1989

The Corporate Contract

Frank H. Easterbrook

Daniel R. Fischel

ARTICLES & COMMENTS

THE CORPORATE CONTRACT

Frank H. Easterbrook and Daniel R. Fischel***

INTRODUCTION[1]

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 public control. This may take the form of regulation of the firm's output and prices. It may take the form of regulation of the securities markets. It may take the form of intervention through 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 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, on the other hand, know how the business is running and can conceal from investors information about the firm and their own activities. As a result the managers can divert income to themselves, stealing and mismanaging at the same time. Diversion and sloth may be subtle, 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 regulations) would restrict "too much" the ability of firms to raise capital.

Yet, although the language of regulation is everywhere, corporate

---

* Judge, United States Court of Appeals for the Seventh Circuit; Senior Lecturer, The Law School, The University of Chicago.

** Lee and Brena Freeman Professor of Law, The Law School, and Professor of Law and Business, The Graduate School of Business, The University of Chicago.

1. A revised version of this essay will appear as Chapter I in F. Easterbrook & D. Fischel, The Economic Structure of Corporate Law (forthcoming Harvard University Press 1990). In writing both the book and this Article, we have adapted some of our published work. The opening pages of Part I come from Easterbrook, Managers' Discretion and Investors' Welfare: Theories and Evidence, 9 Del. J. Corp. L. 540, 544–47 (1984).

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 and without effective restraint on the permissible methods of corporate governance. The handiwork of managers is final in all but exceptional or trivial instances. Courts apply the "business judgment doctrine," a hands-off approach that they would never apply to the decisions of administrative agencies or other entities—the officials of which 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.

Consider the domain of choice. The founders and managers of a firm choose whether to organize as a corporation, trust, partnership, mutual or cooperative. 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, including 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. They choose how the firm will be organized (as a pyramidal hierarchy or as a loose, multi-divisional collective), whether central leadership will be strong or weak, and whether the firm grows (internally or by merger) or shrinks (sells existing assets or spins off divisions). Investors select the members of the board of directors, who may be "inside" or "outside," 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 decisions—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; they set quorum rules, which typically require a third of the board and sometimes half of the investors to participate on critical decisions; they require "major" transactions to be presented to the board (occasionally shareholders too) rather than stand approved by managers or a committee; they forbid the sale of votes divorced from the investment interest and the accumulation of votes in a corporate treasury; they require managers to live up to a duty of loyalty to investors. 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 accommodation is a sidelight. Any theory of corporate law must account for the mandatory as well as the enabling features of the law, 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 later on. For now, though, it is enough to say that what is open to free choice is far more important to the daily operation of the firm, and investors' welfare, than is what the law prescribes. For debt investors and employees, everything (literally) is open to contract; for equity investors, almost everything is open to choice.

Why does corporate law allow managers to set the terms under which they will govern 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? The answers lie in, and help explain, the economic structure of corporate law. The corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy. No one set of terms will be best for all; hence the "enabling" structure of corporate law.

Although managers are self-interested, this interest can be aligned with that of investors through automatic devices, devices that are useless when those in control are "disinterested"; hence the apparent contradiction that self-interested managers have more freedom than disinterested regulators. Of course controls are not free, and much of corporate law is designed to reduce the costs of aligning the interests of managers and investors. Before we explore the nature of the legal rules, however, we develop the framework within which all of our analysis proceeds: the corporate structure is a set of contracts through which managers and certain other participants exercise a great deal of discretion that is "reviewed" by interactions with other self-interested actors. This interaction often occurs in markets, and we shall sometimes call the pressures these interactions produce "market forces." No one should assume from this shorthand, however, that we personify "markets." All economic activity is an interaction among real people, and the interactions that shape the corporate form are among the most interesting.

I. The Dynamics Shaping the Corporate Form

The view one takes of corporations and corporate law is apt to depend on one's assumptions about how investors, employees, and other players come to be associated in a venture. Those who assume that corporations are born with a complement of managers, employees, and investors are more likely to be driven to a regulatory view of corporations. Suppose the world is static. Everyone awakes one morning to find himself a manager or an investor. The veil of ignorance is suddenly parted. The manager exalts: "Aha! No one can stop me!" The investors gasp: "Woe is me, I'm powerless." This is the natural view of one who draws a line at a moment in time without asking how the world came to be as it is.

Managers and investors do not wake up in this way. They 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 are born 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?[2] It is not exactly secret that scattered shareholders can't control managers directly. If the investors know that the managers have lots of discretion, why did they give their money to these managers in the first place? If managers promise to return but a pittance, the investors will not put up very much money. The 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 to as great an ex-

2. The discussion that follows owes much to Jensen & Meckling, Theory of the Firm:. Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976). They and we write in a tradition that began with Coase, The Nature of the Firm, 4 Economica (n.s.) 386 (1937). Other important contributions include Alchian & Demsetz, Production, Information Costs, and Economic Organization, 62 Am. Econ. Rev. 777 (1972); Fama & Jensen, Agency Problems and Residual Claims, 26 J.L. & Econ. 327 (1983); Fama & Jensen, Separation of Ownership and Control, 26 J.L. & Econ. 301 (1983); Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110 (1965); Manne, Some Theoretical Aspects of Share Voting, 64 Colum. L. Rev. 1427 (1964); Winter, State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251 (1977); see also Principals and Agents: The Structure of Business (J. Pratt & R. Zeckhauser eds. 1985); N. Wolfson, The Modern Corporation: Free Markets vs. Regulation (1984); Hansmann, Ownership of the Firm, 4 J.L. Econ. & Organization 267 (1988).

tent 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 people value. 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 the promises. 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 small business 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. 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 certain conduct. 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 select 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 have matured will the firm issue public securities.

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 in 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 generally 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 interests. 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. We accept some costly 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-cost method of handling a problem. Deterrence is a particularly inexpensive method. 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 are 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 structural change to handle the costs of management, are likely very effective in making judgments about optimal governance structures. Governance structures are open and notorious, unlike the conduct they seek to control. Costs of information in knowing about a firm's governance are low. Firms and teams of managers can compete with each other over time 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.[3] Contractual promises and fiduciary rules arise as a result of these considerations.

One of us has considered elsewhere whether this picture is plausible or just wishful thinking.[4] Today's task is 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 beneficiary as one of arm's-length contracting, and legal rules impose many restrictions that the trustee cannot avoid. Why think about corporations differently?

II. Markets, Firms, and Corporations

A. *Firms*

"Markets" are economic interactions among people dealing as strangers and seeking advantage. The extended conflict among selfish people produces prices that allocate resources to their most valuable uses.[5] 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 casual labor is hired. Some production is organized in this way. The construction and longshore industries assemble separate teams for each 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 the firm grows, there must be more and more transactions

3. Our treatment has much in common with R. Nelson & S. Winter, An Evolutionary Theory of Economic Change (1982), even though it is an application of neoclassical analysis that Nelson and Winter challenge. Survivorship stories have been used in economics for a long time. The more sophisticated and rapid the process of natural selection, the better these analyses work. Firms are a paradigm for evolutionary pressure in economic organization.

4. Easterbrook, supra note 1, at 547–53.

5. This is an old story, and Adam Smith's The Wealth of Nations (1776) remains the best exposition.

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 add extra paint, or 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. The integrated firm has difficulty assessing the value of the paint it makes for itself, however. 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, if inaccurate, will 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 are among the costs of markets. Transacting for paint inside the firm is costly too. The firm grows until the costs of organizing production internally exceed the costs of organizing things 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"); this arrangement hires a segment of time but not a specified effort. It may be very 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, often it is very difficult to determine the quality of the work performed. 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 is profitable for the firm would lead to very inaccurate rewards when there are risks beyond the control of the employees or knowledge beyond the reach of the monitors.[6] Unless someone knows the quality of each person's work in relation to the demand, settling up must be imperfect; and 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.

6. There is an extensive economic literature on the design of optimal systems of rewards for work under conditions of risk and incomplete (or asymmetric) knowledge. We need not explore this flourishing field because the proposition that monitoring is costly, imprecise, or both holds under any system of rewards yet designed.

Another way around the difficulty of monitoring the work of the firm's employees is to give each the right to claim the profits from the firm's success. Then he will work hard and monitor the work of his colleagues, lest their sub-par performance reduce his rewards. But the allocation of the venture's profits to the employees—and by employees we mean managers too—is just 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 a less than perfect 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.[7] "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. 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. Every firm uses a different mix 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 two dollars in monitoring to reduce by one dollar the perquisites of employees. The combination of monitoring, bonding, and residual costs is called "agency costs."

---

7. For a discussion of the difficulties that follow when it is not possible to assign the whole profit stream to one person, see Grossman & Hart, The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration, 94 J. Pol. Econ. 691 (1986).

B. *Corporations*

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 "riskbearers") 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 riskbearing from employment is a form of the division of labor. Those wbo 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, in ways to which we return, 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 riskbearing at least potentially increases agency costs by driving a wedge between employees' interests and those of the venture as a whole. Employees will receive less of the return. Investors, on the other hand, will be less effective monitors to the extent 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.[8] "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

8. See R. Hessen, In Defense of the Corporation 15-22, 40-42 (1979). See generally Blumberg, Limited Liability and Corporate Groups, 11 J. Corp. L. 573, 577-605 (1986) (tracing the history of limited liability).

contract when these benefits are small.[9] 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 other firms, 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 United States government, or of Congress, 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 certain group of independent political actors and their employees, and it acts as an entity only when certain forms have been followed. So too with corporations. They are disparate independent actors, from production employees to managers to equity investors to debt investors to holders of warranty and tort claims against the firm.

C. *Corporate Contracts*

The arrangements among the actors constituting the corporation 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, following Jensen and Meckling,[10] of the corporation as a "nexus of contracts" or a set of implicit and explicit contracts. This reference, too, is just a 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.

The agreements that have arisen are wonderfully diverse, matching the diversity of economic activity that is carried on within corporations. Managers sometimes hold a great deal of the firm's stock and are rewarded for success through appreciation of the prices of their investments; 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

---

9. For a discussion of limited liability, see Easterbrook & Fischel, Limited Liability and the Corporation, 52 U. Chi. L. Rev. 89 (1985).

10. Jensen & Meckling, supra note 3, at 311.

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 are vastly different from organization and compensation in an industrial conglomerate, as industrial firms that have acquired investment banks have 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.[11] 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 the 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 1989). 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.[12] 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 more open-

11. Some firms go public under rules that stifle any attempt at control; Ford, for example, issued nonvoting stock, leaving the firm in family hands for a long time.

12. See O. Williamson, The Economic Institutions of Capitalism 273–97 (1985); cf. A. Chandler, The Visible Hand: The Managerial Revolution in American Business (1977).

ended statutes that permit adaptations. This is the reason for the drive toward enabling laws that control process but not structure.

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 blocks 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? But without answering difficult questions about the effectiveness of different devices for controlling agency costs, we cannot tell the appropriate allocation of rights. We will have trouble establishing background rules (that is, principles that apply in the absence of a different term incorporated in a particular corporate contract). We certainly cannot answer questions such as whether and when it is appropriate to override contractual choices actually made or to fetter the ability of participants to change the terms established when the firm was created.

III. Real and Unreal Contracts

The rhetoric of contract is a staple of political and philosophical debate. Contract is a term for voluntary and unanimous agreement among affected parties. It is therefore a powerful image. 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. Even if our forbears 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 living 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. As a rule investors buy stock in the market and 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 tban 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. 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 super-majority vote, or allow change freely but require nonconsenting investors to be bougbt out. That the articles allow uncompensated changes through voting is a real contractual choice. And many remaining terms of the corporate arrangement are contractual in the sense that they are "presets" of fall-back 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, investment banks on behalf of equity investors. Sometimes terms are not negotiated directly but are simply promulgated, in the way 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.[13] 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 what the resulting investment instruments are worth; there are too many other places to put one's 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, reducing the need to pay them with cash from corporate coffers. 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 term inferior as investors see things—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. In general, 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 terms may not be "negotiated"; the pricing and testing mechanisms are all that matters, as long as there are no effects on third parties. This should come as no shock to anyone familiar with the Coase Theorem.[14]

Are the terms of corporate governance priced? The provisions in articles of incorporation and 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. 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.[15] These professionals—market

13. The few third party effects that do crop up are discussed infra Part IV.B.1.

14. Coase, The Problem of Social Cost, 3 J.L. & Econ. 1, 7 (1960).

15. The process we describe below is reasonably well understood, and it has been

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 prospectus 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 at any time 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 twenty dollars in a year, then people will bid that price (less the time value of money) now. No one has a good reason to hold off in this process, because if he does someone else will take the profit. The more astute the professional investors, and the more quickly they can move funds into and out of particular holdings, the faster the process of adjustment will occur.

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.[16]

To say that the price of a stock reflects the value of the firm's gov-

so completely discussed elsewhere that we offer only a sketch. See J. Lorie & M. Hamilton, The Stock Market: Theories and Evidence 87–96 (1973); R. Brealey, An Introduction to Risk and Return from Common Stocks 4–5 (2d ed. 1983); Gilson & Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 569–72 (1984); see also J. Cragg & B. Malkiel, Expectations and the Structure of Share Prices (1982). The process of adjustment to information that we describe happens exceptionally fast, usually within the day the professional investor learns the information. Pearce & Roley, Stock Prices and Economic News, 58 J. Bus. 49, 66 (1985).

16. See T. Sowell, Knowledge and Decisions (1980); Grossman & Stiglitz, Information and Competitive Price Systems, 66 Am. Econ. Rev. Papers & Proc. 246 (1976); Verrecchia, Consensus Beliefs, Information Acquisition, and Market Information Efficiency, 70 Am. Econ. Rev. 874 (1980).

ernance and related rules is not necessarily to say that the price does so perfectly. 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 in a concrete case, 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 stocks are priced perfectly.[17] 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 to find bargains; they therefore do not find it profitable to pursue perfection. None of this matters for our purposes, unless some better device is available. No one argues that regulators are better at valuing terms of corporate governance than are markets.

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. It turns out to be hard to find any interesting item that does not have an influence on price.[18] And even those who believe that markets are less efficient than generally supposed 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.

Let us now suppose, however, that not all terms induce accurate changes in the price of stock. Unless prices are systematically wrong

17. For a summary of data on the efficiency of market prices, see Gordon & Kornhauser, Efficient Markets, Costly Information, and Securities Research, 60 N.Y.U. L. Rev. 761 (1985).

18. See the data collected and discussed in Easterbrook, supra note 1. One of the rare exceptions is derivative litigation, which does not appear to affect the value of shares. See Fischel & Bradley, The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis, 71 Cornell L. Rev. 261, 277–83 (1986).

about the effects of features of governance, as opposed to being noisy and uninformative, managers still have appropriate incentives. The long run will arrive sooner or later, 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 just 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 adjusted.[19] 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 it is possible to demonstrate that the terms chosen by firms are both (a) unpriced and (b) systematically perverse from investors' standards, 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 itself is 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—the ones that impede accurate reflection of governance features in the price of stock—also impede more complete transacting.

This is not to say that corporate contracts are ideal. Perhaps there are third party effects. Perhaps there are obstacles to reaching the ap-

19. This is the Coase Theorem again. See also Epstein, The Social Consequences of Common Law Rules, 95 Harv. L. Rev. 1717, 1750–51 (1982); Schwartz, Justice and the Law of Contracts: A Case for the Traditional Approach, 9 Harv. J.L. & Pub. Pol'y 107 (1986). On warranties see Priest, A Theory of the Consumer Product Warranty, 90 Yale L.J. 1297 (1981).

propriate 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.

IV. 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 principal ones.

A. *Protecting Contracting Parties*

Think of the principal reasons why private agreements may not be enforced.[20] Contracts signed under threat of force displace voluntary arrangements and are unjust; force is therefore illegal. Fraud will vitiate an agreement. Infants and others who do not know their own interests cannot contract. Sometimes people's perceptual apparatuses do not work well. They underestimate the chance that certain risks (floods, earthquakes, failures of the products they buy) will come to pass and as a result 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 each person learns from experience, and because the mass of persons contains many astute searchers, who identify "bargains" and so influence the terms on which all may trade.

Some contracts are not enforced because they have adverse effects on third parties. Contracts to pollute affect people who are not parties to the deal. Cartels (contracts among business rivals to raise prices) affect customers. So we have laws to control pollution and monopolies, and much regulation is based on a belief that a dearth of competition has produced monopoly prices. Legal rules that protect people in need of rescue from excessive prices charged by salvors 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

20. See Sunstein, Legal Interference with Private Preferences, 53 U. Chi. L. Rev. 1129 (1986).

whatever rule maximizes the total value of the firm. Questions of distribution among investors are unimportant because that just causes the price they pay for their stakes to change. 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 goveruance.)

It might seem that the argument based on perceptual biases justifies intervention. Few investors know much about corporate governance; few are repeat players; 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 ignorant investors automatically. The "game" of corporate governance is most assuredly a repeat play game in which people learn from experience. Each corporation has an extended life, so the effects of governance devices may be observed. When scores of corporations use similar devices, it is possible to find out how they fare compared with each 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 iguorant have an army of helpers. The stock market is one. Employees work at terms negotiated by unions (and nonunion employees can observe the terms offered at other firms, which supply much information). Managers and corporations employ headhunters to convey information and match person to job. Holders of bonds are protected by trustees, which negotiate terms and monitor compliance. Many people invest in corporations through their bank accounts; syndicates of banks (after conducting thorough review) pool the money of depositors for investment in corporations. Much pension money is under professional management; the funds hire experts for the benefit of investors who need not even know what stocks they indirectly hold. Individual investors can hire professional 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 that of 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 one-shot 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 agreements.

There is nonetheless a puzzle. Corporate law allows firms to strike almost any imaginable bargain with debt investors, with employees, with suppliers, with local governments that supply essential services from fire protection to the education of the next generation of workers. These will be written and enforced according to the law of contracts. All of these "constituencies" may make formidable investments in the firm, in the sense that they have made irrevocable, specialized commitments of physical or human capital; all are left to protect themselves through contract. The scattered "mandatory" devices in corporate law operate only 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 pick) may not contract out of the "duty of loyalty." Yet the most powerful device for protecting participants in the venture—liquid markets with professional investors—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? The answer lies in part in the special nature of the "residual 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, keep this difference in mind as a puzzle.

B. *The Inefficient Term*

1. *Third-Party Effects and Collective Decisions.* — 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, the ones actually reached may not be optimal. Some of these problems crop up in corporate law and require careful attention to the limits of contracting.

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. A detailed set of mandatory rules is imposed on corporations by the securities laws.[21] 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

21. We have considered the justification for mandatory rules elsewhere. See Easterbrook & Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669 (1984).

unless legal rules set up a requirement of reciprocal disclosure no firm may find it optimal 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.

Tender offers, bids for the outstanding stock of a firm, are another way in which one firm's acts may affect another's. 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; more, 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, 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 ex ante may not be optimal ex post. The investors in the target may quickly change their own contracts, creating an auction. But if such change is possible, 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, investors in targets could also 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, they could restrain themselves from adopting new strategies only 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[22] forbids bidders to line up shares in advance of making a public announcement, and it 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—just may—mean that legal rules can improve on the corporate contracts.

The difficulty of enforcing contracts and observing them also may create opportunities for beneficial intervention. The enforcement problem is simple to see. Suppose a contract to hold an auction for a

22. 15 U.S.C. § 78 (1988).

target 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 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 may make 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 acquirable at all times, but to follow an auctioneering strategy at all times. The strategy privately optimal 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 entitlement 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 genuine easy-to-acquire policies will be injured. Potential 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 that of a given firm.

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. It is possible to show that investors who look only to the welfare of targets will set up rules with too much defense, from the perspective of society.[23] 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.

An example shows why. Suppose the FCC is going to award a license to operate a TV station and ten firms are in the running. An investor in one of these firms will want it to spend money on lawyers, market surveys, and the like, until the marginal dollar spent trying to capture the license brings in one dollar's worth of anticipated profits from having the license (discounted by the probability of not receiving the award). If the license is worth $1,000,000, each firm might spend $50,000, for a total of $500,000 among firms. An investor with stakes in all ten firms would want nothing of the sort, however. He would want all ten firms to do nothing, compelling the FCC to award the license by lot. That way the winner would get the highest possible net value of the license, $1,000,000, and the investors would bear no costs at all and therefore receive the whole profit. The privately beneficial rule (spend until the marginal return is zero) is neither the socially beneficial rule nor the rule that is best for an investor holding stock in all firms. When situations of this sort occur, there are gains to be had in overriding the corporate contracts.[24]

The investor wants to maximize the value of his holdings, not the value of a given stock. The value of holdings is highest if the value of each stock is highest. 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

23. See Grossman & Hart, The Allocational Role of Takeover Bids in Situations of Asymmetric Information, 36 J. Fin. 253, 261–66 (1981); Grossman & Hart, Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation, 11 Bell J. Econ. 42, 60–64 (1980); cf. Schwartz, Search Theory and the Tender Offer Auction, 2 J.L. Econ. & Organization 229 (1986).

24. The investor could achieve the gains without the state's aid by buying all ten firms, but that would come at a cost in diversification. And sometimes the problem of fighting over a fixed pie comes about precisely because an investor tries to gather up all of the interests. Suppose a TV magnate had started making tender offers for the stock of the firms that were trying to acquire the license. Then we could have had a series of costly auctions as each firm tried to capture all of the gains to be had from bringing all under a common umbrella to save the costs of bidding.

by the investors, without regard to how the return is shared among corporations. It is possible to show this with formal logic.[25] It follows that corporate rules that 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.

In thinking about tender offers, an investor does not know whether his firm will be a bidder or a target. 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. Almost all investors are repeat players; if they do not get cut in on gains today, they will tomorrow, and they seek to reduce the process costs along the way. There is one potential objection to this way of looking at optimal corporate contracts: risk aversion. We have assumed so far that an investor is indifferent between a ten 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 behavior 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.[26] Our rationale is simple: diversification. Investors who dislike risk can get rid of risk easily. 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 risk of managers' dishonesty). Those who hold equity instruments may diversify through mutual funds or by selecting some other broad basket. A di-

25. DeAngelo, Competition and Unanimity, 71 Am. Econ. Rev. 18 (1981); Makowski, Competition and Unanimity Revisited, 73 Am. Econ. Rev. 329 (1983); Makowski & Pepall, Easy Proofs of Unanimity and Optimality Without Spanning: A Pedagogical Note, 40 J. Fin. 1245 (1985). The most important assumption leading to unanimous support for wealth maximization is a competitive capital market. Roughly speaking, this means that any one firm's production and financing decisions have negligible effects on both the price of any given investment (that is, any given bundle of risk and return from one firm or many), and on the menu of risk-return combinations that investors can obtain by holding portfolios of instruments issued by different firms. When there is competition, investors agree that the corporation should have the objective of maximizing wealth because greater wealth gives them the ability to consume or purchase portfolios with greater cash returns; in either event, they exercise greater command over resources. Given the depth and richness of the world's capital markets, it is fair to conclude that the conditions for investors' unanimity are satisfied in practice.

26. Our work on limited liability and close corporations deals with risk aversion at greater length. See Easterbrook & Fischel, supra note 9.

versified portfolio will not get rid of risk that goes with the market. It will, however, essentially eliminate 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 it comes out of the hide of another 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; the risk aversion of managers 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 five to ten stocks and trade actively—these people are simply telling us that they are not risk averse. Recall that the only reason to care about diversification is that people who are risk averse 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.

2. *Mistakes.* — Some people take particular provisions 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 argument might be at work here. One is that some third-party effect of the sort mentioned in the preceding section 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 a provision of the corporate contract can make a convincing argument that the consequences of that term could not have been appreciated by investors and priced efficiently, there is no reason for intervening to correct a mistake. Any complexity 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 governmental 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 academics 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. You should trust those who wager with their own money to do the calculations correctly. They may be wrong, but they are less likely to be wrong than are academics and regulators, who wager with other people's 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 competition among firms to weed out the practices that do not assist investors. There is no similar process of winnowing out of academic ideas or regulations. Quite the contrary; mandatory terms prescribed by law halt the process of natural selection and evaluation. 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, there is no basis for displacing actual arrangements as "mistakes" or "exploitation."

C. *The Latecomer Term*

Much of the discussion 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 Nevada. 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, 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 one dollar per share, the price will fall and existing investors will experience a capital loss of one dollar 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[27] 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 incentive 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

27. Easterbrook & Fischel, Voting in Corporate Law, 26 J.L. & Econ. 395 (1983).

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.

One candidate for a rule of law that could overcome a problem in the contracting process is a rule that differentiates among terms according to the time of their adoption. It 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,[28] 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.

D. *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 will arise, they are apt to miss something. All sorts of complexities will arise later. Corporate law—and in

28. See supra Part IV.B.1.

particular the fiduciary principle enforced by courts—fills in the blanks and oversights 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.

And 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 too. 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 otbers 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. 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; it avoids working through problems that do not arise. 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.

V. 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 actually consented, and those who came in later bought stock at a price reflecting 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. We 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 to prefer loans to minority-owned businesses, or to 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 surprise. 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 ethereal 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 when people get around to it or is the operational assumption of successful firms. For most firms the expectation is that the residual riskbearers 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. This allocation of rights among the holders of fixed and variable claims serves an economic function. Riskbearers get a residual claim to profit; those who do not bear risk on the margin get fixed terms of trade.

One thing that cannot survive is a systematic effort 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 as 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, adapted to the corporation's business and worth less in another 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 cannot turn around later and demand an additional device (such as a contract for a term of years) 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. So. for example, a pollution tax 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.