The Economic Structure of Corporate Law
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For our parents

and for R. H. Coase
Preface

We seek to understand the logic of corporate law. Why are managers free to decide what the firm will produce, whether it will pay dividends, and how much to pay themselves as salaries and bonuses? Why are almost all of the important decisions the firm will make committed to private actors’ discretion, while statutes prescribe such trivia as the maximum duration of voting trusts? Why do the same judges who aggressively review the design of aircraft (in product-liability cases) and the decisions of disinterested administrative agencies react in horror at the prospect of deciding whether a manager was negligent when introducing a new product after test-marketing in only two cities? Why are the principal legal constraints directed to the relation between managers and shareholders, leaving employees, bondholders, and other claimants to fend for themselves by contract? Why are there no punitive damages in securities cases, even though punitive damages are staples in other litigation?

These and other distinctive features of corporate law are not random. The same patterns emerge in state after state, firm after firm, decade after decade. They are patterns, adaptations with substantial value in the evolutionary struggle for corporate survival. These patterns are almost impossible to understand if “fairness” or paternalism are the objectives of corporate law, yet simple to understand from an economic perspective. We conclude that corporate law has an economic structure, that it increases the wealth of all by supplying the rules that investors would select if it were easy to contract more fully.

This book joins the legal and economic disciplines. Most of it is an exercise in positive economics—that is, we take the world and its laws as given and try to understand why they are as they are. Some of it is openly normative—we take a few economic principles
and preach to legislatures and judges about what the law ought to be if it is to promote social welfare. Ours is on both fronts an exploratory treatment, a survey. A more complete assessment would examine additional doctrines in detail and offer an explanation not only for the dominant features of the law but also for the departures. Explaining the structure of corporate law, and the engine that drives it, is enough of a task for one book.

For more than a decade we have been bringing economic principles to bear on corporate law. Several of our articles form the core of chapters in this book; others make appearances only in footnotes; still other sections have been written from scratch, and all portions of the book (including those based on articles) have been substantially revised and updated. The abbreviation necessary to produce a tractable study puts us at risk of ignoring our intellectual debts, of which there are many. Although these cannot be repaid, they are acknowledged at the end of this book. In particular, we like all other contemporary scholars in corporate organization owe a great debt to R. H. Coase, who first pointed out the similarity (and differences) between corporations and markets. Although Coase had retired from the faculty of the University of Chicago by the time we joined it, his intellectual legacy enlivens the school and the profession. Without him the economic study of corporate law might lie ahead; to him we have dedicated this book. We dedicate it as well to our parents, also necessary conditions of its existence.

F. H. E.
D. R. F.
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The Corporate Contract

For a long time public and academic discussion of corporations has started from the premise that managers have “control” and use this to exploit investors, customers, or both. The usual prescription is some form of intervention by the government. This may mean prescription of the firm’s output, wages, and prices. It may be regulation of the securities markets. It may take the form of corporate law, which establishes minimum voting rules and restricts how managers can treat the firm and the investors.

The argument is simple. In most substantial corporations—firms with investment instruments that are freely traded, which we call “public corporations”—each investor has a small stake compared with the size of the venture. The investor is therefore “powerless.” The managers, by contrast, know how the business is running and can conceal from investors information about the firm and their own activities. Armed with private knowledge and able to keep investors in the dark, the managers can divert income to themselves, stealing and mismanaging at the same time. Diversion and sloth may not be obvious, but they exist. Even when they do not, the potential for misconduct remains. Only some form of regulation can protect investors. And the limit on regulation is to be found not in principles of free contracting—for the corporate charter is at best a contract of adhesion by which the managers call all the shots—but in a concern that regulation not go “too far.” Thus in the debate about whether public corporations should be permitted to issue nonvoting stock, most people assume that nonvoting stock is bad because it insulates the managers further from investors’ control, and the only question is whether an outright ban (as opposed to severe regulation) would restrict “too much” the ability of firms to raise capital.
Although the language of regulation is everywhere, corporate law has developed along a different path. The corporate code in almost every state is an “enabling” statute. An enabling statute allows managers and investors to write their own tickets, to establish systems of governance without substantive scrutiny from a regulator. The handiwork of managers is final in all but exceptional or trivial instances. Courts apply the “business judgment rule,” a hands-off approach that judges would not dream of applying to the decisions of administrative agencies. Yet administrative officials do not stand to profit from their decisions—and therefore, one might think, are not subject to the pressures that cause managers’ goals to diverge from those of investors. So courts ride herd on disinterested administrators while leaving self-interested managers alone. What can be going on?

Consider the domain of managers’ choice. The founders and managers of a firm choose whether to organize as a corporation, trust, partnership, mutual, or cooperative (a form of ownership by customers). They choose what the firm will make or do and whether it will operate for profit, not for profit, or hold a middle ground, pursuing profit but not to the exclusion of some other objective (as publishers of newspapers do). They choose whether to allow the public to invest or whether, instead, the firm will be closely held. They choose what kinds of claims (debt, equity, warrants) to issue, in what ratios, for what price, with what entitlements: not only the right to receive payments (how often, in what amounts) but also whether these investments allow their holders to vote—and if to vote, how many votes, and on what subjects. They choose where to incorporate (states have different legal rules). They choose how the firm will be organized (as a pyramidal hierarchy or a loose, multidivisional collective), whether central leadership will be strong or weak, and whether the firm will grow (internally or by merger) or shrink (by selling existing assets or spinning off divisions). Investors select the members of the board of directors, who may be “inside” (part of the management team) or “outside” (often associated with investors, suppliers, or customers), and the board decides who exercises which powers on the firm’s behalf. As a practical matter boards are self-perpetuating until investors become dissatisfied and a majority decides to redo everything to a new taste. With trivial exceptions all business deci-
sions—including the managers' pay, bonuses, stock options, pensions, and perquisites—are taken by or under the supervision of this board, with no substantial inquiry by anyone else. Anyone who asks a court to inquire will be brushed off with a reference to the business judgment rule.

Some things are off-limits. States almost uniformly forbid perpetual directorships (persons who cannot be displaced by holders of a majority of the voting power). They set quorum rules (on critical decisions, a third of the board and sometimes half of the investors must participate) and require "major" transactions to be presented to the board (occasionally shareholders too) rather than stand approved by managers or a committee. States also forbid the sale of votes divorced from the investment interest and the accumulation of votes in a corporate treasury (that is, boards cannot perpetuate themselves by voting "treasury shares" or by cross-holding shares of related corporations). They require managers to serve equity investors' interests loyally. Federal law requires firms to reveal certain things when they issue securities, and public firms must make annual disclosures.

Determined investors and managers can get 'round many of these rules, but the mechanisms for doing so are sidelights. Any theory of corporate law must account for the mandatory as well as the enabling features, and must account for the pattern of regulation—one that leaves managers effectively free to set their own salaries yet forbids them to delegate certain questions to subcommittees, that gives shareholders no entitlement to dividends or distributions of any kind but specifies a quorum of one-third of the board for certain decisions. We attend to that task throughout this book. For now it is enough to know that what is open to free choice is far more important to the daily operation of the firm, and to investors' welfare, than what the law prescribes. Restraints on contracts are common (for example, occupational safety laws limit the risks employees may agree to accept), but few of these concern corporate organization.

Why does corporate law allow managers to set the terms under which they will administer corporate assets? Why do courts grant more discretion to self-interested managers than to disinterested regulators? Why do investors entrust such stupendous sums to managers whose acts are essentially unconstrained by legal rules?
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We offer answers to these questions, explanations of the economic structure of corporate law.

The Dynamic Shaping of the Corporate Form

The view you take of corporations and corporate law is apt to depend on your assumptions about how investors, employees, and other players come to be associated in a venture. You are likely to be driven to a regulatory view of corporations if you assume that corporations are born with a complement of managers, employees, and investors, in which managers have complete control of the corporation and investors are powerless. But corporations do not arise by spontaneous generation. Managers assume their roles with knowledge of the consequences. Investors part with their money willingly, putting dollars in equities instead of bonds or banks or land or gold because they believe the returns of equities more attractive. Managers obtain their positions after much trouble and toil, competing against others who wanted them. All interested persons participate. Firms begin small and grow. They must attract customers and investors by promising and delivering what those people value. Corporations that do not do so will not survive. When people observe that firms are very large in relation to single investors, they observe the product of success in satisfying investors and customers.

How is it that managers came to control such resources? It is no secret that scattered shareholders cannot control managers directly. If the investors know that the managers have lots of discretion, why did they fork over their money in the first place? If managers promise to return but a pittance, the investors will not put up very much capital. Investors simply pay less for the paper the firms issue. There is therefore a limit on managers’ efforts to enrich themselves at investors’ expense. Managers may do their best to take advantage of their investors, but they find that the dynamics of the market drive them to act as if they had investors’ interests at heart. It is almost as if there were an invisible hand.

The corporation and its securities are products in financial markets to as great an extent as the sewing machines or other things the firm makes. Just as the founders of a firm have incentives to make the kinds of sewing machines people want to buy, they have incentives to create the kind of firm, governance structure, and
securities the customers in capital markets want. The founders of the firm will find it profitable to establish the governance structure that is most beneficial to investors, net of the costs of maintaining the structure. People who seek resources to control will have to deliver more returns to investors. Those who promise the highest returns—and make the promises binding, hence believable—will obtain the largest investments.

The first question facing entrepreneurs is what promises to make, and the second is how to induce investors to believe them. Empty promises are worthless promises. Answering the first question depends on finding ways to reduce the effects of divergent interests; answering the second depends on finding legal and automatic enforcement devices. The more automatic the enforcement, the more investors will believe the promises.

What promises will the entrepreneurs make in order to induce investors to hand over more money? No set of promises is right for all firms at all times. No one thinks that the governance structure used for a neighborhood restaurant will work well for Exxon or Hydro Quebec. The best structure cannot be derived from theory; it must be developed by experience. We should be skeptical of claims that any one structure—or even a class of structures—is best. But we can see the sorts of promises that are likely to emerge in the competition for investments.

Some promises entail submitting to scrutiny in advance of action. Outside directors watch inside ones; inside directors watch other managers; the managers hire detectives to watch the employees or set up cross-check systems so that employees possess little ability to act independently. At other times, though, prior monitoring may be too costly in relation to its benefits, and the most desirable methods of control will rest on deterrence, on letting people act as they wish but penalizing mistakes and misdeeds. Fiduciary obligations and litigation are forms of subsequent settling-up included among these kinds of devices. Still other methods operate automatically. Managers enjoy hefty salaries and perquisites of office; the threat of losing these induces managers to act in investors' interest.

Managers in the United States must select the place of incorporation. The fifty states offer different menus of devices (from voting by shareholders to fiduciary rules to derivative litigation) for the protection of investors. The managers who pick the state of incorporation that is most desirable from the perspective of investors
will attract the most money. The states that select the best combination of rules will attract the most corporate investment (and therefore increase their tax collections). So states compete to offer—and managers to use—beneficial sets of legal rules. These include not only rules about governance structures but also fiduciary rules and prohibitions of fraud.

Managers decide when to go public. Less experienced entrepreneurs start with venture capital, which comes with extensive strings. The venture capitalists control the operation of the firm with some care. Only after the managerial team and structure has matured will the firm issue public securities. Although the entrepreneurs commonly keep majority control on the initial public sale, they remain bound by contracts with venture capitalists that tie continuation of control to continuation of success. Eventually the entrepreneurs sell working control, and venture capitalists withdraw. The firm has become public in fact as well as in name.

Entrepreneurs make promises in the articles of incorporation and the securities they issue when they go public. The debt investors receive exceptionally detailed promises in indentures. These promises concern the riskiness of the firm’s operations, the extent to which earnings may be paid out, and the domain of managerial discretion. These promises benefit equity investors as well as debt investors. The equity investors usually receive votes rather than explicit promises. Votes make it possible for the investors to replace the managers. (Those who believe that managers have unchecked control should ask themselves why the organizers of a firm issue equity claims that enable the investors to replace the managers.) The managers also promise, explicitly or otherwise, to abide by the standards of “fair dealing” embedded in the fiduciary rules of corporate law. Sometimes they make additional promises as well.

To sum up: self-interested entrepreneurs and managers, just like other investors, are driven to find the devices most likely to maximize net profits. If they do not, they pay for their mistakes because they receive lower prices for corporate paper. Any one firm may deviate from the optimal measures. Over tens of years and thousands of firms, though, tendencies emerge. The firms and managers that make the choices investors prefer will prosper relative to others. Because the choices do not impose costs on strangers to the
contracts, what is optimal for the firms and investors is optimal for society. We can learn a great deal just by observing which devices are widely used and which are not.

It is important to distinguish between isolated transactions and governance structures. There are high costs of operating capital and managerial markets, just as there are high costs of other methods of dealing with the divergence of interest. It is inevitable that a substantial amount of undesirable slack or self-dealing will occur. The question is whether these costs can be cut by mechanisms that are not themselves more costly. Investors, like all of us in our daily lives, accept some unwelcome conduct because the costs of the remedy are even greater. We also use deterrence (say, the threat of punishment for fraud) rather than other forms of legal control when deterrence is the least costly method of handling a problem, which it generally is. The expensive legal system is not cranked up unless there is evidence of wrongdoing; if the anticipated penalty (the sanction multiplied by the probability of its application) is selected well, there will not be much wrongdoing, and the costs of the system will be correspondingly small. A regulatory system (one entailing scrutiny and approval in advance in each case) ensures that the costs of control will be high; they will be incurred even if the risk is small.

Markets that let particular episodes of wrongdoing slide by, or legal systems that use deterrence rather than regulatory supervision to handle the costs of management, are likely to be effective in making judgments about optimal governance structures. Governance structures are open and notorious, unlike the conduct they seek to control. Costs of knowing about a firm's governance are low. Firms and teams of managers can compete with each other over the decades to design governance structures and to build in penalties for malfeasance. There is no substantial impediment to the operation of the competitive process at the level of structure. The pressures that operate in the long run are exactly the forces that shape structure. Contractual promises and fiduciary rules arise as a result of these considerations.

Before tackling particular topics such as limited liability and takeovers, however, it is useful to step back and ask whether corporation-as-contract is a satisfying way of looking at things even in theory. No one portrays the relation between trustee and bene-
ficiary as one of arm's-length contracting, and legal rules impose many restrictions that the trustee cannot avoid. Why think about corporations differently?

Markets, Firms, and Corporations

"Markets" are economic interactions among people dealing as strangers and seeking personal advantage. The extended conflict among selfish people produces prices that allocate resources to their best uses. This is an old story, and Adam Smith's *The Wealth of Nations* (1776) remains the best exposition. A series of short-term dealings in a market may be more useful for trading than for producing goods, however. The firm—an aggregation of people banded together for a longer period—permits greater use of specialization. People can organize as teams with the functions of each member identified, so that each member's specialization makes the team as a whole more productive than it would otherwise be.

Teams could be assembled every day, the way stevedore contractors hire longshore workers. The construction industry assembles teams by the project. More often, however, the value of a long-term relation among team members predominates, and to the extent it does recognizable firms grow. Yet as the size of a firm grows, there must be more and more transactions among members. A manufacturer of cars that makes its own paint must decide how much paint to use, and of what quality. Does it make sense to make the paint job a little less durable? This depends on the value of the paint the firm uses—and on whether someone else could provide the paint for less.

An integrated firm has difficulty assessing the value of the paint it makes for itself. It must take expensive steps to give the paint a value (called a "transfer price"), which at best duplicates information that markets produce and at worst may be quite inaccurate, leading the firm to make inefficient decisions. Managers may specify transfer prices that lead firms to produce paint they should have bought, or to use too much or too little paint in their products. Transacting for paint in markets has risks (will the seller deliver on time? will the quality be good?) that are costly to deal with. Letters of credit, the courts, organized exchanges and credit bureaus, and other institutions are among the costs of markets. The firm grows...
until the costs of organizing production internally exceed the costs of organizing through market transactions.

One cost of cooperative production inside the firm is the divergence of interest among the participants. It is sometimes useful to think of the atoms dealing in markets as individual people who reap the gains and bear the expenses of their own decisions. The organization of production in teams is not so simple. The firm may hire labor by the hour ("hourly employees") or the year ("salaried employees"); either arrangement hires a segment of time but not a specified effort. It is difficult to induce the employee to devote his best effort to the firm's fortunes. Why should he? His pay is the same no matter his performance. Although it may be possible to penalize sluggards by reducing their wages or firing them (a process sometimes called "ex post settling-up"), it is costly to monitor effort—and who monitors the monitors' efforts? On top of that, it is often very difficult to determine the quality of the work performed. A team of designers may put together an excellent airplane (the Lockheed L-1011 comes to mind) that fails in the market either for reasons beyond their control or because it was "too good" and so too costly. A system of monitoring that asked only whether the employees' work was profitable for the firm would lead to inaccurate rewards when there are risks beyond the control of the employees or knowledge beyond the reach of the monitors. Unless someone knows the quality of each person's work in relation to the demand, settling-up must be imperfect. Given that accounts may be settled well after the work has been performed, the time value of money sometimes will make a balancing of accounts impossible.

Another way around the difficulty of monitoring the work of the firm's employees is to give each the right to some profits from the firm's success. Each then will work hard and monitor the work of colleagues, lest their subpar performance reduce his rewards. But the allocation of the venture's profits to the employees—and by employees we mean managers, too—is another cost. It reduces the return to those who contribute the venture's capital. And it, too, is imperfect. Much production is performed in teams. Teams of employees sweep the floor, teams of engineers design new products, teams of managers decide whether and where to build new plants. So long as no monitor can determine what each member's marginal contribution to the team's output is, each member will be less than a perfectly faithful representative of the interests of the team as a
whole. Unless one person receives all the rewards of success and penalties of failure, his incentives are not properly aligned with those of the venture as a whole. “Let George do it” is a predictable response, when any given employee gets some of the benefits of George’s hard work and does not get all of the benefits of his own hard work.

Sometimes this division of interests will lead the employee to divert the firm’s assets to himself. Theft is the dramatic way to do this; diversion of “corporate opportunities” may be another, and in general the discretion managers possess gives them an opportunity to favor themselves in dealing with the other actors. Sometimes this division of interests will lead to less diligent work. The employee may engage in goldbricking, and the upper manager may “slack off” by working seventy hours per week rather than the seventy-five he would work if he received more of the reward from his effort. Sometimes the division of interests dulls the willingness to take risks. The quiet life may be a perquisite of employment. All of these are costs. Monitoring by outsiders to reduce these costs also is costly.

Employees may reduce the amount of monitoring that is necessary by giving “bonds”—not physical certificates but automatic devices that impose penalties for a shortfall in performance. When managers hold the stock of their firm, they are “bonding” their performance (in part) by exposing their wealth to erosion if their performance, and hence the firm’s profits, is substandard. Firms use different mixes of bonding devices, monitoring devices, and residual costs of the divergence of interest. The trick is to hold the total costs of these things as low as possible. It is foolish to spend $2 in monitoring to reduce by $1 the perquisites of employees. Throughout this book we refer to the combination of monitoring, bonding, and residual costs as “agency costs.”

So far we have been describing the firm as an extra-market, team method of production with certain benefits and costs. Corporations are a subset of firms. The corporation is a financing device and is not otherwise distinctive. A corporation is characterized by a statement of capital contributions as formal claims against the firm’s income that are distinct from participation in the firm’s productive activities. The corporation issues “stock” in exchange for an investment; stock need not be held by the firm’s employees. Investors bear the risk of failure (sometimes we call them “risk bearers”) and
receive the marginal rewards of success. Equity investors are paid last, after debt investors, employees, and other investors with (relatively) “fixed” claims. These equity investors have the “residual” claim in the sense that they get only what is left over—but they get all of what is left over.

The separation of risk bearing from employment is a form of the division of labor. Those who have wealth can employ it productively even if they are not good managers; those who can manage but lack wealth can hire capital in the market; and the existence of claims that can be traded separately from employment allows investors to diversify their investment interests. Diversification makes investment as a whole less risky and therefore makes investment both more attractive and more efficient. Investors bear most of the risk of business failure, in exchange for which they are promised most of the rewards of success. The penalty for this arrangement is that separation of management and risk bearing at least potentially increases agency costs by driving a broader wedge between employees’ interests and those of the venture as a whole. Employees will receive less of the return; investors will be less effective monitors to the extent that holdings are widely scattered, for then no one investor has a good reason to monitor. (In other words, investors face their own agency costs that dissuade them from monitoring, which is why investors in public firms often are ignorant and passive.) The corporation will flourish when the gains from the division of labor exceed the augmentation of the agency costs.

Sometimes it is said that the distinctive features of the corporation are limited liability, legal identity, and perpetual existence, but these are misleading descriptions. “Limited liability” means only that those who contribute equity capital to a firm risk no more than their initial investments—it is an attribute of the investment rather than of “the corporation.” This attribute of investors’ risk is related to the benefits of widely held, liquid investment instruments. It often is altered by contract when these benefits are small. We discuss limited liability more fully in Chapter 2. Legal identity and perpetual existence mean only that the corporation lasts until dissolved and has a name in which it may transact and be sued. It is convenient to think of the firm as an “it.” Many firms in addition to corporations, such as business trusts, are treated in the same way. It would be silly to attach a list of every one of Exxon’s investors
to an order for office furniture just to ensure that all investors share their percentage of the cost.

The "personhood" of a corporation is a matter of convenience rather than reality, however; we also treat the executor of an estate as a legal entity without submerging the fact that the executor is a stand-in for other people. It is meaningful to speak of the legislative branch of the U.S. Government, or Congress, or of the House, or of a committee of the Senate, or of members of Congress, depending on context, but it would be misleading to think of Congress—an entity with a name—only as an entity, or to believe that its status as an entity is the most significant thing about the institution. "Congress" is a collective noun for a group of independent political actors and their employees, and it acts as an entity only when certain forms have been followed (such as majority approval in each house). So too with corporations. There are many actors, from production employees to managers to equity investors to debt investors to holders of warranty and tort claims against the firm. The arrangements among these persons usually depend on contracts and on positive law, not on corporate law or the status of the corporation as an entity. More often than not a reference to the corporation as an entity will hide the essence of the transaction. So we often speak of the corporation as a "nexus of contracts" or a set of implicit and explicit contracts. This reference, too, is shorthand for the complex arrangements of many sorts that those who associate voluntarily in the corporation will work out among themselves. The form of reference is a reminder that the corporation is a voluntary adventure, and that we must always examine the terms on which real people have agreed to participate.

Agreements that have arisen are wonderfully diverse, matching the diversity of economic activity carried on within corporations. Managers sometimes hold a great deal of the firm's stock and are rewarded for success through appreciation of their investments prices; other employees may be paid on a piece-work basis; sometimes compensation is via salary and bonuses. Corporations sometimes are organized as hierarchies, with the higher parts of the pyramid issuing commands; sometimes they are organized as dictatorships; sometimes they are organized as divisional profit centers with loose or missing hierarchy. The choice of organization and compensation devices will depend on the size of the firm, the identity of the managers, and the industry (or spectrum of industries) in which the corporation participates. Organization and compensation
in an investment bank is vastly different from organization and compensation in an industrial conglomerate, as industrial firms that acquired investment banks learned to their sorrow.

The organization of finance and control is equally variable. Small, close corporations may have only banks as outside investors, and these banks hold "debt" claims that carry residual rights to control the firm. Highly leveraged public firms may concentrate equity investments in managers while issuing tradable debt claims to the public; the public investors in these firms have no effective control, because debt conventionally does not carry voting rights. Public utilities and national banks may have more traded equity but still no effective shareholders' control, given both regulatory structures and the nature of the risks in the business. Many growing firms have almost no debt investment, and the equity investment pays no dividends; these firms are under the dictatorial control of the entrepreneur. Some firms go public under rules that stifle any attempt at control: Ford, for example, issued non-voting stock, leaving the firm in family hands for a long time. Mature firms may be more bureaucratic, with boards of directors "independent" of managers and answerable to equity investors. Some managerial teams attempt to insulate themselves from investors' control in order to carry out programs that they view as more important than profits. Both the New York Times and the Wall Street Journal have established structures that give their managers substantial freedom to produce news at the (potential) expense of profit.

The way in which corporations run the business, control agency costs, raise money, and reward investors will change from business to business and from time to time within a firm. The structure suited to a dynamic, growing firm such as Xerox in 1965 is quite unsuited to Exxon in 1965 (or to Xerox in 1990). The participants in the venture need to be able to establish the arrangement most conducive to prosperity, and outsiders are unlikely to be able to prescribe a mold for corporations as a whole or even a firm through time. The history of corporations has been that firms failing to adapt their governance structures are ground under by competition.\(^1\) The history of corporate law has been that states attempting to force all firms into a single mold are ground under as well.

Corporations flee to find statutes that permit adaptations (as we discuss in Chapter 8). This is the reason for the drive toward enabling laws that control process but not structure.\textsuperscript{2}

To say that a complex relation among many voluntary participants is adaptive is to say that it is contractual. Thus our reference to the corporation as a set of contracts. Voluntary arrangements are contracts. Some may be negotiated over a bargaining table. Some may be a set of terms that are dictated (by managers or investors) and accepted or not; only the price is negotiated. Some may be fixed and must be accepted at the "going price" (as when people buy investment instruments traded in the market). Some may be implied by courts or legislatures trying to supply the terms that would have been negotiated had people addressed the problem explicitly. Even terms that are invariant—such as the requirement that the board of directors act only by a majority of a quorum—are contractual to the extent that they produce offsetting voluntary arrangements. The result of all of these voluntary arrangements will be contractual.

Just as there is no right amount of paint in a car, there is no right relation among managers, investors, and other corporate participants. The relation must be worked out one firm at a time. A change in technology—whether the technology of applying paint or the technology of assembling blocs of shares to change control of a firm—will be reflected in changes in the operation or governance of corporations. To understand corporate law you must understand how the balance of advantage among devices for controlling agency costs differs across firms and shifts from time to time. The role of corporate law at any instant is to establish rights among participants in the venture. Who governs? For whose benefit? Without answering difficult questions about the effectiveness of different devices for controlling agency costs, one cannot determine the appropriate allocation of rights.

We use economic arguments about agency costs throughout this book to attempt to answer questions about background terms

\textsuperscript{2} The American Law Institute's \textit{Corporate Governance Project}, under way for more than a decade, assumes that one size fits all. The few concessions to structural variations among firms are grudging and limited to unimportant matters. States have paid the project no heed, and any prescription for corporate law that tries to reduce governance options is doomed to similar failure.
(those applying in the absence of a different term incorporated in a particular corporate contract), mandatory terms, and changes in terms. The analogy to contract focuses attention on the voluntary and adaptive nature of any corporation. We treat corporate law as a standard-form contract, supplying terms most venturers would have chosen but yielding to explicit terms in all but a few instances. The normative thesis of the book is that corporate law should contain the terms people would have negotiated, were the costs of negotiating at arm’s length for every contingency sufficiently low. The positive thesis is that corporate law almost always conforms to this model. It is enabling rather than directive. The standby terms grant great discretion to managers and facilitate actual contracts. They leave correction to the interplay of self-interested actors rather than to regulators. But many standby terms—for example, the presumption that equity shares have one vote apiece, that these votes can be used to oust the managers and govern the firm, and that debt investors have no voice in governance—have both important effects and solid economic rationales. We discuss many types of corporate rules in the substantive chapters of the book.

**Real and Unreal Contracts**

The rhetoric of contract is a staple of political and philosophical debate. Contract means voluntary and unanimous agreement among affected parties. It is therefore a powerful concept. It shows up in arguments about "social contracts" that justify political society. The founding of the United States was accompanied by much contractarian reasoning. Philosophers who resort to the "original position" to establish a definition of justice are using a contractarian argument. Yet arguments about social contracts are problematic. They are constructs rather than real contracts. And even if our forebears had entered into an actual contract, why would these rules bind later generations? Such doubts are also part of our political heritage; Jefferson accordingly suggested that the Constitution expire and be renewed whenever half of the population had been born since the last renegotiation. Perhaps the corporate contract, like the social contract, is no more than a rhetorical device. After all, investors do not sit down and haggle among themselves about the terms. Investors buy stock in the market and may know little more than its price. The terms were established by entrepreneurs,
investment banks, and managers. Changes in the rules are accomplished by voting rather than unanimous consent. So why not view the corporation as a republican government rather than as a set of contracts?

The corporate venture has many real contracts. The terms present in the articles of incorporation at the time the firm is established or issues stock are real agreements. *Everything* to do with the relation between the firm and the suppliers of labor (employees), goods and services (suppliers and contractors) is contractual. If AT&T signs a contract allowing the next John Bardeen (the inventor of the transistor) to keep his inventions, this will be enforced; an allocation of rights to the firm also will be enforced. Although it is exceedingly hard to determine the value of things that have yet to be invented, neither the difficulty of attaching prices nor the substantial *ex post* variance among inventors’ (and firms’) wealth will matter. Just so with the rules in force when the firm raises money—whether by issuing debt, the terms of which often are negotiated at great length over a table, or by issuing equity, the terms of which affect the price of the issue. Many changes in the rules are approved by large investors after negotiation with management. And of course the rules that govern how rules change are also real contracts. The articles of incorporation typically allow changes to be made by bylaw or majority vote; they could as easily prevent changes, or call for supermajority vote, or allow change freely but require nonconsenting investors to be bought out. That the articles allow uncompensated changes through voting is a contractual choice. And many remaining terms of the corporate arrangement are contractual in the sense that they are “presets” of fallback terms specified by law and not varied by the corporation. These terms become part of the set of contracts just as provisions of the Uniform Commercial Code become part of commercial contracts when not addressed explicitly.

These contracts usually are negotiated by representatives. Indenture trustees negotiate on behalf of bondholders, unions on behalf of employees, and investment banks on behalf of equity investors. Sometimes terms are not negotiated directly but are simply promulgated, as auto rental companies promulgate the terms of their rental contracts. The entrepreneurs or managers may adopt a set of rules and say, “take them or leave them.” This is contracting nonetheless. We enforce the terms in auto rental contracts, as we enforce the terms of a trust even though the beneficiaries had no say
in their framing. The terms in rental contracts, warranties, and the like are real contracts because their value (or detriment) is reflected in price.

The corporation’s choice of governance mechanisms does not create substantial third-party effects—that is, does not injure persons who are not voluntary participants in the venture. (We discuss below the few third-party effects that crop up.) Investors, employees, and others can participate or go elsewhere. Let us suppose that entrepreneurs simply pick terms out of a hat. They cannot force investors to pay more than the resulting investment instruments are worth; there are too many other places for the investors to put their money. Unless entrepreneurs can fool the investors, a choice of terms that reduces investors’ expected returns will produce a corresponding reduction in price. So the people designing the terms under which the corporation will be run have the right incentives. Suppose they must decide whether to allow managers to take corporate opportunities or instead require them to be used by the firm (or sold to third parties unaffiliated with the firm). Managers’ ability to appropriate opportunities poses obvious risks of diversion; it may also allow efficient use of opportunities and be a source of compensation for managers, which benefits investors. The net effects, for good or ill, will influence the price investors pay for stock. If the managers make the “wrong” decision—that is, choose the inferior term from the investors’ point of view—they must pay for their mistake. To obtain an (inefficient) right to divert opportunities they must pay in advance. The same process applies to terms adopted later; undesirable terms reduce the price the stock fetches in the market, so that investors who buy thereafter will get no less than they pay for. All the terms in corporate governance are contractual in the sense that they are fully priced in transactions among the interested parties. They are thereafter tested for desirable properties; the firms that pick the wrong terms will fail in competition with other firms competing for capital. It is unimportant that they may not be “negotiated”; the pricing and testing mechanisms are all that matter, as long as there are no effects on third parties. This should come as no shock to anyone familiar with the Coase Theorem.³

bylaws often are picky and obscure. Many are not listed in the prospectus of the firm’s stock. Buyers of the original issue and in the aftermarket alike may know nothing of the terms in use, let alone whether a staggered board of directors or the existence of cumulative voting will make them better off. They do not consult the *Journal of Financial Economics* before buying. Yet it is unimportant whether knowledge about the nature or effect of the terms is widespread, at least for public corporations. The mechanism by which stocks are valued ensures that the price reflects the terms of governance and operation, just as it reflects the identity of the managers and the products the firm produces.

The price of stocks traded in public markets is established by professional investors, not by amateurs. These professionals—market makers, arbitrage departments of investment banks, managers of mutual funds and pension trusts, and others—handle huge sums that they are willing to use to purchase undervalued stocks. They study the firm’s profits and prospects and bid or sell accordingly. People who do this poorly will find the funds at their disposal dwindling; people who do it well will command additional sums. At any given instant, the professional traders are those who have generally been successful at assessing the worth of stock.

If the price of a stock is not “right” in relation to the price it will have in the future, then professionals can make a lot of money. If the terms of corporate provisions and the details of corporate structure have any effect on investors’ welfare, this will be reflected in the profits of the firm and hence the eventual price of the stock. Professionals trade among themselves in a way that brings the present value closer to the future value; if it is known that the stock will be worth $20 in a year, then people will bid that price (less the time value of money) now; no one has a good reason to wait, because if he does someone else will take the profit. The more astute the professional investors, and the more quickly they can

4. The process we describe below is reasonably well understood, and it has been so completely discussed elsewhere that we offer only a sketch. See Richard A. Brealey, *An Introduction to Risk and Return from Common Stocks* ch. 2 (2d ed. 1983); Ronald J. Gilson and Reinier Kraakman, “The Mechanisms of Market Efficiency,” *70 Va. L. Rev.* 549 (1984). Adjustment to information is exceptionally fast, usually within the day the professional investor learns the information. Douglas K. Pearce and V. Vance Roley, “Stock Prices and Economic News,” *59 J. Business* 49 (1985).
move funds into and out of particular holdings, the faster adjustment. The process eventually makes it difficult even for professional traders to make money, unless they are the first to obtain or act on a piece of information affecting future value. A great deal of data, including evidence that most professional investors are unable to "beat the market," supports the position that prices quickly and accurately reflect public information about firms. Amateur investors then trade at the same price the professionals obtain. These amateurs do not need to know anything about corporate governance and other provisions; the value of these mysterious things is wrapped up in the price established by the professionals. The price reflects the effects, good or bad, of corporate law and contracts, just as it reflects the effects of good and bad products. This is yet another example of the way in which markets transmit the value of information through price, which is more "informed" than any single participant in the market. 5

To say that the price of a stock reflects the value of the firm's governance and related rules is not necessarily to say that the price does so perfectly. Research into the accuracy of prices suggests that prices often are "wrong," meaning that more information and more time yield improvements. 6 There may be surprises in store, for a firm or for all firms, that make estimates about the effects of governance provisions inaccurate. But these problems of information and assessment also affect any other way of evaluating the effects of governance devices. That is, if professional investors with their fortunes on the line are unable to anticipate the true effects of nonvoting stock or some other wrinkle, how are members of state legislatures or other alternative rule givers to do better? To put this differently, it does not matter if markets are not perfectly efficient, unless some other social institution does better at evaluating the likely effects of corporate governance devices. The prices will be more informative than the next best alternative, which is all anyone can demand of any device.

This means that we need not enter the debate about whether

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stocks are priced perfectly. Prices do not reflect very well information that is not available to the public. They reflect the value of stock to public investors with scattered holdings rather than to insiders or others with the ability to control the firm’s destiny. For any given firm, there will be an irreducible amount of error in the pricing—after all, information that increases the accuracy of prices is costly, and the “perfect price” may cost more to achieve than it is worth. The more accurate the price becomes, the less private gain is available to pros who study the stock and find bargains; thus they do not find it profitable to pursue perfection. None of this matters for our purposes, unless some better device is available. Few believe that regulators are better at valuing terms of corporate governance than are markets. Defects that undercut the performance of capital markets are an order of magnitude smaller than the difficulties besetting regulators.

One might say that the effects of obscure terms in articles of incorporation will be too small to affect price, but prices turn out to be sensitive to changes in governance. As we proceed, we discuss many studies showing how changes in the articles and other structural features have measurable, and predictable, effects on price. It turns out to be hard to find any interesting item that does not have an influence on price! No surprise. Markets price many things routinely. For example, insurance markets offer explicit prices for the risk of theft (fidelity bonds and other insurance of the type is common), so it is predictable that stock prices likewise reflect events that change the risk of managerial delicts. The technology for assessing repeated events (governance structures fall in that category) is well developed.

The price effects generally support the thesis we have advanced.  

7. We mention many of these studies in the chapters addressing particular subjects in corporate governance. For a survey of evidence on most of the subjects in this book, see Frank H. Easterbrook, “Managers’ Discretion and Investors’ Welfare: Theories and Evidence,” 9 Del. J. Corp. L. 540 (1984). Empirical studies pepper the economic literature, appearing too fast to keep track of, and review articles are out of date by the time they reach print. Symposium volumes, however, offer useful surveys. See, for example, Symposium, The Structure and Governance of Enterprise, 26 J. Fin. Econ. (1991); Symposium, The Distribution of Power among Corporate Managers, Shareholders, and Directors, 20 J. Fin. Econ. 1–507 (1988); Symposium, Management Compensation and the Managerial Labor Market, 7 J. Accounting & Econ. 1–257 (1985); Conference, Corporations and Private Prop-
Even those who believe that markets are not particularly efficient concede that changes in prices reflect the marginal value, to investors outside the managerial group, of publicly disclosed information about the firm. Governance structures are known to anyone seeking the information, so the pricing mechanism will embody their effects for good or ill. It is easy to attach prices to risks of theft and incompetence, compared with attaching prices to, say, new products and other business prospects. Anyone who thinks markets even bearably good at pricing future profit from well-managed firms must think them better at pricing the effects of governance structures.

Let us now suppose, however, that markets do not price terms accurately. Unless prices are systematically wrong about the effects of features of governance, as opposed to being noisy and uninformative, managers still have appropriate incentives. The long run will arrive eventually, and terms that are not beneficial for investors will stand revealed; the firm will lose out in competition for investors' money. We therefore treat even hard-to-value terms as contractual. To disregard the terms that appear in corporate documents or to attempt to require corporations to employ governance devices that they have attempted to avoid would only induce the firms to make offsetting adjustments. For example, if corporate law should forbid managers to divert corporate opportunities to themselves, they might respond by drawing higher salaries or working less hard to open up new business opportunities. Similarly, a mandatory term that increased the length of a warranty supplied with a refrigerator would lead to an increase in the price. If the longer warranty was worth the price, the seller would have offered the term in the first place, charged the higher price, and made more money. One cannot tinker with one term in a contract confident that the change will make any party better off after other terms have been adjusted. Because so many terms are open to explicit contracting, it is almost always possible to make an end run around any effort to defeat a particular term.

If the terms chosen by firms are both unpriced and systematically perverse from investors' standpoints, then it might be possible to justify the prescription of a mandatory term by law. This makes
sense, however, only when one is sure that the selected term will increase the joint wealth of the participants—that is, that it is the term that the parties would have selected with full information and costless contracting. But this, too, is a contractual way of looking at the corporation. This formula is the one courts use to fill the gaps in explicit contracts that inevitably arise because it is impossible to cover every contingency. Any system of law that recognizes explicit contracts must deal with gaps and ambiguities. The gap-filling rule will call on courts to duplicate the terms the parties would have selected, in their joint interest, if they had contracted explicitly. It promotes clear thought to understand that the silence or ambiguity in corporate documents is itself a problem of contract, one the parties could solve if they wished and if the costs of negotiating were worthwhile in light of the stakes. High information costs—which impede accurate reflection of governance features in the price of stock—also impede more complete transacting.

This is not to say that corporate documents are ideal. Perhaps there are third-party effects. Perhaps there are obstacles to reaching the appropriate agreements. Perhaps optimal terms, once reached, will be altered in ways that enable managers to escape the consequences of their acts; terms changed by voting may fit in this category. The next section discusses the limits of contracts, both actual and implied.

**Trumping the Corporate Contract**

Many parts of the law contain contract-defeating doctrines. Some of these may be applicable to corporate contracts. We look at the four principal ones.

**Protecting Contracting Parties**

Think of the principal reasons why private agreements may not be honored. Contracts signed under threat of force displace voluntary arrangements and are unjust as well; force is therefore illegal. Some contractual choices are not enforced because unreliable: fraud vitiates a pact; infants and others who do not know their own interests cannot contract. Other parties to a contract may be lacking in perceptual powers: they may underestimate the chance that certain risks (floods, earthquakes, failures of the products they buy) will
come to pass, so they may not choose rationally when confronted with choices about such risks; at other times they may think the probability greater than it is (nuclear calamity). When a person is confronted with a problem or risk for the first (or only) time in his life, the chance of error is greatest. Choices that are made repeatedly and tested against experience are more likely to be accurate—both because every person learns from experience, and because the population as a whole contains many astute searchers who identify "bargains" and so influence the terms on which all participants trade.

Some contracts are not honored because they have adverse effects on third parties. Contracts that yield pollution affect people who are not parties to the deal. Cartels (contracts among business rivals to raise price) affect customers. So we have laws to control pollution and monopolies, and much regulation (such as rate regulation of electrical utilities) is based on a belief that a dearth of competition produces monopoly prices. Legal rules that protect people in need of rescue (passengers on a sinking ship) from excessive prices charged by rescuers serve a similar function. Sometimes the argument for intervention by the state is reinforced by a claim that the person paying the price should be a beneficiary of an income transfer; for example, rent control and minimum wages sometimes are justified by reference to the relative wealth of landlord and tenant (or employer and employee).

None of these justifications for intervention applies to intra-corporate affairs. Investors are not candidates for transfers of wealth; this is not a branch of poverty law. Investors and other participants agree on the stakes: money. They therefore would agree unanimously to whatever rule maximizes the total value of the firm. Questions of distribution among investors are unimportant; allocating gains to one rather than another changes relative prices but not social wealth. There is no fraud; the rules of corporate governance are open for all to see. (There may be fraud in the operation of the firm, but concealed violations of any rules are wrongful; recall that our concern is with the selection of rules of governance.)

It might seem that the argument based on perceptual biases justifies intervention. Few investors know much about corporate governance; therefore most are likely to misunderstand the risks they take. Yet as we have explained, in corporate transactions risks are priced through the stock market, and these prices respond to
the knowledge of professional investors. These prices protect igno-
rant investors automatically. The “game” of corporate governance
is played repeatedly. People learn from experience. Each corpora-
tion has an extended life, so the effects of governance devices may
be observed; and when scores of corporations use similar devices,
it is possible to find out how they fare in comparison to one an-
other. Investors as a whole (and therefore prices) will be informed
and informative, even though most investors are baffled by the
rules embedded in corporate contracts.

Participation in corporations is uniquely amenable to contracting
because even the ignorant have an army of helpers. The stock
market is one automatic helper. Employees work at terms negoti-
ated by unions (and nonunion employees can observe the terms
offered at other firms, which supply much information). Managers
and corporations employ professional search firms (headhunters) to
convey information and match person to job. Holders of bonds are
protected by trustees, which negotiate terms and monitor compli-
ance. Many people invest in corporations through their bank ac-
counts; syndicates of banks (after conducting thorough reviews)
pool the money of depositors for investment in corporations. Much
pension money is under professional management; the funds hire
expertise for the benefit of investors who need not even know what
stocks they indirectly hold. Individual investors can hire profes-
sional advice directly (through brokerage houses) or indirectly (by
investing in mutual funds). They can hedge their bets by buying
diversified portfolios of investments, getting the return of the
market as a whole (or some subset) rather than an individual firm.

In sum, knowledge about corporate transactions does not depend
on the wisdom of individual investors. What is not understood
through professional advice is priced, so that the investor gets what
he pays for (in the absence of fraud). If we honor contracts for
once-in-a-lifetime transactions, such as the construction of a house,
the case for treating as binding contracts the terms under which
corporations operate is ironclad. No contract used in our society is
more likely to satisfy the conditions for enforcing voluntary agree-
ments.

There is nonetheless a puzzle. Corporate law allows firms to
strike almost any imaginable bargain with debt investors, with em-
ployees, with suppliers, and with local governments, which supply
essential services from fire protection to the education of the next
generation of workers. These will be enforced according to the law of contracts. All of these "constituencies" may make formidable investments in the firm (in the sense of irrevocable, specialized commitments of physical or human capital); all are left to protect themselves through contract. The scattered "mandatory" devices in corporate law operate with respect to the equity investors. The board of directors (which equity claimants alone choose) is subject to certain limits; managers (which the board, and hence equity investors, selects) may not contract out of the "duty of loyalty." We noted at the outset a few other mandatory terms. Yet the most powerful device for protecting participants in the venture—liquid markets with professional investors setting price—applies exclusively to investors, principally equity investors. Why is it that these well-protected participants are subject to mandatory terms, while others who gain less from markets must protect themselves, and devil take the hindmost? We suggest later on that the answer lies in part in the special nature of the claim held by equity investors—a claim to "what is left over" rather than to a definable return such as a wage or a payment of interest—and in part in one of the oddities of markets: that when shares are widely traded, no one has the right incentive to gather information and make optimal decisions. For now, though, the reader should keep this difference in mind as a puzzle.

**The Inefficient Term**

The argument that contracts are optimal applies only if the contracting parties bear the full costs of their decisions and reap all the gains. It applies only if contracts are enforced after they have been reached. The argument also depends on the availability of the full set of possible contracts. If some types of agreements are foreclosed, then those actually reached may not be optimal. Some of these problems crop up in corporate law.

**Third-Party Effects and Collective Decisions**

One type of third-party effect is created by the peculiar nature of information and the difficulty of arranging reciprocal disclosure of information among firms. Securities laws impose a detailed set of rules. One possible reason is that firms would disclose too little
information unless compelled. Managers seek to disclose all the information that is privately optimal to investors, because that will induce investors to part with more money for their shares. But some disclosures may be beneficial to other firms, too, and unless legal rules set up a requirement of reciprocal disclosure none of the firms may find it beneficial to disclose information that is valuable to investors. Some kinds of disclosure may be complex, and legal rules can establish a common language that will facilitate transmission of information.

To see another way in which one firm’s acts may affect another’s, consider tender offers—bids for the outstanding stock of a firm. A tender offer is a way of gathering up the equity interests to make some fundamental change in the firm that the existing managers oppose; it is an appeal over managers’ heads to the equity investors. Usually a tender offer is made at a substantial premium over market price. Investors contracting at the time the firm goes public may wish to make tender offers easy to arrange. Bids are delightfully profitable events; moreover, putative bidders serve as possible monitors, holding down the agency costs of management whether or not a given firm is the object of a bid. So before a firm knows whether there will be a bid (that is, \textit{ex ante}), all involved may find it useful to invite scrutiny and bids. But once potential bidders have become interested, or there is a bid on the table, it may be in the interest of the target’s managers and investors alike to change plans and conduct an auction. This will raise the price, they realize. It may also discourage monitoring, but after the monitoring has occurred and the bidding has begun, the investors in the target no longer care about this benefit. The contract that is optimal \textit{ex ante} may not be optimal \textit{ex post}. The investors in the target may quickly change their own contracts, creating an auction. But if such change occurs, then it is not possible to enforce the contract that (by hypothesis) was optimal at the beginning.

Note that this presents a partial view of the available contracts. It assumes that only contracts among participants in targets are possible. Suppose, however, that investors in targets could make contracts with putative bidders. Perhaps they could sell options to purchase their shares at certain prices or under defined conditions. If it were possible to contract in advance with bidders, investors could restrain themselves from adopting new strategies when it looks like a bid is in prospect. Such options turn out to be both
impractical (because they imply contracts with a world of potential bidders, at prohibitive transaction costs) and illegal (because the Williams Act forbids bidders to line up shares in advance of making a public announcement and also forbids the preferential purchases that such options imply). The impracticality and illegality of an important contractual device may mean that the contracts actually adopted are not optimal. This may mean that legal rules can improve on the corporate contracts.

The difficulty of enforcing contracts also may create other opportunities for beneficial intervention. The enforcement problem is simple to see. Suppose a contract to hold an auction is optimal, both *ex ante* and *ex post*, for investors in the putative target. They adopt such a contract explicitly. They also explicitly forbid the managers’ “defending”: that is, they want the firm sold at the highest possible price, not kept “independent.” But can they get what they want? Any auctioneering strategy creates some risk of the bid falling through. If today’s bids are not high enough, an auctioneer may take a painting off the market for a short time, until a higher-valuing bidder appears. The duration of an auction is flexible, and the highest bidder may not appear for a while. Yet any device that allows the managers to defeat all of the first few bids—such as a rule that no bid may be made without the managers’ approval, a rule that poison pill stock approximates—also can be used to defeat any bid. How could anyone tell which strategy was being followed? Would the managers themselves know? They might set an unrealistic reservation price, subjectively believing that they were peddling the firm while objectively making the sale impossible. The difficulty of assuring compliance with the terms of the corporate contract makes particular kinds of contracts less useful.

As for observing contracts, consider this: A strategy of easy-to-acquire may be optimal *ex ante*, and a strategy of auctioneering may be optimal *ex post*, yet if an auctioneering strategy becomes known, bids may not materialize; therefore the best strategy for a given firm may be to look easily acquired at all times, but to follow an auctioneering strategy at all times. The strategy privately maximizing for the target, in other words, is to fool the bidders. This does not violate any rule of contracting; the strategy is beneficial to parties to the contract. Putative bidders have no entitlemeent to learn the target’s true strategy, any more than owners of land have
an entitlement to be told what use the buyer will make of the land. Holding information in confidence often is both privately and socially optimal; firms prospecting for ore would do less searching if they had to reveal to the world what they had found before acquiring the mineral-bearing lands. Yet if some putative targets adopt this hidden strategy, other firms with different strategies will be injured. Some firms may have adopted genuine easy-to-acquire policies. Putative bidders will have a hard time telling which firms will resist and which will not, and therefore they may reduce their monitoring and bidding activities even with respect to firms that would not conduct auctions. The uncertainty concerning the contractual strategy selected will interfere with the process of governance of other firms.

This introduces still another sort of problem: there may be a divergence between private and social optimality. We have assumed so far that investors and other corporate players design rules that are best for their firm. And so they do. Yet there is another perspective from which investors do not care about the performance of a given firm. They can invest in any or every firm. In the long run, therefore, they care about the performance of the economy, not a given firm in it. Some firms may do better, some worse, but an investor who does not know beforehand which firm will be which wants only to maximize the average performance. Investors who think themselves likely to hold interests in either bidders or targets are not interested in rules that try to engross a greater portion of gains for targets; they want instead to facilitate the process with the least possible cost devoted to attempting to allocate the gains among firms.

The idea underlying much of this section is that the investor wants to maximize the value of his holdings, not the value of a given stock. Whenever there is a question about the apportionment of gain, the investor prefers whatever rule maximizes the net gain to be had—which means increasing the probability of a gain-producing transaction and reducing the costs of realizing each gain. The rules for dealing with gain-creating opportunities will be established before any particular opportunity is in sight, and so each investor will prefer the set of rules that maximizes the total value (wealth) enjoyed by the investors, without regard to how the return is shared among corporations. Chapters 4 and 5 take up this subject in much greater detail. If investors want to maximize expected
values, it follows that corporate rules which facilitate costly fighting over who gets the gains from some profitable transaction are not likely to survive in practice and that in filling gaps in existing contracts it is safe to disregard questions of allocation.

So in thinking about tender offers, an investor does not know whether his firm will be a bidder or a target, and we therefore should not expect him to worry much about creating rules that will transfer money to targets (if there is a bid), for that is likely to cost him if his firm turns out to be a bidder. There is one potential objection to this way of looking at optimal corporate contracts: risk aversion. We have assumed that an investor is indifferent between a 10 percent chance of receiving $1,000 and a certainty of receiving $100. Most investors are risk-averse, which implies that the division of gains may have a role in optimal contracts after all. Perhaps investors seek ways to cut down on risk even if that also cuts down on anticipated return. If they do, that has substantial implications for how to supply missing terms in corporate contracts—maybe even for when to override real contracts.

We shall nonetheless largely ignore risk aversion with respect to public corporations. Our rationale is simple: diversification. Investors who dislike risk can get rid of it. They may hold low-risk instruments (high-grade bonds and Treasury obligations). Investors hold equity if and only if the expected value of these investments beats the return available from other sources. Holding a basket of equities enables the investors to realize these expected returns, free from firm-specific risk (whether risk of the firm’s business ventures or of managers’ dishonesty). Those who hold equity instruments may do so through mutual funds or by selecting some other broad basket. A diversified portfolio will not eliminate risk that goes with the market. It will, however, essentially wipe out the risk that goes with conflicts among firms and scraps over the allocation of gains and losses. A person who holds a diversified portfolio has an investment in the economy as a whole and therefore wants whatever social or private governance rules maximize the value of all firms put together. He is not interested in maximizing one firm’s value if that comes out of the hide of some other corporation. Diversification is cheap in the current economy. It costs less to buy and hold a diversified fund than to trade a small number of stocks.

This appears to overlook the fact that many people are not diversified. Some are undiversified by design. Corporate managers
have much of their wealth tied up in the firms they manage, and this lack of diversification reduces the agency costs of management. These managers, as investors, will be risk-averse and interested in the allocation of gains and losses. This is not a reason to treat corporate law as if it ought to care about these allocations, however; managers’ risk aversion is a regrettable cost of the corporate form, not a reason to select a rule other than the wealth-maximizing one. As for other undiversified investors, the “stock-pickers” who hold a few stocks or trade actively, these people are simply telling us that they are not risk-averse. Recall that the only reason to care about diversification is because if people are risk-averse they might want a rule maximizing the lower bound of returns rather than maximizing the expected return, and thus social wealth. If the people who do not like risk can look after themselves at low cost, then there is no remaining reason not to select whatever rule maximizes value. And for what it is worth, the vast majority of investments are held by people with diversified portfolios. The principal investors in most firms are institutions of one sort or another: mutual funds, trust departments of banks, pension funds, and other instrumentalities for diversifying holdings. It is a bad idea to reduce the wealth of the prudent many for the dubious benefit of gamblers.

Mistakes

Some people take particular aspects of corporate organization as proof that the provisions could not have been selected by any contractual process. Suppose the articles of Acme Widget Corporation provide that in deciding whether managers may take a corporate opportunity for their own benefit, interested directors are entitled to vote. Suppose the articles thrust on investors the burden of showing that a self-dealing transaction was unfair to the firm, whether or not the manager disclosed the transaction and obtained approval beforehand. Would not such provisions be so one-sided, so fraught with danger to investors, that their very existence shows managerial domination and overreaching? Would not that justify the imposition by law of terms more favorable to investors?

Two kinds of arguments might be at work here. One is that some third-party effect has caused the interests of a given corporation to diverge from the social optimum. The other is that the particular term in the corporate charter is a blunder, as its investors see
things. Divergence between private and social interest is rare and
does not appear to be at work in these examples. That leaves
mistake. But whose mistake? The investors’, for not seeing through
the ruse and reducing the price paid for the securities? Or the
critics’, for believing that the terms disserve investors’ interests?
Unless the person challenging the portion of the corporate contract
can make a convincing argument that the consequences of the term
could not have been appreciated by investors and priced efficiently,
there is no reason for intervening to correct a mistake. Any com-
plexity that might prevent professional investors from recognizing
the true effects of a given term probably has no less a baleful effect
on the critics’ ability to do so. So the presumptive hypothesis is
that the mistake has been made by the critic, not by the firm and
the investors.

Whenever the costs and benefits of a practice are knowable, they
will be reflected in the prices at which the corporation’s stock
trades. The critic who says that some important term of corporate
governance has escaped this mechanism is saying either that the
costs and benefits are not knowable or that he alone knows the
costs and benefits. Now of course he can reveal these; if people
believe him, the market will respond without the need for govern-
mental intervention. The more likely hypothesis, however, is that
the people who are backing their beliefs with cash are correct; they
have every reason to avoid mistakes, while critics (be they aca-
demics or regulators) are rewarded for novel rather than accurate
beliefs. Market professionals who estimate these things wrongly
suffer directly; academics and regulators who estimate wrongly do
not pay a similar penalty. Persons who wager with their own money
may be wrong, but they are less likely to be wrong than are aca-
demics and regulators, who are wagering with other peoples’
money.

Corporate governance devices that have survived in many firms
for extended periods are particularly unlikely candidates for
challenge as mistakes. We have emphasized that the durability of a
practice both enables people to gauge its effects and allows compe-
tition among firms to weed out the practices that do not assist
investors. There is no similar process of weeding out among aca-
demic ideas or regulations. Quite the contrary, mandatory terms
prescribed by law halt the process of natural selection and evalua-
tion. Unless there is a strong reason to believe that regulation has
a comparative advantage over competition in markets in evaluating the effects of corporate contracts—a reason that depends on the sort of features discussed in the preceding and following sections—there is no basis for displacing actual arrangements as "mistakes," "exploitation," and the like.

THE LATECOMER TERM

Much of the discussion so far has proceeded as if all parts of the corporate contract were established at the beginning. "The beginning" for any participant is when he enters the venture—when he becomes an employee, invests, and so on. This is the critical time for most purposes because the time of entry is when the costs and benefits of governance arrangements are priced. If a term is good (or bad) at the beginning, adjustments in the prices even everything up. But of course many things change after the beginning. The firm may reincorporate in Guam. It may adopt staggered terms for members of the board of directors or a "fair price amendment." It may abolish the executive committee of the board or get rid of all the independent directors (or create a board with a majority of independent directors). What are we to make of these changes?

Changes of this sort have some things in common: they are proposed by the existing managers (unless approved by the board of directors, no change in an ongoing firm's rules will be adopted), the proposals are accepted by voting among the equity investors, and the winning side in the vote does not compensate the losing side. If the changes are adverse to existing participants in the venture, there will be price adjustments—but these adjustments do not compensate the participants. If an amendment reduces the expected profitability of the firm by an amount worth $1 per share, the price will fall and existing investors will experience a capital loss of $1 per share. They can sell, but they can't avoid the loss. The buyers will get shares worth what they pay; the investors at the time of the change are out of luck. The mechanism by which entrepreneurs and managers bear the cost of unfavorable terms does not work—not in any direct way, anyway—for latecomer terms. It will work eventually. Latecomer terms that injure investors will reduce the firm's ability to raise money and compete in product markets. But these eventual reactions are not remedies; they explain why firms that choose inferior governance devices do not survive, and they show
why widespread, enduring practices are likely to be beneficial, but they do nothing for participants in the ventures that are about to be ground under by the heel of history.

The process of voting controls adverse terms to a degree but not perfectly. Investors are rationally uninterested in votes, not only because no investor’s vote will change the outcome of the election but also because the information necessary to cast an informed vote is not readily available. Shareholders’ approval of changes is likely to be unreliable as an indicator of their interests, because scattered shareholders in public firms do not have the time, information, or incentives to review all proposed changes. Votes are not sold, at least not without the shares. The difference between governance provisions established at the beginning and provisions added later suggests some caution in treating the two categories alike. Some of the hardest questions in corporate law concern arrangements that are adopted or changed after the firm is under way and the capital has been raised. Thus doctrines of corporate law refusing to allow shareholders to ratify waste (except unanimously) are well-founded. Yet the rules for amending the rules are themselves part of the original articles, and it is (or should be) possible to draft limitations on amendment. These most commonly take the form of provisions designating some amendments as transactions from which investors may dissent and demand appraisal. Moreover, amendments to governance structures may spark proxy contests in which investors’ attention is focused, and they also may call forth takeover bids. So voting, or at least the opportunity for review set in place by the voting mechanism, is a partial substitute for the pricing mechanism that applies at the beginning.

Law might overcome a problem in the contracting process by differentiating between terms according to the time of their adoption. Law could provide that terms in place at the beginning (at the time the firm is founded, goes public, or issues significant amounts of stock) are always to be honored unless there are demonstrable third-party effects, while terms adopted later that appear to increase the agency costs of management are valid only if adopted by supermajority vote at successive annual meetings or if dissenting investors are bought out. (The dual-meeting rule would allow an intervening proxy or takeover contest to prevent the change from going into effect.) Yet if such a constraint on amendments is beneficial to investors, why are supermajority and dual-meeting
requirements so rare in corporate documents? Investors can and do appreciate the risk that latecomer terms will be damaging, yet perhaps rules that slow down the adoption of changes would be more damaging still on balance. It is not our purpose here to draft rules of law. It is important, however, to keep the latecomer term in mind as a potential problem in a contractual approach to corporate law.

**Why Is There Corporate Law?**

One natural question after all this business of corporation-as-contract is: why law? Why not just abolish corporate law and let people negotiate whatever contracts they please? The short but not entirely satisfactory answer is that corporate law is a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting. There are lots of terms, such as rules for voting, establishing quorums, and so on, that almost everyone will want to adopt. Corporate codes and existing judicial decisions supply these terms “for free” to every corporation, enabling the venturers to concentrate on matters that are specific to their undertaking. Even when they work through all the issues they expect to arise, they are apt to miss something. All sorts of complexities will arise later. Corporate law—and in particular the fiduciary principle enforced by courts—fills in the blanks and oversees with the terms that people would have bargained for had they anticipated the problems and been able to transact costlessly in advance. On this view corporate law supplements but never displaces actual bargains, save in situations of third-party effects or latecomer terms.

There is a ready source of guidance for corporate codes and judicial decisions to draw on in filling in blanks (or establishing background terms): the deals people actually strike when they bargain over the subject. These actual bargains offer models for other firms as well. It is possible that firms that have come to actual bargains on a subject are different from firms that remain silent; the very difference is the reason for the bargain. Possible, but unlikely; differences in transaction costs or perspicacity are more plausible, unless there is some identifiable difference that calls for different rules of governance. Larger firms will find it worthwhile to specify things others leave open, because the gains from resolution increase with the size of the firm. As amateur investors benefit from the work of professionals, so smaller firms and courts can benefit
from the work of professional negotiators who solve problems for larger firms.

The story is not complete, however, because it still does not answer the question: "why law?" Why don't law firms or corporate service bureaus or investment banks compile sets of terms on which corporations may be constructed? They can peddle these terms and recover the cost of working through all of the problems. Yet it is costly for the parties (or any private supplier of rules) to ponder unusual situations and dicker for the adoption of terms of any sort. Parties or their surrogates must identify problems and then transact in sufficient detail to solve them. This may all be wasted effort if the problem does not occur. Because change is the one constant of corporate life, waste is a certainty. Often the type of problem that the firm encounters does not occur to anyone until after the venture is under way. Court systems have a comparative advantage in supplying answers to questions that do not occur in time to be resolved ex ante. Common law systems need not answer questions unless they occur. This is an economizing device. The accumulation of cases dealing with unusual problems then supplies a level of detail that is costly to duplicate through private bargaining. To put it differently, "contractual" terms for many kinds of problems turn out to be public goods!

Even if law firms, investment banks, or other private suppliers of solutions could specify optimal solutions, they could not readily supply answers for all marginal cases. No one firm could capture all of the gains from working out all problems in advance, because other firms could copy the answers without paying the creator. If the value of new solutions is hard to appropriate, and if the gain from private bargaining is small, people will leave things to be worked out later. As we have emphasized repeatedly, what should be worked out and supplied by corporate law is the rule that, if uniformly applied, will maximize the value of corporate endeavor as a whole. The law completes open-ended contracts. There is no reason why it should be used to impose a term that defeats actual bargains or reduces the venturers' joint wealth.

Maximands

An approach that emphasizes the contractual nature of a corporation removes from the field of interesting questions one that has plagued many writers: what is the goal of the corporation? Is it
profit, and for whom? Social welfare more broadly defined? Is there anything wrong with corporate charity? Should corporations try to maximize profit over the long run or the short run? Our response to such questions is: who cares? If the New York Times is formed to publish a newspaper first and make a profit second, no one should be allowed to object. Those who came in at the beginning consented, and those who came later bought stock the price of which reflected the corporation’s tempered commitment to a profit objective. If a corporation is started with a promise to pay half of the profits to the employees rather than the equity investors, that too is simply a term of the contract. It will be an experiment. Professors might not expect the experiment to succeed, but such expectations by strangers to the bargain are no objection. Similarly, if a bank is formed with a declared purpose of giving priority to loans to minority-owned businesses or third-world nations, that is a matter for the venturers to settle among themselves. So too if a corporation, on building a plant, undertakes never to leave the community. Corporate ventures may select their preferred “constituencies.”

The one thing on which a contractual framework focuses attention is surprises. If the venture at its formation is designed in the ordinary fashion—employees and debt investors holding rights to fixed payoffs and equity investors holding a residual claim to profits, which the other participants promise to maximize—that is a binding promise. If the firm suddenly acquires a newspaper and declares that it is no longer interested in profit, the equity investors have a legitimate complaint. It is a complaint for breach of contract, not for derogation from some ideal of corporate governance.

The role of corporate law here, as elsewhere, is to adopt a background term that prevails unless varied by contract. And the background term should be the one that is either picked by contract expressly or is the operational assumption of successful firms. For most firms the expectation is that the residual risk bearers have contracted for a promise to maximize long-run profits of the firm, which in turn maximizes the value of their stock. Other participants contract for fixed payouts—monthly interest, salaries, pensions, severance payments, and the like. We suggest later on that this allocation of rights among the holders of fixed and variable claims serves an economic function. Risk bearers get a residual claim to profit; those who do not bear risk on the margin get fixed terms of trade.
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One thing that cannot survive is systematic efforts to fool participants. If investments are attracted on the promise of efforts to maximize profits, then that plan must be executed; otherwise new money cannot be raised and the firm will fail. If investors should come to doubt the worth of promises made to them, investment in the economy as a whole would fall. Similarly, if a firm building a new plant undertakes to operate it only so long as it is profitable and then to lay off the employees and move away, an effort to change the terms later on (if the feared condition materializes)—to lock the plant in place or compel severance payments—would be a breach of the agreement. Fear of such opportunistic conduct *ex post* would reduce the willingness of investors to put up new plants and hire new workers.

Notice that a contractual approach does not draw a sharp line between employees and contributors of capital. Employees may be investors in the sense that portions of their human capital are firm-specific—that is, are adapted to the corporation’s business and are worth less in some other job. Holding firm-specific human capital is a way of investing in the firm. The question is not whether employees and other “constituencies” of the firm have entitlements or expectations—they do—but what those entitlements are. If employees negotiate for or accept a system of severance payments to protect their firm-specific human capital, they ought not grumble if they are held to their bargains when business goes bad. Each investor must live with the structure of risks built into the firm. Equity claimants lose out to debt claimants when times are bad and are not thereby entitled to some additional compensation. It is all a matter of enforcing the contracts. And for any employee or investor other than the residual claimant, that means the explicit, negotiated contract.

The choice of maximand is still important if political society wishes to change corporate behavior. Given wealth as a maximand, society may change corporate conduct by imposing monetary penalties. These reduce the venturers’ wealth, so managers will attempt to avoid them. A pollution tax, for example, would induce the firm to emit less. It would behave as if it had the interests of others at heart. Society thus takes advantage of the wealth-maximizing incentives built into the firm in order to alter its behavior at least cost. Nothing in our approach asks whether political society should attempt to make firms behave as if they have the welfare of
nonparticipants in mind. We do not address optimal ways to deal with pollution, bribery, plant closings, and other decisions that have effects on people who may not participate in the corporate contract. Society must choose whether to conscript the firm’s strength (its tendency to maximize wealth) by changing the prices it confronts or by changing its structure so that it is less apt to maximize wealth. The latter choice will yield less of both good ends than the former.

One reason is obvious: a manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither. Faced with a demand from either group, the manager can appeal to the interests of the other. Agency costs rise and social wealth falls. Far better to alter incentives by establishing rules that attach prices to acts (such as pollution and layoffs) while leaving managers free to maximize the wealth of the residual claimants subject to the social constraints.

Another reason is no less important but more often missed: maximizing profits for equity investors assists the other “constituencies” automatically. The participants in the venture play complementary rather than antagonistic roles. In a market economy each party to a transaction is better off. A successful firm provides jobs for workers and goods and services for consumers. The more appealing the goods to consumers, the more profit (and jobs). Prosperity for stockholders, workers, and communities goes hand in glove with better products for consumers. Other objectives, too, come with profit. Wealthy firms provide better working conditions and clean up their outfalls; high profits produce social wealth that strengthens the demand for cleanliness. Environmental concerns are luxury goods; wealthy societies purchase much cleaner and healthier environments than do poorer nations—in part because well-to-do citizens want cleaner air and water, and in part because they can afford to pay for it. Soviet plants pollute more than American ones and produce less, because they give less attention to profit rather than despite the difference. Within this nation, goals competing with profits are most likely to be sacrificed as profits fall.

Frequently the harmony of interest between profit maximization and other objectives escapes attention. Firms that close plants in one area while relocating production elsewhere are accused of lacking a sense of responsibility to affected workers and communities. Yet such a statement ignores the greater benefits that workers
and communities in the new locale enjoy. (They must be greater, or there would be no profit in the move.) Firms that cause dislocations by moving their plants are no less ethical than firms that cause dislocations by inventing new products that cause their rivals to go out of business, yielding unemployment at the failed firm. All competition produces dislocation—all progress produces dislocation (pity the makers of vacuum tubes and slide rules!)—and to try to stop the wrenching shifts of a capitalist economy is to try to stop economic growth.

We do not make the Panglossian claim that profit and social welfare are perfectly aligned. When costs fall on third parties—pollution is the common example—firms do injury because harm does not come back to them as private cost. Dumping offal may impose costs on downstream users exceeding the gains to the stockholders. But banning pollution is no panacea. Water is a resource, and if less of it can be used there will be fewer and more expensive products, and more of some substitute means of dealing with wastes, such as turning Staten Island into a garbage dump. Users of the stream impose costs on the firm (and its consumers) as fully as the firm imposes costs on the users of the stream. No rearrangement of corporate governance structures can change this. The task is to establish property rights so that the firm treats the social costs as private ones, and so that its reactions, as managers try to maximize profits given these new costs, duplicate what all of the parties (downstream users and customers alike) would have agreed to were bargaining among all possible without cost. To view pollution, or investment in South Africa, or other difficult moral and social questions as governance matters is to miss the point.