A Timely Rhetoric and a Rallying Label: How the Nexus of Contracts Theory of the Firm Helped Tame the Critics of the Giant Corporation*

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Abstract: This article clarifies the origins, meaning and influence of the nexus of contracts theory of the firm by positioning Jensen and Meckling (1976) in the 1970s debates on corporate social responsibility led by Nader and other critics of big business. Strikingly, the publication of Jensen and Meckling's paper coincided with Nader, Green and Seligman's (1976) *Taming the Giant Corporation*. The argument is that just like Alchian and Demsetz (1972) produced a contractual theory of why capital hires labour in response to the radical challenge, thereby answering Lindbeck's (1971) call to counter the New Left, Jensen and Meckling's theory was a response to those that Posner (1974) called the 'Nader-type muckrakers'. In a nutshell, Jensen and Meckling provided a timely rhetoric and a rallying label for the anti-regulatory movement, and played an important, albeit indirect, role in the rise of corporate law and economics.

Keywords: Jensen and Meckling, nexus of contracts, legal fiction, corporate social responsibility, agency theory, corporate governance, federal chartering, creature of the state, contractual choice, market survival test, anti-regulatory movement, corporate law and economics

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1. Introduction

In March 1979 the inaugural Leo Melamed Prize, attributed for "outstanding scholarship by business school teachers" by the University of Chicago's Graduate School of Business (GSB) for the period running from 1 January 1976 to 31 December 1977,[1] was awarded to two of the school's former students, Michael C. Jensen and William H. Meckling.[2] Since its publication in 1976 in the young *Journal of Financial Economics*, co-founded just a few years earlier by Jensen,[3] the award-winning article, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (henceforth JM76), has become one of the most widely cited papers in economics, ranking in a remarkable third position in a recent study of "what has mattered to economics since 1970" (Kim, Morse and Zingales, 2006: 192).

It is hard to overstate the article's influence on financial economics. JM76's key contribution was that it presented the Modigliani-Miller irrelevance of capital structure theorem as a special case of the so-called "Coase theorem," that is, as something that holds only in the absence of contracting costs and wealth effects (Jensen and Smith, 1984: 9; see also Allen, 1999: 904). By introducing positive "agency costs," the article helped do away with the Modigliani-Miller theorem, and

[1] A belated announcement appeared in GSB's flagship journal (*Journal of Business*, 1981: 361). The prize was established in honor of the famous Chairman of the Chicago Mercantile Exchange who in 1972 launched the world's first financial futures exchange.

[2] After an M.B.A in Finance earned in 1968, Jensen (b. 1939) obtained a PhD in Economics, Finance and Accounting in 1968 at GSB, working under Merton H. Miller. Meckling (1921-1998) had undertaken some post-graduate work at GSB under Milton Friedman between 1949 and 1952. He then worked as a RAND analyst, before being appointed Dean of the Graduate School of Management at the University of Rochester in 1964, a position he held until his retirement in 1983. Early on in his tenure, Meckling hired Jensen as Assistant Professor of Finance in 1967. Jensen was promoted to Associate Professor in 1971, and to full Professor in 1979, a position he held until his definite move to the Harvard Business School in 1989.

[3] Jensen co-founded the Rochester-based journal in 1973 with another student of Miller's, Eugene F. Fama, and Robert C. Merton. The first issue appeared in 1974.

paved the way for significant progress in the field of corporate finance. As a result, the extensively used “agency theory” associated with JM76 was rapidly hailed as the fifth major building block of modern corporate finance, alongside efficient market theory, portfolio theory, capital asset pricing theory, and option pricing theory (see Jensen and Smith, 1984: 4ff). This unequivocal success contrasts with the article’s fate in the theory of the firm literature that developed since the 1970s.

On the one hand, Jensen and Meckling’s (1976: 310) definition of the firm as a “nexus for a set of contracting relationships among individuals” that has passed the market survival test sat well with the Coasean theories of the firm based on the idea that centralized contractual structures may be efficiency-enhancing. Not surprisingly, it may be argued, it was adopted by leading theorists such as Armen A. Alchian (1984: 46) and Harold Demsetz (1988: 154). On the other hand, the claim that as a nexus of contracts the firm is a “legal fiction,” and that it therefore “makes little or no sense to try to distinguish those things which are ‘inside’ the firm … from those things that are ‘outside’ of it” (JM76: 311), is at odds with other theories of the firm. As a result, given the literature’s focus on the determinants of the boundaries of the firm, JM76 came to be much cited but little used, to paraphrase Ronald H. Coase (1972: 63), except as a convenient foil.

The other oddity in JM76 was the dismissal of the “personalization of the firm implied by asking questions such as ‘what should be the objective function of the firm’, or ‘does the firm have a social responsibility’” (JM76: 311). The firm’s “personalization” is “seriously misleading,” Jensen and Meckling insisted, since “*the firm is not an individual*” (*ibid.*: emphasis in original). Like the claim that firm is a legal fiction, statements of this kind stand out from both prior and subsequent discussions in the theory of the firm literature, and their meanings and functions in JM76 are unclear. This suggests that these ideas were not intended for theorists of the firm. Indeed, as the examination of Jensen and Meckling’s publications between 1976 and 1983 reveals, the arguments that seem at odds in terms of the theory of the firm literature were intended for a broad audience comprising besides economists, investors, bankers, accountants, lawyers, judges, regulators and politicians, on both sides of the Atlantic.

This paper positions JM76 in the 1970s debates about corporate social responsibility and federal regulation led by Ralph Nader, then America's most outspoken critic of big business. The argument is that, in this context, Gordon Tullock's (1969) call for a "new theory of corporations" to counter critics of the prevailing corporate system, that Richard A. Posner (1974: 341) rather elegantly called the "Nader-type muckrakers," was answered by JM76's contractual perspective on the corporate form. Their view that the "business corporation is an awesome social invention" that "has thus far survived the market test against potential alternatives" (JM76: 357) provided a timely theory of the firm foundation for the anti-regulatory movement, and a rallying label, "nexus of contracts," for the rising corporate law and economics literature developed in Henry G. Manne's (1967) footsteps. The rest of this paper is organized as follows.

Section 2 sets the stage by briefly summarizing some of the themes that dominated mid-century academic debates about corporations. This background makes it easier to understand Nader's positions. The origins of JM76 are examined in Section 3. In order to gain some insights about the meanings of its claims in 1976, Section 4 discusses testimonies presented at the U.S. Senate's hearings on corporate rights and responsibilities, convened to evaluate Nader's proposal to create a system of federal chartering of the nation's largest corporations. Section 5 focuses on some of the post-1976 influences of JM76. It traces how its ideas were picked up and amplified in defense of corporate America until the prospect of sweeping corporate regulation gradually died out.[4] Section 6 concludes by placing JM76 at a unique intersection of (a) economics, (b) finance and (c) law and economics.

2. Context

The rise during the first half of the twentieth century of what Alfred D. Chandler (1977: 287ff) described as the "modern industrial corporation," driven by the relentless search for productive and organizational efficiency, left many contemporary observers with a mixture of awe and apprehension. Indeed, the new-

[4] Marion Fourcade and Rakesh Khurana's (2013) recent discussion of the move "from social control to financial economics" provides an interesting parallel story.

found opulence seemed to come at a price.[5] While mass production meant an unprecedented flow of cheap goods that benefited everyone, many industries were increasingly concentrated and polluting. In this world of imperfect competition, the emergence of corporate giants with dispersed ownership structures meant the irrevocable separation of ownership and control, as Adolf A. Berle and Gardiner C. Means (1932: 112ff) had pointed out, and the concentration of vast and potentially unchecked economic powers in the hands of corporate executives.

In this context, as John K. Galbraith (1952) argued, "countervailing powers" of some kind were needed. Whether in the form of trade union action, investor action, consumer action, or state regulation, the capacity of otherwise "self-perpetuating" managers (Galbraith, 1967: 73ff) to "administer prices" without fear of being replaced (Means, 1962: 78ff) needed to be curbed.[6] Corporate executives wishing to avoid regulation were advised to embrace their "social responsibilities" (Drucker, 1946: 306; Bowen, 1953: 14ff; Berle, 1954: 182ff) regarding issues like product safety or industrial pollution. In Berle's (1959: 90ff) words, managers should develop a true "corporate conscience" and act in accordance with a "public consensus" determined by civil society. To the extent that "every great industrial enterprise is clothed with a quasi-public interest," Arthur S. Miller (1960: 1552) wrote, there is a sense in which corporate law can be construed as constitutional law.[7]

These suggestions were attacked by key members of the Chicago School and its Virginia and Rochester offshoots.[8] The important point Berle and others seemed to be missing, observed Wilber G. Katz (1960: 83), is that stock prices reflect

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[5] See Richard Adelstein (2012) on these and other ambivalent perceptions at the turn of the century.

[6] American institutionalists generally viewed the "absentee ownership" decried by Thorstein Veblen (1923) as a source of problems, and promoted the idea that some sort of "social control of business" was needed, to quote the title of John M. Clark's (1926) book. See Malcolm Rutherford's (2011) detailed account.

[7] Earl Latham (1959: 218) and Richard S.F. Eells (1960: 9ff) agreed that corporations could be likened to state-like political entities, the government of which should be a public matter.

[8] A concise overview of the Chicago law and economics tradition is provided by Steven G. Medema (2010).

profitability, meaning that “a free market for stock is thus important as an institution to secure management responsive to the interests of stockholders.” It is clear, Friedrich A. Hayek (1960: 100) agreed, that “if we want effectively to limit the powers of corporations to where they are beneficial, we shall have to confine them … to one specific goal, that of the profitable use of the capital entrusted to the management by the stockholders” (see also Friedman, 1962: 133). Those who would have corporations pursue other idealistic social goals need to remember, Hayek (1960: 106) warned, that “a corporation cannot be rich,” only individuals can be: to impose costs on corporations is really to impose costs on individuals, ultimately the stockholders.

Manne (1962: 430) argued that the time had come for a “comprehensive analysis” of the economic forces involved, pointing out that would-be reformers generally did not seem to understand the economic nature of corporations and the economic functions of capital markets. These markets, as the evidence accumulating in the University of Chicago’s Center for Research in Security Prices seemed to suggest, could be described as properly efficient: share prices could be shown to clearly reflect a corporation’s intrinsic profitability (Fama, 1965: 90). By conveying information about the relative performance of management share prices fulfill the Hayekian role of signals, and direct the powerful forces of the “market for corporate control” (Manne, 1965: 112; 1967: 265) to constrain managers without any need for additional regulations. What was really missing to counter critics of the prevailing corporate system, observed Tullock (1969: 297), was a full-fledged theory of corporations based on arguments of “comparative efficiency.”[9]

[9] Manne, an early pioneer of corporate law and economics, earned his J.D. at the University of Chicago Law School in 1952. He was Professor of Law at the University of Rochester’s Law School from 1968 to 1974. He remained in close contact with Chicago throughout his moves to the University of Miami in 1974, to Emory University in 1980, and to George Mason University in 1986, from where he retired in 1996. Manne founded his famous Law and Economics Center (LEC) at Miami, but the LEC travelled with him. In 1947 Tullock also received a J.D. at the University of Chicago Law School. He was Associate Professor at the University of Virginia when he co-authored *The Calculus of Consent* with James M. Buchanan (1962), at a time when Coase was still there (Coase moved to the University of Chicago Law School in 1964). Tullock left Virginia in 1967, and finally moved to George Mason in 1983. It was Tullock who in 1986 persuaded Manne to serve as Dean of the Law School at Rochester (Teles, 2008: 208-209).

By the end of the 1960s the engagement with the progressive critique of corporate America had ceased to be primarily an academic battle. A national debate on corporate misbehavior ensued from Nader's (1965) best-selling revelations about General Motors's reluctance to invest in safety measures in some of their vehicles, and his demand that Congress do something about it.[10] During the subsequent "auto safety war" (Klebanow and Jonas, 2003: 420) waged as Nader and corporate executives were heard by the U. S. Senate's Committee on Commerce, the firm's failed attempt to discredit Nader and the public apology issued by James M. Roche, its president, gave Nader's actions immediate headlines. His enhanced lobbying efforts paid off when Congress passed the *National Traffic and Motor Vehicle Safety Act* in 1966. Invigorated, Nader turned his attention to other societal issues, including environmental pollution, food safety, energy policy and anti-trust enforcement.[11] In mid-1968 he began recruiting teams of law school students to undertake investigations of government agencies, starting with the Federal Trade Commission (Klebanow and Jonas, 2003: 434ff).

Nader's repeated assaults on big business and his energetic advocacy of consumer rights earned him the title of "consumer crusader" on the cover of *Newsweek* (22 January 1968). In 1969 he received the *New Republic*'s inaugural Public Defender Award. Nader literally personified "the consumer revolt" on a cover of *Time* (12 December 1969), while his "study groups" of activist students were collectively known as "Nader's raiders" (*Washington Post*, November 13 1968).[12] With news coverage of this kind, Nader launched *Campaign GM* in early 1970 (*New*

[10] Nader graduated with brio in 1955 from the Woodrow Wilson School of Public Affairs at Princeton, having majored in Government and Economics, and went on to received his LL.B. from Harvard Law School in 1958 (Klebanow and Jonas, 2003: 417-418). He published shortly after his first critical piece on auto safety in *The Nation* (11 April 1959).

[11] Nader was not only successful in raising the public's awareness; he also managed to get elected politicians to endorse his legislative proposals (see Klebanow and Jonas, 2003: 429). During the late 1960s he played a pivotal role in the adoption of a series of regulations, including the *Wholesome Meat Act* (1967), the *Natural Gas Pipeline Safety Act* (1968), the *Wholesale Poultry Act* (1968), the *Radiation Control for Health and Safety Act* (1969), and the *Coalmine Health and Safety Act* (1969).

[12] In mid-1970 Nader established the Public Interest Research Group, the first of a growing network of nonprofit advocacy organizations, many of which are still active (see Klebanow and Jonas, 2003: 436ff). These included: Public Citizen (1971), Corporate Accountability Research Group (1971), Litigation Group (1971), and Congress Watch (1973).

York Times, 8 February 1970).[13] This highly-publicized campaign to expand the firm's board to "public" representatives and create a "Committee for Corporate Responsibility" was implicitly endorsed by the Securities and Exchange Committee (SEC), and led the firm, already damaged by Nader, to create a Public Policy Committee composed of five outside directors to advise management on matters concerning the public interest (see Schwartz, 1971a: 432ff, 1971b: 764ff).[14]

In 1972 lawyer and civil rights activist Theodore L. Cross founded the *Business and Society Review*, a journal that Cross (1972: 4) defined as "devoted to the responsibilities of business to the public interest." Cross assembled for the launch issue a collection of critical essays by fellow lawyers Nader and Schwartz, and by notorious social critics, Galbraith, Robert A. Dahl and Amitai Etzioni.[15] The issue also included a piece by Paul A. Samuelson (1972) on "the businessman's shrinking prerogatives," and a favorable discussion of corporate responsibility by SEC Chairman William J. Casey (1972). Although by this time business schools across the country had already started to incorporate courses on social responsibilities for future managers (Hanson, 1973: 75ff), many reformers pushed for more. As Kenneth J. Arrow (1973: 316-317) observed at the time, ethical codes" of conduct "will not develop completely without institutional support" in the form of "taxes, regulations, and legal remedies."

Nader and his followers, including besides Schwartz, Mark J. Green and Joel F. Henning, urged the federal government to take over the chartering process traditionally left to states (Nader, 1972: 9; 1973: 67ff; Schwartz, 1972: 96ff; Henning, 1972: 918ff; Nader and Green, 1973: 174ff). Under the proposed scheme, revocable federal charters would be provided only to corporations that fulfilled various disclosure requirements imposed by the regulator, and whose board members were mostly independent. Nader's argument was that this would help

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[13] Short for *Campaign to Make General Motors Responsible*. Nader's raiders formed the Project on Corporate Responsibility to formally acquire a few GM shares in view of bringing their proposals to shareholder meetings (Schwartz, 1971a: 423ff).

[14] This led *Campaign GM* activist Donald E. Schwartz (1971b: 769) to triumphantly comment: the growing social awareness of the late 1960s had "finally hit the corporate structure in th[e] country."

[15] Berle would have undoubtedly been invited to contribute but he had passed away in 1971.

overcome the failure of states to curb managerial discretion given, in William L. Cary's (1974a: 663) famous words, the new "race to the bottom" initiated by Delaware's highly permissive (i.e., pro-management) 1967 corporate statutes. Although Cary, a former SEC Chairman, did not endorse Nader's "politically unrealistic" solution (Cary, 1974a: 700), he did suggest the "the time ha[d] come … to consider a Federal Corporate Minimum Standards Act" (Cary, 1974b: 1101; see also Cary, 1974a: 700ff) in order to protect the rights of investors and consumers from unchecked managerial power.[16]

3. Origins

Inspired by Friedman's (1970) *New York Times Magazine* piece that famously argued that "the social responsibility of business is to increase its profits," written as an implicit response to the public clamor created by Nader's *Campaign GM*, Jensen and Meckling decided to write a paper on the "antisocial responsibility of business" in 1971 (Fox, 2009: 161).[17] Friedman had presented stockholders as the "principals" and corporate executives as their "agents," but his "journalistic arguments" needed to be translated "into the language of economics" (*ibid.*: 161-162). They began looking more closely at the executives' incentives, but, as Jensen put it in a recent interview, "the more we looked … the more we became convinced that we couldn't say that profit maximization was a positive description of what went on in firms" (Walking and Jensen, 2010: 8).[18] This realization, Jensen explained, "was the beginning of the breaking open the black box of the firm."

As they opened the black box to focus on the conflicts of interest, the idea that "agency costs" had an important role to play gradually developed into a discussion of how these costs, conceptualized as the sum of the principals' monitoring costs

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[16] Even Ernest L. Folk (1972: 312ff), the former Chairman of the Delaware statute drafting committee, agreed that higher standards of managerial responsibility were desirable.

[17] Justin Fox's account is based mainly on interviews with Jensen and other key financial economists.

[18] This is of course the basic insight behind the managerial theory of the firm of William J. Baumol (1959), Robin Marris (1964) and Oliver E. Williamson (1964), that stems from the "realism of assumption" debate of the 1940a and 1950s.

and the agents' bonding expenditures (plus a form of deadweight loss), varied with the proportion of the stock held by managers. Before long they were examining how agency costs varied with the firm's ratio of debt to equity.[19] It became clear that the Modigliani-Miller irrelevance of capital structure (see Modigliani and Miller, 1958) was misguided: given its production decisions, it was clear that a firm's financing decisions were not a matter of indifference. On the contrary, the comparative institutional analysis recommended by Coase (1964: 194) and Demsetz (1969: 1-2) could be mobilized to propose a theory of alternative ownership structures. The separation of ownership and control could be shown to be efficiency-enhancing after all.

The first draft of the paper was completed in 1973 (Jensen *et al.*, 1998: 167). It was presented to an audience of "colleagues and friends" at Rochester who, as Jensen recalled, were "furious" (Walking and Jensen, 2010: 9).[20] When presented at the University of Chicago Finance Workshop later that year, where attendees included Fisher Black, Miller and Fama, the reception was "equally riotous." Jensen had started the seminar with a reference to Fama and Miller's (1972) *The Theory of Finance* that he called the "White Bible" of corporate finance, saying that the paper he was about to present was about how Chapter 4, the one that explained that "capital structure didn't count," was all wrong (Walking and Jensen, 2010: 9; see also Fama, 2011: 5). Jensen wanted to dispute the Modigliani-Miller theorem in Miller's presence, and this didn't go down very well.[21] Jensen and Meckling's arguments "were torn to pieces" (Fox, 2009: 354).

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[19] "Over the years that Bill and I worked on the paper we were able to open that black box and look at the conflicts of interests between stockholders and bondholders and the managers and a little bit on the conflicts of interest between bondholders and stockholders" (Walking and Jensen, 2010: 9).

[20] "They ran us out of the room on a rail. They were furious at us. I remember to this day, walking out of that room in the face of this antagonism, this almost hatred. Bill and I walked up to his office, never saying a word to each other. I sat on the one side of the desk and he on the other. He pulled out a cigar, put his feet up on the desk, lit his cigar and said: 'Well, Mike, we sure didn't sell that one!'" (*ibid*.).

[21] "So at that seminar, there wasn't a lot of knowledge transfer either. It was something like 20 or 25 years later, at his 60th or 70th birthday party, where Merton [Miller] finally said that there was something of value in this paper" (*ibid*.).

Perhaps because it implicitly presented the Modigliani-Miller framework as an example of what Demsetz's (1969: 1) called the "nirvana approach," the paper proved to be difficult to publish. In 1973 it was refused by the *Bell Journal of Economics and Management Science*. But Jensen soon received "an unsolicited acceptance" from Fama, his co-editor of the *Journal of Financial Economics*.[22] They had started the journal, as Jensen recently explained, because "the profession (… in those days, we called them the old guys …) had very little interest in publishing papers from the younger guys" (Walking and Jensen, 2011: 14). The ambitious young guys felt "very fortunate to be taking part in this revolution in finance from the old-style finance to modern finance," and clearly believed that they "had a monopoly on most of the good stuff" (*ibid.*).[23] Spurred by the prospect of success, Jensen told Meckling that their paper was going to be a "very important paper in the profession," and that he was planning to exercise his rights as Editor "to make it the lead article" (Walking and Jensen, 2010: 9).

Although it would turn out to be "a big hit" (*ibid.*), it took some time to get the paper published.[24] Following Fama's (1970) example, Jensen continued to gather evidence on the efficient market hypothesis (see Jensen, 1975), and together with Meckling, worked on the remaining fine details of the paper. In mid-1974 they presented a newer version of the paper at a conference on "Analysis and Ideology" organized in the Swiss Alps (Interlaken) by Karl Brunner, their Rochester colleague.[25] With the support of Rochesters' Center for Research in Government

[22] "We originally submitted it to the *Bell Journal of Economics*. Oliver Williamson was the editor at the time and referees turned it down flat. They more than just turned it down; they were incensed that anybody would even dare to submit a paper like this to the *Bell Journal*. It was a bit discouraging when we got the rejection. At that time … Gene [Fama] was in Belgium and somehow got a copy of the working paper and sent me an unsolicited acceptance … I appreciated his good taste and so did Bill. I would never have done that myself, but since Gene did, then I could accept it" (*ibid.*)."

[23] Given the paradigm shift the young guys provoked, it did not take long for the journal to rank with established journals.

[24] As Jensen explained, the "economics profession as a whole" (Chew and Jensen, 2010: 23) remained reluctant to set aside the view of the firm as a profit-maximizing black box; "in those days there wasn't much of an interest in transaction cost economics" (Walking and Jensen, 2010: 8-9).

[25] Brunner left Switzerland for America in 1949 and joined Chicago's Cowles Commission in 1950. He soon moved to UCLA, staying there until 1966. In 1968 he coined the term "monetarism" to describe his pioneering work with Friedman. Meckling brought him to Rochester's Graduate

Policy and Business, this was to be the first of a series of annual conferences designed, in Brunner's mind, to create a bridge between Europe and America. Brunner wanted to change the way many of his left-leaning European colleagues "thought about economics" (Chew and Jensen, 2010: 17; see also Walking and Jensen, 2010: 8), and the event allowed Jensen and Meckling to sharpen their arguments. Both attended the next three editions.[26]

3. Meaning in 1976

A few weeks before Friedman's Nobel Memorial Lecture, JM76 was finally published in October 1976. The 1976 presidential campaign was reaching its climax, and the time was ripe. On the campaign trail, soon-to-be-narrowly-elected U.S. President Jimmy Carter (D) announced that he hoped to rival with Nader in his defense of consumers against corporate misbehavior (*New York Times*, 10 August 1976). In the meantime, the legislative battle surrounding Nader's flagship campaign of the 1970s was being waged in Congress. Following the introduction in 1975 by Rep. James V. Stanton (D-OH) of the *Corporate Citizenship and Competition Act*, a bill to establish a Federal Corporate Chartering Commission, the Committee on Commerce of the U.S. Senate held hearings on *Corporate Rights and Responsibilities* in June 1976. Nader, accompanied by Green and Joel Seligman (1976a), as well as Schwartz (1976), defended the federal chartering proposal. Their testimonies summarized the main arguments made in *Taming the Giant Corporation* (Nader, Green and Seligman, 1976b), the book version of the widely-circulated pamphlet published in January that year.[27]

Nader reminded the Senators that, properly understood, "a corporation is a legal fiction that has been given constitutional rights as well as limited liability to its

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School of Management in 1971 (Lys, 1998: x-xi), where he founded the *Journal of Monetary Economics* in 1975. See Meckling's (1977) tribute.

[26] Other regular attendees included Alchian and Demsetz (see Brunner, 1979).

[27] William Ocasio and John Joseph (2005: 167) argue that Nader was "one of the key players in the emergence of the domain of corporate governance," and that *Taming the Giant Corporation* was the "earliest available theorization of the term 'corporate governance'." In effect, the book popularized the view that corporate governance was about limiting the powers of large corporations.

investors and others privileges" (Nader, Green and Seligman, 1976a: 207). In effect, "the government provides the charter to the corporation, exchanging considerable privileges … in return for certain standards that have to be observed" (*ibid.*; see also Nader, Green and Seligman, 1976b: 63).[28] The state, Nader inferred, should be able to regulate its creations, both "by statute and by regulatory standards" (Nader, Green and Seligman, 1976a: 198), and has the right if not the duty to sanction as appropriate socially irresponsible or harmful activities.[29] The race to the bottom that inevitably undermines individual states' incentives and abilities to regulate corporations would be avoided, Nader concluded, if the chartering process were taken away from states and put into the hands of an independent federal agency. The "real question," as Green and Seligman observed, "is whether the competitive enterprise system can be made to work equitably and efficiently" (*ibid.*: 218). Federal chartering, they were persuaded, could "help attain this end."[30]

Manne (1976) joined forces with Yale's Ralph K. Winter (1976) and Robert Hessen (1976a), a fellow at Stanford's Hoover Institution, to discredit these ideas.[31] Their testimonies shed an interesting light on the meanings of JM76's claims in 1976. The view "that the State is the creator and the corporation is the recipient" is false, Hessen (1976a: 14) argued, and designed to obscure the fact that "a corporation is created by a voluntary contractual agreement between individuals

[28] Berle (1954: 104) had similarly described the corporation as a "creature of the state."

[29] Nader explained: "It is against a background of a huge body of empirical information showing rampant corporate crime, an epidemic of late only because it was disclosed" (Nader, Green and Seligman, 1976a: 201), that "our proposal for Federal chartering recognizes that there needs to be a broad and deep expansion of initiatory rights and remedies by citizens as they are aggrieved or abused in the course of coercive receipt of corporate action. Many of the examples which we adduce in our report reflect … non-consensual corporate impacts on a number of citizen constituencies which we conveniently categorize as shareholders, consumers, workers, taxpayers, and community residents" (*ibid.*: 198).

[30] While Roderick M. Hills, then Chairman of the SEC, acknowledged problems with the existing checks and balances in state and federal regulatory frameworks he was not convinced that federal chartering would be "more effective than the course we are now on" (Hills, 1976a: 332). Hills (1976b: 17) viewed voluntary corporate compliance more favorably.

[31] Hessen (1976b) had fired the opening round in the financial press a few weeks before the hearings.

seeking to promote their own financial self-interest" (*ibid.*: 9).[32] The state is not a party to the contract; "nor does it give life or birth to the corporation," since "the role of the State is simply to record the formation of every corporation – nothing more" (*ibid.*). All the so-called "privileges" of corporations can be achieved by contractual arrangement, and in this sense corporations are just highly developed partnerships (*ibid.*: 21ff).[33] Manne (1976: 229) agreed with Nader that corporations were "legal fictions," but his conclusion was different: since "the corporation is … simply a label which denotes a group of individuals banded together in a contractual relationship" (Hessen, 1976a: 14; see also Manne, 1976: 236), talk of corporate rights or responsibilities is nonsensical.

It follows that any regulatory intervention designed to increase the corporation's accountability to the public only raises costs for the real individuals involved. This contrasts, Winter (1976: 45ff) explained, with what happens when states are left free to compete for corporate charters. Cary and others have misconstrued jurisdictional competition as a race to the bottom when in actual fact it benefits investors by reducing the average costs of incorporation. Ultimately, the characteristics of corporate law, including the allegedly problematic separation of ownership and control, result from an evolutionary trial-and-error process (*ibid.*: 52), and in principle federally-imposed standards can only interfere with this efficiency-enhancing market mechanism. Moreover, as Manne (1976: 226ff) opined, to the extent that the efficient market hypothesis is correct, any attempt to impose outside directors representing the public interferes with the working of the market for corporate control that ensures the replacement of less productive managerial teams by more efficient ones.

These were JM76's arguments in a nutshell. The business corporation is technically a legal fiction serving as a nexus for a "complex set of contracting relationships which delineate the rights of the parties involved" (JM76: 357). Since

[32] In a reply published shortly after the hearings Green (1976b) wrote: "The theme of his commentary is that … a corporation is created by a voluntary agreement among individuals … Perhaps Hessen would like the law to reflect his version of Social Darwinism, but today in each state corporations may not only be formed if they satisfy certain minimal … requirements."

[33] Corporate law is hence more usefully construed as a form of contract law.

corporations are "purely conceptual artifacts," as Meckling (1976: 548) clarified at the time, they can have neither rights nor responsibilities, "even when they are assigned the legal status of individuals."[34] Despite the agency costs inherent in the corporate form, it is truly an "awesome social invention" that has thus far "survived the market test against potential alternatives" (JM76: 357). As most new institutional economists have argued, given private property rights, contractual freedom and competition among organizational forms, market forces would eventually reward the institutional arrangements best suited to a large variety of needs and circumstances, and these will tend to ultimately survive.[35] Two hundred years after *The Wealth of Nations*, observed Alchian (1976: 358), the defense of the "property private property system itself" was a battle worth fighting.

4. Post-1976 Influence

Federal chartering never passed the Committee stage of the legislative process, and support for it dwindled.[36] Nevertheless, the "corporate governance movement," as Daniel R. Fischel (1982) described it, was gaining momentum, spurred by the Supreme Court's controversial *Bellotti* decision in 1978.[37] The Court recognized in

[34] A case can be made for the fact that 1976 marks the genuine resurgence of a debate that has been recurring for many centuries but that had been dormant since the late 1920s (see Gindis, 2009). The fiction theory of corporations, according to which corporations are *persona ficta*, nothing but the individuals composing them, was encountered Roman and Medieval law. A commonplace implication, derived by Pope Innocent IV in 1245, was that corporations, fictions without bodies or souls, could not be held responsible for the actions of their members.

[35] In order to promote these ideas and develop new ones Jensen and Meckling established in 1976 a new graduate course at Rochester, "Coordination and Control," focusing explicitly on the organizational problems revealed once the black box of the firm had been opened (Jensen *et al.*, 1998: 167).

[36] Nader had other chances to be heard by Congress. Nader and Green (1977) represented essentially the same case in mid-1977at the hearings on *The Role of the Shareholder in the Corporate World*, where his contradictor was once again Winter (1977). In March 1978 he was the keynote speaker at a high-profile conference on the "ethics of corporate conduct," organized by Columbia University's non-partisan American Assembly. Other speakers included a SEC Commissioner, the senior vice president of Gulf Oil Corporation, Kenneth E. Boulding, and Tullock, who said: "I'm somewhat a strange bird here … because I'm opposed to the whole social responsibility of business movement" (American Assembly, 1977: 55).

[37] *First National Bank of Boston v. Bellotti*, 435 U.S. 765 (1978).

corporate political contributions the expression of freedom of speech, to be protected as First Amendment rights, and this seemed to confirm the existence of the "business-government symbiosis" decried by Miller (1975) and others (e.g., Lindblom, 1977). That same year, the SEC reinforced its disclosure requirements, the American Law Institute (ALI) initiated its *Corporate Governance Project*, and the American Bar Association (ABA) published the *Corporate Director's Guidebook* outlining the standards of conduct and responsibilities of the board of directors. The regulatory mood was also conspicuous in the speeches given by Carter-appointed SEC Chairman Harold M. Williams and various SEC Commissioners between 1978 and 1980.[38]

Jensen and Meckling published "Between Freedom and Democracy" (Meckling and Jensen, 1977) and "Can the Corporation Survive?" (Jensen and Meckling, 1978) in this context. Both papers insisted that the private corporation, "an enormously productive social invention," was being "destroyed" (Meckling and Jensen, 1977: 41) by politicians and special interest groups seeking to impose social responsibilities of various kinds. Since "the corporations is, in fact, merely the nexus for a very complex set of contract rights among individuals" (Jensen and Meckling, 1978: 34), government-imposed involuntary wealth transfers interfere with "*the system of contract rights, which has been the wellspring of our economic growth*" (*ibid*.: 32, emphasis in original).[39] Regulation, in other words, was threatening not just the survival of the corporate form as a viable contractual choice but the very foundations of American prosperity. These papers delivered without needless academic jargon the key points of JM76 to corporate America. The message was loud and clear. Jensen was a rising star, and Meckling well connected.

In 1978 Manne's LEC published *The Attack on Corporate America: The Corporate Issues Sourcebook*, a collection of 61 digestible essays by Manne, Demsetz, and many others, designed to "provide a 'quick fix'" for businessmen and

[38] Williams (1977:31) suggested that it was up to business leaders to recognize and respond to the "problems of corporate governance" if they wanted to avoid otherwise painful government regulations, and warned that "the very future of the private enterprise system" was at stake. A more detailed account of these events is provided by Brian Cheffins (2013: 47ff).

[39] Jensen and Meckling (1978: 32) predicted that unless the "gradual encroachment of government" was curbed, the "corporate form of organization [was] likely to disappear completely."

students, "understandably uncertain about the substance and validity of the latest attacks on corporations" (Johnson, 1978: xi).[40] Jensen and Meckling's ideas were becoming familiar among business school students, corporate executives, bankers, accountants, financial analysts and investors, spearheading the anti-regulatory rebellion.[41] *Bellotti* provided an opportunity to drive home a key point. Simply put, those who object to the Court's decision on the grounds that it accorded constitutional rights to entities that the Bill of Rights was not intended for (e.g., Miller, 1979: 82ff) seem to have forgotten that the real referents of constitutional rights such as "free speech" are always the human beings involved, in this case the shareholders. The Court, in other words, was merely protecting their right to use the corporate form as a collective "medium of expression" (Pilon, 1979: 1321) in the marketplace for ideas.[42]

In a late-1978 *Wall Street Journal* piece, entitled "Facts on Federal Chartering," one could read the following: "Until now proponents of federal chartering [citing Nader and Cary] have faced two main problems. One is that the clamor for federal chartering has not come from investors … The other is the remarkable study by Professors Michael Jensen and William Meckling … Now advocates of federal chartering face a third problem – an empirical one." Indeed, as the writer explained, Jensen's Rochester students, Peter Dodd and Richard Leftwich, had finally managed to test Cary's conjecture that state competition for federal charters damaged investors. Since Nader's campaign crucially depended on the race to the bottom argument, this could be a decisive blow. And it was, since the study

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[40] The book was divided into four parts: "Sociopolitical Analogies and the Corporation," "Control of the Corporation," "State versus Federal Chartering of Corporations," and "Corporate Power and the Market."

[41] "Can the Corporation Survive?" began as a Rochester working paper in May 1976. Prior to its final 1978 version it was widely reprinted with permission by corporations, think tanks and educational organizations. It was reprinted twice in 1976 and no less than seven times in 1977, one of which as the cover story of *MBA Magazine* (March 1977). See http://www.people.hbs.edu/mjensen/pub2.html.

[42] Of course, as Hessen (1979b: 108) observed, "to Nader the First Amendment is expendable."

(see Dodd and Leftwich, 1980) found the opposite effect, just as Winter (1977b) had predicted.[43]

Thanks to this fresh scientific legitimacy, two decades after Tullock's (1969: 290-291) call for a "new theory of corporations," there finally was "a contractual and private property model" (Hessen, 1979a; see also Winter, 1978) that worked. It was perhaps the powerful simplicity of these timely arguments that was recognized when in mid-1979 "Can the Corporation Survive?" was awarded the prestigious Graham and Dodd Plaque, attributed since 1960 by the Financial Analysts Federation for excellence in financial writing, despite the fact that the article did not contain the type of mathematical analyses normally awarded the prize.[44] In the meantime, in 1978 the Business Roundtable had released the response of the CEOs of major U.S. corporations to what was seen as excessive and unnecessary disclosure requirements in its own report, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*.[45]

In mid-1980, a few months before Ronald Reagan's (R) election, Americans Concerned with Corporate Power, a Nader-backed public interest group, staged a nation-wide *Big Business Day* to coincide with the introduction by Rep. Benjamin S. Rosenthal (D-NY) of the *Corporate Democracy Act* to establish penalties for corporations' failure to heed to publicly-defined social responsibilities. Another bill to establish federal minimum standards for the duties of corporate directors, the *Protection of Shareholder Rights Act*, was introduced almost simultaneously by Sen. Howard Metzenbaum (D-OH). Both bills failed to produce any law, and the prospects of significant new federal legislation died rather abruptly with Reagan's

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[43] Dodd and Leftwich (1980) provided empirical support for the view that jurisdictional competition on the supply side and contractual freedom on the demand side leads to a "climb to the top" (Fischel, 1982b: 920) rather than the reverse. As Posner (1977: 307) had argued, "competition among states to attract corporations for taxing purposes should result in optimal rules of corporate law."

[44] Franco Modigliani and William F. Sharpe were among its past winners. See http://www.cfapubs.org/page/doddAwards?journalCode=faj.

[45] In this context, Ross Watts, Jensen and Meckling's Rochester colleague, founded the *Journal of Accounting and Economics* in 1979, inviting papers explaining accounting phenomena, including disclosure matters, using the theory of the firm, the theory of regulation, public choice, agency theory, and financial economics (Watts, 1979). Alchian, Fama and Jensen sat on the journal's editorial board.

election, combined with the historic Republican victory in the Senate. However, the anti-regulatory movement had yet to win the battle of ideas in law schools and the judiciary.

Manne's role as chief "intellectual entrepreneur" was pivotal (Teles, 2008: 101ff). In 1976, while at Miami, Manne had created a series of LEC training programs, *Economics Institute for Federal Judges* (also known as the "Manne Programs"), sponsored by the Liberty Fund. Instructors included, besides Manne himself, Friedman, Alchian and Demsetz, as well as Samuelson, for ideological balance (Teles, 2008: 112). The rapid success of the program was such that *Fortune* published a cover (21 May 1979) depicting a judge reading an economics textbook, with Samuelson's *Economics* and Friedman's *Capitalism and Freedom* on the floor beside him. The caption read: "Judges Get a Crash Course in Economics" (Butler, 1999: 363).[46] Manne's network and previous successful experience with the organization of intensive courses on economics for hand-picked selections of law professors certainly helped.[47] The LEC generated excitement and enthusiasm. In the spirit of Manne's belief that "just about everyone would benefit from more exposure to economics" (*ibid.*: 355), it launched other *Economics Institutes*, including one for law review editors.

The LEC also began offering refresher courses, introducing an *Advanced Course on Antitrust Economics* in 1980, with Alchian and Demsetz among the instructors (*ibid.*: 367). Roughly at the same time, the main strands of a new field of corporate law and economics were assembled in Posner and Kenneth E. Scott's (1980), *Economics of Corporation Law and Securities Regulation*, a reader edited mainly for law professors. Before turning to technical issues, the book's first section addressed "The Economics of the Corporate Firm," reproducing key passages from Alchian and Demsetz (1972) and JM76. This was immediately followed by a section

[46] By 1990, according to Henry N. Butler (1999: 352ff), a close collaborator of Manne's at George Mason and LEC's current director, roughly 40% of U.S. sitting federal judges had completed the Manne's flagship program.

[47] The popular *Economics Institutes for Law Professors*, an Econ 101-type course based on Alchian and William R. Allen's (1964) classic textbook, *University Economics*, was launched in 1971 at Rochester. It moved with Manne to Miami in 1974. Among many other future big names of law and economics, Winter was an *Institutes* graduate.

on “The Corporation’s Social Responsibility,” explicitly depicting Nader and Galbraith as social critics who had failed to understand the economics of the firm.[48] An *Advanced Course on Corporate Governance and Financial Markets* was added in 1982. Alongside Alchian, Jensen and Meckling taught on the course (Butler, 1999: 368). By that time, Fama (1980) had come on board, and Alfred Rappaport (1981) had already coined the term “shareholder value” that ushered in the ethos of the financial economics of the 1980s.

Jensen and Meckling continued to diffuse their ideas and engage with their opponents. With Hessen, they organized a sort of counter-Nader conference at Rochester in 1982 on the familiar topic of controlling the giant corporation. The conference rejected Nader’s “crusades” and his scholarship (Hessen, 1982; Johnson, 1982). In the lead paper Meckling and Jensen (1982: 86) once again rejected Nader’s “anthropomorphic practice,” emphasized the vulnerability of the corporation as a social invention, and stressed the importance of the “organizational test of survival” (*ibid.*, 84).[49] A few months later in Los Angeles Jensen restated his case at a conference on corporate governance (Jensen and Meckling, 1983) at which papers were given by Schwartz, Metzenbaum and Williams (see Huizenga, 1983). Interestingly, a panel discussion covering issues of rights, markets, externalities and regulation united Jensen directly with Green (Green *et al.*, 1983). Meckling retired later that year. In early 1984 a conference in his honor was organized at Rochester. The theme was executive compensation (see Jensen and Zimmerman, 1985), one of the many hot topics of the 1980s that Jensen would champion.

5. Conclusion

Alchian (1983: 267) singled out in his tribute to Meckling several simple but powerful ideas with which his name would remain associated: first, “the firm is not an individual entity with a single objective”; second, it “does not have goals in the sense individuals do”; and finally, “the concept of a ‘firm’ [i]s vacuous and without

[48] Fischel (1982a: 1261) similarly emphasized Nader’s “lack of understanding of the economic … theory of the firm” to discredit the corporate governance movement.

[49] This paper appeared later as Meckling and Jensen (1983).

analytical use." These ideas certainly capture the key lessons of JM76. This paper has tried to make sense of these claims, otherwise at odds with the theory of the firm literature, by contextualizing JM76 in the 1970s debates on corporate social responsibility and federal chartering led by Nader and many other critics of corporate America. In this context, the argument is that JM76 provided the timely theory of the firm foundation that the anti-regulatory corporate law and economics movement required.

Just like Alchian and Demsetz's (1972) contractual explanation of why capital hires labor could be seen as a reaction to Assar Lindbeck's (1971) call to counter the New Left's critique of capitalist forms of production, so too can JM76's contractual explanation of why corporations have survived thus far be seen as a reaction to Tullock's (1969) call to counter the critics of big business.[50] Coase's original problem ("why firms?") was to account for the existence of firms in a market economy in fairly general terms. Alchian and Demsetz's question ("why capitalist firms?") introduced a discussion of property rights to defend the capitalist order of society against the radical challenge. From this perspective, JM76's question ("why corporations?") introduced a discussion of capital markets to defend the corporate order of society against the progressive challenge.

In the process, JM76 supplied a rallying label, "nexus of contracts," that identified their approach in (a) economics (theory of the firm), (b) finance (corporate finance) and legal scholarship (corporate law and economics). By the end of the 1980s the impact had been so strong in law schools and legal journals that Lewis A. Korhauser (1989: 1449) wrote: "critics and advocates agree that a revolution, under the banner 'nexus of contracts,' has … swept the legal theory of the corporation." William W. Bratton (1989: 409) likewise observed that in many circles the notion that corporations are legal fictions was accorded "the weight of scientific truth: it has been received in the legal literature as an ontological discovery with immediate

[50] There is clearly a sense in which Nader and his followers, who were reformers but not radicals, composed the conservative side of the New Left. As Posner (1974a: 341) pointed out, Nader's movement shared with the radicals the belief that "big business – the capitalists – control the institutions of … society."

and significant implications for corporate law discourse." Jensen, by then at Harvard, had already turned his attention to other pressing matters.

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