fact not corporations, but are statutory variants thereof.[227] Indeed Section III.B below discusses why corporate variants, as well as provisions limiting the corporate purpose, do not interfere with managerial independence.

Conceding the descriptive point for argument's sake, the main assertion of this Article is that even if such charter provisions are permissible, they are misguided and harmful to the economy.

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[224] McRitchie v. Zuckerberg, 315 A.3d 518, 574-77 (Del. Ch. 2024)

[225] *Id.*

[226] Jones Apparel Grp., Inc. v. Maxwell Shoe Co., Inc., 883 A.2d 837, 846 (Del. Ch. 2004) ("Although § 141(a) does not explicitly prohibit charter provisions affecting the board's authority that are 'contrary to the laws of this State,' a fair reading of that statute in conjunction with § 102(b)(1), as well as the fact that privately adopted charter provisions are by definition hierarchically inferior to mandatory aspects of the positive law of the State, make it clear that the ability to adopt charter provisions is not unlimited.").

[227] *See e.g.*, McRitchie, *supra* note 224, at 577 ("For present purposes, the illustrative exemplar appears in Subchapter XV of the DGCL, Public Benefits Corporations, where Section 361 authorizes the charter of a public benefit corporation to identify a public benefit with the effect that the corporation "shall be managed in a manner that balances the stockholders' pecuniary interests, the best interests of those materially affected by the corporation's conduct, and the public benefit or public benefits identified in its certificate of incorporation."); New Enter. Associates 14, L.P. v. Rich, 295 A.3d 520, 556 (Del. Ch. 2023) ("One statutory exemplar appears in Subchapter XIV of the DGCL, titled Close Corporations, and authorizes a close corporation to provide for management by its stockholders.").

Regardless as to whether managerial independence is contractable through the charter or through shareholder agreements (or the bylaws, for that matter), doing so precludes the only legal path that ever existed for hiring a residual obligor with strong-form separation of ownership and control. Unlike agency and trust arrangements, the hiring of such a fiduciary requires that the judgment of managers will not be subject to either ex ante (as is the case with trustees) or ex post (as is the case with agents) subordination. Solving the various coordination problems explained above, it is essential that investors are able to pool their assets under the guidance of a fiduciary while blurring their respective property rights.[228] Once contractual intervention in managerial judgment is permitted, the blurring of property rights by investors is disabled. This is so because it creates a contractual environment that allows those with leverage to insert their wishes into asset management decisions, resurrecting the residual claimant structure that was meant to be avoided in the first place. Similarly to trust arrangements, enabling contractual intervention means that the firm can be managed by owners, and the fiduciary is required to consult the contract rather than their open-ended obligations to manage the firm. As shown in Part II, doing so defeats the unique and essential solution to firm formation that having a residual obligor brings to the table.[229] In other words, the debate over altering rules aside, it is essential that managerial independence in the corporation remains immutable—it is the only viable legal path towards achieving this indispensable form of organization. It is the mandatory separation of ownership and control that enables this essential economic activity.

B. Appropriate Deviations

The following objection may be raised at this junction: if directorships cannot tolerate the contracting around of managerial independence through power and duty limiting provisions, how come it can tolerate doing so through entity choice or corporate purpose provisions? In other words, isn't it the case that investors choosing to organize as an LLC or close corporations (which allow full contractibility around

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[228] *Supra Part II.*
[229] *Id.*

managerial powers),[230] or under a corporation for a narrowly defined business purpose, is the same as enabling contracting around managerial independence in the charter or shareholder agreements? The following explains why the answer is no.

First, regarding the entity choice point, it is important to not confuse the enablement of blurring property rights by investors and the requirement that they *always* do so. This Article shows that it is sometimes more beneficial for investors to blur property rights and price residual obligation, but that is not to say that it is always the case. Of course, firms with residual claimants structures remain an important part of economic activity and organization. The point is that for those situations in which a residual obligor structure is required there must be a method by which investors can agree to avail themselves of a statutorily mandated structure that will not carry over any residual contractual rights. If managerial independence in the corporation is preserved immutably, investors can do so cheaply as all they have to agree on is forming a corporation. This solves the prohibitively expensive transaction costs brought forth by the commons and anticommons issues encountered in the markets. Investors that agree to join corporations can do so in the shadow of confidence that no contractual mechanism will subvert the independent judgement of directors who answer to the firm only. That other forms of organization exist, such as the statutory close or benefit corporations, or LLCs, do not disturb that option. What is important is that investors have one way of agreeing to pool their assets without the impossible transaction costs of guaranteeing managerial independence mechanically.

Second, regarding the corporate purpose point, it is essential to distinguish between external and internal corporate limitations. To do so, recall Heller's Alzheimer medication example discussed above.[231] If a number of patent holders want to come together and create an Alzheimer medication, but they cannot do so because it is prohibitively expensive to contract around all the various intellectual property rights claims involved, one way to enable them to do so is to organize them under a residual obligor structure. If they do so, the economic solution will not be disturbed if the corporation only exists

[230] *See supra* note 12.
[231] *See supra* notes 207-210 and accompanying text.

"for the creation and commercialization of an Alzheimer medication." To be sure, such a narrow purpose provision does limit directors in a sense. For instance, it presumably prevents directors from deciding to invest all the firm's assets in a fast-casual restaurant. But this limitation on directors is at most an *external* limitation. It narrows the scope of the markets in which the residual obligor will operate, but it does not amount to an *internal* limitation imposing on the director's judgment as to how to conduct their business within the Alzheimer market. So long as the directors' business decision is motivated by a desire to compete in the Alzheimer medication market, they remain free to do so. For instance, such a limitation does not even prevent the director from taking some of the firm's cash on hand and investing it in various real estate funds for the purpose of hedging revenue results and managing future cash flow from medication sales.[232]

In other words, so long as the manager remains internally free to operate in the market as they please, the residual obligor solution remains intact. To be sure, it is conceivable that charter provisions limiting the corporate purpose can get so specific or "creative" so as to amount to an internal interference with the manger's judgment. For example, if the charter stated that the corporation exists for the purpose of "conducting business in the fast-casual restaurant business in accordance with the wishes of shareholder X" it would certainly amount to a contracting around managerial independence. It is, again, descriptively unclear whether such provisions are allowed, but if they are, the law needs to be changed to disallow them.

The law allowing shareholder agreements to interfere with the director's managerial judgment should therefore be repealed. Similarly, the recent decisions conclusively enabling the charter to interfere with the director's judgment should be overturned. Both legal changes, separately and together, have undone a socially indispensable form of organization—directors as residual obligor. This merging of ownership and control is a damaging and seismic shift in the law of business associations that must be addressed.

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[232] *Id.*

Conclusion

Managerial independence in the corporate form must remain immutable. The current consensus that managerial independence should be contractable stems from a misunderstanding of the firm. Directorships are fiduciary arrangements, but they are inherently different from fiduciary arrangements such as agency and trust. The accepted theory of the firm, however, is committed to fiduciary essentialism—the reductionist view that firm formation is fundamentally a choice between hiring any fiduciary and hiring a contractor. Corporate directorships are essentially different from other fiduciary arrangements as they are the only path for utilizing a residual obligor with a strong-form separation of ownership and control: the hiring of a manager whose judgment is subordinated to fiduciary obligations but not to either interim or contractual instructions by the owners.

Maintaining this necessary organizational and economic structure requires repealing the ability of shareholders to contract around managerial independence, regardless as to whether that is done through the charter, bylaws, or shareholder agreements. Ownership and control must remain separate.