

Contracting within the Firm

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ABSTRACT. Ever since Coase, transaction cost economics has posed a basic choice for how to organize production – firms or markets. In markets, decentralized parties contract with one another, while in firms, decisions are made on the basis of hierarchy and command. Over the last several decades, scholars have shown that the market is actually pervaded by relationships that support and sometimes supplant legal contracts. Yet the image of a corporation’s internal organization remains predominantly one of authority and informality.

I show that a surprising phenomenon exists: Corporations that use negotiated agreements to organize their internal commercial activities and specialized adjudication to address any subsequent disputes, mimicking the hard-edged incentives of market contracts in a single entity and without the possibility of enforcement by law. This phenomenon, which I call *contracting within the firm*, poses a puzzle, however. Why organize economic activity within a firm, only to reintroduce the tools of the market? Drawing on new developments in the theory of the firm, I identify several benefits. Most importantly, contracting within the firm can mitigate the agency problem that plagues hierarchies. Understanding intra-firm contracting offers many insights for theory and practice. It illuminates the basic choice between corporations and contracts in organizing production, while also informing how firms can approach a wide variety of internal governance issues.

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INTRODUCTION

Transaction cost economics poses a basic choice for how to organize production – firms or markets.¹ In markets, decentralized parties contract with one another, while in firms, production is organized by means of hierarchy and fiat.² When cooperation breaks down, market counterparties resolve their disputes through the state’s courts, while commercial disputes among the employees or divisions of a firm are settled by the senior manager’s command. Over the last several decades, scholars have successfully shown that the market is actually pervaded by relationships that support and sometimes supplant legal contracts.³ Commercial actors frequently eschew the state’s courts, relying instead on informal, nonlegal sanctions to organize their commercial relationships. Some merchant communities go so far as to reject the judicial system entirely and establish their own private legal systems instead.⁴

Yet the image of corporations’ internal organization remains predominantly one of informality.⁵ Economic activity within the firm is explained,⁶ lauded,⁷ and critiqued⁸ as the distinctive product of hierarchy, authority, and fiat.

¹ Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 388 (1937) (posing the firm and market as the economy’s “alternative methods of co-ordinating production”); OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* (1985) (outlining Williamson’s foundational theory of transaction cost economics); *see also infra* footnotes 39-42. For evidence of the vast influence of Coase’s thinking on organizational theory, one need look no further than a recent thousand-page summary of work in the field. *See generally* *THE HANDBOOK OF ORGANIZATIONAL ECONOMICS* (Robert Gibbons & John Roberts eds., 2013).

² *See* Coase, *supra* note 1, at 388 (“Outside the firm, price movements direct production, which is co-ordinated through a series of exchange transactions on the market. Within a firm, these market transactions are eliminated and in place . . . is substituted the entrepreneur-co-ordinator, who directs production.”).

³ *See, e.g.,* Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 *AM. SOC. REV.* 55, 60-62 (1963) (documenting reliance on informal relationships, rather than legal contracts, among Wisconsin manufacturing firms).

⁴ *See, e.g.,* Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 *J. LEGAL STUD.* 115 (1992); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms and Institutions*, 99 *MICH. L. REV.* 1724, 1760 (2001). There is a large and sophisticated literature addressing the richness of contractual practices in markets, discussed further in Part II.

⁵ Gilson et al note that “the distinction between contract and organization, or market and firm, has been at core of efforts to construct a theory of the firm since” the 1930s. Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 *COLUM. L. REV.* 431, 494(2009). *But see* Graf-Peter Calliess & Stephan von Harder, *Intra-Firm Trade Law: Contract Enforcement and Dispute Resolution in Transnational Corporations*, in *TRANSNATIONAL CORPORATIONS AND TRANSNATIONAL GOVERNANCE: THE COST OF CROSSING BORDERS IN THE GLOBAL ECONOMY* (Sarianna Lundan

Based on interviews, primary materials, and the literature on multinational corporations, I show that a surprising phenomenon exists: Corporations that use negotiated agreements to organize their internal commercial activities and specialized adjudication to address any subsequent disputes within *a single legal entity*.⁹ These are disputes, not about discrimination or wrongful discharge, but about whether an upstream division has delivered quality goods to a downstream division or whether one employee performed a promised task for another. In resolving them, these businesses turn to the transactional techniques of contract familiar from markets, but unexpected in firms. These firms go beyond merely formalizing documentation, and empower employees to engage in bargained-for exchanges with one another, with subsequent disputes subject to formal adjudication. I call this phenomenon *contracting within the firm*.¹⁰

Consider just a few real world examples. At Morning Star, the world's largest tomato processor, every divisional manager negotiates written agreements with the other divisions most relevant to their work, which carefully define performance obligations and metrics of success.¹¹ These "internal contracts" are contained within a single corporation and are legally unenforceable. However, they delineate an intricate network of commitments among divisions and introduce into the firm some of the hard-edged

ed. 2014) (providing a look at dispute resolution in multinational enterprises from the perspective of transnational commercial law).

⁶ See, e.g., Oliver E. Williamson, *The Vertical Integration of Production: Market Failure Considerations*, 61 AM. ECON. REV. 112, 114 (1971) (explaining that resource allocation in firms differs from markets because firms can resolve conflict through fiat). As one prominent scholar summarized, "according to the standard formulation: firms are hierarchies bounded by markets. Hierarchies work by orders, whereas markets work by bargains. At the point where an organization touches a market, administration ends and trade begins." Robert Cooter, *Who Gets on Top in Democracy? Elections As Filters*, 10 SUP. CT. ECON. REV. 127, 136 (2003). See also Stephen M. Bainbridge, *The Business Judgment Rule As Abstention Doctrine*, 57 VAND. L. REV. 83, 104 (2004) (explaining that "while markets allocate resources via the price mechanism, corporations do so via fiat—i.e., authoritative direction.").

⁷ See, e.g., Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1697 (2001) ("The choice between transacting in markets versus bringing transactions within firms is essentially the choice between using contracts as a governing device versus using the authority structure of the firm's hierarchy.").

⁸ Robert G. Eccles & Harrison C. White, *Price and Authority in Inter-Profit Center Transactions*, 94 AM. J. SOC. S17, S18-19 (Supp. 1988) (criticizing "the romantic view held by many institutional economists of hierarchical over market exchanges").

⁹ See *infra* Subsection II.B.3.

¹⁰ While a more precise definition is provided in Subsection II.A.2, contracting in the firm encompasses: (1) agreements negotiated between distinct actors, and (2) adjudicated by a more formal means than fiat.

¹¹ See *infra* Subsection II.B.2.

incentives of the market. Disputes concerning the agreements are resolved through impartial mediation by panels of peers.¹²

Lockheed Martin, the massive defense contractor, employs a similar practice.¹³ Lockheed operates several major business divisions within a single legal entity. Those divisions focus on different aspects of Lockheed's business. What is surprising is that when they cooperate with each other, they do so not through handshakes, but through multipage written agreements negotiated between divisional heads. Nor is the adjudication of disputes regarding these agreements left to informal fiat. Instead, the agreements themselves define how disputes should be resolved, such as by a joint board consisting of an equal number of members from both divisions.

One example of an internal Lockheed agreement is especially telling. Two Lockheed divisions entered an internal joint venture in which they agreed to pursue distinct categories of business opportunities generated by a third business unit.¹⁴ After four very successful years, one of those two divisions was sold to BAE—one of Lockheed's fiercest competitors. Yet remarkably, *the same agreement* continued to govern the transformed joint venture: BAE's name was simply substituted for the name of the division, while no other changes were made. The same terms now governed the joint venture contract between two competing corporations as had governed the (legally unenforceable) joint venture agreement between two "sister divisions."¹⁵ Depending on how a firm structures its internal transactions, it seems that the relationship between two divisions in one firm may be just as "arm's length" as the relationship between two competing corporations.

There are other examples, and while important details vary, the existence of these alternatives suggests that there are boundaries to the efficiency of fiat within a hierarchical entity. Beyond those bounds, firms will opt for more formal, arm's length, and impartial techniques for structuring and resolving disputes.

This world of contracting within the firm poses a puzzle, however. First, it establishes in the firm the transactional structure paradigmatic of the market. Yet the theory of the firm suggests that it is precisely when contracting *fails* that the firm becomes an efficient way of organizing transactions. Hierarchy's advantage over markets consists in resolving disagreements rapidly through command, rather than by unproductive haggling.¹⁶ So why organize production through a firm, only to try to

¹² *Id.*

¹³ See *infra* Subsection II.B.2.

¹⁴ See *infra* notes 164-178.

¹⁵ See *infra* note 82.

¹⁶ The two most prominent theories of the firm—the transaction cost and property rights approaches—share this focus, which combines incomplete contracts and asset specificity into hold-up problems that are resolved through integration. See Oliver E. Williamson, *The Economics of Governance*, 95 AM. ECON. REV. 1, 9-10 (2005) (the absence of law in the firm "authenticates hierarchy by supporting its main purpose, namely, timely responsiveness to consequential disturbances for which coordinated adaptations are needed."); Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J.

recreate a market within it? Second, contracting within a legal entity is puzzling because the most familiar function of a contract—creating the possibility of legal enforcement—is *unavailable* when an agreement is between two divisions of the same corporation. Courts simply do not enforce agreements among divisions, no matter how meticulously documented.¹⁷ So why negotiate a lengthy and complex agreement, which the law cannot enforce, requiring instead internal adjudication? Contracting in the firm poses a challenge to our understanding of commercial organizations.

The first and central contribution of this Article is thus to demonstrate that while corporations and contracts are the basic building blocks of commerce, it has been a mistake to view them strictly as alternatives. Contracts may be most familiar from markets, but a single legal entity can also make use of negotiated agreements and specialized adjudication where the possibility of legal enforcement of this contract-like agreement is absent. The second contribution is to delineate a series of benefits suggesting *why* contracting within the firm could be an efficient organizational tool. While the reasons for contracting within firms are likely to be as varied as the reasons for contracting between firms, I identify a series of specific benefits that intra-firm contracts can provide corporations, which future empirical research could explore.¹⁸

In particular, contracting within the firm can mitigate the central problem of hierarchy and corporate law – the *agency problem* of aligning a firm’s managers’ interests with those of the firm’s owners.¹⁹ I show how intra-firm contracts can address several aspects of this agency problem. For instance, because managers make decisions that affect the private welfare of other employees, those employees have incentives to spend time lobbying management, rather than being productive. These “influence activities” are the private sector equivalent of the familiar phenomenon of wealth-destructive rent-seeking in public law.²⁰ Contracting within the firm can suppress influence activities or what might colloquially be called “firm politics” by reallocating decision-rights over disputes from managers to insulated adjudicators and by formalizing agreements to facilitate their impartial adjudication.

POL. ECON. 691 (1986) (emphasizing the allocation of residual control rights among contracting parties as the key benefit of ownership and the firm); Oliver D. Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990).

¹⁷ It is a bedrock principle of law that only legal persons have standing to act in the legal system, including own property, contract, sue, or be sued. As a result, while a corporation—as a legal person—can contract, acquire title, and litigate, an unincorporated division of a firm can do none of these things. *See, e.g., E.E.O.C. v. St. Francis Xavier Parochial Sch.*, 77 F. Supp. 2d 71, 79 (D.D.C. 1999) (“Unincorporated divisions of an organization lack any independently recognized legal status.”); *see also* Subsection II.A.1.

¹⁸ *See infra* Sections III.B-C.

¹⁹ *See infra* Section III.A.

²⁰ *See, e.g.,* Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 WESTERN ECON. J. 224 (1976); Richard Posner, *The Social Costs of Monopoly and Regulation*, 83 J. POL. ECON. 807 (1975); Victor P. Goldberg, *Reflections on the Welfare Loss Triangle*, 4 I.O. REV. 151 (1976). *See infra* Sections III.B-C (discussing the economic literature on influence activities).

Recognizing contracting within the firm engages with new developments in contract theory. Contract theorists have recently begun to offer a more nuanced look at the world of complex commercial relationships in markets. A series of articles have carefully traced how some sophisticated parties interweave formal and informal contractual elements to optimize their commercial dealings.²¹ Referring to the phenomenon as “braiding,” the authors argue that sophisticated parties use legal contracts to supplement and protect their business relationships.²² This Article suggests that braiding goes both ways. Commercial life within the firm can also benefit from combining formal and relational contracts.

Contracting within the firm also complements two additional extensive literatures through which Coase’s archetypal vision of the firm has been challenged. First, at least since the first-year contracts law classic, *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971), legal scholars have known that subsidiaries within *corporate groups* enter actual legal contracts with each other, which can occasionally result in litigation. Indeed, a substantial scholarly literature has arisen to explain why contracts among the entities in corporate groups take the form they do and to address the varied adjudicatory structures by which intra-group disputes are resolved, especially Calliess (2014).²³ Relatedly, a literature within organizational economics has modeled and contrasted centralized and decentralized forms of inter-divisional trade within a firm.²⁴ These literatures observe varied forms of internal complexity within corporate groups and multinational organizations and model potential benefits of decentralization. Both of these literatures abstract away, however, from the question of most interest to me, which is the specifically *legal* one of agreements *within a single legal entity*. Complex corporate

²¹ See *supra* note 38 and accompanying text.

²² *Id.*

²³ See Anthony J. Casey, *The New Corporate Web: Tailored Entity Partitions and Creditors’ Selective Enforcement*, 124 YALE L.J. 2680, 2744 (2015) (arguing that intra-group contracts create options for selective enforcement by creditors); Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 VA. L. REV. 515, 517 (2007) (arguing that corporate groups may partition assets among subsidiaries to impose legal frictions on internal capital markets); Richard Squire, *Strategic Liability in the Corporate Group*, 78 U. CHI. L. REV. 605, 607 (2011) (explaining intra-group contracts as representing a specific form of opportunism by shareholders against creditors); Calliess & Harder, *supra* note 5.

²⁴ See, e.g., Bengt Holmström & Jean Tirole, *Transfer Pricing and Organizational Form*, 7 J.L. ECON. & ORG. 201 (1991) (providing a formal model to assess Eccles’ work on centralized and decentralized forms of internal trade); Bengt Holmström, *The Firm as a Subeconomy*, 15 J.L. ECON. & ORG. 74, 80 (1999) (modeling the capacity of firms to design complex internal incentive structures); George Baker, Robert Gibbons & Kevin J. Murphy, *Subjective Performance Measures in Optimal Incentive Contracts*, in 109 Q. J. Econ. 1125 (1994); Phillippe Aghion & Jean Tirole, *Formal and Real Authority in Organizations*, 105 J. POLIT. ECON. 1 (1997) (providing a classic model of the operation of authority in organizations). This work partly responds to sociologist Robert Eccles’ pioneering work on transfer pricing. See Robert G. Eccles & Harrison C. White, *Price and Authority in Inter-Profits Center Transactions*, 94 AM. J. SOC. S17, S27-28 (Supp. 1988); see also ROBERT G. ECCLES, *THE TRANSFER PRICING PROBLEM: A THEORY FOR PRACTICE* (1985).

groups have a long and varied history – well-worth exploring – but mechanisms mimicking markets can arise even without the possibility of the legal frictions associated with separate subsidiaries and are the focus here.

Understanding contracting within the firm also offers insights for theory and practice. Intra-firm contracting illuminates the role of organizational law in facilitating private ordering as well as the function of legal sanctions. Most interestingly, recognizing contracting in the firm calls into question a neat equation of markets with arm’s length contracts and firms with hierarchy and fiat. To a far greater extent than scholars initially supposed, the market’s invisible hand is guided by relationships and norms and management’s visible hand by internal competition and bargained-for exchange.²⁵ In-firm drafting techniques, remedies provisions, and adjudicatory processes may even cast insight on longstanding debates in contracts and public law.

This Article proceeds in four parts. Part I describes the conventional wisdom about markets and firms. It also shows how contracting within firms can expand our understanding of organization and contract. Part II provides a set of case studies, showing how a number of leading business enterprises have adopted contractual technologies to govern their internal transactions. Part III explains how applying a broadly contractual approach to internal firm disputes can sometimes increase organizational efficiency. Part IV outlines implications of the account offered here for legal practice and policy.

I. RETHINKING THE CONVENTIONAL WISDOM

A vast literature in both law and economics has picked up on Coase’s seminal questions launching the theory of the firm: Why do firms exist, and what determines when production is more efficiently organized through a firm than a market?²⁶ Before Coase, whether production was organized through a firm or a market had been taken for granted as the starting point of analysis.²⁷ Coase pointed out that the choice between firm and market had to be economically justified and offered a canonical interpretation of how the two differ: in markets, decentralized actors contract with one another at arm’s length and resolve disputes through the state’s courts, while in firms, centralized management directs production and any disputes are resolved by the manager’s fiat.²⁸ This view has

²⁵ Cf. See also ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* (1977).

²⁶ Coase, *supra* note 1, at 388 (“if production is regulated by price movements, production could be carried on without any organisation at all, [so] well might we ask, why is there any organisation?”).

²⁷ Coase posed the market and firm as “alternative methods of organizing production” and showed why that it was important to understand why one, rather than the other was chosen and when each would be more efficient. *Id.* at 388.

²⁸ *Id.*

had immense influence on subsequent work in both law and economics and remains the basic frame for organizational theory.²⁹

Over the last several decades, however, contract scholars have successfully challenged the first half of this dichotomy. They have shown that market contracting is vastly more complex than complete contracts that address all possible contingencies, and court adjudication of any subsequent disputes. Starting with Stewart Macaulay's pioneering work, evidence began to suggest that some businesses actually seldom rely on formal contracts to plan exchange relationships and even more rarely use legal sanctions to resolve disputes.³⁰ Instead, they used informal arrangements, tacit understandings, and the threat of the cessation of future business to structure their commercial dealings—what contract theory has come to call “relational contracts.”³¹

Some industries even go so far as to reject state courts entirely, establishing “private legal systems” in which non-state actors adjudicate disputes and impose sanctions.³² Lisa Bernstein's work shows how various merchant communities within the U.S. established comprehensive alternatives to state courts to resolve their commercial

²⁹ This view of Coase's echoes endlessly through organizational scholarship. For instance, Merrill and Smith write: “Coase showed that the boundary of the firm can only be explained by the relative costs of conducting transactions within the firm (by fiat) and outside the firm in the market (by market contracting).” Thomas W. Merrill & Henry E. Smith, *Making Coasean Property More Coasean*, 54 J.L. & ECON. S77, 93 (2011); see also Robert Gertner & David Scharfstein, *Internal Capital Markets*, in THE HANDBOOK OF ORGANIZATIONAL ECONOMICS 659 (Robert Gibbons & John Roberts eds., 2013) (“The idea that firms replace price-based relationships with authority-based relationships dates back to Coase”). On a simple statistical measure of the influence of Coase's organizational views in law, see Stewart J. Schwab, *Coase's Twin Towers: The Relation Between the Nature of the Firm and the Problem of Social Cost*, 18 J. CORP. L. 359, 359 (1993) (“Coase's *The Nature of the Firm* may well be the second most cited article in law and economics.”). See also *infra* note 44.

³⁰ Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 60-62 (1963).

³¹ Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 7 NW. U. L. REV. 854 (1978); Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519 (1983); Victor Goldberg, *Competitive Bidding and the Production of Pre-Contract Information*, 8 BELL J. ECON. 250 (1977); Victor Goldberg, *Regulation and Administered Contracts*, 7 BELL J. ECON. 426 (1976); Victor Goldberg, *Toward an Expanded Economic Theory of Contract*, 10 J. ECON. ISSUES 45 (1976).

³² John McMillan & Christopher Woodruff, *Private Order Under Dysfunctional Public Order*, 98 MICH. L. REV. 2421, 2433-36 (2000); Barak D. Richman, *Firms, Courts, and Reputation Mechanisms: Towards A Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328 (2004); Gillian K. Hadfield, *Contract Law is Not Enough: The Many Legal Institutions That Support Contractual Commitments*, in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS (Claude Menard & Mary Shirley eds. 2004); Robert D. Cooter, *Structural Adjudication and the New Law Merchant: A Model of Decentralized Law*, 14 INT'L REV. L. & ECON. 215, 215-18 (1994).

disputes.³³ Diamond merchants, for instance, systematically avoid state law, opting instead for an elaborate set of rules, institutions, and sanctions internal to the diamond industry, including their own private arbitration system.³⁴

In the last few years, leading contract scholars have further complicated this picture. They have begun to question the neat distinction between relational and legal contracts, suggesting that written documents and formal adjudicative procedures may have a significant role even within very complex commercial interactions.³⁵ Ron Gilson, Bob Scott, and Chuck Sabel analyze how sophisticated parties in innovation-intensive sectors “braid” together formal and informal contractual elements to optimize their commercial relationship.³⁶ They suggest that formal contracts can serve a variety of functions in sustaining vulnerable relational contracts.

³³ Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms and Institutions*, 99 MICH. L. REV. 1724, 1760 (2001) (“The cotton industry has almost entirely opted out of the public legal system, replacing it with one of the oldest and most complex systems of private commercial law.”). See generally Lisa Bernstein, *Private Commercial Law*, in THE NEW PALGRAVE ENCYCLOPEDIA OF ECONOMICS AND THE LAW (Peter Newman ed., 1998). But see Richman, *supra* note __ at 2365 (criticizing accounts of private legal ordering as driven by administrative and adjudicative advantages). History offers a fascinating catalog of commercial actors who developed private legal systems for documenting transactions, adjudicating disputes, and enforcing sanctions, typically, through reputational mechanisms. These adjudicatory systems often filled in for the dysfunctionality or absence of state courts. Avner Greif, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders’ Coalition*, 83 AM. ECON. REV. 525, 527-28; Avner Greif, *Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders*, 49 J. ECON. HIST. 857, 858 (1989); Paul R. Milgrom et al., *The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs*, 2 ECON. & POL. 1, 4-6 (1990). Notably, though, these private legal systems continue to exist in the modern commercial world.

³⁴ Bernstein, *supra* note 4, at 115.

³⁵ See, e.g., Scott Baker & Albert Choi, *Contract’s Role in Relational Contract*, 101 VA. L. REV. 559 (2015) (arguing for the benefits of legal contracts even in complex commercial relationships between sophisticated parties); Lisa Bernstein, *Private Ordering, Social Capital, and Network Governance in Procurement Contracts: A Preliminary Exploration*, __ Journal of Legal Analysis __ (forthcoming 2015); Iva Bozovic & Gillian K. Hadfield, *Scaffolding: Using Formal Contracts to Build Informal Relations to Support Innovation* (USC Law & Econ. Research Paper Series No. C12-3, 2012) (arguing legal contracts serve as “scaffolding” around which informal contractual relationships can be coordinated); see also Andrew Verstein, *Ex Tempore Contracting*, 55 WM. & MARY L. REV. 1869, 1923-24 (2014).

³⁶ Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431, 458-71 (2009) (analyzing three contracts as exemplars of “contracting for innovation”); Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377, 1447 (2010) (providing a more general theory of how formal contracts can sustain relational contracts under conditions of high uncertainty);

What has received remarkably little analysis is how transactions are structured and conflicts resolved within commercial organizations. As a result, the simple image of informal relationships and fiat remains widespread. As one leading scholar summarized the conventional wisdom: “while markets allocate resources via the price mechanism, corporations do so via fiat — i.e., authoritative direction.”³⁷ Corporations are “hierarchies in which decisions are made on an authoritarian basis.”³⁸

Indeed, Williamson describes fiat as a core advantage of hierarchy.³⁹ As he notes, “when conflicts develop, the firm possesses a comparatively efficient conflict resolution machinery” – “fiat” – which can be “a more efficient way” to resolve conflicts than haggling or litigation.⁴⁰ This characterization of the basic distinction between markets and firms has remained pervasive.⁴¹

Yet what the case studies to follow suggest is that “braiding” goes both ways. It does not merely occur between private parties, who weave together formal and informal contractual elements in the market. Braiding also occurs *within* legal entities as managers combine relational contracts and fiat with formalized agreements and specialized adjudication. As a result, contract theory must expand to give full account to the activity of firms. Figure 1 depicts the range of archetypical options available for contract, given the possibilities of structuring transactions formally and informally in both markets and firms. In between formal and informal, lie the “braided” options, both between and within firms.

Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Contract and Innovation: The Limited Role of Generalist Courts in the Evolution of Novel Contractual Forms*, 88 N.Y.U. L. REV. 170 (2013) (identifying limitations of generalist courts in adjudicating sophisticated commercial contracts).

³⁷ Stephen M. Bainbridge, *The Business Judgment Rule As Abstention Doctrine*, 57 VAND. L. REV. 83, 104 (2004).

³⁸ Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 555 (2003). *See also* ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* (1977).

³⁹ Oliver E. Williamson, *The Vertical Integration of Production: Market Failure Considerations*, 61 AM. ECON. REV. 112, 114 (1971).

⁴⁰ *Id.* at 114. “Interorganizational conflict can be settled by fiat only rarely, if at all. . . . By contrast, *intraorganizational* settlements by fiat are common.” *Id.*

⁴¹ *See, e.g.*, Amnon Lehari & Amir N. Licht, *Eminent Domain, Inc.*, 107 COLUM. L. REV. 1704, 1732 (2007) (“firms are solutions devised to overcome market failures—in particular, when parties fail to reach a contractual agreement because transaction costs are too high. . . . In Coase’s view, firms help solve this market failure by allowing for the allocation of resources by fiat rather than by agreement.”); Ian B. Lee, *Efficiency and Ethics in the Debate About Shareholder Primacy*, 31 DEL. J. CORP. L. 533, 585 (2006) (“firms arise where the transactions costs of repeated market interactions justify a structure in which allocative decisions are made by fiat.”); Érica Gorga & Michael Halberstam, *Knowledge Inputs, Legal Institutions and Firm Structure: Towards A Knowledge-Based Theory of the Firm*, 101 NW. U. L. REV. 1123, 1165 (2007) (describing “Coase’s reliance on the superior allocation of resources through the fiat-control of the entrepreneur within the firm hierarchy”).

Figure 1: Contractual Modes of Organizing Production

	Market	Firm
Formal	Legal contracting	Contracting within the firm
Informal	Relational contracting	Fiat

This paper differs from the existing literature in three key respects. The first is the environment, which is trade within the firm, rather than the market. As the next section shows, intra-firm trade plays an outsized role in commerce, although we know very little about it. Scholars of both contracts and business organizations have focused on the variables driving changes in the *boundaries* of firms, rather than the factors that might explain the internal organization of firms themselves.⁴² The second difference, relatedly, is the comparison of interest. The extant scholarship provides rich and varied illustrations of contracting tools that are framed as alternatives to *state courts*. The literature thus emphasizes the administrative savings and industry expertise that flows from using relational contracts and private legal systems, rather than the formal judiciary. The clearest advantages of intra-firm contracting, however, are avoiding the *costs of hierarchy and fiat*.

Lastly, it focuses attention on one of contract theory’s traditional blind spots. Until recently, contract theory tended to focus exclusively on contract law’s doctrine at the expense of actual contracting practice.⁴³ So understood, contract theory focused on the rules promulgated by public actors, while ignoring how commercial parties actually structure their relationships. This Article embraces this shift to look at the actual practice of contracting within firms.

⁴² Although called the “theory of the firm,” the economic and legal endeavor to understand the role of organizations in commerce has focused almost exclusively on “analyzing the boundaries of firms” with “little to say about what actually goes on inside firms and how firms should be organized internally.” Patrick Bolton & Mathias Dewatripont, *Authority in Organizations*, in THE HANDBOOK OF ORGANIZATIONAL ECONOMICS 342, 342 (Robert Gibbons & John Roberts eds., 2013). Or as Gibbons summarizes, “the make-or-buy problem has come to be called the theory of the firm . . . it is important not to lose sight of the broader usage . . . in which “theory of the firm” means descriptive and prescriptive models of firms’ decisionmaking processes.” Robert Gibbons, *Four Formal(izable) Theories of the Firm?*, 58 J. ECON. BEHAV. & ORG. 200, 201 (2005) (providing a series of models offering insight into the internal organization of firms).

⁴³ Avery Katz has put it well: “a court-centered perspective is characteristic of academic legal scholarship in general . . . legal scholars should focus more on addressing the contractual decisions of private lawmakers (that is, transactional lawyers and their clients) and less on the decisions of public lawmakers (that is, courts and legislatures).” Avery W. Katz, *Contractual Incompleteness: A Transactional Perspective*, 56 CASE W. RES. L. REV. 169, 171 (2005). Katz’s argument for his normative claim is both that “most [students] will operate as private lawmakers in a contractual setting” and that “courts are not in a position to effectively supervise many of the things that the parties know and do in negotiating and performing their agreement,” so that it is important for lawyers to help the parties get things right themselves. *Id.*

II. CONTRACTING WITHIN THE FIRM

The goal of this Part is to establish what “contracting within the firm” encompasses. Part II.A briefly sketches the law governing firms; the conditions necessary for transactional conflict within a firm; and defines intra-firm contracting. Part II.B looks at a series of real-world illustrations of contracting within firms.

A. Commercial Life in the Large Firm

1. *The Law Governing Firms*

The “firm,” as the term is used in economics and common parlance, encompasses both businesses operated through a single legal entity as well as businesses operated through corporate groups. In common usage, ExxonMobil is thus a “firm,” although Exxon is not a single corporation, but encompasses well-over 200 subsidiaries.⁴⁴ Unlike unincorporated divisions, Exxon’s subsidiaries are independent legal persons, having been duly incorporated under organizational law. For many purposes, single-entity firms and corporate groups may function similarly—implementing a business vision established by senior management—but the applicable law is importantly different. I will first consider the law applicable to commercial activity within a legal entity and then within a corporate group.

(a) *The Legal Entity and Divisions*

Tort and criminal law apply to employees of firms as do a variety of more specialized bodies of law. For instance, tax law, employment law, laws against harassment and discrimination, and corporate law all impose substantive requirements on firm decision-makers.⁴⁵

Perhaps more important, however, is *the absence of law within the firm*. Units and functions within a firm that are not themselves legal persons lack standing in the legal system.⁴⁶ They cannot contract, own property, sue or be sued. A corporation can litigate an action; an unincorporated division cannot.⁴⁷ Nor can the managers who run those

⁴⁴ <http://www.sec.gov/Archives/edgar/data/34088/000119312511050134/dex21.htm>.

⁴⁵ Other statutory schemes, in areas like environmental and national security, impose their own bodies of labyrinthine regulation on relevant firms. See PHILLIP I. BLUMBERG & KURT A. STRASSER, *THE LAW OF CORPORATE GROUPS: PROBLEMS OF PARENT AND SUBSIDIARY CORPORATIONS UNDER STATUTORY LAW SPECIFICALLY APPLYING ENTERPRISE PRINCIPLES* (1992) (exploring specific statutory schemes).

⁴⁶ “Unincorporated divisions of an organization lack any independently recognized legal status.” *E.E.O.C. v. St. Francis Xavier Parochial Sch.*, 77 F. Supp. 2d 71, 79 (D.D.C. 1999) *aff’d sub nom. E.E.O.C. v. St. Francis Xavier Sch.*, 254 F.3d 315 (D.C. Cir. 2000).

⁴⁷ See, e.g., *United States v. ITT Blackburn Co., a Div. of ITT*, 824 F.2d 628, 631 (8th Cir. 1987) (an “unincorporated division cannot be sued or indicted, as it is not a legal entity”); *Salzstein v. Bekins Van Lines, Inc.*, 747 F.Supp. 1281, 1282 n. 1 (N.D.Ill.1990) (“by definition a corporate division is not a separate legal entity and hence is not suable”).

divisions bring a suit on the division's behalf, as all of the division's property is owned by the corporation itself.⁴⁸ The boundaries of the entity thus define a space within which law is unavailable for a variety of disputes. Within the firm's boundaries, private ordering has a kind of exclusive dominion.

This feature of the firm led Oliver Williamson to refer to the “contract law” of the firm as “forbearance.”⁴⁹ Forbearance denotes the fact that courts “routinely grant standing to firms should there be disputes over prices,” but will “refuse to hear disputes between one internal division and another over identical technical issues.”⁵⁰ The result of the absence of law is that “parties must resolve their differences internally. Accordingly, *hierarchy is its own court of ultimate appeal.*”⁵¹ Forbearance arises from simple—even bedrock—legal principles, but it is of enormous consequence to firms. It means that a detailed written agreement between two divisions of a firm, which defines consideration, prices, volumes, and delivery obligations, is legally unenforceable. That agreement cannot serve the most familiar function of a legal contract—to bind the counterparties in the eyes of the law. The fact that some major businesses still choose to carefully draft such agreements and then formalize the adjudication of any disputes is the central puzzle of this paper.

(b) The Corporate Group: Parents, Subsidiaries, and Affiliates

The legal situation governing transactions among the separate entities in a corporate group is vastly more complicated than transactions within a single entity.⁵² These complications arise from corporate, tax, securities, and debtor-creditor law and become only more labyrinthine when transactions have a transnational element.⁵³ Even if wholly owned by a parent company, every corporate entity is required to have a distinct board of directors and to maintain its own corporate formalities.⁵⁴ Commonly controlled corporate affiliates that have minority shareholders are legally required to treat each other

⁴⁸ See generally Iacobucci & Triantis, *supra* note 23 at 524 (“A division of the corporation . . . does not have legal personality. A division cannot sue or be sued, cannot own property, and cannot contract.”).

⁴⁹ Oliver E. Williamson, *Comparative Economic Organization: The Analysis of Discrete Structural Alternatives*, 36 ADMIN. SCI. QUART. 269, 274 (1991).

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² See generally PHILLIP I. BLUMBERG & KURT A. STRASSER, *THE LAW OF CORPORATE GROUPS I-V* (1995).

⁵³ See George G. Triantis, *Organizations As Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102, 1125-1131 (2004) (examining the various legal requirements that are imposed on the movement of capital between entities, but not within them).

⁵⁴ See generally Iacobucci & Triantis, *supra* note 23 at 561 (discussing the legal ramifications of separate corporate existence among commonly controlled entities).

at arm's length under U.S. law.⁵⁵ If shareholders challenge the transfer of resources or funds between such related entities, courts may end up reviewing those transactions under a stringent "entire fairness" standard, if certain triggers are shown.⁵⁶ Taxation likewise emphasizes entity-level revenue, subjecting inter-entity transactions within the same firm to far more scrutiny than intra-entity transactions.⁵⁷ Similar rules apply in securities and debtor-creditor law.⁵⁸ So, while Williamson is correct that one division within an entity cannot bring suit against another, forbearance is not quite an accurate characterization of transactions within a corporate family.

2. *Exchange and Conflict in Firms*

To some, the idea of "trade," "exchange," or "transactions" within a firm may sound strange, let alone the idea of divisional managers disputing such transactions in a manner analogous to contractual counterparties disputing a default in the market. Perhaps the simplest way to think about transactions or exchange within a firm is in the context of a transfer of goods or services between an upstream and downstream division.⁵⁹

Consider a simple example of a transaction between two divisions within a single entity.⁶⁰ The Basic Chemicals Division of Locke Chemical Company is responsible for manufacturing a number of chemicals used by other divisions, such as Plastics and Molding. It transfers building block chemicals on a cost basis to the downstream

⁵⁵ *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971). *Sinclair* is the rare lawsuit among affiliates.

⁵⁶ *Id.* at 722.

⁵⁷ See PHILLIP I. BLUMBERG & KURT A. STRASSER, *THE LAW OF CORPORATE GROUPS: PROBLEMS OF PARENT AND SUBSIDIARY CORPORATIONS UNDER STATUTORY LAW SPECIFICALLY APPLYING ENTERPRISE PRINCIPLES* 269-303 (1992) (discussing tax issues arising in corporate groups). Especially relevant here are transfer pricing issues in taxation.

⁵⁸ *Id.* at 533-585 (discussing securities issues specific to corporate groups); *id.* at 383-409 (discussing intra-group reorganizations and liquidations).

⁵⁹ The "M-form" or multidivisional corporation developed over the Twentieth Century to become the norm for large businesses. See ALFRED D. CHANDLER, JR., *STRATEGY AND STRUCTURE: CHAPTERS IN THE HISTORY OF THE AMERICAN INDUSTRIAL ENTERPRISE* 325 (1990) ("An enterprise can be said to have adopted the new [M-] form if it came to have a general office with executives whose primary tasks were general rather than functional and if it also had at least two major multidepartmental, relatively autonomous divisions."). It has been lauded by Williamson as "American capitalism's most important single innovation of the twentieth century." See Oliver E. Williamson, *Managerial Discretion, Organizational Form, and the Multi-Division Hypothesis*, in *THE CORPORATE ECONOMY* (Robin Marris & Adrian Wood eds. 1971); Omari Scott Simmons & James D. Dinnage, *Innkeepers: A Unifying Theory of the in-House Counsel Role*, 41 *SETON HALL L. REV.* 77, 95 (2011) (referring to the multidivisional form as perhaps "the greatest functional innovation in the development of the modern corporation").

⁶⁰ This extended example is drawn from a case study conducted by organizational sociologists Eccles and White. See Robert G. Eccles & Harrison C. White, *Price and Authority in Inter-Profit Center Transactions*, 94 *AM. J. SOC.* S17, S27-28 (Supp. 1988); see also ROBERT G. ECCLES, *THE TRANSFER PRICING PROBLEM: A THEORY FOR PRACTICE* (1985).

divisions, which then create products that are sold externally on the market. This is a classic “transaction” or exchange—one party creates a good and transfers it to another. In this case, it does so in exchange for payment on a cost basis mandated by the management of the firm, while also potentially serving to keep score for internal accounting purposes.

This transaction also illustrates how easy it is for conflict to arise out of in-firm transactions. When Basic Chemicals creates more building block chemicals than needed to satisfy internal demand, it is allowed to sell that excess product to external customers.⁶¹ Basic Chemicals makes substantially more money from these transactions than internal transactions, as they occur at market prices far in excess of cost. If a downstream division requires more products than it had budgeted for, it likewise has to purchase them from the Basic Chemicals division, but now at the market, rather than cost, price. Divisional managers were highly invested in all of these differences, which significantly affected each division’s end of year performance as well as the bonus income to the managers.⁶² Predictably, conflict resulted, often taking the form of disputes about whether the cost and market prices were being appropriately calculated.⁶³

3. *Defining Contracting in the Firm*

It is important to clarify what contracting in the firm is *not*. It is not all documentation within a company. It is not the countless emails, memoranda, and accounting slips that transmit information and instructions among employees and units within a firm. It is not every purchase order an employee fills out for internal accounting purposes or every fax one division sends another division providing information on an incoming shipment. Nor is it all formal governance within a company. It is not the employee compensation committee, or office of the ombudsman, or grievance procedures.

There are two transactional technologies that together constitute “contracting within the firm,” when used within a single legal entity. First is the use of *agreements*—usually written—*negotiated* between distinct actors within the same organization that explicitly define commitments for both parties. Intra-firm contracting thus distinguishes itself from mere directions embodied in writing, such as the instructions of a supervisor, or the mere formalization of hierarchy (e.g., heavily-documented communication systems or division-specific profit and loss statements). The second aspect is *specialized adjudication* of these agreements. When the parties subject to an intra-firm “contract” cannot resolve a dispute themselves, they do not merely escalate it to a shared senior manager. Instead, a firm adopts some more structured alternative to fiat. Together, these two features represent a distinctly different approach to intra-firm transactions than the conventional wisdom about firms suggests.

⁶¹ *Id.* at S28.

⁶² *Id.* at S32.

⁶³ *Id.* at S28.

Even at their most formal, however, intra-firm “contracts” are not legal contracts if they are between unincorporated divisions of the firm (which is the focus of the following sections). A legal contract is an agreement between two or more legal persons that can be adjudicated by a third party and ultimately enforced by the legal system.⁶⁴ Legal contracts thus include contracts requiring arbitration, provided that state courts will uphold the arbitrator’s decision.⁶⁵ As a matter of commercial practice, contracts between sophisticated commercial parties are almost inevitably in writing,⁶⁶ and many contracts must be in writing to be enforceable.⁶⁷ The typical business contract thus combines together the two “technologies”⁶⁸ I noted – written agreements and specialized adjudication, but adds the element of legal enforceability.⁶⁹

B. Contracting in Firms

The majority of the section will present examples of legally unenforceable, but carefully negotiated agreements among employees or unincorporated divisions within firms, and the nonlegal, but formal adjudication of those agreements. I will also illustrate

⁶⁴ RESTATEMENT (SECOND) OF CONTRACTS § 1 (1979) (defining a contract as “a promise . . . for the breach of which the law gives a remedy”).

⁶⁵ 9 U.S.C. §§ 1–16 (the Federal Arbitration Act establishes federal policy favoring arbitration). See Ronald J. Gilson et. al., *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377, 1389 (2010) (“Arbitration is also a formal enforcement strategy. While arbitration displaces some of the legal rules associated with litigation, it still requires the intervention of the state to enforce the arbitration award.”).

⁶⁶ David K. Lutz, *The Law and Economics of Securities Fraud: Section 29(a) and the Non-Reliance Clause*, 79 CHI.-KENT L. REV. 803, 835 (2004) (“Yet, contracts between sophisticated parties ordinarily entail negotiated agreements, whereby long, complex, and intense negotiations are reduced to writing in a final agreement.”).

⁶⁷ RESTATEMENT (SECOND) OF CONTRACTS § 110 (1981) (defining the statute of frauds, which requires many categories of contracts to be in writing to be enforceable); U.C.C. § 2-201 (defining the Uniform Commercial Code Statute of Frauds).

⁶⁸ See Kevin E. Davis, *Contracts As Technology*, 88 N.Y.U. L. REV. 83, 85 (2013) (arguing that contracts are a kind of technology).

⁶⁹ This may be the place for a note on the argot of contract theory. A “contract” in first-year contracts class typically means a legally enforceable agreement between two parties. In contrast, contract theory uses the term more capaciously to denote any voluntary arrangement among parties. “Relational contracts” are thus informal arrangements or understandings between parties that structure their interactions without the use of a legal contract. I follow contract theory’s broader usage here. See, e.g., Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913, 933 (1999) (discussing “the informal, non-legally enforceable set of protections that constitute relational ‘contracts.’”). Robert Gibbons defines relational contracts as “informal agreements, unwritten codes of conduct, and norms that powerfully affect the behaviors of individuals in firms.” Robert Gibbons, *Trust in Social Structures: Hobbes and Coase Meet Repeated Games* (2000), http://web.mit.edu/rgibbons/www/trust_sf.pdf.

an intra-firm legal system that adjudicates legally enforceable contracts among a firm's subsidiaries.

This evidence consists of qualitative illustrations. Unfortunately, gathering rich data on intra-firm transactions poses particular difficulties. Data on intra-entity transactions is not gathered systematically in any form, and firms are individually loath to disclose their internal governance structures.⁷⁰ Gathering even limited qualitative data is difficult. Executives frequently consider their internal practices a source of strategic advantage and refuse to discuss them. Nonetheless, the illustrations to follow provide suggestive evidence for the significance of market-like transactional technologies in firms, and given the enormous significance of intra-firm exchange, suggest directions for more systematic analysis.

A caveat may also be in order regarding the interviews conducted. As part of this study, I interviewed about ten executives or former executives at various businesses regarding their firms' practices for structuring and resolving internal exchanges.⁷¹ These interviews add a measure of qualitative "color" to the analysis, but the case studies draw predominately on publicly available data and sources.

1. Fiat

It is no wonder that the image of trade in the firm as a web of relational contracts and adjudication by fiat has survived for so long. Several interview subjects described their firm in these terms and expressed bewilderment at the possibility of any other arrangement.⁷² They described an environment in which managers constantly collaborated and frequently disagreed, but in which those disagreements were resolved through diplomacy, collegiality, and personality, under the shadow of fiat.⁷³ When conflict could not be eliminated by means of negotiation, the disagreement was simply escalated up the chain of command and a senior manager resolved the dispute by command.⁷⁴

2. Intra-Entity Contracting

What does contracting in the firm look like then? Industry leaders across very different sectors paint vivid portraits of intra-firm contracting.

⁷⁰ Indeed, under Coase's view, the idea of comparing intra-entity and inter-entity transactions is incoherent because it is the very absence of the price mechanism that marks off a transaction as intra-firm.

⁷¹ These semi-structured interviews were conducted "on background," meaning that I agreed to the request—made by all interviewees—that they not be identified. The executives generally came from some of the largest corporations in the U.S. and ranged from primarily business to primarily legal capacities.

⁷² See Interviews 3, 4, 7.

⁷³ *Id.*

⁷⁴ See Interview 4.

a. *Lockheed Martin*

Ranging across aerospace, security, and complex technologies, defense contractors are some of the U.S.'s most important businesses.⁷⁵ They operate in a highly competitive⁷⁶ and technologically demanding field that is in constant flux.⁷⁷ The world's largest defense contractor is Lockheed Martin,⁷⁸ which specializes in the research, design, and development of technology systems, and generates over \$46 billion in annual revenue.⁷⁹

Lockheed operates several major unincorporated business units.⁸⁰ Those units focus on different aspects of Lockheed's business. For instance, its Sanders unit specializes in airborne electronic warfare and countermeasures, while its LMSTS unit focuses on informational systems. When these units need to cooperate with each other, they do so not through informal agreements, but through multipage written internal memoranda of agreement. These internal contracts are not an occasional device, but the standard way of organizing exchange between the firm's divisions.⁸¹ Lockheed explicitly disavows that these internal contracts are meant to be legally enforceable, referring to them instead as structuring cooperation among "sister divisions."⁸²

Consider an example of one such agreement. It defines how Lockheed's business units, Sanders and LMSTS, would approach business opportunities generated by a third

⁷⁵ Combined, Lockheed Martin, Boeing, and Northrop Grumman have revenue well in excess of \$150 billion. See *The Boeing Company, Competitors*, YAHOO! FINANCE, <http://finance.yahoo.com/q/co?s=BA+Competitors> (last check Aug. 4, 2015).

⁷⁶ A. Paul Ingraio, *Joint Ventures: Their Use in Federal Government Contracting*, 20 PUB. CONT. L.J. 399 (1991) (describing increasingly sophisticated international competitors of U.S. defense contractors).

⁷⁷ Norman R. Augustine, *Reshaping an Industry: Lockheed Martin's Survival Story*, May HARV. BUS. REV. (1997) (describing mergers and acquisitions activity involving some of the defense industry's largest firms).

⁷⁸ Michael Joyce & Bettina Schechter, *The Lean Enterprise—A Management Philosophy at Lockheed Martin*, DEFENSE ACQUISITION REV. J. 173 (2004).

⁷⁹ See *Lockheed Martin Corporation (LMT), Profile*, YAHOO! FINANCE, <https://finance.yahoo.com/-q?s=LMT>.

⁸⁰ These facts about Lockheed were all revealed as part of a multiyear litigation in Delaware courts. See Docket No. 3099-VCN. In particular, see *BAE Sys. Info. & Elec. Sys. Integration, Inc. v. Lockheed Martin Corp.*, No. CIV.A. 3099-VCN, 2009 WL 264088, at *1-2 (Del. Ch. Feb. 3, 2009). Most of the facts proceeding are drawn from the record in that action.

⁸¹ No. 3099-VCN, Dkt. Entry 20096004, at 3 (describing use of intra-divisional agreements as "consistent with Lockheed Martin's practice of business units dealing with one another in exchanging goods or services").

⁸² *Id.* at 7 (describing the "agreement between two sister divisions of a single company -- neither of which would be expected to be using such a document to create enforceable contractual obligations upon which it could sue").

unit, LM Aerospace, which designs and manufactures military aircraft.⁸³ LM Aerospace is frequently awarded contracts to build aircrafts and typically outsources the design of automated test systems (ATS) to other divisions of Lockheed. ATS are automated programs that quickly perform measurements and evaluate results to ensure a device is properly operational. For instance, one Lockheed ATS, known as the Consolidated Automated Support System, has validated the combat-readiness of every aircraft in the U.S. military for the last twenty years.⁸⁴

The agreement carefully “defines the strategic business relationship” among the three units, establishing how Sanders and LMSTS would divide and pursue future ATS opportunities generated by LM Aerospace.⁸⁵ The majority of the agreement is devoted to defining the boundaries between the divisions and which opportunities are assigned to which division. It states that the LMSTS division “shall focus on and lead the pursuit of generic/standard ATS and logistics information systems, while BAE Systems shall focus on and lead the pursuit of application specific, platform support system design, embedded and field diagnostic ATS.”⁸⁶ Other preexisting opportunities are specifically excluded, and an agreed-upon distribution of work for a larger set of opportunities is included in an affixed table.⁸⁷ The agreement also specifies that LM Aerospace would transfer certain of its employees with relevant specialties to Sanders and others to LMSTS.⁸⁸

The agreement also defined how future disputes and modifications involving its terms would be determined. The inter-divisional agreement creates a joint governance structure consisting of an equal number of members from both divisions.⁸⁹ This governance structure—a joint board composed of an equal number of members from both parties—is typical of corporate joint ventures in the marketplace.⁹⁰ The agreement also requires the divisions to coordinate with each other and to meet as necessary in order to resolve matters of shared business strategy and investment at a minimum of four times per year.⁹¹ The agreement is signed by the heads of the two divisions.⁹² This “internal

⁸³ This discussion is based on the agreement itself, which is available at *BAE Sys. Info. & Elec. Sys. Integration, Inc. v. Lockheed Martin Corp.*, 2007 WL 7154752 (Del.Ch.) (Exhibit A: Memorandum of Agreement), as Exhibit A to Verified Complaint. The document was made public as part of a lengthy litigation in Delaware Chancery Court, which will be discussed later.

⁸⁴ Lockheed Martin, *Automated Test System for the Navy Begins Production*, Jan. 13, 2014, <http://www.lockheedmartin.com/us/news/features/2014/140113-mst-ecass-automated-test-system-for-the-navy-begins-production.html>.

⁸⁵ Memorandum at § 2.0.

⁸⁶ *See, e.g.*, Memorandum at § 4.0.

⁸⁷ Memorandum at Table 1.

⁸⁸ Memorandum at § 5.1.

⁸⁹ Memorandum at § 5.0.

⁹⁰ *See, e.g.*, The Boeing Company; Form 8-K; Item 1.01; Filed: May 4, 2005, Joint Venture Master Agreement between The Boeing Company and Lockheed Martin Corporation.

⁹¹ *Id.* In the event that the arrangement became unacceptable to LMSTS, then it was dissolved in its entirety. Memorandum at § 5.1.

⁹² *Id.* at § 6.0.

joint venture” was highly successful, resulting in at least \$52 million in added revenue for Lockheed.⁹³

b. Morning Star

Manufacturing remains big business in many states and sectors, including food processing, which has become an intensely globalized industry.⁹⁴ Located throughout California, Morning Star is the world’s largest tomato processor with almost \$1 billion in annual revenue.⁹⁵ Founded in 1970, Morning Star has grown over 45 years from a one-truck company to an employer of thousands, accounting for over 25% of California’s tomato processing production and supplying over 40% of U.S. tomato paste.⁹⁶

Organizationally, the core of the company is a single legal entity that houses 20 distinct business units, each of which has its own profit and loss ledger and balance sheet. The company carefully creates a contractual scaffolding for the relationships among its employees and resolves intra-firm disputes through a variety of impartial, if informal means.

At the beginning of every year, each Morning Star employee negotiates a written agreement with the colleagues who are most relevant to her work, which defines that employee’s operating plan for how to fulfill her role within the company. Called a Colleague Letter of Understanding (“CLOU”), this agreement acts as a kind of “peer-to-peer contract” within the firm. Drafting the CLOU may involve discussions with ten or more peers and be more than ten pages long. The CLOU defines performance metrics for each relevant activity and may cover up to 30 areas of involvement.⁹⁷ So, for example, a CLOU might involve the individual who operates the cooling tower in a processing factory defining how she will improve the efficiency of the equipment, comply with regulatory requirements, handle repairs, invest in new parts, assess whether superior technology is available, and help train new employees. In aggregate, the CLOUs define a dense network of inter-relationships among Morning Star’s employees.⁹⁸ Although one

⁹³ No. 3099-VCN, Dkt. Entry 25073998.

⁹⁴ Colin A. Carter, *Economics of the California Processing Tomato Market*, 10 AGRICULTURAL AND RESOURCE ECON. UPDATE (2006).

⁹⁵ <http://www.inc.com/audacious-companies/leigh-buchanan/morning-star.html>; Richard Daft, *Management* 62 (2015).

⁹⁶ Morning Star, *Company History*, <http://morningstarco.com/index.cgi?Page=About%20Us/Company%20History>.

⁹⁷ FREDERIC LALOUX, *REINVENTING ORGANIZATIONS* 57 (2014).

⁹⁸ It is emphatically not a matter of drafting a contract to be enforced by courts. Instead, the CLOU raises the same puzzle encountered by Bozovic and Hadfield when they studied business that carefully draft contracts will collaborators even as the executives aver that they have no intention of legally enforcing them. This is all the more true here. The CLOU acts as an explicit “scaffold” that organizes employees’ expectations and relationships with one another. As Morning Star’s founder puts it, “the CLOUs create structure” but still permit relationships to “change form more easily” than if fixed by hierarchy. Hamel

colleague could not sue another based on a CLOU and Morning Star does not consider them legal documents, the CLOU is thought of as a kind of “internal contract.”⁹⁹

Following a process analogous to individual employees’ negotiation of a CLOU, the company’s 20 business units also negotiate agreements with one another each year.¹⁰⁰ Bargaining defines obligations with granularity: volumes, prices, and delivery dates are defined. Because units each have their own bottom line, the negotiations can be intense.¹⁰¹

The firm also establishes its own method of resolving commercial disputes among employees and divisions. Specifically, Morning Star takes a structured approach to dispute resolution through a multi-tier internal mediation system. When two employees have a persistent disagreement concerning operational responsibilities within the firm, the two first choose an internal mediator to adjudicate their dispute.¹⁰² If the disputants continue to disagree regarding the mediator’s decision or proposed remedy, then a panel of six colleagues is assembled to mediate. Given the dense network of reputational capital that Morning Star is at pains to create, there is already a high price to pay for merely invoking such a panel. The six-person panel of mediators then reconsiders the disagreement. It either endorses the initial mediator’s decision or proposes an alternative resolution.¹⁰³ By this stage, virtually all disputes within the firm are resolved. This dispute resolution structure is apiece with the organizational concept Morning Star seeks, which is to have “no command authority whatsoever.”¹⁰⁴ As one former executive put it, at Morning Star: “There is no fiat. Fiat doesn’t exist.”

c. John Mowlem Construction

John Mowlem, a sprawling construction company, provides another intriguing example of “internal joint ventures” alongside Lockheed.¹⁰⁵ With almost \$1 billion in

⁹⁹ Interview 5.

¹⁰⁰ *Id.*

¹⁰¹ LALOUX, *supra* note 97, at 124. Additional methods of governance buttress the sense of accountability to commitments within Morning Star. At the end of each year, the main teams within the organization present a self-evaluation of their work to colleagues, including the CEO. Presentations each last for hours, and while candor is expected of employees, they can also expect an interrogation from their colleagues.

¹⁰² DAVE GRAY & THOMAS VANDER WAL, *THE CONNECTED COMPANY* 138 (2014).

¹⁰³ Rufer, the president of Morning Star, notes of the panel mediation system: “When a panel of peers gets convened, people can see that the process is fair and reasonable. Everyone knows they have recourse. We’ve taken away the power a boss has to treat an employee as a punching bag.” Hamel. Gary Hamel, *First, Let’s Fire All the Managers*, *HARV. BUS. REV.*, Dec. 2011, <https://hbr.org/2011/12/first-lets-fire-all-the-managers>; JEAN PHILLIPS & STANLEY GULL, *ORGANIZATIONAL BEHAVIOR: TOOLS FOR SUCCESS* 476 (2013).

¹⁰⁴ Interview 4.

¹⁰⁵ Mowlem was one the UK’s largest and most important construction and engineering companies until 2006, when it was purchased by Carillion plc. See Caroline Muspratt, *Carillion to Buy Mowlem for £291m*, *THE TELEGRAPH*, Dec. 7, 2005, <http://www.->

revenue and over 10,000 employees, Mowlem was a major player in the British construction scene. Its original expertise had been civil engineering, but by the late 1980s Mowlem was struggling to capture the most desirable new construction contracts.¹⁰⁶ The company thus took itself through a major internal re-organization. The company's board decided to treat each division as a separate profit center, eschew direct involvement in conflicts among the different divisions, and instead promote a policy of divisions entering contractualized internal joint ventures with one another.¹⁰⁷

These internal contracts included most of the core provisions of a joint venture contract between two separate firms.¹⁰⁸ Each "partner" was liable for the independent acts or omissions in which it engaged and indemnified the other partner for harm to third parties as a result of its actions. Each party would transfer its profits to the company, but a careful apportionment of responsibility would be maintained.

Lastly, the contract defined the mechanism for resolving disputes under its terms. As with the other examples we have seen, this mechanism carefully avoids the escalation-and-fiat familiar from the theory of the firm (and many organizations). Instead, disputes were referred first to the project's managers for informal negotiation, then to their senior managers, and then to an independent arbitrator to be appointed by the board of the firm. The success of these organizational changes was remarkable. Mowlem saw a significant uptick in the construction bids it won and in the prices it was able to offer.¹⁰⁹

3. *Inter-Entity Contracting within the Firm*

The examples so far have been of agreements in firms that are unenforceable because they are not between legal persons. A last few illustrations will highlight the additional complexities involved when agreements within a firm are between separate legal persons and hence are legally enforceable, but are nonetheless adjudicated within the firm.

(a) *Other Examples*

Hobbes Instrument Company, an electronic equipment and components manufacturer, provides another portrait of internal contracting. In the case of Hobbes, the Internal Products Division manufactured a variety of inputs for three other divisions, Basic Systems, Intermediate Systems, and Advanced Systems.¹¹⁰ These inputs were not allocated to the various divisions by fiat, however. Instead, Hobbes encouraged divisional

telegraph.co.uk/finance/2927860/Carillion-to-buy-Mowlem-for-291m.html. The facts in this section are drawn from an extended case study of Mowlem by John Naylor and Mark Lewis, which studied 10 years of company minutes and records and interviews with executives within the company as well as competitors. See generally John Naylor & Mark Lewis, *Internal Alliances: Using Joint Ventures in a Diversified Company*, 30 LONG RANGE PLANNING 678, 678 (1997).

¹⁰⁶ Naylor & Lewis, *supra* note 105, at 682.

¹⁰⁷ *Id.*

¹⁰⁸ *Id.* at 686.

¹⁰⁹ *Id.* at 686.

¹¹⁰ Eccles, *supra* note 63, at 130-140.

managers to autonomously negotiate the prices of transactions with each other.¹¹¹ One manager described them as “hard-headed negotiations with much saber rattling. We sit down . . . with Semiconductors and negotiate prices.”¹¹²

Conflict under this system was rife, but, at least in the company’s view, beneficial. As one manager summarized it, “there is a healthy discontent.”¹¹³ The quasi-arm’s length relationships among divisional management drove predictably guarded responses among employees. Product managers carefully monitored each other’s performance, scrutinized the resources supplied to them, and gathered information about the costs and prices offered by external competitors offering the same product as the internal supplier.

Another example is a large multinational enterprise that created extensive sets of rules and regulations to govern its own internal commercial conflicts.¹¹⁴ The firm employed an “‘Internal Trading Policy’ that regulates how units in the corporation interact,” which specified what rules govern different commonly occurring scenarios of conflict and how conflicts should be resolved.¹¹⁵ The firm was organized along the lines of individual cost centers that regularly entered sales contracts with each other. Firm bonuses were based on individual cost center performance leading, predictably, to frequent conflict. The internal contracts entered pursuant to the firm’s trading policy defined warranties and other contractual rights in detail, the identity and the obligations of the different parties, and who had to bear the costs of a defective product.¹¹⁶

These governing provisions also specified how a conflict is resolved if the immediate parties cannot settle it within a defined period of time. The disagreement is presented to an intra-firm dispute resolution-board consisting of members from three different departments—project management, claim management, and the finance department.¹¹⁷ The parties to the transaction have no input on the choice of the members of the board. The board then receives a brief report on the dispute, may speak to the individuals involved in the conflict, and then rapidly issue a decision that is binding on the parties.¹¹⁸

¹¹¹ Eccles & White, *supra* note 63, at S37.

¹¹² Eccles, *supra* note 63, at 135.

¹¹³ *Id.* at S38.

¹¹⁴ Calliess & Harder, *supra* note 5, at 226.

¹¹⁵ *Id.* The same policy applied irrespective of whether the conflict was between virtual units within the same legal entity or between different legal entities within the broader firm.

¹¹⁶ Calliess, *supra* note 5, at 226. An executive at the company summarized. “[O]ther rights are all stipulated in detail: Who has to do what; who has to remove the parts; who has to examine them; who has to pay for transport and so forth. What happens, if no fault can be established; who bears the cost then.” *Id.* Calliess and Harder found these policies sufficiently detailed to constitute a kind of “‘intra-firm law.’” *Id.* at 225.

¹¹⁷ *Id.* at 232.

¹¹⁸ *Id.*

Other interviews revealed similar institutions, although not always on the same scale. Nonetheless, several interviewees noted their experience of divisions entering written agreements with one another.¹¹⁹ One interviewee described in detail that divisions entered service agreements with one another. These agreements expressly define performance obligations with quantifiable and standardized terms for output where possible.¹²⁰

(b) *Gazprom*

The publicly-traded oil giant Gazprom is Russia's largest business enterprise.¹²¹ Gazprom generates approximately 8% of Russia's GDP,¹²² and it is the world's largest natural gas producer with annual revenues consistently exceeding \$100 billion.¹²³

In 1993, Gazprom adopted its current charter of incorporation. In that charter, a new institution within the firm was introduced – the Gazprom arbitration court.¹²⁴ The court is a permanent tribunal, which was established for the exclusive purpose of settling intra-firm trade disputes among the company's subsidiaries.¹²⁵ The number and complexity of the relationships within the Gazprom corporate family is bewildering. There are hundreds of subsidiaries.¹²⁶ Disputes among managers of the subsidiaries are frequent.

The Gazprom court has all the features of a fully functioning private judicial system. Its rules are 45 pages long and define in detail the allocation of costs, the filing of

¹¹⁹ Interviews 4 and 7.

¹²⁰ Interview 3.

¹²¹ Top Russia, *Fortune Global 500, Russia Rank*, INVEST IN RUSSIA, <http://www.investinrussia.ru/-russia-200>.

¹²² See Vladimir Soldatkin, *Gazprom Net Income Plunges 86 Pct on Oil Price Drop, Rouble*, REUTERS, Apr. 29, 2015, <http://www.reuters.com/article/2015/04/29/us-gazprom-results-idUSKBN0NK1XP20150429>.

¹²³ Hoovers, Dun & Bradstreet, *Gazprom OAO Revenue and Financial Data*, http://www.hoovers.com/company-information/cs/revenue-financial.Gazprom_OAO.f7d840aa24447a0d.html. In 2011, Gazprom topped Forbes' list of the world's most profitable companies with \$44 billion in profit. *Russia's Gazprom is the World Most Profitable Company*, RT, July 30, 2012, <http://rt.com/business/gazprom-profit-list-forbes-391/>.

¹²⁴ Articles of Association Open Joint-Stock Company Gazprom, Article 51. Company's Arbitration Court ("The Company shall set up a permanent Arbitration Court for resolution of business disputes. The competence and procedure for establishing the Arbitration Court of the Company shall be determined by the corresponding regulation approved by the Company's Board of Directors"); Ivan Philippov, *The Problem of "Pocket Arbitration Courts" in Russia: Finally Resolved?*, CIA Arbitration Forum, Apr. 7, 2015, <http://www.cisarbitration.com/2015/04/07/the-problem-of-pocket-arbitration-courts-in-russia-finally-resolved/>.

¹²⁵ Gazprom Release, *Arbitration Court Judges Meet at Gazprom Premises*, Feb. 27, 2009, <http://www.gazprom.com/press/news/2009/february/article67884/>.

¹²⁶ Gazprom, *Companies with Gazprom's Participation and Other Affiliated Entities*, <http://www.gazprom.com/about/subsidiaries/list-items/>. The majority are wholly-owned, but many have minority shareholders, and in a small number, Gazprom is a minority shareholder.

claims, the selection of arbitrators, the notification of parties, counterclaims, and grounds for disqualifying arbitrators.¹²⁷ Its list of standing arbitrators are a “who’s who” of Russian legal professionals, industry experts, and Gazprom managers.¹²⁸ The court’s reasoning tends to be pragmatic and functional, rather than formalistic and legal. As one practitioner noted of it, “the arbitrators tend to . . . have a more economic approach, i.e. analyze the situation from the economic point of view before deciding the case.”¹²⁹

Indeed, the Gazprom arbitral court’s success was sufficient that the set of parties from whom it heard disputes eventually expanded beyond Gazprom itself. The arbitral court now hears disputes between subsidiaries and non-Gazprom entities and among totally unrelated parties, including non-Russian firms.¹³⁰

III. THE UTILITY OF CONTRACTING IN THE FIRM

Contracting within firms appears across multiple industries, from defense and aerospace to food processing, engineering, and natural gas exploration. Given the volume of intra-firm trade, there is expansive scope for the use of internal contracts and adjudicatory procedures to play an important role in world commerce. As a result, the reasons for contracting within firms are likely to vary enormously, just as the reasons for contracting between firms. Nonetheless, this Part shows how internal contracting offers firms tools for addressing a variety of organizational needs. In particular, I emphasize the ability of contracting within firms to mitigate the agency problem firms face. This problem—of aligning the interests of a firm’s employees with the interests of the firm’s owners—is often considered the central problem of corporate law.¹³¹ Contracting within the firm can address several different aspects of it, including strengthening incentives, mitigating information asymmetries, and reducing lobbying within firms. Because the incentive and informational benefits of contracting are fairly familiar, I devote more time to the ability of contracting in firms to reduce internal lobbying.

I focus on the agency problem not only because of its importance to organizational success, but because it reveals a function of contract *distinctive to hierarchy*, highlighting why contract might, surprisingly, be far more robust to the firm-market distinction that scholars have thought. It is worth repeating, however, that these

¹²⁷ Rules of the Arbitration Court at Joint Stock Company Gazprom, Gazprom, <http://pandia.org/text/79/084/79082.php>.

¹²⁸ <http://www.gazprom.ru/about/arbitral/>. Half of the arbitrators are professors at Russian universities or academics at other forms of educational institutions. A large minority are attorneys connected with major law firms, bar associations, or other arbitral institutions. The third largest group of arbitrators consists of various Gazprom employees, and lastly, there are a small group of arbitrators from the Russian Chamber of Commerce and the oil industry. Gazprom Release, *Arbitration Court Judges Meet at Gazprom Premises*, Feb. 27, 2009, <http://www.gazprom.com/press/news/2009/february/article67884/>.

¹²⁹ Interviewee # 8.

¹³⁰ Gazprom Release, *Gazprom Arbitration Court Leading among Largest Arbitration Centers*, Mar. 26, 2013, <http://www.gazprom.com/press/news/2013/march/article158923/>.

¹³¹ KRAAKMAN ET AL., *ANATOMY OF CORPORATE LAW* Ch. 1 (2d ed. 2009).

explanatory factors will not—individually, or in aggregate—explain all instances of contracting within the firm. Instead, they illustrate the more general claim that even without enforcement by law, these contract-like structures can create important benefits.

A. *Incentives and Information*

The agency problem of aligning agents' interests with those of their principal is in part a problem of incentives and opportunism. Agents need incentives to motivate them to act in the principal's interests, and well-designed incentives must not only be strong, but guard against agents pursuing them in unproductive ways. It is not possible to fully replicate for an agent the full incentive intensity of the market. For instance, for the incentive compensation of a corporation's officers' to fully replicate the incentives of the corporation's owners, the officers would have to own 100% of equity, solving the separation of ownership and control by dissolving it. As a result, it is widely held that firms cannot replicate the incentive intensity available between unrelated actors in a market.¹³² Indeed, Williamson treats diminished incentive intensity as a fundamental characteristic of firms, and *ceteris paribus*, as a downside of the firm as a mode of organizing production.¹³³ What Williamson and others have missed is the possibility of reinstating aspects of contract within a firm in order to increase incentive intensity. Here, I briefly explore how internal contracts can reduce agency costs by strengthening employees' incentives and reducing information asymmetries.

The most basic economic rationale for enforcing contracts is that agreements resulting from voluntary, bargained-for exchange are presumptively beneficial for both parties.¹³⁴ An environment in which transfers of goods must be voluntary thus leads to a situation in which individuals have incentives to produce goods that others will desire to purchase.¹³⁵ To illustrate this simple but fundamental idea, consider two very different approaches to organizing and pricing transfers of goods between upstream and downstream divisions in the same company. One way of organizing those transfers would be for senior management to mandate that the upstream division transfer a certain

¹³² See, e.g., Tian Zhu, *Incentive Intensity, Forbearance Law and the Governance of Transactions*, 13 *INDUS. & CORP. CHANGE* 855 (2004) (Zhu's analysis is especially explicit about this assumption and it drives his conclusions); Susheng Wang & Tian Zhu, *Contract Law and the Boundaries of the Firm*, 9 *J. ECON. RES.* 93, 93 (2004) (arguing that "the application of the forbearance doctrine to internal organization limits the use of incentive contracts within the firm and gives rise to the cost of integration").

¹³³ Steven Tadelis & Oliver Williamson, *Transaction-Cost Economics*, in *THE HANDBOOK OF ORGANIZATIONAL ECONOMICS* (Robert Gibbons & John Roberts eds., 2013).

¹³⁴ ROBERT E. SCOTT & JODY S. KRAUS, *CONTRACT LAW AND THEORY* 27 (3d ed. 2002) ("The possibility of coordination through voluntary cooperation rests on the elementary . . . proposition that both parties to an economic transaction benefit from it, provided the transaction is bilaterally voluntary and informed."); MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* 13 (1962).

¹³⁵ The benefits identified in this subsection in many ways parallel the general benefits of decentralization identified by Hölmstrom & Tirole, *supra* note 23.

quantum of goods to the downstream division based on a price determined by the CEO after consulting with both divisions' managers. Contrast that with the approach of Lockheed Martin, which represents a specific way of implementing this decentralized approach. Within Lockheed, divisions are encouraged to purchase inputs from the supplier offering the best value with no preference for an internal division of Lockheed, even if it produces that exact input.¹³⁶ Rather than mandating internal transfers at a price determined by senior managers, Lockheed encourages divisions to treat each other just like external suppliers. This competitive internal pricing dynamic strengthens incentives for Lockheed's internal divisions to produce high-quality, low-cost products. It also means that divisional managers drive hard bargains when negotiating agreements and prices with one another. The bottom line is that even holding the amount of incentive compensation constant, *organizational changes in how transactions within a firm are structured and governed can intensify employees' incentives.*¹³⁷ Lockheed's approach here exemplifies the economic benefits of decentralization emphasized in Hölmstrom & Tirole's pioneering work.¹³⁸

Lockheed's internal contracting system also illustrates a second simple, but fundamental benefit of contracting within the firm, which is overcoming information asymmetries between the most senior management of the firm and lower level employees. Ever since Hayek's seminal work, scholars have appreciated that contracts can function as a *revelation mechanism.*¹³⁹ That is, if two individuals with distinct interests negotiate the price and other terms of an agreement, they credibly reveal information about how much they desire a product and how much they are willing to do or give up to receive it. They must, as the saying goes, "put their money where their mouth is." So, for instance, because Lockheed's managers receive extensive division-specific performance compensation, each divisional manager has a strong interest in striking the best possible terms on an intra-firm agreement. The resulting agreement thus conveys credible information to senior managers who might never had access to that information had they simply dictated a transfer price for the shipment of goods between an upstream and downstream division.¹⁴⁰

¹³⁶ R. PRESTON MCAFEE, *COMPETITIVE SOLUTIONS: THE STRATEGIST'S TOOLKIT* 152 (2009).

¹³⁷ Cf. Michael Klausner, *Governance Mechanism in Long-term Contracts*, in *CONTRACT GOVERNANCE: DIMENSIONS IN LAW AND INTERDISCIPLINARY RESEARCH* (STEFAN GRUNDMANN, FLORIAN MÖSLEIN & KARL RIESENHUBER EDS. 2015). Klausner suggests that features of long-term contracts *between* firms can be usefully considered as "contractual governance" that can mitigate moral hazard and hold-up problems. In a similar spirit, agreements *within* firms can likewise serve as governance mechanisms that mitigate intra-firm problems.

¹³⁸ Hölmstrom & Tirole, *supra* note 23.

¹³⁹ Friedrich Hayek, *The Use of Knowledge in Society*, 35 *AM. ECON. REV.* 519 (1945).

¹⁴⁰ Contract scholars have analyzed why one should expect different agreements to be drafted based on the *fact* of subsequent adjudication as well as the *identity* of the adjudicator. See Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 *YALE L.J.* 814 (2006) (analyzing how parties deliberately trade-off the front-end costs of drafting against the back-end costs of litigation when designing contracts).

B. Influence Activities

A distinct, but powerful agency-cost rationale for firms to turn to the market's transactional tools has recently emerged in the organizational economics literature. In his seminal paper launching the theory of the firm, Coase suggested that hierarchy must also involve costs.¹⁴¹ If it did not, we would expect to see all production in an economy occur inside a single enormous firm.¹⁴² For decades afterward, however, the theory of the firm did not precisely address Coase's question. Scholars focused instead on what determined the boundaries of firms and their make-buy decisions (i.e., whether to produce a product in-house or purchase it from an external supplier).¹⁴³

Recently, however, the theory of the firm has finally arrived at analyzing the costs of hierarchy and fiat. And increasingly, the theoretical and empirical work focuses on a particular strain of agency costs known as "influence activities" as a central cost of fiat.¹⁴⁴ Senior personnel within a hierarchy make decisions that impact other members of the firm. Because managers' decisions affect other employees' welfare, a ubiquitous type of agency cost, referred to as "influence activities," appears: agents have incentives to influence the manager to make the decision that maximizes their private benefit, rather than benefit to the firm.¹⁴⁵ The private benefit employees seek may be a desirable assignment, a pay raise, job security, a faster promotion, or less scrutiny from the boss. Seeking those benefits, employees will spend time and resources trying to influence

¹⁴¹ Coase, *supra* note 1, at 394.

¹⁴² Coase, *supra* note 1, at 394 (asking "Why is not all production carried on by one big firm?").

¹⁴³ Robert Gibbons, *Inside Organizations: Pricing, Politics, and Path Dependence*, 2 ANNUAL REV. ECON. 337, 337 (2010) (describing how even within the theory of the firm, "when economists have considered organizations, attention has focused on the boundary of the firm, rather than its internal structure and processes.").

¹⁴⁴ See Robert Gibbons, *Four Formal(izable) Theories of the Firm?*, 58 J. ECON. BEHAV. ORGAN. 200 (2005) (providing formal models of prominent theories of the firm, including the political approach as the one theory that focuses on internal organization); Raghuram G. Rajan & Luigi Zingales, *The Tyranny of Inequality*, 76 J. PUBLIC ECON. 521 (2000) (analyzing the role of authority); Phillippe Aghion & Jean Tirole, *Formal and Real Authority in Organizations*, 105 J. POLIT. ECON. 1 (1997) (providing a classic model of the operation of authority in organizations); Robert Gibbons, *Team Theory, Garbage Cans and Real Organizations: Some History and Prospects of Economic Research on Decision-Making in Organizations*, 12 IND. CORP. CHANGE 753 (2003).

¹⁴⁵ As a definitional matter, "influence activities" count as a form of "agency costs." Agency costs are an umbrella category composed of all the ways in which an agent delegated a task by a principal can deviate from the first-best outcome of perfectly serving the principal's interests. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). The most famous agency costs are those stemming from the "separation of ownership and control" between dispersed shareholders and senior management, but agency costs appear everywhere in a firm and throughout a managerial hierarchy.

managers, rather than engaged in directly productive activities. Managers' time will accordingly become preoccupied with attempts at influence.¹⁴⁶

Intra-firm transactions are ripe for generating influence activities. Consider two divisional managers who enter an informal, unwritten agreement obligating each manager's division to perform a service for the other's division. Performance occurs, but one manager contends that the other's performance has been defective. Under fiat, the mode of dispute adjudication is simple. The two employees first attempt to resolve their differences themselves through informal discussion and negotiation. If they cannot, however, then they escalate the dispute to their senior manager who has authority over them both. The manager simply dictates a resolution.

It is easy to see why influence activities could take on a prominent role where fiat resolves internal transactional disputes important to employees. The dispute could be important because that manager's bonus income is tied to her division's performance or because that division's performance will shape the manager's future career prospects. In either case, the *ex ante* incentives for influence are powerful. These forces are clearly at play in the real world.

For instance, Paine Chemical Company is among the world's largest manufacturers of plastic resins, which are viscous plastics used to create a wealth of everyday products, including food packaging materials, soda bottles, and credit cards.¹⁴⁷ The company employs three distinct profit centers with an upstream Plastic Resins Division that transfers plastic resins to downstream Rigid Packaging and Flexible Packaging Divisions. The firm's senior management mandated an internal system in which resins were sold downstream at "market" prices, so that the two packaging divisions transferred funds to Plastic Resins reflecting what an external customer would have paid for the resin inputs.

What that price was mattered enormously to the managers of each division because their performance income was based on their division's profitability. As a result, conflict was common. The downstream managers argued that an external customer would surely have received a volume discount from the normal market price, given that they were Plastic Resins' first and second largest customers. Additionally, the problem of finding a benchmark "market" price was complicated by the fact that fine-tuning resin manufacturing requires significant specific investments, which Plastic Resins—but no external supplier—had made. A direct comparison on price was thus unavailable. The result was enormous conflict.¹⁴⁸ That conflict was concentrated on the CEO, Larry Johnson, who had intentionally structured governance so that "he was the only executive

¹⁴⁶ Paul R. Milgrom, *Employment Contracts, Influence Activities, and Efficient Organizational Design*, 96 J. POL. ECON. 42, 43 (1988) ("influence costs,' attend any increase in centralized control, . . . which arise because participants inevitably care about the decisions that the central authority can make and so spend too much time trying to influence the authority's decisions.").

¹⁴⁷ Eccles & White, *supra* note 63, at S35.

¹⁴⁸ *Id.* at S39.

with sufficient authority to resolve real conflicts.”¹⁴⁹ Paine, in other words, chose one mode of resolving internal disputes—the authority and fiat of the senior manager.

The problem is that this invites the wealth of avenues available for attempts to influence the CEO (or any other executive). These range from the fairly anodyne (e.g., seeking a positive relationship with the boss) to those which are likelier to compromise the firm’s profitability (e.g., spending most of one’s time “buttering up” the manager or selecting inferior projects because the manager is perceived to prefer them). One channel of influence is especially noteworthy – the manipulation of information flows within an organization. Sociologist James March was among the first to note that “in a conflict system, information is an instrument of consciously strategic actors.”¹⁵⁰ As a result, “information itself is a game,” subject to deliberate or unconscious distortion by lower-level employees.¹⁵¹ Thus, information has “considerably less value than it might if strategic considerations were not so pervasive.”¹⁵² This is because reasonable managers will understand that lower level employees’ incentives will lead to biased information transmission, designed to manipulate managers’ decisions. Those managers will consequently interpret information with greater caution, discounting its probative value. Influence activities and managers’ rational response to them thus degrades the informational quality of signals in a firm. Even if influence attempts fail to systematically skew managerial decisions because information is discounted, they thus destroy value for the firm.

There are a number of distinct efficiency losses that stem from influence activities. Most directly, there is the time lower level employees devote to lobbying managers and the time managers lose in attending to that lobbying, all of which could have been deployed on behalf of productive activity for the firm.¹⁵³ This is an opportunity cost that destroys economic value. Second, there are the inferior decisions made by managers whose information degrades in quality as personnel distort communication as part of lobbying efforts. Third, there is the efficiency loss due to a firm deviating from its

¹⁴⁹ *Id.*

¹⁵⁰ James March, *Decisions in Organizations and Theories of Choice*, in PERSPECTIVES ON ORGANIZATION DESIGN AND BEHAVIOR 205, 217 (A. Van de Ven & W. Joyce eds. 1981).

¹⁵¹ *Id.*

¹⁵² *Id.* See also CYERT R, MARCH J, A BEHAVIORAL THEORY OF THE FIRM 79, 85 (1992 2d ed.) (“[w]here different parts of the organization have responsibility for different pieces of information relevant to a decision, we would expect . . . some attempts to manipulate information as a device for manipulating the decision. . . . [But] we cannot reasonably introduce the concept of communication bias without introducing its obvious corollary—“interpretive adjustment.”). See also Michael Powell, *An Influence-Cost Model of Organizational Practices and Firm Boundaries*, 10 J. LAW, ECON. & ORG. 1, 3 (2015) (“The disempowered manager may seek out additional information that favors her view, she may neglect to mention certain points that do not, or she may attempt to tell a story consistent with the facts but biased in its conclusion.”).

¹⁵³ Paul Milgrom & John Roberts, *Bargaining Costs, Influence Activities, and the Organization of Economic Activity*, in PERSPECTIVES ON POLITICAL ECONOMY 57 (James Alt & Kenneth Shepsle eds. 1990).

first-best organizational structure in order to establish mechanisms to suppress influence activities.

Empirical evidence suggests that managers do sometimes engage in wealth-destroying influence activities within firms. They distort the flow of information directed to senior managers to manipulate their perception of projects' performance.¹⁵⁴ They displace productive activities in order to expend resources obtaining personal benefits, such as early promotions.¹⁵⁵ They form coalitions to wrest desirable assignments from headquarters.¹⁵⁶ Case studies also document the value-destructive consequences of intra-firm politics. One especially colorful study shows how conflict between two departments eventually devolved into "the outbreak of war between operations and marketing" regarding a proposed change in a firm's production.¹⁵⁷

1. *Intra-Firm Contracting and Influence Activities*

In this section, I discuss how written agreements and specialized adjudication form an organizational mechanism that can effectively mitigate influence activities. Essentially, intra-firm contracting re-allocates decision rights away from management to raise the costs of influence activities, while creating the record necessary for third party adjudication.

(a) *Documented Agreements*

The core reason that formalizing agreements can reduce influence activities is because formal agreements facilitate the *verification* of disputes by third parties. Contract theory distinguishes between events and disputes that are *observable* and those that are *verifiable*.¹⁵⁸ Consider a violinist who commits contractually to deliver an "excellent"

¹⁵⁴ See, e.g., John E. Barbuto, Jr. & Kevin Warneke, *If at First You Don't Succeed: A Framework for Understanding Follower Compliance in Multiple Influence Attempts*, 8 Int'l J. Leadership Stud. 1 (2014); Bower, J.L., *Managing the Resource Allocation Process: A Study of Corporate Planning and Investment* (1986).

¹⁵⁵ MADISON, D.L., R.W. ALLEN, L.W. PORTER, P.A. RENWICK, AND B.T. MAYES, ORGANIZATIONAL POLITICS: AN EXPLORATION OF MANAGERS' PERCEPTIONS. HUMAN RELATIONS (1980); David Kipnis, Stuart M. Schmidt, & Ian Wilkinson, *Intraorganizational Influence Tactics: Explorations in Getting One's Way*, 65 J. APP. PSYCH. 440 (1980).

¹⁵⁶ See, e.g., Barbuto & Warneke, *supra* note 148, at 4.

¹⁵⁷ C. Morrill, *Conflict Management, Honor, and Organizational Change*. 97 AM. J. SOC. 585 (1991); see also J.J. Rotemberg and G. Saloner, *Overt Interfunctional Conflict (and its Reduction through Business Strategy)*, 26 RAND J. ECON. 630 (1995); J.C. Stein & D.S. Scharfstein, *The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment*, 55 J. FIN. 2537 (2000); Roman Inderst, Holger M. Muller & Karl Warneryd, *Influence Costs and Hierarchy*, 6 ECON. GOV. 177, 178 (2005).

¹⁵⁸ Oliver Hart, *Norms and the Theory of the Firm*, 149 U. PA. L. REV. 1701, 1702 (2001) (discussing how transaction costs make contracts, in a variety of ways, incomplete).

performance of a Bach partita at a local patron's home.¹⁵⁹ Upon payment, however, the violinist delivers a deliberately mediocre performance that materially breaches the contract. Both the violinist and patron observe this fact, but the patron may still find it impossible to prove breach to a judge because of the subjectivity involved both in the standard of "excellence" and in any effort to demonstrate the quality of a complex musical performance. If the quality of the performance could not be proved, it would be an observable, but not verifiable breach. Imagine though that the contract had required a violin performance meeting certain technical metrics of quality and that the patron had carefully tracked these metrics. The breach might now be both observable and verifiable.

A central function of a formal agreement is to move disputes from being merely observable to being verifiable. The fact that the written agreement memorializes the material terms of a transaction and was agreed to by both parties makes it a uniquely powerful piece of evidence for a third party in adjudicating a dispute.

A formalized agreement can even make an unobserved breach verifiable.¹⁶⁰ It need not be the case that either party directly involved in a dispute is in a position to determine if a breach was material. So, for instance, both the patron and violinist may have been too personally enraptured by the performance to keep track of its technical metrics. A third party adjudicator, however, gathering evidence from the full set of family members and friends attending the concert might be able to come to an informed conclusion that there was a breach. This would be a verifiable, but not observable default. In either case, a formal agreement straightforwardly facilitates verifiability by an adjudicator who was not a party to the dispute. This makes it possible for a third party adjudicator to determine the material facts surrounding a dispute.

Verifiable disputes are a necessary predicate of dispute resolution by a specialized adjudicator who was not personally privy to the facts of a dispute. The examples above featured firms that went to costly lengths to formalize agreements so that they could later be presented to an adjudicator. So, for instance, Morning Star's CLOUs expressly memorialized the material terms of inter-employee and division agreements. Likewise, Lockheed's inter-divisional agreements defined the material structure of their internal joint venture. John Mowlem too used carefully written agreements to structure its internal joint ventures.

(b) *Adjudication*

We can take fiat to be the organizational default of a hierarchy. If two managers transact with one another and subsequently disagree, they escalate the dispute to a shared senior manager whose command resolves the disagreement. Intra-firm contracting sets up a variety of alternatives whose commonality is forgoing fiat, and instead reassigning decision rights to one or more persons who do not stand directly in the disputants' organizational line of command. This mitigates influence activities by making attempts at influence costlier and less harmful to the firm. First, there is the step of simply

¹⁵⁹ This example is in the spirit of Hart's *reference points* paper. See Hart, *supra* note 21.

¹⁶⁰ Gilson et. al., *Braiding*, *supra* note 38, at 1398.

reallocating decision rights away from senior management. This eliminates employees' incentives to lobby their immediate managers based on anticipation that they will resolve future disputes. Those incentives exist where senior managers have authority over the outcome of disputes important to employees' welfare, which they no longer do. This alone can have beneficial effects. It can reduce the harmfulness of influence activities just by reassigning decision rights to individuals whose opportunity cost is lower than immediate management.

Contracting in the firm not only removes decision rights from immediate management, however, it then confers those rights on an adjudicatory body *insulated* in some way from influence activities, raising their cost. One device for doing so is simply to make the pool of possible adjudicators large or indefinite. Several firms chose this route. In John Mowlem, the identity of the adjudicator was unknown, removing any target of *ex ante* lobbying. Disputes are escalated first to senior managers but then to an independent arbitrator appointed by the firm's board.¹⁶¹

Another route, which can be combined with the first, is to confer decision rights on an individual who is chosen by both disputants. So, for instance, in Morning Star, disputes are resolved by mediators chosen by both parties to a dispute after it has occurred.¹⁶² As a Morning Star manager noted of their intra-firm adjudicatory practices, "It does have the effect of draining politics."¹⁶³ Similarly, in Lockheed, disputes concerning the joint venture were governed by a joint board consisting of an equal number of members from both divisions. These devices are familiar from the formal legal and arbitration systems. The federal district courts generally randomly assign judges to cases, while arbitration typically works through both parties consensually selecting an arbitrator or each selecting one arbitrator and those two consensually selecting a third. Through both of these routes, the choice of adjudicator makes influence attempts costlier either by increasing the number of adjudicators or concealing their identity *ex ante*.

C. Further Explanations

The agency problem is central to understanding the internal organization of firms. Contracting within firms can also serve a number of other important roles, however. Here, I consider a few of them.

1. Managing Changes in Corporate Boundaries

Changes in corporate boundaries remain big business globally. In 2014 alone, worldwide volume in mergers and acquisitions activity exceeded \$2.4 trillion,¹⁶⁴

¹⁶¹ See *supra* Subsection II.B.3.

¹⁶² See *supra* Subsection II.B.2.

¹⁶³ Interview 5.

¹⁶⁴ Mark Brady & Matthew Klotz, *Merger Tracker*, WILLIAM BLAIR, M&A MARKETS ANALYSIS Q4 2014, 1, https://www.williamblair.com/Research-and-Insights/Insights/-Investment-Banking-Market-Analysis/2015/~media/Downloads/Emarketing/2015/-IB/Merger_Tracker_2015_02.pdf;

suggesting that businesses can find significant efficiencies in changing their corporate boundaries, whether through combinations or divestitures.¹⁶⁵ Frequently, firms seeking an acquisition place a high value on the business unit being acquired retaining its existing commercial relationships and opportunities.

Consider, for example, a manufacturer evaluating the purchase of a major supplier. If the target of the acquisition is a division of a firm whose principal commercial relationships are all undocumented, informal, and intra-firm, then the acquiring business is going to face a very difficult time in smoothly continuing the division's business after having acquired it.¹⁶⁶ By acquiring such a division as opposed to a separate legal entity, it will face the risk of losing all the obligations of that entity, as opposed to being able to acquire an entity with its many contracts for factory leases, employment agreements, and intellectual property intact. The costs of reconstructing all of a division's agreements could be extremely high, especially for a business with a complicated set of intra-firm interrelationships. Intra-firm contracting, by documenting written agreements negotiated among individual managers can solve this problem.

A litigation involving Lockheed Martin provides a vivid illustration of how intra-firm contracting can preserve real options for subsequent divestitures. As mentioned earlier, the Sanders and LMSTS divisions of Lockheed were involved in an internal joint venture in which they pursued different sets of corporate opportunities generated by Lockheed's LM Aerospace division.¹⁶⁷ That internal joint venture had proved extremely successful for several years and the Sanders division attracted outside interest. In July

Bengt Holmström & John Roberts, *The Boundaries of the Firm Revisited*, 12 J. ECON. PERS. 73, 73 (1998) (explaining how the theory of the firm offers to explain mergers and acquisitions activity).

¹⁶⁵ Combinations include mergers, acquisitions, or majority share acquisitions. See, e.g., Alan S. Gutterman, 1 CORPORATE COUNSEL'S GUIDE TO STRATEGIC ALLIANCES (outlining different forms of business combination). Divestitures include spin-offs, carve-outs, and partial liquidations. See Iacobucci & Triantis, *supra* note 23, at 565-69.

¹⁶⁶ Informal arrangements between a now-acquired division and its former sister divisions in another entity will usually fail to constitute enforceable contracts for a variety of reasons. "Not every agreement is a contract," and informal arrangements typically lack the definiteness in material terms required for an enforceable contract. *Trauma Serv. Group, Ltd. v. United States*, 33 Fed. Cl. 426, 429 (Fed. Cl. 1995), *aff'd*, 104 F.3d 1321 (Fed. Cir. 1997); RESTATEMENT (SECOND) OF CONTRACTS § 33 (1981) (outlining requirements of definiteness for an enforceable contract); see also Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1652 (2003) (analyzing a sample of cases in which definiteness was at issue and finding that courts often will refuse to enforce indefinite agreements). The statute of frauds similarly requires many important agreements to be in writing to be enforceable. RESTATEMENT (SECOND) OF CONTRACTS § 110 (1981) (outlining the contracts covered by the statute of frauds). As a result of these requirements, informal arrangements between affiliates within a corporate group will often fail to be enforceable before a court.

¹⁶⁷ See Subsection II.B.2(a).

2000, BAE, a major defense contractor and one of Lockheed's most important competitors, acquired Lockheed's Sanders division for \$1.67 billion.¹⁶⁸

As part of that transaction, the internal Lockheed joint venture was rolled over to become a legally enforceable corporate joint venture between two Lockheed divisions and its competitor BAE, which now included the former Lockheed Sanders division. The joint venture agreement was changed in no respects other than substituting "BAE/Sanders" for "Sanders," and incorporating a letter between Sanders and LMSTS into the agreement by reference.¹⁶⁹ For five years after the acquisition, the now-corporate joint venture was a continued success. The most remarkable feature of this arrangement is the fact that three major internal divisions of Lockheed had dealt with each other under an agreement *substantially identical* to that now governing their relationship with one of their fiercest competitors. The continuity of the agreement and the continued success of the joint venture for nine years—four years internally, and five years externally—is a striking narrative.

In early 2005 the joint venture unraveled, however, in the midst of allegations by BAE that Lockheed had ceased performing under the agreement.¹⁷⁰ In essence, BAE claimed that Lockheed had stopped sharing business opportunities with BAE in the manner defined by the agreement.¹⁷¹ The principal issue in the ensuing litigation was whether the agreement was sufficiently definite as to constitute a legally enforceable agreement.¹⁷² If it was, BAE might be entitled to tens of millions of dollars in damages. Conversely, if the agreement was insufficiently definite, then it was merely a writing that produced "no enforceable obligations."¹⁷³

The case was eventually settled, but the basic point is clear: whether internal agreements adequately define transactions to be legally enforceable can be an important value proposition for a potential acquirer by ensuring that the acquired unit's commercial relationships remain enforceable upon acquisition.¹⁷⁴ The time of acquisition itself will usually be too late to reconstruct and record these relationships. The managers who entered transactions may well have moved on or forgotten the initial plans. If transactions were organized purely on the basis of fiat, intra-firm actors may simply have no idea of what would constitute an appropriate price for a transaction or division of labor among divisions. Indeed, the additional complications of divesting an unincorporated division, as

¹⁶⁸ *BAE Sys. Info. & Elec. Sys. Integration, Inc. v. Lockheed Martin Corp.*, No. CIV.A. 3099-VCN, 2009 WL 264088, at *1-2 (Del. Ch. Feb. 3, 2009).

¹⁶⁹ *Id.* at *2.

¹⁷⁰ *Id.* at *3.

¹⁷¹ *Id.*

¹⁷² *Id.* at *4-6.

¹⁷³ BAE Systems Information and Electronic Systems Integration Inc.'s Answering Brief in Opposition to Lockheed Martin's Motion to Dismiss the Amended Verified Complaint, No. 3099-VCN, 2008 WL 2784862, at *27 (Del. Ch. July 15, 2008) (Trial Motion, Memorandum and Affidavit).

¹⁷⁴ Conversely, we may sometimes observe intra-firm contracting as an artifact—whether in a division that has been acquired or merely anticipated it—of a firm establishing real options for a subsequent change in corporate boundaries.

opposed to an incorporated subsidiary, are recurrent themes in the practitioner M&A literature.¹⁷⁵

Moreover, it is worth noting the immense volume of M&A activity that is devoted to divestitures – transactions in *parts* of companies, short of the wholesale acquisition of a company or merger of two distinct companies.¹⁷⁶ In the U.S. alone, there are typically thousands of divestitures yearly with total deal value exceeding \$300 billion.¹⁷⁷ Globally, divestitures consistently account for over 40% of total M&A activity, and in 2013, divestitures accounted for almost half.¹⁷⁸

2. Managing Organizational Complexity

Fiat and management are expensive. Due simply to the administrative complexity of managing a large organization, it will sometimes be less costly to formalize transactions and the adjudication of disputes than to employ more informal, purely relational tools. This can be true for a number of reasons. First, it will sometimes be cheaper for firms to concentrate dispute resolution over certain disputes in a specialized forum rather than tax the limited bandwidth of senior management. For instance, even within a fairly simple organizational structure, there will sometimes be no shared senior manager to resolve a dispute between two divisional heads for several layers of a hierarchy. Rather than escalate a potentially minor dispute to the CEO, or recreate internal lines of command ad hoc, some firms may simply create a decision-making structure to adjudicate these interstitial disputes.¹⁷⁹

Second, contracts in firms can serve some of the basic functions that contract theory has identified for written agreements in markets, which do not pivot on the value of legal sanctions. For instance, in recent work Hadfield, Weingast, and Bozovic highlight how written agreements can provide a kind of support structure or “scaffolding” for commercial relationships by coordinating expectations.¹⁸⁰ Hadfield and Bozovic study

¹⁷⁵ See, e.g., Merger & Acquisition Focus, *When to Sell a Division or Subsidiary*, at 2-3, April/May 2009 (discussing why “standalone subsidiaries are typically easier to sell than divisions”).

¹⁷⁶ “A divestiture is the sale of a portion of the firm’s assets to a third party—typically another company or a private equity fund The assets sold may be a division, segment, subsidiary, or product line.” B. Espen Eckbo & Karin S. Thorburn, *Corporate Restructuring: Breakups & LBOs*, in HANDBOOK OF EMPIRICAL CORPORATE FINANCE 431, 437 (B. Espen Eckbo ed. 2008).

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¹⁷⁷ See, e.g., B. ESPEN ECKBO, TAKEOVER ACTIVITY, VALUATION ESTIMATES AND MERGER GAINS: MODERN EMPIRICAL DEVELOPMENTS 727 (2010).

¹⁷⁸ Boston Consulting Group, *The 2014 M&A Report* (2014).

¹⁷⁹ Calliess & Harder, *supra* note 5.

¹⁸⁰ Iva Bozovic & Gillian K. Hadfield, *Scaffolding: Using Formal Contracts to Build Informal Relations in Support of Innovation*, Working Paper (2015); Gillian K. Hadfield & Barry R. Weingast, *What is Law? A Coordination Account of the Characteristics of Legal Order*, 4 J. LEGAL ANALYSIS 1 (2012).

companies with innovation-oriented external relationships and find that they frequently use written contracts to manage those relationships.

They claim that these companies do not draft these contracts in order to credibly threaten state-imposed sanctions, but rather to coordinate beliefs about what composes breach of a set of profoundly ambiguous obligations.¹⁸¹ The contract thus acts as a scaffold – a fulcrum around which expectations can be formed. Lawyers and precedent form the valuable additional role of providing formalized reasoning and expertise regarding what terms in these agreements mean.¹⁸² The more complex the set of obligations between employees or divisions within a firm, the more written agreements will have value in simply defining those obligations and serving as a record on which expectations can be formed and around which disagreements can pivot.¹⁸³ Likewise, agreements within the firm can serve the function of creating a set of expectations around which firm employees can coordinate their behavior.¹⁸⁴

3. Tax Considerations

Many readers may object that tax considerations are likely to drive the corporate structures discussed above. If intra-company contracts are executed between affiliates that reside in different tax jurisdictions, then companies will have a strong motive to increase firm profitability by using internal transfers to shift revenue to the lower-tax jurisdiction. From an international tax perspective, this very issue of transfer pricing – the prices firms assign to inter-affiliate transfers – “is probably the most important tax issue in the world.”¹⁸⁵ Empirical evidence suggests that many firms’ transfer pricing policies significantly exploit tax advantages.¹⁸⁶

Tax considerations undoubtedly shape the nature of intra-firm transfers and governance. Nonetheless, they are unlikely to be the determinants of the principal

¹⁸¹ Bozovic & Hadfield, *supra* note 173.

¹⁸² *Id.*

¹⁸³ This is similar to Oliver Hart’s concept of reference points – one benefit of writing out an agreement in advance is settling the direction of expectations going forward. The contract thus serves as a “reference point” around which parties can plan their conduct. *See* Hart, *supra* note 21, at 408-09; *see also* Oliver Hart & John Moore, *Contracts as Reference Points*, 123 *QUART. J. ECON.* 1 (2008).

¹⁸⁴ There are likely to be a number of other considerations, ranging from securities to labor law, relevant to the optimal boundaries of a firm and its internal organization that I cannot touch on here, but which are likely to play an increasingly important role in shaping how commercial cooperation is organized. In further work, I hope to explore these factors further.

¹⁸⁵ John J.A. Burke, *Re-Thinking First Principles of Transfer Pricing Rules*, 30 *VA. TAX REV.* 613, 614 (2011); *see also* Yehonatan Givati, *Resolving Legal Uncertainty: The Unfulfilled Promise of Advance Tax Rulings*, 29 *VA. TAX REV.* 137, 169 (2009) (“Multinational companies identify transfer pricing as the ‘most important tax issue they face’”).

¹⁸⁶ Kimberly A. Clausing, *Tax-Motivated Transfer Pricing and U.S. Intrafirm Trade Prices*, 87 *J. PUB. ECON.* 2207 (2003); Andrew B. Bernard, J. Bradford Jensen & Peter K. Schott, *Transfer Pricing by U.S.-Based Multinational Firms*, Working Papers 08-29, Center for Economic Studies, U.S. Census Bureau (2008).

illustrations discussed above. This is for two distinct reasons. First and most importantly, the agreements within, say, Lockheed and Morning Star are agreements *internal to a single legal entity*. As a result, U.S. and international tax requirements governing inter-entity transfers simply do not apply. Those provisions govern trade between distinct corporate entities within a single corporate group, but not trade between distinct unincorporated divisions. The second reason is that the agreements in Lockheed, Morning Star, or John Mowlem are all voluntarily *negotiated* between different employees or divisions in a firm. Yet having employees with distinct interests voluntarily negotiating the prices and terms of contracts among themselves is a good way to get an arm's length price, rather than a price that facilitates tax avoidance.

4. Compliance Purposes

Tax or other compliance considerations may still drive the development of intra-firm contracts. For instance, under § 482 of the Internal Revenue Code a firm must be prepared to show that the transfer price of a transaction between two commonly-controlled affiliates fits within the range of what an “arm's length” transaction between two entities lacking common control would produce.¹⁸⁷ Similarly, when two affiliates transact, but one is wholly-owned by the parent, while the other has minority shareholders, the law again imposes an arm's length requirement on the transaction.¹⁸⁸ In either case, a firm might implement a procedure for fair price discovery in order to ensure compliance and avoid any risk of liability. If done in good faith, this could represent a genuine display of intra-firm contracting in which distinct participants voluntarily negotiate agreements and any subsequent disputes are subject to adjudication. On the other hand, it could be done simply as a fig-leaf in case of audit. To avoid misinterpreting the latter, scholars must be careful in interpreting data regarding firms' internal practices.

D. The Costs of Intra-Firm Contracting

The relational contracting literature has carefully documented the costs of formal contract.¹⁸⁹ Intra-firm contracting imports many of those costs into how a firm resolves internal transactional disputes. As a result, senior managers designing their firms' decision-making architecture will have to make an explicit trade-off between the benefits and costs of different ways of governing internal transactions. I briefly survey some of those costs here.

Fiat has two principal virtues, and forgoing fiat bears the cost of losing those benefits. First is adjudicator knowledge and the second is adjudicator expertise. Two disputants' immediate manager is likely in many, if not most circumstances to be the third party most knowledgeable about both their individual credibility and the substance

¹⁸⁷ I.R.C. § 482 (statutory definition of standard); Treas. Reg. 1.482-1(b) (implementing regulation); *U. S. Steel Corp. v. C. I. R.*, 617 F.2d 942, 947 (2d Cir. 1980) (interpreting the legal standard).

¹⁸⁸ See *supra* note 55.

¹⁸⁹ See *e.g.*, note 33.

of their dispute. The manager will typically have assigned them their duties and have responsibility for supervising their activities. Continued oversight will have made the manager conversant with the highly fact-specific particulars of their individual tasks. In many firms, he or she will have previously occupied the roles of the disputants. As a result, that manager would need the least additional information to make an informed decision. Re-assigning decision-making rights to another individual in the firm forgoes this benefit. Besides substantive knowledge of the dispute, the immediate manager is also likely to have expertise in adjudicating the relevant kind of dispute. For instance, the head of Paine Chemicals is likely to not only know a vast amount about chemical manufacturing, but also to possess deep expertise in determining whether a delay in shipment between one division and another was a material breach or whether a pre-determined price should be altered in light of changing market conditions.

IV. IMPLICATIONS

This explanation of contracting in the firm offers many insights for theory and practice. It can help guide the work of transactional attorneys in creating economic value for firms, illuminate the advantages of formal legal contracting, and enrich organizational theory.

A. The Jurisdiction-Stripping Function of Organizational Law

Several scholars of corporate law have argued that a principal function of the business judgment rule is to enable private ordering: to establish a sphere in which nonlegal forms of governance can organize economic activity without judicial interference.¹⁹⁰ From this perspective, the business judgment rule acts as a kind of jurisdictional doctrine that excludes review of managers' decisions by courts.

Consider how the business judgment rule plays this role: A corporation's directors owe the corporation fiduciary duties.¹⁹¹ If they violate these duties, then the corporation's shareholders may have a legal claim against the directors for damages. The business judgment rule acts as a court-created presumption that directors making a business decision acted in good faith, loyally, and with due care, absent evidence of self-interest or conflicts of interests among the directors.¹⁹² The effect of the business judgment rule is to effectively immunize directors' decisions from review by courts as long as there is no evidence of self-interest.

¹⁹⁰ See, e.g., Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1664 (2001) (arguing that a variety of important contract law doctrines function to facilitate private ordering by norms); Stephen M. Bainbridge, *The Business Judgment Rule As Abstention Doctrine*, 57 VAND. L. REV. 83, 109 (2004) (arguing that the business judgment rule is best viewed as a doctrine of abstention whereby courts refuse to review board decisions); Lori McMillan, *The Business Judgment Rule as an Immunity Doctrine*, 4 WM. & MARY BUS. L. REV. 521, 524 (2013).

¹⁹¹ See, e.g., *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

¹⁹² See, e.g., *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

The point I want to suggest here is that the *legal entity* has a similar jurisdictional role, which scholarship has overlooked, and which the phenomenon of intra-firm contracting makes especially vivid. Organizational law is the body of law governing the creation and structure of legal entities, like corporations, LLCs, and LLPs.¹⁹³ Combined with basic principles of standing, organizational law plays a *jurisdiction-stripping role*, one which may be as important as the business judgment rule. Organizational law does this because it treats a legal entity, like a corporation, as a single legal person. Under the common law, only legal persons had standing to contract, own property, sue, or be sued.¹⁹⁴ All of a corporation's property as well as its right to take legal action is vested in the entity itself. As a result, a corporation can contract, sue, be sued, and own property, but a division of a corporation can do none of these things. Likewise, the manager of a division has no standing to bring an intra-firm dispute before a court.

By conducting transactions between units within a single legal entity, a firm thus ensures that those units and their respective managers cannot bring claims in a court disputing those transactions. The choice to conduct a transaction within a single entity, rather than to transact with a separate entity, acts to take disputes regarding that transaction out of the jurisdiction of courts. The legal personality of a corporation establishes a sphere of private ordering in which divisional managers lack standing to raise transactional disputes before courts. Contracting within the firm makes this role especially clear. Two divisional managers can draft a written agreement that precisely defines material terms and each party's obligations. This is precisely the kind of agreement that would be a litigable contract were it between private parties, but is not litigable if between two divisions.

The jurisdiction-stripping role of organizational law is even clearer under federal law. Under the common law, an unincorporated association could not bring suit, since it lacked a legal existence independent of its members.¹⁹⁵ Under federal law, however, an unincorporated association of persons sometimes has standing to sue.¹⁹⁶ A group of individuals working together on some common goal can easily qualify as an unincorporated association.¹⁹⁷ They could thus bring suit. However, case law makes clear that the power of an unincorporated group to sue or be sued is *eliminated* when the group becomes *a division of a corporation*.¹⁹⁸ The inclusion of an unincorporated association in

¹⁹³ Henry Hansmann & Reinier Kraakman, *Organizational Law as Asset Partitioning*, 44 EUROPEAN ECON. REV. 807 (2000).

¹⁹⁴ See *infra* note 186.

¹⁹⁵ See *Moffat Tunnel League v. U.S.*, 289 U.S. 113, 118-19 (1933); 2 BUS. & COM. LITIG. FED. CTS. § 18:30 (3d ed.).

¹⁹⁶ See *Associated Students of Univ. of Cal. v. Kleindienst*, 60 F.R.D. 65, 67 (C.D.Cal.1973).

¹⁹⁷ See *Penrod Drilling Co. v. Johnson*, 414 F.2d 1217, 1222 (5th Cir.1969) (defining an unincorporated association as "a body of persons acting together, without a charter, but upon methods and forms used by a corporation, for the prosecution of some common enterprise"); see also *Local 4076, United Steelworkers v. United Steelworkers*, 327 F.Supp. 1400, 1403 (W.D.Pa.1971); *Delta Coal Program v. Libman*, 554 F.Supp. 684, 687 (N.D.Ga.1982).

¹⁹⁸ One decision explains clearly that while an unincorporated association is "a collection of persons working together for a common objective" that can bring suit, it must also be "an entity operating without a corporate charter." As a result, "an unincorporated division of a corporation"

an incorporated one destroys its separate standing under federal law. Thus, while two informal groups might be able to sue one another over a dispute—and two distinct corporations certainly could—those divisions lose the power to sue when both are housed in the same legal entity. The legal personality of the firm, like the business judgment rule, acts to shield intra-firm transactions from legal scrutiny, effectively immunizing them from review.

B. Designing Optimal Governance

Lawyers become legislators, litigators, and judges, but just as commonly, they become transactional lawyers – creating the governance of transactions in the private sector.¹⁹⁹ They draft contracts structuring deals between private parties, design the control structure of corporations, and counsel managers in changing their firms’ corporate boundaries. Scholars can serve an important role in not only documenting innovations in how intra-firm trade is governed and communicating them to students, but also in crafting them. As Avery Katz has put it, legal scholars should study private ordering “not only for the purpose of advising courts and legislators whether to defer to such rules, but for the purpose of helping other [private organizations] decide whether to imitate them or instead to draft their own new forms,” and to help parties “design and learn to use dispute-resolution devices with better incentive properties.”²⁰⁰

Understanding the phenomenon of intra-firm contracting and the factors that drive it suggests a number of ways in which lawyers can add value when designing transactional governance within and between firms. One way is to appreciate the complexity of the agency problem within an organization and design transactional structures so as to mitigate that problem. In this way, intra-firm contracting—with both the costs and benefits it involves—competes against the other tools available to a firm’s managers in addressing agency problems.

cannot meet “the definition of an unincorporated association” because “unlike the unincorporated associations defined above, a division of a corporation does operate with a charter—the charter of the larger corporation.” *E.E.O.C. v. St. Francis Xavier Parochial Sch.*, 77 F. Supp. 2d 71, 77 (D.D.C. 1999) *aff’d sub nom. E.E.O.C. v. St. Francis Xavier Sch.*, 254 F.3d 315 (D.C. Cir. 2000); *see also Saud v. Chicago Police Dept.*, 1986 WL 8373, at *1 (N.D.Ill.1986).

¹⁹⁹ Avery W. Katz, *Contract Theory-Who Needs It?*, 81 U. CHI. L. REV. 2043, 2067-68 (2014) (“Private lawyers do not just litigate contractual disputes . . . They also need to use contract law as a tool to create the structures of agreement that will enable their clients to pursue their respective goals and activities with effectiveness.”).

²⁰⁰ *See Avery Katz, Taking Private Ordering Seriously*, 144 U. PA. L. REV. 1745, 1757 (1996). This is reminiscent of Ronald Gilson’s famous analogy of a skillful transactional attorney to a “transaction cost engineer.” Ronald Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 255 (1984) (emphasizing that a good transactional attorney must understand why and how governance works and noting that “the tie between legal skills and transaction value is the business lawyer’s ability to create a transactional structure which reduces transaction costs”).

In this sense, contracting within the firm matters for the same reason that corporate governance matters, which is that it can help ameliorate the agency problem between a firm's owners and the individuals who actually operate the firm. But while corporate governance has emphasized a firm's most important actors – the directors and officers – intra-firm contracting addresses agency problems throughout the remainder of the managerial hierarchy.

For instance, contracting within the firm might mitigate pathologies inherent in a firm's internal capital market. A firm's internal capital market consists of the possible in-firm projects competing for funding by senior management. George Triantis has noted the important role that legal boundaries can play in optimizing the internal capital market within a firm.²⁰¹ It can be valuable for a firm to retain options to switch how capital is allocated among various ongoing projects. However, if agency costs are high and junior managers are likely to misallocate capital, then a firm may find it efficient to carve up its assets into multiple separate legal entities, which creates frictions for managers seeking to move around capital within the broader firm.²⁰² These frictions take the form of legal requirements placed on transactions among affiliates, many of which were discussed earlier, such as the requirement that transactions among minority-owned affiliates be arm's length.²⁰³ As Triantis summarizes: within a single entity "capital may be redeployed over time by fiat," whereas movement across boundaries comes at a greater cost.²⁰⁴

Intra-firm contracting, however, provides a separate set of tools for achieving these aims of reducing the agency costs of investments and transactional decisions made within firms. Rather than creating separate entities, with all the costs they incur, senior managers may create a governance structure within the firm that constrains managerial fiat through written contracts and impartial adjudication.²⁰⁵

C. Understanding Legal Sanctions

After collecting data on firms' infrequent use of legal contracts, Stewart Macaulay posed a question that has haunted contract scholarship ever since: "What good is contract

²⁰¹ See George G. Triantis, *Organizations As Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102, 1104 (2004).

²⁰² *Id.* at 1124-1127 (discussing the various procedural and substantive requirements imposed on capital movements between distinct corporations within a corporate group).

²⁰³ See *supra* Subsection II.A.3.

²⁰⁴ *Id.* at 1102; *id.* at 1105 ("The distinction between external and internal capital markets is that capital moves between projects by contract in the former case and by authority or fiat in the latter.").

²⁰⁵ *Id.* at 1124-1138. Intra-firm contracting may sometimes be a superior substitute for the creation of legal boundaries in resolving agency costs. At a minimum, the comparison between the two is explicitly a cost-benefit trade-off. Legal boundaries impose costs in the form of frictions to desirable capital movements, while intra-firm contracting may derogate decision-making quality and impose administrative expenses.

law?”²⁰⁶ What function does it serve if commercial transactions largely rely upon relationships? Scholars have offered a number of responses, in part to explain the prevalence of formal contracts in the commercial world, notwithstanding the importance of relationships.²⁰⁷ Intra-firm contracting does much to sharpen those answers. Appreciating the possibility of formalized, tailored agreements and adjudication within firms forces contract theory to come to a more precise understanding of what the distinctive benefits of legal sanctions are, if any.

For instance, in an important paper, Baker and Choi suggest that private parties in markets often combine relationships and legal sanctions because each offers distinctive advantages and disadvantages.²⁰⁸ In particular, they argue that legal sanctions offer two virtues that less granular relational sanctions cannot. First, legal sanctions enable parties to design remedies, decoupling the deterrent effect of a remedy from the value of a relationship. This is in contrast to the threat of ending a commercial relationship – a paradigmatic relational sanction – in which both the threat of the sanction and the loss in value to the party imposing the sanction vary together. Second, the process of adjudication can be tailored so as to uncover evidence the counterparties would otherwise lack. This evidentiary function allows parties to better understand when sanctions are appropriate. The problem with Baker and Choi’s argument is that both of these benefits can (and sometimes are) delivered by intra-firm contracting, which can make no use of state law.²⁰⁹ Non-legal sanctions, in other words, can actually have much of the flexibility that has been attributed to the legal system.

D. The Theory of the Firm and Contracting Inside It

Contracting within the firm poses a puzzle for organizational theory. Scholars of the commercial world tend to draw fundamental distinctions between integrated and external production, contrasting in-house with arm’s length transactions, where the former are governed by hierarchy and fiat and the latter by formal contracts. Contracting in the firm calls the usefulness of these contrasts into question. To return to the Lockheed joint venture, the *same agreement* governed the internal joint venture among three of Lockheed’s internal divisions as governed the corporate joint venture between two of those internal divisions and BAE – one of Lockheed’s largest competitors. This suggests that units within a legal entity may sometimes relate to each other in a manner substantially similar to how they relate to external parties in the market.²¹⁰ Indeed, the

²⁰⁶ Macaulay, *supra* note 32, at 55.

²⁰⁷ See, e.g., Bozovic & Hadfield, *supra* note 173.

²⁰⁸ Baker & Choi, *supra* note 37, at 561-64.

²⁰⁹ While Baker and Choi often refer to their two benefits as virtues of legal sanctions, they may agree that they are simply virtues of formalized agreements and adjudication more generically. *Id.*

²¹⁰ The remarkable symmetry between in-firm and between-firm transactions in the Lockheed-BAE scenario is not singular. For instance, for years the huge pharmaceutical company Eli Lilly and Company maintained both an external and internal venture capital fund. The first fund operated like a typical venture capital fund, seeking out promising start-up companies and making targeted equity investments. The internal fund, on the other hand, made investments in new

relationships between some internal business units may be significantly more arm's length than a cozy relationship between two separate entities in the marketplace, whose long-term supply contract is nested within a thicket of personal, religious, or ethnic ties.

If hierarchy shows up in market transactions,²¹¹ and arm's length agreements in firms then there may not be a clear transactional technology accompanying each form of organizing economic cooperation. This is in the spirit of Gilson, Scott, and Sabel's more wholesale critique of the theory of the firm. They question whether the effort to identify different types of transactions as better suited to market or firm is worthwhile.²¹² Instead, they argue that the "firm does not have an essence or nature: It bundles governance instruments as the calculus of advantage in particular contexts suggests."²¹³ Intra-firm contracting is vivid evidence for thesis. The firm-market dichotomy may no longer be a perspicuous frame for trying to understand how transactions are governed in the economy. Instead, identifying and analyzing complicated bundles of formal and informal contractual elements may be a better route to understanding (and optimizing) commercial relationships.²¹⁴

CONCLUSION

A pervasive view in law, economics, and management is that in markets decentralized parties contract with one another, while in firms, production is organized by means of hierarchy and fiat. Through a series of illustrations, this Article showed that a surprising phenomenon exists: firms that use formal agreements and adjudication to resolve their own internal commercial disputes.

This world of contracting within the firm poses a puzzle for both law and economics. First, the most obvious function of a contract—enabling legal enforcement—is *unavailable* when an agreement is between two divisions of a corporation. Second, the theory of the firm suggests that it is precisely when contracting *fails* that the firm becomes an efficient way of organizing transactions, so it is unexpected to observe firms trying to recreate markets within themselves. The significance of this puzzle is underlined by the astonishing scale of trade within the firm. While intra-firm exchange constitutes a

business ideas by Lilly employees, which did not fit in a traditional line of company business, but which transformative potential for the pharmaceutical industry. See Richard Hamermesh, Ron Laufer & David Lane, *Corporate Venture Capital at Eli Lilly*, Harv. Bus. School Case Study No. 9-806-092, at 1 (2007).

²¹¹ See *supra* Gilson et al, *Contracting for Innovation*, *supra* note 38, at 458-72 (discussing elements of hierarchical governance in corporate joint ventures); Bernstein, *supra* note 37 (discussing role of hierarchical governance mechanism in procurement contracts).

²¹² Gilson et al, *Contracting for Innovation*, *supra* note 38, at 496. Their analysis draws heavily on a noteworthy reflection on the theory of the firm by two leading economists. See Bengt Holmström & John Roberts, *The Boundaries of the Firm Revisited*, 12 J. ECON. PERSP. 73 (1998).

²¹³ Gilson et al, *Contracting for Innovation*, *supra* note 38, at 498.

²¹⁴ Cf. Benjamin Klein et al., *Vertical Integration, Appropriable Rents and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 326 (1978).

large fraction of both domestic and international trade, we know next to nothing about how it is organized.

This Article developed an explanation for intra-firm contracting, drawing on recent developments in organizational economics. Specifically, I showed how intra-firm contracting could mitigate wasteful influence activities within a hierarchy as well as serving some more familiar functions. The main point, however, was that the character of trade within firms is far more varied and complex than scholars have noticed and that we have much to learn from looking inside the firm.