Chapter V
Information Costs and Transaction Costs

In the theoretically ideal market, all mutually beneficial transactions occur and all gains from trade are realized because economists assume that markets operate without cost. For example, the assumption of zero information costs means that all potentially mutually beneficial transactions are identified by market participants. Similarly, the assumption of zero transaction costs means that no potential transactions are defeated by the cost of negotiating and enforcing contracts. Obviously, this is not an accurate depiction of the real world where there is a lot of friction that prevents the realization of all potential gains from trade. This chapter considers how market participants function when confronted with information costs and transaction costs.

Information is necessary to the proper functioning of any market. However, information is scarce and costly to obtain. Individuals invest in information until the expected marginal benefits of collecting additional information equal the marginal costs of collecting additional information. This suggests that, in many instances, individuals will act without complete information; that is, rational individuals will act when uncertain about the results of their action. The positive costs of information mean that individuals often gamble on their decision making.

In many instances, either the costs of collecting information or the costs of acting without complete information are trivial. This is especially true for frequently purchased products, such as individual food products in the grocery store. On the other hand, the technical characteristics of many goods and services make it very difficult (i.e., costly) for purchasers to gather the amount of information necessary to make satisfactory choices. For example, most purchasers do not possess the technical expertise to evaluate the quality of automobiles, washing machines, televisions, doctors, lawyers, and so forth. Because mistakes in the purchasing of such goods and services can be very expensive, consumers gather information from numerous sources, including sales staff, *Consumer Reports*, as well as friends and relatives. Moreover, sellers attempt to convey information to consumers by developing reputations for providing the level of quality that the consumer desires.

Transaction costs are the out-of-pocket and opportunity costs of negotiating, drafting, and enforcing contracts. Transaction costs can frustrate potential mutually beneficial market transactions — i.e., contracts — and cause firms to take the transaction away from the market by moving the gains from trade inside the firm. Contract law is a system of rules for enforcing promises. It demonstrates the extent to which our society allows people to make promises or commitments that are legally binding, and the legal consequences of failure by one party to perform as promised. Transaction costs — primarily negotiation and enforcement costs — increase the costs of exchange and thus decrease the number of mutually beneficial exchanges. Contract law reduces transaction costs by imposing external rules that create rights and duties for each party to the exchange and provides remedies in the event that the duties are breached. Instantaneous exchanges, such as the purchase of a Diet Coke from a street vendor, occur without any assistance from contract law. Thus, contract law is most important in situations where the negotiations are not immediately followed by simultaneous performances on both sides of the transaction.

Of course, voluntary, mutually beneficial exchanges also take place in the absence of contract law. Continued dealing with the same parties reduces negotiation costs and increases the likelihood that a contract will be performed in good faith. One may seek to reduce transaction

costs by limiting his or her trading partners to only those who have a reputation for honesty and fair dealing. In a sense, therefore, the market controls dishonest and unfair behavior by reducing the demand for the goods and services provided by dishonest and unfair traders. That is, market adjustments act as an enforcement mechanism against dishonest and unfair practices.

Contract law reduces transaction costs in a number of ways. First, contract law enforces contract terms by imposing costs — typically in the form of a court ordering the payment of damages — on parties who breach their promises. For example, contract law enforces an agreed upon allocation of risk after the occurrence of a contingency that may make performance appear unattractive to one of the parties. Second, the common law of contracts provides a number of standard form, off-the-rack, contractual provisions that specify the basic details and fill gaps in negotiated contracts. Unless contradicted by the explicit terms of a contract, the common law rules are an implied part of all contracts. This reduces transaction costs by allowing contracting parties to form enforceable contracts without having to specify every standard of performance and without having to negotiate the allocation of risk associated with every conceivable contingency. All executory contracts face the risk of disruption due to totally unanticipated contingencies — circumstances with which the contract cannot deal because the contracting parties don't know what might occur — and contract law provides the basic rules to deal with various contingencies. Third, contract law discourages careless contracting by penalizing behavior which induces other parties to act in reliance on the first party's actions or representations. In effect, this saves transaction costs by allowing contracting parties to rely on the other party's actions without having to worry about what information the other party really means to convey.

Contract law produces the greatest reduction in transaction costs if the off-the-rack contract rules supplied by contract law mimic the agreements for which most contracting parties would bargain if negotiation costs were zero. For example, if every contracting party would agree that payment should be in U.S. dollars, it is clear that negotiation costs can be reduced by making such a term an implicit part of every contract. This bargaining principle provides an analytical framework for analyzing the rules of contract law, as well as other substantive areas of law such as corporation law and bankruptcy.

In applying the bargaining principle, it is essential to recognize that **freedom of contract** is an overriding philosophy of contract law. The contracting parties are almost always able to contract around the off-the-rack rules when they decide that it is in their interest to do so. Conceptually, if the benefits of altering the standard form rules are greater than the transaction costs of contracting, then the parties are made better off through modification of the standard contract rules. The philosophy of freedom of contract also explains why the common law of contracts is likely to be efficient in the sense that it comes close to satisfying the bargaining principle. Inefficient contract rules will not be used because contracting parties will contract around them until the courts recognize that the old default rules should be abandoned due to disuse.

Section A presents an overview of market and contractual responses to asymmetric information. Section B introduces agent-principal contracting and the economics of monitoring performance. Section C goes into greater detail about the costs of using markets to coordinate economic activity and the contractual arrangements that have evolved to control transaction costs. Finally, Section D applies the agency perspective to the issue of corporate governance and examines how market forces resolve some of the conflicts between managers and shareholders in large, publicly-held corporations.

A. Asymmetric Information andMarket Responses

Consumers frequently do not know how quality varies across brands of products or services. There is asymmetric information: one party (usually the seller) to a transaction knows a material fact (the quality of the good or service) that the other party (usually the buyer) does not know. At first glance, the phenomenon of asymmetric information appears to present sellers with the opportunity to exploit buyers. However, further analysis reveals that asymmetric information can be a major problem for the seller.

1. The Market for "Lemons"

The used car market is a nice vehicle (pun intended) for illustrating this point. Assume that Paige wants to sell her 2012 Ford Mustang GT. Paige has perfect information about the quality of her car — she is the original owner of the car; she has been a careful, non-abusive driver; she has followed all routine maintenance procedures; the car has not required any major repairs; and in sum, she knows that the car is in great condition. However, it is well known that (1) some Mustang GTs have had serious problems requiring numerous major repairs; and (2) many owners of Mustang GTs drive them hard and fast. Unfortunately for both Paige and the potential buyers of 2012 Ford Mustang GTs, it is very difficult for potential buyers to distinguish between Paige's "cream puff" and the "lemons" lurking in the market. At best, potential buyers know the probability of getting a good car.

If buyers cannot distinguish between good and bad used cars, all used 2012 Mustang GTs sell for the same price (assuming they have the same mileage). As a result, bad cars are overvalued and good cars are undervalued. But this is not the end of the analysis. Because Paige knows that she has a good car, she is not going to sell it at a market price that undervalues her car. Moreover, the owners of bad cars are encouraged to sell their cars because the market overvalues bad cars. This phenomenon is referred to as **adverse selection**: the only sellers who select to participate in the market are the ones who benefit from the asymmetric information. As more bad cars are offered for sale and fewer good cars are offered, the market price is forced downward to reflect the increasing probability that any given buyer will end up with a lemon. The bad cars drive out the good cars, and there is no market for good used cars. The lemons sour the market.

Obviously, the "lemons market" phenomenon has the potential to destroy markets whenever there is asymmetric information. Both sellers and buyers, who see potential mutually-beneficial exchanges frustrated, have incentives to solve the lemons problem. Paige, for example, could show her maintenance records (and even her driving record) to potential buyers. However, many buyers will remain suspicious of the quality of her information. Used car dealers attempt to solve the lemons problem by offering warranties on "certified pre-owned cars." Numerous alternative mechanisms for solving problems associated with asymmetric information are discussed in this section.

2. Adverse Selection and Insurance Contracts

The "lemons market" phenomenon poses a particularly challenging problem in insurance markets because the parties wishing to purchase insurance often know much more about their own particular circumstances than it is possible for insurers to know. For example, individuals who apply for health insurance know their own health record and tendency towards risky behavior and may be able to conceal important information from insurers. The asymmetric

information can lead to adverse selection in the insurance pool, as high risk individuals find insurance to be a good deal for themselves but low risk individuals decide to forego insurance coverage. Thus, the selection of people who purchase insurance is not a normal, random sample of the population, but rather includes some people with private information about their personal situations that increases the likelihood they will receive a higher than average level of benefit under the insurance policy. For example, high risk patients (e.g., cancer-prone, drug users, etc.) apply to insurance companies while young healthy persons do not. As more high risk individuals purchase insurance, higher payouts by insurance companies will force them to raise rates which, in turn, makes the insurance less attractive to low risk individuals. Insurance companies, of course, are well aware of this potential and devote a great deal of effort to avoiding adverse selection. For example, life insurance companies and health insurance companies attempt to control the riskiness of their insurance pools by requiring applicants to answer detailed questions, like whether they enjoy extreme sports, on the application form and to undergo medical examinations. Insurance companies set limits on pre-existing conditions, through either limited coverage or higher premiums for the additional risk. Chapter VI on risk includes a detailed discussion of the economics of insurance.

3. Reputational Bonds and Other Market Mechanisms for Disclosing Information About Quality

Consumers are understandably concerned about the quality of the products and services that they purchase in the market. This concern presents a problem for sellers of high-quality products and services because some consumers are not going to pay for quality unless they are assured that they will receive it. Many sellers respond to this problem by offering warranties, guarantees, and follow-up services. Sellers also invest in developing a reputation for high quality products and services. A reputation is an important asset of a seller but it is also very fragile because it can be quickly destroyed by the seller failing to live up to the expectations generated by the reputation. Imagine the damage done to the reputation of Ikea in 2013 when horsemeat was found in the retailers' Swedish meatballs and wiener sausages. Indeed, because the reputational asset can be destroyed by the firm's own behavior, it is very similar to a performance bond. Thus, a forfeitable reputational bond assures consumers that they will get what they bargained for. This is just one of many examples of how firms attempt to solve information problems in the market.

The Role of Market Forces in Assuring Contractual Performance

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I. Introduction

An implicit assumption of the economic paradigm of market exchange is the presence of a government to define property rights and enforce contracts. An important element of the legal-philosophical tradition upon which the economic model is built is that without some third-party enforcer to sanction stealing and reneging, market exchange would be impossible. But economists also have long considered "reputations" and brand names to be private devices which provide incentives that assure contract performance in the absence of any third-party enforcer. This private-contract enforcement mechanism relies upon the value to the firm of repeat sales to satisfied customers as a means of preventing nonperformance. . . .

This paper examines the nongovernmental repeat-purchase contract-enforcement mechanism. To isolate this force, we assume throughout our analysis that contracts are not enforceable by the government or any other third party. Transactors are assumed to rely solely on the threat of termination of the business relationship for enforcement of contractual promises.[1] This assumption is most realistic for contractual terms concerning difficult-to-measure product characteristics such as the "taste" of a hamburger. However, even when the aspects of a contract are less complicated . . . and performance more easily measurable by a third party such as a judge, specification, litigation, and other contract-enforcement costs may be substantial. Therefore, explicit guarantees to replace or repair defective goods (warranties) are not costless ways to assure contract performance. Market arrangements, such as the value of lost repeat purchases, which motivate transactors to honor their promises may be the cheapest method of guaranteeing the guarantee. . . . [O]ur approach is general in the sense that the value of future exchanges can motivate fulfillment of all types of contractual promises. . . .

In Section II, the conditions are outlined under which firms will either honor their commitments to supply a high level of quality or choose to supply a quality lower than promised. In order to emphasize the ability of markets to guarantee quality in the absence of any government enforcement mechanism, a simple model is presented which assumes that consumers costlessly communicate among one another. Therefore, if a firm cheats and supplies to any individual a quality of product less than contracted for, all consumers in the market learn this and all future sales are lost. A major result of our analysis is that even such perfect interconsumer communication conditions are not sufficient to assure high quality supply. Cheating will be prevented and high quality products will be supplied only if firms are earning a continual stream of rental income that will be lost if low quality output is deceptively produced. The present discounted value of this rental stream must be greater than the one-time wealth increase obtained from low quality production.

This condition for the "notorious firm" repeat-purchase mechanism to assure high quality supply is not generally fulfilled by the usual free-entry, perfectly competitive equilibrium conditions of price equal to marginal and average cost. It becomes necessary to distinguish between production costs that are "sunk" firm-specific assets and those production costs that are salvageable (i.e., recoverable) in uses outside the firm. Our analysis implies that firms will not cheat on promises to sell high quality output only if [the] price is sufficiently above salvageable production costs. [That is, the price of the product must be sufficiently high to assure profits above those that can be recovered by liquidating the assets to assure high quality.] While the perfectly competitive price may imply such a margin above salvageable costs, this will not necessarily be the case. The fundamental theoretical result of this paper is that market prices above the competitive price and the presence of nonsalvageable capital are means of enforcing quality promises.

In Section III our theoretical model (of quality-guaranteeing price premiums above

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[1] This assumption is consistent with the pioneering work of Macaulay (1963), where reliance on formal contracts and the threat of explicit legal sanctions was found to be an extremely rare element of interfirm relationships. Macaulay provides some sketchy evidence that business firms prevent nonfulfillment of contracts by the use of effective nonlegal sanctions consisting primarily of the loss of future business. This "relational" nature of contracts has been recently emphasized by Macneil (1974). . . .

salvageable costs) is extended to examine how the capital value of these price-premium payments can be dissipated in a free-entry equilibrium. The quality-guaranteeing nature of nonsalvageable, firm-specific capital investments is developed. Alternative techniques of minimizing the cost to consumers of obtaining a high quality product are investigated. We also explore market responses to consumer uncertainty about quality-assuring premium levels. Advertising and other production and distribution investments in "conspicuous" assets are examined as competitive responses to simultaneous quality and production-cost uncertainties. Finally, a summary of the analysis and some concluding remarks are presented in Section IV.

II. Price Premiums and Quality Assurance

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Intuitively, the quality-assuring price treats the potential value of not producing minimum quality as an explicit opportunity cost to the firm of higher quality production. Hence the quality-assuring price must not only compensate the firm for the increased average production costs incurred when quality above that detectable prior to purchase is produced, but must also yield a normal rate of return on the foregone gains from exploiting consumer ignorance. This price "premium" stream can be thought of as "protection money" paid by consumers to induce high quality contract performance. Although the present discounted value of this stream equals the value of the short-run gain the firm can obtain by cheating, consumers are not indifferent between paying the "premium" over time or permitting the firm to cheat. The price "premium" is a payment for high quality [rather than spending time and energy determining quality before purchase]. The relevant consumer choice is between demanding minimum quality output at a perfectly competitive (costless information) price or paying a competitive price "premium," which is both necessary and sufficient, for higher quality output.

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III. Competitive Market Equilibrium: Firm-specific Capital Investments

Our analysis has focused on the case where costless information (perfectly competitive) prices do not imply sufficient firm-specific rents to motivate high quality production. A price premium was therefore necessary to induce high quality supply . . .

A. Brand Name Capital Investments

Competition to dissipate the economic profits . . . involves *firm-specific capital* expenditures. This firm-specific capital competition motivates firms to purchase assets with (nonsalvageable) costs equal to the capital value of the premium rental stream earned when high quality is supplied at the quality-assuring price. . . . Such firm-specific capital costs could, for example, take the form of sunk investments in the design of a firm logo or an expensive sign promoting the firm's name. Expenditures on these highly firm-specific assets are then said to represent brand name (or selling) capital investments.

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If the firm decides to cheat it will experience a capital loss equal to its anticipated future profit stream. . . . That is, the market value of the competitive firm's brand name capital is equal to the value of total specific or "sunk" selling costs made by the firm which, in turn, equals the present value of the anticipated premium stream from high quality output. . . .

What assures high quality supply is the capital loss . . . of future business if low quality is produced. Since the imputed value of the firm's brand name capital is determined by the firm's expected quasi rents on future sales, this capital loss from supplying quality lower than promised is represented by the depreciation of this firm-specific asset. [As direct profits are gained from lower quality goods they are offset by indirect losses in the form of lost reputation.] The

expenditures on brand name capital assets are therefore similar to collateral that the firm loses if it supplies output of less than anticipated quality and in equilibrium the premium stream provides only a normal rate of return on this collateral asset.

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C. Consumer Cost Uncertainty: A Role for Advertising

The discussion to this point has assumed complete consumer knowledge of firms' costs of producing alternative quality outputs and knowledge of the extent to which any capital production costs or brand name capital selling costs are salvageable. This knowledge is necessary and sufficient to accurately calculate both the quality-guaranteeing premium and price. However, consumers are generally uncertain about cost conditions and therefore do not know the minimum quality-guaranteeing price with perfect accuracy. In fact, consumers cannot even make perfect anticipated quality rankings across firms on the basis of price. That one firm has a higher price than another may indicate a larger price premium or, alternatively, more inefficient production. In this section, we examine how the more realistic assumption of consumer cost uncertainty influences market responses to prepurchase quality uncertainty.

We have shown that increases in the price premium over average recoverable cost generally increase the relative returns from production of promised (high) quality rather than deceptive minimum (low) quality. The existence of a high price premium also makes expenditures on brand name capital investments economically feasible. The magnitude of brand name capital investments in turn indicates the magnitude of the price premium. When a consumer is uncertain about the cost of producing a particular high quality level of output and therefore the required quality-assuring premium, information about the actual level of the price premium will provide information about the probability of receiving high quality. If consumers are risk averse, this uncertainty about receiving anticipated high or deceptively low quality output will increase the premium that will be paid. The premium will include both a (presumably unbiased) estimate of the quality-assuring premium and an extra payment to reduce the risk of being deceived.

. . . Implicit information about the sufficiency of price as a guarantee can be supplied by "conspicuous" specific asset expenditures. Luxurious storefronts and ornate displays or signs may be supplied by a firm even if yielding no direct consumer service flows. Such firm-specific assets inform consumers of the magnitude of sunk capital costs . . . and hence the opportunity cost to the firm if it cheats. Both the informational services and the direct utility producing services of assets are now relevant considerations for a firm in deciding upon the most valuable form the brand name capital investment should take.

The value of information about the magnitude of a firm's specific or "sunk" capital cost, and therefore the magnitude of the price premium, is one return from advertising. Indeed, the role of premiums as quality guarantors provides foundation for Nelson's (1974) argument that advertising, by definition, supplies valuable information to consumers — namely, information that the firm is advertising. A sufficient investment in advertising implies that a firm will not engage in short-run quality deception since the advertising indicates a nonsalvageable cost gap between price and production costs. [T]hat is, the existence of a price premium. This argument essentially reverses Nelson's logic. It is not that it pays a firm with a "best buy" to advertise more, but rather that advertising implies the supply of "best buys," or more correctly, the supply of promised high quality products. Advertising does not directly "signal" the presence of a "best buy," but "signals" the presence of firm-specific selling costs and therefore the magnitude of the price premium. We would therefore expect, ceteris paribus, a positive correlation not between

advertising intensity and "best buys," as Nelson claims, but between advertising intensity and the extent of quality that is costly to determine prepurchase.

Conspicuous sunk costs such as advertising are, like all sunk costs, irrelevant in determining future firm behavior regarding output quality. However, consumers know that such sunk costs can be profitable only if the future quasi rents are large. In particular, . . . a price premium on future sales sufficient to prevent cheating is estimated to exist. . . .

Our theory also suggests why endorsements by celebrities and other seemingly "noninformative" advertising such as elaborate (obviously costly to produce) commercials, sponsorships of telethons, athletic events, and charities are valuable to consumers. In addition to drawing attention to the product, such advertising indicates the presence of a large sunk "selling" cost and the existence of a price premium. And because the crucial variable is the consumers' estimate of the stock of advertising capital (and not the flow), it also explains why firms advertise that they have advertised in the past (e.g., "as seen on ‘The Tonight Show'"). Rather than serving a direct certifying function (e.g., as recommended by *Good Housekeeping* magazine), information about past advertising informs consumers about the magnitude of the total brand name capital investment.

Firms may also provide valuable information by publicizing the large fees paid to celebrities for commercials. Information about large endorsement fees would be closely guarded if the purpose were to simulate an "unsolicited endorsement" of the product's particular quality characteristics rather than to indicate the existence of a price premium. Viewed in this context, it is obviously unnecessary for the celebrity to actually use the particular brand advertised. This is contrary to a recent FTC ruling (see Federal Trade Commission 1980).

This analysis of advertising implies that consumers necessarily receive something when they pay a higher price for an advertised brand. An expensive name brand aspirin, for example, is likely to be better than unadvertised aspirin because it is expensive. The advertising of the name brand product indicates the presence of a current and future price premium. This premium on future sales is the firm's brand name capital which will be lost if the firm supplies lower than anticipated quality. Therefore, firms selling more highly advertised, higher priced products will necessarily take more precautions in production.[2]

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IV. Conclusion

. . . We have analyzed the generally unrecognized importance of increased market prices and nonsalvageable capital as possible methods of making quality promises credible. We obviously do not want to claim that consumers "know" this theory in the sense that they can verbalize it but only that they behave in such a way as if they recognize the forces at work. They may, for example, know from past experience that when a particular type of investment is present such as advertising they are much less likely to be deceived. Therefore, survivorship of crude decision rules over time may produce consumer behavior very similar to what would be predicted by this model without the existence of explicit "knowledge" of the forces we have

[2] The greater is the cost to consumers of obtaining deceptively low quality, the greater will be the demand for quality assurance. The very low market share of "generic" children's aspirin (1 percent) vis-à-vis generic's share of the regular aspirin market (7 percent) is consistent with this implication. Many individuals who claim "all aspirin is alike" apparently pay the extra price for their children where the costs of lower quality are greater and therefore quality assurance is considered more important.

examined.

Our analysis implies that consumers can successfully use price as an indicator of quality. We are not referring to the phenomenon of an ignorant consumer free riding on the information contained in the market price paid by other more informed buyers but rather to the fact that consumer knowledge of a gap between firm price and salvageable costs, that is, the knowledge of the existence of a price premium, supplies quality assurance. . . .

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We do not wish to suggest that use of implicit (price premium-specific investment) contracts is always the cheapest way to assure quality supply. When quality characteristics can be specified cheaply and measured by a third party, and hence contract enforcement costs are anticipated to be low, explicit contractual solutions with governmentally enforced penalties (including warranties) may be a less costly solution. When explicit contract costs are high and the extent of short-run profit from deceptively low quality supply and hence the quality-assuring price premium is also high, governmental specification and enforcement of minimum quality standards may be an alternative method of reducing the costs of assuring the supply of high quality products.

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. . . More generally, however, all market transactions, including those "within" the firm such as employer-employee agreements, consist of a combination of the two basic forms of contractual arrangements. Some elements of performance will be specified and enforced by third-party sanctions and other elements enforced without invoking the power of some outside party to the transaction but merely by the threat of termination of the transactional relationship.

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Notes and Questions

1. A Price Premium for Being a Hostage: The Klein-Leffler analysis claims that price premiums are quality guaranteeing because the present value of the price premiums is a return on a firm-specific, non-salvageable investment. If the firm does not produce the promised quality, it will lose the price premium and go out of business. The firm-specific investment will be lost. The firm effectively holds itself hostage by promising to "fall on the sword" if it does not perform as promised. Consumers are convinced of the value of the guarantee. Try to come up with examples of these types of investments. Start, perhaps, by looking at law firms.

2. Reputation as a Bonding Mechanism: Individuals or businesses invest in developing their reputation for good-faith performance, high-quality workmanship, etc. These investments take time and cost money, and they are very valuable assets. If a business develops a good reputation, it can purchase supplies on more favorable terms and charge higher prices to customers. However, if the business then starts acting in a manner inconsistent with the reputation, the business reputation is forfeited. In other words, reputation is a forfeitable performance bond — if the business fails to perform as promised, it is penalized in the market. The potential penalty not only gives firms the incentive to perform, it also saves transaction costs by allowing contracting parties to rely on less formal contractual arrangements when dealing with a more reputable firm.

***3. Advertising as "Collateral"*:** Klein and Leffler state that a celebrity does not have to use the product to show the existence of a price premium. If that is the case, do companies need celebrities at all or will other large public expenditures also show their dedication to high quality?

4. Is Advertising "Good" or "Bad" for Consumers?: **Advertising** is defined as any

communication that businesses offer customers in an effort to increase demand for their products. No subject in the economics of market structure — industrial-organization economics — has been debated as intensively as advertising. Some economists consider advertising to be wasteful or "self-canceling," while others consider it to be evidence of the presence of vigorous competition. One of the primary sources of debate among economists has been over the information content of advertising. Critics of advertising argue that most ads are tasteless, wasteful assaults on consumers' senses and that it creates illusory differences between products that are actually very close substitutes for one another. In this view, advertising is not productive because it merely allocates demand among competing firms producing goods that are fundamentally alike. On the other hand, defenders of advertising argue that it offers real information about products and their characteristics (including their prices). The provision of such information lowers the consumers' cost of searching for goods, and permits consumers to make a rational choice among competing goods. Moreover, the Klein-Leffler excerpt argues that the very fact that a firm is advertising (that is, investing in a firm-specific non-salvageable asset) conveys important information to consumers. Regardless of one's position on the value of nonfraudulent information, almost all economists would accept the proposition that false advertising is socially wasteful. In fact, all of the questionable criticisms of nonfraudulent advertising are valid criticisms of false advertising. False advertising is not only socially wasteful, but it also harms consumers by inducing them to purchase goods and services that they might otherwise not purchase. Moreover, it harms competing producers who lose potential customers to the fraudulent advertiser.

5. Search Costs and the Economics of Advertising: As discussed in Chapter VII, in the perfect competition model, firms are price takers. If one firm raises its price above the equilibrium price, it loses all of its customers. In most markets, however, buyers have limited information. When a store raises its price, many buyers may not realize that the product is cheaper elsewhere, so the store may lose only some of its customers. Similarly, when a store reduces its price, many people may continue to buy from higher-priced competitors because the consumers have not learned about the price cut. Firms face downward-sloping demand curves when buyers have limited information about prices. A buyer with limited information may search for the best price. This search for a lower price or better products has costs (of time, travel, phone calls, and so forth). Search costs are the time and money costs of obtaining information about prices and products. The optimal amount of search occurs when the expected marginal benefit of searching (the expected benefit of trying one more store) equals its expected marginal cost. Because of search costs, it is perfectly rational for people to pay a high price when they are reasonably sure that a lower price is available. In most instances, people do not know which stores charge high prices. They must learn from experience and from other sources, such as talking with friends about the expected benefits of searching and paying attention to advertising.

6. The Distribution of Prices: Some buyers know more about prices than others. Tourists, for example, have less information than local residents about which stores charge higher prices. Moreover, it may be costly for tourists to acquire that information. For that reason, tourists are more likely to buy products at high-priced stores. When some customers have better information than others, a distribution of prices can exist even in very competitive markets. Informed consumers go to low-priced stores. Some uninformed consumers go to the low-priced stores by chance, but others buy from high-priced stores because they do not know that other stores offer lower prices.

7. Better Information Reduces Prices: As consumers acquire better information about

prices, they pay lower prices on average. With better information, more buyers go to low-priced stores and fewer to high-priced stores, which in turn gives high-priced stores the incentive to reduce their prices. Better information can reduce prices even if all consumers are not equally informed because the information improves their own estimates about which stores charge lower prices.

8. Search Costs Versus Advertising Costs: Evaluate the following statement: "If it were not cheaper for sellers to provide the information in lieu of having consumers search for it, some sellers would cease to advertise and would lower their prices by more than the cost to consumers of getting the information. Non-advertising sellers could then drive out of the market those sellers who continued to advertise. This, of course, has not happened."

B. Monitoring Contractual Performance: Agent-Principal Contracting

Specialization and comparative advantage mean that individuals often find it desirable to hire someone to engage in activities on their behalf. In the jargon of the law-and-economics literature, a **principal** hires an **agent** to do something on his or her behalf. People hire a general contractor to build their house, a real estate agent to sell their house, and a stock broker to buy and sell stocks for them. Shareholders hire managers (officers and directors) to run their corporations. Citizens elect legislators to represent their interests. Professors hire publishing companies to publish their books, and so forth.

These principal-agent contracts are usually executory in the sense that performance takes place some period of time after the agency relationship is created. In order to make sure that the agent does what he has agreed to do, the principal must monitor the agent's performance. This monitoring involves at least three types of costs. First, the principal incurs information costs because information about the agent's performance is scarce and costly to obtain. Second, there are opportunity costs because the principal must spend some time monitoring the agent. Third, the principal often lacks the specialized knowledge to determine whether the agent is in fact doing what he promised to do. In addition to these monitoring costs, there are **agency costs**, which are the costs associated with the agent's ability not to act in the principal's best interest. Agency costs include the costs to the principal of the agent not acting as promised plus the costs incurred by the principal to prevent the agent from deviating from the promised action. Like all economic decisions, the principal has the incentive to monitor his or her agent's behavior up to the point where the marginal cost of additional monitoring is equal to the expected marginal benefit from ensuring that the agent behaves according to their agreement. The existence of positive monitoring costs means that the principal will make a rational decision not to attempt to monitor all of the agent's actions.

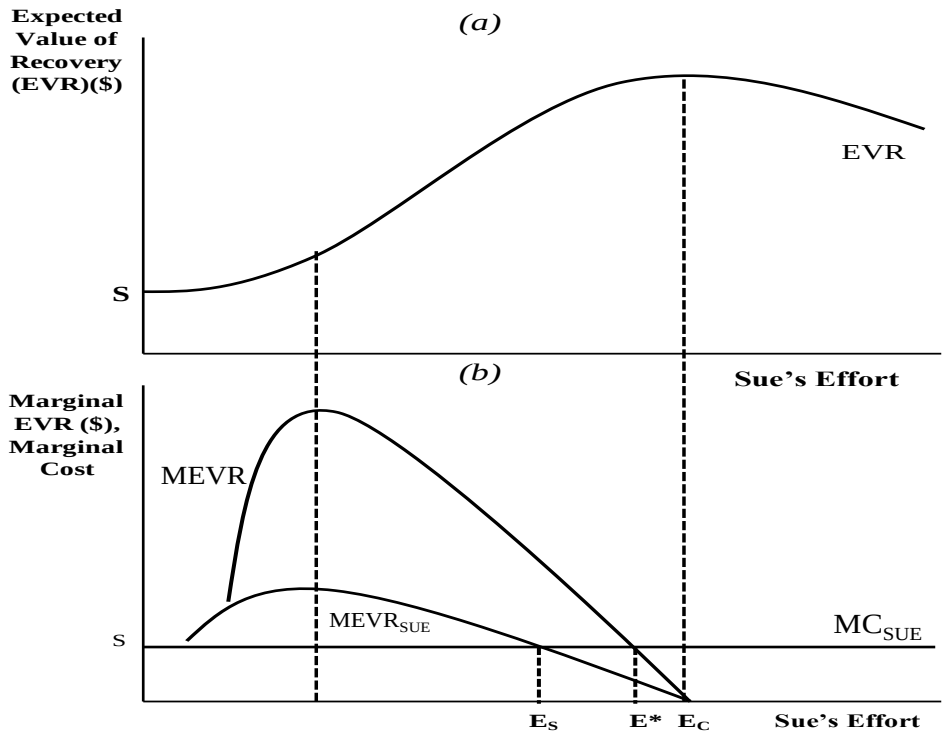
Positive monitoring costs also means that the agent knows that there is a range of activity in which the agent can shirk, or not perform as promised, with little concern about repercussions. Moreover, this incentive to shirk is often exacerbated by the existence of more immediate incentive conflicts between the best interests of the principal and the best interests of the agent. **Agent-principal conflicts** arise when the agent's incentives are not aligned with the principal's interests. Specifically, when the agent acting on behalf of the principal bears costs that the principal does not bear, or when the agent receives benefits that the principal does not receive, the divergence between costs and benefits is likely to drive a wedge between what is best for the agent and what is best for the principal.

Attorney-client relationships are fraught with potential agent-principal conflicts. Consider

the situation of a personal injury lawyer working under a contingent fee. Assume that the client, Charles, has retained the lawyer, Sue, to represent him in a case involving the alleged wrongful death of his wife. Sue is to receive 33.33% of any amount recovered through settlement, trial, or appeal. Sue is an experienced litigator, and she has determined that their chances for success depend on the amount of time and effort that Sue (and her team of associates, clerks, and paralegals) devotes to the case. The defendant's insurance company is pushing for a negotiated settlement prior to trial. The settlement offer is tempting for Sue because one-third of the proposed offer is a guaranteed fee for the firm — it is the proverbial "bird in the hand" — while a potentially larger recovery is speculative and will require much more work by her team. Nevertheless, Sue believes that the additional effort by her team will increase both the dollar amount of future settlement offers and the potential amount awarded after the trial. On the other hand, Sue's continued prosecution of the case involves considerable opportunity cost — her practice is booming and continued work on Charles' case takes her away from other profitable opportunities. Charles is interested only in maximizing his expected value of recovery.

The potential agent-principal conflict can be demonstrated diagrammatically. In Figure V-1 (a), expected value of recovery (EVR) is shown on the vertical axis and Sue's effort (a proxy for the effort of her litigation team) on the horizontal axis. The EVR curve begins at level S because the settlement amount (S) can be recovered without any additional effort. The EVR curve then increases at an increasing rate, but eventually increases at an decreasing rate as the law of diminishing marginal returns sets in, and ultimately begins to decline at E_C. Charles would prefer, and probably expects, Sue to use effort level E_C. However, Sue's incentives are different because she must bear the marginal costs of additional effort by her team. In order to demonstrate this, we need to transform the EVR curve (which depicts *total* EVR) into a marginal curve, MEVR, which is shown in Figure V-1(b).

Figure V-1. Agent-Principal Conflict



Now, consider Sue's decision. Assume, for convenience, that Sue's team has constant marginal costs, or MC_S, in Figure V-1(b). On the margin, Sue expects to recover one-third of Charles' MEVR. In Figure V-1(b), this is shown as $MEVR_S$. Sue will continue devoting effort to this case up to the effort level where her marginal expected value of recovery, $MEVR_S$, is equal to her marginal cost, MC_S. Note that the level of effort that maximizes Sue's EVR is E_S.

The agent-principal conflict is clear. Charles wants Sue to work up to E_C, while Sue wants to work up to E_S. Sue's marginal cost drives a wedge between what is best for her principal and what is best for her team.

At one level of analysis, principal-agent conflicts are simply contracting problems. Informed parties can recognize the potential for conflict and write detailed contracts that specify the precise terms of the principal-agent relationship. For example, Charles could include a clause in his agreement with Sue that requires Sue to act as if her marginal costs were zero. Alternatively, Charles and Sue could negotiate a cost sharing arrangement such that one-third of the MC is paid by Sue and two-thirds is paid by Charles. Arrangements such as these move both parties to E*, where the combined MEVR equals their combined MC. However, negotiating, writing, and enforcing those contracts is a costly endeavor. For example, consider the difficulty of negotiating a contract that allocates a portion of the law firm's overhead costs to this specific case. Because of those transaction costs, not all agency costs will be addressed in the contract.

At another level of analysis, agent-principal conflicts are resolved because the anticipated shirking affects the contract price and, thus, agents have incentives to take steps that convince principals that they will not shirk. Agents who develop a reputation of "going the extra mile" for their principals will likely be more highly valued in the market.

Manufacturers of some types of goods likewise face agency costs when they attempt to distribute their output through separately owned distribution networks. The basic problem is the best interests of the distributors and retailers who handle the manufacturer's goods will not always coincide with the manufacturer's best interests. This conflict of interest presents opportunities for dealers to take opportunistic "free rides" to the detriment of manufacturers.

Whenever the demand for a particular product is positively related to the amount of point-of-sale and post-sale services provided, there exists the possibility of transaction failures caused by free riding. An automobile dealership illustrates the provision of these types of services. The typical dealership provides an elaborate showroom, a trained sales force, large amounts of local advertising, a substantial inventory, and a parts department. Of course, these services are costly for dealers to provide. A dealer (dealer X), therefore, would incur these costs only if there was a reasonable expectation of a larger market share and higher profits. The potential for opportunistic behavior will take the form of dealers "free riding" on the service efforts of other dealers. In other words, dealers will not have the incentive to provide the necessary services when they know that the demand for the product has been increased by the service efforts of other dealers of the same brand.

Consider what would happen if another dealer (dealer Y) selling the same brand, but not providing services, opens a dealership across the street from dealer X. As a result, some of the benefits of X's provision of services will flow to Y, and X's expected return on services will not be realized. Since Y does not provide point-of-sale and post-sale services, his lower costs will enable him to charge a lower price for automobiles. The rational consumer will take advantage of X's showroom services and then cross the street and purchase his car from Y. Clearly, Y is taking a "free ride" on X's provision of services.

A transaction failure, an overall degeneration in the provision of services, is caused by

this intrabrand free-riding behavior. Since X does not capture the benefits of providing services, he will not do so. This reduction in the provision of point-of-sale services, a transaction failure, reduces sales and thus reduces the manufacturer's profits. Consumers are also harmed because they are denied access to valuable services for which they would have been willing to pay. See Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977), *infra*, Chapter VII, and accompanying Notes and Questions.

C. Opportunism: Market and Contractual Solutions

Opportunism has been defined as "self-interest seeking with guile." *See* Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 Journal of Law & Economics 233, 234 n.3 (1979). In more technical terms, opportunism occurs when one party to a transaction recognizes that the other party cannot economically retaliate against post-contractual manipulation of the terms of trade, and then engages in such manipulation in order to effectuate an unexpected transfer of wealth from the other party to himself.

Two examples illustrate the basic phenomenon of opportunistic behavior. First, consider a plaintiff's attorney in a private antitrust action. The plaintiff and the attorney have negotiated a contingent fee contract in which the attorney's fee will equal one-tenth of the total damages award in the case. Suppose the attorney, who has become intimately involved in the case and cannot be replaced on short notice, has presented a very effective case so that prior to final arguments all observers agree that the plaintiff will win the case and recover a substantial treble damages award. However, immediately prior to final arguments, the attorney tells the plaintiff he will intentionally lose the case unless the plaintiff agrees to increase his fee to twenty-five percent. Ignoring for the moment the ethical issues and the legal enforceability of the increase, the plaintiff must meet the attorney's opportunistic demand or lose the case.

As a second example, suppose individual *A* owns a vacant lot and individual *B* wishes to build a house. *A* could lease the lot to *B* for a short time and *B* could build on the lot, but after the lease expires, *A* will be able to engage in opportunism by raising the rent to reflect the costs to *B* of moving the house to another lot. Instead of submitting himself voluntarily to the possibility of such behavior, *B*, a rational individual, may choose to avoid the exchange altogether. Another solution to this problem would be for *B* to purchase the building lot. Conceptually, this would be a form of vertical integration. *See* Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 Journal of Law & Economics 297, 299 (1978) (emphasizing that vertical integration is a means of economizing on costs and avoiding risks of appropriation of quasi-rents in specialized assets by opportunistic individuals). The costs imposed on one trading party by the opportunistic behavior of the other trading party are important components of transaction costs.

Potential victims of opportunism are protected through several types of activities. Other than avoiding the transaction altogether, the following five methods of eliminating or reducing the risk of becoming victims should be emphasized:

1. *Vertical Integration:* It may be possible to avoid the risk of opportunism through vertical integration. In the above examples, the use of an in-house attorney and the purchase of the building lot would avoid the possibility of opportunism.
2. *Price Adjustment:* The potential victim may adjust the initial price to deter the occurrence of the opportunism. For example, if the attorney's initial fee in the first example had been twenty instead of ten percent, then the attorney's opportunistic

threat would have been less credible because the attorney would have had more to lose, now a potential twenty percent instead of ten, had he "thrown" the case.

3. *Brand Name:* Adverse market adjustments may prevent a substantial portion of myopic opportunism. The future value of the attorney's services, for example, will surely diminish as a result of his opportunistic fee manipulation. A lawyer, like a manufacturer, has an economic incentive to establish and maintain a good reputation, a lawyer's "brand name."
4. *Implicit Contracts:* Although potential victims may have signed relatively simple contracts, they can rely on implicit contract terms based on legal principles that do not allow for the enforcement of certain types of post-contractual modifications. For example, the attorney's opportunistic modification may not be enforceable under the pre-existing duty rule.
5. *Explicit Contracts:* The parties can agree to and write a complete, fully specified contingent contract and rely on the courts to enforce the agreement. For example, the landowner and the homeowner could specify contractually how the future rent is to be determined upon expiration of the initial lease.

These methods will not act as a complete deterrent to opportunism in all circumstances. After all, contracting parties will invest in controlling opportunism only up to the point where the expected marginal benefit is equal to the marginal cost — but they can substantially reduce the risks associated with many transactions.

1. Firm-Specific Investments and the Appropriation of Quasi-Rents

Transaction failures in procurement and production resulting from opportunistic behavior are most likely to occur when firms become specialized with respect to each other. A major reason firms invest in assets that are specialized when compared to the assets of other firms is to gain the technological advantages of coordinated or joint production processes. The cost savings generated from the improvement in productive efficiency are called "appropriable quasi-rents." These "quasi-rents" represent wealth that is potentially appropriable by an opportunistic party.

One form of opportunism involves the post-contractual manipulation of transfer prices by a supplier and a manufacturer who have become specialized to each other. Consider the example of steel production. The fabrication of steel products requires the shaping of molten steel. If fabrication facilities are located near the point where steel ingots are cast, production efficiency is improved by the reduced cost of transporting and reheating ingots. However, obtaining these technical efficiencies does not require joint ownership of the steel ingots facilities, only physical proximity. Yet ingot casting and fabrication facilities are often commonly owned and vertically integrated because, in the absence of integration, opportunism between separate ingot casting and steel fabrication firms would preclude technical efficiency.

This proposition is easily demonstrated. Imagine that an ingot producer builds an ingot casting plant that is physically integrated with a steel fabricating facility owned by another firm. These separately owned facilities are designed to work together; each is highly specialized to the other. As a result, there are no other ingot facilities that can supply cast steel to the fabricator as cheaply as the caster, and no other fabrication plant that can make steel products from the ingot producer's castings as cheaply as the specialized fabricator. Under these circumstances, opportunistic price manipulation can occur with respect to the transfer price for ingot. If the transfer price of the ingot is greater than the going market price of cold delivered ingot (of

comparable quality) plus the costs associated with reheating it, the purchaser can threaten to go to the outside supply source unless the ingot casting plant lowers its price. The price could be forced below the market price plus the cost of reheating, but the ingot caster need not take less than market price of cold ingot. Thus a bargaining range exists that, depending upon circumstances, can leave one of the firms with a much lower than expected rate of return on the investment. More importantly, this uncertainty about the division of the technical cost savings and the rate of return on investment can have an adverse impact on investment behavior.

In the steel example, it was assumed that the ingot and fabrication plants were already built in close physical proximity. The most important transaction failure occurs, however, when the *prospect* of opportunism leads a firm not to become as specialized. Although individuals may agree in advance to split the cost savings, each knows that the other may renege *once the plants are built.* Once this occurs, the next best alternative is poor. Thus, each firm becomes subject to opportunistic behavior if it leaves the eventual outcome solely to market-mediated exchange. Opportunistic appropriation of quasi-rents, however, rarely interferes with a market-mediated exchange, because firms have developed nonmarket or market-suppressing solutions in response to potential transaction failures. In this regard, the transaction costs that would have led to transaction failures are replaced by negotiation and search costs.

Lake River Corp. v. Carborundum Co.

United States Court of Appeals for the Seventh Circuit

769 F.2d 1284 (1985)

POSNER, Circuit Judge.

This diversity suit between Lake River Corporation and Carborundum Company requires us to consider questions of Illinois commercial law, and in particular to explore the fuzzy line between penalty clauses and liquidated-damages clauses.

Carborundum manufactures "Ferro Carbo," an abrasive powder used in making steel. To serve its midwestern customers better, Carborundum made a contract with Lake River by which the latter agreed to provide distribution services in its warehouse in Illinois. Lake River would receive Ferro Carbo in bulk from Carborundum, "bag" it, and ship the bagged product to Carborundum's customers. The Ferro Carbo would remain Carborundum's property until delivered to the customers.

Carborundum insisted that Lake River install a new bagging system to handle the contract. In order to be sure of being able to recover the cost of the new system ($89,000) and make a profit of 20 percent of the contract price, Lake River insisted on the following minimum-quantity guarantee:

> In consideration of the special equipment [i.e., the new bagging system] to be acquired and furnished by LAKE-RIVER for handling the product, CARBORUNDUM shall, during the initial three-year term of this Agreement, ship to LAKE-RIVER for bagging a minimum quantity of [22,500 tons]. If, at the end of the three-year term, this minimum quantity shall not have been shipped, LAKE-RIVER shall invoice CARBORUNDUM at the then prevailing rates for the difference between the quantity bagged and the minimum guaranteed.

If Carborundum had shipped the full minimum quantity that it guaranteed, it would have owed Lake River roughly $533,000 under the contract.

After the contract was signed in 1979, the demand for domestic steel, and with it the demand for Ferro Carbo, plummeted, and Carborundum failed to ship the guaranteed amount.

When the contract expired late in 1982, Carborundum had shipped only 12,000 of the 22,500 tons it had guaranteed. Lake River had bagged the 12,000 tons and had billed Carborundum for this bagging, and Carborundum had paid, but by virtue of the formula in the minimum-guarantee clause Carborundum still owed Lake River $241,000 — the contract price of $533,000 if the full amount of Ferro Carbo had been shipped, minus what Carborundum had paid for the bagging of the quantity it had shipped.

When Lake River demanded payment of this amount, Carborundum refused, on the ground that the formula imposed a penalty. At the time, Lake River had in its warehouse 500 tons of bagged Ferro Carbo, having a market value of $269,000, which it refused to release unless Carborundum paid the $241,000 due under the formula. Lake River did offer to sell the bagged product and place the proceeds in escrow until its dispute with Carborundum over the enforceability of the formula was resolved, but Carborundum rejected the offer and trucked in bagged Ferro Carbo from the East to serve its customers in Illinois, at an additional cost of $31,000.

Lake River brought this suit for $241,000, which it claims as liquidated damages. Carborundum counterclaimed for the value of the bagged Ferro Carbo when Lake River impounded it and the additional cost of serving the customers affected by the impounding. The theory of the counterclaim is that the impounding was a conversion, and not as Lake River contends the assertion of a lien. The district judge, after a bench trial, gave judgment for both parties. Carborundum ended up roughly $42,000 to the good: $269,000 + $31,000 - $241,000 - $17,000, the last figure representing prejudgment interest on Lake River's damages. (We have rounded off all dollar figures to the nearest thousand.) Both parties have appealed.

The only issue that is not one of damages is whether Lake River had a valid lien on the bagged Ferro Carbo that it refused to ship to Carborundum's customers — that, indeed, it holds in its warehouse to this day. Although Ferro Carbo does not deteriorate with age, the domestic steel industry remains in the doldrums and the product is worth less than it was in 1982 when Lake River first withheld it. If Lake River did not have a valid lien on the product, then it converted it, and must pay Carborundum the $269,000 that the Ferro Carbo was worth back then.

* * *

[The court held that Lake River's asserted lien was not a lien.]

The hardest issue in the case is whether the formula in the minimum-guarantee clause imposes a penalty for breach of contract or is merely an effort to liquidate damages. Deep as the hostility to penalty clauses runs in the common law, we still might be inclined to question, if we thought ourselves free to do so, whether a modern court should refuse to enforce a penalty clause where the signator is a substantial corporation, well able to avoid improvident commitments. Penalty clauses provide an earnest of performance. The clause here enhanced Carborundum's credibility in promising to ship the minimum amount guaranteed by showing that it was willing to pay the full contract price even if it failed to ship anything. On the other side it can be pointed out that by raising the cost of a breach of contract to the contract breaker, a penalty clause increases the risk to his other creditors; increases (what is the same thing and more, because bankruptcy imposes "deadweight" social costs) the risk of bankruptcy; and could amplify the business cycle by increasing the number of bankruptcies in bad times, which is when contracts are most likely to be broken. But since little effort is made to prevent businessmen from assuming risks, these reasons are no better than makeweights.

A better argument is that a penalty clause may discourage efficient as well as inefficient breaches of contract. Suppose a breach would cost the promisee $12,000 in actual damages but

would yield the promisor $20,000 in additional profits. Then there would be a net social gain from breach. After being fully compensated for his loss the promisee would be no worse off than if the contract had been performed, while the promisor would be better off by $8,000. But now suppose the contract contains a penalty clause under which the promisor if he breaks his promise must pay the promisee $25,000. The promisor will be discouraged from breaking the contract, since $25,000, the penalty, is greater than $20,000, the profits of the breach; and a transaction that would have increased value will be forgone.

On this view, since compensatory damages should be sufficient to deter inefficient breaches (that is, breaches that cost the victim more than the gain to the contract breaker), penal damages could have no effect other than to deter some efficient breaches. But this overlooks the earlier point that the willingness to agree to a penalty clause is a way of making the promisor and his promise credible and may therefore be essential to inducing some value-maximizing contracts to be made. It also overlooks the more important point that the parties (always assuming they are fully competent) will, in deciding whether to include a penalty clause in their contract, weigh the gains against the costs — costs that include the possibility of discouraging an efficient breach somewhere down the road — and will include the clause only if the benefits exceed those costs as well as all other costs.

On this view the refusal to enforce penalty clauses is (at best) paternalistic — and it seems odd that courts should display parental solicitude for large corporations. But however this may be, we must be on guard to avoid importing our own ideas of sound public policy into an area where our proper judicial role is more than usually deferential. The responsibility for making innovations in the common law of Illinois rests with the courts of Illinois, and not with the federal courts in Illinois. And like every other state, Illinois, untroubled by academic skepticism of the wisdom of refusing to enforce penalty clauses against sophisticated promisors, see, e.g., Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle*, 77 Colum. L. Rev. 554 (1977), continues steadfastly to insist on the distinction between penalties and liquidated damages. To be valid under Illinois law a liquidation of damages must be a reasonable estimate at the time of contracting of the likely damages from breach, and the need for estimation at that time must be shown by reference to the likely difficulty of measuring the actual damages from a breach of contract after the breach occurs. If damages would be easy to determine then, or if the estimate greatly exceeds a reasonable upper estimate of what the damages are likely to be, it is a penalty.

The distinction between a penalty and liquidated damages is not an easy one to draw in practice but we are required to draw it and can give only limited weight to the district court's determination. . . .

Mindful that Illinois courts resolve doubtful cases in favor of classification as a penalty, we conclude that the damage formula in this case is a penalty and not a liquidation of damages, because it is designed always to assure Lake River more than its actual damages. The formula — full contract price minus the amount already invoiced to Carborundum — is invariant to the gravity of the breach. When a contract specifies a single sum in damages for any and all breaches even though it is apparent that all are not of the same gravity, the specification is not a reasonable effort to estimate damages; and when in addition the fixed sum greatly exceeds the actual damages likely to be inflicted by a minor breach, its character as a penalty becomes unmistakable. This case is within the gravitational field of these principles even though the minimum-guarantee clause does not fix a single sum as damages.

Suppose to begin with that the breach occurs the day after Lake River buys its new

bagging system for $89,000 and before Carborundum ships any Ferro Carbo. Carborundum would owe Lake River $533,000. Since Lake River would have incurred at that point a total cost of only $89,000, its net gain from the breach would be $444,000. This is more than four times the profit of $107,000 (20 percent of the contract price of $533,000) that Lake River expected to make from the contract if it had been performed: a huge windfall.

Next suppose (as actually happened here) that breach occurs when 55 percent of the Ferro Carbo has been shipped. Lake River would already have received $293,000 from Carborundum. To see what its costs then would have been (as estimated at the time of contracting), first subtract Lake River's anticipated profit on the contract of $107,000 from the total contract price of $533,000. The difference — Lake River's total cost of performance — is $426,000. Of this, $89,000 is the cost of the new bagging system, a fixed cost. The rest ($426,000 - $89,000 = $337,000) presumably consists of variable costs that are roughly proportional to the amount of Ferro Carbo bagged; there is no indication of any other fixed costs. Assume, therefore, that if Lake River bagged 55 percent of the contractually agreed quantity, it incurred in doing so 55 percent of its variable costs, or $185,000. When this is added to the cost of the new bagging system, assumed for the moment to be worthless except in connection with the contract, the total cost of performance to Lake River is $274,000. Hence a breach that occurred after 55 percent of contractual performance was complete would be expected to yield Lake River a modest profit of $19,000 ($293,000 - $274,000). But now add the "liquidated damages" of $241,000 that Lake River claims, and the result is a total gain from the breach of $260,000, which is almost two and a half times the profit that Lake River expected to gain if there was no breach. And this ignores any use value or salvage value of the new bagging system, which is the property of Lake River — though admittedly it also ignores the time value of money; Lake River paid $89,000 for that system before receiving any revenue from the contract.

To complete the picture, assume that the breach had not occurred till performance was 90 percent complete. Then the "liquidated damages" clause would not be so one-sided, but it would be one-sided. Carborundum would have paid $480,000 for bagging. Against this, Lake River would have incurred its fixed cost of $89,000 plus 90 percent of its variable costs of $337,000 or $303,000. Its total costs would thus be $392,000, and its net profit $88,000. But on top of this it would be entitled to "liquidated damages" of $53,000, for a total profit of $141,000 — more than 30 percent more that its expected profit of $107,000 if there was no breach.

The reason for these results is that most of the costs to Lake River of performing the contract are saved if the contract is broken, and this saving is not reflected in the damage formula. As a result, at whatever point in the life of the contract a breach occurs, the damage formula gives Lake River more than its lost profits form the breach — dramatically more if the breach occurs at the beginning of the contract; tapering off at the end, it is true. Still, over the interval between the beginning of Lake River's performance and nearly the end, the clause could be expected to generate profits ranging from 400 percent of the expected contract profits to 130 percent of those profits. And this is on the assumption that the bagging system has no value apart from the contract. If it were worth only $20,000 to Lake River, the range would be 434 percent to 150 percent.

* * *

. . . [I]t is apparent from the face of the contract that the damages provided for by the "liquidated damages" clause are grossly disproportionate to any probable loss and penalize some breaches much more heavily than others regardless of relative cost. . . .

* * *

The fact that the damage formula is invalid does not deprive Lake River of a remedy. The parties did not contract explicitly with reference to the measure of damages if the agreed-on damage formula was invalidated, but all this means is that the victim of the breach is entitled to his common law damages. In this case that would be the unpaid contract price of $241,000 minus the costs that Lake River saved by not having to complete the contract (the variable costs on the other 45 percent of the Ferro Carbo that it never had to bag). The case must be remanded to the district judge to fix these damages.

* * *

The judgment of the district court is affirmed in part and reversed in part, and the case is returned to that court to redetermine both parties' damages in accordance with the principles in this opinion. The parties may present additional evidence on remand, and shall bear their own costs in this court.

Notes and Questions

1. Firm-Specific Investment, Forfeitable Reputational Bonds and Penalty Clauses: Firm-specific investment, reputation, brand name, advertising, etc., all play important roles in ensuring contractual performance. Consider the negotiations between Lake River and Carborundum. Carborundum induced Lake River to make a contract-specific investment in the bagging system. (Obviously, the system could be used to bag other products, but its most valuable use to Lake River and, indeed, the reason for the investment, was to bag Ferro Carbo.) Apparently, Carborundum did not have any other distributors of Ferro Carbo and, therefore, probably did not have a well-developed reputation for good faith dealing with distributors. In economic terms, Carborundum did not have a forfeitable reputational bond to ensure its performance after Lake River made the investment and, thus, Lake River would not have been willing to make the contract-specific investment unless Carborundum could bond its performance. In this regard, a penalty stipulated damages clause is a substitute for a reputational bond because both carry substantial penalties for nonperformance. Thus, because Carborundum could not bond its performance with a well-developed (yet forfeitable) reputational bond, it convinced Lake River to make the investment by offering a penalty clause. A major difference between the reputational bond and the penalty clause is that the reputational bond penalty is not paid to the promisee and, thus, there is no incentive to induce breach. Does this analysis suggest that penalty clauses such as the one in Lake River should be evaluated in terms of their overall economic context — for example, should the absence of a reputational bond be taken into account?

2. Unenforceable Penalty Clauses: Efficiency or Paternalism?: The distinction between enforceable and unenforceable penalty clauses is interesting from a policy perspective. A stipulated damage clause that amounts to a penalty may merely reflect the promisee's very strong desire to have the project finished on schedule. Moreover, it seems unreasonable to suspect that the inclusion of a penalty clause does not impact other terms in the contract, including the negotiation of the completion date and the total value of the contract. Thus, the refusal of the common law courts to enforce penalty clauses appears to be based on some type of paternalistic notion. On the other hand, it has been suggested that the distinction between penalty clauses and reasonable damage clauses is justified on efficiency grounds because penalty clauses create perverse incentives for the beneficiary of the clauses to induce the breach of the contract in order to collect the penalty. Consider the following analysis:

> An important cost of stipulated damage clauses . . . results from activities that

may induce breach and from activities to prevent breach inducement, both of which waste scarce resources. Consider, for example, a contract to build a bridge with a stipulated damage clause of $500 for each day of delay beyond a specified completion date chosen to correspond with the first day that the purchaser expects to use the bridge. If the clause is carefully drafted, the $500 will closely approximate the expected damage to the purchaser from the actual delay. Suppose, however, that during construction (or, for that matter, even at the time of the initial contract) the cost of delay to the purchaser becomes zero because the bridge could not be used until much later than originally planned. Since the producer's breach would now actually improve the purchaser's position, the purchaser has an incentive to undertake activities to cause delay as long as the additional expected revenues from creating delay ($500 multiplied by the number of days of delay) exceed the additional costs. . . . [E]ven if all stipulated damage clauses are enforced, the incentive to induce breach would exist only when the potential breach-inducer knows that actual damages will be less than the stipulated amount. This may occur either at the time of initial contracting or, more likely, at some time during performance when circumstances change, affecting the likely amount of damages upon breach. When the incentive for breach inducement is present, a further cost could be incurred since the producer might devote time and resources to detect and prevent possible breach-inducing activities. This may entail additional personnel to acquire information about the purchaser or to monitor activities of the purchaser.

Resources spent both on breach-inducing activities and on detecting and preventing breach inducement are wasteful. They do not produce any real good or service that the contracting parties value, nor do they move resources to production of goods or services whose value is greater than to the contracting parties. Accordingly, the value of *all* resources expended in inducement is wasted and increases the costs of forming, completing, and monitoring the contract. Such expenditures, like those employed to defraud others, are merely necessary inputs in obtaining the benefits from induced breach and, again, like real resources spent to defraud, contribute to overall costs without producing real products. If these costs could be avoided while retaining the desirable outcomes of stipulated damage clauses (and without incurring any new costs), contracting parties as a group, and hence society, would gain.

Besides incentive, the potential breach-inducer needs opportunity before he will induce breach. Since detected inducement would result in nonenforcement of the clause, thereby removing the incentive to waste resources, breach inducement will present special difficulties only when the courts are unable to detect it easily. The opportunity to induce breach does arise, however, in situations where inducement is exceedingly costly to detect, particularly where the producer's performance depends at least in part upon the purchaser's cooperation and assistance. For example, a party may intentionally withhold useful information for a critical period of time, yet still comply with the contract. Thus, in our bridge hypothetical, the purchaser may withhold certain information whose existence or source is not known to the producer, such as information about difficult construction conditions. Further, if the contract calls for close cooperation with respect to the building specifications, the purchaser may delay (or become unexpectedly "fussy") in providing assistance necessary to complete construction on time. It may also be possible to supply information or resources that are clearly inferior but within the limits of the contract. Purchasing parties may even provide misleading or erroneous data, such as on the

> condition of the river bed soil in the bridge case. . . .
>
> Although the policy underlying the distinction has baffled the legal community, for hundreds of years courts have categorized stipulated damage clauses as either liquidated damages or penalties. Finding the previous explanations of this distinction to be unsatisfactory, we have asked whether economic efficiency could justify nonenforcement of stipulated damages in certain situations, and, if so, whether the justification could explain the results, if not the reasoning, of the reported decisions. The answer to both questions supports an economic distinction between liquidated damages and penalties. Through a broad, poorly articulated reasonableness test, the courts appear to have attained efficient results. . . .

Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 Wisconsin Law Review 351, 368–372, 378. Do the facts in *Lake River* suggest that the breach was induced by Lake River? The court clearly demonstrates the incentive for Lake River to breach, but did Lake River have the opportunity to induce breach? Given that the court recognized the penal nature of the stipulated damages clause, isn't it reasonable to assume that the contracting parties recognized this as well and took it into account in their initial negotiations over price and other terms?

3. Opportunistic Renegotiation and Appropriable Quasi-Rents: Exchanges between individuals or firms often require that the parties invest in an asset that is transaction specific. That is, the value of the asset in question is clearly maximized when used for the specific purpose called for in the transaction. These types of assets are highly specialized, meaning that the asset's value in its current use far exceeds its next best alternative. Thus, an attempt to switch specialized assets from one use to another can involve substantial costs to the owner. In a sense, parties who invest in specialized assets are "locked into" the deal and part of the investment can be appropriated by the other contracting party. The notion of "appropriable quasi-rents" has been developed as follows:

> Assume an asset is owned by one individual and rented to another individual. The quasi-rent value of the asset is the excess of its value over its salvage value, that is, its value in its next best *use* to another renter. The potentially appropriable specialized portion of the quasi-rent is that portion, if any, in excess of its value to the second highest-valuing *user*.

Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 Journal of Law & Economics 297, 298 (1978) (emphasis in original.). When parties are required to bring a specialized asset to the exchange, each has an incentive to take advantage of the other party — the so called **"hold-up" problem**. The buyer can refuse to accept unless the price is reduced and the seller can refuse to deliver unless the price is increased. The buyer will be able to extort a price discount equal to the difference between the agreed upon price and the value of the specialized asset in its next best use. Likewise, the seller can extort a price increase equal to the difference between the agreed upon price and the cost to the buyer of finding a new supplier. This difference, which is the asset owners' quasi-rent, can be opportunistically appropriated. Individuals who bring specialized assets to a transaction desire protection from others' opportunistic behavior. That is, the owners of specialized assets will seek out devices to protect their quasi-rents from being appropriated or "held-up." Klein, Crawford, and Alchian give a numerical example of the determination of the opportunistic post-contractual bargaining range:

> Imagine a printing press owned and operated by party A. Publisher B buys printing services from party A by leasing his press at a contracted rate of $5,500 per day. The

> amortized fixed cost of the printing press is $4,000 per day and it has a current salvageable value if moved elsewhere of $1,000 (daily rental equivalent). Operating costs are $1,500 and are paid by the printing-press owner, who prints final printed pages for the publisher. Assume also that a second publisher C is willing to offer at most $3,500 for daily services. The current quasi rent on the installed machine is $3,000 ($5,500 - $1,500 - $1,000), the revenue minus operating costs minus salvageable value. However, the daily quasi rent from publisher B relative to use of the machine for publisher C is only $2,000 ($5,500 - $3,500). At $5,500 revenue daily from publisher B the press owner would break even on his investment. If the publisher were then able to cut his offer for the press from $5,500 down to almost $3,500, he would still have the press service available to him. He would be appropriating $2,000 of the quasi rent from the press owner. The $2,000 difference between his prior agreed-to-daily rental of $5,500 and the next best revenue available to the press once the machine is purchased and installed is less than the quasi rent and therefore is potentially appropriable. If no second party were available at the present site, the entire quasi rent would be subject to threat of appropriation by an unscrupulous or opportunistic publisher.

Klein et al., *supra*, at 298–99.

4. Deterrence of Efficient Breaches: The court summarizes one economic view of penalty clauses as follows: "[S]ince compensatory damages should be sufficient to deter inefficient breaches (that is, breaches that cost the victim more than the gain to the contract breaker), penal damages could have no effect other than to deter some efficient breaches." Does the potential forfeiture of a reputational bond deter efficient breaches, that is, does it lead to "inefficient performance?"

2. Franchising

Manufacturers, restaurant franchisors, nationwide tax preparation services, and many other providers of goods and services often rely on a system of wholesale distributors and retailers to move their goods and services to consumers. A wide variety of distribution systems are used. Obviously, grocery stores, department stores, and discount stores carry many different competing brands of goods. At the other end of the continuum is the franchisee that represents only one brand, say McDonald's.

Consider the possibilities for opportunism in a successful franchised motel chain. The franchisor's trademark — which is the franchisor's most important asset — signals to consumers a specific standard of quality, service, and rates. Individual franchisees must undertake expenditures if they wish to maintain these attributes. The possibility for opportunistic behavior arises because customers base their decision to stay at franchised motels on their experiences with other motels in the chain. This gives an individual franchisee the incentive to engage in free-riding by shirking on expenditures on quality because he will continue to attract customers who, based on their experience with other motels in the chain, expect to receive, and are willing to pay for, the higher quality. The free-riding franchisee benefits by the entire amount of his savings on expenditures and bears only a portion of the costs, which is shared by the franchisor and the other franchisees through the decreased value of the trademark. Consumers, of course, are also injured.

Similarly, the franchisor has opportunities to engage in opportunistic behavior because the franchisee is required to make transaction-specific investments, including payment of an initial franchise fee, which are potentially appropriable by the franchisor. For example,

McDonald's franchisees must make considerable McDonald's-specific investments in the building, equipment, and training. These investments, which are of little value if not used in a McDonald's franchise, make the franchisee vulnerable to extortion by the franchisor. Moreover, franchisors often include a clause allowing for unilateral "at will" termination of the franchise arrangement. The "at will" clause might enable the franchisor to engage in opportunistic behavior by terminating a franchisee without cause, thereby appropriating the franchise fee and purchasing the franchise rights at a distress price. Thus, the typical franchise contract appears to be "unfair" to the franchisees. However, it is important to remember that the franchise relationship is founded on a mutually beneficial exchange. With these economic concepts in mind, evaluate the relative economic positions of the contracting parties in the following case.

Corenswet, Inc. v. Amana Refrigeration, Inc.
United States Court of Appeals for the Fifth Circuit
594 F.2d 129 (1979)

Wisdom, J.
* * *

I.

The primary facts are not disputed.

The plaintiff, Corenswet, Inc., is an independent wholesale distributor of appliances, dishware, and similar products. Since 1969 Corenswet has been the exclusive distributor of Amana refrigerators, freezers, room air conditioners, and other merchandise in southern Louisiana. Amana is a Delaware corporation domiciled in Iowa. Under the Amana system, products manufactured by Amana are sold to wholesale distributors such as Corenswet and to Amana's factory wholesale branches. The independent distributors and the factory branches then resell the merchandise to retail dealers who, in turn, sell to the public. The first distributorship agreement executed between Amana and Corenswet was of indefinite duration, but terminable by either party at any time "with or without cause" on ten days' notice to the other party. According to the record, the agreement was modified twice, in 1971 and again in July 1975, before the institution of this lawsuit. The 1975 agreement modified the termination provision to allow termination by either party "at any time for any reason" on ten days' notice.

As is so often the case with franchise and distributorship relationships, the termination clause in the standard form contract was of little interest or concern to the parties so long as things were going well between them. At the hearing before the district court, Corenswet introduced testimony that it understood, in the early 1970's, that the relationship would be a lasting one, a relationship that would continue so long as Corenswet performed satisfactorily. According to Corenswet, it developed an organization for wholesale distribution of Amana merchandise: it hired a manager and salesmen for the line, as well as specially trained repairmen. Corenswet also expanded its physical plant. In all, Corenswet contended, it invested over $1.5 million over the period of 1969 to 1976 in developing the market for Amana products in the southern Louisiana area. The parties stipulated in district court that the annual sales of Amana products in the distributorship area increased from $200,000 in 1969 to over $2.5 million in 1976. The number of retail outlets selling Amana products in the area increased from six in 1969 to seventy-two in 1976. Corenswet, in short, developed an important new market for Amana products. And Amana became as important to Corenswet as Corenswet became to Amana: sales of Amana products as a percentage of Corenswet's total sales of all products swelled from six percent in 1969 to nearly twenty-six percent in 1976. Over the seven and one-half-year period,

Amana representatives repeatedly praised Corenswet for its performance.

At the 1976 mid-year meeting of Amana distributors, however, George Foerstner, Amana's president, informed Corenswet that Amana would soon terminate its relationship with Corenswet because Corenswet was underfinanced. The parties agree that in early 1976 Corenswet had exceeded its credit limit with Amana, and that Amana at that time indicated that it might have to take a security interest in Corenswet's Amana inventory. According to a January communication from Amana, however, the "problem" was viewed by Amana as "a good kind of problem," reflecting, as it did, the growth of Corenswet's sales and hence purchases of Amana products. It is Corenswet's contention that the problem was not a serious one. Amana executives, the record reflects, assured Corenswet at the 1976 mid-year meeting that "satisfactory arrangements would be made" and that, Foerstner's statement notwithstanding, Corenswet would retain its distributorship.

There followed a complicated sequence of negotiations concerning Amana's security for credit extended. Amana sought a security interest in Corenswet's Amana inventory, to which Corenswet agreed. Amana asked also that Corenswet obtain more working capital from its parent corporation, Select Brands, Inc., as well as a bank letter of credit or line of credit. There is ample evidence in the record that Corenswet responded adequately to each Amana request, but that Amana persisted in changing its requirements as quickly as Corenswet could respond to its requests. In September, 1976, Corenswet met in New Orleans with Amana's representative, George Tolbert. Sam Corenswet, the company's president, informed Tolbert that Corenswet was ready and able to meet Amana's latest request: a $500,000 bank letter of credit. Tolbert relayed the information to Foerstner. Within a week Corenswet received a letter, prepared by Tolbert at Foerstner's direction, notifying Corenswet of its decision to terminate the distributorship because Corenswet was "unable to provide us with what we felt to be the minimum guarantees and/or security to sustain a continuing pattern of growth with Amana."

In October 1976, Corenswet filed suit for damages and injunctive relief in state court alleging that Amana had breached the distributorship agreement by terminating it arbitrarily. The reasons given by Amana for the termination, it contended, were pretextual. The state court issued a temporary restraining order barring termination. The TRO was retained in force after Amana removed the case to federal district court.

The district court conducted a three-day hearing on Corenswet's prayer for a preliminary injunction. The court concluded that Amana had indeed acted arbitrarily in deciding to terminate Corenswet. The record reflects that in early 1976, well before the mid-year distributor meeting, Amana began negotiating with another New Orleans concern, George H. Lehleitner & Co., about transferring its area distributorship to Lehleitner. The beginning of Amana's alleged concern over Corenswet's finances corresponded neatly with its Lehleitner negotiations. There was ample evidence in the record, moreover, to support the district court's conclusion that the real factor motivating Foerstner's decision was animosity towards Fred Schoenfeld, the president of Corenswet's parent corporation, Select Brands, Inc. That animosity dated back to 1972, when Schoenfeld's action in protesting to Raytheon Corporation, Amana's parent, aborted Amana's attempt to transfer the distributorship from Corenswet to Corenswet's then Amana sales manager.

The district court ruled that the arbitrary termination was a breach of the distributorship agreement. The court rejected Amana's argument that the termination clause, which permitted either party to terminate the contract "for any reason," permitted termination for any reason be that reason good, bad, or indifferent. Although unwilling to accept Corenswet's position that the term "for any reason" imported a good or just cause limitation, the court ruled that the term

means "for some reason, not for no reason . . . for something that appeals to the reason, to the mind, to the judgment, not for something that is arbitrary, capricious or wanton." In the alternative, the court ruled that the U.C.C.'s "good faith" principle forbids the bad faith termination of exclusive distributorships and found Amana's actions to have been in bad faith. The court issued the preliminary injunction prohibiting Amana from terminating or attempting to terminate the relationship in November 1976.

In late 1977, Corenswet filed a declaratory judgment action in response to Amana's request that Corenswet sign the new standard form distributorship agreement. . . . In September of 1977, Amana filed a motion requesting the court to modify or vacate the preliminary injunction to permit Amana to terminate the distributorship. Amana urged that Corenswet's refusal to execute the new distributorship agreement was sufficient cause or reason under the existing agreement and the injunction to justify termination of Corenswet's distributorship. The court denied Amana's motion, but amended the injunction to require Corenswet to execute the agreement within five days or suffer termination of the agreement, and to place restrictions on Amana's rights to refuse to renew the one-year term of the new agreement. The modification of the injunction, entered in November 1977, forbade Amana to refuse to renew the distributorship term "without reason" and enjoined Amana to accord Corenswet equal treatment with Amana's other distributors.

II.

* * *

Amana asserts that the district court erred in construing the contract's termination clause to prohibit unilateral termination of the distributorship except for some "reason" that appeals to the mind. The contractual language "for any reason," it argues, was intended to remove all limitations upon the exercise of the termination power. Because the district court looked to extrinsic evidence in construing the contract its interpretation is, under Iowa law, treated as a factual one. Amana, therefore, has the burden of persuading us that the court's interpretation was clearly erroneous.

* * *

The starting point . . . is the express terms of the agreement. Under the contract, Amana was free to terminate the relationship "at any time and for any reason." The district court did not expressly rely on record evidence concerning the parties' understanding or the common understanding of the term "any reason" in concluding that the term means "something that appeals to the reason, to the mind." In the common understanding, it seems to us, the phrase "for any reason" means "for any reason that the actor deems sufficient." The phrase, that is, is ordinarily used not to limit a power, but to free it from implied limitations of "cause." That this is the intendment of the phrase becomes all the more clear when it is read in conjunction with the immediately preceding phrase "at any time." That phrase plainly frees the termination power from limitations as to timing. The exact parallelism of the two phrases reinforces the interpretation of the "any reason" language as negating any limitations whatsoever. . . .

* * *

. . . Amana never conceded that it needed a justification, in the sense of a reason grounded in Corenswet's conduct, for ending the relationship. Even if it is assumed that Amana needed "some reason" to terminate the contract, that reason is supplied by its evident desire to give the New Orleans distributorship to the Lehleitner company, just as we think that Corenswet would, under the contract, be entitled to terminate the relationship by reason, to take an example, of its wish to handle Kelvinator, rather than Amana, products.

* * *

We take Corenswet to be arguing that the contractual language must be interpreted in light of Amana's historical treatment of Corenswet and its other distributors. . . . In this case, however, no reasonable construction can reconcile the contract's express terms with the interpretation Corenswet seeks to glean from the conduct of the parties. The conflict could not be more complete: Amana's past conduct, with regard both to Corenswet and to its other distributors, may have created a reasonable expectation that Amana would not terminate a distributor arbitrarily, yet the contract expressly gives Amana the right to do so. We can find no justification, except in cases of conduct of the sort giving rise to promissory estoppel, for holding that a contractually reserved power, however distasteful, may be lost through nonuse. The express contract term cannot be construed as Corenswet would constitute it, and it therefore controls over any allegedly conflicting usage or course of dealing.

The district court's alternative rationale was that arbitrary termination of a distributorship agreement contravenes the Code's general obligation of good faith dealing. . . .

* * *

The parties have not cited and we have not found Iowa cases on the issue decided under the Uniform Commercial Code. The Iowa case law on this question is pre-Code and follows the common law rule, which is essentially [that "[w]here the contract provides for successive performance but is indefinite in duration it is valid for a reasonable time but unless otherwise agreed may be terminated at any time by either party."]

* * *

. . . When a contract contains a provision expressly sanctioning termination without cause there is no room for implying a term that bars such a termination. In the face of such a term there can be, at best, an expectation that a party will decline to exercise his rights.

As a tool for policing distributorship terminations, moreover, the good faith test is erratic at best. It has been observed that the good faith approach "is analytically unsound because there is no necessary correlation between bad motives and unfair terminations. . . . The terminated dealer seeks relief against the harsh effects of termination which may be unfairly placed on him, not against the manufacturer's ill will." The better approach . . . is to test the disputed contract clause for unconscionability. . . . The question these cases present is whether public policy forbids enforcement of a contract clause permitting unilateral termination without cause. Since a termination without cause will almost always be characterizable as a "bad faith" termination, focus on the terminating party's state of mind will always result in the invalidation of unrestricted termination clauses. We seriously doubt, however, that public policy frowns on any and all contract clauses permitting termination without cause. Such clauses can have the salutary effect of permitting parties to end a soured relationship without consequent litigation. Indeed when, as here, the power of unilateral termination without cause is granted to both parties, the clause gives the distributor an easy way to cut the knot should he be presented with an opportunity to secure a better distributorship from another manufacturer. What public policy does abhor is economic overreaching, the use of superior bargaining power to secure grossly unfair advantage. That is the precise focus of the Code's unconscionability doctrine; it is not at all the concern of the Code's good faith performance provision. It is the office of the unconscionability concept, and not of the good faith concept, to strike down "unfair" contract terms.

We conclude that, under the better view, the Code does not *ipso facto* bar unilateral arbitrary terminations of distributorship agreements. . . .

Corenswet's rights with respect to termination extend only to a right to notice. . . . But

any claim that Corenswet might have based on inadequate notice would not entitle Corenswet to injunctive relief. . . .

The district court's decisions are REVERSED, and the preliminary injunction is VACATED.

Transaction Cost Determinants of "Unfair" Contractual Arrangements

Benjamin Klein
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Terms such as "unfair" are foreign to the economic model of voluntary exchange which implies anticipated gains to all transactors. However, much recent statutory, regulatory and antitrust activity has run counter to this economic paradigm of the efficiency properties of "freedom of contract." The growth of "dealer day in court" legislation, FTC franchise regulations, favorable judicial consideration of "unequal bargaining power," and unconscionability arguments, are some examples of the recent legal propensity to "protect" transactors. This is done by declaring unenforceable or illegal particular contractual provisions that, although voluntarily agreed upon in the face of significant competition, appear to be one-sided or unfair. Presentation of the standard abstract economic analysis of the mutual gains from voluntary exchange is unlikely to be an effective counterweight to this recent legal movement without an explicit attempt to provide a positive rationale for the presence of the particular unfair contractual term. This paper considers some transaction costs that might explain the voluntary adoption of contractual provisions such as termination at will and long-term exclusive dealing clauses that have been under legal attack.

I. The "Hold-up" Problem

. . . Given the presence of incomplete contractual arrangements, wealth-maximizing transactors have the ability and often the incentive to renege on the transaction by holding up the other party, in the sense of taking advantage of unspecified or unenforceable elements of the contractual relationship. Such behavior is, by definition, unanticipated and not a long-run equilibrium phenomenon. Oliver Williamson has identified and discussed this phenomenon of "opportunistic behavior," and my recent paper with Robert Crawford and Armen Alchian attempted to make operational some of the conditions under which this holdup potential is likely to be large. In addition to contract costs, and therefore the incompleteness of the explicit contract, we emphasized the presence of appropriable quasi-rents due to highly firm-specific investments. After a firm invests in an asset with a low-salvage value and a quasi-rent stream highly dependent upon some other asset, the owner of the other asset has the potential to hold up by appropriating the quasi-rent stream. For example, one would not build a house on land rented for a short term. After the rental agreement expires, the landowner could raise the rental price to reflect the costs of moving the house to another lot. . . .

II. Contractual Solutions

Since the magnitude of the potential holdup may be anticipated, the party to be cheated can merely decrease the initial price he will pay by the amount of the appropriable quasi-rents. For example, if an employer knows that an employee will cheat a certain amount each period, it will be reflected in the employee's wage. Contracts can be usefully thought to refer to anticipated rather than stated performance. Therefore the employee's behavior should not even be considered "cheating." A secretary, for example, may miss work one day a week on average. If secretary

time is highly substitutable, the employer can cut the secretary's weekly wage 20 percent, hire 20 percent more secretaries, and be indifferent. The secretary, on the other hand, presumably values the leisure more than the additional income and therefore is better off. Rather than cheating, we have a voluntarily determined, utility-maximizing contractual relationship.

In many cases, however, letting the party cheat and discounting his wage will not be an economical solution because the gain to the cheater and therefore his acceptable compensating wage discount is less than the cost to the firm from the cheating behavior. For example, it is easy to imagine many cases where a shirking manager will impose costs on the firm much greater than his personal gains. Therefore the stockholders cannot be made indifferent to this behavior by cutting his salary and hiring more lazy managers. The general point is that there may not be perfect substitutability between quantity and quality of particular services. Hence, even if one knew that an unspecified element of quality would be reduced by a certain amount in attempting the holdup, an ex ante compensatory discount in the quoted price of the promised high-quality service to the cost of providing the anticipated lower-quality supply would not make the demander of the service indifferent. Individuals would be willing to expend real resources to set up contractual arrangements to prevent such opportunism and assure high-quality supply.

The question then becomes how much of the holdup problem can be avoided by an explicit government-enforced contract, and how much remains to be handled by an implicit self-enforcing contract. This latter type of contract is one where opportunistic behavior is prevented by the threat of termination of the business relationship rather than by the threat of litigation. A transactor will not cheat if the expected present discounted value of quasi-rents he is earning from a relationship is greater than the immediate holdup wealth gain. The capital loss that can be imposed on the potential cheater by the withdrawal of expected future business is then sufficient to deter cheating. . . . [O]ne way in which the future-promised rewards necessary to prevent cheating can be arranged is by the payment of a sufficiently high-price "premium." This premium stream can usefully be thought of as "protection money" paid to assure noncheating behavior. The magnitude of this price premium will be related to the potential holdup, this is, to the extent of contractual incompleteness and the degree of specific capital present. In equilibrium, the present discounted value of the price-premium stream will be exactly equal to the appropriable quasi-rents, making the potential cheater indifferent between cheating and not. But the individual paying the premium will be in a preferable position as long as the differential consumer's surplus from high-quality (noncheating) supply is greater that the premium.

One method by which this equilibrium quasi-rent stream can be achieved without the existence of positive firm profits is by having the potential cheater put up a forfeitable-at-will collateral bond equal to the discounted value of the premium stream. Alternatively, the potential cheater may make a highly firm-specific productive investment which will have only a low-salvage value if he cheats and loses future business. The gap between price and salvageable capital costs is analytically equivalent to a premium stream with the nonsalvageable asset analytically equivalent to a forfeitable collateral bond.

III. "Unfair" Contractual Terms

Most actual contractual arrangements consist of a combination of explicit and implicit enforcement mechanisms. Some elements of performance will be specified and enforced by third-party sanctions. The residual elements of performance will be enforced without invoking the power of some outside party to the transaction but merely by the threat of termination of the transactional relationship. The details of any particular contract will consist of forms of these general elements chosen to minimize transaction costs (for example, hiring lawyers to discover

contingencies and draft explicit terms, paying quality-assurance premiums, and investing in nonsalvageable "brand name" assets) and may imply the existence of what appear to be unfair contract terms.

Consider, for example, the initial capital requirements and termination provisions common in most franchise contractual arrangements. These apparently one-sided terms may be crucial elements of minimum-cost quality-policing arrangements. Given the difficulty of explicitly specifying and enforcing contractually every element of quality to be supplied by a franchisee, there is an incentive for an individual opportunistic franchisee to cheat the franchisor by supplying a lower quality of product than contracted for. Because the franchisee uses a common trademark, this behavior depreciates the reputation and hence the future profit stream of the franchisor.

The franchisor knows, given his direct policing and monitoring expenditures, the expected profit that a franchisee can obtain by cheating. For example, given the number of inspectors hired, he knows the expected time to detect a cheater. Given the costs of low-quality inputs, he knows the expected extra short-run cheating profit that can be earned. Therefore the franchisor may require an initial lump sum payment from the franchisee equal to this estimated short-run gain from cheating. This is equivalent to a collateral bond forfeitable at the will of the franchisor. The franchisee will earn a normal rate of return on that bond if he does not cheat, but it will be forfeited if he does cheat and is terminated.

* * *

It is important to recognize that franchise termination, if it is to assure quality compliance on the part of franchisees, must be unfair in the sense that the capital cost imposed on the franchisee that will optimally prevent cheating must be larger than the gain to the franchisee from cheating. Given that less than infinite resources are spent by the franchisor to monitor quality, there is some probability that franchisee cheating will go undetected. Therefore, termination must become equivalent to a criminal-type sanction. Rather than the usually analyzed case of costlessly detected and policed contract breach, where the remedy of making the breaching party pay the cost of the damages of his specific breach makes economic sense, the sanction here must be large enough to make the expected net gain from cheating equal to zero. The transacting parties contractually agree upon a penalty-type sanction for breach as a means of economizing on direct policing costs. Because contract enforcement costs (including litigation costs which generally are not collectable by the innocent party in the United States) are not zero, this analysis provides a rationale against the common-law prohibition of penalty clauses.

The obvious concern with such seemingly unfair contractual arrangements is the possibility that the franchisor may engage in opportunistic behavior by terminating a franchisee without cause, claiming the franchise fee and purchasing the initial franchisee's investment at a distress price. Such behavior may be prevented by the depreciation of the franchisor's brand name and therefore decreased future demand by potential franchisees to join the arrangement. However, this protective mechanism is limited by the relative importance of new franchise sales compared to the continuing franchising operation, that is, by the "maturity" of the franchise chain.

More importantly, what limits reverse cheating by franchisors is the possible increased cost of operating the chain through an employee operation compared to a franchise operation when such cheating is communicated among franchisees. As long as the implicit collateral bond put up by the franchisee is less than the present discounted value of this cost difference, franchisor cheating will be deterred. Although explicit bonds and price premium payments

cannot simultaneously be made by both the franchisee and the franchisor, the discounted value of the cost difference has the effect of a collateral bond put up by the franchisor to assure his noncheating behavior. This explains why the franchisor does not increase the initial franchise fee to an arbitrarily high level and correspondingly decrease its direct policing expenditures and the probability of detecting franchisee cheating. While such offsetting changes could continue to optimally deter franchisee cheating and save the real resource cost of direct policing, the profit from and hence the incentive for reverse franchisor cheating would become too great for the arrangement to be stable.

Franchisees voluntarily signing these agreements obviously understand the termination-at-will clause separate from the legal consequences of that term to mean unopportunistic franchisor termination. But this does not imply that the court should judge each termination on these unwritten but understood contract terms and attempt to determine if franchisor cheating has occurred. Franchisees also must recognize that by signing these agreements they are relying on the implicit market-enforcement mechanism outlined above, and not the court, to prevent franchisor cheating. It is costly to use the court to regulate these terminations because elements of performance are difficult to contractually specify and to measure. In addition, litigation is costly and time consuming, during which time the brand name of the franchisor can be depreciated further. If these costs were not large and the court could cheaply and quickly determine when franchisor cheating had occurred, the competitive process regarding the establishment of contract terms would lead transactors to settle on explicit governmentally enforceable contracts rather than rely on this implicit market-enforcement mechanism.

The potential error here is, after recognizing the importance of transaction costs and the incomplete "relational" nature of most real-world contracts, to rely too strongly on the government as a regulator of unspecified terms. While it is important for economic theory to handle significant contract costs and incomplete explicit contractual arrangements, such complexity does not imply a broad role for government. Rather, all that is implied is a role for brand names and the corresponding implicit market-enforcement mechanism I have outlined.

IV. Unequal Bargaining Power

An argument made against contract provisions such as termination-at-will clauses is that they appear to favor one party at the expense of another. Hence it is alleged that the terms of the agreement must have been reached under conditions of "unequal bargaining power" and therefore should be invalid. However, a further implication of the above analysis is that when both parties can cheat, explicit contractual restraints are often placed on the smaller, less well-established party (the franchisee), while an implicit brand-name contract-enforcement mechanism is relied on to prevent cheating by the larger, more well-established party (the franchisor).

If information regarding quality of product supplied by a large firm is communicated among many small buyers who do not all purchase simultaneously, the potential holdup relative to, say, annual sales is reduced substantially compared to the case where each buyer purchased from a separate independent small firm. There are likely to be economies of scale in the supply of a business brand name, because in effect the large firm's total brand-name capital is put on the line with each individual sale. This implies a lower cost of using the implicit contract mechanism, that is, a lower-price premium necessary to assure non-breach, for a large firm compared to a small firm. Therefore one side of the contract will be relatively more incomplete.

For example, in a recent English case using the doctrine of inequality of bargaining power to bar contract enforcement, an individual songwriter signed a long-term (ten-year)

exclusive service contract with a music publisher for an agreed royalty percentage. Since it would be extremely costly to write a complete explicit contract for the supply of publishing services (including advertising and other promotion activities, whose effects are felt over time and are difficult to measure), after a songwriter becomes established he has an incentive to take advantage of any initial investment made by a publishing firm and shift to another publisher. Rather than rely on the brand name of the songwriter or require him to make a specific investment which can serve as collateral, the exclusive service contract prevents this cheating from occurring.

The major cost of such explicit long-term contractual arrangements is the rigidity that is created by the necessity of setting a price or a price formula ex ante. In this song publishing case, the royalty formula may turn out ex post to imply too low a price to the songwriter (if, say, his cooperative promotional input is greater than originally anticipated). If the publisher is concerned about his reputation, these royalty terms will be renegotiated, a common occurrence in continuing business relationships.

If an individual songwriter is a small part of a large publisher's total sales, and if the value of an individual songwriter's ability generally depreciates rapidly or does not persist at peak levels so that signing up new songwriters is an important element of a publisher's continuing business, then cheating an individual songwriter or even all songwriters currently under contract by refusing to renegotiate royalty rates will imply a large capital cost to the publisher. When this behavior is communicated to other actual or potential composers, the publisher's reputation will depreciate and future business will be lost. An individual songwriter, on the other hand, does not generally have large, diversified long-term business concerns and therefore cannot be penalized in that way. It is therefore obvious, independent of any appeal to disparity of bargaining power, why the smaller party would be willing to be bound by an explicit long-term contract while the larger party is bound only implicitly and renegotiates terms that turn out ex post to be truly divergent from ex ante, but unspecified, anticipations.

However, the possibility of reverse publisher cheating is real. If, for example, the songwriter unexpectedly becomes such a great success that current sales by this one customer represents a large share of the present discounted value of total publisher sales, the implicit contract enforcement mechanism may not work. Individuals knowingly trade off these costs of explicit and implicit-enforcement mechanisms in settling upon transaction cost-minimizing contract terms. Although it would be too costly in a stochastic world to attempt to set up an arrangement where no cheating occurs, it is naive to think that courts can cheaply intervene to discover and "fix up" the few cases of opportunistic behavior that will occur. In any event, my analysis makes it clear that one cannot merely look at the agreed-upon, seemingly "unfair" terms to determine if opportunism is occurring. . . .

Notes and Questions

1. The Termination Clause: Klein offers several explanations for why it is mutually beneficial for franchisors and franchisees to have termination clauses included in the franchise agreement. Do those explanations apply to the inclusion of the clause in the Amana contract?

2. Market Protection Against Arbitrary Termination: Franchisors are in the business of selling franchises at the highest price obtainable, with the price being determined by the value of the trademark and the franchisor's reputation for dealing fairly with franchisees. A franchisor, in effect, depreciates the value of the trademark when he opportunistically or arbitrarily terminates a franchisee. Managerial talent is limited, competition among franchisors is intense, and the

market for franchises offers potential franchisees a large number of opportunities. Even if all franchisors were offering the same expected net cash flow, the best franchisees would not pay as much for franchises from franchisors that have a reputation for mistreating their franchisees.

3. Managerial Discretion, Personal Preferences, and Agency Costs: In *Corenswet*, was Amana's termination of Corenswet in Amana's best interest or was it a personal vendetta by George Foerstner, the president of Amana? Amana publicly stated that Corenswet was underfinanced and, thus, should not be allowed to continue as a dealer of Amana products. However, behind the scenes, there was strong evidence of a personal feud between the two company presidents. Amana's president desired to terminate Corenswet and replace it with George H. Lehleitner & Co. Would you expect word of the personal feud to have a negative impact on Amana's ability to attract other dealers? If so, can you determine whether Foerstner was a good agent for Raytheon, Amana's parent?

4. Relative Bargaining Power of Franchisors and Franchisees: Corenswet's Experience: Footnote 12 of the *Corenswet* opinion offers some insights into the relative bargaining power of franchisees and franchisors:

> To prevail on a theory of unconscionability Corenswet would have to demonstrate (1) that it had no "meaningful choice" but to deal with Amana and accept the contract as offered, and (2) that the termination clause was "unreasonably favorable" to Amana. *Williams v. Walker-Thomas Furniture Co*., 1965, 121 U.S. App. D.C. 315, 319, 350 F.2d 445, 449. The record evidence relevant to these questions is scanty. Sam Corenswet testified that Amana in 1969 aggressively sought Corenswet as a distributor and that he only reluctantly decided to commit his company to Amana. Another Corenswet witness, at one point in his testimony, said of the 1975 amended contract that, in view of Corenswet's heavy investment in the Amana line, "we had to take it." The court interrupted that testimony and expressed its view that it was irrelevant to the hearing issues. There was no other evidence regarding the parties' relative bargaining power at the time the relationship began, nor any evidence as to the relative usefulness of the termination clause to the two sides.

Corenswet, 594 F.2d at 139. Ex ante Corenswet was courted, but after Corenswet made Amana-specific investments it was vulnerable to opportunistic amendment of the contract. In light of the analysis of the preceding note and the Klein excerpt, one should be hesitant to evaluate individual clauses or individual actions without considering the totality of the circumstances. For example, was the 1975 amendment a substantial change in the contract or was it merely a formal statement of the "off-the-rack" implied terms?

5. Franchisees as "Victims": The United States Supreme Court, in granting relief to "victims" of the alleged superior bargaining power of franchisors, has exhibited a sympathetic policy to franchisees. Consider, for example the Court's treatment of the Midas Muffler franchise contract. In *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), a group of franchise dealers operating Midas Muffler shops charged that Midas, its parent International Parts, and two other subsidiaries unlawfully conspired to restrain competition under section 1 of the Sherman Act and section 3 of the Clayton Act. The dealers had accepted contracts to sell Midas mufflers at prices fixed by Midas and agreed to not deal with any of Midas's competitors. In considering these franchise agreements, the Supreme Court noted: "Petitioners (the dealers) apparently accepted many of these restraints solely because their acquiescence was necessary to obtain an otherwise attractive business opportunity." *Id.* at 139. The franchised dealers, who clearly wished to take the benefits of the bargain without the burdens, alleged that Midas and its

parent had conspired against them, forcing them to accept the onerous terms of the franchise agreements. The Court apparently viewed the dealers as victims of a superior economic force that had bound them to an unfair and ill-advised bargain. The oppressed dealers, according to the Supreme Court, were entitled to relief under the antitrust laws, which, in effect, allowed the federal courts to rewrite their contracts for them. The Supreme Court's willingness to rewrite contracts because of their apparently "unfair" terms reflects the inability of the Court to understand the importance of transaction costs and the relational nature of franchising arrangements. For example, in order to deter franchisee shirking and intrabrand free riding, both of which depreciate the franchisor's brand name, the franchisor insists on a swift and stiff penalty embodied in the termination-at-will clause for cheating franchisees that are caught. The apparent fear of the Supreme Court is that franchisors will not act in "good faith" and will abuse the "unfair" provisions. Although the Court fears that the franchisors may behave opportunistically, it ignores the market forces that deter such opportunistic behavior.

6. Consumers and Employees as "Victims"?: Even more commonly than franchisees, courts (and legislatures) treat consumers and employees as victims (or at least potential victims) of unfair contract terms in so-called "contracts of adhesion." To what extent does Klein's argument apply to consumers and employees as well as to franchisees?

7. Opportunism and Wasted Resources: Parties who recognize the possibility of being subjected to opportunistic behavior will invest real resources in attempting to avoid manipulation. On the other hand, parties who recognize the potential to act opportunistically will invest real resources in perpetrating opportunism. These joint expenditures of resources are socially wasteful, in that real resources are not invested for the purpose of creating wealth but solely for the purpose of transferring wealth. Unlike a mutually beneficial exchange, which is a positive sum game, opportunism is a negative sum game. The threat of opportunism, moreover, increases the transaction costs of exchange, which in turn reduces the volume of mutually beneficial exchanges. The net result of this allocation of real resources, for the purpose of opportunistically transferring wealth, is a reduction in the wealth of society and, *a fortiori,* consumer wealth.

8. Other Uncompensated Wealth Transfers and Wasted Resources: Opportunistic behavior wastes resources. One activity that results in an analogous waste of resources is theft. Theft involves more than the transfer of wealth from one party to another. It also involves the investment of time and other resources by thieves in managing the transfer, as well as the investment of resources by potential victims in avoidance of the transfer. In the absence of theft, these resources would be invested in other, presumably more productive, uses. *See* Gary S. Becker, *Crime and Punishment: An Economic Approach,* 76 Journal of Political Economy 169, 209 (1968) (optimal legislative policies to combat illegal behavior are part of an optimal allocation of resources); Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft,* 5 Western Economic Journal 224, 231 (1967) ("A successful bank robbery will inspire potential thieves to greater efforts, lead to the installation of improved protective equipment in other banks, and perhaps result in the hiring of additional policemen.").

9. Long-Term, Incomplete, and Relational Contracts: As previously discussed, the common law of contracts provides a number of standard form, off-the-rack contractual provisions that specify the basic details and fill gaps in negotiated contracts. Unless contradicted by the explicit terms of a contract, the common law rules are an implied part of all contracts. This reduces transaction costs by allowing contracting parties to form enforceable contracts without having to specify every standard of performance and without having to negotiate the

allocation of risk associated with every conceivable contingency. All executory contracts face the risk of disruption due to unanticipated or remote contingencies — circumstances the contract is ill-suited to resolve because the contracting parties do not know all that might occur, or circumstances not worth dealing with because there is only a small probability that they will arise.

Occasionally, however, the bargaining situation becomes too complicated and otherwise mutually beneficial transactions fail to occur. In those situations, one alternative is for the parties to integrate into a single entity, which substitutes firm coordination for market coordination. Another alternative to transaction failure is for the inter-firm activity to be coordinated by a relational contract. The nature of a relational contract is found in its contrast with the traditional contingent contract:

> A contract is relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such definitive obligations may be impractical because of inability to identify uncertain future conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance.

Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 Virginia Law Review 1089, 1091 (1981). The goal of relational contract law is the maintenance of the relationship in the face of conflict that would usually result in termination under traditional contract law approaches. Founded in mutually-beneficial exchange, the relational approach abandons the strict reliance on discrete contracts and focuses on the relationship itself. In a sense, the relationship takes on the properties of "a minisociety with a vast array of norms beyond the norms centered on the exchange and its immediate processes." Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 Northwestern Law Review 854, 901 (1978). The exchange is no longer dominant; that is, the original contractual agreement is no longer considered the only source of party-initiated adjustment processes when the relationship is in trouble. Instead, "[t]he reference point is the entire relation as it had developed to the time of the change in question (and in many instances as it has developed since the change). This may or may not include an ‘original agreement;’ and if it does, may or may not result in great deference being given to it." *Id.* at 890. Thus, a relational contract system attempts to save contractual relationships that are in trouble by going beyond the four corners of the original contract and looking to "the overall context of the whole relation." *Id.* A significant advantage of relational contracting is that it not only provides for the sharing of risks but also a possible reduction of risk. This reduction is possible because the long-term nature of relational contracts reduces the incentives of contracting parties to engage in the types of opportunistic behavior that lead to transaction failures in discrete market transactions.

D. Corporate Governance

In the modern corporation, the key contract is between the owners of the corporation, i.e., the shareholders, and the managers (agents) hired to run the firm. Under this particular contract, a shareholder invests capital in the corporation in return for a residual claim to the net cashflows that result from differences between inflows of cash and promised payments to the other contractual parties which comprise the firm. Shareholders bear the residual risk inherent in the ownership of resources *specific* to the corporation and thus will *demand* the right to **control** the organization. In other words, while a corporation is a nexus of contracts among its customers,

managers, suppliers of materials, etc., the corporation vests control in the constituency that bears the residual risk of the organization.

Corporate law puts no restrictions on those who can own residual claims and thus makes it possible for other contractual participants to avoid bearing any of the residual risks. Hence, the fact that anyone can own a residual claim allows specialization in risk-bearing by those investors who choose to do so. In addition, unrestricted stock ownership distributes the residual risk of the firm among many individuals. Individuals can reduce the cost of bearing such risks by holding a diversified portfolio of investments. Because the firm only has to pay investors to bear undiversifiable risk, it will be able to raise capital at a lower cost.

A major intellectual theme in the study of the modern corporation is the "**separation of ownership and control**" thesis, which Adolf A. Berle and Gardiner C. Means first popularized in their famous 1932 book *The Modern Corporation and Private Property*. The basic notion is that dispersed owners of the modern corporation do not have the incentive to control corporate management — directors and officers — and that managers often act in their own interests rather than in the stockholders' interests. Over the years, the Berle and Means thesis has provided the basis for many calls for more stringent legal controls on managerial behavior. This area of corporate policy is called "corporate governance," which refers to the manner in which the relations between the parties to the corporate contract are restrained by government regulation or private ordering.

1. Shareholder Voting and Rationally Ignorant Shareholders

The Berle and Means thesis is quite simple: managers have gained control of modern corporations and have effectively disenfranchised the owners/voters, i.e., the shareholders. With this control, managers have been able to follow their own agendas to the detriment of shareholders. In other words, managers have been able to maximize their own utility by not maximizing the profits of the corporation. This, of course, is a classic agency problem where the manager-agents are not acting in the best interests of their shareholder-principals. Since management does not generally "own" the corporation, managers receive little or no benefit as a result of an increase in monetary profits that ultimately belongs to the residual claimants, i.e., the common shareholders. Moreover, Berle and Means argued that existing corporate law did not provide sufficient mechanisms for owners to control the management. More specifically, Berle and Means argued that there were few contested elections for boards of directors because the management controlled the proxy mechanism and was therefore able to rig the process. As a result of the Berle and Means thesis, political pressures developed (especially during the New Deal) to increase what is referred to as **corporate democracy**. This is not surprising since the Berle and Means model is a political rather than an economic model of the corporation. One political result of the Berle and Means thesis was sections of federal securities laws that increased access by shareholders to the proxy mechanism. Much to the consternation of those who politically adopted the Berle and Means thesis, however, shareholders showed little interest in these statutory rights.

The Berle and Means critique of the publicly traded corporation was based in part on the assumption that shareholders wanted direct control over managers. However, simple economics suggests that shareholders' specialization in bearing the residual risk of the firm does not mean that they have the incentive to actively monitor their agents. In fact, Berle and Means characterize shareholders as **rationally ignorant** because of the large costs associated with

staying informed about the corporation's internal affairs and the very small expected benefits to the individual shareholder of being informed. Moreover, even after bearing the costs of informing themselves, the shareholders are unlikely to be able to influence the corporation's policies and in any event they must share the benefits of intervention if they are successful. Given the divergence of costs and benefits, small shareholders find it rational to **free ride** on other shareholders' monitoring activity:

> Of all those standing in relation to the large corporation, the shareholder is least subject to its power. Through the mechanism of the security markets, his relation to the corporation is rendered highly abstract and formal, quite limited in scope, and readily reducible to monetary terms. The market affords him a way of breaking this relation that is simple and effective. He can sell his stock, and remove himself, qua shareholder, at least from the power of the corporation.
>
> Shareholder democracy, so-called, is misconceived because the shareholders are not the governed of the corporation whose consent must be sought. If they are, it is only in the most limited sense. Their interests are protected if financial information is made available, fraud and overreaching are prevented, and a market is maintained in which their share may be sold. *A priori*, there is no reason for them to have any voice, direct or representational, in the catalogue of corporate decisions . . . on prices, wages, and investment. They are no more affected than nonshareholding neighbors by these decisions. . . . [T]hey deserve the voiceless position in which the modern development left them.

Abram Chayes, *The Modern Corporation and the Rule of Law*, in The Corporation in Modern Society 25, 40–41 (Edward S. Mason ed. 1960). If a shareholder does not like what is happening to his or her shares, then that shareholder can exit, i.e., can sell his or her shares. Hence, given the cost and benefits of such ignorance, it is rational for most shareholders to be ignorant of most corporate matters, thus ignoring the "proxy" control mechanism.

Limited liability clearly facilitates this specialization by shareholders because it allows shareholders to be "rationally ignorant" of managerial practices. Because their risk is limited to their initial investment, shareholders do not waste their time trying to monitor managerial behavior. Thus, limited liability allows investors to be passive with respect to the internal affairs of companies and to concentrate on the externally observable traits like profits and rate of return on investment.

2. Agency Costs and Owner/Manager Conflicts

In general, agency theory suggests that unity of ownership and control is not a necessary condition of efficient performance of a firm. This perspective stresses the voluntary, contractual nature of the corporation. A first step in understanding this market-oriented approach is to recognize that it is based in part on the assumption that the shareholders' primary interest is in the maximization of the value of their investments, and that the contractual relations among participants in the firm must convince shareholders that managers will not abuse the shareholders' interests. A corporation's managers, which are defined to include its officers and directors, are agents of the shareholders. In this view, the so-called separation of ownership and control in the large corporation is an agency relationship, which exists because the benefits of the relationship exceed the agency costs associated with it. That is, the agency relationship exists because both the principal and the agent share in the benefits of the relationship.

At this point, it is helpful to be more precise in the identification of conflicts between managers and shareholders in the corporate firm:

(1) *Effort*: A primary concern of agency theory and the separation of ownership and control literature is whether entrenched managers have the incentives to maximize their efforts in pursuing the maximum rate of return for shareholders.

(2) *Horizon*: This conflict refers to the issue of how to encourage a manager to act in the shareholders' interests as the manager approaches retirement or prepares to leave the firm for other opportunities.

(3) *Risk Aversion*: Entrenched managers have an incentive to avoid bankruptcy at all costs, but shareholders with diversified portfolios are risk neutral with respect to individual securities in their portfolios. In the absence of corrective governance mechanisms, managers' interests will be more closely aligned with those of bondholders than shareholders.

(4) *Underleveraged*: Within a certain range the tax savings from debt and increased leverage can increase a firm's profit. Risk averse managers may not like the increased risk associated with increased leverage and debt service demands, but, once again, shareholders could prefer the undertaking of such risk because they specialize in bearing such risks.

(5) *Dividend Payout Problem*: Risk averse managers may prefer to reinvest their firm's profits in the firm rather than distribute them to shareholders even though the shareholders could put them to a more productive use.

This list of conflicts between managers and shareholders is not exhaustive, but it serves as a reference for discussing the roles of different corporate governance mechanisms that control corporate agency costs.

Agency theory and transaction cost economics attempt to explain the development of institutional arrangements that convince shareholders voluntarily to allow managers to control their resources. The resources devoted to controlling agency costs are properly identified as agency costs. Thus, agency costs include not only the direct costs associated with agents acting in their own interest at the expense of shareholders, but also the costs of controlling managerial agents through legal or market governance arrangements. Nonetheless, recognizing that the parties to the contract will bear the agency costs implicit in the arrangement is crucial to understanding the agency problem. Thus, agents have the incentive to attempt to minimize agency costs by writing contracts that provide monitoring and bonding activities to the point where the marginal costs of such activities equals the marginal gain of reducing agency costs. According to the contractual theory discussed below, managers select the least costly manner of controlling agency costs. The use of corporate governance mechanisms merely reveals that the costs of monitoring are justified by reducing the costs of an agent's deviation from the behavior that would occur if the agent and principal were one.

3. The Contractual Theory of the Corporation

The fundamental insight of the Berle and Means theory — that shareholders should be concerned about delegating control over their financial capital to corporate managers — provides the cornerstone of the contractual theory of the corporation. This section offers a summary of the governance mechanisms and powerful market forces that encourage managers to act in shareholders' interests. Taken together, the identification of these market forces and the understanding of their interaction represent the contractual theory of the corporation. The corporation is based on voluntary contracts, and the realities of the corporate agency relationship dictate that the corporation's managers select the contractual terms that are then offered to

potential investors. In order to raise capital at the lowest possible price, managers must offer contract terms — including evidence of the existence of intra-firm incentive structures — that convince investors that agency costs will be minimized.

a. The Market for Corporate Control

If managers control the corporation, then it seems reasonable for shareholders to be concerned that manager-created intra-firm corporate governance devices, such as managerial incentive contracts, may not always be effective in controlling managerial agency costs. An alternative control mechanism, beyond the direct control of entrenched managers, is found in the stock market. The stock market discipline of managers is manifest in the threat of tender offers, takeovers, or other forms of changes in corporate control whenever entrenched managers adopt strategies and behavior that fail to maximize the value of the corporation's shares. The so-called market for corporate control provides an *external* monitoring mechanism that forces managers to be concerned about their shareholders. Prior to this theoretical development by Henry G. Manne (see Manne, *Mergers and the Market for Corporate Control*, 73 Journal of Political Economy 110 (1965)), commentators on the modern corporation were at a total loss when it came to explaining how corporate managers could be constrained to act in their shareholders' interests. Because the market for corporate control plays the preeminent role in the other governance mechanisms in the contractual theory of the corporation, it warrants further discussion.

A viable market for corporate control requires freely transferable voting shares so that dissatisfied shareholders can sell their shares rather than attempt to control agency problems through internal control mechanisms. The result of this exit process is that the shares of poorly managed firms trade at a discount below the price that could be attained with better and more loyal managers. This creates the possibility of large capital gains from purchasing shares and replacing incompetent or shirking managers with a new group of more efficient managers.

The identification of firms trading below their potential value due to management problems, however, is very costly. Prospective bidders monitor the performance of managerial teams by comparing a corporation's potential market value with its value under current management. In this regard, management inefficiency must be understood to include not only the failure to minimize costs and maximize profits through current operations, but also failures to distribute excess cash flow, take advantage of acquisitions and restructuring opportunities, and communicate to the stock market the health and prospects of the company. If a firm is not performing up to its financial potential under current and expected market conditions, regardless of the reason, then it is an attractive target for a change in corporate control. According to the theory, the acquiring firm purchases the stock of the target company, replaces the inefficient managers with efficient managers, and then reaps a large profit as the stock price rises to reflect the increased earning potential under the more efficient managerial team. The market for corporate control operates through many different forms of control transactions. Of course, the most dramatic is the takeover via a hostile tender offer. In addition, friendly mergers, negotiated tender offers, sales of control by large shareholders, and proxy contests are mechanisms for changing control of corporations and replacing inefficient managers with more efficient ones. In basic terms, the firm's assets are worth more in the hands of the new managers. In many instances, the source of the premium for the replacement of managers is the reduction of agency costs. But a more general view of the role of the market for corporate control is that it is the *threat* of takeover, not the actual occurrence of a takeover, which serves to align managers' interests with shareholders' interests.

Notes on the Market for Corporate Control

1. Takeovers, Managers, and the Williams Act: Tender offers are regulated by the Williams Act, which was an amendment to the Securities Exchange Act of 1934. A tender offeror is required to file a Schedule 13D, which in effect mandates complete disclosure of the tender offeror's background, sources of financing, and plans for the corporation if the tender offer is successful. The stated purpose of this regulation was to establish "an even playing field." However, while that may be the "intent" of the Act, unintended (or, perhaps, intended) consequences of the Williams Act quickly surfaced. Incumbent managers surely benefited from the reduced threat of hostile takeovers.

2. Empirical Evidence: The role of the market for corporate control in the governance of the modern corporation is not based on some mystical or ideological belief in the power of market forces, but rather it is supported by numerous empirical studies. *See* Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 Journal of Financial Economics 5 (1983); Gregg A. Jarrell et al., *The Market for Corporate Control: The Empirical Evidence Since 1980,* 2 Journal of Economic Perspectives 49 (1988); s*ee also* Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 Delaware Journal of Corporate Law 540 (1984). The role of the stock market in controlling managerial discretion was one of the first important applications of economics to corporation law and facilitated the development of the contractual theory of the corporation.

3. Managerial Responses to Tender Offers: One of the most heated debates in corporate law during the 1980's involved the question of the proper role of incumbent managers of a target corporation when presented with a tender offer for control. The incumbent managers, who are faced with the prospect of losing their jobs if the takeover is successful, may have an incentive to try to defeat the takeover even if it appears to be in the shareholders' best interests. Shareholders encounter a dilemma in deciding whether managerial defensive tactics are in their best interests. If a firm is a target, the shareholders benefit if the managers' defensive activities result in a higher price as long as their activities do not actually defeat the tender offer. If the defensive tactics defeat the tender offer, shareholders are clearly worse off — the managers have, in effect, denied them the opportunity to sell their shares at a higher price. But all of this reflects an ex post analysis of the proper managerial response once a takeover has been initiated; an economic perspective adopts an ex ante view of the proper managerial response when the shareholders are not certain that their corporation will become a target. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harvard Law Review 1161, 1177 (1981). In actuality, most firms are never takeover targets (although all are potential targets and thus must respond to the threat of tender offers). The threat effect of a takeover often means that firms will not be attractive targets — the managers are already being forced to act in the shareholders' best interests. Establishing ex ante a rule allowing managers to defend against takeover increases the costs of (and reduces the effectiveness of) the market for corporate control as a monitoring mechanism and thus merely increases the problems associated with the separation of ownership and control. That is, raising the defensive tactics provides managers with more room to act in their own interest without being totally concerned about shareholder-welfare. It has been argued that, given a choice, shareholders as a group would be better off ex ante under a system that forces all managers to act in the shareholders' best interests at all times as opposed to a system that occasionally results in high stakes takeover

battles. This reasoning has led to calls for mandating the role of the market for corporate control in all corporations by legally restricting the ability of managers to defend against takeover bids.

4. Stakeholders: Some commentators, especially those who are concerned about adverse employment effects or harm to some communities, argue that corporate managers should consider more than just shareholders' interests in deciding whether to attempt to defeat a hostile tender offer. In effect, these commentators characterize shareholders as just one of the many constituencies, sometimes referred to as stakeholders, of the company. The contractual theory of the corporation suggests that those commentators misunderstand the role of shareholders. Shareholders are not equal to these other constituencies because they bear the residual risk inherent in the ownership of resources *specific* to the corporation and thus will *demand* the right to control the organization. In other words, while a corporation is a nexus of contracts among its customers, managers, suppliers of materials, etc., the corporate contract vests control in the constituency that bears the residual risk of the organization.

5. The Glue: Exclusive reliance on the market for corporate control to solve all of the potential conflicts of interest associated with the separation of ownership and control is neither justified nor necessary. Managerial discretion is constrained by other market and legal mechanisms. For example, in some large corporations, agency costs are reduced by the corporation being owned by shareholders who hold a large percentage of outstanding stock and therefore have the incentive to monitor managerial behavior closely. Nevertheless, the market for corporate control provides a last resort mechanism for correcting excessive managerial discretion and, as a direct consequence, reduces the likelihood that shareholders will be harmed by their agents. The market for corporate control provides the glue that holds together the nexus of contracts.

b. Product Market Competition

Product market competition forces managers to attempt to maximize the profits of the corporation. Failure to maximize profits in competitive markets often means the failure of the firm, which may be as costly for the managers as it is for the shareholders. Because of firm-specific investments in their own human capital and the likelihood of compensation in the form of stock or stock options, managers typically have a larger percentage of their total wealth tied up in the firm they work for relative to the percentage of the typical diversified shareholder. Thus, managers of firms that do not have market power have a strong incentive to act in the shareholders' interests. Moreover, if a firm does have market power, the market will have already capitalized the higher expected profits into the corporation's stock price so a failure to maximize profits will result in a below-average return on the shareholders' investments, thus making the firm an attractive takeover target.

c. Capital Market Competition and Capital Structure

Most corporations use a mixture of debt and equity financing. In a path-breaking 1958 article, Franco Modigliani and Merton Miller showed that, under a set of specified assumptions including absence of transaction and information costs, the capital structure of a firm — that is, its debt to equity mix — was irrelevant to the total value of the firm. *See* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, 48 American Economic Review 261 (1958); *see also* Merton H. Miller, *The Modigliani Miller Propositions After Thirty Years*, 2 Journal of Economic Perspectives 99 (1988). This raises the issue of why different capital structures are observed across firms. The contractual theory of the

corporation demonstrates its analytical strength by answering the Modigliani and Miller riddle. In a landmark article, Michael Jensen and William Meckling used agency problems and monitoring of managers to identify the relevance of capital structure to the value of a firm. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 Journal of Financial Economics 305 (1976). An all-equity structure gives substantial discretion to managers to use corporate assets for their own benefit, subject only to the vague proscriptions of fiduciary duties. However, managers have an incentive to minimize their combined costs of debt and equity capital because failure to do so would make them vulnerable to takeover. In order to raise equity capital at the lowest possible cost, a corporation's managers must convince potential shareholders that agency costs will be minimal. Bondholders also must address conflict of interest problems. For example, a debt-heavy structure induces those who hold equity and managers who are responsive to their interests to make highly risky investments that may produce great benefits to the equity holders if they succeed and losses to the debt holders if they fail. Bondholders contain and monitor these agency costs by using contracts that expressly limit the discretion of management to act against their interests. Under the Jensen-Meckling view, different capital structures may be responses to different types of agency costs. There is no one optimal capital structure for all corporations.

d. Corporate Performance and Executive Compensation

Managerial salaries and other forms of compensation are often linked to how well the firm is performing. Managers monitor each other's performances and reward achievements with bonuses and salary adjustments as a form of "ex post settling up" that substantially alleviates incentive problems. Also, if managers enjoy especially favorable salaries or other terms of employment, they may be disciplined by the prospect of being fired. A high salary — that is, higher than a manager's opportunity cost or next best paying job — can be thought of as "two-edged sword." On the one hand, the high salary can be viewed as evidence that the manager's compensation is not being effectively monitored by the board; on the other hand, the manager may be extremely motivated to work hard to keep a position when she knows she is overpaid. Managers' proclivities towards shirking can be reduced even further by the use of stock options, restricted stock, and bonus plans which alter a manager's time horizon for her managerial decisions so as to ensure that she acts in accordance with the long-term interests of her principals. As managers approach retirement, defined benefit pension plans under which benefits are linked to the last period's salary resolve some of the horizon problems. Stock options in retirement packages can also serve to alleviate horizon problems.

In general, corporate compensation packages appear to be structured in a manner to solve most of the conflicts between managers and shareholders. Analytically, corporate compensation packages can include three components: (1) unconditional compensation, such as salary and pension and insurance benefits; (2) compensation conditioned on stock market-based performance, such as stock options, restricted stock, and bonuses; and (3) compensation conditioned on accounting-based performance, such as profit sharing. Stock market-based performance measures are beyond managers' direct control or manipulation because stock prices reflect all available information, including the discounted value of long-term consequences of short-term actions, regarding the value of a firm. On the other hand, accounting-based performance measures are subject to manipulation by senior executives through, for example, decisions to maximize short-term accounting profits at the expense of greater long-term profits, which are beyond managers' employment terms. Thus, accounting-based performance measures

are a potential source of agency costs, and most senior executives' compensation contracts do not include a component based on accounting performance.

Kamin v. American Express Co.
Supreme Court of New York
383 N.Y.S.2d 807 (1976)

Edward J. Greenfield, Judge

In this stockholders' derivative action, the individual defendants, who are the directors of the American Express Company, move for an order dismissing the complaint for failure to state a cause of action . . . and alternatively, for summary judgment. . . .

The complaint is brought derivatively by two minority stockholders of the American Express Company, asking for a declaration that a certain dividend in kind is a waste of corporate assets, directing the defendants not to proceed with the distribution, or, in the alternative, for monetary damages. The motion to dismiss the complaint requires the court to presuppose the truth of the allegations. It is the defendants' contention that, conceding everything in the complaint, no viable cause of action is made out.

After establishing the identity of the parties, the complaint alleges that in 1972 American Express acquired for investment 1,954,418 shares of common stock of Donaldson, Lufken and Jenrette, Inc. (hereafter DLJ), a publicly traded corporation, at a cost of $29,900,000. It is further alleged that the current market value of those shares is approximately $4,000,000. On July 28, 1975, it is alleged, the board of directors of American Express declared a special dividend to all stockholders of record pursuant to which the shares of DLJ would be distributed in kind. Plaintiffs contend further that if American Express were to sell the DLJ shares on the market, it would sustain a capital loss of $25,000,000 which could be offset against taxable capital gains on other investments. Such a sale, they allege, would result in tax savings to the company of approximately $8,000,000, which would not be available in the case of the distribution of DLJ shares to stockholders. It is alleged that on October 8, 1975 and October 16, 1975, plaintiffs demanded that the directors rescind the previously declared dividend in DLJ shares and take steps to preserve the capital loss which would result from selling the shares. This demand was rejected by the board of directors on October 17, 1975.

It is apparent that all the previously-mentioned allegations of the complaint go to the question of the exercise by the board of directors of business judgment in deciding how to deal with the DLJ shares. The crucial allegation which must be scrutinized to determine the legal sufficiency of the complaint is paragraph 19, which alleges: "19. All of the defendant Directors engaged in or acquiesced in or negligently permitted the declaration and payment of the Dividend in violation of the fiduciary duty owed by them to Amex to care for and preserve Amex's assets in the same manner as a man of average prudence would care for his own property."

* * *

Examination of the complaint reveals that there is no claim of fraud or self-dealing, and no contention that there was any bad faith or oppressive conduct. . . .

. . . [T]he question of whether or not a dividend is to be declared or a distribution of some kind should be made is exclusively a matter of business judgment for the board of directors. "Courts will not interfere with such discretion unless it be first made to appear that the directors have acted or are about to act in bad faith and for a dishonest purpose. It is for the directors to say, acting in good faith of course, when and to what extent dividends shall be declared. The

statute confers upon the directors this power, and the minority stockholders are not in a position to question this right, so long as the directors are acting in good faith." *Liebman v Auto Strop Co.*, 241 NY 427, 433–434.

Thus, a complaint must be dismissed if all that is presented is a decision to pay dividends rather than pursuing some other course of conduct. A complaint which alleges merely that some course of action other than that pursued by the board of directors would have been more advantageous gives rise to no cognizable cause of action. Courts have more than enough to do in adjudicating legal rights and devising remedies for wrongs. The directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions which will have an impact on profits, market prices, competitive situations, or tax advantages. As stated by Cardozo, J., when sitting at Special Term, the substitution of someone else's business judgment for that of the directors "'is no business for any court to follow.'" (*Holmes v Saint Joseph Lead Co.*, 84 Misc 278, 283, quoting from *Gamble v Queens County Water Co.*, 123 NY 91, 99.)

It is not enough to allege, as plaintiffs do here, that the directors made an imprudent decision, which did not capitalize on the possibility of using a potential capital loss to offset capital gains. More than imprudence or mistaken judgment must be shown. "Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient." *Pollitz v Wabash R.R. Co.*, 207 NY 113, 124.

* * *

Nor does this appear to be a case in which a potentially valid cause of action is inartfully stated. The defendants have moved alternatively for summary judgment and have submitted affidavits . . . , and plaintiffs likewise have submitted papers enlarging upon the allegations of the complaint. The affidavits of the defendants and the exhibits annexed thereto demonstrate that the objections raised by the plaintiffs to the proposed dividend action were carefully considered and unanimously rejected by the board at a special meeting called precisely for that purpose at the plaintiffs' request. The minutes of the special meeting indicate that the defendants were fully aware that a sale rather than a distribution of the DLJ shares might result in the realization of a substantial income tax saving. Nevertheless, they concluded that there were countervailing considerations primarily with respect to the adverse effect such a sale, realizing a loss of $25,000,000, would have on the net income figures in the American Express financial statement. Such a reduction of net income would have a serious effect on the market value of the publicly traded American Express stock. This was not a situation in which the defendant directors totally overlooked facts called to their attention. They gave them consideration, and attempted to view the total picture in arriving at their decision. While plaintiffs contend that according to their accounting consultants the loss on the DLJ stock would still have to be charged against current earnings even if the stock were distributed, the defendants' accounting experts assert that the loss would be a charge against earnings only in the event of a sale, whereas in the event of distribution of the stock as a dividend, the proper accounting treatment would be to charge the loss only against surplus. While the chief accountant for the SEC raised some question as to the appropriate accounting treatment of this transaction, there was no basis for any action to be taken by the SEC with respect to the American Express financial statement.

The only hint of self-interest which is raised, not in the complaint but in the papers on the motion, is that 4 of the 20 directors were officers and employees of American Express and members of its executive incentive compensation plan. Hence, it is suggested, by virtue of the action taken earnings may have been overstated and their compensation affected thereby. Such a claim is highly speculative and standing alone can hardly be regarded as sufficient to support an inference of self-dealing. There is no claim or showing that the four company directors dominated and controlled the 16 outside members of the board. Certainly, every action taken by the board has some impact on earnings and may therefore affect the compensation of those whose earnings are keyed to profits. That does not disqualify the inside directors, nor does it put every policy adopted by the board in question. All directors have an obligation, using sound business judgment, to maximize income for the benefit of all persons having a stake in the welfare of the corporate entity. What we have here as revealed both by the complaint and by the affidavits and exhibits, is that a disagreement exists between two minority stockholders and a unanimous board of directors as to the best way to handle a loss already incurred on an investment. The directors are entitled to exercise their honest business judgment on the information before them, and to act within their corporate powers. That they may be mistaken, that other courses of action might have differing consequences, or that their action might benefit some shareholders more than others present no basis for the superimposition of judicial judgment, so long as it appears that the directors have been acting in good faith. The question of to what extent a dividend shall be declared and the manner in which it shall be paid is ordinarily subject only to the qualification that the dividend be paid out of surplus (Business Corporation Law, § 510, subd [b]). The court will not interfere unless a clear case is made out of fraud, oppression, arbitrary action, or breach of trust.

Courts should not shrink from the responsibility of dismissing complaints or granting summary judgment when no legal wrongdoing is set forth. . . .

In this case it clearly appears that the plaintiffs have failed as a matter of law to make out an actionable claim. Accordingly, the motion by the defendants for summary judgment and dismissal of the complaint is granted.

Notes and Questions

1. Market Evaluation of American Express's Investment in DLJ: In terms of stock market valuation of the business, American Express made a poor business decision by not taking the substantial capital loss and resulting tax savings. The large accounting loss would have been anticipated by investors who, after all, could observe what had happened to the market value of American Express's investment in DLJ. That is, prior to the board's decision, AMEX's market price already reflected the anticipated losses (and tax savings) from the decline in DLJ stock. By not taking the large capital loss, the expected future cash flows to American Express declined because they now had to pay higher taxes. The stock market price should have fallen in response to this unexpected change.

2. Accounting-Based Compensation. Accounting is an art that involves many subjective, discretionary decisions that can impact the reported financial position of a company. Accounting data can be manipulated by senior managers. In *Kamin*, the senior managers wanted to avoid showing an accounting loss from the DLJ investment. Consider how the executives' incentives structures affected this transaction. Four members of the Board of Directors apparently were compensated according to the accounting profits of the firm. In most basic terms, accounting profit is the residual after subtracting expenditures from revenues. Shareholders are interested in

maximizing the value of their shares, but accounting profits do not always relate directly to stock price. In this case, the directors avoided recognizing the loss on the DLJ investment and thus made profits appear larger than they would have if they had followed the traditional route of selling the shares and distributing the proceeds to the shareholders. This unusual result occurred because the compensation of the directors was linked to accounting profits instead of stock market price. They could not take the large capital loss without substantially affecting their bonuses, so they came up with a novel way to avoid taking the loss. However, this creative decision to directly distribute the stock to the shareholders cost American Express and its shareholders the tax benefits of the anticipated accounting loss. This move clearly was not in the best interests of shareholders — it cost them in the form of higher than anticipated taxes. The incentive structure was the problem.

3. The Business Judgment Rule: Judicial interpretations of the fiduciary duty of due care protect managers from second-guessing informed business decisions. See the discussion in this section, *infra*.

4. Typical Compensation Arrangements: Accounting-based profit-sharing arrangements are often used for middle and lower-level employees who are generally not in a position to manipulate accounting data. However, for top-level executives, compensation is usually linked to stock price. The stock market is an external monitor of firm performance and is difficult to fool with using accounting shenanigans. With the proper compensation system in place, manipulation does not occur and shareholders are better off. However, if the incentives are wrong and if directors do not diligently monitor the executives who have the ability to manipulate accounting numbers, then disaster can strike. The meltdowns of Enron, WorldCom, and Arthur Andersen in 2001 are examples of how bad things can get when incentives are misaligned, and board monitoring is non-existent.

e. Markets for Managers

Corporate managers recognize that they can improve the performance of the firm by reducing agency costs. Managers compete with one another to attain the top positions in their companies, and most promotion decisions are made on the basis of an individual's productivity. Shareholders benefit as managers attempt to climb the corporate ladder by improving their productivity and impressing their superiors. Moreover, top-level managers often increase their salaries by jumping to other firms (or at least threatening to do so). Thus, competition for managerial services, both inside and outside the corporation, encourages managers to act in shareholders' best interests.

f. The Board of Directors

At the heart of Berle and Means' attack on the large publicly traded corporation is the board of directors' acquiescence to the decisions of the management. In this perspective, the board is assumed to reflect the same agency problems as managers. Recent developments in the economics of corporate hierarchy have helped to clarify the board's role as a monitor of managerial decisions. This analysis takes the separation of ownership (residual risk bearing) and control (decision management) analysis one step further and looks at the specialization of functions by agents who control the firm. One branch of this analysis has concentrated on the complementary roles of managers and directors.

The role for the board of directors is to establish an effective decision monitoring structure. The control of the corporation by agents is separated according to function whereby

decision management (the initiation and implementation of strategic plans) is entrusted to senior managers and decision control (the ratification and monitoring of the strategy formulation and implementation process) is the domain of the board of directors. That is, the management control functions are delegated to the board by the residual claimants, and the board then delegates most decision management functions and many decision control functions to internal agents. However, the board retains ultimate control over the internal agents — including the right to ratify and monitor major policy initiatives and to hire, fire, and set the compensation of top level decision managers. Agency problems are reduced by tying compensation to these specialized activities. Thus, unlike the Berle and Means perspective, which views directors as pawns in the managers' hands, the role of the directors is important to the control of agency costs and, hence, the long-term survival of the firm. However, when directors behave the way Berle and Means describe, disasters such as Enron and WorldCom are more likely.

g. Ownership Structure

Ownership structure often plays an important role in the governance of corporations. In contrast to the convention of viewing the governance role of residual claimants as that of being "rationally ignorant" of the firm's internal affairs and exiting the firm upon dissatisfaction, owners of large blocks of shares may have so much of their wealth tied up in a firm that they cannot afford to ignore the governance of the corporation. Monitoring, or the possibility of monitoring, by large shareholders alters managerial behavior and reduces agency costs. Thus, ownership structure is another of the many corporate governance mechanisms that can be utilized in controlling agency costs. Of course, in many corporations, the ownership structure is so diffuse that shareholders are truly rationally ignorant, making the other governance mechanisms relatively more important.

In the last few decades however, the rise of hedge funds has led to an increase of shareholder activism. Marcel Kahan and Edward Rock argue that unlike large institutional investors, which have the ownership stakes to impact managers' decision making but also the diversification that makes control unnecessary and uneconomical, hedge funds typically have similar ownership stakes and a focused investment strategy that makes active fund management economical. *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 University of Pennsylvania Law Review 1021 (2007), Investors pay hedge fund managers to actively manage their money in search of uncorrelated and superior returns in the market. One way hedge fund managers achieve those results is by concentrating funds on a smaller number of companies than traditional institutional investors. This allows them to monitor their portfolio companies' managers more closely. Institutional investors are willing to follow the hedge funds' lead, giving them enough votes to hold management more accountable than under the traditional Berle and Means model.

h. Corporate Law and Fiduciary Duties

Emphasis on the interaction of market forces under the contractual theory of the corporation has led some scholars to argue that markets will lead managers to adopt optimal governance structures and that corporate law is irrelevant. However, market mechanisms may be inadequate to deal with last-period, or one-time, divergences when the agent rationally concludes that the benefits of the one-time use of discretion is worth whatever penalties may be forthcoming in the employment market for the agent's services. In this regard, the corporate law of fiduciary duties serves as a legal constraint on managerial opportunism.

Moreover, because markets do not operate without cost, it appears that corporate law plays a productive role in the contractual theory of the corporation by providing a standard form contract that reduces the transaction and negotiating costs of reaching and adhering to optimal contracts. In fact, some commentators have argued that it is appropriate to view corporation law as a standard form contract. Through the law of fiduciary duties, which proscribes theft and specifies standards of care and loyalty, corporate law serves as a substitute for costly, fully contingent contracts. The directors and the officers occupy a **fiduciary relationship** with the corporation and its shareholders. As fiduciaries, the directors and officers have a duty to act with the highest standard of good faith when acting on behalf of the corporation and its shareholders. The primary enforcement mechanism is to hold directors and officers liable for the losses to the corporation that result from their failure to fulfill their fiduciary duties.

Jordan v. Duff and Phelps, Inc.

United States Court of Appeals for the Seventh Circuit

815 F.2d 429 (1987)

EASTERBROOK, Circuit Judge.

Flamm v. Eberstadt, 814 F.2d 1169 (7th Cir.1987), holds that a corporation need not disclose, to investors trading in the stock market, ongoing negotiations for a merger. A public corporation may keep silent until the firms reach agreement in principle on the price and structure of the deal. Things are otherwise for closely held corporations. *Michaels v. Michaels*, 767 F.2d 1185, 1194–97 (7th Cir.1985), holds that a closely held firm must disclose material information to investors from whom it purchases stock, and that a decision to seek another firm with which to merge may be the sort of material information that must be disclosed to the investor selling his shares, even though the firm has not reached agreement in principle on the price and structure of a deal.

The treatment of public and private corporations is different because of the potential effects of disclosure. Often negotiations must be conducted in secrecy to increase their prospects of success. The prospect of disclosure to the public, and therefore to potential rival bidders, may reduce the willingness of some firms to enter negotiations and lead others to cut back on the best price they will offer. Investors are entitled to the benefits of secrecy during the negotiations; a law designed to prevent frauds on investors tolerates silence that yields benefits for investors as a group. *Flamm* also points out that negotiating firms need to know when they must disclose. Uncertainty may lead to premature disclosures that investors would like to avoid. A close corporation may disclose to an investor without alerting the public at large, however, so that disclosure does not injure investors as a whole. Moreover, a rule that the close corporation (or its managers) must disclose in the course of negotiating to purchase stock supplies a timing rule on which the firm may rely. It need disclose the existence of the decision to sell (and the status of negotiations) only to the person whose stock is to be acquired. The face-to-face negotiations allow the investor to elicit the information he requires, while permitting the firm to extract promises of confidentiality that safeguard the negotiations.

This case contains two wrinkles. First, it involves the acquisition of a closely held corporation by a public corporation. Second, the investor in the closely held corporation was an employee, and he was offered shares to cement his loyalty to the firm; yet he quit (and was compelled by a shareholders' agreement to sell his shares) for reasons unrelated to the value of the stock. The parties hotly contest the effects of these facts.

* * *

Duff and Phelps, Inc., evaluates the risk and worth of firms and their securities. It sells credit ratings, investment research, and financial consulting services to both the firms under scrutiny and potential investors in them. Jordan started work at Duff & Phelps in May 1977 and was viewed as a successful securities analyst. In 1981 the firm offered Jordan the opportunity to buy some stock. By November 1983 Jordan had purchased 188 of the 20,100 shares outstanding. He was making installment payments on another 62 shares. Forty people other than Jordan held stock in Duff & Phelps.

Jordan purchased his stock at its "book value" (the accounting net worth of Duff & Phelps, divided by the number of shares outstanding). Before selling him any stock, Duff & Phelps required Jordan to sign a "Stock Restriction and Purchase Agreement" (the Agreement). This provided in part:

Upon the termination of any employment with the Corporation . . . for any reason, including resignation, discharge, death, disability or retirement, the individual whose employment is terminated or his estate shall sell to the Corporation, and the Corporation shall buy, all Shares of the Corporation then owned by such individual or his estate. The price to be paid for such Shares shall be equal to the adjusted book value (as hereinafter defined) of the Shares on the December 31 which coincides with, or immediately precedes, the date of termination of such individual's employment.

* * *

While Jordan was accumulating stock, Hansen, the chairman of the board, was exploring the possibility of selling the firm. Between May and August 1983 Hansen and Francis Jeffries, another officer of Duff & Phelps, negotiated with Security Pacific Corp., a bank holding company. The negotiators reached agreement on a merger, in which Duff & Phelps would be valued at $50 million, but a higher official within Security Pacific vetoed the deal on August 11, 1983. As of that date, Duff & Phelps had no irons in the fire.

Jordan, however, was conducting a search of his own — for a new job. Jordan's family lived near Chicago, the headquarters of Duff & Phelps, and Jordan's wife did not get along with Jordan's mother. The strain between the two occasionally left his wife in tears. He asked Duff & Phelps about the possibility of a transfer to the firm's only branch office, in Cleveland, but the firm did not need Jordan's services there. Concluding that it was time to choose between his job and his wife, Jordan chose his wife and started looking for employment far away from Chicago. His search took him to Houston, where Underwood Neuhaus & Co., a broker-dealer in securities, offered him a job at a salary ($110,000 per year) substantially greater than his compensation ($67,000) at Duff & Phelps. Jordan took the offer on the spot during an interview in Houston, but Underwood would have allowed Jordan to withdraw this oral acceptance.

On November 16, 1983, Jordan told Hansen that he was going to resign and accept employment with Underwood. Jordan did not ask Hansen about potential mergers; Hansen did not volunteer anything. Jordan delivered a letter of resignation, which Duff & Phelps accepted the same day. By mutual agreement, Jordan worked the rest of the year for Duff & Phelps even though his loyalties had shifted. He did this so that he could receive the book value of the stock as of December 31, 1983 — for under the Agreement a departure in November would have meant valuation as of December 31, 1982. Jordan delivered his certificates on December 30, 1983, and the firm mailed him a check for $23,225, the book value (at $123.54 per share) of the 188 shares of stock. Jordan surrendered, as worthless under the circumstances, the right to buy the remaining 62 shares.

Before Jordan cashed the check, however, he was startled by the announcement on January 10, 1984, of a merger between Duff & Phelps and a subsidiary of Security Pacific. Under the terms of the merger Duff & Phelps would be valued at $50 million. If Jordan had been an employee on January 10, had quickly paid for the other 62 shares, and the merger had closed that day, he would have received $452,000 in cash and the opportunity to obtain as much as $194,000 more in "earn out" (a percentage of Duff & Phelps's profits to be paid to the former investors — an arrangement that keeps the employees' interest in the firm keen and reduces the buyer's risk if profits fall short). Jordan refused to cash the check and demanded his stock back; Duff & Phelps told him to get lost. He filed this suit in March 1984, asking for damages measured by the value his stock would have had under the terms of the acquisition.

* * *

All of this supposes that Duff & Phelps had a duty to disclose anything to Jordan. Most people are free to buy and sell stock on the basis of valuable private knowledge without informing their trading partners. Strangers transact in markets all the time using private information that might be called "material" and, unless one has a duty to disclose, both may keep their counsel. The ability to make profits from the possession of information is the principal spur to create the information, which the parties and the market as a whole may find valuable. The absence of a duty to disclose may not justify a lie about a material fact, but Duff & Phelps did not lie to Jordan. It simply remained silent when Jordan quit and tendered the stock, and it offered the payment required by the Agreement. Duff & Phelps maintains that it was entitled to be silent . . . even though it could not have lied in response to the questions Jordan should (in retrospect) have asked but did not.

This argument is unavailing on the facts as we know them. The "duty" in question is the fiduciary duty of corporate law. Close corporations buying their own stock, like knowledgeable insiders of closely held firms buying from outsiders, have a fiduciary duty to disclose material facts. . . .

Because the fiduciary duty is a standby or off-the-rack guess about what parties would agree to if they dickered about the subject explicitly, parties may contract with greater specificity for other arrangements. . . . The obligation to break silence is itself based on state law, and so may be redefined to the extent state law permits. But we need not decide how far contracts can redefine obligations to disclose. Jordan was an employee at will; he signed no contract.

The stock was designed to bind Duff & Phelps's employees loyally to the firm. The buy-sell agreement tied ownership to employment. Understandably Duff & Phelps did not want a viper in its nest, a disgruntled employee remaining only in the hope of appreciation of his stock. So there could have been reason to divorce the employment decision from the value of the stock. Perhaps it would have been rational for each employee to agree with Duff & Phelps to look to salary alone in deciding whether to stay. A contractual agreement that the firm had no duty to disclose would have uncoupled the investment decision from the employment decision, leaving whoever was in the firm on the day of a merger to receive a surprise appreciation. Some might lose by leaving early; some might reap a windfall by buying just before the announcement; all might think it wise to have as little as possible said in the interim.

Yet an explicit agreement to make all employment decisions in ignorance of the value of the stock might not have been in the interests of the firm or its employees. Duff & Phelps was trying to purchase loyalty by offering stock to its principal employees. The package of compensation contained salary and the prospect of appreciation of the stock. Perhaps it paid a lower salary than, say, Underwood Neuhaus & Co., because its package contained a higher

component of gain from anticipated appreciation in the stock. It is therefore unwarranted to say that the implicit understanding between Jordan and Duff & Phelps should be treated as if it had such a no-duty clause; we are not confident that this is the clause firms and their employees regularly would prefer. Duff & Phelps has not identified any firm that adopted such a clause explicitly, and the absence of explicit clauses counsels caution in creating implicit exceptions to the general fiduciary duty.

* * *

The closest Duff & Phelps came is the provision in the Agreement fixing the price of the stock at book value. Yet although the Agreement fixed the price to be paid those who quit, it did not establish the terms on which anyone would leave. . . .

* * *

Our dissenting colleague concludes that all of this is beside the point because Hansen could have said, on receiving Jordan's letter on November 16: "In a few weeks we will pull off a merger that would have made your stock 20 times more valuable. It's a shame you so foolishly resigned. But even if you hadn't resigned, we would have fired you, the better to engross the profits of the merger for ourselves. So long, sucker." This would have been permissible, under our colleague's interpretation, because Jordan was an employee at will and therefore could have been fired at any time, even the day before the merger, for any reason — including the desire to deprive Jordan of a share of the profits. The ability to fire Jordan enabled the firm to "call" his shares, at book value, on whim. On this view, it is foolish to say that Duff & Phelps had a duty to disclose, because disclosure would have been no use to Jordan. . . . Perhaps Duff & Phelps does not want to establish a reputation for shoddy dealing; as our dissenting brother observes, a firm's desire to preserve its reputation is a powerful inducement to treat its contractual partners well. To attribute to a litigant an argument that it will take every possible advantage is to assume that the party wishes to dissipate its reputation, and the assumption is unwarranted.

More than that, a person's status as an employee "at will" does not imply that the employer may discharge him for every reason. Illinois, where Jordan was employed, has placed some limits on the discharge of at-will employees. . . . The silence of the parties may make it necessary to imply other terms — those we are confident the parties would have bargained for if they had signed a written agreement. One term implied in every written contract and therefore, we suppose, every unwritten one, is that neither party will try to take opportunistic advantage of the other. "[T]he fundamental function of contract law (and recognized as such at least since Hobbes's day) is to deter people from behaving opportunistically toward their contracting parties, in order to encourage the optimal timing of economic activity and to make costly self-protective measures unnecessary." Richard A. Posner, *Economic Analysis of Law* 81 (3d ed. 1986). . . .

Employment creates occasions for opportunism. A firm may fire an employee the day before his pension vests, or a salesman the day before a large commission becomes payable. Cases of this sort may present difficult questions about the reasons for the decision (was it opportunism, or was it a decline in the employee's performance?). The difficulties of separating opportunistic conduct from honest differences of opinion about an employee's performance on the job may lead firms and their employees to transact on terms that keep such disputes out of court — which employment at will usually does. But no one . . . doubts that an *avowedly* opportunistic discharge is a breach of contract, although the employment is at-will. . . . An employer may be thoughtless, nasty, and mistaken. Avowedly opportunistic conduct has been treated differently, however.

The stock component in Jordan's package induced him to stick around and work well. Such an inducement is effective only if the employee reaps the rewards of success as well as the penalties of failure. We do not suppose for a second that if Jordan had not resigned on November 16, the firm could have fired him on January 9 with a little note saying: "Dear Mr. Jordan: There will be a lucrative merger tomorrow. You have been a wonderful employee, but in order to keep the proceeds of the merger for ourselves, we are letting you go, effective this instant. Here is the $23,000 for your shares." Had the firm fired Jordan for this stated reason, it would have broken an implied pledge to avoid opportunistic conduct. . . .

The timing of the sale and the materiality of the information Duff & Phelps withheld on November 16 are for the jury to determine. . . .

* * *

REVERSED AND REMANDED.

* * *

POSNER, Circuit Judge, dissenting.

* * *

Jordan's deal with Duff and Phelps required him to surrender his stock at book value if he left the company. It didn't matter whether he quit or was fired, retired or died; the agreement is explicit on these matters. My brethren hypothesize "implicit parts of the relations between Duff & Phelps and its employees." But those relations are totally defined by (1) the absence of an employment contract, which made Jordan an employee at will; (2) the shareholder agreement, which has no "implicit parts" that bear on Duff and Phelps' duty to Jordan, and explicitly ties his rights as a shareholder to his status as an employee at will; (3) a provision in the stock purchase agreement between Jordan and Duff and Phelps (signed at the same time as the shareholder agreement) that "nothing herein contained shall confer on the Employee any right to be continued in the employment of the Corporation." There is no occasion to speculate about "the implicit understanding" between Jordan and Duff and Phelps. The parties left nothing to the judicial imagination. The effect of the shareholder and stock purchase agreements (which for simplicity I shall treat as a single "stockholder agreement"), against a background of employment at will, was to strip Jordan of any contractual protection against what happened to him, and indeed against worse that might have happened to him. Duff and Phelps points out that it would not have had to let Jordan withdraw his resignation had he gotten wind of the negotiations with Security Pacific and wanted to withdraw it. On November 14 Hansen could have said to Jordan, "I accept your resignation effective today; we hope to sell Duff and Phelps for $50 million but have no desire to see you participate in the resulting bonanza. You will receive the paltry book value of your shares as of December 31, 1982." The "nothing herein contained" provision in the stockholder agreement shows that this tactic is permitted. Equally, on November 14, at the board meeting before Hansen knew that Jordan wanted to quit, the board could have decided to fire Jordan in order to increase the value of the deal with Security Pacific to the remaining shareholders.

These possibilities eliminate any inference that the stockholder agreement obligated Duff and Phelps to inform Jordan about the company's prospects. Under the agreement, if Duff and Phelps didn't want to give him the benefit of the information all it had to do to escape any possible liability was to give him the information and then fire him. . . .

* * *

Was Jordan a fool to have become a shareholder of Duff and Phelps on such disadvantageous terms as I believe he agreed to? (If so, that might be a reason for doubting

whether those were the real terms.) He was not. Few business executives in this country have contractual entitlements to earnings, bonuses, or even retention of their jobs. They would rather take their chances on their employer's good will and interest in reputation, and on their own bargaining power and value to the firm, than pay for contract rights that are difficult and costly to enforce. If Jordan had had greater rights as a shareholder he would have had a lower salary; when he went to work for a new employer in Houston and received no stock rights he got a higher salary.

I go further: Jordan was protected by Duff and Phelps' own self-interest from being exploited. The principal asset of a service company such as Duff and Phelps is good will. It is a product largely of its employees' efforts and skills. If Jordan were a particularly valuable employee, so that the firm would be worth less without him, Hansen, desiring as he did to sell the firm for the highest possible price, would have told him about the prospects for selling the company. If Jordan was not a particularly valuable employee — if his departure would not reduce the value of the firm — there was no reason why he should participate in the profits from the sale of the firm, unless perhaps he had once been a particularly valuable employee but had ceased to be so. That possibility might, but did not, lead him to negotiate for an employment contract, or for stock rights that would outlast his employment. By the type of agreement that he made with Duff and Phelps, Jordan gambled that he was and would continue to be such a good employee that he would be encouraged to stay long enough to profit from the firm's growth. The relationship that the parties created aligned their respective self-interests better than the legal protections that the court devises today.

My brethren are well aware that Duff and Phelps faced market constraints against exploiting its employee shareholders, but seem to believe that this implies that the company also assumed contractual duties. Businessmen, however, are less enthusiastic about contractual duties than lawyers are, see Macauley, *Non-Contractual Relations in Business: A Preliminary Study*, 28 Am. Sociological Rev. 55, 64 (1963), so it is incorrect to infer from the existence of market constraints against exploitation that the parties also imposed a contractual duty against exploitation. Contractual obligation is a source of uncertainty and cost, and is therefore an expensive way of backstopping market forces. That is why employment at will is such a common form of employment relationship. It is strange to infer that firms invariably assume a legal obligation not to do what is not in their self-interest to do, and stranger to suppose — in the face of an explicit disclaimer — that by "allow[ing] employees to time their departures to obtain the maximum advantage from their stock," Duff and Phelps obligated itself to allow them to do this.

* * *

The majority's view that "the silence of the parties" is an invitation to judges to "imply other terms — those we [judges] are confident the parties would have bargained for if they had signed a written agreement" is doubly gratuitous. The parties did not want their relationship dragged into court and there made over by judges. And the parties were not silent. The stockholder agreement provides that Jordan's rights under it do not give him any employment tenure. . . . There was no "implied pledge to avoid opportunistic conduct" any more than there were "implicit parts of the relations" giving rise to contractual obligations. . . .

And if Duff and Phelps had fired Jordan (or refused to let him withdraw his resignation), this would not necessarily have been opportunistic. One might equally well say (in the spirit of Villada) that by trying to stick around merely to participate in an unexpectedly lucrative sale of Duff and Phelps, Jordan would have been the opportunist. The majority says that

"understandably Duff & Phelps did not want a viper in its nest, a disgruntled employee remaining only in the hope of appreciation of his stock." I call that "viper" an opportunist.

* * *

Notes and Questions

1. Easterbrook Versus Posner: Which of the judges — both law-and-economics scholars — gets the better of the argument?

2. Contract and Incorporation: Although considerable historical and economic evidence indicates that the corporation is founded in private contract, legal recognition of the corporation is gained through the granting of a charter from a state. In essence, the state's corporation law specifies the terms of the contract, including the property rights of the parties to the contract — the shareholders, directors, and officers. Most corporation laws are enabling statutes in the sense that they reflect the philosophy of freedom of contract which has guided corporation law since the first truly modern general incorporation laws were passed in the late nineteenth century. Most, if not all, of the terms can be altered by a specific provision in the articles or bylaws. The state law specifies the terms of the contract in the absence of a specific provision amending the laws. By defining rights, the articles of incorporation perform a function analogous to that of a private constitution. Firms may alter some aspects of the corporation law applicable to them by amending the corporation's articles of incorporation or bylaws to suit their particular needs.

3. Duty of Care, the Business Judgment Rule, and Shareholders' Interests: Directors are supposed to direct the management of the corporation's affairs. Failure to do so may result in liability for the resulting losses. A major problem in this area of corporation law, however, is deciding when a director has failed to fulfill the obligations of the position. In general, the courts are hesitant to second-guess managerial decisions that turn out to be mistaken. In most cases, courts give managers the benefit of the doubt and relieve them of liability through application of the **business judgment rule**. This rule protects decisions made by an honest, unbiased judgment, and it also benefits shareholders. A major policy reason in support of the business judgment rule is that holding directors liable in situations where hindsight reveals that they made a mistake would make it difficult to attract top-quality individuals to serve on boards of directors. In recognition of the adverse impact of holding directors and officers liable when they acted in good faith, several states' corporation laws authorize corporations to indemnify (reimburse) directors for liability payments or for expenses incurred in defending against unwarranted suits.

While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, such a statement is misleading. Whereas an automobile driver who makes a mistake in judgment as to speed or distance and injures a pedestrian will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment as to economic conditions, consumer tastes, or production line efficiency will rarely, if ever, be found liable for the damages suffered by the corporation. Whatever the terminology, the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment, and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labeled the business judgment rule. Although the rule has suffered under academic criticism, it is not without rational basis.

First, shareholders to a very real degree voluntarily undertake the risk of bad business judgment. Investors do not need to buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers. Nor do investors need to buy stock in particular corporations. In the exercise of genuine free choice, the quality of a firm's management is often decisive and information is available from professional advisors.

Since shareholders can and do select among investments partly on the basis of management, the business judgment rule merely recognizes that shareholders assume the risk of bad business decisions.

Second, courts recognize that after-the-fact litigation is an imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty. A decision that was well-reasoned at the time it was made may seem a wild hunch when viewed years later against a background of perfect knowledge.

Third, because potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions. Some opportunities offer great profits at the risk of very substantial losses, while the alternatives offer less risk of loss but also less potential profit. Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others. With mutual funds and similar forms of diversified investment, courts need not bend over backwards to give special protection to shareholders who refuse to reduce the volatility of risk by not diversifying. A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally.

Whatever its merit, however, the business judgment rule extends only as far as the reasons which justify its existence. Thus, it does not apply in cases in which, e.g., the corporate decision lacks a business purpose, is tainted by a conflict of interest, is so egregious as to amount to a no-win decision, or results from an obvious and prolonged failure to exercise oversight or supervision. Other examples may occur. Joy v. North, 692 F.2d 880, 885–86 (7th Cir. 1982).

4. The Evolution of Business Organizations: Much of the economic literature on the governance of the modern corporation reflects an evolutionary view of the development and use of certain governance mechanisms. This view is clearly reflected in the following statement: "Absent fiat, the form of organization that survives in an activity is the one that delivers the product demanded by customers at the lowest price while covering costs." Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 Journal of Law & Economics 301, 301 (1983). The modern corporation appears to be passing the test of time.

i. Corporate Federalism

The relationship between shareholders and managers is governed by two sources of law. Federal securities laws, which are primarily concerned with securities transactions, set forth detailed procedures for shareholder votes. Otherwise, state corporation law governs the internal affairs of corporations. Importantly, corporations (or, more correctly, corporations' managers) can incorporate under the laws of any state, regardless of the location of the corporate headquarters. To the extent that there are differences in corporate laws across states, corporate law is one of the governance mechanisms that *can be* selected by the contracting parties to minimize corporate agency costs. States, however, don't always offer laws that appear to be in shareholders' best interests. See, e.g., Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496 (7th Cir. 1989).

Notes and Questions on Corporate Federalism

1. Race for the Bottom: The competition among the states — which is often referred to as a **race for the bottom** — has been criticized because it allegedly lowers the standards of managerial accountability to shareholders. Justice Louis Brandeis provided an early articulation of the negative effects of jurisdictional competition in the interstate market for charters: "Companies were early formed to provide charters for corporations in states where the cost was lowest and the laws least restrictive. The states joined in advertising their ware. The race was not one of diligence but of laxity." *Liggett Co. v. Lee*, 288 U.S. 517, 256 (1933) (Brandeis, J., dissenting). In the modern debate on corporate governance, the attack on competition among the states is based on the following syllogism: states gain from chartering corporations; managers prefer fewer restraints on their accountability to shareholders; managers effectively control the selection of the chartering states; therefore, states compete through lowering (to the bottom) the legal fiduciary standards of managerial performance and accountability to shareholders. Assuming, for the sake of argument, that the competition does result in a lowering of standards of managerial conduct, the appropriate policy response still depends on how important fiduciary standards are to controlling managerial behavior. Conflicting policy recommendations may be the result of different conceptions of the corporation.

2. Race for the Top: Judge Ralph Winter has questioned the logic of the "race to the bottom" analysis:

> (1) If Delaware permits corporate management to profit at the expense of shareholders and other states do not, then earnings of Delaware corporations must be less than earnings of comparable corporations chartered in other states and shares in the Delaware corporations must trade at lower prices. (2) Corporations with lower earnings will be at a disadvantage in raising debt or equity capital. (3) Corporations at a disadvantage in the capital market will be at a disadvantage in the product market and their share price will decline, thereby creating a threat of takeover which may replace management. To avoid this result, corporations must seek out legal systems more attractive to capital. (4) States seeking corporate charters will thus try to provide legal systems which optimize the shareholder-corporation relationship.

Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 Journal of Legal Studies, 251, 256 (1977).

j. Corporate Federalization

While traditionally corporate law is the domain of state law, the federal government has followed the general trend of hastily passing corporate governance legislation in the wake of major economic downturns. For example, the Securities and Exchange Acts of 1933 and 1934 were a product of the 1929 stock-market crash and Great Depression. More recently, two major federal laws passed in the wake of the last two downturns have vastly expanded the federal government's role in regulating corporate governance—the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 Cornell L. Rev. 1019, 1020 (2012).

Notes and Questions on Corporate Federalization

1. Sarbanes-Oxley and the End of Jurisdictional Competition in Corporation Law?: In late 2001 and early 2002, following a stock-market bubble and recession, American stock

markets were further hit with reports of several massive financial accounting frauds. The collapse and bankruptcy of Enron in December 2001 was the most spectacular. Numerous corporations were reporting accounting irregularities and restating their financial reports. Although Congress held hearings in the spring of 2002, it appeared that significant legislative intervention was unlikely. However, when WorldCom declared bankruptcy in the summer of 2002, Congress responded by passing the Sarbanes-Oxley Act of 2002 (SOX). For a history of the passage of SOX, see Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale Law Journal 1521 (2005).

Prior to SOX, the states were the primary source of the law of corporate governance. In general, this remains true today. Delaware, of course, is the leader in the competition among the states for corporate chartering. Jurisdictional competition is a dynamic process that penalizes mistakes and forces state law to evolve to meet the changing needs of businesses or to become extinct. This competition has served us well since 1875 when New Jersey passed the first truly modern general incorporation law. Yet, SOX effectively nationalized several substantive areas of corporate law — and, in the process, struck a major blow against our long established system of creating corporate law — without serious in-depth analysis of the value or the consequences of the changes. For example, SOX imposed four changes in substantive corporate law — (1) independent audit committees; (2) provision of non-audit services; (3) executive loans; and (4) executive certification of financial statements. The weight of academic evidence strongly suggests that these changes do not provide any benefits to shareholders. Will they do harm? Yes, if they impose costs without providing offsetting benefits. From a structural perspective, SOX's intrusion into internal corporate affairs is problematic. Competition among the states provides a mechanism for corporations to move away from inefficient legal regimes, whereas nationalization of corporation law takes away the self-correcting forces generated by competition. Of course, competition continues — it just becomes competition between nations. In this international competition, SOX hurts the competitiveness of all American businesses instead of the few located in a wayward state. International competition might ultimately save American corporations from SOX — because, to the extent SOX penalizes American businesses, there will be political pressure to correct the mistakes in Washington.

Agency theory provides a useful framework for thinking about the role of SOX in protecting shareholder value from managerial malfeasance. A good starting point is to remember that the optimal amount of corporate malfeasance is not zero because the cost of eliminating all malfeasance is greater than the benefit it would provide. In the extreme, we can stop all malfeasance only by outlawing the corporation. But given that the optimal amount of malfeasance is not zero, how do we determine the optimal amount? One approach is to put it in the context of risk — specifically, risk bearing by shareholders. Shareholders are the residual risk bearers in the corporation; they don't get paid until all other claimants are satisfied. Shareholders are assumed to own a diversified portfolio of stocks. Shareholders diversify many different risks — including the risks of managerial ineptness, managerial entrenchment, accounting fraud, malfeasance, lawsuits, and so forth. Prior to SOX, the corporate governance system relied on a combination of ex ante incentives and ex post penalties to control managerial behavior while at the same time allowing managers to take reasonable business risks on behalf of shareholders. Such reasonable business risks would include strategic decisions — markets to enter, mergers and acquisitions, research and development, and so forth — as well as organizational control issues — such as how much to invest in internal controls and in monitoring employee performance. In general, these business decisions were protected by the business judgment rule,

which reflected a public policy of allowing managers to take reasonably informed risks without fear of second-guessing by litigious shareholders with 20-20 hindsight. Corporation law implicitly recognizes that shareholders want directors and executives to take calculated risks — as long as the expected benefits are greater than the expected costs — of all different kinds. In a diversified portfolio, some stocks will perform poorly because of risk taking and some will exceed expectations. Shareholders voluntarily take on these diversified risks in order to achieve a superior combination of risk and return than they could achieve by concentrating their portfolio. To some extent, the investor protection mandates of SOX treat shareholders as if they have concentrated portfolios. Shareholders, however, do not want this type of protection because they can diversify the risk. Forcing directors and managers to be overly concerned about malfeasance builds in underperformance in the sense that it requires managers to devote resources to reducing risks when it is not justified by rational cost-benefit analysis.

2. The Great Recession and the Dodd-Frank Act of 2010: True to form after the massive financial crisis and recession of 2007-2009, Congress, empowered by interest group and populist outrage at large financial institutions, passed another omnibus financial and corporate regulation bill called the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010. Although the legislation's main purpose is to end "too big to fail" banks that are systemically risky to the economy, it includes many corporate governance provisions that apply to all corporations. These corporate governance provisions shift more corporate regulation and monitoring from the states, primarily Delaware, to the federal government and its agencies.

The Dodd-Frank Act aims to change two major aspects of corporate governance. The Act first aims to reduce "excessive" executive compensation. Over the preceding three decades boards of directors, attempting to align management and shareholder interests, have increased the use of stock and other pay-for-performance compensation plans. Many commentators including Harvard Law School's Lucian Bebchuk argue these compensation plans incentivized management to take too much risk is search of short term gains in the form of stock price increases. Secondly, the Act aims to increase proxy access to give active shareholders more influence in choosing the board of directors. The inclusion of the proxy access provisions have little connection to the immediate problems associated with the crisis but made their way into the bill nonetheless.

Stephen Bainbridge argues that the changes to corporate governance are a mixture of therapeutic disclosures and potentially distorting one-size-fits-all rules. The drafters of the Dodd-Frank Act designed the disclosure rules specifically to "shame" corporations into reducing executive compensation, but it is expensive for businesses to implement the disclosures because the data required to comply is complex and difficult to analyze. The rules include a provision to penalize executives for failed investments ex post. The provision will likely meet the aim of reducing the amount of risk executives take, but it necessarily includes risks the shareholders *want* the executives to take. Market forces continue to cap the upside of an investment, but now the down side has potentially greater negative value for the managers beyond that of the shareholders. Thus, managers will now be *even more* risk averse than the shareholders. However, other provisions in the act like say-on-pay and increased proxy access may overpower provisions reducing managers' propensity to take risks on behalf of shareholders. Although the stated purpose of including the governance provisions in the Act was to increase management risk aversion, these provisions, if they work as designed, are likely to further align shareholder and management risk taking goals. The ultimate problem with trying to reduce systemic risk through corporate governance, like the Dodd-Frank Act attempts to do, is the fundamental

misalignment of goals between shareholders and society. Shareholders want managers to be less risk averse, but society wants managers — specifically bank managers — to be more risk averse. Thus the changes made by the Dodd-Frank Act may have the exact opposite consequences as the drafters intended and may facilitate rather than prevent another crisis. Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 Minn. L. Rev. 1779 (2011).

3. Post-Post-Crisis Equilibrium: The post-crisis legislative reaction is not the end of the story. John Coffee, Jr. notes that after the crisis subsides, the main stage shifts back to the states and courts where manager and investor interest groups are more effective. He argues the provisions that are better stay around and the provisions that do the most damage are slowly repealed or overruled by the courts. The most recent example is the repeal of SOX section 404 as part of the Dodd-Frank bill. After the passage of SOX, it became clear that section 404 was expansive, unpopular, and ineffective. Courts and administrative agencies chipped away at the section before Congress finally repealed it in 2010. John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 Cornell Law Review 1019, 1020 (2012).

Figure V-1. Agent-Principal Conflict