The Extent to which a Corporation is a Nexus of Contracts

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Abstract

The place of corporate entities in the economy cannot be downplayed; indeed, with each passing day, more and more corporations are incorporated or registered, and it is very unlikely to find big ticket transactions being conducted by businesspersons in their individual capacities. Commercial transactions are characterized by 'angel investors', persons who basically give their money to businesses and walk away to only await financial gains on their investment. In fact, unique forms of corporations, such as private equity entities, are now more visible as investors in corporations which conduct various forms of businesses; most of these entities are not involved in the day-to-day operations of the corporations they invest in, but rather seek to enjoy some form of consent powers for purposes of protecting their interests. The question on the nature of a corporation is therefore very relevant, and at the core of this question is the debate on the corporation as a nexus or series of contracts.

Since the 19th century, there have been several theories on the nature of the corporation, ranging from considerations of the corporation as a mere assembly of natural persons whose existence cannot be separated from the corporation, the corporation as a legal entity separate and distinct from its shareholders or members as determined in the locus classicus Salomon v Salomon & Company, the corporation as a creation of the state and the corporation as a product of private bargains among individuals. The theory on the corporation as a product of private bargains was adopted by neo-classical economic theorists who argued for anti-regulation and shareholder

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benefit as the core tenets of freedom of contract. The argument for anti-regulation stems from the era when states regulated who could form a corporation and emphasis on what social problems the corporation sought to solve to warrant grant of a charter to operate and should therefore not be confused to mean that the proponents shunned away from any kind of regulation of their operations. The debate on the corporation as a tool of private bargains, now coined as the corporation as a nexus of contracts is still alive and evident in various commercial litigation proceedings and decisions. This article seeks to explore the development and validity of this concept, which may also be referred to as the 'contractarian theory of corporations.' It also seeks to elucidate to the reader other relevant discussions regarding the nature of the corporation as a creation of the state, the corporations as a product of trust law and the corporation as a natural entity born of the minds of individuals who come together to conduct business.

1. Introduction

A contract is defined as an agreement between or among parties creating mutual obligations that are enforceable by law. The elements of a valid contract include offer and acceptance, consideration, legality and capacity.[2] A corporation on the other hand is defined as a legal entity, incorporated with the purpose of doing business and creating profit, and is distinct from its owners. The argument that a corporation is a nexus of contracts was first formulated in *'The Theory of the Firm-Managerial Behaviour, Agency Costs and Ownership Structure'* by Michael Jensen and William Meckling in 1976. The argument attempts to explain that ultimately, a corporation represents a set of reciprocal arrangements that have been agreed upon among the owners of the corporation, the directors and the managers, the suppliers, investors and other persons who deal with the corporation with a view to making profit. The concept borrows from the arguments on shareholder benefit as the primary concern in the operations of a corporation, but also introduces an economic analysis of the existence of a corporation. This article will discuss the extent to which a corporation is a nexus of contracts, departing from the history of the conception, its development and justification, criticisms against the concept and an analysis of the extent to which it is true or unsatisfactory.

[2] Miceli J. Thomas, *The Economic Approach to law*, (Stanford University Press 2017).

2. History

In 1937, Ronald Coase argued that activities will only be included within a firm if the costs of contracting in the market are higher than the costs of direction by authority. He stated that outside the firm, the movement of prices directs production which is coordinated through a series of exchange transactions in the market. Within the firm, these market transactions are replaced by the directions of an entrepreneur coordinator or a manager.[4] The basis of Coase's argument was that some economic activities take place within firms such that they are directed by authority, while others take place across markets, such that they are determined by contract. His argument was based on the cost analysis of decisions, which is seen in the Coase Theorem on consideration of transactions costs in bargaining. This article will analyse whether this argument is valid, as shareholders would in their individual capacities contract in the market, but for some benefits based on efficiency, both legal and economic.

In 1972, Armen Alchian and Harold Demsetz objected to Coase's arguments, stating that it is a delusion to see the firm characterised by the power to settle issues by fiat, authority or disciplinary action that is superior to that available in the market.[5] They posited that the forces in the market are not any different from those within a firm- that in the market, where there is breach of contract, punishment takes the form of withholding future business or seeking redress in the courts. Within a firm, an employer imposes punishment for lack of performance by terminating the employment relationship or seeking legal redress. They instead argued that the difference between a firm and the market is the utilization of team input, agreement and monitoring within the firm, hence a corporation is a nexus of contracts but with agreement on management, whose role is to oversee the voluntary negotiations among the various actors who participate in the business activities of the firm.[6]

[3] Ronald H. Coase, The Nature of the Firm (1937). <https://onlinelibrary.wiley.com/doi/full/10.1111/j.1468-0335.1937.tb00002.x> Accessed 19th August 2022.

[4] Ibid.

[5] Armen A. Alchian & Harold Demsetz *Production, Information Costs and Economic Organization* (The American Economic Review 62(5) 1972). <https://www.jstor.org/stable/1815199> Accessed 26th August 2022.

[6] William W. Bratton, *The Nexus of Contracts Corporation* (The Cornell law Review 1989) <https://scholarship.law.cornell.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=3409&context=clr> Accessed 29 August 2022.

Jensen and Meckling agreed with Armen Alchian and Harold Demsetz but noted that the argument on team input in production was not exhaustive. On their part, they argued that contractual relations are the essence of the firm, not only between employees and employers but also among suppliers, creditors or financiers and customers. This is where the conception that the firm is a nexus of contracts originated; that *'most organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals.'*[7] Whether this concept revives the argument of a corporation as a legal fiction, a mere aggregate of natural persons who have privately agreed to conduct business is a point of consideration.

3. Justification

3.1. A Corporation as a Bundle of Contracts

It has been argued that corporations are only a guise in which cooperating individuals act; that they are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals.[8] This argument, which may be summed up as 'corporations represent or are simply a bundle of contracts' holds water when one considers how a corporation operates. Before an entity is incorporated, the interested persons come together and agree that they wish to incorporate an entity to conduct certain business with a view to making profit. In sole corporations, this is still the case as the individual puts his ideas together and decides to incorporate an entity. Once there is a meeting of the minds, the person(s) instructs a representative to advice on and assist with incorporation. In some instances, these persons will enter into a shareholders' agreement or a joint venture agreement as relevant to the desired business. Such an agreement is a contract and is binding among the shareholders. The parties also agree on the terms of the articles of association or the constitution of the corporations (in the instance of a company) or other form of statutory document required as

[7] Michael C. Jensen &William H. Meckling, *The Theory of the Firm-Managerial Behaviour, Agency Costs and Ownership Structure'* (Harvard Business School, 1976) <https://www.sfu.ca/~wainwrig/Econ400/jensen-meckling.pdf>

[8] Easterbrook, Frank H. & Daniel R. Fischel, Limited Liability and the Corporation (1985) 52 (1) University of Chicago Law Review, 89–117.

per the laws of that jurisdiction. The articles of association are binding as between the corporation and the shareholders and regulate (in addition to and subject to the relevant statute), how the affairs of the corporation are conducted. The process of incorporation or registration on its own demonstrates that the assertion that a corporation is a nexus of contracts is true. Once the corporation commences its operations, it acts on behalf of its shareholders and enters into contracts with various persons including financiers, suppliers, managers and employees to ensure that the business desired by the shareholders is carried out and that they make profits. The shareholders appoint directors, who act as the brains and hands of the corporation. The directors have obligations (in both common law and statute), which they must perform, and where they fail to do so, both the shareholders and the corporation have remedies against them. The directors are also authorised to appoint a management team consisting of persons experienced in the corporation's area of business to oversee the day to day running of the corporation. It is therefore evident that at every level, there is some form of contract being entered into by persons authorized to act on behalf of the corporation.

3.2. Decision Making in a Corporation

In a contract, parties are free to make decisions that reflect or would best achieve the desired results. In a corporation, shareholders also enjoy this freedom, albeit within the regulations or provisions of the governing statutes, the constitution of the corporation and any private agreements among them such as a shareholders' agreement. While some authors argue that such regulations are a hurdle to the concept of the corporation as a nexus of contracts, decision making ultimately rests with the shareholders and in some instances, the directors who are duly authorised to act on behalf of the company. The provisions of the governing statutes and regulations only serve to give direction on how matters should be run and to protect the interests of the shareholders (and minority shareholders), provisions which cannot be comprehensively included in an agreement. Moreover, the fact that persons agree to incorporate an entity under the laws of a specific jurisdiction implies that they agree to be bound by the provisions of the

governing statute, and where they intend to exclude some provisions (which can be excluded as per that law), they do so in the articles of association or constitution of the corporation. The proponents of this concept argue that to the extent that there is any need for legislation, its objective should be to provide mandatory contract returns that are designed to mitigate or lessen agency costs.[9] The proponents of anti-regulation of corporations also sought to dismiss the corporation as a fiction or a legal person, and argued that the corporation is a natural entity as it is a product of private individuals who have chosen to do business together. As such, the formation of a corporation should not be the basis for subjecting the financial interests of these individuals to laws that would otherwise not apply if they conducted the same business in their individual capacities.

Ultimately, the shareholders of a corporation, even where they have appointed directors to make certain decisions, remain the true parties to any contract that the corporation enters into as they are the only residual parties that bear the costs of agency risks, thus validating the concept that a corporation is a nexus of contracts.

3.3. The Place of a Corporation in Economic Relationships

It is undeniable that corporations are formed with the purpose of doing business and making profit. Armen Alchian and Harold Demsetz posit that the mark of a capitalistic society is that resources are owned and allocated by non-governmental organizations such as firms and productivity is increased through cooperative specialization.[10] While there is a difference between how a corporation carries on its business and how an individual would conduct the same business, they both occupy the same position in the market, at least from the point of view of the consumers. The individual businessperson is replaced by

[9] David K. Millon, *Theories of the Corporation* (Washington and Lee University School of Law, 1990).

[10] Armen A. Alchian & Harold Demsetz, *Production, Information Costs and Economic Organization* (The American Economic Review 62(5) 1972). <https://www.jstor.org/stable/1815199> Accessed 26th August 2022.

a corporation, but the difference is that within a corporation there is a team utilization of inputs and a centralized contractual agent.[11]

If shareholders could conduct the business in their individual capacities, they would, but they form a corporation for purposes of some benefits for instance with regard to taxation and also to maximize efficiency with regard to expertise and production, risk allocation and limitation of liability. On the part of consumers or persons who enter into business relations with a corporation, their interests are better protected as compared to if they did business with individuals. This is because the life period of a corporation is not dependent on the founders; a corporation would still exist even where the founding shareholders are deceased, more so where there is a succession plan in place. As such, persons who contract with corporations can still enforce their rights against a corporation despite the death of its shareholders. This is not the case where contracts are entered into with individuals, as performance mostly depends on the individual party being alive.

In essence, a corporation is a special purpose vehicle for contracting and doing business, and its place in economic relationships is critical as it ensures continuity despite the death or incapacitation of the members of a corporation.

4. Criticisms against the Concept

a. Ownership of the Corporation

The concept of corporations as a nexus of contracts does not take into consideration the ownership of the corporation by its shareholders. The relationship is viewed as contractual, where shareholders are viewed as a mere but different group of suppliers to the corporation. This argument cannot be entirely true, as shareholders, by virtue of their ownership of the corporation, bear the costs of agency risks and in case of insolvency, they may be the biggest losers as they rank lowest in distribution of the corporation's assets or proceeds of the sale of those assets. The same applies to when the corporation is performing

[11] Ibid.

optimally, and the shareholders are the biggest beneficiaries in terms of sharing in profits. In fact, according to Milton Friedman, the only responsibility of the (employees) of corporations is to fulfil the wishes of the owners, whatever those wishes may be.[12]

In practice, any person or other corporations may enter into contractual relationships with a corporation, and where there is breach of contract, their redress would be in damages, specific performance, rescission and restitution.[13] On the other hand, shareholders, being the owners of the corporation, would enjoy some remedies against the company which are ordinarily not available to persons who are not shareholders such as the right of minority shareholders to institute unfair prejudice petitions based on conduct of the company that unfairly prejudices them.

Further, shareholders have limited liability (limited to the unpaid amount on the shares they hold), while the liability of contracting parties is based on the obligations outlined in contract. When a corporation is wound up, shareholders would not be prioritised with regard to distribution of assets, while creditors who contracted with the corporation would be prioritized. In essence, ownership by shareholders, which carries significant risks (and benefits) cannot be downplayed in favour of the argument for contract as the basic means of operation by a corporation. According to Jonathan Macey, if the argument that the corporation or the firm is not an entity but a set of contracts is accepted, then the organization is broken down into groups of identifiable participants including managers, employees, suppliers, investors etc. who negotiate among themselves. The consequence of this is to deny that any of these persons have a right to claim ownership of the property in the corporation.

[12] Richard N. Langlois, "The Corporation is not a nexus of contracts: it's an iPhone" (2016). <https://www.researchgate.net/publication/317997558_The_Corporation_is_Not_a_Nexus_of_Contracts_It's_an_iPhone> Accessed 19th August 2022.

[13] Steven Shavell, "The Design of Contracts and Remedies for Breach" (1984) 99 (1) Quarterly Journal of Economics. <https://www.nber.org/system/files/working_papers/w0727/w0727.pdf> Accessed 28th August 2022.

In addition, parties to a contract must actively be involved in discharging the obligations outlined in the contract. Shareholders of a corporation on the other hand, more so in the modern era where maximisation of value demands the separation of ownership and control, are mostly reduced to passive investors who have trusted professional managers with their economic interests.[14] Whether in this case the passive investor position occupied by shareholders is purely a child of contract is a point for debate.

b. The Corporate Entity as a Right in Rem

A right in *rem* is distinguished from a right in *personam* in that the former surrounds a thing that gives the possessor dominion or authority to exclude an indefinite number of unspecified persons[15] while the latter involves specific obligations between or among specified persons. It therefore goes that contract sits within rights in *personam* while property sits within rights in *rem*. The distinction between a corporate entity that conducts business and other types of entity that conduct business is ownership, limitation of liability and recognition as a legal person with features such as the ability to sue and be sued in its name and entering into contracts in its name. As aforementioned, a corporation is a product of consensus ad idem among persons who agree to incorporate an entity which will act on their behalf. Therefore, while this consensus is characterised by contract, the underlying factor is ownership of that entity. As such, to the extent that the corporation will coordinate various contracts as it conducts business on behalf of the owners, the argument that a corporation is a nexus of contracts is true. However, when one considers the basis of agreement to incorporate, then the issue of property in rem arises. Richard N. Langlois argues that the corporate entity borrows from the concept of property rights and not from the role as a nexus of contracts.[16] As such, while contract

[14] David K. Millon, *Theories of the Corporation* (Washington and Lee University School of Law, 1990).

[15] Armen Alchian, *Some Economics of Property Rights* (1965) 30 (4) Politico 816. <https://www.sfu.ca/~allen/AlchianPR.pdf> Accessed 26th August 2022.

[16] Richard N. Langlois, *The Corporation is not a nexus of contracts: it's an iPhone* (2016). <https://www.researchgate.net/publication/317997558_The_Corporation_is_Not_a_Nexus_of_Contracts_It's_an_iPhone> Accessed 19th August 2022.

(and contract law) heavily informs the existence and operations of a corporation, a corporation is not purely a nexus of contracts.

c. The Ambiguities of the Concept

Lewis A. Kornhauser argues that the concept of corporations as a nexus of contracts represents ambiguities as it sometimes relies on appeal to legal authority and rules of contract law, other times it relies on moral authority based on the consensual decisions of independent actors, while at times it relies on the theory of utilitarianism, demanding that interpretation and judgment should be based on what best promotes the interests of the parties to the contract.[17] Lewis A. Kornhauser further criticises the concept by positing that the argument, as put by Judge Easterbrook and Professor Fischel, offers three formulations of the rule of construction. One of these instructions is to maximize joint wealth. The other two, which he argues are not clear, include the instruction to duplicate the terms that the parties would have selected in the joint interest if they had contracted explicitly and the instruction to fill gaps with the terms that the parties would have chosen if they wished and if the costs of negotiating were worthwhile in the light of the stakes.[18] He argues that this amounts to a selection of the rules of construction or interpretation that a judge should adopt; in contract law the court should respect the agreement among the parties and respect the terms of a legally enforceable contract. In the context of the corporation or corporate transactions, he argues that the 'agreement' is generally unwritten, and the concept of the contracts approach seeks to construct an agreement out of the interests of the parties concerned, hence the need to select the rule of construction that a court should adopt, which is in any case inconsistent.

[17] Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel* (Columbia Law Review, Vol. 89, No.7, Contractual Freedom in Corporate Law 1989). <https://www.semanticscholar.org/paper/The-Nexus-of-Contracts-Approach-to-Corporations%3A-A-Kornhauser/141ce1855bedebe420f5a288e4e0b1ebe8211299> Accessed 19th August 2022.

[18] Ibid, 1451-1452.

d. The Mandatory Rules of Corporate Law

Several authors have argued that the concept of the corporation as a trust has been replaced by that of the corporation as a nexus of contracts. The law of trusts imposes certain mandatory duties including the fiduciary duties of loyalty and care on the directors of a corporation. In contract law on the other hand, the parties are free to negotiate on the terms of contract, and it is well known that an 'ideal' contract, which presupposes all eventualities, does not exist. As such, the cost of negotiating all the terms is too high, and the parties would desire a set of mandatory rules which protect them in case of unforeseen eventualities. This then implies that the metaphor of the corporation as a trust, based on fiduciary roles for the benefit of the beneficiaries, is still valid, even to the concept of the corporation as a nexus of contracts.[19] While the common law duties of directors (which were heavily based on trusts law) have been codified in most jurisdictions, the common law rules are still heavily cited and relied on in enforcing the duties of directors. Even where the directors have entered into a contract with the corporation, their fiduciary duties are still applicable, and they must perform them even where not expressly provided for in the contracts.

5. Conclusion

In conclusion, the corporation is heavily a product of private negotiations among individuals who agree to incorporate an entity with a separate legal personality to conduct business with a view to making profit. The process of incorporation is grounded on both contract and regulation, and the operations of a corporation are largely based on contract. Further, the main objective of corporate law is to protect the interests of shareholders which is evidenced by numerous provisions including but not limited to providing for the duties of directors, provisions on protection of minority shareholders and provisions on decision making by shareholders. As is evident, such provisions are not concerned with the rights of third parties, who must specifically contract with the corporation where they have interests in order for some of the laws such as laws on insolvency to apply to them.

[19]Ibid, 1457-1460.

However, there are provisions or laws aimed at protecting the public from any harmful business practices of corporations; they cover environmental, social and governance matters. Some of these laws are mandatory for listed entities while others are a matter of good practice to enhance sustainability of business operations. This points to the fact that a corporation is not purely a nexus of contracts as some obligations owed by the corporation to the society are not based on contract.

Additionally, the argument that a corporation is a creation of the state may also hold water when one considers the process of incorporation or the process undertaken when the members or directors of a corporation wish to effect some changes with regard to ownership, directorship or the incorporation documents of the entity. A change of directors must for instance be approved by the state (through the relevant offices) when it comes to both resignation and appointment. A change of shareholding is also regulated by the state, which is the custodian of the register of members of a corporation that is available to the public on payment of prescribed fees. Mandatory rules on shareholding and directorship are also dictated by the state, and a corporation can only come into existence if the state approves its incorporation. Similarly, during liquidation, the state is involved through the courts and a corporation can only be dissolved once the state approves.

Further, while in contractual relations the doctrine of privity of contract is key and persons who are not parties cannot claim, some areas of business laws may rightfully claim from the actions or inactions of corporations which are parties to a contract. A good example is the competition law regulators who have a right to investigate the conduct of corporations with regard to competition, and demand that such corporations subject their operations to approvals from the regulator for purposes of assessment of effects on competition. Where corporations do not adhere to such laws, the regulators impose fines or undertake other punitive actions, and the contracts entered into by these corporations are considered void hence unenforceable. If business was only conducted by individuals, perhaps competition laws would not have been birthed as market forces would easily put in check the business behaviour of these

individual businesspersons. However, the moment they come together to form an entity to conduct business on their behalf, then the state comes in to regulate their behaviour in the market.

In essence, the corporation is a nexus of contracts that incorporates aspects of the law of trust, social responsibility and its nature as a creation of the state cannot be ignored.