FOUNDATIONS OF
Corporate Law

Roberta Romano

FOUNDATION PRESS

FOUNDATIONS OF CORPORATE LAW

By

ROBERTA ROMANO

Allen Duffy/Class of 1960 Professor of Law
Yale Law School

New York, New York
FOUNDATION PRESS
1993

395 Hudson Street
New York, NY 10014
Phone Toll Free 1–877–888–1330
Fax (212) 367–6799
fdpress.com
Printed in the United States of America

ISBN 1–56662–997–7

TEXT IS PRINTED ON 10% POST CONSUMER RECYCLED PAPER

2nd Reprint—2004

PREFACE

Corporate law underwent a revolution over the past decade. In the midst of an extraordinary period of innovation in business organization and acquisitive activity, legal scholarship was transformed by the use of the new analytical apparatus of the economics of organization and modern corporate finance. This learning has already had, and will increasingly have, a profound impact on corporate practice and, accordingly, on the teaching of corporate law. This book of readings seeks to provide an accessible introduction to the enduring policy debates in corporate law as well as the intuition for the fundamental economic concepts of the new learning that informs the debates. In addition, a concerted effort has been made to provide a realistic sense of the institutional landscape, which is foreign to many students, by extensive referencing of the burgeoning empirical research on corporate governance.

The key feature of the public corporation is Adolph Berle and Gardiner Means's insight concerning the separation of ownership and control: managers of the firm, who run the business, are not the owners. This separation creates a host of organizational problems, because managers' incentives are not always aligned with the owners' interest; such problems are generically referred to as agency problems. Much of corporate law is directed at mitigating agency problems, as selections in the reader illustrate. The readings also indicate how the economic theory of organization as well as corporate finance clarify different facets of the agency problem and suggest ways of mobilizing the legal system to address this master problem.

A word on the format is in order. I have used materials in this reader to supplement casebooks in my courses in corporate law and corporate finance. The reader was crafted with the intention that it be used as a springboard for class discussion in a corporations course, but there are comprehensive notes and questions to ensure that it is sufficiently self-contained for independent, self-directed use. All of the selections have been extensively edited to facilitate accessibility. Mathematics appearing in original works has been suppressed, although simple numerical examples have been retained or included in the notes to illustrate concepts. A danger with such an approach is that complexities of the literature can easily be lost, and this may convey the misimpression that there is no ambiguity to policymaking. I have sought to temper this risk by juxtaposing sharply differing positions in the selections or accompanying notes. In addition, references and most footnotes have been omitted from excerpts. Precision and bibliographic convenience have been sacrificed for the pedagogic benefit of greater readability. Readers who are sufficiently intrigued by an excerpt can follow up on arguments and references by recourse to the original source.

This book would not have been completed without the superb assistance of Cathy Briganti and the unflagging encouragement and support of Albert Romano. I cannot begin to thank them; I can only end by acknowledging that fact.

R.R.

New Haven
October 1992

*

FOUNDATIONS OF CORPORATE LAW

*

CONTENTS

I

Theory of the Firm and Capital Markets

The readings in this chapter provide a framework for understanding corporate law. The selections in part A on the theory of the firm offer explanations of why individuals organize their economic activity into firms and why certain institutional arrangements are so prevalent. They also suggest that the markets in which firms operate affect their organizational structures. A critical market for public corporations is the capital market. This is because one of the explanations for organizing a business as a corporation is its greater accessibility to capital, which, as discussed in Chapter II, is facilitated by corporate characteristics of free transferability of shares and limited liability. The selections in part B introduce the building-block concepts of modern corporate finance that are prerequisites for understanding the operation of capital markets.

In neoclassical economics, the firm is a black box, represented by a production function. Although firms have an objective, profit maximization, the neoclassical approach focuses on aggregate firm behavior (markets) rather than the individual firm. The readings in this chapter on the theory of the firm, however, take a more microanalytical approach, delving inside the firm and differentiating the players and their interests.

Michael Jensen and William Meckling's analysis of the firm proceeds from the key organizational problem of the modern corporation identified by Adolph Berle and Gardiner Means over sixty years ago, the separation of ownership and control: ownership rights (stock) are not held by the individuals who manage the corporation. Berle and Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932). This separation creates a potential for the divergence of shareholder and manager interests, which is referred to as a principal-agent problem. Firms are, therefore, not necessarily profit maximizers. As Jensen and Meckling explain, managers will seek to maximize their own utility (satisfaction, happiness, pleasure), which will not be the same as maximizing the firm's profits because managers obtain non-pecuniary benefits (such as on-the-job perquisites of expensive office furnishings), which are neither convertible to cash nor available to nonmanaging owners. In addition, managers may not expend maximum effort working on their job (that is, shirking is a nonpecuniary benefit).

Jensen and Meckling emphasize the organizational consequences of the agency problem: time and effort must be expended in fashioning institutions that align managers' incentives with owners' preferences. These expenditures are referred to as agency costs. Many features of corporate and securities laws fall into this cost category, such as audited financial statements. The separation of ownership and control does not imply that managers can operate firms in complete disregard of shareholder interests. Rather, institutions of corporate law, which are the focus of Chapter V, such as the board of directors, are devised to mitigate the agency problem. In addition, the many markets in which firms operate—product, labor, capital, and corporate control markets—constrain agency costs. For example, if managers shirk or consume excessive nonpecuniary benefits, the firm's production costs will rise and it will compete less effectively in its product market. This raises the cost of capital and places management at risk, for executives of poorly performing firms experience greater than normal turnover in their positions (see Chapter V, part A, note 5 and Chapter VI, part A, note 1). The role of the market for corporate control in reducing agency costs is explored in Chapter VI (see in particular the selections by Henry Manne and Michael Jensen).

Oliver Williamson focuses on complications for exchange that arise from uncertainty and two features of the human condition: opportunism and bounded rationality. Opportunism encompasses the possibility that individuals will act strategically to further their own interests at the expense of others. Bounded rationality refers both to limits on the information available to individuals when entering exchange relations and to limits on their ability to process information. Firms become necessary with the addition of another key variable, transaction-specific assets, assets necessary for an exchange transaction that are nonredeployable (that is, their value in the next-best use is significantly lower than their value in the specified exchange transaction). The owner of such an asset is vulnerable to exploitation: by realizing that the asset owner will suffer a loss if she does not transact with a particular party, that party can behave opportunistically and raise the transacting price. Williamson contends that in such a situation, simple contracts and markets will not do, and protective institutional arrangements, termed governance structures, are necessary to facilitate exchange. The corporation is one such device.

A real-world example should aid in understanding Williamson's analysis. Consider the owner of an aluminum refining plant located near a bauxite mine (the ore from which aluminum is produced). This plant is most valuable (production costs are lowest) if ore is purchased from the neighboring mine. Ore obtained from a more distant mine will be considerably more expensive because it must be transported: the refining process requires a large quantity of ore to extract a small quantity of aluminum and bauxite is a bulky product to ship. Consequently, once the refiner locates the plant near a specific mine, the mine owner can raise her price for ore (up to the refiner's costs of transporting ore from a more distant mine). The refining plant is a transaction-specific asset; it cannot be costlessly torn down and rebuilt elsewhere. Before locating the refining plant, the owner faced a competitive market in bauxite, but once built, the situation is fundamentally transformed, as it now matters with whom the refiner deals. It is much more profitable to transact with the adjoining mine owner than anyone else. The solution in the aluminum industry to this potential holdup problem is, indeed, a complex governance structure: vertical integration. Refining firms buy mines. See John Stuckey, *Vertical Integration and Joint Ventures in the Aluminum Industry* (Cambridge, Mass.: Harvard University Press, 1983).

Henry Hansmann extends the transaction cost analysis of firm organization by introducing as a key variable the cost of collective decision making by owners, in addition to the market and monitoring costs emphasized by Jensen and Meckling and Williamson. Homogeneity of interest across owners lessens decision costs. This insight is helpful in understanding why the vast majority of firms are owned by shareholders rather than workers.

Burton Malkiel provides an overview of modern portfolio theory, giving systematic content to the adage don't put all your eggs in one basket. Diversification reduces risk without a commensurate reduction in return, as the judiciously chosen portfolio eliminates risks that are idiosyncratic to specific firms. The investor who does not diversify pays a penalty; she bears unnecessary, and uncompensated, risk.

The selection from Stephen Ross, Randolph Westerfield, and Jeffrey Jaffe's textbook introduces the concept of an efficient market. A capital market is efficient if stock prices fully reflect all available information. As Ross, Westerfield, and Jaffe discuss, U.S. equity markets are extremely efficient. This insight is important for corporate law because an efficient capital market provides high-powered incentives for managers to act in the shareholders' interest. In an efficient market, decisions that fail to maximize stock value depress the firm's stock price, subjecting managers to an increased likelihood of replacement by either the board of directors or a change in control. Market efficiency is also important in assessing the regulation of securities markets, the topic of Chapter VII.

A

Theory of the Firm

Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*

MICHAEL C. JENSEN AND WILLIAM H. MECKLING

We define an agency relationship as a contract under which one or more persons (the principal[s]) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal. The *principal* can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition in some situations it will pay the *agent* to expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions. However, it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint. In most agency relationships the principal and the agent will incur positive monitoring and bonding costs (nonpecuniary as well as pecuniary), and in addition there will be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal. The dollar equivalent of the reduction in welfare experienced by the principal due to this divergence is also a cost of the agency relationship, and we refer to this latter cost as the "residual loss." We define *agency costs* as the sum of:

1. the monitoring expenditures by the principal,[1]
2. the bonding expenditures by the agent,
3. the residual loss.

* Reprinted by permission from 3 *Journal of Financial Economics* 305 (Amsterdam: Elsevier Science Pub., 1976).

1. As it is used in this article the term monitoring includes more than just measuring or observing the behavior of the agent. It includes efforts on the part of the principal to "control" the behavior of the agent through budget restrictions, compensation policies, operating rules, and so forth.

. . .

Since the relationship between the stockholders and manager of a corporation fit the definition of a pure agency relationship it should be no surprise to discover that the issues associated with the "separation of ownership and control" in the modern diffuse ownership corporation are intimately associated with the general problem of agency. . . .

Overview

In this section we analyze the effect of outside equity on agency costs by comparing the behavior of a manager when he owns 100 percent of the residual claims on a firm to his behavior when he sells off a portion of those claims to outsiders. If a wholly owned firm is managed by the owner, he will make operating decisions which maximize his utility. These decisions will involve not only the benefits he derives from pecuniary returns but also the utility generated by various nonpecuniary aspects of his entrepreneurial activities such as the physical appointments of the office, . . . the level of employee discipline, the kind and amount of charitable contributions, personal relations ("love," "respect," etc.) with employees, a larger-than-optimal computer to play with, purchase of production inputs from friends, and so forth. The optimum mix (in the absence of taxes) of the various pecuniary and nonpecuniary benefits is achieved when the marginal utility derived from an additional dollar of expenditure (measured net of any productive effects) is equal for each nonpecuniary item and equal to the marginal utility derived from an additional dollar of after tax purchasing power (wealth).

If the owner-manager sells equity claims on the corporation which are identical to his (i.e., share proportionately in the profits of the firm and have limited liability) agency costs will be generated by the divergence between his interest and those of the outside shareholders, since he will then bear only a fraction of the costs of any nonpecuniary benefits he takes out in maximizing his own utility. If the manager owns only 95 percent of the stock, he will expend resources to the point where the marginal utility derived from a dollar's expenditure of the firm's resources on such items equals the marginal utility of an additional 95 cents in general purchasing power (i.e., *his* share of the wealth reduction) and not one dollar. Such activities, on his part, can be limited (but probably not eliminated) by the expenditure of resources on monitoring activities by the outside stockholders. . . . The owner will bear the entire wealth effects of these expected costs so long as the equity market anticipates these effects. Prospective minority shareholders will realize that the owner-manager's interests will diverge somewhat from theirs, hence the price which they will pay for shares will reflect the monitoring costs and the effect of the divergence between the manager's interest and theirs. Nevertheless, ignoring for the moment the possibility of borrowing against his wealth, the owner will find it desirable to bear these costs as long as the welfare increment he experiences from converting his claims on the firm into general purchasing power [2] is large enough to offset them.

As the owner-manager's fraction of the equity falls, his fractional claim on the outcomes falls and this will tend to encourage him to appropriate larger amounts of the corporate resources in the form of perquisites. This also makes it desirable for the minority shareholders to expend more resources in monitoring his behavior. Thus, the wealth costs to the owner of obtaining additional cash in the equity markets rise as his fractional ownership falls.

We shall continue to characterize the agency conflict between the owner-manager and outside shareholders as deriving from the manager's tendency to appropriate perquisites out of the firm's resources for his own consumption. However, we do not mean to leave the impression that this is the only or even the most important source of conflict. Indeed, it is likely that the most important conflict arises from the fact that as the manager's ownership claim falls, his incentive to devote significant effort to creative activities such as searching out new profitable ventures falls. He may in fact avoid such ventures simply because it requires too much trouble or effort on his part to manage or to learn about new technologies. Avoidance of these personal costs and the anxieties that go with them also represent a source of on-the-job utility to him and it can result in the value of the firm being substantially lower than it otherwise could be. . . .

The Role of Monitoring and Bonding Activities in Reducing Agency Costs

In practice, it is usually possible by expending resources to alter the opportunity the owner-manager has for capturing nonpecuniary benefits. These methods include auditing, formal control systems, budget restrictions, and the establishment of incentive compensation systems which serve to more closely identify the manager's interests with those of the outside equity holders, and so forth. . . .

Since the current value of expected future monitoring expenditures by the outside equity holders reduce the value of any given claim on the firm to them dollar for dollar, the outside equity holders will take this into account in determining the maximum price they will pay for any given fraction of the firm's equity. . . . The entire increase in the value of the firm that accrues will be reflected in the owner's wealth, but his welfare will be increased by less than this because he forgoes some nonpecuniary benefits he previously enjoyed. . . .

2. For use in consumption, for the diversification of his wealth, or more importantly, for the financing of "profitable" projects which he could not otherwise finance out of his personal wealth.

It makes no difference who actually makes the monitoring expenditures—the owner bears the full amount of these costs as a wealth reduction in all cases. Suppose that the owner-manager could expend resources to guarantee to the outside equity holders that he would limit his activities which cost the firm [a specific amount]. We call these expenditures "bonding costs," and they would take such forms as contractual guarantees to have the financial accounts audited by a public account, explicit bonding against malfeasance on the part of the manager, and contractual limitations on the manager's decision-making power (which impose costs on the firm because they limit his ability to take full advantage of some profitable opportunities as well as limiting his ability to harm the stockholders while making himself better off).

If the incurrence of the bonding costs were entirely under the control of the manager, ... he would incur them.... This would limit his consumption of perquisites ... and the solution is exactly the same as if the outside equity holders had performed the monitoring. The manager finds it in his interest to incur these costs as long as the net increments in his wealth which they generate (by reducing the agency costs and therefore increasing the value of the firm) are more valuable than the perquisites given up. This optimum occurs [at the same point] in both cases under our assumption that the bonding expenditures yield the same opportunity set as the monitoring expenditures. In general, of course, it will pay the owner-manager to engage in bonding activities and to write contracts which allow monitoring as long as the marginal benefits of each are greater than their marginal cost....

Pareto Optimality [3] and Agency Costs in Manager-Operated Firms

In general we expect to observe both bonding and external monitoring activities, and the incentives are such that the levels of these activities will satisfy the conditions of efficiency. They will not, however, result in the firm being run in a manner so as to maximize its value. The difference between ... the efficient solution under zero monitoring and bonding costs (and therefore zero agency costs), and ... the value of the firm given positive monitoring costs, are the total gross agency costs defined earlier in the introduction. These are the costs of the "separation of ownership and control." ... The solutions outlined above to our highly simplified problem imply that agency costs will be positive as long as monitoring costs are positive—which they certainly are.

The reduced value of the firm caused by the manager's consumption of perquisites outlined above is "nonoptimal" or inefficient only in comparison to a world in which we could obtain compliance of the agent to the principal's wishes at zero cost or in comparison to a *hypothetical* world in which the agency costs were lower. But these costs (monitoring

3. Pareto optimality or efficiency is a technical concept that refers to a situation in which no change can make one person better off without making some other person worse off [EDITOR'S NOTE].