June 2012

Using Game Theory and Contractarianism to Reform Corporate Governance: Why Shareholders Should Seek Disincentive Schemes in Executive Compensation Plans

Elias Pete George

Follow this and additional works at: http://digitalcommons.law.ggu.edu/ggulrev
Part of the Business Organizations Law Commons

Recommended Citation
http://digitalcommons.law.ggu.edu/ggulrev/vol42/iss3/4

This Article is brought to you for free and open access by the Academic Journals at GGU Law Digital Commons. It has been accepted for inclusion in Golden Gate University Law Review by an authorized administrator of GGU Law Digital Commons. For more information, please contact jfischer@ggu.edu.
ARTICLE

USING GAME THEORY AND CONTRACTARIANISM TO REFORM CORPORATE GOVERNANCE: WHY SHAREHOLDERS SHOULD SEEK DISINCENTIVE SCHEMES IN EXECUTIVE COMPENSATION PLANS

ELIAS PETE GEORGE

INTRODUCTION

During the last decade, a surprising number of corporate scandals led to significant shareholder losses. As American stock exchanges imploded during 2001 and 2008, outrage among shareholders prompted Congress to enact a new set of corporate governance laws, including the Sarbanes-Oxley Act of 2002 ("SOX") and the Dodd-Frank Wall Street

1 Law Clerk to the Honorable Chief Judge Jennifer P. Togliatti of the Eighth Judicial District Court in Clark County, Nevada; Associate, Gordon Silver, as of Fall 2012; Adjunct Professor of Economics, College of Southern Nevada. J.D. 2011, University of Nevada, Las Vegas, William S. Boyd School of Law; B.A. 2006, Economics, University of Nevada, Las Vegas. I would like to thank my family and friends for their boundless love and support. I would also like to thank the Golden Gate University Law Review Editorial Board, without whose guidance this paper would not have been published. I am particularly grateful to Professor Bradley S. Wimmer, Professor Keith A. Rowley, Professor Nancy B. Rapoport, Joanna M. Myers, Esq., and Gary Davis, CFP, CLU, ChFC who provided helpful comments and edits. I would also like to extend a thank you to His Grace, Ilia Katre of Philomelion, whose constant guidance and words of wisdom prove to be invaluable.

1 For example, Enron, Adelphia, Global Crossing, Worldcom, Bear Stearns, and Lehman Brothers.

Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”). SOX sought to restore public confidence in publicly traded corporations and public accounting firms by increasing transparency and accountability between shareholders and corporate managers. The Dodd-Frank Act sought to further clarify executive compensation and corporate governance provisions by imposing additional restrictions on compensation plans of publicly traded companies. Yet legal and economic scholars have criticized SOX and the Dodd-Frank Act for failing to improve corporate governance and for failing to establish effective incentive structures for corporate managers. The focus of both


6 Robert Prentice, a supporter of Sarbanes-Oxley, stated that “Wall Street and its supporters claim that SOX . . . is damaging New York’s status as center of the financial world.” Robert Prentice, Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404, 29 CARDOZO L. REV. 703 (2007). He further observed that “SOX critics assume that when those who control U.S. companies take them private or those who control foreign firms drop their U.S. listing in apparent efforts to evade SOX’s requirements, they are acting in the best interests of the firm.” Id. at 704; see also John C. Coates IV, The Goals and Promise of the Sarbanes-Oxley Act, 21 J. ECON. PERSP. 91 (2007) (“Sarbanes-Oxley has been attacked as a costly regulatory overreaction.”); Cheryl L. Wade, Sarbanes-Oxley Five Years Later: Will Criticism of SOX Undermine Its Benefits?, 55 LOY. U. CHI. L.J. 595, 595-96 (2008) (noting that “the business community’s criticism of SOX is almost virulent,” as evidenced by a large number of surveys taken of those in academics and business); J.C. Boggs et al., Dodd-Frank at One Year: Growing Pains, 2 HARV. BUS. L. REV. ONLINE 52 (2011), available at www.hblr.org/wp-content/uploads/2011/07/Boggs-Foxman-Nahill-Growing-Pains.pdf (providing a brief analysis of Democratic and Republican arguments for and against Dodd-Frank); The Dodd-Frank Act: Too Big Not to Fail, ECONOMIST, Feb. 18, 2012, available at www.economist.com/node/21547784 (arguing that “there is an ever-more-apparent risk that the harm done by the massive cost and complexity of [Dodd-Frank’s] regulations, and the effects of its internal inconsistencies, will outweigh what good may yet come from it.”); Eric Dash, Feasting on Paperwork, N.Y. TIMES, Sept. 8, 2001, available at www.nytimes.com/2011/09/09/business/dodd-frank-paperwork-a-bonanza-for-consultants-and-lawyers.html?pagewanted=all (describing how Dodd-Frank created a new legal industry that seeks to ensure corporations are in compliance: “Dodd-Frank Act is quickly becoming such a gold mine that even Wall Street bankers, never ones to undercharge, are complaining that the costs are running amok.”); Jody Freeman & Jim Rossi, Agency Coordination in Shared Regulatory Space, 125 HARV. L. REV. 1131, 1148 (2012) (stating that the Dodd-Frank Act “overhauled key aspects of the [regulatory] system . . . . Yet much complexity remains in place. Congress did not substantially reduce or consolidate existing federal regulators . . . . Thus, information sharing and coordination remain significant challenges [among corporations] . . . .”).

7 See Erica Beecher-Monas, Corporate Governance in the Wake of Enron: An Examination of the Audit Committee Solution to Corporate Fraud, 55 ADMIN. L. REV. 357, 390-91 (2003) (arguing that SOX “does little to change existing law, while imposing high costs on corporate
Acts on reforming only incentive-based executive compensation plans, rather than promulgating disincentive compensation plans, has failed to assure shareholders that corporate managers will comply with their fiduciary duties, specifically their duty of loyalty.

In light of the 2008 financial crisis, the debate in corporate governance of how best to incentivize corporate managers to serve the interests of shareholders intensified. The collapse of Bear Stearns, Countrywide, and Lehman Brothers, and the greatly diminished power of Bank of America, CitiBank, and AIG heightened this demand for reform. President Barack Obama echoed this concern during his inaugural speech, saying, “our economy is badly weakened, a consequence of greed and irresponsibility on the part of some.” Later that summer, in an effort to reform corporate governance, President Obama unveiled his financial regulatory reform package. Senator Charles E. Schumer (D-N.Y.), a strong proponent of Wall Street, responded with a letter to Kenneth Feinberg, the Special Master for TARP Executive Compensation, writing that this reform was only the “tip of the iceberg,” and urging a more significant overhaul.

Less than a year later, the Obama administration responded with the Dodd Financial Reform Bill. The bill sought in part to provide shareholders with non-binding votes on executive compensation and to require that directors of public companies be elected by a majority of shareholders”). “Studies of corporate compliance have illustrated their ineffectiveness in deterring corporate misconduct, due to the pervasiveness of agency costs, incentives to shift the locus of liability further down the corporate hierarchy, [and] tendencies to make cosmetic rather than real changes.”


11 Troubled Asset Relief Program (TARP) was signed into law by President George W. Bush on October 3, 2008 and was aimed at addressing the subprime mortgage crisis by purchasing assets and equity from financial institutions “to strengthen market stability, improve the strength of financial institutions, and enhance market liquidity.” Troubled Asset Relief Program (TARP) Information, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Sept. 14, 2011), www.federalreserve.gov/bankinf/tarpinfo.htm.


votes cast by shareholders. The Council of Institutional Investors ("CII"), a nonprofit association that champions strong shareholder rights and good corporate governance, applauded the bill as "an important step in the right direction" toward corporate governance reform. CII warned that "improving the regulatory system alone is not enough"; efforts must also be made to rein in corporate manager malfeasance. In July 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, remarking that the Act "demand[ed] accountability and responsibility from everyone," including corporate managers.

Over the last two decades, there has been a great deal of academic literature examining how Congress and federal regulatory bodies—chiefly the Securities and Exchange Commission—can better effectuate corporate governance regulations. Many have applied a behavioral economics approach, which has gained momentum in recent years. Others have incorporated lessons from public-choice theory, while some have called for continued regulation or immediate deregulation.

17 Id.
20 Kent Greenfield, Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as Regulatory Tool, 35 U.C. DAVIS L. REV. 581 (2002); see, e.g., Erica Beecher-Monas, Corporate Governance in the Wake of Enron: An Examination of the Audit Committee Solution to Corporate Fraud, 55 ADMIN. L. REV. 357, 390-91 (2003).
21 Greenfield, Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as Regulatory Tool, 35 U.C. DAVIS L. REV. 583, 586 n.13 ("If one could invest in areas of legal scholarship, 'behavioral law and economics' (BLE) would be a growth stock.")
23 See, e.g., Robert B. Thompson & Hillary A. Sale, Securities Fraud as Corporate Governance: Reflections upon Federalism, 56 VAND. L. REV. 859 (2003) (stating that federal regulation helps to effectively reduce agency costs and remove abuse by corporate managers who have broadened their power under state law).
and a few have even gone so far as to argue that a corporation is not a mechanism to maximize shareholder value, but rather an instrument of the state aimed to maximize societal utility. None of these models, however, satisfactorily answer how best to structure corporate actors’ incentives and disincentives to best serve the interest of shareholders.

This Article employs a model of game theory, a progeny of neoclassical economics, to advocate a novel solution—the inclusion of disincentive provisions in executive compensation contracts.

Currently, the importance of judge-made law in corporate governance and how shareholders should strategically react to these rulings is often overlooked. Legislatures lack expertise in how best to structure a corporation; therefore, they provide for organizational gaps to be filled by judicial intervention. This allows lawyers and corporate actors to more easily react to changes within corporate governance. For example, though statutory law provides a multitude of protections inherent in the corporate form, especially limited liability, the law protecting investors who stand “in vulnerable dependence upon the superior knowledge and capacities” of management is grounded in the courts. Given the potential for abuse by corporate managers who are entrusted with others’ assets, courts have established standards of good-faith dealing. These fiduciary duties are an attempt to effectively

26 Given the primacy of statutory law over judge-made law in matters of corporate governance, theorems also readily focus on mandating change by seeking legislative reform. Unsurprisingly, this has produced myopic solutions that are overly dependent upon cookie-cutter reform packages.
27 Often there is an absence of statutory language that specifically addresses areas of corporate law, especially since public corporations operate in an ever-changing business environment. As a result, courts are often given the task of examining legislative intent and the plain meaning of the words in a statute to make substantive rulings and to fill in the gaps left behind by legislatures.
28 JAMES WILLARD HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780-1970 126 (1st ed. 1970) [hereinafter HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION]; ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 221 (1932) (“The main rules of conduct applicable to management were developed out of common law and not out of statute; which may perhaps account for their development along lines which seem, to the detached observer, more healthy than those of statutes [in terms of flexibility and adaptability].”).
30 See, e.g., STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 2 (2002) (discussing six valuable characteristics corporations provide: formal creation provided by statute, legal personality, separation of ownership and control, free transferability of investor assets, indefinite duration, and limited liability for investors).
32 Id.
manage the divergent interests between shareholders and management.\textsuperscript{33} Court opinions, however, have become replete with inefficiencies and corporate governance has been negatively impacted at the expense of shareholders.\textsuperscript{34} These rulings have skewed fiduciary duties in favor of management, leaving shareholders subject to the whims of corporate managers.\textsuperscript{35}

Employing a model of game theory, this Article shows how current judge-made law in areas of the duty of loyalty does not adequately prevent corporate managers from violating their fiduciary duty. This Article presents a solution, advising shareholders to reform corporate governance through executive compensation contracts that would properly incentivize corporate managers to comport with their duty of loyalty. Part I examines the rise of contractarianism, the prominent legal academic view of a corporation that helps to guide judicial interpretation of corporate law pertaining to managers’ fiduciary duties. Part II examines agency costs, a subset of transaction costs, and the role of fiduciary duties. Part III employs lessons from game theory to show how courts have effectively created incentives for managers to violate their duty of loyalty. And Part IV examines how executive compensation contracts can be structured to properly incentivize managers to comply with their fiduciary duties.

I. THE RISE OF CONTRACTARIANISM

Historically, there have been several competing theories of the law of corporations.\textsuperscript{36} Prior to the Great Depression, natural entity theory viewed a corporation as an entity itself, with an existence separate from its shareholders and corporate managers.\textsuperscript{37} Following the Great Depression, scholars advocated viewing a corporation as a natural person with social obligations, even if that meant a reduction in profits.\textsuperscript{38} Today, the most prominent legal academic view of a corporation is contractarianism.\textsuperscript{39} Contractarianism views a corporation not as entity

\begin{itemize}
  \item \textsuperscript{33} ROBERT C. CLARK, CORPORATE LAW § 4.1 (1986).
  \item \textsuperscript{34} See Frank H. Easterbrook, Manager’s Discretion and Investors’ Welfare: Theories and Evidence, 9 DEL. J. CORP. L. 540, 549 (1984) (discussing the “race to the bottom” phenomenon).
  \item \textsuperscript{35} Id.
  \item \textsuperscript{36} David Millon, Theories of the Corporation, 1990 DUKE L.J. 201, 201-04 (1990).
  \item \textsuperscript{37} Id. at 202. “This view perceived the corporation as an entity . . . and emphasized the state’s constitutive role.” Id. In other words, this view focused on the state using its “charter[ed] authority to impose substantive regulations on corporate activity.” Id.
  \item \textsuperscript{38} Id. at 203 (“[A]dvocates of corporate social responsibility seized on [this] theory in the wake of the Depression and used it as a basis for arguments in favor of corporate citizenship idea.”).
  \item \textsuperscript{39} Id. at 202-03. While David Millon did not use the word “contractarianism,” he stated that “the corporation [i]s a mere aggregation of natural individuals without a separate existence.” Id.
\end{itemize}
itself, but rather as a collection of contractual relationships between shareholders and corporate managers. This contractarian model provides a sounder approach in protecting shareholders’ interests because it focuses attention on the role of transactional costs within these contractual relationships. A historical analysis of the rise of contractarianism follows, as it helps to better understand the role of transactional costs within the context of corporate governance.

A corporation is a creature of statute that pools money from shareholders, and labor from executives and employees, with the primary goal of maximizing investments. Today, corporations in the United States have become an invaluable tool in facilitating economic growth, accounting for almost 90% of all business receipts and holding over $29 trillion of assets. Given the economic magnitude of these entities in combination with their legal construct, the study of corporate law has interested both legal and economic scholars.

A. NEOCLASSICAL ECONOMICS APPROACH TO THE FIRM

Neoclassical economics dominated and continues to maintain a stronghold over the study of the corporation, viewing this legal construct as a subset of a firm. A firm, in its most basic form, can simply be described as a collection of labor lacking substantial internal market

---

40 Id. at 202-03 (asserting that this view seeks “an anti-regulatory conception of corporate law that protect[s] the financial interests of shareholders from any special restrictions on their property rights”). Further, advocates of contractarianism view a corporation through a lens of neoclassical economics, and “used the freedom-of-contract metaphor to support their shareholder primacy, anti-regulatory policy objectives.” Id.

41 See Prudential Ins. Co. of Am. v. Cheek, 259 U.S. 530, 536 (1922) (finding the corporation to be a “creature of the law”).


forces that both derives benefits via specialization and incurs costs via “agency costs.”

47 A corporation is a financial tool in which investors bear the risk and hold claim against the firm’s income and are otherwise removed from the productive activities of the firm. 48 This division of labor between employers (shareholders) and employees (management) diversifies risk through specialization while minimizing transaction costs. 50 Transactional costs are often defined as “the costs involved in organizing economic activity through voluntary exchange.”

The neoclassical approach rests upon three fundamental economic teachings: 1) the specialization of tasks through the division of labor; 52 2) the benefits derived from the aggregation of capital; 53 and 3) the lowering of costs and higher production levels resulting from economies of scale. 54

For almost 100 years the neoclassical approach to corporate law has dominated both legal and economic academia and has provided a

47 This phenomenon simply refers to the monitoring of employees, bonding, and residual costs. For an excellent discussion clearly distinguishing a firm from a corporation, see Easterbrook & Fischel, Contractual Freedom in Corporate Law, 89 COLUM. L. REV. at 1424. A firm may be a large conglomerate or an individual, single-owner proprietary business.

48 Id. at 1425.

49 Employees risk their own physical bodies, time and labor, whereas investors bear the financial risk yet receive a potential return.


51 RICHARD A. POSNER, ECONOMIC ANALYSIS OF THE LAW 419 (7th ed. 2007) (defining transaction costs as “the costs involved in organizing economic activity through voluntary exchange”).

52 Thomas S. Ulen, The Coasean Firm in Law and Economics, 18 J. CORP. L. 301, 305 (1993). This first economic teaching is the specialization of tasks through the division of labor. Given a collection of labor within a business enterprise, limited tasks can be assigned to specific employees where they are able to gain greater degrees of productive efficiency. This specialization of tasks, which proportionately increases the productive power of labor, is rooted in the principles of comparative advantage. See ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 43 (1776).

53 Ulen, The Coasean Firm in Law and Economics, 18 J. CORP. L. at 305. The second economic teaching, which guides the theory of a firm, is grounded in the aggregation of capital goods. Individual production has significant limitations, as it is based entirely on the savings, creditworthiness and human capital of a single actor. A business enterprise, on the other hand, is able to raise considerable more money, maintain superior access to human capital, and more easily invest in technological development, while enjoying limited liability. Id.

54 Id. at 305-06. The third economic teaching rests upon the phenomenon of economies of scale. Economies of scale exist when the long-run average cost curve of a corporation declines as output increases, and often occurs when higher production levels allow for specialization among employees. Corporations rely on economies of scale to generate more profit for their shareholders; as a corporation grows, the cost per widget produced and sold reduces, translating into wider margins. Id.
fundamental framework to better understand the function of corporations.\textsuperscript{55} Multiple rationales help to explain this dominance.\textsuperscript{56} The theory can be deconstructed mathematically, allowing for empirical investigations to test the validity of various hypotheses.\textsuperscript{57} Furthermore, the theory can be manipulated by changing variables such as wages or taxes to predict how a firm will respond accordingly. The theory has also survived as it has because it allows for analysis into how firms realistically interact with one another—imperfect competition.\textsuperscript{58}

Despite its persistence, the theory has two substantive weaknesses. First, neoclassical economics fails to define the arrangements within a firm: how production is organized, how conflicts of interest between firm players are resolved, and how profit is maximized.\textsuperscript{59} Pursuant to this shortfall, economists have famously described the firm as a “black-box,” where inputs are simply put in one end and outputs come out another, somehow maximizing profits.\textsuperscript{60} Second, the neoclassical approach fails to address questions concerning the firm’s size, why it splits or merges, and why some functions are performed in-house while others are contracted away.\textsuperscript{61} As economists sought to address these two substantive weaknesses, their work served as a catalyst to the development of contractarianism, beginning most notably with Ronald Coase’s Theory of the Firm.

B. RONALD H. COASE’S THEORY OF THE FIRM

Both these weaknesses are confronted in Ronald H. Coase’s 1937 classic article, “The Nature of the Firm.”\textsuperscript{62} Coase’s work is arguably the most profound piece of literature examining the internal organization of a corporation while also addressing why there is a firm in the theory of price.\textsuperscript{63} The Nobel Prize winning article\textsuperscript{64} asserted this:

\begin{itemize}
  \item[56] Id.
  \item[57] Id.
  \item[58] See id.
  \item[59] See id.
  \item[61] Hart, \textit{An Economist’s Perspective on the Theory of the Firm,} 89 COLUM. L. REV. at 1758.
\end{itemize}
Outside the firm, price movements direct production, which is coordinated through a series of exchange transactions on the market. Within a firm these market transactions are eliminated, and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-co-ordinator, who directs production. It is clear that these are alternative methods of co-ordinating production. Yet having regard to the fact that if production is regulated by price movements, production could be carried on without any organization at all, well might we ask, why is there any organization?\(^{65}\)

Coase observed that market interactions (“price mechanism”) govern the relationships between firms, whereas interactions within a firm are made by “entrepreneurial coordination,” a function of economic planning, where resources are allocated to their most efficient use via hierarchical direction, not by the price mechanism.\(^{66}\) To illustrate this point, Coase demonstrated that “if a workman moves from department Y to department X [within a firm], he does not go because of a change in relative prices, but because he is ordered to do so.”\(^{67}\)

In presenting this theory of the firm, Coase looked primarily to transaction costs—"cost of transactions under the price mechanism."\(^{68}\) First, a firm comes into existence to reduce transaction costs by grouping labor and capital.\(^{69}\) For instance, absent a firm, steps of the production process would require separate contracts between independent businesses to properly coordinate resources. Coase posits that the costs associated with negotiating and arranging these enforceable contracts can be minimized by giving one party (management) authority over the production process; that is, having a boss instruct employees rather than the employees issuing orders between themselves via contracts.\(^{70}\)

Second, Coase argued that functions are performed within a firm, as opposed to contracted away, when the costs of using the price mechanism to effectuate contracts and transactions are greater than the

More definitively, price theory is a fundamental tool economists use to examine the interaction of two opposing players, where one seeks to maximize marginal utility while the other seeks to minimize marginal costs. For an excellent critique and discussion of price theory, see MILTON FRIEDMAN, PRICE THEORY (2007).

\(^{64}\) Ronald H. Coase was awarded the Nobel Memorial Prize in Economic Science in 1991 for his work in The Nature of the Firm, and The Problem of Social Cost, 3 J.L. & ECON. 1 (1960).

\(^{65}\) Coase, The Nature of the Firm at 72-73.

\(^{66}\) Id.

\(^{67}\) Id.

\(^{68}\) Id. at 75.

\(^{69}\) Id.

\(^{70}\) Id. at 84. The allocation of resources within a firm occurs without the intervention of the price mechanism because of the direct connection and accountability between owners (shareholders) and managers. Id.
costs of using direct authority. To better understand this relationship between external and internal transaction costs, Coase discussed the phenomenon of “diminishing returns to management.” As a firm gets larger, the responsibility of management correspondingly increases, reducing management’s functionality—the ability of management to allocate scarce resources toward their most valuable use correspondingly decreases. This increases the costs of organizing additional transactions, thus diminishing returns. When the marginal benefit of organizing an extra transaction is exceeded by the marginal cost of that additional transaction, a firm will cease expanding and begin contracting out each additional transaction.

Though Coase did much to expand the neoclassical approach to explain the inner workings and outer boundaries of a firm, he poignantly summed up the shortfall of his neoclassical colleagues in *The Firm, the Market, and the Law*, stating:

> Why firms exist, what determines the number of firms, what determines what firms do . . . are not questions of interest to most economists. . . . This lack of interest is quite extraordinary, given that most people in the United States . . . and other western countries are employed by firms, that most production takes place within firms, and that the efficiency of the whole economic system depends to a very considerable extent on what happens within these economic molecules.

C. CONTRACTARIANISM: NEXUS-OF-CONTRACTS THEORY

The genius of Coase’s theorems lay dormant for over thirty years until the work of Armen Alchian and Harold Demsetz helped to bring his analysis of the firm to the forefront of legal and economic scholarship. Specifically, they argued that resources within a firm are allocated to their most efficient use, not via the hierarchical direction as posited by Coase, but rather via the price mechanism. In other words, Alchian and

---

71 Id. at 79.
72 Id.
73 Ultimately, in analyzing the nature of the firm through the transactional-cost lens, Coase likened the price mechanism within the market to a contract within entrepreneurial coordination: tools that both help to efficiently coordinate resources. See generally id.
Demsetz suggested that the same market forces that govern the external affairs of a firm also govern the firm’s internal affairs. 76

Alchian and Demsetz emphasized the importance of voluntary exchanges through contracts, monitored by team production, in coordinating intra-firm transactions. 77 They were careful in identifying that because a firm rarely owns all of its inputs, “it has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people.” 78 For instance, if an employee disobeys orders from the employer, he or she may be fired, sued or both. 79 This is in essence the same way a consumer (employer) can fire his or her grocer (employee) for offering low-quality products, by shopping elsewhere. 80

Both the Coase and Alchian-Demsetz view of a corporation placed emphasis on how best to effectuate relationships inside and outside a firm in an effort to minimize transaction costs. Their work in examining what governs the external and internal affairs of a corporation helped give rise to contractarianism. 81

77 Id.
78 Id. at 777-78.
79 Id.
80 Id. at 778.
81 In arguing that the same market forces govern both the external and internal affairs of a firm, Alchian and Demsetz explain that the difference between a consumer-grocer relationship and an employer-employee relationship is rooted in team production. Cooperative productive activity is advantageous because the “team” is able to yield more output, often of better quality, at reduced transactional costs. Id. at 780. This reduction in transaction costs and increase in both aggregate and quality of goods is grounded in the theory of specialization. To better incentivize team employees, remuneration should be based upon the marginal productivity of each laborer. Marginal productivity is simply calculated by dividing total output by the number of laborers. But, because both work and play enter into an employee’s utility function, problems of shirking (an agency cost) inevitably arise. Id. at 781. Shirking is conduct of an individual that diverges from the interests of the firm, and it is aimed at maximizing the individual’s utility at the expense of the team’s efforts. HAROLD DEMSETZ, THE ECONOMICS OF THE BUSINESS FIRM: SEVEN CRITICAL COMMENTARIES 1, 18 (1995). As a result, team production presents two problems that actually increase transactional costs: monitoring input production and monitoring rewards to best economize incentives. Alchian & Demsetz, Production, Information Costs, and Economic Organization, 62 AM. ECON. REV. at 778. Alchian and Demsetz posited that the best monitoring tool is a “centralized contractual agent” (a “specialist”) who monitors the marginal productivity of the employees. Id. To best incentivize this specialist, Alchian and Demsetz concluded that he or she must be given five rights (ownership) in the firm: “(1) to be a residual claimant; (2) to observe input behavior; (3) to be the central party common to all contracts with inputs; (4) to alter the membership of the team; and (5) to sell [this bundle of] rights.” Id. at 783. This “bundle of rights” language has spearheaded theorems that characterize firms under the rubric “property rights.” Reza Dibadj, Reconceiving the Firm, 26 CARDOZO L. REV. 1459, 1470 (2005). The bundle of rights, which represents a separation in security ownership and control between the employer and employee, is facilitated by a set of contracts. Alchian & Demsetz, Production, Information Costs, and Economic Organization, 62
While Coase, Alchian, and Demsetz laid the groundwork for contractarianism, Michael Jensen and William Meckling are credited with fathering the nexus-of-contracts theory, famously stating that:

The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals.

This contractual nature of the firm, as described by Delaware Chancellor William T. Allen in 1993, was and remains today the prominent legal academic view. Whereas Alchian and Demsetz focused on voluntary exchanges through contracts within a firm, Jensen and Meckling expanded this view, emphasizing that a firm is not an entity per se, but a nexus for contracting multiple relationships among laborers, capital providers, materials, and consumers. This “contractarian” model emphasizes AMER. ECON. REV. at 794. The terms of these contracts form the basis of the firm and are intended to minimize transactional costs and maximize marginal productivity, a byproduct of team production. Id.; see also DEMSETZ, THE ECONOMICS OF THE BUSINESS FIRM: SEVEN CRITICAL COMMENTARIES at 11.


William T. Allen, Contracts & Communities in Corporation Law, 50 WASH. & LEE L. REV. 1395, 1399 (1993); see Cent. States, Se. & Sw. Areas Pension Fund v. Sherwin-Williams Co., 71 F.3d 1338, 1341 (7th Cir. 1995) (“A corporation is just a nexus of contracts.”); Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 195 n.75 (Del. Ch. 2006) (analyzing contractarianism, and adopting the view that a corporation is a nexus of contracts where corporate managers owe fiduciary duties to shareholders, but not the entity); New Orleans Opera Ass’n v. S. Reg’l Opera Endowment Fund, 993 So. 2d 791, 797-98 (La. Ct. App. 2008) (“A corporate charter or articles of incorporation are a contract between the corporation and its shareholders and forms a contractual relationship between the shareholders themselves, which sets forth rights, obligations and liabilities. . . . A corporation is in law a contractual creature, a nexus of contracts.”) (internal citations and quotation marks omitted). Cf. Kidde Indus., Inc. v. United States, 40 Fed. Cl. 42, 55 & n.7 (1997) (“The modern theory of the corporation[,] which looks at corporations as fictitious entities, provides an excellent analytical framework in which to evaluate the economic effects of a corporate action.” Furthermore, a “corporation is simply a legal fiction which serves as a nexus of contracts.”). The Kidde court, however, failed to apply contractarianism to existing tax laws, holding instead that “tax laws treat corporations as distinct and substantive legal entities which are taxed separate and apart from the entities that own them.” Id. at 55.


this legal fiction (firm) as an aggregation of inputs, aimed at bringing competing interests from the market place into equilibrium to efficiently produce goods and services at reduced transaction costs.87 This equilibrium, contractarians believe, is facilitated by both express and implied contracts.88

Viewing the firm as a nexus of contracts, as opposed to an entity, focuses attention on the complex set of contractual relationships that arise for different types of organizations.89 As a result, legal and economic scholars are better able to examine how reducing transactional costs within these contractual relationships can lead to greater degrees of economic efficiency.90

Contractarians argue that corporations arise due to their ability to “reduce the costs necessary to plan, coordinate and accomplish the complex contracts that large-scale ongoing projects would require.”91 The contracting parties are able to pick from a set of default terms, including limited liability, indefinite life, separation of ownership and control, and free transferability of investor shares. These boilerplate terms remove bargaining costs and minimize uncertainty, thereby reducing transaction costs and increasing economic efficiency.92 As the number of parties and transactions increases, the corporation will continue to grow until the benefits derived from the aggregation of labor and capital are exceeded by the costs associated with organization.93

Because contractarians view the corporation as an intricate set of long-term contracts between shareholders and corporate managers,94 they reject the concept that a corporation is an entity independent of its shareholders. Rather, they view shareholders as an input bargained for

91 Allen, Contracts & Communities in Corporation Law, 50 WASH. & L. REV. at 1400.
92 See Bainbridge, Contractarianism in the Business Associations Classroom: Kovacik v. Reed and the Allocation of Capital Losses in Service Partnerships, 34 GA. L. REV. at 635.
94 Id. at 90.
and bound by voluntary contracts. Through these voluntary contracts, shareholders are the residual claimants to the firm’s assets and cash flows, exposing shareholders to the risk of loss and making them the sole “risk bearers” in the corporation. Thus, the interests of shareholders and corporate managers are divergent: shareholders’ interest lies in maximizing corporate profits, whereas corporate managers’ interest lies in maximizing personal monetary gain. This inherent divergence of interest is known as the “principal-agency problem.” To curtail the costs associated with the principal-agency problem, courts have developed fiduciary duties.

This judge-made law has given rise to the structure of corporate governance, which is why a corporation can simply be referred to as a “contractual governance structure.”

Contractarianism provides rich insight into how corporate managers’ fiduciary duties best effectuate a well-organized corporate governance structure. The contract analogy helps scholars to better understand the role of transactional costs in the theory of the firm, specifically how those transactional costs may be minimized through more efficient contracting, thus providing a more economically sound corporate governance structure. This ultimately helps shareholders, as

---

97 Id. at 210.
99 Id.
102 See EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW at 14 (“To understand corporate law you must understand how the balance of advantage among devices for controlling agency costs [e.g., corporate manager fiduciary duties] differs across firms and shifts from time to time.”). Easterbrook and Fischel also likened fiduciary principles to actual contracts, and explained how the study of these principles in light of contractarianism helps to better “shield” shareholders from disloyal corporate managers. Id. at 92-93. Part II of this Article discusses the role of corporate manager fiduciary duties in corporate governance in greater detail.
residual claimants, by better protecting their interests through strengthen- 
ing corporate managers’ fiduciary duties.103

II. AGENCY COSTS AND THE ROLE OF FIDUCIARY DUTIES WITHIN A CORPORATION

In viewing a corporation as a “nexus of contracts,” the subtle difference between an economic and legal analysis of a contract becomes noticeable.104 Economists focus primarily on the positive theory of agency and how best to allocate resources and incentives amongst the contracting parties so as to best maximize reciprocal expectations.105 In forming a corporation, this approach relies upon both an ex ante incentive-alignment method, and an ex post governance-mechanism approach, both of which seek to mitigate the divergent interest between corporate managers and shareholders that may subsequently arise.106 For instance, economists advocate constructing incentive-based contracts to compel one party, generally the corporate manager, to work in the best interest of another party, the shareholder.107 This contract is governed by (1) the threat of being fired, (2) the opportunity of being hired elsewhere, and (3) the free flow of information.108

Legal practitioners, on the other hand, have adopted a broader interpretation of the contract known as normative contractarianism.109 The lawyer pays “particularly close attention to the indicia of contract formation—offer and acceptance, an exchange of promises—ideally reflected in an explicit bargaining process.”110 These elements of contract formation are enforced both by statutory law and by the common law of fiduciary duty.111 Essentially, lawyers’ interpretation of a contract within corporate law incorporates the economist’s approach to

---

103 Part II outlines how court-imposed fiduciary duties aim to mitigate transactional costs by reducing the need to individually contract these duties, thereby allowing for more certainty in contract terms and enforcement.
105 Id. at 1549-50.
106 Id. at 1550.
108 Id.
109 Gordon, The Mandatory Structure of Corporate Law, 89 Colum. L. Rev. at 1549.
110 Id.
111 Id.
Initially, there may be some confusion concerning the application of the principal-agency problem to discuss the function of fiduciary duties as they apply to corporate directors, who are not agents in the proper sense. For purposes of this Article, the word agent is to be read broadly to include both corporate officers and directors, both of whom work primarily to advance the interests of the principal (shareholders). As a result, both corporate officers and directors will be referred to collectively as “corporate managers.”

Normative contractarianism aims to incentivize corporate managers to serve the interests of shareholders by structuring their fiduciary duties

---

112 Id. at 1550; see Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 YALE L. J. 87, 88-89 (1989) (describing how fiduciary duties are immutable terms that cannot be waived by the contracting parties, which is an attempt by the judiciary to reduce transaction costs).

113 An often-cited decision on corporate fiduciary duties in Delaware stated as follows: “Corporate officers and directors . . . stand in a fiduciary relation to the corporation and its stockholders.” Guth v. Loft, 5 A.2d 503, 510 (Del. 1939). See also WILLIAM MEADE FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 837.50 (2003) (“[C]orporate directors and officers occupy a fiduciary capacity . . . .”); id. § 991 (“To a great extent, the rules governing liability are the same whether the officer sued is a director or some other officer such as the president, vice president, secretary . . . .”); see, e.g., Hillary A. Sale, Delaware’s Good Faith, 89 CORNELL L. REV. 456, 462 n.28 (2004) (The fiduciary duties discussed in this Article apply both to directors and officers.). Executive compensation contracts are negotiated and executed on behalf of shareholders by executive committees, such as compensation committees. While directors ultimately ratify these contracts, this Article views directors as agents for purposes of principal-agency theory since directors are bound by the same fiduciary duties as corporate officers.

114 This view is not uncommon and is often used when examining the duties that directors and officers owe to the shareholders. Though common, grouping directors and officers under the same umbrella of fiduciary duties has confused and even stumped courts. Robert Cooter & Bradley J. Freedman, The Fiduciary Relationship, Its Economic Character & Legal Consequences, 66 N.Y.U. L. REV. 1045, 1046 n.2 (1991) (quoting LAC Minerals Ltd. v. Int’l Corona Res. Ltd., [1989] 2 S.C.R. 574 (Can.)). The court in LAC Minerals stated:

There are a few legal concepts more frequently invoked but less conceptually certain than that of the fiduciary relationship. In specific circumstances and in specific relationships, courts have no difficulty in imposing fiduciary obligations, but at a more fundamental level, the principle on which that obligation is based is unclear. Indeed, the term “fiduciary” has been described as “one of the most ill-defined, if not altogether misleading terms in our law . . . .”

LAC Minerals Ltd., 2 S.C.R. 574. Even Justice Frankfurter referenced the ubiquitous nature of fiduciary relationships in S.E.C. v. Chenery Corp., 318 U.S. 80, 85-86 (1943), stating,

[T]o say that a man is a fiduciary only begins analysis: it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?

Chenery Corp., 318 U.S. at 85-86.
more appropriately. Corporate governance refers to the set of rules that codifies the relationship between shareholders and corporate managers. Strong corporate governance rules increase transparency and accountability by minimizing transaction costs and efficiently balancing management discretion. The strength of these rules correlates with greater capital investment and thus market development. Conversely, weak corporate governance rules lead to gross mismanagement, waste, and ultimately capital flight.

A. PRINCIPAL-AGENCY PROBLEM AND AGENCY COSTS

Though contractual relationships have incorporated fiduciary duties for nearly 250 years, the purpose of this judge-made doctrine and its function within a corporate governance scheme is best understood in light of agency costs. Agency costs, which include shareholder-monitoring costs, are incurred when the contracting parties attempt to curtail the principal-agency problem by limiting their divergent interests.

Corporate governance scholars famously noted that the central problem of corporate governance is rooted in this divergent interest between shareholders and corporate managers. Shareholders have

---

117 Id.
118 Id.
119 Id.
121 Eugene Fama, Agency Problems and the Theory of the Firm, in THE ECONOMIC NATURE OF THE FIRM, A READER, 200-02 (1980); ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 123 (1932). These divergent interests have haunted economists and legal theorist for centuries, dating back most notably to Adam Smith’s The Wealth of Nations in 1776:

The directors of [jointstock] companies, however, being the managers, rather of other people’s money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. . . . Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

surrendered their right to the corporation by entrusting their assets to corporate managers, who shareholders hope will act in their best interest.123 Shareholders also pool their money to take advantage of economies of scale, and they choose corporate managers based in part on the managers’ human capital and existing professional relationships.124

This interdependent relationship gives rise to the principal-agency problem: “the interests of ownership and control are in large measure opposed if the interests of the latter grow primarily out of the desire for personal monetary gain.”125 This lesson is rooted in the neoclassical thought that parties to a contract are utility maximizers.126 While shareholders are primarily concerned with maximizing return on investment, they risk appropriation and/or arbitrage127 by the corporate managers they hire.128 Corporate managers may “slack off,” another threat to shareholders’ interest.129 “Slacking off” occurs when an agent gains a greater degree of utility by introducing more play than work into his or her utility function.130 In essence, the corporate manager is able to increase his or her hourly wage or salary by working less.131

123 Sheehy, Scrooge—The Reluctant Stakeholder, 14 U. MIAMI BUS. L. REV. at 211.
124 BERLE & MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY at 119-25; Michael Jensen & William Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, in THE ECONOMIC NATURE OF THE FIRM, A READER, 209, 212. (1986). This agency relationship was also famously defined by Jensen and Meckling as “a contract under which one or more person (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.” Id. at 123.
125 Id. at 123.
126 Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, in THE ECONOMIC NATURE OF THE FIRM, A READER, 209, 212 (1986); see HAROLD DEMSETZ, THE ECONOMICS OF THE BUSINESS FIRM: SEVEN CRITICAL COMMENTARIES 66-67 (1995) (noting that some economists bifurcate utility-maximizing behavior from profit-maximizing behavior, arguing that agency problems arise only when principals maximize profit, not utility). This Article takes a common approach, which is to view profit as an independent variable within an actor’s overall utility function.
127 The term “arbitrage” refers to the simultaneous purchase and sale of some good or service in different markets to profit from unequal prices.
128 Id.
129 Easterbrook & Fischel, Contractual Freedom in Corporate Law, 89 COLUM. L. REV. at 1424.
130 See id.
131 Id. at 1422.
This principal-agency problem gives rise to agency costs.\textsuperscript{132} Agency costs are defined as “the sum of: (1) the monitoring expenditures by the principal, (2) the bonding expenditures by the agent, [and] (3) the residual loss.”\textsuperscript{133} Monitoring costs are incurred by the shareholder when he or she seeks to enforce a corporate manager’s incentive-based contract, which was originally designed to limit divergent interests.\textsuperscript{134} This form of oversight is used when the marginal benefit achieved through reduced shirking exceeds or is equal to the marginal cost of monitoring the agent’s aberrant activities.\textsuperscript{135}

When monitoring becomes too costly or impractical, shareholders will bond the corporate manager.\textsuperscript{136} Bonds are devices, which may include attaching the corporate manager’s pay to the corporation’s performance, that ensure the shareholder is compensated when the corporate manager takes a certain action.\textsuperscript{137} On the other hand, bonding may prevent the agent, through the imposition of penalties, from taking actions that might materially impair the shareholder’s interest.\textsuperscript{138} The transactional costs incurred by the shareholder via monitoring and bonding reduce the shareholder’s dollar value in the corporation.\textsuperscript{139} This loss is referred to as the “residual loss.”\textsuperscript{140}

Both “monitoring” and “bonding” are methods of private regulation.\textsuperscript{141} More generally, these methods include the employment market: the threat of being fired or penalized with lower wages, or the

\begin{itemize}
  \item \textsuperscript{132} Erica Beecher-Monas, \textit{Enron, Epistemology, and Accountability: Regulating in a Global Economy}, 37 IND. L. REV. 141, 146 (2003). Harold Demsetz provides an excellent discussion regarding the economics of agency costs within a firm. He states that, because monitoring and bonding costs cannot feasibly be eliminated, transaction and information costs are positive. This results from the greater degrees of diffuseness of ownership structure, the severity of the agency problem, and the utility function of the principal. \textit{Harold Demsetz, The Economics of the Business Firm: Seven Critical Commentaries} 23-30 (1995).
  \item \textsuperscript{134} Id.
  \item \textsuperscript{135} Id. at 212-13.
  \item \textsuperscript{136} Id.
  \item \textsuperscript{137} Id.; see also Easterbrook & Fischel, \textit{Contractual Freedom in Corporate Law}, 89 COLUM. L. REV. at 1422-25.
  \item \textsuperscript{138} Jensen & Meckling, \textit{Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure} at 212; see also Easterbrook & Fischel, \textit{Contractual Freedom in Corporate Law}, 89 COLUM. L. REV. at 1422-25.
  \item \textsuperscript{139} Jensen & Meckling, \textit{Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure} at 213.
  \item \textsuperscript{140} Id.
  \item \textsuperscript{141} Easterbrook & Fischel, \textit{Contractual Freedom in Corporate Law}, 89 COLUM. L. REV. at 1422-25.
\end{itemize}
hope of being rewarded for quality performance.\textsuperscript{142} These methods also include the marketplace, where only well-managed firms will survive.\textsuperscript{143} Sophisticated principals may create full-time monitoring contracts, known as employment contracts, to ensure that their interests are protected.\textsuperscript{144} Full-time monitoring and bonding mechanisms were found by principals to be too costly, and often ineffective because of the lack of proper supervision and enforcement.\textsuperscript{145}

B. THE ROLE OF FIDUCIARY DUTIES

An alternative to costly, private monitoring methods is the common-law doctrine of fiduciary duties.\textsuperscript{146} Fiduciary duties are public control mechanisms initially developed by the judiciary to reduce the cost of corporate manager deviance and to maximize shareholder wealth by limiting oversight costs.\textsuperscript{147} Specifically, court-imposed fiduciary duties limit the need for monitoring and bonding costs\textsuperscript{148} because the duties are immutable terms in every corporate manager contract.\textsuperscript{149} This reduces agency costs, a subset of transactional costs,\textsuperscript{150} making the contract more efficient.\textsuperscript{151} The imposition of fiduciary duties in the corporate context “is designed for the protection of the entire community of interests in the

\textsuperscript{143} Id.
\textsuperscript{144} Id. at 92.
\textsuperscript{146} Easterbrook & Fischel, Contractual Freedom in Corporate Law, 89 COLUM. L. REV. at 1431-34.
\textsuperscript{147} Easterbrook & Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW at 92.
\textsuperscript{148} Id.
\textsuperscript{149} Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 YALE L. J. 87, 88 (1989) (distinguishing between default terms (e.g., the warranty of merchantability) that the parties can contract around, and immutable terms (e.g., fiduciary duties) that the parties cannot change by contractual agreement).
\textsuperscript{150} When assessing corporate managers’ fiduciary duties, some scholars have attempted to bifurcate transactional costs and agency costs into separate economic fields; however, the approach adopted in this Article is that agency costs should be viewed as a subset of transactional costs. See Reza Dibadj, Reconceiving the Firm, 26 CARDOZO L. REV. 1459, 1469 (2005); William T. Allen, Contracts & Communities in Corporation Law, 50 WASH. & LEE L. REV. 1395, 1399-1440 (1993). This view is not uncommon; Delaware Chancellor William T. Allen opined that “[t]he transaction costs that corporation law can reduce include costs of negotiation and documentation of the corporate form, but in the dominant academic vision, most importantly they include other so-called agency costs.” Allen, Contracts & Communities in Corporation Law, 50 WASH. & LEE L. REV. at 1400 (emphasis added).
corporation—creditors as well as shareholders." There are two fundamental purposes guiding this doctrine, both of which are byproducts of contractarianism.

First, assuming information symmetry between the contracting parties, perfect fiduciary duties would have been bargained for at minimal or no transactional costs. Unfortunately, since the corporate manager has superior access to inside information and is better positioned to amend corporate policy, relaxed rules governing the corporate manager’s behavior result. A mandatory inclusion of fiduciary duty in every corporate manager contract eliminates this unequal bargaining power and provides shareholders with the aid of the legal system. This aid comes in many forms: ex post review of actions that turned out poorly, imposing both civil and criminal liability as effective deterrents, reducing transactional costs through increased certainty (analyzing prior case law), and leveraging the courts’ comparative advantage in reviewing contract breaches.

Moreover, given the prevalence of corporations today, without these mandatory rules, a considerable variety of private contracts would arise, increasing ambiguity and variance among enforcement efforts. Ultimately, a standardized set of fiduciary duties enhances shareholder reliance on residual trust and minimizes the threat of opportunism among corporate managers, thus, better serving shareholder interests.

A second function of this doctrine is the restraint that contractarianism imposes upon parties from contracting around corporate manager fiduciary duties. Courts have made opting out extremely difficult and cost-prohibitive, especially for elements of the duty of

154 Id. at 1593; Easterbrook & Fischel, The Economic Structure of Corporate Law at 92.
155 Gordon, The Mandatory Structure of Corporate Law, 89 Colum. L. Rev. at 1593.
156 Id.; see Easterbrook & Fischel, The Economic Structure of Corporate Law at 94-95.
159 Gordon, The Mandatory Structure of Corporate Law, 89 Colum. L. Rev. at 1593.
161 Gordon, The Mandatory Structure of Corporate Law, 89 Colum. L. Rev. at 1593-94.
162 Id.
Establishing fiduciary duties as immutable terms provides more information and assurance to the shareholder today by reducing uncertainty in the future. This hypothetical approach does not assure that the parties will receive their share of the gain, but rather maximizes the interest of all parties in the aggregate. Contractarians argue that, under this approach, parties will choose the ex post wealth maximizing rule that will most benefit the shareholder in the long run. This approach also assumes that the contracting parties have the ability to diversify their risk.

Though a number of arguments have outlined the various purposes and benefits of fiduciary duties, many have simply stated that the duty exists solely to maximize shareholder value. This view, rooted in contractarianism, seeks to make contracts between shareholders and corporate managers more efficient by reducing transactional costs. To best reduce these costs and thus make the parties more willing to contract, the divergent interests between shareholders and corporate managers must be reconciled to the greatest extent possible. Courts created fiduciary duties to mollify these inherently imperfect relationships, and to assure shareholders that their interests will be

---

163 Id.; see also Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 YALE L.J. 87, 126 (1989) (noting that contracting out of immutable terms (such as fiduciary duties) is so cost-prohibitive, given the ex post imposed penalties, that contracting parties find these judge-made gap fillers more efficient in comparison). There has been a recent attempt by the Delaware Chancery Court to allow even those immutable terms, like fiduciary duties, to be modified by contract. See Amirsaleh v. Bd. of Trade of the City of N.Y., Inc., 27 A.3d 522 (Del. 2011) (reversing court of chancery decision). For a brief discussion of the advantages and disadvantages into the effects of Amirsaleh, see J. Robert Brown, What if Contract Replaced Fiduciary Duties? A Lesson from Amirsaleh v. Board of Trade of the City of New York, www.theracetothebottom.org (Nov. 24, 2008), www.theracetothebottom.org/preemption-of-delaware-law/what-if-contract-replaced-fiduciary-duties-a-lesson-from-ami.html. This function finds authority in the Kaldor-Hicks rule, which attempts ex ante to maximize benefit to shareholders ex post. Gordon, The Mandatory Structure of Corporate Law, 89 COLUM. L. REV. at 1594.


165 Id.


167 See id. at 93 (“Detailed contracting, costly enough at the outset of a venture, is almost impossible once a firm has been established. After the firm has raised necessary capital, investors have no practical way of revising the articles on their own to overcome intervening legal surprises. To use the fiduciary principle for any purpose other than maximizing the welfare of investors subverts its function by turning the high costs of direct monitoring—the reasons fiduciary principles are needed—into a shield that prevents investors from controlling manager’s conduct.”).


protected and prioritized.\textsuperscript{171} The result is that contracting costs are reduced and information is more freely exchanged between the parties.

Although the courts’ goal in mandating fiduciary duties, including the duty of loyalty and care, is to protect shareholders, the courts have actually incentivized corporate managers to breach their duty of loyalty. This is because the penalty for breaching one’s duty of loyalty is generally the mere disgorgement of ill-gotten gains.

III. GAME-THEORETIC APPROACH TO THE DUTY OF LOYALTY

Given the evolution of fiduciary duties, courts have found that management owes both a duty of care and a duty of loyalty to all shareholders. Courts will find a violation of the duty of care when management consciously disregards the financial ramifications of its decisions, or when it fails to obtain a rudimentary understanding of the business.\textsuperscript{172} The chief remedy in such cases is to award compensatory (actual) damages to the shareholders.\textsuperscript{173} The duty of loyalty, on the other hand, addresses issues of conflict, where courts require corporate managers to place the corporation’s interest ahead of their own.\textsuperscript{174} This is often referred to as the doctrine of fairness and is imposed primarily by social norms.\textsuperscript{175} The courts more closely scrutinize the duty of loyalty, as compared to the duty of care, because the business-judgment rule is not a valid defense as it is in a duty-of-care violation.\textsuperscript{176} The primary remedy when there has been a violation of the duty of loyalty is disgorgement.\textsuperscript{177} Disgorgement alone, however, is an insufficient


\textsuperscript{172}Francis v. United Jersey Bank, 432 A.2d 814, 821-22 (N.J. 1981) (describing manager’s duty of care to corporation); EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW at 103.

\textsuperscript{173}Francis, 432 A.2d at 826 (in discussing the elements for a duty of care violation, the court states that “the plaintiff has the burden of establishing the amount of the loss or damages caused by the negligence of the [offending officer]. Thus, the plaintiff must establish not only a breach of duty, ‘but in addition that the performance by the director of his duty would have avoided loss, and the amount of the resulting loss.’” (citations omitted)).

\textsuperscript{174}Casey v. Woodruff, 49 N.Y.S.2d 625, 642-43 (N.Y. Sup. Ct. 1944).


\textsuperscript{176}EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW at 103; Camara, Shareholder Voting and the Bundling Problem in Corporate Law, 2004 WIS. L. REV. at 1436 (explaining that courts “impose [a] stiffer standard [here] because there is less reason to trust that directors are exercising their business judgment to the benefit of the corporation when they have interests on both sides of a transaction”).

\textsuperscript{177}Deborah A. DeMott, Causation in the Fiduciary Realm, 91 B.U. L. REV. 851, 852 (2011) (“when a fiduciary breaches the duty of loyalty, a distinctive remedy is available to the beneficiary—
remedy, as it is unlikely to deter managers from violating their duty of loyalty.

A. DUTY OF LOYALTY

Like all contractual obligations that form the corporation, the duty of loyalty is born out of an agreement and consent. The duty of loyalty incorporates elements of fairness and discourages corporate managers from entering into transactions that are unfavorable to the firm. Unlike the duty of care, which is a default term that can be manipulated by contract, the duty of loyalty is non-waivable and thus inherent in every corporate arrangement. Courts have found that willful misappropriation of a firm’s assets is akin to stealing property, which violates fundamental concepts of fairness.

There are two categorical violations of the duty of loyalty. The first is referred to as self-dealing and involves a corporate manager appropriating the firm’s capital without the shareholders’ knowledge or informed consent. To avoid liability on a claim of breach of duty of loyalty, the fiduciary—generally a corporate manager—must prove both that the principal would have consented to the transaction and that no malfeasance was committed.

The second category involves a scenario in which the corporate manager may seek the consent of the shareholder but intentionally omits material facts, thereby stealing profits or opportunities that belong to the firm. This is often referred to as usurping a corporate opportunity; a corporate manager cannot divert to himself or herself an opportunity directed to the corporation. Though a fiduciary is often burdened with proving the fairness of a transaction if he or she is accused of violating disgorgement of the benefit that the fiduciary obtained through the breach.”) (citing Restatement (Third) of Restitution and Unjust Enrichment § 43(1) (Tentative Draft No. 4, 2005)).

181 See id.
183 Id.
184 Id.
185 Id. at 1055.
the duty of loyalty, the opportunity doctrine places the initial burden on the shareholder to prove that the agent usurped an opportunity.187

Since the common remedy for a violation of the duty of loyalty is disgorgement, the corporate manager must pay back to the corporation the fair market value of the profits stolen or the opportunities diverted.188 Though disgorgement is used to deter wrongful conduct by forcing the manager to repay ill-gotten profits,189 this remedy fails to provide a sufficient disincentive for managers to violate their duty.190 This is because mere repayment is an inconsequential concern, absent any other punitive consequences, when weighed against the immense financial gains a corporate manager may net if his or her wrongful conduct is not discovered. Economic game theory is a useful tool in demonstrating this dilemma facing shareholders as they seek to fortify their interests.

B. LESSON FROM GAME THEORY APPLIED TO THE DUTY OF LOYALTY

Game theory, rooted in neoclassical economic theory, is based on the assumption that all players are utility maximizers.191 In light of other rational-based economic tools, like Bayesian probability,192 legal

187 In Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939), the court famously laid out the factors that must be weighed jointly when determining whether a corporate opportunity was usurped by a corporate manager:

[II]f there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is, from its nature, in the line of the corporation’s business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself.

Guth, 5 A.2d at 511.

188 Lynn A. Stout, On the Proper Motives of Corporate Directors (Or, Why You Don’t Want to Invite Homo Economicus to Join Your Board), 28 Del. J. Corp. L. 1, 5-6 (2003).

189 See S.E.C. v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, 102 (2d Cir. 1978) (“Unlike damages, [disgorgement] is a method of forcing a defendant to give up the amount by which he was unjustly enriched.”).

190 Stout, On the Proper Motives of Corporate Directors (Or, Why You Don’t Want to Invite Homo Economicus to Join Your Board), 28 Del. J. Corp. L. at 5-6 (observing that disgorgement is “not the kind of threat to strike terror into a larcenous heart”).


192 Bayesian analysis is “controversial,” restricting players’ equilibrium beliefs as merely responsive behavior (only after they witness how a previous player behaved), whereas game theory provides a better analysis of the law, incorporating out-of-equilibrium or external decisions as forms of “passive conjectures.” Ian Ayres, Three Approaches to Modeling Corporate Games: Some Observations, 60 U. Cin. L. Rev. 419, 420-21 (1991) (“Game theory shows that a wide variety of diverse behavior can fly under the banner of rational decision-making when there is incomplete or imperfect information.”).
Theorists have long favored game-theoretic models.\(^\text{193}\) Game theory allows legal theorists to model scenarios in which asymmetric and incomplete information is possessed by shareholders and corporate managers.\(^\text{194}\)

Game theory, despite the payoff matrices, “game trees” and arcane mathematics, is simply a normative tool that examines how rational players would maximize their utility in the face of “conflict, competition, collusion and cooperation.”\(^\text{195}\) There are numerous independent variables in the theory of games, including the number of players, probability and magnitude of outcome, external and internal influences, and even elements of fairness, equity and property rights.\(^\text{196}\) In the corporate context, this applies to how shareholders and corporate managers can best achieve equilibrium that maximizes their respective utilities.\(^\text{197}\) Since both kinds of parties are presumably rational utility-maximizing players, game theory may be used to test whether the duty of loyalty achieves its primary goal of protecting shareholders.

Game theory brings to light two patent deficiencies resulting from the strict application of the duty of loyalty. First, there is no punitive consequence to a manager who steals profits or usurps a corporate opportunity.\(^\text{198}\) Second, the primary remedy for a duty of loyalty violation is disgorgement—not a punishment per se. Nevertheless, disgorgement remains the remedy favored by the SEC and state governments when regulating the breach of a corporate manager’s duty of loyalty.\(^\text{199}\)

1. Why Punishment Is Important to Effectively Deter Violations

To adequately deter a manager from violating his or her fiduciary duty, the cost of violation should be greater than the potential gain from

\(^{194}\) Id. at 422.
\(^{196}\) Id.
\(^{197}\) Id. at 301; Easterbrook & Fischel, Contractual Freedom in Corporate Law, 89 COLUM. L. REV. at 1435 (“The ‘game’ of corporate governance is most assuredly a repeat game in which people learn from experience.”).
\(^{198}\) Lynn A. Stout, On the Proper Motives of Corporate Directors (Or, Why You Don’t Want to Invite Homo Economicus to Join Your Board), 28 DEL. J. CORP. L. 1, 5-7 (2003).
The following two figures illustrate how court-imposed penalties would be effective in protecting shareholder welfare and limiting manager appropriation.

Figure 1 depicts the potential gains and losses in a scenario in which no penalty is imposed upon a corporate manager who misappropriates a shareholder’s investments. As in all corporate scenarios, a shareholder, the first player to move, must decide whether to make an investment of 1 unit. If he or she decides not to invest, then there is nothing for the manager to respond to, and the game concludes.

<table>
<thead>
<tr>
<th>Corporate Manager (Agent)</th>
<th>Cooperate</th>
<th>Misappropriate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Invest</strong></td>
<td>0.5</td>
<td>2</td>
</tr>
<tr>
<td><strong>Don’t Invest</strong></td>
<td>0.5</td>
<td>-1</td>
</tr>
<tr>
<td><strong>Shareholder (Principal)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Invest</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Don’t Invest</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

If, on the other hand, the shareholder does decide to invest 1 unit, the corporate manager has the opportunity to cooperate or misappropriate. Cooperation produces a total payoff (gain) of 1, which is then equally divided between the players, hence the 0.5 gain for each player in the northwest quadrant (the shareholder, of course, also retains the right to his or her original investment of 1 unit). Here, the principal-agency problem is not present and both players have increased their welfare. Alternatively, if the corporate manager decides to misappropriate (steal) the shareholder’s investment, the shareholder will lose his initial investment of 1, whereas the corporate manager will gain the initial 1 unit he stole, plus the 1 unit of gain earned by the investment, as illustrated in the northeast quadrant.


201 ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 203-07 (5th ed. 2007).

202 For ease of illustration, these scenarios assume that an initial investment of 1 unit will generate 1 unit of gain.
In this scenario, if the shareholder, the first to make a move, decides
to invest, the most profitable response for the corporate manager would
be to misappropriate. Given that the shareholder is likely to anticipate
misappropriation, particularly if there is no disincentive for the corporate
manager to do otherwise, the shareholder’s best move is not to invest.

To respond to this gridlock, courts should impose adequate penalties
on corporate manager misappropriation. The aim would be to protect
shareholders while providing them an incentive to invest. Figure 2
depicts such a scenario, where damages that exceed the gain from
wrongdoing are imposed.

**Figure 2—Penalty Imposed**

<table>
<thead>
<tr>
<th>Shareholder (Principal)</th>
<th>Cooperate</th>
<th>Misappropriate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Invest</td>
<td>0.5</td>
<td>-1</td>
</tr>
<tr>
<td>Don’t Invest</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

In Figure 2, if the shareholder decides to invest 1 unit and the
manager cooperates, then both will receive a 0.5 gain from the
transaction. If, on the other hand, the manager is found liable for
misappropriation of shareholder investments, a court will impose a
penalty upon the corporate manager. Here, for example, the corporate
manager is required to disgorge the initial investment of 1 back to the
shareholder, as well as deliver an additional 1.0 penalty to the
shareholder, which would have been the recovered investment for both
the shareholder and the manager had the corporate manager cooperated.
Thus, the corporate manager is penalized a unit of 1, as opposed to
profiting 2 units in the previous scenario when no penalties were
imposed. Under this scenario, the corporate manager has an incentive to
cooperate and therefore not violate the duty of loyalty to the investing
shareholder. As a result, both shareholders and corporate managers gain
from the transaction. These figures simply illustrate that to effectively
sanction and disincentive corporate managers, damages must equal or exceed the benefit of wrongdoing.

2. Disgorgement Alone Is Not Enough to Protect Shareholders

To better understand these Figures and the role of disgorgement, a simple algebraic equation may be utilized. The expected sanction associated with violating a duty of loyalty “equals the probability that a sanction will be imposed multiplied by its magnitude.” This may be written mathematically as \( E(S) = P \times M \), where \( E(S) \) is the expected sanction the corporate manager must pay, \( P \) is the probability of holding the manager liable, and \( M \) represents the ratio between the sanction and perfect disgorgement; disgorgement is “perfect” when the sanction imposed is equal to the ill-gotten gains (\( M = 1 \)). When \( M < 1 \), the sanction is less than perfect disgorgement. When \( M > 1 \), this does not mean that the probability of discovering a breaching corporate manager is greater than a 100%, but rather indicates a “punishment,” something greater than simply disgorging stolen profits.

Current corporate governance schemes only require perfect disgorgement (\( M = 1 \)) when a manager violates his or her duty of loyalty. The manager is expected only to disgorge those profits or opportunities stolen from shareholders. When disgorgement is perfect (\( M = 1 \)), the manager is indifferent between cooperating or misappropriating profits or business opportunities because when the breaching manager is discovered he must disgorge only the unit gained, but is otherwise no worse off than if he or she had not misappropriated.

This equation demonstrates that only two scenarios adequately protect shareholders’ interests: \( M > 1 \) (Scenario 1); or \( P = 1 \) (Scenario 2). Scenario 1, where a corporate manager is penalized some amount greater than perfect disgorgement, is the most effective way to deter manager disloyalty as illustrated in Figure 2 above. Scenario 2, where the corporate manager is found liable 100% of the time (\( P = 1 \)), is an

---


204 While “\( P \)”—the probability that the manager will be held liable—dramatically impacts court-imposed sanctions, this equation serves to show how the role of disgorgement alone is insufficient at deterring corporate managers from violating their duty of loyalty.


206 Id. at 1052-53.

207 COOTER & ULEN, LAW & ECONOMICS 257-58 (5th ed. 2007). As a tangential note, President Truman is alleged to have joked (complained) that he could never find a one-handed economist.
idealistic approach, existing only if there is perfect symmetry and all information is openly communicated.

Unfortunately, only one scenario exists today: the probability that a disloyal manager will be liable is something less than 100% while perfect disgorgement is the only remedy available under the law. This is due to the principal-agency problem, where imperfect and asymmetric information is possessed by the principal and agent. Accordingly, $P < 1$ and $M = 1$ means $(P \times M) < 1$, which equates to $E(S) < 1$. To be effective, the expected sanction imposed upon a disloyal manager must exceed the gain from his or her wrongdoing. Thus, under the current state of the law, sanctions are generally inadequate to prevent managers from breaching their duty of loyalty and fail to protect shareholder welfare.

In sum, game theory illustrates that current corporate governance schemes fail to protect innocent shareholders from disloyal managers. Given the lethargic pace of the judiciary, and Congress’s failed attempts at seeking corporate governance reform, specifically in the area of executive compensation, the best arena to protect shareholder interest is the private contract market. Here, shareholders will be able to construct specially designed employment contracts in an attempt to make $M > 1$.

IV. CONSTRUCTING AN EFFICIENT CORPORATE MANAGER EMPLOYMENT CONTRACT

In light of the recent financial crisis, the divergent interests of shareholders and corporate managers have resurged in corporate governance. As legislatures seek to protect shareholder interests while reining in manager deviance, fierce debate exists over how best to accomplish these goals. Judge Frank H. Easterbrook has observed that “the trick in constructing a corporate governance structure is to align the

209 Id.
211 Steven H. Kropp, Corporate Governance, Executive Compensation, Corporate Performance, and Worker Rights in Bankruptcy: Some Lessons from Game Theory, 57 DePaul L. REV. 1, 10 (2007).
interest of the agents with those of the investors, not to pretend that self-interest is a pestiferous thing to be conquered.”

Unfortunately, many corporate governance mechanisms have fallen short of their intended purpose of minimizing transaction costs and protecting shareholder interests. Many of the problems associated with mitigating the principal-agency problem are rooted in the development of corporate contracts. For example, questions arise as to whether a complex contract protecting shareholders can be written, and whether it can be done feasibly and without prohibitively high transactional costs.

Given the difficulty of developing an effective corporate governance scheme, it is surprising that there is little discussion on Capitol Hill about reforming the duty of loyalty. The reason, perhaps, is because the duty of loyalty is an immutable term that finds its justification outside the legal system. For instance, scholars state that the operation of the social norm of loyalty and fairness acts as a sanction against managers who fail to cooperate. In other words, scholars have argued that $M$ is in fact larger than 1 given internal pressures, “including . . . a [manager’s] sense of honor; her feelings of responsibility; her sense of obligation to the firm and its shareholders; and, her desire to do the right thing.”

However, as an immutable term, “[t]he duty of loyalty is . . . imposed . . . [by law but] seldom, if ever, imposed by a real contract.”

---


214 Reza Dibadj, Reconceiving the Firm, 26 CARDOZO L. REV. 1459, 1477 (2005) (“The three most important mechanisms to minimize agency costs—managerial incentives, the board of directors, and the market for corporate control—have proven themselves to be embarrassingly weak constraints in their implementation.”).


216 Id.

217 Lynn A. Stout, On the Proper Motives of Corporate Directors (Or, Why You Don’t Want to Invite Homo Economicus to Join Your Board), 28 DEL. J. CORP. L. 1, 7-8 (2003).

218 See id. (citing various scholars who look to this social norm and fairness doctrine); Dibadj, Reconceiving the Firm, 26 CARDOZO L. REV. at 1477-78 (examining fairness and social norm as authoritative); Sheehy, Scrooge—The Reluctant Stakeholder, 14 U. MIAMI BUS. L. REV. at 214; K.A.D. Camara, Shareholder Voting and the Bundling Problem in Corporate Law, 2004 WIS. L. REV. 1425, 1444-45 (2004) (“Common sense teaches that norms of responsible conduct and internalized ideas of right and wrong combined with preferences, as opposed to incentives, for doing right are important bulwarks against deviant conduct.”).

219 Stout, On the Proper Motives of Corporate Directors (Or, Why You Don’t Want to Invite Homo Economicus to Join Your Board), 28 DEL. J. CORP. L. at 8-9 (internal quotation marks omitted).

220 Melvin A. Eisenberg, Corporate Law and Social Norms, 99 COLUM. L. REV. 1253, 1274 (1999); Easterbrook & Fischel, Contractual Freedom in Corporate Law, 89 COLUM. L. REV. at 1436 (“[M]angers . . . may not contract out of the ‘duty of loyalty.’”).

http://digitalcommons.law.ggu.edu/ggulrev/vol42/iss3/4
As a result, scholars propose that if courts increase the impact of these social norms, thereby increasing sanctions, this will better protect shareholder interests since managers will internalize the higher cost associated with violating these norms.221 This utopian view is rooted in the belief that “trust plays an essential role” in corporate contracting, and that any attempt to include the duty of loyalty into a real contract undermines the very purpose upon which this duty is based: fairness and social norms.222

These “trust” scholars agree, however, that current legal sanctions against disloyal managers are insufficient to deter manager deviance.223 Yet, they vehemently argue that the social norm of loyalty “adds the sanction of loss of reputation to the legal sanctions,” which in turn strengthens and thus confirms the duty of loyalty as a valid deterrent.224 Without these social norms, monitoring costs would escalate, resulting in prohibitively high transaction costs.225

Unfortunately, there are two major shortfalls to this belief. First, adopting such a romantic view of corporate law undoubtedly limits the legal and mathematical analysis of the duty of loyalty.226 This in turn restricts scholars’ ability to examine and strengthen this area of law to better protect shareholder welfare. Second, these “trust” scholars fail to note that managers of large, publicly traded corporations operate within a tightly knit social circle, almost entirely immune from allegations voiced.

221 Eisenberg, Corporate Law and Social Norms, 99 COLUM. L. REV. at 1274. Most recently, the United States Attorney’s Office in Manhattan successfully prosecuted Raj Rajaratnam, former head of the Galleon Group hedge fund, of insider trading, where he was sentenced to eleven years in prison and ordered to pay $10 million in fines and forfeit $54.8 million. In response to questions about Mr. Rajaratnam’s sentencing, U.S. Attorney Preet S. Bharrara noted that the deterrent effect of harsh insider-trading sentences is designed to “convince rational business people that the risk is not worth it.” Ultimately, Mr. Bharara pointed to the importance of increasing sanctions on agents—those who oversee others’ assets. Peter Lattman, Rajaratnam Gets 11 Years in Prison for Insider Trading, N.Y. TIMES, Oct. 14, 2011, available at http://articles.boston.com/2011-10-14/business/30280284_1_galleon-group-raj-rajaratnam-zvi-goffer.


223 Eisenberg, Corporate Law and Social Norms, 99 COLUM. L. REV. at 1276; Stout, On the Proper Motives of Corporate Directors (Or, Why You Don’t Want to Invite Homo Economicus to Join Your Board), 28 DEL. J. CORP. L. at 7-8.

224 Eisenberg, Corporate Law and Social Norms, 99 COLUM. L. REV. at 1276.

225 Id.

226 K.A.D. Camara, Shareholder Voting and the Bundling Problem in Corporate Law, 2004 WIS. L. REV. 1425, 1445 (2004) (stating that legal scholars must rely primarily upon psychologists to provide answers or in-depth analysis of the actions taken by corporate managers).
by angry shareholders and news outlets. As a result, the social norm of loyalty is diminished and rendered ineffective as a useful sanction.

Though Congress is not looking directly to the duty of loyalty as a tool for achieving corporate governance reform, it has been examining in great detail executive compensation packages. These pay packages, acting as effective monitoring systems, implicate the duty of loyalty and may be used by shareholders to mitigate the principal-agency problem. However, the benefit of these packages must be weighed against the higher transactional costs of contracting, monitoring, and bonding. Though they present an opportunity to rein in manager disloyalty, executive compensation contracts inevitably incorporate lax fiduciary standards since they are immunized from duty-of-loyalty reviews. Accordingly, corporate managers face little or no punishment for poor performance while the shareholders bear the risk.

In an attempt to balance these divergent interests in light of game theory, Congress and/or shareholders should seek to punish (M > 1) executives who act disloyally, rather than offer purely incentive-based contracts. This Article is not intended to fully develop all material terms of an executive compensation contract for purposes of successfully reining in manager deviance; rather, it will explore problems with the...
status quo and present potential contract terms that might help to increase M over 1.

A. PROBLEMS WITH CURRENT EXECUTIVE COMPENSATION SCHEMES

The current state of executive compensation schemes is under assault as Congress and scholars seek to discover a panacea for this corporate ill. For example, H.R. 1664 proposes to prohibit pay plans that are “unreasonable or excessive, as defined in standards established by the Secretary [of the Treasury]” or a bonus “not directly based on performance-based measures set forth in standards established by the Secretary [of the Treasury].” The problem with this proposal is that it is rooted in the myopic view adopted by Congress that bonuses should rest entirely on performance-based measures.

Over the years, executive pay plans have sought to strengthen the relationship between performance and pay. Traditionally, scholars argued that corporate managers were “overinvested” in the corporation because the manager’s wealth and human capital were tied to that firm. To prevent risk aversion due to this overinvestment, compensation agreements began including risk-incentive components (e.g., stock options), to protect managers from downside exposure while rewarding them for riskier ventures. However, in light of the recent


237 This view was promulgated during the 1980’s and 1990’s when economists and legal theorists sought to restore shareholder confidence by establishing a strong link between pay and performance. See JOHN McMILLAN, GAMES, STRATEGIES AND MANAGERS 123 (1992). For example, Harold Demsetz noted: “[E]xecutive compensation systems in large corporations (today) seem weak in their relationship to firm performance. They seem poorly designed even when one of the objectives is to link compensation to performance.” HAROLD DEMSETZ, THE ECONOMICS OF THE BUSINESS FIRM: SEVEN CRITICAL COMMENTARIES 65-66 (1995). Statistics during this period showed that the marginal rate of payment between firm performance and manager pay was 0.002%. JOHN McMILLAN, GAMES, STRATEGIES AND MANAGERS at 123. So, a corporate manager’s direct pay would increase two cents when the market value of the company increased by $1,000. Id. With respect to stock options, statistics showed the marginal rate of payment was 0.325%. So, for every $1,000 increase in the stock-market value of the corporation, a manager’s remuneration would increase $3.25. Id. at 124. These relationships were extremely tenuous at best, proving that executive incentives were not strong enough. Id. at 124-25.


239 Id.
financial meltdown, positive incentive-based systems alone, without help from a disincentive counterpart, have failed to successfully rein in manager deviance and protect shareholders’ interests.\(^\text{240}\) These risk-incentive terms have caused more harm than good, as firms took on excessively high levels of risk due in part to downward risk protection contracted to corporate managers.\(^\text{241}\) Ultimately, a strictly positive incentive-based scheme, or a “direct incentive scheme,” without a punishment mechanism, incentivizes managers to take on risky ventures without internalizing that risk, thus failing to protect shareholders.\(^\text{242}\) In direct incentive schemes, “[d]irectors are always better off stealing from the corporation . . . than not stealing because they enjoy fully what they steal but only a fraction (the incentive payment for not stealing over the value of the item in question) of what they leave alone.”\(^\text{243}\) Hence there is a need to supplement this positive incentive scheme with a disincentive, or punishment scheme.

B. INCLUDING “PUNISHMENT” TERMS (M > 1) IN EXECUTIVE COMPENSATION SCHEMES

Corporate governance contract terms are often negotiated between executive committees, acting on behalf of shareholders, and corporate managers, whereas the duty of loyalty is nonnegotiable. Though this term is imputed in contracts to reduce transactional costs, shareholders are fully able to include terms that “disingenuously” or punish managers who act disloyally. There are a number of methods and broad terms that could be included in executive compensation contracts to supplement direct incentive terms in a way that would better protect shareholders.

1. The Free Market

The first method relies upon a neoclassical economics approach: the open market rather than the judiciary. The free flow of information, not only between contracting parties, but also within the market that facilitates these corporate contracts, is critical in developing effective compensation plans.\(^\text{244}\) Since corporate governance issues are


\(^{241}\) See id.

\(^{242}\) Camara, Shareholder Voting and the Bundling Problem in Corporate Law, 2004 Wis. L. Rev. at 1443.

\(^{243}\) Id.

\(^{244}\) John McMillan, Games, Strategies and Managers 127 (1992); Easterbrook & Fischel, The Economic Structure of Corporate Law 319 (1991) ("Though information is the
contractual in nature, contractarianism teaches us that punishment terms will be fully priced into the transaction between managers and shareholders.\textsuperscript{245} Though this would otherwise increase agency costs through increased monitoring and bonding efforts to enforce these terms, “the cost of crafting alternatives to the standard-form contracts in the nexus-contracts will be borne only when the perceived benefits exceed the drafting costs.”\textsuperscript{246}

As shareholders increasingly demand punishment terms in executive compensation, the markets—not the negotiating parties—will efficiently price these terms.\textsuperscript{247} However, poorly drafted terms will lead to disloyal management, and overly restrictive terms might cause the best corporate managers to take their talents elsewhere, as well as deter prudent investors. By contrast, well-drafted terms will emerge in the market place, respond to changes accordingly, and effectively attract preeminent talent.\textsuperscript{248} To develop an effective contract to disincentivize managers from violating their duty of loyalty, shareholders must be willing to pay relevant costs in advance, since these terms are preemptory.\textsuperscript{249} As Stephen Bainbridge poignantly stated, “The predictive power of any model of the corporation must be measured by the model’s ability to predict the separation of ownership and control . . . .”\textsuperscript{250}

2. Net-Harm Function

A more viable method is to include damages in the executive compensation plan as a function of the harm caused by the manager’s disloyal acts. The aim is to provide comprehensive incentives to managers while also compelling them to pay damages. This method encourages managers to cooperate and not violate their duty.\textsuperscript{251}

To mitigate costs and maximize shareholder benefit, the optimal punishment is the harm of the disloyal acts, divided by the probability that this disloyalty will be discovered and successfully prosecuted: the

\textsuperscript{245} Easterbrook & Fischel, \textit{Contractual Freedom in Corporate Law}, 89 \textit{COLUM. L. REV.} at 1430.
\textsuperscript{246} ROBERT COOTER & THOMAS ULEN, \textit{LAW & ECONOMICS} 322-23 (5th ed. 2007).
\textsuperscript{247} Easterbrook & Fischel, \textit{Contractual Freedom in Corporate Law}, 89 \textit{COLUM. L. REV.} at 1430.
\textsuperscript{248} \textit{Id.}
\textsuperscript{249} \textit{Id.}
\textsuperscript{250} STEPHEN M. BAINBRIDGE, \textit{CORPORATION LAW AND ECONOMICS} 3 (2002).
net-harm function. For example, if a manager appropriates $100, under a theory of perfect disgorgement (100% discovery/prosecution), he or she will pay back only $100 ($100/100%). If the probability that the manager will be discovered and successfully prosecuted is 50%, he or she will then pay back $200 if caught ($100/50%). In other words, the lower the probability that the corporate manager will be discovered misappropriating funds, the greater the penalty. For example, a disloyal manager who skillfully places stolen assets in an offshore bank account, or establishes various sham entities to hide those assets, is less likely to be discovered. That said, the potential penalty is proportionately greater. Accordingly, the probability that a disloyal manager will be discovered positively correlates to the egregiousness of his or her misconduct. Similar to the assignment of liability under tort law, assigning the probability that the corporate manager would be discovered is best determined by the trier of fact.

This “net harm” function implies an inverse relationship between punishment and the probability of a successful prosecution. A successful prosecution includes the cost of investigation. There are number of components to this investigation cost. First, as shareholders investigate the manager’s actions to ensure loyalty, they will do so until the cost associated with the investigation is at most equal to the benefit derived by the investigation. If shareholders have reason to believe that money stolen or opportunities usurped by a manager were excessive, more investigations would undoubtedly result. Second, as investigation costs rise, the social costs associated with discovering offenses will increase the cost of doing business. In other words, firms that are successful at litigating against their own managers must

253 When a corporation is injured by the breach of a corporate manager’s fiduciary duty, shareholders may bring a derivative action to protect their interests. Schoon v. Smith, 953 A.2d 196, 199 (Del. 2008) (“a stockholder derivative action is available to redress any breach of fiduciary duty . . .”). Furthermore, the net-harm function applies equally to directors as they too are bound by the same fiduciary duties as corporate officers.
256 See EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 321 (1991) (“The structure of rewards should induce enforcers to expend resources finding and prosecuting violations until, at the margin, the last dollar of resources spent on enforcement reduces the (cost of manager disloyalty) by just one dollar.”).
257 Id. at 324.
convince subsequent shareholders that their managers are loyal and that the firms themselves are viable investment options.\textsuperscript{258}

Though this “net harm” function increases agency costs (investigation costs) at the margin, shareholders will benefit in the aggregate through reduced transaction costs. Given the inverse relationship between the probability of successful prosecution and punishment, a manager’s utility function is significantly impacted; the manager, in a sense, monitors himself or herself. For example, shareholders are currently less willing to investigate disloyal acts, unless the money or opportunity stolen was paramount, since their recovery is capped (disgorgement). They are forced to weigh the costs of investigation against the extremely low probability of a successful prosecution (duty of loyalty laws are extremely deferential to managers). Yet, under the “net-harm” function, most of the risk is shifted to managers, who must rationalize whether the benefit derived from a disloyal act is worth the cost of being successfully prosecuted and thus ordered to pay a substantial sum. In other words, as the risk to shareholders increases, the “net-harm” function shifts that risk to the managers, acting as a cost-free monitoring system, thereby reducing transactional costs.

Ultimately, the inclusion of such penalty provisions in executive compensation plans discourages efficient breaches.\textsuperscript{259} Under the theory of efficient breach, the liability for misappropriation must be sufficiently high to reduce the likelihood of breach.\textsuperscript{260} Figure 3 below represents the above statement in a mathematical fashion:

\textbf{Figure 3:}

\[
[\text{Manager’s cost of cooperating} > \text{Manager’s liability for misappropriating (shareholder’s benefit from performance)}] \\
\implies \text{Efficient to misappropriate}
\]

\[
[\text{Manager’s cost of cooperating} < \text{Manager’s liability for misappropriating (shareholder’s benefit from performance)}] \\
\implies \text{Efficient to cooperate} \textsuperscript{261}
\]

\textsuperscript{258} \textit{Id. (“[T]ruthful firms must spend (more money) to distinguish themselves from slipshod and untruthful firms.”).}

\textsuperscript{259} \textit{Id. at 317.}

\textsuperscript{260} \textit{ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 210 (5th ed. 2007).}

\textsuperscript{261} \textit{Id. at 209.}
Figure 3 illustrates that when the corporate manager internalizes the cost of the misappropriating (liability), he or she then has an efficient incentive to perform, which in turn maximizes shareholders’ benefit. In contrast, perfect disgorgement makes a manager indifferent between misappropriating and cooperating, all other things being equal. The following formula summarizes this statement:

**Figure 4:**

\[
\text{Manager's cost of cooperating} = \text{Manager's liability for misappropriating (shareholder's benefit from performance)} \\
\Rightarrow \text{Indifferent between misappropriating or cooperating}\]

Figures 3 and 4 both illustrate how a contract that seeks to punish a disloyal corporate manager can be constructed so as not to overburden the manager while at the same time discouraging disloyal acts. It is important to align the corporate manager’s incentives with the shareholder’s interests so as to maximize the payout for each party.

While this “net-harm” function poses significant advantages, there exists the threat of executive flight. As firms begin including disincentive schemes in executive compensation plans, they may initially deter managers, even potentially loyal ones, who would prefer to work in an environment absent these terms and stress. “Punishment” terms in executive pay plans like the “net-harm” function might send an inappropriate signal to the contracting manager that the shareholders’ trust in the manager is limited to the job offering, not the guaranteed pay.

This argument is shortsighted and unrealistic in a capitalistic society. To stave off competitors who might offer lucrative contracts excluding these terms, shareholders would offer a combination of incentive and disincentive schemes to sweeten the deal. For example, shareholders may reward the manager if his or her performance exceeds specifications, resulting in higher pay in comparison to competitors. These minimums ought to be designed in relation to industry-wide performance standards (e.g., top 25% in the industry) rather than blindly tied to an index (e.g., S&P or NYSE). Ultimately, as these disincentive schemes become standardized and harmonized in the executive compensation market, shareholders will demand even those truthful and loyal companies to incorporate these terms in contracts.

---

262 *Id.*
263 *Id.*
264 STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 3 (2002).
CONCLUSION

The collapse of the market in 2008 highlighted the shortfalls of corporate governance schemes, spawning heated debate on Capitol Hill as to how best to reform current regulations. The legislature is failing to note the importance of judge-made law in areas of fiduciary duty by focusing solely on disclosure requirements as they relate to executive compensation plans. Even more surprising is the lack of attention given to the serviceability of disincentive schemes, particularly discouraging manager disloyalty in executive pay plans. Currently, the primary protection allotted to shareholders when a manager violates his or her duty of loyalty is disgorgement.

Judge Frank H. Easterbrook and Professor Daniel R. Fischel summarized the corporate governance reform debate best: “To understand corporate law you must understand how the balance of advantage among devices for controlling agency costs differs across firms and shifts from time to time.” Though this passage may seem overly romantic and markedly theoretical, Judge Easterbrook and Professor Fischel provide essential insight into corporate governance and the critical role of transaction costs. A progeny of contractarianism, transactional costs lie at the center of corporate law reform today, with scholars examining how best to mitigate these costs through the open market as opposed to judicial or legislative measures.

Mandatory rules like the duty of loyalty—a judicial construct—serve a critical function in corporate law to reduce transactional agency costs. These reduced costs are evidenced by less manager shirking, lower litigation costs, and increased certainty, thus leading to more efficient corporate contracts. As game theory informs us, manager disloyalty is not remedied by way of disgorgement, but actually incentivizes managers to breach their duty. Congress must recognize this shortfall and seek changes in corporate governance through corporate contracts, which would lead to more efficient executive pay plans through the adoption of disincentive schemes. Private corporate contracts will seek to reduce transactional costs while protecting shareholders’ interests.

265 See generally Brian Montopoli, Obama Signs Sweeping Financial Reform into Law, CBS NEWS, available at www.cbsnews.com/8301-503544_162-20011201-503544.html (last visited Apr. 3, 2012) (in signing the Dodd-Frank Act, President Obama stated that “we had to overcome the furious lobbying of an array of powerful interest groups, and a partisan minority determined to block change”).
267 Easterbrook & Fischel, Contractual Freedom in Corporate Law, 89 COLUM. L. REV. at 1428.
As Carl C. Icahn wrote in the *Wall Street Journal*, “Nothing will do more to improve our economy than corporate governance changes.”

Ultimately, as firms evolve in reaction to legislative and judicial reform, “those [who fail] to adapt their governance structure are ground under by competition.”

---


269 *Id.*