THE CONTRACTUAL THEORY OF THE CORPORATION

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INTRODUCTION

The modern corporation is one of the most successful inventions in history, as evidenced by its widespread adoption and survival as a primary vehicle of capitalism over the past century. Economists, however, have only recently begun to understand the economic nature of the corporation. In the last fifteen years, the economic theory of the firm has advanced from a struggle with the identification of the economic conditions that lead to the formation of firms to a discourse on sophisticated issues concerning intra-firm relationships. As a consequence of these developments, economists have come to view the firm as a "nexus of contracts" among participants in the organization.[1] When applied to the corporate form of organization, the theory of the firm is often referred to as the contractual theory of the corporation.[2]

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1. The literature is far too extensive to list, but several of the major contributions to this literature include: O. Williamson, The Economic Institutions of Capitalism (1985); Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 Am. Econ. Rev. 777 (1972); Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J. Law & Econ. 179 (1985); Cheung, *The Contractual Nature of the Firm*, 26 J. Law & Econ. 1 (1983); Coase, *The Nature of the Firm*, 4 Economica 386 (1937); Fama & Jensen, *Separation of Ownership and Control*, 26 J. Law & Econ. 233 (1983); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. Fin. Econ. 305 (1976); Klein, Crawford & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. Law & Econ. 297 (1978); Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965).

2. Legal commentaries reflecting this contractual theory include N. Wolfson, The Modern Corporation: Free Markets versus Regulation (1984); Baysinger & Butler, *Anti-Takeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 Va.

The contractual theory of the corporation is in stark contrast to the legal concept of the corporation as an entity created by the state. The entity theory of the corporation supports state intervention — in the form of either direct regulation or the facilitation of shareholder litigation — in the corporation on the ground that the state created the corporation by granting it a charter. The contractual theory views the corporation as founded in private contract, where the role of the state is limited to enforcing contracts. In this regard, a state charter merely recognizes the existence of a "nexus of contracts" called a corporation. Each contract in the "nexus of contracts" warrants the same legal and constitutional protections as other legally enforceable contracts.[3] Moreover, freedom of contract requires that parties to the "nexus of contracts" must be allowed to structure their relations as they desire.

The contractual theory of the corporation should be of practical as well as academic interest. For example, the influential American Law Institute's Corporate Governance Project is based, at least in part, on a conflicting view of the nature of the corporation.[4] The long delay in adopting the ALI reporters' recommendations is evidence of the growing influence of the contractual theory. On the other hand, much legal scholarship on the nature of the corporation continues to be influenced by outmoded views of the nature of the corporation. Recently, corporation law scholars antagonistic to the contractual theory have adopted the methodology and terminology of the contractual theory, but have misapplied it in a way that reaches contrary policy positions.[5] Although these mistakes might be due to something other

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L. Rev. 1257 (1985); Butler & Ribstein, *State Antitakeover Statutes and the Contract Clause*, 57 U. Cin. L. Rev. 611 (1988); Fischel, *The Corporate Governance Movement*, 35 Vand. L. Rev. 1259 (1982); Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. Chi. L. Rev. 119 (1987); Haddock, Macey & McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 Va. L. Rev. 701 (1987); Ribstein, *An Applied Theory of Limited Partnership*, 37 Emory L. J. 835 (1988).

3. *See* Butler & Ribstein, The Contract Clause and the Corporation (1989) (unpublished manuscript).

4. Principles of Corporate Governance: Analysis and Recommendations, (Tent. Draft No. 8, 1988). The A.L.I.'s corporate governance project has been very controversial, possibly because it attempts to go beyond the traditional restatement to include recommendations for changes in the law. Representative samples of the literature include Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 Cornell L. Rev. 261 (1986) and Eisenberg, *An Introduction to The American Law Institute's Corporate Governance Project*, 52 Geo. Wash. L. Rev. 495 (1984). For a critique of the legal scholarship reflected in the drafts, *see* Carney, *Section 4.01 of the American Law Institute's Corporate Governance Project: Restatement or Misstatement?*, 66 Wash. U.L.Q. 239 (1988).

5. For statements of the anti-contractarian position, see Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 Colum. L. Rev. 1403 (1985); Coffee, *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53

than a mere misunderstanding of the contractual theory, it seems clear that the corporate governance debate has reached a point where it should benefit from a comprehensive statement of the contractual theory of the corporation.

This paper offers a summary of the contractual theory of the corporation and considers some of its general implications for corporate law.[6] Section I sets the stage for the discussion by presenting a summary of the traditional legal view of the modern corporation. Section II presents a summary of the theory of the firm as it relates to corporate organization. Section III describes the market and contractual constraints that force managers of large, dispersed-owner corporations to act in their shareholders' best interests. Section IV considers the implications of the contractual theory of the corporation for private ordering of corporate governance issues. Section V offers some concluding comments.

I. BACKGROUND: THE BERLE-AND-MEANS APPROACH TO CORPORATE GOVERNANCE

A major intellectual theme in the study of the modern corporation is the "separation of ownership and control" thesis, which was first popularized by Adolf A. Berle and Gardiner C. Means, in 1932 in their famous book *The Modern Corporation and Private Property*. The basic notion is that dispersed owners of the modern corporation do not have the incentive to effectively control corporate management — directors and officers — and that managers often act in their own interests rather than in the stockholders' interests.

Over the years, the Berle and Means thesis has provided the basis for many calls for more stringent legal controls on managerial behavior. This area of corporate policy is called "corporate governance," which refers to the manner in which the relations between the parties to the corporate contract are restrained by government regulation or private ordering. In this section, the relevance of the contractual theory of the corporation to the corporate governance debate is analyzed.

Much of the Berle and Means analysis is based on their belief that shareholders should, but do not, play a major, direct role in monitoring corporate managers. At first glance this seems reasonable because, after all, the voting rules of corporations suggest that corporations are democratic institutions: Shareholders elect directors and have the right to offer recommenda-

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Brooklyn L. Rev. 919 (1988). For a critique, see Butler & Ribstein, Liberating the Corporate Contract: A Response to the Anti-Contractarians (1989) (unpublished manuscript).

6. This paper represents a general outline of the economics of the large publicly-traded corporation. The law and economics of the small closely-held corporation presents an entirely different set of issues. The seminal article on this subject is Manne, *Our Two Corporation Systems: Law and Economics*, 53 Va. L. Rev. 259 (1967).

tions to be voted upon by fellow shareholders through the corporate proxy machinery. Despite these legal rights, however, the reality of the large corporation is far from democratic because shareholders rarely have the incentive to exercise their legal rights. For many individual shareholders, dissatisfaction with the management of the corporation results in the sale of the stock. The so-called "Wall Street Rule" is that "rationally ignorant"[7] shareholders sell their shares rather than become involved in the internal affairs of the corporation. Because of the seeming indifference of shareholders, Berle and Means and their progeny have assumed that directors and managers are free to operate the corporation in a manner that is not necessarily in the shareholders' best interest.

The Berle and Means perspective on the corporation has fostered the view among some legal commentators that corporation law is the only meaningful constraint on managerial behavior. This has led to public policy arguments that place great emphasis on the role of laws in governing the relationship between shareholders and managers. In essence, some commentators have assumed that managers, freed from legal constraints, can abuse shareholders' interests without cost. Corporation law, according to this view, plays a pre-eminent role in maintaining balance in the large corporation characterized by a separation of ownership and control. These critics of corporation law often assume that the law is not fulfilling that role and that states or even the federal government must take a more active role in regulating the internal affairs of the corporations they create.[8] A more cynical view of their motivations is that some lawyers are attempting to increase the demand for their legal services at the expense of lower-cost, market-oriented governance mechanisms.[9]

The fundamental insight of the Berle and Means theory — that shareholders should be concerned about delegating control over their financial capital to corporate managers — provides the cornerstone of the contractual theory of the corporation presented in this Article. But the normative implications of the Berle and Means theory have been refuted by the contractual theory and supporting empirical evidence. Nevertheless, adherents to this intellectual tradition continue their persistent calls for greater regulation and preemption of private ordering.

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7. *See infra* note 20 and accompanying text.

8. The outstanding example of this view is Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L.J. 663 (1974).

9. Kristol, *The War Against the Corporation*, Wall St. J., Jan. 24, 1989, at A20, col. 3.

II. THE THEORY OF THE FIRM AND THE NATURE OF THE CORPORATION

In order to understand the nature of the corporation and to provide the basis for a survey of the contractual theory of the corporation, it is helpful to explore several fundamental economic issues. This section examines why firms exist, the role of efficient capital markets, the theoretical advantages of the corporate firm, the role of shareholders in the corporate firm, and the importance of controlling agency costs in the publicly traded corporation.

A. *Transaction Costs and the Emergence of Firm Organization*

The theory of the firm seeks to explain the choice of methods of coordination among specialized individuals in a market economy. There are two basic methods of economic coordination in a market economy — market coordination and firm coordination. Market coordination is the process through which the price system embodied in the form of contracts directs production decisions. In theory, all possible gains from specialization could be realized through market coordination in the absence of transaction costs, which include negotiating, contracting, and enforcing costs. Firm coordination is the process through which production decisions are directed through a "firm" — an economic organization that purchases and organizes resources to produce desired goods and services. In essence, the use of the firm to coordinate and direct the flow of resources represents a substitution of hierarchical or bureaucratic decision making in production processes for production organized through discrete market contracts. Management organizes, coordinates, and monitors the production processes within the firm. The market still serves to guide the economic decisions of the firm with respect to what products or services to produce, but the internal decision processes are directed by the managerial organization of the firm.

The emergence of firm organization, as well as the particular organizational structure adopted, has been explained as an effort to solve the shirking-monitoring problem of joint production. Ronald Coase was the first to explain that the emergence of the firm as a method of economic coordination was the result of an effort to reduce the transactions costs of market coordination.[10] In a world with zero transactions costs, there would be no need for the organization of economic activities in firms because all activities could be handled through spontaneous market transactions. However, once transactions costs are added, the least costly, or most efficient, form of coordination of certain economic activities may be through the firm. On the other hand, the use of firm coordination also involves costs — generally through the loss of

10. Coase, *The Nature of the Firm*, 4 Economica 386 (1937).

information and control of employees in the hierarchical organizational structure. These internal control costs explain why firms will not grow without limit — that is, why the economy is not managed by one huge firm. In general, a firm will expand to the point where the marginal benefit in the form of reduced transactions costs is just offset by the marginal cost of internal organization. Profit maximizing firms will tend to evolve to the most efficient size — the size that reflects the optimal mix of market coordination and firm coordination.

The modern theory of the firm entered a new era when Alchian and Demsetz went beyond identifying circumstances that led to firm coordination and developed a framework for analyzing how the nature of the production process affects the form of organization (e.g., sole proprietorship, partnership, or corporation) and the internal organization of the firm. Alchian and Demsetz addressed the emergence of the firm as a response to the benefits of team production.[11] For some production processes, the least cost method of production requires that individuals work together as a team in order to produce the final product. Whenever a team can produce a product or service at a lower cost, firms will exist. The benefits of team production, however, are not free. The transaction costs associated with team production arise because it is often difficult to monitor the marginal productivity of each individual member of the team and reward him on the basis of his contribution. Of course, the members of the team will realize this, and some will rationally take advantage of the situation by shirking — exerting less than the normal productive effort — because they know that their wages will not fully adjust to reflect their decreased effort. So long as the increased productive efficiency of team production exceeds the shirking costs (which include the costs of controlling shirking), the firm will expand to replace independent production by individuals.

Alchian and Demsetz's seminal article spurred a series of important theoretical contributions. Jensen and Meckling used agency theory to explain the development of alternative capital structures within corporations, when finance theory suggests that the capital structure is irrelevant to the total value of the firm.[12] Williamson explored the problem of shirking as post-contractual opportunism and has identified contractual arrangements designed to

11. Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 Am. Econ. Rev. 777 (1972).

12. Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).

prevent opportunism.[13] Cheung explained why productive individuals would voluntarily submit to the managers' commands within a firm. The key point in understanding this is related to the free rider problem: It is rational for individuals to shirk so long as the other members of the team do not shirk; however, if all of the members of the team shirk, then the wages of all members will decline as each bears a portion of costs of shirking. Faced with these alternatives, its seems rational for the team members to hire someone to monitor their behavior in order to enhance the productivity of the team.[14] The monitor is called the manager, but it is not clear who is working for whom within the contractual arrangements. In this perspective, the essence of the firm is "the nexus of contracts restraining the behavior of contractors."[15]

In general, the role of the manager in the theory of the firm is to monitor the production process, coordinate team production, and discourage shirking by tying compensation closely to productivity. Of course, this raises the question of who is monitoring the monitors? In an important theoretical contribution, Klein, Crawford, and Alchian focused on the role of residual claimants — the contracting parties with the right to the firm's residual income — and firm-specific investments.[16] They suggested that the "monitoring the monitors" problem is often solved by making the owners of the most firm-specific assets the residual claimants. This analysis is most helpful in identifying situations where firms will integrate, and perhaps where firms will have a concentrated ownership structure, but it does not offer much for the organization of the publicly traded corporation. The "monitoring the monitors" issue underlies much of the corporate governance debate in the United States and provides a starting point for the analysis of the contractual theory of the corporation in Section IV.

The theory of the firm helps explain not only why certain activities are organized through firms rather than markets, but also the particular type of firm organization utilized under different circumstances. In this regard, the theory of the firm views different types of organizations, including sole

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13. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 Am. Econ. Rev. 519 (1983); Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J. Law & Econ. 233 (1979).

14. *See* Cheung, *The Contractual Nature of the Firm*, 26 J. Law & Econ. 1 (1983).

15. Alchian & Woodward, *Reflections on the Theory of the Firm*, 143 JITE 110, 111 (1987). *See* Jensen & Meckling, *supra* note 11, at 311 ("The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals.").

16. Klein, Crawford & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. Law & Econ. 297 (1978).

proprietorships, partnerships, and corporations, as contractual responses to the needs of the firm's participants.

B. *The Importance of the Efficient Capital Markets Hypothesis*

The development of the theory of the firm, which provides the theoretical basis for the contractual theory of the corporation, would not have been possible without the development and empirical verification of the Efficient Capital Markets Hypothesis.[17] The hypothesis states, in most basic terms, that securities prices are efficient in that they accurately reflect all publicly available information about the security. Prices of actively traded securities quickly reflect at least all public information about a company.

The basic mechanism of market efficiency is that information about a firm continually alters investor expectations about future returns and hence the prices at which they will sell and buy their securities.[18] This information reaches investors in a wide variety of ways, including voluntary and mandatory disclosures by firms, stories in the media, reports by securities analysts, and disclosure of insider trades.

The efficient markets hypothesis is important because it means that corporate contracts that harm investor interests will be recognized and punished by price reductions in the market. Incorporation in a state with corporation law that facilitates managerial abuse of shareholders, for example, will result in lower share prices than would be found if the same firm were incorporated in a state with a different corporation law.[19]

From a legal perspective, where the concern is often with fairness rather than efficiency, the efficient capital markets hypothesis means that securities markets are fair in the sense that a corporate shareholder gets what he is paying for in both the terms of the contract and the substantive nature of the product, including the quality of management. The contractual theory of the corporation suggests that share prices will not only be fair, but also that corporate managers will have incentives to maximize share value.

C. *The Corporate Firm: Residual Claimants, Shareholders, and Monitors*

Explaining the emergence of the firm does not explain why most of the largest firms are organized as corporations. The attractiveness of the corporation relative to other forms of business associations is due in large part to the

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17. For a detailed explanation of the Efficient Capital Markets Hypothesis, see R. Brealey & S. Meyers, Principles of Corporate Finance (3d ed. 1988).

18. Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549 (1984).

19. *See generally* Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" versus Federal Regulation*, 53 J. Bus. 259 (1980).

economic benefits of issuing shares of stock that limit the shareholders liability to the initial investment in the firm. The issuing of stock facilitates the productive specialization of activities. The publicly traded corporation allows individuals with no managerial expertise to participate in corporations as owners by purchasing shares of stock. The corporate form also allows specialization, or centralization, of management functions through the hiring of professional managers. Specifically, the corporation allows individuals with little financial capital, but considerable managerial talents, to specialize as professional managers of corporations. The talents of such individuals would be much more difficult to tap in the absence of the corporate form of business association based on the separation of ownership and management functions.

The theory of the firm also sheds some light on the internal organization of the corporation, especially the role of managers and residual claimants. Common stockholders are the residual claimants in the publicly traded corporation because, in basic terms, the common shareholders get what is left after everyone else has been paid. As a consequence, common stock prices, which reflect the present discounted value of the residual claim, are extremely sensitive to changes in expectations about the future prospects of the business. Other types of financial instruments, backed by contractual claims, have a more stable rate of return.

The residual claimant status of common shareholders means that they are the primary risk bearers of the corporation. Common shareholders sell their risk bearing services to the corporation. In fact, it is often suggested in the economic literature on the theory of the firm that the productive role of common shareholders is that of risk bearers, rather than owners. Limited liability clearly facilitates this specialization by shareholders because it allows shareholders to be "rationally ignorant" of managerial practices.[20] That is, because their risk is limited to their initial investment, shareholders do not waste their time trying to monitor managerial behavior.[21] Thus, limited lia-

20. Shareholders are characterized as rationally ignorant because of the large costs associated with staying informed about the corporation's internal affairs and the very small expected benefits to the individual shareholder of being informed. After bearing the costs of becoming informed, such shareholders are unlikely to be able to influence the corporation's policies and in any event they must share the benefits of intervention if they are successful. *See generally* Manne, *Some Theoretical Aspects of Share Voting: An Essay in Honor of Adolf A. Berle*, 64 Colum. L. Rev. 1427, 1440-42 (1964); Fischel, *The Corporate Governance Movement*, 35 Vand. L. Rev. 1259, 1277 (1982).

21. Limited liability encourages investment by individuals that have neither the time nor the expertise to monitor the management of the business. In order to understand the importance of this aspect of limited liability, consider the plight of an investor in a large company that does not have limited liability. Because the investor's entire personal fortune is tied to the success or failure of the company (that is, failure of the company allows the company's creditors to attach the investor's personal assets), the investor will attempt to minimize that great risk

bility allows investors to be passive with respect to the internal affairs of companies and to concentrate on the externally observable traits like profits and rate of return on investment.

Another major advantage of the publicly traded, limited-liability corporation is that the investors' ownership interests can be transferred without the permission of fellow owners and without the expense of locating buyers. For example, when a shareholder becomes dissatisfied with the operations or profitability of a corporation in which he or she owns stock, the shareholder can sell the shares instead of becoming involved in the corporation's decision-making process. Many shareholders are specialized investors who convey their evaluation of managerial performance by selling or buying shares. The transferring of shares is facilitated by limited liability which allows buyers to purchase shares without incurring more risk than the potential loss of the purchase price. Passive investors further benefit from limited liability and "rational ignorance" because they are able to diversify their portfolio by owning interests in several different firms at the same time.

The presence of "rationally ignorant" shareholders, however, presents managers of corporations with opportunities to engage in activities that are not necessarily in the shareholders' best interests. These so-called "agency costs" are discussed below.

D. *Agency Theory and the Corporation*

The theory of the firm has helped economists and economic oriented lawyers develop a perspective on the corporation which, although recognizing the potential conflict between shareholders and managers, argues that most of those conflicts are solved by competitive forces that align managers' interests with shareholders' interests.[22] This theoretical approach, which is called agency theory or transaction costs economics, provides the theoretical bases for the contractual theory of the corporation.

In general, agency theory suggests that unity of ownership and control is not a necessary condition of efficient performance of a firm. This perspective stresses the voluntary, contractual nature of the corporation. A first step

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by carefully monitoring the management of the firm. Obviously, the typical risk-averse investor would not be able to invest in more than one or two companies if faced with unlimited liability. For a thorough discussion of this and other reasons for limited liability, see Woodward, *The Economics of Limited Liability*, J. Institutional & Theoretical Econ. 141 (1985). The benefits associated with limited liability are not free, however. Meiners, Mofsky & Tollison, *Piercing the Veil of Limited Liability*, 4 Del. J. Corp. L. 351 (1979).

22. Another set of conflicts that must be resolved in the firm is the relationship between bondholders and shareholders. For identification of these conflicts and an analysis of contractual solutions, see Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. Fin. Econ. 117 (1979).

in understanding this market-oriented approach is to recognize that it is based in part on the assumption that the shareholders' primary interest is in the maximization of the value of their investments and that the contractual relations among participants in the firm must convince shareholders that managers will not abuse the shareholders' interests. A corporation's managers, which are defined to include its officers and directors, are agents of the shareholders. In this view, the so-called separation of ownership and control in the large corporation is an agency relationship, which exists because the benefits of the relationship exceed the agency costs associated with it. That is, the agency relationship exists because both the principal and the agent share in the benefits of the relationship.

At this point, it is helpful to be more precise in the identification of conflicts between managers and shareholders in the corporate firm.

> (1) *Effort*: A primary concern of agency theory and the separation of ownership and control literature is with whether entrenched managers have the incentives to maximize their efforts in pursuing the maximum rate of return for shareholders.
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> (2) *Horizon*: This conflict refers to the issue of how to encourage a manager to act in the shareholders' interests as the manager approaches retirement or prepares to leave the firm for other opportunities.
>
> (3) *Risk Aversion*: Entrenched managers have an incentive to avoid bankruptcy at all costs, but shareholders with diversified portfolios are risk neutral with respect to individual securities in their portfolios. In the absence of corrective governance mechanisms, managers interests will be more closely aligned with those of bondholders than shareholders.
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> (4) *Underleveraged*: Within a certain range the tax savings from debt and increased leverage can increase a firm's profit, but risk averse managers may not like the increased risk associated with increased leverage and debt service demands although, once again, shareholders could prefer the undertaking of such risk because they specialize in bearing such risks.
>
> (5) *Dividend Payout Problem*: Risk averse managers may prefer to reinvest their firm's profits in the firm rather than distribute them to shareholders even though the shareholders could put them to a more productive use.[23]

This list of conflicts between managers and shareholders is not intended to be exhaustive, but it does serve as a reference for discussing the roles of different corporate governance mechanisms that control corporate agency costs.

Agency theory and transaction costs economics attempt to explain the development of institutional arrangements that convince shareholders volun-

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23. *See generally* Jensen, *Agency Costs of Free Cash Flow: Corporate Finance and Takeovers*, 76 Am. Econ. Rev. 323 (1986).

tarily to allow managers to control their resources. The resources devoted to controlling agency costs are properly identified as agency costs. Thus, agency costs include not only the direct costs associated with agents acting in their own interest at the expense of shareholders, but also the costs of controlling managerial agents through legal or market governance arrangements. According to the contractual theory discussed below, managers select the least cost manner of controlling agency costs. The use of corporate governance mechanisms merely reveals that the costs of monitoring are justified by reducing the costs of an agent's deviation from the behavior that would occur if the agent and principal were one.

III. CORPORATE GOVERNANCE MECHANISMS AND THE CONTRACTUAL THEORY OF THE CORPORATION

Much of the economic literature on the governance of the modern corporation reflects an evolutionary view of the development and use of certain governance mechanisms. This view is clearly reflected in Professors Fama's and Jensen's statement: "Absent fiat, the form of organization that survives in an activity is the one that delivers the product demanded by customers at the lowest price while covering costs."[24] The modern corporation is passing the test of time. This section offers a summary of the governance mechanisms that are believed to explain the phenomenal success of the modern corporation.

The discussion focuses on powerful market forces that encourage managers to act in shareholders' interests. Taken together, the identification of these market forces and the understanding of their interaction represent the contractual theory of the corporation. The corporation is based on voluntary contract, and the realities of the corporate agency relationship dictate that the corporation's managers select the contractual terms that are then offered to potential investors. In order to raise capital at the lowest possible price, managers must offer contract terms — including evidence of the existence of intra-firm incentive structures — that convince investors that agency costs will be minimized. This section identifies and discusses those contractual terms.

A. *The Market for Corporate Control*

A potential concern of investors is that intra-firm corporate governance devices such as managerial incentive contracts designed by entrenched

24. Fama & Jensen, *Separation of Ownership and Control*, 26 J. Law & Econ. 301, 301 (1983).

managers, although clearly more useful than monitoring by diffuse shareholders, may not always be effective in controlling managerial agency costs. An alternative control mechanism, beyond the direct control of entrenched managers, is found in the stock market. The stock market discipline of managers is manifest in the threat of tender offer, takeovers, or other forms of changes in corporate control whenever entrenched managers adopt strategies and behavior that fail to maximize the value of the corporation's shares. The so-called market for corporate control provides an external monitoring mechanism that forces managers to be concerned about their shareholders. Prior to this theoretical development by Henry G. Manne,[25] commentators on the modern corporation were at a total loss when it came to explaining how corporate managers could be restrained to act in their shareholders' interests. Because the market for corporate control plays the preeminent role in the other governance mechanisms in the contractual theory of the corporation, it warrants further discussion.

A viable market for corporate control requires freely transferable voting shares so that dissatisfied shareholders can sell their shares rather than attempt to control agency problems through internal control mechanisms. The result of this exit process is that the shares of a poorly managed firm trade at a discount below the level that could be attained with better and more loyal managers. This creates the possibility of large capital gains from purchasing shares and replacing incompetent or shirking managers with a new group of more efficient managers.

The identification of firms trading below their potential value due to management problems, however, is very costly.[26] Prospective bidders monitor the performance of managerial teams by comparing a corporation's potential market value with its value under current management. In this regard, management inefficiency must be understood to include not only the failure to minimize costs and maximize profits through current operations, but also the failure to distribute excess cash flow, the failure to take advantage of acquisitions and restructuring opportunities, and even the failure to communicate to the stock market the health and prospects of the company.

If a firm is not performing up to its financial potential under current and expected market conditions, regardless of the reason, then it is an attractive target for a change in corporate control. According to the theory, the acquiring firm purchases the stock of the target company, replaces the inefficient

25. *See* Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965).

26. For a thorough discussion of this point, see Macey & McChesney, *A Theoretical Analysis of Corporate Greenmail*, 93 Yale L.J. 13 (1985).

managers with efficient managers, and then reaps a large profit as the stock price rises to reflect the increased earning potential under the more efficient managerial team. In basic terms, the firm's assets are worth more in the hands of the new managers. In many instances, the source of the premium for the replacement of managers is the reduction of agency costs. But a more general view of the role of the market for corporate control is that it is the *threat* of takeover, not the actual occurrence of a takeover, which serves to align managers' interests with shareholders' interests.

The market for corporate control uses many different forms of control transactions. Of course, the most dramatic is the takeover via a hostile tender offer. In addition, friendly mergers, negotiated tender offers, sales of control by large shareholders, and proxy contests are mechanisms for changing control of corporations and displacing inefficient managers with more efficient managers.

The role of the market for corporate control in the governance of the modern corporation is not based on some mystical or ideological belief in the power of market forces, but rather it is supported by numerous empirical studies.[27] This important insight about the role of the stock market in controlling managerial discretion must be counted as one of the first important steps in the application of economics to corporation law and in the development of the contractual theory of the corporation.

The freedom of contract perspective on corporate law is illustrated by its application to one of the most heated debates in corporate law — the proper role of incumbent managers of a target corporation when faced with a tender offer for control. The incumbent managers, who are faced with the prospect of losing their jobs if the takeover is successful, may have an incentive to try to defeat the takeover even if it appears to be in the shareholders' best interests. Shareholders are faced with a dilemma in deciding whether managerial defensive tactics are in their best interests. If a firm is a target, the shareholders benefit if the managers' defensive activities result in a higher price as long as their activities do not actually defeat the tender offer. If the defensive tactics defeat the tender offer, shareholders are clearly worse off — the managers have, in effect, denied them the opportunity to sell their shares at a higher price. But all of this reflects an *ex post* analysis of the proper managerial response once a takeover has been initiated; an economic

27. *See* Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. Fin. Econ. 5 (1983); Jarrell, Brickley & Netter, *The Market for Corporate Control: The Evidence Since 1980*, 2 J. Econ. Persp. 49 (1988). *See also* Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 Del. J. Corp. L. 540 (1984).

perspective adopts an *ex ante* view of the proper managerial response when the shareholders are not certain that their corporation will become a target.[28]

In actuality, most firms are never takeover targets (although all are potential targets and thus must respond to the threat of tender offers). The threat effect of a takeover often means that firms will not be attractive targets — the managers are already being forced to act in the shareholders' best interests. Establishing *ex ante* a rule allowing managers to defend against takeover increases the costs of (and reduces the effectiveness of) the market for corporate control as a monitoring mechanism and thus merely increases the problems associated with the separation of ownership and control. That is, raising the costs of successful takeovers by allowing incumbent managers to engage in defensive tactics provides managers with more room to act in their own interest without being totally concerned about shareholder welfare.

It has been argued that, given a choice, shareholders as a group would be better off *ex ante* under a system that forces all managers to act in the shareholders' best interests at all times as opposed to a system that occasionally results in high stakes takeover battles. This reasoning has led to calls for mandating the role of the market for corporate control in all corporations by legally restricting the ability of managers to defend against takeover bids.[29]

But this *ex ante* perspective is based on a market, as opposed to contractual approach, to corporate governance. It denies fully informed shareholders the opportunity to insulate *ex ante* their managers from the sometimes disruptive threat of the market for corporate control. An approach consistent with the contractual theory of the corporation would allow for shareholders to contract for whatever role of management resistance that they desire.[30]

Exclusive reliance on the market for corporate control to solve all of the potential conflicts of interest associated with the separation of ownership and control is neither justified nor necessary. Managerial discretion is constrained by other market and legal mechanisms. For example, in some large corporations, agency costs are reduced by the corporation being owned by large owners who have the incentive to closely monitor managerial behavior.

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28. This is the main theoretical contribution of Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161 (1981). This article spurred the debate about managerial response to tender offers. The literature on this debate is too extensive to either summarize or list; important early contributions included: Fishel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 Tex. L. Rev. 1 (1978); *see supra* notes 12-15, 17.

29. *See* Easterbrook & Fischel, *supra* note 25 (arguing for mandatory rule of incumbent management passivity in takeovers).

30. *See* Baysinger & Butler, *supra* note 2; Haddock, Macey & McChesney, *supra* note 2; and Knoeber, *Golden Parachutes, Shark Repellants, and Hostile Takeovers*, 76 Am. Econ. Rev. 155 (1986).

Nevertheless, the market for corporate control provides a last resort mechanism for correcting excessive managerial discretion and, as a direct consequence, reduces the likelihood that shareholders will be harmed by their agents. The market for corporate control provides the glue that holds together the nexus of contracts.

B. *Product Market Competition*

Product market competition forces managers to attempt to maximize the profits of the corporation. Failure to maximize profits in competitive markets often means the failure of the firm, which may be as costly for the managers as it is for the shareholders. Because of firm-specific investments in human capital and the likelihood of compensation in the form of stock or stock options, managers typically have a larger percentage of their total wealth tied up in the firm they work for relative to the percentage of the typical diversified shareholder's wealth tied up in a particular firm. Thus, managers of firms that do not have market power have a strong incentive to act in the shareholders' interests. Moreover, even if a firm does have market power, the expectation of higher profits will have already been capitalized into the price of the corporation's shares so that failure to maximize profits will be reflected in a below-average return on shareholders' investments, thus making the firm an attractive takeover target.

C. *Capital Market Competition and Capital Structure*

Most corporations use a mixture of debt and equity financing. In a pathbreaking 1958 article, Franco Modigliani and Merton Miller showed that, under a set of specified assumptions including absence of transaction and information costs, the capital structure of a firm — that is, its debt to equity mix — was irrelevant to the total value of the firm.[31] This raises the issue of why different capital structures are observed across firms.

The analytical strength of the contractual theory of the corporation is demonstrated by its ability to answer the Modigliani and Miller riddle. In a landmark article, Jensen and Meckling used agency problems and monitoring of managers to identify the relevance of capital structure to the value of a firm.[32] An all-equity structure gives substantial discretion to managers to use corporate assets for their own benefit subject only to the vague proscriptions of fiduciary duties. But corporation managers have an incentive to minimize

31. Modigliani & Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, 48 Am. Econ. Rev. 261 (1958). *See also* Miller, *The Modigliani-Miller Propositions After Thirty Years*, 2 J. Econ. Perspectives 99 (1988).

32. Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).

their combined costs of debt and equity capital because failure to do so would make them vulnerable to takeover. In order to raise equity capital at the lowest possible cost, a corporation's managers must convince potential shareholders that agency costs will be minimized. Bondholders also must address conflict of interest problems. For example, a debt-heavy structure induces those who hold equity and managers who are responsive to their interests to make highly risky investments that may produce great benefits to the equity holders if they succeed and losses to the debt holders if they fail. Under the Jensen-Meckling view, different capital structures may be responses to different types of agency costs. There is no one optimal capital structure for all corporations.[33]

D. *Corporate Performance and Executive Compensation*

Corporate compensation packages appear to be structured in a manner that solve most of the conflicts between managers and shareholders. Analytically, corporate compensation packages can include three components: (1) unconditional compensation, such as salary and pension and insurance benefits; (2) compensation conditioned on stock market-based performance, such as stock options and bonuses; and (3) compensation conditioned on accounting-based performance, such as profit sharing. Stock market-based performance measures are beyond direct control or manipulation because stock prices reflect all available information, including the discounted value of long-term consequences of short-term actions, about the value of a firm. On the other hand, accounting-based performance measures are subject to manipulation by senior executive decisions through, for example, decisions to maximize short-term accounting profitability at the expense of greater long-term (beyond managers' employment terms) sacrifice. Thus, accounting-based performance measures are a potential source of agency costs, and most senior executives' compensation contracts do not include a component based on accounting performance. Profit-sharing arrangements are used for middle- and lower-level employees who are generally not in a position to manipulate accounting data. The other two components, however, can play a major role in reducing agency costs.

33. Agency theory and the contractual theory of the corporation also have helped to solve one of the major puzzles in the corporate finance literature: why do corporations continue to pay dividends when assets can be distributed to shareholders in other ways that are less costly to shareholders? For two possible answers, see Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 Am. Econ. Rev. 650 (1984); and DeAlessi & Fishe, *Why do Corporations Distribute Assets? An Analysis of Dividends and Capital Structure*, J. Institutional & Theoretical Econ. 34 (1987).

Managerial salaries and other forms of compensation are often linked to how well the firm is performing.[34] Fama argues that managers monitor each others' performances and reward achievements with bonuses and salary adjustments as a form of "ex post settling up" that substantially alleviates incentive problems.[35] Also, with respect to salaries, Becker and Stigler have supplied a strong argument that if managers enjoy especially favorable salaries or other terms of employment, they may be disciplined by the prospect of being fired.[36] Managers' proclivities towards shirking can be reduced even further by the use of stock options and bonus plans which alter a manager's time horizon for his managerial decisions so as to ensure that he acts in accordance with the long-term interests of his principals.[37] As managers approach retirement, defined benefit pension plans under which benefits are linked to the last period's salary resolve some of the horizon problems. Stock options in retirement packages can also serve to alleviate horizon problems.

E. *Markets for Managers*

Corporate managers recognize that they can improve the performance of the firm by reducing agency costs. Managers compete with one another to attain the top positions in their companies, and most promotion decisions are made on the basis of an individual's productivity.[38] Shareholders benefit as managers attempt to rise the corporate ladder by improving their productivity and impressing their superiors. Moreover, top-level managers often increase their salaries by jumping to other firms (or at least threatening to do so).

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34. *See, e.g.*, Couglan & Schmidt, *Executive Compensation, Management Turnover, and Firm Performance*, 7 J. Acct. & Econ. 43 (1985); Murphy, *Corporate Performance and Managerial Remuneration: An Empirical Analysis*, 7 J. Acct. & Econ. 11 (1985); and Murphy, *Incentives, Learning, and Compensation: A Theoretical and Empirical Investigation of Managerial Labor Contracts*, 17 Rand J. Econ. 59 (1986). *But see* Jensen & Murphy, *Are Executive Compensation Contracts Structured Properly?*, (The relation between pay and performance, while positive, seems too low to provide optimal incentives for managers; but suggesting that this is due to public and private political constraints.).

35. *See* Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288, 295-306 (1980).

36. Becker & Stigler, *Law Enforcement, Malfeasance, and Compensation of Enforcers*, 3 J. Legal Stud. 1, 9-10 (1974).

37. Another potential component of managerial compensation plans, contracting for insider trading by managers, would be an excellent mechanism for aligning managers' interests with shareholders' interests (if it were legal). See H. Manne, Insider Trading and the Stock Market 166 (1986); Haddock & Macey, *A Coasian Model of Insider Trading*, 80 Nw. U.L. Rev. 1449 (1987).

38. *See* Fama, *supra* note 35.

Thus, competition for managerial services, both inside and outside the corporation, encourages managers to act in shareholders' best interests.[39]

F. *Corporate Hierarchy and the Board of Directors*

The board of directors' acquiescence in management's decisions lies at the heart of Berle and Means's attack on the large publicly traded corporation. In this perspective, the board is assumed to reflect the same agency problems as managers. Recent developments in the economics of corporate hierarchy have helped to clarify the board's role as a monitor of managerial decisions.[40] This analysis takes the separation of ownership (residual risk bearing) and control (decision management) analysis one step further and looks at the specialization of functions by agents who control the firm. One branch of this analysis has concentrated on the importance of the structure of the corporate hierarchy to controlling agency costs, while the other has looked at the complementary roles of managers and directors.

The separation of strategic decision making from day-to-day operating decision making was the most important development of the so-called "M-form" revolution.[41] Beginning in the 1920s, the unitary (non-divisionalized or U-) form of organization in large firms was gradually replaced by the multi-divisional (M-) form of firm organization. The M-form organization is characterized by a general corporate office and staff that handle long-term entrepreneurial activities of the firm. The existing theoretical and empirical literature suggest that the M-form is more efficient than the U-form for most large enterprises. In particular, the M-form corporation appears to promote an increase in emphasis on strategic management and appears to reduce agency problems. The general office reduces agency costs as it specializes in monitoring the performance of separately staffed, self-contained operating divisions.[42] The success of the general office is then evaluated by externally observable variables — such as stock prices and rate of return.

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39. *See, e.g.*, Faith, Higgins & Tollison, *Managerial Rents and Outside Recruitment in the Coasian Firm*, 74 Am. Econ. Rev. 60 (1984).

40. *See* Fama & Jensen, *Separation of Ownership and Control*, 26 J. Law & Econ. 301 (1983); Williamson, *Organizational Form, Residual Claimants, and Corporate Control*, 26 J. Law & Econ. 351 (1983).

41. This modern theoretical contribution finds its roots in the works of A. Chandler, Strategy and Structure; Chapters in the History of Industrial Enterprise (1962) and O. Williamson, Markets and Hierarchies (1975), which recognized and elaborated upon the agency control aspects of large business organizations as they evolved in the early twentieth century.

42. *See* A. Chandler, *supra* note 37, at 323.

Recent theoretical contributions have found a role for the board of directors at the top of the M-form firm.[43] The control of the corporation by agents is separated according to function whereby decision management (the initiation and implementation of strategic plans) is entrusted to senior managers and decision control (the ratification and monitoring of the strategy formulation and implementation process) is the domain of the board of directors. That is, the management control functions are delegated to the board by the residual claimants, and the "[b]oard then delegates most decision management functions and many decision control functions to internal agents, but it retains ultimate control over internal agents — including the right to ratify and monitor major policy initiatives and to hire, fire, and set the compensation of top level decision managers."[44] Agency problems are reduced by tying compensation to these specialized activities. Thus, unlike the Berle and Means's perspective, which views directors as pawns in the managers' hands, the role of directors is important to the control of agency costs and, hence, the long-term survival of the firm.

This evolutionary perspective is supported by empirical evidence indicating that systematic relationship between board composition and corporate financial performance.[45] Moreover, the analysis indicates that, within a specified range, changes in board composition occur because increased independence is related to improved financial performance. Consistent with adherence to the Berle and Means's thesis, board independence is important. For example, the degree of board independence from managerial influence may be very important in determining the hiring and firing of inept management, enforcing the loyalty of managerial agents (that is, controlling agency costs), and determining the corporation's policy when faced with a hostile tender offer that will likely result in the displacement of the incumbent managers. However, the evidence also indicates that increased board independence is subject to diminishing marginal returns and ultimately negative marginal returns in terms of financial performance.[46] This latter result is interpreted as evidence that there is an opportunity cost to putting independent directors on the board because they

43. *See* Fama & Jensen, *Separation of Ownership and Control*, 26 J. Law & Econ. 301 (1983).

44. *Id.* at 313.

45. *See* Baysinger and Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J. L. Econ. & Organization 101 (1985).

46. The negative returns typically set in before the board reaches the level of independence advocated by most proponents of an independent board. *See* Baysinger & Butler, *Revolution versus Evolution in Corporation Law: The ALI's Project and the Independent Director*, 52 Geo. Wash. L. Rev. 557 (1984).

must replace either managerial insiders or functional directors (such as bankers, lawyers, or accountants) whose expertise can be important to the decision control function of the board.

G. *Ownership Structure*

Ownership structure has recently been identified as playing an important role in the governance of corporations.[47] In contrast to the convention of viewing the governance role of residual claimants as that of being "rationally ignorant" of the firm's internal affairs and exiting the firm upon dissatisfaction, owners of large blocks of shares may have so much of their wealth tied up in a firm that they cannot afford to ignore the governance of the corporation. Monitoring, or the possibility of monitoring, by large shareholders alters managerial behavior and reduces agency costs. Thus, ownership structure is another of the many corporate governance mechanisms that can be utilized in controlling agency costs. Of course, in many corporations, the ownership structure is so diffuse that shareholders are truly rationally ignorant, in which case the other governance mechanisms become relatively more important.

H. *Corporate Law and Fiduciary Duties*

Emphasis on the interaction of market forces under the contractual theory of the corporation has led some scholars to argue that markets will lead managers to adopt optimal governance structures and that corporate law is irrelevant.[48] However, the market mechanisms may be inadequate to deal with last-period, or one-time, divergences when the agent rationally concludes that the benefits of the one-time use of discretion is worth whatever penalties may be forthcoming in the employment market for the agent's services. In this regard, corporate law of fiduciary duties serves as a legal constraint on managerial opportunism.

Moreover, because markets do not operate without cost, it appears that corporate law plays a productive role in the contractual theory of the corporation by providing a standard form contract that reduces the transaction and negotiating costs of reaching and adhering to optimal contracts. In fact, some commentators have argued that it is appropriate to view corporation law as a standard form contract that through the law of fiduciary duties, which pro-

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47. *See* Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J. Law & Econ. 179 (1985); and Demsetz & Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. Pol. Econ. 1155 (1985).

48. *See, e.g.*, Diamond & Verrecchia, *Optimal Managerial Contracts and Equilibrium Security Prices*, 37 J. Finance 275 (1982); Jensen & Meckling, *supra* note 11; and Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 (1980).

scribes theft and specifies standards of care and loyalty, substitutes for costly, fully contingent contracts.[49] The terms of corporate law is one of the governance mechanisms that can be selected by the contracting parties to minimize corporate agency costs.

I. *Evaluation of the Contractual Theory*

The managers of firms select the mix of legal and market governance mechanisms that is optimal given the particular circumstances of the firm. The "nexus of contracts" specifies the extent of reliance upon differing mechanisms. Managers substitute among the various governance mechanisms until the marginal net productivity of each mechanism is equal. The corporate governance mechanisms, when combined in the manner most appropriate for the particular circumstances of each firm, resolve most of the conflicts between shareholders and managers identified at the end of Section II.

The concern about managerial loyalty and effort is resolved by the combined competitive pressures from each of the governance mechanisms. In particular, the market for corporate control provides an external monitoring mechanism that discourages shirking and encourages managers to select the optimal governance contracts for their corporation. The horizon problem is reduced by the use of stock options and pension plans. The risk aversion and under leverage problems are ameliorated by stock options. The dividend payout problem is rationalized by capital market competition.

The contractual theory of the corporation does not assert that agency costs are reduced to zero, rather it asserts that agency costs are minimized by the contractual terms agreed upon in the face of market and legal constraints. The contractual theory of the corporation provides theoretical and empirical bases for understanding not only the organization and success of the large corporation, but also the appropriate role of privately negotiated contracts and mandatory legal rules.

IV. FREEDOM OF CONTRACT, CORPORATE LAW, AND THE CONTRACTUAL THEORY OF THE CORPORATION

It is reasonable to assume that the parties to the nexus of contracts that form a firm anticipate the numerous problems associated with specialization, delegation, team production, and agency relationships. Freedom of contract

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49. *See* Easterbrook & Fischel, *Corporate Control Transactions*, 91 Yale L.J. 698, 702 (1982). For example, Professor Fischel has suggested that "[o]ptimal fiduciary duties should approximate the bargain that investors and managers would reach if transactions costs were zero." Fischel, *The Corporate Governance Movement*, 38 Vand. L. Rev. 1259, 1265 (1982).

allows the parties to structure their relations in a manner that ameliorates most of the agency problems inherent in the large corporation. In this regard, it is useful to consider the legal nature of the corporation within the context of the contractual theory of the corporation.

Although considerable historical[50] and economic evidence indicates that the corporation is founded in private contract, legal recognition of the corporation is gained through the granting of a charter from a state. In essence, the state's corporation law specifies the terms of the contract, including the property rights of the parties to the contract — the shareholders, directors, and officers. Most corporation laws are enabling statutes in the sense that they reflect the philosophy of freedom of contract which has guided corporation law since the first truly modern general incorporation laws were passed in the late nineteenth century. Most, if not all, of the terms can be altered by a specific provision in the articles or bylaws. The state law specifies the terms of the contract in the absence of a specific provision amending the laws. By defining rights, the articles of incorporation perform a function analogous to that of a private constitution. Firms may alter some aspects of the corporation law applicable to them by amending the corporation's articles of incorporation or bylaws to suit their particular needs.

Once a productive role for corporation law has been identified, the policy question arises as to the optimal substantive content of corporate law. In recent years, most areas of corporate law doctrine have been analyzed from the agency theory perspective. Intuitively, one would expect that the optimal contracts would differ from firm to firm. This is most obvious when comparing the legal rules applicable to closely held firms with the needs of firms with widely scattered holdings. This trade-off, or contingency, model of corporation law argues that the desirability of certain corporate law provisions is a function of the characteristics of the particular corporation under examination.[51] It follows from this theoretical and empirical point that only the contracting parties can know the particular set of corporate law rules that is most appropriate to their circumstances. Freedom of contract allows the corporate transactors to contract for the optimal mix of market and legal restraints on agency costs.

The efficient capital markets hypothesis provides considerable support for this contractual view of the substantive content of corporation law. The

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50. *See* Butler, *Nineteenth Century Jurisdictional Competition and the Market for Corporate Privileges*, 14 J. Legal Stud. 129 (1985); and R. Hessen, In Defense of the Corporation (1979).

51. Baysinger and Butler, for example, have demonstrated that the ownership structure of corporations differs across states of incorporation. Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J. Law & Econ. 179 (1985).

information efficiently reflected in market prices includes the statutory and case law of the firm's state of incorporation. State law specifies, to some extent, the terms of contracts constraining managerial discretion and the prospects that this discretion will be exercised consistently with investor interests. Any change in these contracts, and any new information about the managers of such a corporation, such as their track records, reputations and the like, will be reported in the financial media and reflected in market price. For example, empirical studies have demonstrated the impact of changes in legal rules — statutory or case law — on the trading price of affected firms' securities.[52] Thus, the stock market constrains managerial decision making in selecting the optimal corporate contract. Freedom of contract does not mean that managers are free to adopt contractual terms that harm shareholders.

V. CONCLUDING COMMENTS

The agency costs associated with the separation of ownership and control are alleviated by contracting motivated by market forces. Market forces constrain managers to act *as if* they have the shareholders' interests at heart; which is all that can be expected. Moreover, the corporation — and the current body of corporate law — appears to have passed the ultimate market test as evidenced by the fact that the corporation is the dominant form of business organization. It must be recognized, however, that the reduction of agency costs through contract and reliance on market forces is not free. For example, the market for corporate control and the other market mechanisms do not work without costly monitoring of the agents' performance. Nevertheless, the contractual theory of the corporation has been supported by a tremendous amount of historical, legal, and economic research. The market theory provides a powerful set of tools for responding to persistent calls for mandated changes in corporate governance. The one overbearing lesson of these theoretical developments is that the success of the large publicly traded corporation should encourage critics of the corporation to attempt to figure out what is right with the modern corporation before trying to fix it.

Economic analysis has forced legal commentators on corporation law and securities regulation to show a greater appreciation for the economic implications of alternative legal rules. Unfortunately, many legal commentators have mistaken the market model of the corporation for a pawn in a political debate when, in fact, its development represents a major advance in our un-

52. For a survey of some of these studies, see Romano, *The State Competition Debate in Corporation Law*, 8 Cardozo L. Rev. 709 (1987).

derstanding of the nature of the corporation law and the proper role of government in the corporation.

Finally, the contractual theory of the corporation offers a new perspective on the corporation and the role of corporation law. The corporation is in no sense a ward of the state; it is, rather, the product of contracts among the owners and others. Once this point is fully recognized by the state legislators and legal commentators, the corporate form may finally be free of unnecessary and intrusive legal chains.