

CONTRACTUALISM AND CORPORATE LAW

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INTRODUCTION

1. No one seriously disputes that economic analysis dominates corporate law scholarship in North America.<sup>1</sup> The economics of corporate law has come to be known as a contractarian account. It is a form of economic contractarianism based in the Coase Theorem, which perhaps links to Hobbesian interest-based versions of contractarianism.<sup>2</sup> It has developed into the nexus of contracts approach to understanding corporate law. It is by far the majority view in corporate law scholarship.<sup>3</sup> Given that the Coase Theorem forms the foundation for economic analysis of law generally, it is not clear what the contract language adds to the economic analysis of corporate law.<sup>4</sup> But my aim is not to challenge the interest-based contractarianism that dominates corporate law scholarship. Rather, my aim is offer a sketch of how a right-based version of contractarianism offers an alternative and possibly better way of understanding corporate law. To strive for clarity, I use "contractualism" to refer to the right-based version of contractarianism.<sup>5</sup>
2. I use "interest-based" to refer to theories of social cooperation in which people agree to cooperate based on their self interest and "right-based" to refer to theories in which moral notions do not reduce to some non-moral notion such as self-interest.<sup>6</sup> I make no claim that economic contractarians offer anything like a moral theory; in fact I would claim that they do not.
3. Contractualism is commonly associated with the work of John Rawls and T.M. Scanlon. Rawls' *A Theory of Justice*, first published in 1972, is one of the most important books in moral and political theory in the twentieth century.<sup>7</sup> Scanlon's account is most fully articulated in his book, *What We Owe to Each Other*, published in 1998.<sup>8</sup> My emphasis is on Scanlon's version of contractualism.

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<sup>1</sup> STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 31 (Foundation Press 2002).

<sup>2</sup> For the distinction between interest-based and right-based views of contractarianism, see SAMUEL FREEMAN, JUSTICE AND THE SOCIAL CONTRACT 18-20 (Oxford University Press 2007).

<sup>3</sup> *Id.*

<sup>4</sup> Melvin Eisenberg made this point in Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989).

<sup>5</sup> These terminological distinctions can be found in T.M. SCANLON, WHAT WE OWE TO EACH OTHER (1998) and STEPHEN DARWALL, CONTRACTARIANISM/CONTRACTUALISM (Wiley-Blackwell 2002).

<sup>6</sup> Freeman, *supra* note 2.

<sup>7</sup> JOHN RAWLS, A THEORY OF JUSTICE (Harvard University Press rev. ed. 2001).

<sup>8</sup> Scanlon, *supra* note 5.

4. My account is both descriptive and prescriptive. My work in contractualism in general is to show that the structure of normative justification in the law is contractualist, and if it is not, it should be. Moral theory cannot help but be evaluative and prescriptive. By "in general" I mean to convey, in part, that I do not claim any special contractual nature for corporations or in the relationships of corporate constituencies. Contractualism goes to the structure of legal justification, not to anything specific about relations of factors of production to management in a firm.
5. A contractualist account of corporate law centers normative justification on notions of reasonableness, justification to others, and reciprocity among moral equals or equal citizens. Rationality describes the behavior of persons. Reasonableness describes the normative standards by which we evaluate that behavior.
6. Contractualist approaches to understanding the law have been with us for some time, but have made very little contact with corporate law. I attempt nothing like a survey here, but will mention just a few examples of what I shall call casual contact. Victor Brudney's work is perhaps the most well-known among nexus of contract theorists; it is anti-contractarian but not contractualist.<sup>9</sup> Robert Clark began a discussion of contractualism in his article for the well-known 1989 symposium on economic contractarianism and corporate law, published in the *Columbia Law Review*,<sup>10</sup> but provided nothing near philosophical justification. In evaluating the distributive features of insider trading prohibitions, Jonathan Macey sketched some preliminary discussion of Rawls's second principle of justice in his recent book, but it is clearly not the main focus of his work, which is a version of economic contractarianism.<sup>11</sup>
7. To conclude that my work falls within the progressive school of thought about corporate law would be a mistake, as it will not always reach the familiar conclusions. And the progressive literature is not in the main philosophical in approach.
8. My account is not social scientific in the sense that it is not naturalistic. It makes no claims about how people actually behave. That would be a conventionalist account differing substantially from the normative account I provide here.
9. Contractualism has the potential to solve a number of problems that are difficult to solve in other accounts. For example, it has few problems with the shareholder wealth maximization norm but provides ways of reconciling shareholder interests with those of other groups. It provides a unified way of taking the interests of persons not typically associated with the corporate contract into account. It offers an explanation why pure private ordering and a system of corporate law comprised purely of default rules is neither descriptively true nor prescriptively reasonable. It provides a way of understanding why insider trading is wrong and should be unlawful.
10. My research is in very early stages. I provide no more than a preliminary sketch here.

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<sup>9</sup> Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985).

<sup>10</sup> Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1717-18 (1989).

<sup>11</sup> JONATHAN R. MACEY, *CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 189-93* (Princeton University Press 2008).

## I. MAKING CONTRACTUALISM LEGAL

1. Moral theorists divide their inquiry into two sets of claims, meta-ethical and normative. Meta-ethics is inquiry about the nature of morality. Normative ethics is inquiry about particular moral claims.<sup>12</sup> Meta-ethical claims about contractualism center on the idea that the form of moral argument is contractualist. Normative claims about contractualism center on the moral demands that come from such moral argument. The focus in the sections to follow are on normative contractualism. This section is about meta-ethical contractualism; it lays foundation for the discussion to follow.<sup>13</sup>
2. In contractualism, the form of moral argument is in social agreement, determined constructively, through a hypothetical procedure. The idea is to use a hypothetical procedure to find moral principles to apply in the actual world. If we used actual as opposed to hypothetically derived norms, we would be doing something very different, a form of moral conventionalism. We want to reliably know when people are mistaken, so opinion polls cannot be determinative.
3. Contractualism is an account of morality in the social contract tradition, but the object of agreement is not a constitution or political obligation, but morality or justice. It is unlike what are perhaps more historically understood social contract theories, in which the object of social contracting is to specify the concept of political obligation.
4. Contractualism is a way of doing moral theory that is to be distinguished from consequentialist and utilitarian ways of doing moral theory.
5. In summary, contractualism can be understood from nine of its features:
  - a. *Justification to others*, usually formulated as a requirement that we justify our action on general principles to regulate our behavior on terms others must reasonably accept, or, in Scanlon's formulation, no one can reasonably reject. The basic notion is "put yourself in my shoes and I'll put myself in yours." Think of these notions in terms of demands a person might make on another person, or an obligation a person might have to another person. We give content to demands, obligations, and judgments about right and wrong. That content comes from putting ourselves in the place of others, and those others doing the same for us.
  - b. *Reasonableness not rationality*. Reasonableness relates to the idea of justification to others. My demands have to be reasonable to you and yours to me. Reasonableness specifies the normative. Rationality, in contrast, is about how people actually behave. We want people to act reasonably, but their actual behavior may conform to means-ends rationality or to some other norm, as human behavior is understood from the standpoint of behavioral

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<sup>12</sup> T.M. Scanlon, *The Aims and Authority of Moral Theory*, 12 OXFORD J. LEGAL STUD. 1 (1992).

<sup>13</sup> This section benefits from Samuel Freeman, *Moral Contractarianism as a Foundation for Interpersonal Morality*, in JAMES L DRIER, CONTEMPORARY DEBATES IN MORAL THEORY 57 (Wiley-Blackwell 2006); Freeman, *supra* note 2, at 17-49.

economics, psychology, or other social sciences. Rational behavior can be unreasonable and does not form the basis for moral principles.

- c. *Moral equality or equal citizens.* In contractualism, each person is of equal dignity and respect. Moral equality affects the way we understand moral accountability to each other. It is a basic notion that affects what is permissible in a hypothetical agreement and the reasonableness of putative moral principles.
- d. *Idealized deliberation and hypothetical agreement.* Contractualist moral theories rely on hypothetical agreement among moral equals, usually in some sort of idealized conditions such as Rawls' veil of ignorance in the original position. Scanlon argues that we can deliberate hypothetically without Rawls' conditions. Contractualists use wide reflective equilibrium to work out principles for the general regulation of behavior that on one can reasonably reject. What is left in the culmination of this work-out are principles with the weakest objections to them. Contractualist methods do not aggregate interests except in limited conditions. Agreement is not the subject of a bargain. Bargaining permits people to take power and position into account and can lead to unreasonable principles.
- e. *Normative not naturalistic.* Contractualism is not social science. It is justificatory and not predictive. It is not designed to offer predictions about the way people actually behave. People may actually behave quite differently from the way they should behave if they are properly deliberating moral agents. It is a theory about how persons justify their behavior to others in a moral sense. It is not a theory external to the way people actually reason morally; rather, because it is philosophical, its focus is internal, on getting clear on the form that moral argument actually has. Its method of justification, however, wide reflective equilibrium, requires us to take into account all considered judgments, not just moral judgments, particularly when extended into the realm of law and public policy.<sup>14</sup> We have to ask whether and not assume that the moral domain is hierarchically superior to other normative domains. Such questions help us to articulate moral principles that are suitably interpersonal and agent relative.
- f. *Nonreductionist.* Contractualism is right-based, which means that moral principles are not explained by some other non-moral facts, such as self-interest or prudence.
- g. *General principles for the regulation of human action and deliberation.* Hypothetical agreement can result in general principles to regulate human action. Read Scanlon's work and you will see the derivation of principles on promises, rescue, etc.

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<sup>14</sup> NORMAN DANIELS, *JUSTICE AND JUSTIFICATION: REFLECTIVE EQUILIBRIUM IN THEORY AND PRACTICE* 6 (Cambridge University Press 1996).



courts of the conditions for accountability of directors and management to shareholders. That tradition of public justification comes not from contract but from equity, from notions of honesty, fairness, fidelity, and faithfulness.

4. I summarily explain how a contractualist might approach two problems: executive compensation and *Caremark* oversight duties. I am not doing a full-blown contractualist account here, as that would require that I develop and test alternative principles that no one could reasonably reject.
5. Despite the many claims of economic contractarians that corporate law is comprised wholly or mainly of default rules, and that the nature of the corporation is in contract and private ordering, saying so does not make it so. Fiduciary duties have substantial mandatory features. Contractualism accounts for these mandatory features. In a contractualist justification of fiduciary duties, shareholders can reasonably reject the conversion of a number of corporate statutory provisions into default rules.

#### A. *Executive Pay*

6. The AIG bonus controversy, though possibly exaggerated in significance by the media, is a recent example of the failure of corporate governance. AIG could not survive without billions of dollars of bailout funds from the US federal government. Regardless of whether AIG management bears any responsibility for the failure of the company or the current economic crisis, it is a firm in severe financial distress and in no position to pay out over \$1 billion in bonuses. Yet the AIG CEO testified before the U.S. Congress that the law obligates AIG to "honor its contracts" and the Obama Administration ended up agreeing with this assessment. If indeed it is not a breach of fiduciary duty for a board of directors to approve contracts that pay guaranteed compensation regardless of the financial status of the firm, then the law fails to provide boards with the adequate incentives to protect shareholders. AIG executives have more protection than university professors whose tenure is subject to financial exigency conditions and who forego high levels of compensation for job security, autonomy, and reputational rewards.
7. In their book, *Pay Without Performance*, Lucian Bebchuk and Jesse Fried explain that courts have stayed away from shareholder litigation challenging executive pay.<sup>17</sup> Corporate lawyers are familiar with the near impossibility of overcoming the presumption of the business judgment rule and succeeding with a waste or breach of duty of care claim.<sup>18</sup>
8. Executive pay is an area in which the content of legal standards are reasonably rejectable by shareholders. Legal standards should move towards recognition of structural conflicts of interest. These structural conflicts of interest are well

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<sup>17</sup> LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE* 45-48 (Harvard University Press 2004).

<sup>18</sup> *See Id.* (referring to Mark J. Lowenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 S.M.U. L. REV. 201 (1996)).

understood.<sup>19</sup> In *Oracle*, the Delaware Chancery Court held that it will take them into account in evaluating the decisions of special litigation committees in demand excused cases.<sup>20</sup> *Disney* moved towards expanding and clarifying notions of good faith.<sup>21</sup> A more active judicial review, along with the sorts of shareholder empowering mechanisms that Bebchuk and Fried recommend, will bring institutions closer to the required reasonableness and justification to others.

9. A way to get judicial review of compensation packages into the zone of reasonableness would be for courts to establish presumptions based on structural conflicts of interest. If a shareholder-plaintiff can demonstrate that a board is captured by management, through various objective indicia, then the court should evaluate the merits of the executive pay package, under established judicial conceptualizations of evaluating the “fairness” of board decisions.
10. I have not yet developed any of this to the appropriate level of detail to qualify as legal standards for courts to apply, but I do think that it is unreasonable for directors to be captured and that capture presents a loyalty and not a care problem for courts.

#### B. *Caremark Duties*

11. Briefly, the move in *Stone v. Ritter* towards conceptualizing *Caremark* oversight duties as duties of loyalty (via the duty of good faith) is an example of requiring directors to justify themselves to shareholders based on notions of reasonable rejection. In *Stone*, the Delaware Supreme Court endorsed *Caremark’s* finding that boards have obligations to be “reasonably informed” and must assure themselves that the corporation has in place information and reporting systems “reasonably designed” to provide senior management and the board with information sufficient for “informed judgments.”<sup>22</sup> *Stone* endorsed the Delaware Chancery Court’s standard for director liability when directors are uninformed of employee conduct resulting in corporate liability: “only a sustained or systematic failure of the board to exercise oversight – such as utter failure to attempt to assure a reasonable information and reporting system exists – will establish the lack of good faith that is a necessary condition to liability.”<sup>23</sup> By making oversight obligations issues of loyalty and good faith, the Court removes the possibility of DGCL §102(b)(7) absolving directors of liability for “utter failures” to oversee the corporation.
12. The moves in *Stone* get us closer to principles that no relevant corporate constituency could reasonably reject. The main difficulty with the standard is it may be too easy on directors. Utter failure does not seem justifiable to shareholders.

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<sup>19</sup> See Bebchuk & Fried, *supra* note 17; Macey, *supra* note 11.

<sup>20</sup> *In re Oracle Corp. Deriv. Litig.*, 824 A.2d 917 (Del. Ch. 2003).

<sup>21</sup> *In re The Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006).

<sup>22</sup> *Stone v. Ritter*, 911 A.2d 362, 368 (Del. 2006), quoting *In re Caremark Int'l Deriv. Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).

<sup>23</sup> *Stone*, 911 A.2d at 369, quoting *Caremark*, 698 A.2d at 971.

### III. INSIDER TRADING

1. At least since Henry Manne's influential book, economic contractarians have puzzled over the unlawfulness of insider trading.<sup>24</sup> The “immediate and vitriolic rejection”<sup>25</sup> of calls to eliminate prohibitions on insider trading may reflect an appropriate reactive attitude from a moral point of view.
2. There are cases in which insider trading does not harm shareholders or traders. We can assume that as a given. But harm is not the only reason why insider trading is wrong. Some harmless wrongs are the proper aim of legal prohibition and redress in criminal law, tort law, and property law.<sup>26</sup>
3. The principles I am about to articulate need much more work, including fuller specification. I am in the very early stages of trying to explain why traders might have reason to reject any principle that would permit classic insider trading, tippee trading, misappropriator trading, and manipulative devices or contrivances in securities trading.
4. Insider trading might be wrong because it violates several moral principles. One such principle is what I call Principle E: It is wrong for a person to use inside information she acquires solely because of her official position to gain an advantage for herself in an exchange medium in which others do not have access to the information solely by reason of their position. The idea here is what Joel Feinberg calls exploitation or unjustified gain.<sup>27</sup> Principle E informs us that unjustified gain is reasonably rejectable by traders.
5. Another route to reasonable rejection of insider trading might be more directly through the principal-agent relationship. Consider Principle P1: It is wrong for an agent to use information she acquires from her position, or to use her position generally, in a way the principal cannot reasonably permit, to profit from exchange relationships with third parties. Principle P1 may be considered along with Principle P2: It is wrong for a principal to permit an agent to engage in conduct specified in Principle P1 without adequate disclosure, for whatever reason we might want to specify, such as reasons grounded in harm to market participants, reasonable expectations of traders, or even adverse selection effects. Principles P1 and P2 could be said to prohibit unjustified gain, but they also are grounded in notions of the rights, duties, and reasonable expectations of principals, agents, and third parties.
6. There are likely other moral principles at work. For example, Stuart Green specifies the wrongfulness of insider trading in the concept of cheating.<sup>28</sup>

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<sup>24</sup> HENRY MANNE, *INSIDER TRADING AND THE STOCK MARKET* (Free Press 1966).

<sup>25</sup> Bainbridge, *supra* note 1, at 586 (“The response to most law professors, lawyers, and regulators (to Henry Manne’s book) was immediate and vitriolic rejection.”).

<sup>26</sup> See JOEL FEINBERG, *HARMLESS WRONGDOING* (Oxford University Press 1990); Arthur Ripstein, *Beyond the Harm Principle*, 34 *PHIL. PUB. AFF.* 215 (2006).

<sup>27</sup> Feinberg, *supra* note 26, at 220-22.

<sup>28</sup> STUART P. GREEN, *LYING, CHEATING, AND STEALING: A MORAL THEORY OF WHITE-COLLAR CRIME* 240-42 (Oxford University Press 2006).

7. The harm principle commonly understood to underlie much of the criminal law also applies to insider trading. To the extent that insider trading threatens the integrity of the securities markets and has some real potential to cause harm to third parties as a result, these third parties have reasonable grounds to object to its permissibility.
8. These principles do not forbid investors from using their natural abilities to profit from securities trades. Nor do they forbid investors from using public information from gaining advantages in the market. I do not think they forbid *Switzer* type situations either.<sup>29</sup>

#### IV. CORPORATE MORAL AGENCY AND SHAREHOLDER WEALTH MAXIMIZATION

1. One attractive feature of contractualism is that the interests of various constituencies beyond those who are parties to the standard corporate contract are taken into account in a way that does not lead to all-or-none propositions about whether shareholder wealth maximization is an appropriate goal for the corporation. Contractualism is an appealing account because (a) it requires shareholders to expect maximization of their own interests only when it can be justified to others but (b) since morality is interpersonal, shareholder interests also must be reasonably taken into account.
2. Morality is not a choice. It makes demands on us. To say that a corporation has no moral obligation is like saying it can have no tort liability.
3. In a contractualist account, shareholder wealth maximization is based on justification to stakeholders (and others) on grounds they could not reasonably reject. Contractualism leaves a host of shareholder wealth maximizing legal rules intact. It takes shareholder interests into account as a class of affected persons, but it requires shareholder interests to give way when they are unreasonable. When contractualism is understood from the standpoint of shareholder wealth maximization, it has the potential to explain a number of corporate law rules.
4. Very simply, corporations have moral agency but contractualism permits us to take corporate and shareholder interests reasonably into account.

#### CONCLUSION

1. I have attempted to lay out some very general preliminaries about ways of understanding corporate law from the standpoint of contractualist moral theory.
2. A contractualist accepts majoritarian defaults only if they can be justified to others. In some cases mandatory rules might be preferred, to protect minorities or the less powerful who have reasons to reject alternative default rules, or we might prefer minoritarian defaults that are costly to overcome. Minoritarian mandatory rules

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<sup>29</sup> See *id.* (discussing in context of Green's "cheating" rationale).

already exist in corporate law, such as rules to protect minority shareholders,<sup>30</sup> though some might claim these rules are majoritarian in the sense that rational hypothetical bargainers would agree to them. Though my conclusions are tentative at this point, contractualism seems to explain these rules well.

3. We can think of the contractualist project as one of understanding how corporate law forms (or might form) around principles of right and justice that stand on their own and do not reduce to prudence or self interest. As Rawls tells us, "justice is the first virtue of social institutions, as truth is of systems of thought."<sup>31</sup>

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<sup>30</sup> See, e.g., *Weinberger v. UOP, Inc.* 457 A.2d 701 (Del. 1983).

<sup>31</sup> Rawls, *supra* note 7, at 3.