

A CONTRACTARIAN DEFENSE OF CORPORATE REGULATION

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“The nation and the markets have recently experienced, and remain in the midst of, one of the most serious economic crises of the past century.” Securities and Exchange Commission, June 10, 2009

I. INTRODUCTION

The challenge of modern corporate law scholarship continues to be: first, whether regulation of corporations is justified, and second, when and to what degree that regulation is appropriate.¹ This essay will attempt to address those perennial questions – questions which are all the more poignant during the current economic crisis.

Ironically, the answers may lie in the framework for analysis that has most often been presented to discredit regulation, the nexus-of-contracts framework.² That economically-oriented framework posits that a corporation is little more than a nexus of contracts, and that each of the constituents that surround the corporation is

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¹ Donald C. Langevoort, Trends in Business Associations Scholarship Session: Taking Stock of the Field and Corporate Social Accountability, Presentation at the American Association of Law Schools Conference on Business Associations (June 9, 2009) (highlighting this challenge).

² See generally Michael C. Jensen & William H. Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (introducing the conception of a corporation as a nexus of contracts); Melvin A. Eisenberg, *The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 DEL. J. CORP. L. 819, 822 (1999). Professor Eisenberg criticizes the proponents of this contractarian view of the corporation, claiming that they are not using the notion of a contract in its usual legal sense as meaning a promise, which the law will enforce. See *id.* at 822-23. Professor Eisenberg argues that this mistaken use of the concept is intentional and may have been done for strategic or normative reasons, namely to promote a libertarian agenda that frees corporations from government regulation. See *id.*

connected to it by a relationship represented by either an explicit or implicit contract.³

Proponents of this concept of the corporation, called contractarians, often go one step further. They argue that because corporations involve nothing more than private contractual orderings among various parties, there should be little or no meaningful regulation to impinge on those parties' liberty to contract as they see fit.⁴ It is this last conclusion that this essay will argue is fallacious. Indeed, this kind of extreme libertarianism was discredited at the conclusion of the *Lochner* era in the 1930s.⁵ *Lochner v. New York*⁶ was itself a case that struck down a regulation mandating maximum working hours for bakers. Just as many of the *Lochner* era cases mistakenly claimed that there should be little or no intrusion into private contractual orderings,⁷ so too is this uninhibited contemporary call for liberty of contract in the corporate context mistaken. Rather, the very integrity of the contracting process and the sanctity of the resulting contracts demands legal involvement both through regulation *ex ante* and litigation *ex post*.

This essay will begin with a brief description of the nexus-of-contracts conception of the corporation. It will then proceed to discuss why that framework actually supports a call for regulation that specifically addresses potential weaknesses

³ This theory is, of course, still debated, and is countered by progressive corporate scholars advancing stakeholder theories. See, e.g., Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. CORP. L. 743, 747 (1999); Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 905 (1993).

⁴ "Contractarians contend that corporate law is generally comprised of default rules, from which shareholders are free to depart, rather than mandatory rules. As a normative matter, contractarians argue that this is just as it should be." Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 860 (1997).

⁵ For a lengthy listing of scholars who have decried the *Lochner* case as a glaring example of judicial activism and an attempt by those Justices to empower businesses at the expense of the working classes, see David N. Mayer, *The Myth of "Laissez-Faire Constitutionalism": Liberty of Contract During the Lochner Era*, 36 HASTINGS CONST. L.Q. 217, 218-19 (2009). Included in that listing are such heavy hitters as Roscoe Pound, Learned Hand, Charles Warren, and contemporary scholars such as Geoffrey Stone, Jesse Choper, Lawrence Tribe, and Robert Bork. *Id.*

⁶ 198 U.S. 45 (1905).

⁷ One hundred eighty-four cases decided during the *Lochner* era found state legislative regulations unconstitutional as violations of the liberty interest protected by the 14th Amendment. Benjamin F. Wright, *The Growth of American Constitutional Law* 154 (Univ. of Chicago Press 1942). See, e.g., *Adkins v. Children's Hosp.*, 261 U.S. 525, 539 (1923) (striking down minimum wage regulations); *Coppage v. Kansas*, 236 US 1, 4-7 (1915) (striking down regulations preventing employment contracts from prohibiting employees from joining unions); *Meyer v. Nebraska*, 262 U.S. 390, 399 (1923) (striking down a law requiring children to be raised in English-only schools).

in the contracting process. The essay will close with a brief examination of a few examples that might help apply and develop the thesis presented here.

II. THE CORPORATION AS A NEXUS OF CONTRACTS

Contractarians argue that the nexus-of-contracts conception of the firm can be helpful in two ways. First, it can help us understand what a corporation is as a positive matter.⁸ Second, it can help determine how government should interact with the corporation as a normative matter.⁹

As a positive matter, the theory suggests that one should think of a corporation as a nexus of contracts – that is, a set of contracts between the corporation, on the one hand, and each of its constituents on the other.¹⁰ Those constituents include, among others, shareholders, creditors, employees, suppliers, officers, and directors.¹¹

The contractarian view is most obviously observed in the case of creditors and employees. Each of those groups has explicit contracts with the corporation. Creditors typically negotiate and enter into loan agreements with corporations; employees typically negotiate¹² and enter into employment agreements with corporations. The duties and responsibilities of each of the parties to those contracts are clearly spelled out within those particular contracts.

The more controversial aspect of the nexus-of-contracts theory is the proposition that the shareholders themselves have entered into a contract with the corporation. This contract is both explicit and implicit. It is explicit to the extent that the rights of the shareholder are defined by the corporation's charter documents, which authorize and describe that particular shareholder's shares of stock, and by the corporate law of the state in which the corporation is organized. It is implicit to the extent that the shareholder is implied to have consented to those terms and nothing more when the shareholder purchases the shares.

Proponents of the nexus-of-contracts concept of the corporation might go on to say that even the community within which the corporation is situated has

⁸ See Eisenberg, *supra* note 2, at 820-24.

⁹ *Id.* at 824 (citing Stephen M. Bainbridge, *supra* note 4, at 860).

¹⁰ "The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships." Jensen & Meckling, *supra* note 2, at 311.

¹¹ "Contractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, and so on." *Id.* at 310.

¹² Negotiate may be too strong a word for many employees of a corporation who are more likely to be in a "take-it-or-leave-it" situation. Nonetheless, even in those circumstances, the employees can be said to have knowingly entered into a bargain, aware of its terms.

entered into a contract with that corporation. That contract is also both explicit and implicit. It is explicit to the extent that the duties and obligations of the corporation and its management are spelled out in the corporate law of the state of incorporation. In addition, the obligations of the state with regard to the corporation are made clear in that body of law. It is implicit to the extent that both the corporation and the state are deemed to have entered into an agreement whereby each will uphold its respective obligations spelled out in that law with regard to the other.

Critics of the nexus-of-contracts conception of a corporation argue, among other things, that the concept does not positively describe a corporation adequately. In particular, it does not account for the notion that the shareholders are actually considered by law to be the owners of the corporation, making their status different from that of a mere contracting party.¹³ Further, from a legal realist perspective, critics contend that shareholders cannot be said to have actually bargained for the conditions set forth in a corporation's charter.¹⁴ However, defenders retort that such criticisms miss the point, which is to observe that there are resulting bargains between these parties and, therefore, the contract framework is still helpful when observing the dynamics at play between the corporation and these constituencies.¹⁵ Regardless of these critiques or the merit of the defense, the nexus-of-contracts conception has persisted, and is, perhaps, the predominant framework for understanding a corporation.¹⁶

The most problematic portion of the nexus-of-contracts framework for me has been the normative claim that many proponents of the framework have proffered: that, because the corporation can be viewed as this bundle of privately ordered contracts, regulation is largely unnecessary and undesirable.¹⁷ In accord with the contract law principle that parties to any contract should be given autonomy to enter into any arrangement that they deem appropriate, the law should make minimal intrusions into these contractual arrangements.¹⁸ Thus, corporate law should be

¹³ See Eisenberg, *supra* note 2, at 825-26.

¹⁴ See generally LAWRENCE E. MITCHELL, TRUST, CONTRACT, PROCESS, IN PROGRESSIVE CORPORATE LAW 207 (Lawrence E. Mitchell, ed., Westview Press 1995).

¹⁵ Bainbridge, *supra* note 4, at 861-62.

¹⁶ Professor Stephen Bainbridge has claimed that “[i]t is virtually impossible to find serious corporate law scholarship that is not informed by economic analysis.” STEPHEN BAINBRIDGE, CORPORATION LAW AND ECONOMICS VOL. 5 (2002). Further, Professor Bainbridge has pronounced that “the debate over the contractual nature of the firm is over.” *Id.* at 31.

¹⁷ See Bainbridge, *supra* note 4, at 860.

¹⁸ See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 15, 22-23 (1991).

largely a body of default rules that are triggered when the parties have not specifically bargained for some particular right.¹⁹

One example of this is preemptive rights. Shareholders can, theoretically, bargain for preemptive rights if they think those rights are valuable. Contractarians believe that the default rule is of minimal significance since the parties are able to negotiate for the opposite result regardless of whether the default provides for preemptive rights or not.²⁰

Indeed, normative claims that less regulation is better and that the private parties involved in these transactions should be allowed to structure them in an uninhibited way seem to have influenced policymaking. The securities law reforms enacted by the Securities and Exchange Commission (SEC) in 2005 are one such example. Those reforms enacted a broad array of changes to the Securities Act of 1933 (the 1933 Act), including dismantling in large part the heightened liability imposed on issuers of new securities by the 1933 Act.²¹ It is too early to assess the empirical impact of those reforms, but the logical result of removing a heightened standard of liability for fraud is an increase in fraudulent activity.

III. THE CONTRACTARIAN VIEW SUPPORTS REGULATION

Contrary to the contract-based aversion to regulation described above, using a contractarian concept of the corporation does not lead to the necessary conclusion that minimal regulation is the optimal result. On the contrary, having begun with a contract-based framework for the description of the corporation, it is quite important to delve further into contract law jurisprudence before making any conclusions about the appropriate amount of regulation or the propriety of any one particular regulation.

Thus, concepts that are central to contract law jurisprudence should be considered, including: capacity, duress, undue influence, misrepresentation, fraud, unconscionability, and even public policy. All of these doctrines are instructive for setting regulations *ex ante* to achieve an appropriate environment for the contracting

¹⁹ See Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990) (arguing that all corporate law has become trivial).

²⁰ See Bainbridge, *supra* note 4. See also Roberto Romano, *Answering the Wrong Question, The Tenuous Case for Mandatory Corporate Laws*, 89 CLMLR 1599, 1601 (1989) (arguing that state corporate laws have become quite permissive over time, allowing corporations to structure their firms and transactions as they see fit).

²¹ See Joseph F. Morrissey, *Rhetoric and Reality: Investor Protection and the Securities Regulation Reform of 2005*, 56 CATH. U. L. REV. 561, 593-97 (detailing those reforms).

process that is either explicit or implicit in the structuring and on-going business life of any corporation.²²

Accordingly, any regulation affecting corporations can be potentially evaluated based on its ability to redress any of the structural or procedural flaws related to contracting that are already a part of contract law jurisprudence. For example, where a regulation is designed to limit the ability for fraud to enter the bargain, it is likely justifiable. Where a regulation is designed to remove an element of duress from the bargain, it should likely also be justifiable. But, where a regulation is not redressing a structural or procedural flaw in the contracting process, it should be given heightened scrutiny and perhaps ruled inappropriate.

IV. ANTI-FRAUD, DISCLOSURE AND PROXY REGULATIONS AS EXAMPLES

There is an enormous array of existing regulations that affect corporations, and more that are currently being proposed. This section will endeavor to analyze a sampling of such regulations – two existing and one proposed – under this new contract-based framework for justifying regulation.

A. *Anti-fraud Rules*

Consider, for example, Rule 10b-5²³ and its wide-reaching prohibition on fraud in connection with the sale of any securities. There are many critics of Rule 10b-5 who claim that the markets are sufficient to police for fraud.²⁴ Such critics argue that investors tend to invest in companies that are honest, thereby incentivizing honest behavior.²⁵ More specifically, investors will enter into contracts to purchase or sell securities based, in part, on an attraction to securities whose companies are known to have more integrity than others in the marketplace. There is, no doubt, some truth in that claim. There is a market incentive for honesty in

²² Professor Eisenberg touched on this notion in his critique of the nexus-of-contracts theory, pointing out that even contracts are subject to mandatory rules such as those governing consideration, unconscionability, and good faith. *See* Eisenberg, *supra* note 2, at 823.

²³ Rule 10(b)-5 was promulgated under § 10b of the Securities and Exchange Act of 1934. Securities and Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5 (2006).

²⁴ *See, e.g.*, Larry Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 3 (2002) (stating that “[t]he only effective antidotes to fraud are active and vigilant markets and professionals with strong incentives to investigate corporate managers and dig up corporate information.”).

²⁵ “Even if the market cannot know the evil that lies within managers’ hearts, it can observe the contracts that tend to keep them honest. Investment dollars will tend to flow to the firms with the most efficient governance devices.” *Id.* at 8. *See also* Frank H. Easterbrook, *The Race for the Bottom in Corporate Governance*, 95 VALR 685, 698 (2009) (discussing the ability of capital to migrate and suggesting less regulation of corporations, while accepting criminalization of fraud).

communications with investors in securities. However, as events throughout the business history of time show, there are also tremendous incentives to deceive others in the securities markets. The better a person or entity is at deception, the more lucrative the endeavor. One need refer only to the decades-long Madoff scandal that has been recently exposed for evidence of this.²⁶ Of course, other examples abound as the now copious volumes of corporate scandals detail.²⁷

Just as the securities law reforms of 2005, described above, have limited the availability of heightened liability under the 1933 Act, a de-regulatory movement in the 1990s limited the availability of Rule 10b-5 to potential plaintiffs. In 1994 the U.S. Supreme Court in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* eliminated a private right of action for aiding and abetting fraud under Rule 10b-5.²⁸ Then, the Public Securities Law Reform Act of 1995²⁹ and the Securities Litigation Uniform Standards Act of 1998³⁰ made it more difficult for plaintiffs to bring suit under Rule 10b-5.

Using a contract-based approach to corporations, it is certainly possible to defend this de-regulatory approach and argue that parties should be at liberty to negotiate with each other for the purchase or sale of a security, uninhibited by federal regulation mandating a duty of honesty and candor in connection with that transaction. However, the contract-based framework in fact justifies such a regulation as one that enhances the nature of the contracting process and ensures a more fair result. Understanding that fraud is generally a jurisprudential contract claim that can undermine a contract *ex post*, Rule 10b-5 can be seen as a regulation designed *ex ante* to further protect the integrity of the bargaining process and the fairness of its outcome.

B. Disclosure Rules

As another example, disclosure regulations can generally be viewed as a heightened anti-fraud mechanism that is completely compatible with a contract-based view of the corporation. The 1933 Act and the Securities Exchange Act of 1934 (the “1934 Act”) promote accurate and adequate disclosure of both

²⁶ See Robert Frank, *et al.*, *Madoff Jailed After Admitting Epic Scam*, WALL ST. J., Mar. 13, 2009, at A1; Diana B. Henriques, *Court Denies Madoff Aide’s Request for Bail*, N.Y. TIMES, Oct. 28, 2009, at B4 (citing the estimate of cash damages to victims as of October 28, 2009 to be \$21.2 billion).

²⁷ See, e.g., NANCY B. RAPOPORT ET AL., *ENRON AND OTHER CORPORATE FIASCOS: THE CORPORATE SCANDAL READER* (2d ed. 2009).

²⁸ 511 U.S. 164 (1994).

²⁹ Pub. L. No. 104-67, 109 Stat. 737 (1995).

³⁰ Pub. L. No. 105-353, 112 Stat. 3227 (1998).

investment-specific and company-specific information. The full extent to which disclosure is required and the form that disclosure takes has shifted over the years. For example, in 2002, in addition to requiring annual and quarterly reports, the periodic reporting system was made more rigorous by requiring more events to be disclosed on a current basis on Form 8-K.³¹ Further, the Sarbanes-Oxley Act of 2002 imposed the requirement that the chief executive officer and chief financial officer both certify the accuracy of information contained in annual and quarterly reports, and that certain internal controls be put in place to make sure that all material information would reach that officer's attention.³²

Whether extending the disclosure regulations to include these new and increased requirements was appropriate reflects the central question of this essay, whether and what kinds of regulations are appropriate. When seen through the contractarian lens, the argument might have been made that liberty of contract should prevail with a call for less regulation. However, when considering contract law jurisprudence – regulations designed to enhance the integrity of the contracting process and prevent any structural disabilities from infecting the resulting explicit or implicit contracts – these heightened regulatory requirements can be justified. Where investors are typically at a structural disadvantage, vis-à-vis the corporation, when attempting to assess the value of any corporation's security, mandating increased disclosures helps those investors get a more complete and honest understanding of the security in question. Mandating chief executive officer and chief financial officer certifications likewise enhances the quality of the information and the integrity of the resulting bargains in the market for the underlying securities. Seen through this lens, these regulations are justifiable as making the bargaining process more fair and the outcome more equitable.

C. *Proposed Proxy Reforms*

As another example, consider the very recent proposed SEC reform of the proxy rules. The SEC has introduced a proposed set of rules that would make it easier for shareholders to meaningfully nominate and elect directors of their choice.³³ Part of the implicit contract between shareholders who own voting stock and the corporation is the right of shareholders to vote and elect directors.³⁴ Proponents of

³¹ See Exchange Act Release No. 34-46084, 17 CFR Parts 228, 229, 240 & 249 (June 25, 2002).

³² Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.) (2002) § 302 (2002).

³³ Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024 (June 10, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249, 274).

³⁴ Generally, state corporate law statutes provide that shareholders do not participate in management decisions of a corporation, but do vote for board members. See e.g. MODEL BUS. CORP. ACT § 801(2002) (corporations are managed by their boards of directors); MODEL BUS. CORP. ACT § 721

the nexus-of-contracts conception of the corporation would see this right as part of the implicit bargain shareholders make when they buy shares and become owners.

However, commentators largely agree that such a right has generally been illusory.³⁵ It is currently extremely difficult for shareholders to mount any sort of challenge to the list of candidates incumbent management puts forth for election. The SEC Release proposing the new rule describes the rule as designed “to remove impediments so shareholders may more effectively exercise their rights under state law to nominate and elect directors at meetings of shareholders.”³⁶ The proposed proxy reforms are designed to change this, and, under certain limited circumstances, mandate that incumbent management include shareholders’ nominees for board positions.³⁷

Through a contractarian framework, this new reform could be justified as an attempt to better create the result that investors are theoretically bargaining for when they buy shares and become owners of a corporation: a more meaningful ability to actually nominate and elect directors. The regulation could be seen as an *ex ante* specific performance remedy to a potential breach of the shareholders’ implied contract that has been allowed to persist for many years. Thus, through the contractarian lens, again in this example, regulation is both desirable and appropriate.

CONCLUSION

In the 1905 case of *Lochner v. New York*,³⁸ the United States Supreme Court declared the primacy of liberty of contract. The general libertarian approach to economic life associated with *Lochner* was discredited in the 1930s during a time of economic crisis.³⁹ That troubled era welcomed regulation of contracts in a realistic

(2002) (shareholders are generally entitled to vote); MODEL BUS. CORP. ACT § 803 (2003) (boards of directors are elected at shareholders meetings).

³⁵ Stock ownership is so dispersed in modern corporations that a typical shareholder does not own enough shares to make a material difference when voting. Bainbridge, *supra* note 4 at 195-96 (citing Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* (Harcourt, Brace & World 1968) (1932)).

³⁶ The SEC Release proposing the new rule describes the rule as designed “to remove impediments so shareholders may more effectively exercise their rights under state law to nominate and elect directors at meetings of shareholders.” Securities Act Release No. 33-9046; Exchange Act Release No. 34-60089, 17 CFR 200, 232, 240, 249 & 274, p. 10 (June 10, 2009).

³⁷ “The new rules would require, under certain circumstances, a company to include in the company’s proxy materials a shareholder’s, or group of shareholders’, nominees for director.” *Id.*

³⁸ See *Lochner v. New York*, 198 U.S. 45, 64 (1905).

³⁹ See *supra*, note 5.

attempt to improve the economic condition of shareholders, workers, and employers alike.⁴⁰

Likewise, in 2009, in the midst of “one of the most serious economic crises of the past century,”⁴¹ a conception of the corporation as little more than a nexus of contracts should not inhibit regulations designed to correct flaws inherent in the bargain between a corporation and any of its constituents. In the *Lochner* case itself, the Court stated that certain encroachments on liberty of contract were appropriate and permissible if they were designed to protect the public welfare.⁴² Any current regulations designed to improve the process of any bargain struck with a corporation, and to ensure the integrity of the outcome of that bargain, should, likewise, be appropriate and permissible.

⁴⁰ *W. Coast Hotel v. Parrish*, 300 U.S. 379 (1937) (upholding minimum wage regulations) ushered in a new era of cases that upheld social and economic regulations that impinged on the liberty of contract ideal that the *Lochner* Court espoused.

⁴¹ See *supra*, note 1.

⁴² See *Lochner*, 198 U.S. at 53.