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The Embedded Firm: Corporate Governance, Labor, and Finance Capitalism – Commentary

Abstract: Enlightened shareholder wealth maximization – long-term thinking about improving and perfecting the corporation’s products and services that translates into sustainably increased future cash flows – has almost entirely given way to an overzealous focus on short-term stock performance. This commentary synthesizes a few basic concepts before this backdrop: (1) Any theory that suggests the solution rather than a solution is bound to fail because people will learn to game it. It is more appropriate to have a number of theories – including shareholder wealth maximization – to take from the shelf and apply as needed. (2) All major corporate stakeholders exercise their often significant power over corporate affairs to their financial benefit. (3) Shareholders are not always the residual claimants of a corporation’s assets because, for example, of bankruptcy or regulation.

Keywords: shareholder wealth maximization, residual risk bearing, labor

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1 Introduction

The last dozen years have seen spectacular corporate failures by a diverse array of firms like Enron, Lehman Brothers, and even the quasi-governmental Fannie

Mae. The United States and the world have likewise seen equally spectacular taxpayer-funded bailouts of collapsed firms and financial institutions. The idea that a firm can be too big to fail has become, at least for now, generally accepted as a dark side of capitalism.

It is, therefore, a fitting time to question the conventional wisdom underpinning the purpose of the corporation¹ – shareholder wealth maximization – and whether it is sufficient to ensure that firms behave properly and not to the detriment of society (or, in economic parlance, that they do not create negative externalities and are socially responsible). *The Embedded Firm: Corporate Governance, Labor, and Finance Capitalism*, a collection of essays assembled by editors Cynthia A. Williams and Peer Zumbansen, does just that from a myriad of perspectives. The work is comprised of 21 chapters covering the broad topics of historical business regulation, recent departures from shareholder centrality as the proper goal of the firm, organized labor's role as a corporate stakeholder, and the global financial crisis that began in 2008.

The book inspires a number of questions, which this commentary considers below. First, a consistent undercurrent of *The Embedded Firm* is that contemporary market mechanisms are imperfect and vulnerable to abuse by creative individuals. This weakness must, therefore, be kept at the fore when analyzing the nature and theory of the corporation. Next, the tension between short- and long-term conceptions of shareholder value is discussed. The general vision of shareholder wealth maximization can manifest itself in many forms. These depend on the evolving power and behavior of key corporate actors, especially shareholders and boards of directors. Discussed next is the relationship of shareholder wealth maximization to residual risk bearing. Courts put shareholder financial interests first in fiduciary-duty analysis because they are said to bear the ultimate risk of a firm's well-being. But the traditional analysis changes when some or all corporate risk is borne by others. Finally, the role of labor is addressed with regard to the previous three categories. The power of labor's executive management in the corporate enterprise has evolved as pension funds have become major shareholders.² The place of its power in the

¹ As a matter of analysis, some situations dictate that the discrete *corporation* be distinguished from the broader *firm* in the context of holding companies. Where a parent corporation and its subsidiaries are most accurately considered a single entity – a single firm consisting of multiple corporations – enterprise analysis is appropriate (Strasser & Blumberg, 2011). For the purposes of this comment, the terms are interchangeable. In addition, the potential for the misuse of corporate subsidiaries is addressed below. See footnote 7 and accompanying text.

² As discussed herein, employees will not reap the benefits of this newfound power if their leaders and fund managers do not act in the employees' interests.

corporate enterprise thus deserves to be briefly examined. This commentary ultimately concludes that shareholder wealth maximization, applied in a long-term incarnation in the appropriate situation may, like other approaches, be a socially beneficial analytical approach.³ There are situations, however, such as when a firm's shareholders are no longer its residual risk bearers, in which other approaches are appropriate.

2 Human craftiness

No discussion of the role of the corporation or the standard by which its governance should be judged can be complete without acknowledging the limitlessness of human ingenuity. Humans cannot create fraud-proof, crash-proof, bias-proof legal regimes because there will always be other humans working on ways to beat these systems – they will learn to “operate at the perimeter of regulation” (Condon, 2011). Even the Securities Act of 1933 ('33 Act) and the Securities Exchange Act of 1934 ('34 Act) – two statutes, which have exhibited exceptional staying power, that were enacted to protect investors from corporate managers and shareholders – have been amended numerous times to accommodate newly perceived threats to market stability.

Thus, any theory or model that suggests *the* solution rather than *a* solution is bound to fail because people will learn to game it. It is more appropriate to have a number of approaches – be that shareholder wealth maximization or an alternative – to take from the shelf and apply as the situation dictates. A flexibility and wisdom to apply the appropriate approach at the appropriate time is the key. It can fairly safely be said that, from the point of view of minimizing negative externalities, most approaches work well some of the time in certain situations, and less well at other times under other circumstances.⁴

³ Of course, switching to, and having the institutional willpower to maintain, such a long-term view may be more difficult than it sounds (Clarke, 2013, p. 23). Over 50 years ago, Professor Robert N. Anthony, said of profit maximization that “It is too difficult. It is unrealistic. It is immoral.” (Anthony, 1960, p. 126). Yet he states that profit maximization may be appropriate for “[m]any companies formed to achieve some specific, short run objective,” and that it can be a useful analytical tool (Anthony, 1960, pp. 127–128).

⁴ Biondi (2011), applies this concept to the measurement of efficiency in the allocation of wealth, showing that various approaches to allocation will be deemed efficient or not depending on the allocative goal and the criteria considered in determining what is efficient.

A great example of the craftiness of managers and shareholders is how quickly they found ways around the legal capital system. In the early days of corporations, after it became possible for anyone to form a one without special legislative permission, a firm's incorporation documents filed with its state had to show the minimum amount of capital, or *legal capital*, to be raised by the sale of stock to investors. It was the amount that the owners placed at risk in the business. The figure was expressed in terms of the number of shares to be sold and the minimum consideration, or *par value*, paid to the corporation for each share. Corporate statutes uniformly required that the level of the firm's legal capital be disclosed, and that the firm not voluntarily reduce its capital reserves below its legal capital. (Though operating losses could reduce the amount below that which was invested). The legal capital was intended to be a permanent capital cushion that could not be distributed to shareholders, with which non-shareholder creditors could be paid if a corporation's fortunes turned sour.

Despite the legal capital system's noble intentions, it did not take long for firms to begin issuing shares with miniscule par values of fractions of \$0.01. Most shareholder equity was in this way kept distinct from legal capital, sidestepping its maintenance and related obligations. Coupled with legislatures unwilling (perhaps because of the corporate lobby) to tighten the system or other loose distribution laws allowing easy extraction of money from a firm via dividends and share buybacks (and, nowadays, via antitakeover devices like poison pills that shift a great deal of value from the firm to shareholders in nearly an instant, ostensibly for the purpose of protecting the corporate enterprise), non-shareholder stakeholders were suddenly at a substantial disadvantage when a corporation fell into distress. This problem has been exacerbated in the last decade when many companies spent more on share buybacks than on research and development or on maintaining adequate reserves to withstand financial shocks (Clarke, 2013).

Another example of legal creativity is the use of corporate subsidiaries. For about a century after the ready availability of corporate limited liability without individualized legislative permission, corporations could not own shares in other corporations. That changed at the end of the nineteenth century, when state legislatures moved as a group to allow the practice. Allowing corporations to make equity investments in other firms certainly has advantages. For example, it can enable a manufacturing firm to invest in its supply chain, allowing for better control over its supply, thus reducing the risk of sudden shortages.⁵ But it was not long before managers began putting the riskier segments of their

⁵ Taking such an action of course raises corporate-law fiduciary-duty questions. But if it is done properly so as not to harm minority shareholders, it can be beneficial to the investing corporation and its stakeholders.

business enterprises into thinly capitalized subsidiaries. Where previously a claimant against the risky segment could look to the assets of the entire enterprise for satisfaction, now it was to the limited assets of the subsidiary.⁶

Rational self-interest and competition have a similar vulnerability: Adam Smith's utopian combination will not always ensure free markets because it does not stop collusion.⁷ Collusion can be dangerous in the corporate arena, especially when it takes place between boards of directors and managers, or between firms and legislatures. In a perfect market, with perfect information and a perfect ability of stakeholders to react, such connivance could be prevented. But markets, including financial markets and the market for regulation, are imperfect, and their systems are thus subject to abuse. *The Embedded Firm* is rife with examples in which incentive compensation of managers can be beneficial or disastrous depending on the situation. And although it only touches on the point in passing, it has indirectly made a solid case for the proposition that corporate law should be federalized only with great caution and trepidation: Once⁸ the federal level (Congress, the Securities Exchange Commission, etc.) has been captured by stakeholder interests, where is one to go? But if Delaware is captured, there are some 50 to 55 other U.S. jurisdictions to which one might turn.

A prime example of human ambition is the “financialism,” or “financialisation,” which the book's contributors so effectively assail. The financial-services industry is supposed, in theory at least, to be a *service* industry that catalyzes other, tangible production. Over the last several decades, however, it has devolved into one that believes that it should be served by the very industries it should enable. The rise of financialism is perhaps best evidenced by the vast expansion in all manner of financial institutions of proprietary trading... often of derivatives. But financialism in the broad sense is, at least today, not limited to financial institutions. Modern investors too infrequently invest in a company for its ability to create, instead betting on the hoped-for capital appreciation and dividends associated with a ticker symbol. Scarce is the hedge fund that has built a business from scratch. Modern equity investing has become little

⁶ This is not to say that allowing the parent subsidiary structure is necessarily bad. For example, the inability of a corporation to put a relatively risky business into a subsidiary may cause it to spin the business off entirely, resulting in the severing from the parent *all*, as opposed to only the financial, risk of the subsidiary (compare Strasser & Blumberg, 2011 with Bainbridge, 2001, pp. 532–534).

⁷ As Former Federal Reserve Board Chairman, Alan Greenspan, said, “I made the mistake in presuming that the self-interests of organizations ... were such that they were the best capable of protecting their own shareholders and their equity of the firm” Johnson & De Graaf (2011).

⁸ “Once” may be an overly optimistic word with which to begin this sentence.

removed from picking the best number on a roulette wheel: too often, short-term speculation and manipulation (which can originate from within and externally – just think of Enron and AIG) drives stock prices rather than the underlying firm’s innovation and production capabilities. “[T]he corporation had become a virtual realm for investment” (Zumbansen, 2011).

But financialism is little more than a new flavor of an old poison. The ’33 and ’34 Acts, with their complementary provisions on accounting and disclosure, were passed precisely because there was a widespread belief that “naked speculation” and “evasions, suppressions, distortions, exaggerations, and outright misrepresentations practiced by corporations with intent to cloak their operations and to present to the investing public a false or misleading appearance as to financial condition” caused the stock-market crash of 1929, and the social devastation that came in its wake.⁹ It bears repeating that crafty individuals will always find new ways to externalize the costs of their activities, whether by circumventing rules, lobbying lawmakers, or gambling with other people’s money. Given such creativity, it is worth asking whether and to what extent shareholder wealth is in fact being maximized in today’s corporations.

3 Who is maximizing what?

Shareholder wealth maximization is grounded in the idea that the incentives of shareholders are at odds with those of their manager “agents.” As a result, managers will run firms in a way that will maximize their own wealth at the expense of that of the shareholders whose investment enabled the corporate enterprise. A corollary to agency theory is that managers will also place the interests of non-shareholder stakeholders behind their own. But because shareholders risked the wealth that created and finances the firm, they are entitled to a “residual” claim on everything left over after the firm’s contractual obligations have been fulfilled. The misalignment of incentives causes the firm to be run inefficiently – in a way that creates less overall value – with the resulting loss of overall wealth termed “agency costs.” To minimize agency costs, the theory goes, the law should require managers’ to exert their best efforts to maximize shareholder wealth. With this corporate goal in mind, non-shareholder stakeholders – employees, customers, creditors, communities, and others – can contract *ex ante* for their fair share of the value created by the corporation.

⁹ S.Rep. No. 73–792, at 1, 11 (1934).

If one needs any more convincing than has come to light in the last dozen years that the actual maximization of shareholder wealth is not taking place in today's firms in any strong form, *The Embedded Firm* provides it. The chief complaint about shareholder wealth maximization, about with which (almost) everyone agrees, is that managers' focus on short-term performance (mainly based upon erratic share-market prices) as a measure of shareholder wealth distorts incentives, hinders overall value creation, and creates negative externalities.

But can it really be said that running firms to maximize *long-term* share price is improper? Another sort of shareholder wealth maximization – based on *long-term* thinking about improving and perfecting the firm's products and services that translates into sustainably increased future cash flows, and that is impliedly thought by some not to be encompassed by agency theory (e.g., Clarke, 2013; Stevelman, 2013; Stout, 2013; Weinstein, 2013) – has certainly given way to an overzealous focus on short-term share price.¹⁰ This focus has been fueled in large part by an oversupply of short-term, and a dearth of long-term, management incentive compensation. The effectiveness of such a compensation system is questionable in an environment where “80 percent of [corporate managers] report [that] they would sacrifice future economic value to manage short-term earnings to meet investor expectations” (Johnson & De Graaf, 2011).

“Shareholder value is a result, not a strategy” (Aguilera & Williams, 2011). It should not come as a surprise that, say, a car company that focuses on building better cars rather than on propping up its share price or meeting the current quarter's earnings target at all costs will provide its shareholders *and* its other stakeholders with greater value in the long term. After all, long-term thinking about making better cars will lead to more satisfied customers willing to buy the

¹⁰ Though some scholars may not consider the long-term maximization of shareholder wealth to be part of agency theory, courts do not insist that corporate managers maximize short-run stock returns. It is only at the “*Revlon* moment” when managers must maximize the price that shareholders obtain in the short term. The *Revlon* moment occurs either when a company is certain to be sold, *Revlon, Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173 (Del. 1986), or when a transaction causes control to shift from a diffuse set of shareholders to a concentrated block, *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1993). Short-term share-price maximization is required in these situations because they are the last opportunities for shareholders to maximize their return in their investment or for minority shareholders to be paid for their control premia. Where there is no inevitable sale of the company or transfer of control that would subject shareholders to the risks and consequences borne by holders of minority shares, the courts allow for the consideration of long-term corporate benefit. *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989); *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011); see also *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1993); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (1985).

firm's cars. This, in turn, will translate into more secure creditors, employees with more secure and better-paying jobs, and communities with a greater tax base. And the longer-run residual benefit to shareholders is obvious: a company with greater (or more stable) future expected cash flows will pay greater (or more secure and continued) dividends, and assuming that markets function more-or-less properly, have some of that cash flow capitalized into its current share price. But if managers are compensated based on short-term results, they will prefer putting the firm's cash into a bank account over investing it in research and development if R&D would yield lower short-term returns than a bank's interest. A version of shareholder wealth maximization that focuses on short-term results would condone such behavior.

If an enlightened form of shareholder wealth maximization were enforceable, and it came with its attendant bargaining by all stakeholders for an equitable share of corporate wealth, it may alleviate many problems. Unfortunately, such a vision is very difficult to realize. Management of a certain level, with its superior knowledge of the firm's workings, is better positioned than shareholders and outside stakeholders to extract wealth from it. The recent corporate collapses have shown that, while manipulating appearances in the long term is difficult, doing so in the short term is relatively easy. It does not help matters that a manager-board economy has developed in which each keeps the other happy, thus making both only nominally responsible to shareholders, or any other constituency. Add to this the difficulty of switching from the status quo to a long-term mindset, convincing shareholders that their long-run interests are in fact being pursued, and resisting the temptation to take short-term profits (Clarke, 2013, p. 23), and it becomes clear that the change cannot be a swift one.

Neither is increasing shareholder participatory rights the answer. Corporate law's current shareholder paradigm is based on the middle-class "retail investor" of the post-World War II era who began seriously investing in stocks during the highest-ever growth of the U.S. economy. The stock market was no longer the domain of the rich. Retail investors generally purchased in small lots, and were so dispersed as to be unable to act collectively to influence corporate policy. They invested for the long term (perhaps to fund their retirements or their children's college educations) and were content to have managers run their firms.

This is not to say, of course, that these managers were any less self-interested than today's managers. It may simply be that there was enough growth to go around that it was not worth it for shareholders to attempt to overcome their collective-action problem to police managers. In addition, managers were once more connected to their firms and to the sectors in which their firms operated, and they received a larger portion of their compensation as fixed salaries.

This made it more costly (because their reputations were tied to smaller communities) and less profitable (because their compensation did not vary wildly based on short-term results) for managers to, as it were, manage their near-term figures.

But the paradigm of the passive, patient retail investor, around whose behavior current corporate law was created, no longer holds. Today's typical shareholders belong to a concentrated and activist group of sophisticated institutional investors. Whereas retail investors owned 75% of outstanding shares in the 1950s, today the reciprocal is true, with institutional investors owning three quarters of outstanding corporate equity securities. This group has a short-term investment horizon (indeed, the time horizons of “[h]edge funds, which make more than half the trades on the NYSE,” are “sometimes less than a second” (Jacoby, 2011)), and is empowered politically and legally (having the ability to influence the legal and regulatory environment in which they exist), as well as economically (having amassed enough shares, and thus voting power, to guarantee themselves a say in corporate affairs).

Modern institutional shareholders are willing to use their power to influence corporate governance to their benefit. Amplifying the incentives created by short-term executive-compensation arrangements, they often pressure management to deploy assets to yield short-term profits that match their short-term investment horizons. The situation is only worsened by the financial press and analyst communities microscopically scrutinizing quarterly (and even daily) results and news. That shareholders have been given even more power over corporate affairs, such as through the proxy-access rules that have slowly but surely expanded in Delaware and at the federal level, will therefore only exacerbate the lamentable lack of long-term commitment to corporations. Now, neither managers nor shareholders have much long-term interest in their corporations. One very unfortunate result is that the residual risk that is supposed to have been borne by shareholders falls upon a far wider range of constituencies.

4 Residual risk bearing

The law should recognize that it can only be safely said that shareholders are a corporation's residual risk bearers when it is on solid financial footing. The most obvious situation when they are not, and one which befell over 40,000 businesses last year, is bankruptcy (United States Courts, 2012). In the case of Enron, for example, one can argue that “[t]hose bearing the greatest residual risk were Enron employees who lost their jobs and also much of their

retirement incomes (Deakin, 2011).¹¹ In these situations, shareholders' equity interests are usually wiped out, and the remaining stakeholder-creditors are left to scramble for whatever is left over. The Delaware Supreme Court has recognized that "[w]hen a corporation is insolvent ... its creditors take the place of the shareholders as the residual beneficiaries of any increase in value,"¹² and are entitled to maintain derivative breach-of-fiduciary-duty actions. However, the court declined to allow creditors to bring direct claims against an insolvent corporation's directors.¹³ Similarly, it held that creditors may not bring derivative actions against corporations in the "zone of insolvency."¹⁴ But directors' incentives to focus on short-term figures and take unnecessary risks by betting on negative-expected-value projects with high potential returns in the hope that the firm can be saved may be most acute when their firm is about to go out of business.

It is not only creditors with direct contacts to the corporation that can become bearers of its residual risks. Regulation and legislation can cause the state – sometimes reluctantly, sometimes intentionally to serve a particular favored constituency – to become a residual risk bearer. Retirement plans are a case in point. If priced perfectly in a perfect market, defined-contribution and defined-benefit plans should have the same expected payout, and each should thus entail identical contributions from employees. (The risk to employees is greater with defined-contribution plans the farther the investment environment is from perfect competition.) If priced properly in an *imperfect* market, employers should offer a lower return on funds invested into a defined-benefit plan because the employer would have to leave a cushion for market risk *if the employer actually intends to pay the contracted-for pension*. But if the state insures pensions, as does the Pension Benefit Guarantee Corporation in the United States in many industries, the state bears all the downside residual risk in place of employers and employees. In these cases, both employers' and employees' incentives change: Employers, and management compensated in the short-term in particular, have great incentive to offer higher returns than they anticipate earning on their employees' pension funds, and employees have great incentive to bargain for greater-than-market pension packages. Indeed, with pension funds becoming major shareholders in their own right, Labor's part in the corporate arena cannot be ignored.

¹¹ The fact that Enron employees should likely not have invested so much of their wealth in the company for which they worked, disproportionately increasing their risk, does not change the reality on the ground that a great many of them in fact did so.

¹² *N. Am. Catholic Educ'l Programming Found'n, Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007).

¹³ *Id.* at 103.

¹⁴ *Id.*

5 Labor¹⁵

The corporate constituency that is perhaps most often said to suffer from a shareholder-focused approach is Labor. A return to the norm of the long-term employer–employee relationship, as the contributors to *The Embedded Firm* tellingly argue, would clearly result in benefits to most or all corporate stakeholders, at least most of the time. However, in industries where concentrated pension funds manage employees' retirements, employees as a group often behave as the institutional shareholders that they in fact are via their pension funds, exhibiting an ability and willingness to influence firm behavior.

The rise of pension funds is logical: Diffuse workers needed money to have a say in corporate affairs, so they pooled their money to get it. Whether the pooling was planned (it probably was not) or merely an unplanned-but-recognized opportunity is beside the point. An equilibrium has been reached in which pension funds are a full-fledged participant in firm governance. Power and money influence behavior. Now that pensioners-to-be and existing pensioners have achieved a critical mass of wealth, they have power, and can be expected to behave as would any investor that has the ability to promote its self-interest. As one contributor to *The Embedded Firm* describes, contrary to their historical behavior, they are now “involve[d] in the ‘paper economy’ (short-term trading in securities) versus the productive ‘real economy’ (real economy investment) (Archer, 2011).” The financial returns to its beneficiaries may be less direct (and, indeed, suboptimal for the same reasons that shareholder wealth maximization does not exist in any sort of strong form: pension fund managers may themselves behave in their own self-interest, at the expense of their pensioner-to-be and pensioner principals), but they are necessarily at another's stakeholder's expense.

Organized labor also has the distinct advantage of being able to exercise monopoly power – for all their laudable traits, labor unions are, after all, monopolies on labor. A monopoly that is protected by law (for example, by laws requiring collective bargaining) is especially capable of extracting wealth from those with whom it transacts. For example, it is not uncommon for unions to pressure employers to deduct union dues from the paychecks of employees who are not union members, including those who will never be union members

¹⁵ The analysis in this section is very important to the preceding discussion regarding the nature and purpose of the corporation. For more on the relationship of labor to the corporation in other contexts, see the rich material found in *The Embedded Firm*.

because of their predetermined tenure (i.e., interns). It is no secret that a strike can bring an entire industry with a tight supply chain to a halt within days.

6 Conclusion

The corporate form is essential to the efficient functioning of modern economies. One of its many benefits is that, when properly employed, it allows investors to voluntarily tie up capital with each other in a way that facilitates a long-term view. Even if one shareholder decides to escape a corporation by selling, it has to find another to take its place; it cannot cripple the enterprise by withdrawing its investment on a whim. But “a company exists by grace of the law that called it into being” (Zumbansen, 2011). The firm may be described as a “nexus of contracts” with many stakeholders, ranging from shareholders to employees to the state (Easterbrook & Fischel, 1996)¹⁶ if incentives – including legal ones – are properly aligned. In this case, the result can be wealth maximizing for all parties involved. Shareholder wealth maximization, like other approaches to the proper goal of the firm, can be socially beneficial when it is properly applied in the proper situation. But like all approaches, it can be gamed. It is the responsibility of the law, and in particular the common-law courts that have made shareholder wealth maximization the bedrock principle of corporate law, to consider not only the role of all parties to the contract, but the negative externalities that they have the incentive and ability to create. Corporate law is a field of complicated legal questions requiring complicated and creative, rather than one-size-fits-all, legal solutions. The editors and authors of *The Embedded Firm*, who have made clear that short-term “share price maximization” (Deakin, 2011) does not equate to value maximization, deserve our gratitude for bringing these questions to light.

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16 There are other models of the firm, many of which are consistent with the nexus-of-contracts approach despite their not being described in contractual terms. See, e.g., Biondi, Canziani, and Kirat (2007). For the purposes of this commentary, the nexus-of-contracts view is sufficient. In addition, while many consider the nexus-of-contracts model of the corporation to be coincident with agency theory, it can be safely disconnected from that theory and need not rely on it for its existence (e.g., Weinstein, 2013, p. 46).

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