On the Origins, Meaning and Influence of Jensen and Meckling's Definition of the Firm

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Abstract: Jensen and Meckling's 1976 definition of the firm as a legal fiction which serves as a nexus for contracts between individuals sits well with the Coasean narrative on the firm while at the same time being at odds with it. Available interviews with Jensen shed little light on the origins and meaning of this unusual definition. The paper shows how the definition captured, and was a response to, the American socio-political context of the early and mid-1970s, and traces how Jensen and Meckling employed it once they themselves got immersed in the public debate about corporate responsibility and regulation in the late 1970s and early 1980s. It also considers Jensen and Meckling's place in the literature on the economics of corporate law developed mostly in the 1980s.

Keywords: Jensen and Meckling, theory of the firm, legal fiction, corporate responsibility, corporate regulation, economics of corporate law

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1. Introduction

In 1979 the inaugural Leo Melamed Prize, attributed by the University of Chicago's Graduate School of Business (GSB) for outstanding scholarship by business school teachers, was awarded to two former Chicago students, Michael Jensen and William Meckling.[1] Since its publication in 1976 in the *Journal of Financial Economics*, founded by Jensen a few years earlier at the University of Rochester's Graduate School of Management (GSM), the award-winning article, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (henceforth JM76), has become one of the most cited papers in economics (Kim *et al.*, 2006), finance (Arnold *et al.*, 2003), accounting (Chen and Liano, 2009) and corporate governance (Durisin and Puzone, 2009). While this record reflects its appeal to multiple audiences in economics departments and business schools, the article's impact, as this paper shows, was also profound in law schools.

It is hard to overstate its influence on corporate finance and financial economics more generally. JM76 demonstrated that Franco Modigliani and Merton Miller's (1958) proposition that, given perfect capital markets, the firm's market value was independent of its capital structure, was a special case of the Coase theorem, namely something that held only in the absence of contracting costs and wealth effects. By relaxing these assumptions the article showed that the allocation of property rights affected the firm's financing decisions, thereby paving the way for subsequent developments in the field. The agency theory it proposed rapidly became

[1] Jensen (b. 1939) earned an MBA (1964) and a PhD (1968) at GSB. Meckling (1921-1998) pursued postgraduate studies in economics at Chicago (1949-1952) but left without completing his PhD.

a building block of modern financial economics, alongside the efficient market hypothesis, portfolio theory, the capital asset pricing model and option pricing theory (Jensen and Smith, 1984).

It is also difficult to exaggerate the article's importance for corporate governance and management more generally. JM76 showed that although the conflict of interest between owners and managers was indeed the source of the managerial negligence and profusion decried by Adam Smith,[2] it was not the case, as Adolf Berle and Gardiner Means (1932) had assumed, that managerial discretion would remained unchecked. Agency costs arising from the separation of ownership and control could be reduced by contractual arrangements and the operation of what Henry Manne (1965) called the "market for corporate control," which ensured the timely replacement of underperforming managerial teams. These claims informed the boom in executive compensation and takeover activity that came to define the 1980s (Fourcade and Khurana, 2017).

These success stories contrast with the article's fate in the theory of the firm literature. On the one hand, JM76 helped do away with the view of the firm as "a 'black box' operated so as to meet the relevant marginal conditions with respect to inputs and outputs, thereby maximizing profits" (JM76: 306-307),[3] replacing it with a focus on "how the conflicting objectives of individuals are brought into equilibrium" (JM76: 307) within the contractual structure of the firm. The depiction of the nature of the firm as a "nexus of a set of contracting relationships among individuals" (JM76: 311) sat well with Coasean insight that centralized contractual

[2] Smith's (1937: 700) observation that negligence and profusion prevailed in joint-stock companies because their directors managed other people's money was chosen as JM76's epigraph.

[3] The now-standard reference to the textbook firm as a "black box" first appeared in JM76.

structures were efficiency-enhancing, and generalized Armen Alchian and Harold Demsetz's (1972) earlier work on owner-managed firms to corporations.

At the same time, the definition of the firm as a "legal fiction," namely an "artificial construct under the law which allows certain organizations to be treated as individuals" (JM76: 310n12), was, and remains, at odds with the theory of the firm literature. And the additional claim that it "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), which Jensen and Meckling presented as an implication of their view of the nature of the firm, was certainly at variance with the literature's focus on the determinants of the boundaries of the firm. As a result, to paraphrase Ronald Coase (1972), JM76's definition of the firm came to be much cited but little used, except as a convenient foil (e.g., Hart, 1988).

In order to shed light on why Jensen and Meckling adopted such an unusual definition, this paper first turns to the "official history" of JM76 supplied by Jensen in several interviews. While instructive, these accounts are incomplete. Jensen tells an essentially internalist story which explains how their interest in the firm grew out of the requirements of teaching, and how the inadequacies of existing conceptions of the firm led to the formulation of agency theory. He does not use the expressions "nexus of contracts" or "legal fiction," and downplays the socio-political context. This is unsatisfactory, because JM76 explicitly alluded to contemporary "popular and professional debates over 'social responsibility'" (JM76: 307), and seemed to define the firm in a way that reflected these debates.

Taking 1970 as a starting point, the paper examines the context within which JM76 was written, and shows that Jensen and Meckling's definition captured, and was a response to, the public debate about corporate responsibility and regulation of the 1970s. It then traces how Jensen and Meckling spelled out the meaning and implications of their conception of the firm once they themselves joined the fray. The main message conveyed to the business community in the late 1970s and early 1980s was that corporations were unlikely to survive additional regulatory burdens imposed by activists and politicians who believed that costs could be imposed on corporations without harming individuals, particularly stockholders.

The paper then highlights the close connections between JM76 and the economics of corporate law developed over the course of the 1980s by a new breed of corporate lawyers trained in economics. The influence of JM76's agency theory was as profound in economics departments and business schools as it was in law schools. But it was in law schools that JM76's definition of the firm truly made an impact. In economics departments and business schools, it was cited but little used; in law schools, it was cited and used. In effect, JM76 supplied the budding economics of corporate law exactly what it needed: an economic theory of the firm upon which a new legal understanding of the corporation and corporate law could be built.

2. The Official History

Jensen discussed the origins of JM76 in a series of interviews (Chew and Jensen, 2010; Jensen and Walking, 2010, 2011), all of which refer to it as "the agency paper" (Jensen and Walking, 2010: 9; Jensen and Walking, 2011: 13; Chew and Jensen, 2010: 16). Jensen's account of how his teaching developed (Jensen *et al*., 1998) provides an additional source. There are also some secondary sources based on interviews or personal communications with Jensen (Khurana, 2007; Fox, 2009;

Fourcade and Khurana, 2017). According to this official history, the requirement of relevance in executive education was what first got Jensen and Meckling interested in the firm, but it was the realization that the textbook theory of the firm was problematic which led to the development of what became JM76.[4]

Breaking Open the Black Box

JM76 was an exemplar of the kind of ambitious research conducted at the Rochester's GSM under Meckling's leadership. Meckling was appointed Dean in 1964[5] by the university's new President, Allen Wallis, the former Dean of Chicago's GSB. Meckling sought to emulate what Wallis had achieved at Chicago, namely to create a distinctive economics-dominated curriculum. In 1967 he hired Jensen. By the time the first issue of the *Journal of Financial Economics* was published in 1974, Meckling had assembled the key elements of the faculty that cemented GSM's reputation in microeconomics, finance, accounting, monetary theory and macroeconomics: George Benston, Karl Brunner, Ronald Hansen, John Long, Walter Oi, Clifford Smith, Ross Watts and Jerold Zimmerman.

Although it was at "a time of great intellectual ferment at Rochester" (Jensen *et al*., 1998: 167) when Jensen and Meckling first became interested in the firm, their work on the topic was not initially an exercise in high theory. The students enrolled on Rochester's Executive Development Program "questioned the usefulness

[4] This narrative bears some resemblance to Coase's (1988) account of how the ideas developed in his celebrated article on the firm were formed while having to teach a course on the organization of the business unit, a topic that prevailing conceptions of atomistic competition in markets was ill-equipped to deal with.

[5] GSM was then known as the College of Business Administration. It was renamed GSM in 1970, and is now known as the Simon Business School.

of … price theory” (Jensen *et al*., 1998: 166) to the running of businesses, and this prompted them to start teaching it from a managerial perspective, using “the vehicle of … a large, multidivisional firm” (Chew and Jensen, 2010: 14). As they examined topics such as transfer pricing and peak-load pricing, they became themselves “captured by the organizational problems” (Chew and Jensen, 2010: 15) being considered.

The “actual precipitation of the agency theory paper” (Jensen and Walking, 2010: 8) was an “accident” (Chew and Jensen, 2010: 17) which “came about through Karl Brunner,” who since his arrival at Rochester in 1971 directed the Center for Research in Government Policy and Business. Brunner “invited us to attend the Interlaken conference that he had started to bridge the gap between American economists and the much more liberal economists in Europe” (Jensen and Walking, 2010: 8), and asked “us to give what was intended to be a controversial lecture … along the lines of what Milton Friedman was writing … in the *New York Times Magazine* about the same time” (Chew and Jensen, 2010: 18), something about “the business of business is to maximize profits” (Jensen and Walking, 2010: 8).[6]

Jensen and Meckling agreed with Friedman’s (1970) portrayal of executives as agents serving the interests of their principals, the stockholders,[7] and set out to “translate Friedman’s journalistic arguments into the language of economics” (Fox, 2009: 161). But “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

[6] Brunner’s invitation could not have been extended before early 1973, when he first conceived the Interlaken Seminar on Analysis and Ideology (Brunner, 1979: viii), but the official history erroneously records the year as 1971 (Fox, 2009: 161; Fourcade and Khurana, 2017: 354).

[7] Many at Chicago, including Aaron Director, Friedrich Hayek and Wilbur Katz, held this view.

firms" (Jensen and Walking, 2010: 8). Since "firms don't act, only individuals act" (Jensen and Walking, 2010: 8), and individuals are self-interested, it was clear that "the likelihood that they would all behave as though a simple maximizing outcome at the top would occur was close to zero" (Chew and Jensen, 2010: 18-19). This realization was the beginning of what they called "breaking open the black box of the firm" (Jensen and Walking, 2010: 8).

They began building a mathematical model which allowed for conflicts of interests and yielded "predictions about what was happening and how it would evolve" (Chew and Jensen, 2010: 19).[8] The key idea was that agency costs, conceptualized as the sum of the principals' monitoring costs and the agents' bonding expenditures, plus a form of deadweight loss that they called "residual loss" (see JM76: 308), had an important role to play.[9] This gradually developed into a discussion of how agency costs 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 and were affected by the parties' divergent interests. Jensen recalls:

> "We focused on the conflicts of interest between managers who were not 100% owners of the firm and shareholders and bondholders, and we focused on the conflicts between bondholders and shareholders." (Chew and Jensen, 2010: 19)

[8] This was not the first time that internal conflicts of interest were modelled. Nor was it the first time that doubts about the profit maximization hypothesis had been raised. In the 1950s and 1960s, similar observations had produced the managerial theory of the firm, which emphasized management's discretion to maximize something other than profits (e.g., sales revenue in Baumol, 1959), as well as the behavioral theory of the firm, which viewed the firm as a coalition of individuals and groups with conflicting goals in pursuit of satisfactory, as opposed to optimal, solutions (Cyert and March, 1963). For an overview of the history of the theory of the firm, see Bertrand (2016).

[9] The inclusion of costs incurred not just by the principal but also by the agent was an improvement on existing discussions (e.g., Ross, 1973).

It became clear that the Modigliani-Miller theorem was misguided: a firm's financing decisions were not a matter of indifference. Moreover, the focus on capital structure obscured the trade-off between inside and outside equity. Adopting the term "ownership structure" instead, Jensen and Meckling mobilized the comparative institutional analysis recommended by Coase (1964) and Demsetz (1969) to propose a model of alternative ownership structures along the lines intimated by Alchian and Demsetz (1972). The model showed that the separation of ownership and control helped reap the benefits of specialization, and that the markets for managers and the firm itself helped mitigate the associated agency costs. Millions of individuals would not be willing to entrust managers with their savings if this were not the case.

Initial Reception

The first draft was completed in mid-1973.[10] Before giving the paper at Brunner's Interlaken Seminar in mid-1974, Jensen and Meckling presented it in early 1974 to an audience of "colleagues and friends" (Jensen and Walking, 2010: 9) at the Rochester Finance Workshop, where attendees included Benston, Smith, Watts and Zimmerman. Although robust challenges by otherwise friendly colleagues were the norm at Rochester's GSM,[11] the reaction was not quite what they expected: they "ran us out on a rail," they "accused us plagiarizing Armen Alchian" (Chew and Jensen, 2010: 19). Alchian had indeed made a number of similar arguments at an American Enterprise Institute (AEI) symposium that Manne organized in Washington in 1968

[10] Michael Rozeff, at the time Jensen's PhD student, recalls (in personal communication) commenting on the first draft before the fall term of 1973.

[11] I am grateful to Ronald Hansen, at the time Associate Director of the Center for Research in Government Policy and Business, for sharing (in personal communication) his recollections.

(Manne, 1969), just before he accepted Wallis's invitation to set up a law school at Rochester. Both Jensen and Meckling had attended that event.

Alchian argued that the appropriate units of analysis were individuals within firms, rather than firms themselves, and claimed that interpersonal conflicts of interests resulted in competition within firms, with the implication that the assignment of property rights, particularly when as regards what he called the "ownership-agency relation" (Alchian, 1969: 343), tended to be efficiency-enhancing. There were similarities with Jensen and Meckling's presentation, but there were also important differences, most notably the specification of agency costs and the detailed comparative institutional analysis of the trade-offs involved. It seems these novelties were lost on some members of the audience.

Benston, who had also attended Manne's 1968 symposium, was dismissive: "What's new here? Accountants have been talking about stewardship accounting for decades. Stewardship is another term for agency relations. Accounting arose to control agency problems."[12] After the presentation, Jensen reports,

> "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!'" (Jensen and Walking, 2010: 9)

As it turned out, the paper nevertheless "inspired many at Rochester to tackle new kinds of organizational problems" (Jensen *et al*., 1998: 167).

Jensen failed to sell the paper in Chicago at the GSB Finance Workshop in early 1975, where attendees included Fischer Black, Fama and Miller. His claim that

[12] I am grateful to Jerold Zimmerman for sharing (in personal communication) this anecdote.

the chapter in Fama and Miller's (1972) *The Theory of Finance* showing that "capital structure didn't count" was wrong (Jensen and Walking, 2010, p. 9)[13] did not go down well: "they hated it" (Chew and Jensen, 2010: 21). The audience, as Roger Ibbotson recalls,[14] was "used to seeing more mathematical or empirical papers," and did not recognize "it to be a seminal paper creating a whole new field," although "Michael [Jensen] pitched the paper somewhat as if it were." As it turned out, the paper nevertheless inspired many at Chicago, including Fama himself, to turn to agency theory.

Perhaps because it presented the Modigliani-Miller framework as an example of what Demsetz (1969) had called the "nirvana approach," the paper proved to be difficult to publish. It was rejected when it was first submitted in mid-1975:

> "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*." (Jensen and Walking, 2010: 9)

For Jensen, the reviewers' reaction mirrored the state of the "economics profession as a whole" (Chew and Jensen, 2010: 23), which remained reluctant to discard the black box view of the firm. Also, "in those days there wasn't much of an interest in transaction cost economics" (Jensen and Walking, 2010: 8-9). Fortunately, in late 1975, they received an unexpected letter:

> "Gene [Fama] … somehow got a copy of the working paper and sent me an unsolicited acceptance for the *Journal of Financial Economics* … I

13 The episode in mentioned in Fama's (2011) autobiographical essay.

14 In personal communication with the author.

> would never have done that myself, but since Gene did, then I could accept it." (Jensen and Walking, 2010: 9)

They had started the journal because "the profession … the old guys … had very little interest in publishing papers from the younger guys" (Jensen and Walking, 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 thought they "had a monopoly on most of the good stuff" (Jensen and Walking, 2011: 7).[15] Jensen predicted that the paper was going to be "very important," and told Meckling he was planning to "exercise [his] rights as Editor to make it the lead article" (Jensen and Walking, 2010: 9). JM76 was published in the fall of 1976.

3. JM76's Definition in Context

Jensen's account explains how the search for a more realistic theory of the firm led the development of the agency theory. Barring a reference to Friedman's *New York Times Magazine* piece and Brunner's proposal to debate left-leaning Europeans, the official history is an internalist account which does not explain what Jensen and Meckling had in mind when they defined the firm as a legal fiction. While one might surmise that, in hindsight, Jensen no longer considers this definition to be central to the paper's main argument, it likely did mean something at the time. The key lies in the JM76's rejection of the "personalization of the firm."

[15] Given the paradigm shift the young guys provoked, it did not take long for the *Journal of Financial Economics* to rank with established journals (Liebowitz and Palmer, 1984).

Misleading Personalization

Jensen and Meckling dismissed the personalization (or personification) of the firm in a heavily-cited passage of JM76:

> "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' is seriously misleading. *The firm is not an individual*." (JM76: 311, emphasis in original)

The reference to the firm's objective function reflected how the sin of personalization was routinely committed by economists. Jensen and Meckling's explicit point was that the black box view of the firm was seriously misleading because only individuals could act or have objective functions. Their implicit point was that managerial theories of the firm, which replaced profits with sales revenue or something of that sort in the firm's objective function, were equally misleading. For most interesting questions the appropriate way to look at "firm behavior" was to understand how the "conflicting objectives of individuals … are brought into equilibrium within a framework of contractual relations" (JM76: 311).[16]

The contractual structure of the firm was efficiency-enhancing when "the owners of labor, material and capital inputs and the consumers of output" (JM76: 311) contracted with the firm instead of with each other. Transaction costs were reduced thanks to the legal treatment of firms as if they were individuals with contractual capabilities of their own. But it was important to keep in mind that lying at the nexus of

[16] As Jensen (1983: 328) later clarified, treating the firm as if it were a profit-maximizing individual could nonetheless be useful. Explanations of how outputs of a firm or industry responded to price changes, for example, were more productively addressed using the black box view, as long as one remembered that it was a "convenient abstraction." The influence of Friedman's (1953) instrumentalist methodology is clear.

the contracts making up the firm was a legal fiction, something that existed only in contemplation of law. Jensen and Meckling saw the gravest consequences of personalization in the uncritical acceptance of the fact that the law allowed certain organizations to be treated as individuals (Gindis, 2016). The implications were not addressed in JM76 but were revealed elsewhere.

As Meckling (1976: 548) explained, the truth was that, stripped to their essentials, firms were "pure conceptual artifacts, even when they are assigned the legal status of individuals." Hence when contracting or property rights were legally assigned to firms, those rights always ultimately belonged to real individuals. By the same token, duties or costs could only be imposed on individuals. In the end, "we can only do things *to* and *for* individuals" (Meckling, 1976: 548, emphasis in original). The importance of these considerations was captured in the reference to social responsibility in JM76's dismissal of personalization. In addition to being an allusion to Friedman, it provided the link with the contemporary professional and popular debate. Jensen and Meckling's definition of the firm was meaningful in that context.

Corporate Social Responsibility and Its Discontents

Although corporate social responsibility was at the forefront of the public debate in the early 1970s, calls for executives to embrace social and political responsibilities were hardly new. At the height of the Great Depression, Berle and Means (1932) wanted business to assume economic statesmanship, and in the 1960s, while economists such as Means (1962) and John Kenneth Galbraith (1967) argued that self-perpetuating managers could administer prices without fear of being replaced, lawyers such as Arthur Miller (1960) and Berle (1963) promoted the view that large corporations were private governments that had to operate in the public interest. By the late 1960s, however, this was no longer primarily an intellectual debate. The counterculture of the 1960s had fueled the public's antipathy toward corporate America. Organized anti-corporate action in the form of picket lines, sit-ins and boycotts had become a part of the American political landscape.

In this context, a national debate about corporate misbehavior, lax safety and environmental standards and ineffective federal regulatory agencies was spearheaded by Ralph Nader, an energetic Harvard-trained lawyer that the press described as a "self-appointed lobbyist."[17] Aided by groups of activist students recruited from top law schools – collectively known as "Nader's Raiders[18] – and thanks to the receptiveness of many politicians in Washington to the causes he championed, Nader was behind the adoption of a series of consumer, worker, and environmental protection regulations in the late 1960s. He was also instrumental in the creation of new federal agencies.[19]

In early 1970 a Nader-backed group called Project on Corporate Responsibility launched *Campaign GM* to force General Motors to expand its board to representatives of civil society and create a Committee for Corporate Responsibility to advise management on matters of public interest. Worried about its image, the firm created a Public Policy Committee and appointed a member of the civil rights movement to its board. As other major corporations were targeted, the pressure exercised by what became known as the "public interest movement" (Vogel, 1978)

[17] "Ralph Nader, Crusader; Or, the Rise of the Self-Appointed Lobbyist," *New York Times Magazine*, 29 October 1967.

[18] "Nader's Raiders: The Lone Ranger Gets a Posse," *Life*, 3 October 1969.

[19] Most notably the Occupational Safety and Health Administration and the Environment Protection Agency.

continued to build up, with the backing of the voting public.[20] As Paul Samuelson (1971: xxi) put it, "it is not primarily hippies or activists who mutter, 'Right on,' when Nader's legions castigate General Motors" but "many of the readers of *Time* magazine."

High-profile business leaders, including David Rockefeller and Eli Goldston, at the time a Director of the NBER, advocated a growth of corporate charitable giving and called for business to play a greater role in society. The Committee for Economic Development, a business-led public policy think tank, argued that business statesmanship was in business' "enlightened self-interest" in a number of reports, including *A New Rationale for Corporate Social Policy*, released in 1970, in which William Baumol pointed out that, as with other public goods, philanthropic and social responsibility services were likely to be underprovided by business. "Institutional support" in the form of "taxes, regulations, and legal remedies," Kenneth Arrow (1973: 316-317) reasoned, was required.[21]

In this spirit, Nader and a group of raiders called Corporate Accountability Research Group proposed a systemic solution in a highly-publicized book, *Taming the Giant Corporation* (Nader, Green and Seligman, 1976a). The book argued that "megacorporations" were private governments serving a broad range of constituencies (Nader, Green and Seligman, 1976a: 8), but that a "perverse form of forum-shopping inspired by the states with the most lax corporate laws" (Nader, Green and Seligman, 1976a: 246) perpetuated managerial entrenchment, to the

[20] "The Harris Survey: Public Support for Nader Rises Steadily," *Washington Post*, 18 December 1972.

[21] Arrow, Baumol, James Buchanan, Roland McKean, Edmund Phelps, William Vickrey, and others addressed these topics at a 1972 Russell Sage Foundation conference on "Altruism, Morality and Economic Theory" (Phelps, 1975). Other economists working on these themes included Neil Chamberlain, Neil Jacoby, and Henry Wallich. See Lee Preston's (1975) overview of the debate in the *Journal of Economic Literature*.

detriment of investors, employees, consumers and the wider community. To eliminate the Delaware-led race "race to the bottom" denounced by William Cary (1974), Nader proposed that the largest corporations be chartered by the federal government itself.

Corporate reformers were persuaded that if ever there was a time to push for substantial changes in the operation of American corporations, then surely this was it. Public confidence in business was at an all-time low (Silk and Vogel, 1976). In a decade that began with the bankruptcy of Penn Central, "the most spectacular case of corporate mismanagement in recent history,"[22] the energy crisis led many to accuse oil companies of profiteering. While the country was still reeling from the Watergate revelations, the news was dominated by a series of large-scale foreign corruption scandals, which the Securities and Exchange Commission (SEC) described as the "second half of Watergate, and by far the larger half."[23]

In early 1976, the Senate Committee on Commerce announced that hearings on *Corporate Rights and Responsibilities* would be held to evaluate the case for federal chartering. The hearings' significance was potentially profound: any "law or set of laws" emerging from this legislative process "may turn out to have as much impact on the conduct of business …as the New Deal reforms did in the 1930s."[24] Nader and his co-authors were invited to testify. On the eve of the hearings in the summer of 1976, the Committee's witness list also featured representatives of employer associations, trade unions, the SEC, the Delaware Bar Association, and a range of

[22] "Penn Central: The Unanswered Question," *Forbes*, 15 December 1970.

[23] "How Clean Is Business?" *Newsweek*, 1 September 1975.

[24] "A Step Toward the Federal Corporate Charter," *Business Week*, 21 June 1976.

business executives and academics, among whom Manne.

Opponents of corporate reform had initially struggled to make their voice heard in the Nader-dominated public debate. Tellingly, perhaps, despite being a direct response to *Campaign GM*, Friedman's *New York Time Magazine* piece had not mentioned Nader. It was Manne who first took the gloves off in the business press (Manne, 1970, 1971). Like Friedman, Manne affirmed the principle that management's sole duty was to maximize profits on behalf of the corporation's owners, but unlike Friedman, Manne portrayed Nader as an uninformed zealot whose positions lacked empirical support. This was the stance that Manne, soon described as "Ralph Nader's most outspoken critic,"[25] was the most active in conveying throughout the first half of the 1970s.

Manne was particularly perplexed to see business leaders subscribe to the idea of corporate social responsibility. Given their experience of dealing with "disparate individual interests in large corporations," it was surprising that they were willing to entertain the idea that corporations could have interests separate from those of individuals (Manne, 1973: 709). "Many corporate officials," he regretted, "sounding … oddly like Ralph Nader, cherish the myth of a collective, substantive existence for corporations, as though the companies themselves could bear costs without passing them along to real live human beings" (Manne, 1975: 27). His testimony, given on the same day as Nader, developed these ideas.

Nader viewed the hearings as an opportunity to "initiate the greatest public debate on the role of the giant corporation in American history" (Nader, Green and

[25] "Meet Ralph Nader's Most Outspoken Critic," *Business Week*, 24 July 1971.

Seligman, 1976b: 197).[26] Contrary to the claims of his detractors, he insisted, the federal chartering proposal was not about the creation of vast discretionary powers in Washington, but about using the instrument of federal charters to redefine the place of business in society. Charters were in effect contracts between corporations and the state: "government provides the charter to the corporation, exchanging considerable privileges … in return for certain standards that have to be observed" (Nader, Green and Seligman, 1976b: 207).

Manne was not impressed. "A little knowledge of the workings of our economic system," he countered, "would go a long way to counter simplistic thinking" (Manne, 1976: 241) professed by "would-be economic tinkerers" (Manne, 1976: 225) such as Nader. Referring the Committee to Alchian and Demsetz's (1972) "classic analysis" of the firm as an example of the "new and sophisticated theories to explain the corporate system" and the "complex organizational mechanism" known as the corporation, Manne (1976: 236-237) pointed out that these had yet to permeate the "popular or journalistic" debate "or the more narrowly legal writings on the subject," which all too often viewed corporations as political, as opposed to economic, entities.

One could not ignore, Manne (1976, p. 236) explained, the "fundamental role played by market forces in the design, the structure, and the performance of modern corporate enterprise." In particular, one could not snub "the most exhaustive and conclusive series of empirical studies done on any aspect of modern economic theory," namely the "now famous 'efficient market hypothesis'," which showed that share prices "reflect with extreme accuracy and speed all information" (Manne, 1976: 226) investors needed to make the right

[26] Quotes are taken from the oral testimonies and written statements.

decisions.[27] Underperforming corporate boards could not go undetected for long; their replacement was inevitable.

Ultimately, corporations were merely "complex congeries of interacting private contractual arrangements" (Manne, 1976, p. 236) between individuals seeking personal gain. There was no contract with the state. And there certainly was no such thing as corporate responsibility: "a corporation is not such an entity or a being that can have ethical attributes, or an altruistic spirit, or a social responsibility" (Manne, 1976: 227). Indeed:

> "We are learning in our study of corporate organizations … that the only and ultimate unit of analysis is individuals, only individuals have incentives, constraints, motivations, responsibilities … The corporation is … a legal fiction." (Manne, 1976: 228-229)

These were Jensen and Meckling's arguments in a nutshell. While it may not be possible to show how exactly Jensen and Meckling came to use the expression "legal fiction,"[28] JM76's definition of the firm was linked to the rejection of the personalization of the firm, and was meaningful within the socio-political context of the mid-1970s. It is also possible to interpret the claim that it "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) as a critique of the notion of the "giant corporation." Corporate size was not the issue, for Jensen and Meckling. What mattered was the contractual allocation of property rights.

[27] Jensen (1978: 95) likewise wrote: "I believe there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis."

[28] Michael Jensen (in personal communication) has no precise recollection.

4. How JM76's Definition was Put to Use

Federal chartering never passed the Committee stage of the legislative process, but the push for corporate reform in the name of social responsibility seemed to be spreading. Jensen and Meckling became directly involved in the public debate, in effect replacing Manne as leading Nader critics. As they spelled out the implications of the personalization of firm in way that mattered to the business community, the first econometric study to refute Nader's agenda was being developed by Jensen's students at Rochester. The results, along with the key messages of JM76, were integrated into the new literature on the economics of corporate law which Manne successfully promoted in law schools.

Can the Corporation Survive?

In 1977 corporate reformers had every reason to be optimistic. Following his election, Jimmy Carter appointed several Nader loyalists in his administration, while the Federal Trade Commission set up a Task Force on Corporate Accountability. The following year, a Senate Advisory Committee on Corporate Governance was appointed, and the American Law Institute (ALI) initiated its Corporate Governance Project. Reform, it seemed, was imminent.[29] As SEC Chairman Harold Williams (1978: 1) admitted, one could not rule out "jump in the degree to which that law controls the exercise of corporate power and authority." While the business press exposed the dangers of regulatory overkill, Jensen and Meckling asked: "Can the

[29] "Governance of U.S. Companies: Proposals on Reform Likely Soon," *New York Times*, 24 February 1978.

Corporation Survive?"

They had written a Center for Research in Government Policy and Business working paper under this title in mid-1976,[30] and had published it in *Financial Analysts Journal* in 1978. Jensen and Meckling's answer was dire:

> "We believe that the era of dramatic economic growth is over … because *government is destroying the system of contract rights, which has been the wellspring of our economic growth*. The corporate form of organization … is likely to disappear completely. Even if it survives in some form the larger corporations as we know them are destined to be destroyed." (Jensen and Meckling, 1978: 32, emphasis in original)

This forecast had a "high probability of being realized" (Jensen and Meckling, 1978: 37) unless the gradual encroachment of government was curbed. Recent attacks on corporations, they pointed out in a companion paper published in *The Banker*, followed a recurring pattern: "they usually involve hearings by the Congress" and "often there is some 'public interest' group in the background – like Nader's raiders" (Meckling and Jensen, 1977: 46) seeking to impose additional responsibilities on corporate executives. Activists, the political allies and their enablers in the press failed to see that this amounted to transferring wealth from the owners of corporations to these other groups, because they seemed to believe that costs could be imposed on corporations without harming individuals. As they had argued in JM76, albeit not in so many words:

> "The corporation is only a convenient legal fiction that serves as a nexus for a very complex set of contract rights between individuals. The costs and benefits allegedly imposed on the corporation are in fact imposed on the human parties to the contracts (explicit or implicit) and merely effected

[30] It was cited in JM76.

through the corporation." (Jensen and Meckling, 1978: 36)

The more social responsibilities are imposed on executives, the higher the costs of running corporations, and the lower the value of the stockholders' residual claims. The fall in the value of corporate securities reduced capitalization, which in turn affected the viability of the financial claims underpinning corporations. The system of private property rights sustaining markets was in danger. In fact, as there will always be alliances between special interest groups seeking to improve their welfare at the expense of investors and politicians seeking to enhance the scope of their decision-making powers, the collapse of the American free enterprise system was only a matter of time. "We hope that bringing the problem to the attention of the public," Jensen and Meckling (1978: 37) concluded, "will generate a solution."

The key message, that "if you look at a corporation as nothing but a set of contracts … what really hits you over the head is the vulnerability of all those contractual claims," as Jensen and Meckling put it in a mid-1976 *Forbes* interview,[31] was delivered to a broad audience. Prior to its publication in 1978, the article had appeared in several corporate and industry newsletters, as the cover story of *MBA Magazine*, in the American Institute for Economic Research's *Economic Education Bulletin* and, with an introduction by Alchian, as a pamphlet circulated by the International Institute for Economic Research (IIER).[32] It was quoted widely in the national press. Additional jargon-free papers, bearing titles such as "Freedom and the Role of Government" (Jensen, 1977a) and "The Debasement of Contracts and the Decline of Capital Markets" (Jensen, 1977b), drove the point home.

[31] 'As We See It', *Forbes*, 15 June 1976.

[32] Alchian (1976) had endorsed and cited it in his dialogue with Adam Smith.

In 1979 "Can the Corporation Survive?" was awarded the Financial Analysts Federation's prestigious Graham and Dodd Plaque, despite the fact that it did not contain the type of mathematical analyses normally awarded the prize.[33] A few months earlier one could read the following in the *Wall Street Journal*:

> "Until now proponents of federal chartering 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 [which] concluded that the main threats to stockholders' wealth are federal laws … that diminish the value of securities by reducing the property rights of the owners … Now advocates of federal chartering face a third problem – an empirical one. In a study of the Managerial Economics Research Center at the University of Rochester, Peter Dodd and Richard Leftwich tested the claim the competition among states for corporate charters results in a reduction of stockholders' wealth … They conclude: 'The evidence presented here lends no support to the argument … Empirical science has a way of disarming rhetoric.'"[34]

The results of this first econometric study of the race to the bottom argument which underpinned Nader's federal chartering campaign, conducted by Jensen's students at the Managerial Economics Research Center he had set up earlier that year, were crucial. They showed that jurisdictional competition on the supply side and freedom to incorporate in any state on the demand side created benefits for investors: Delaware captured a large share of the market for corporate charters not because its corporate law favoured management but because it helped reduce investment costs. Other states copied Delaware's corporate law for this reason. Although futher research was needed, the study's reliance on "empirical science" stood in stark contrast, Dodd and Leftwich (1980: 260) observed, with the attitude of "proponents

[33] Modigliani and William Sharpe were among its previous recipients.

[34] "Facts on Federal Chartering," *Wall Street Journal*, 28 November 1978.

of federal chartering," who saw fit to initiate congressional hearings yet "present[ed] no empirical evidence."

Heavy regulation pushed by the White House had by this time become unlikely – the Carter administration had already initiated the era of deregulation – federal chartering, and Nader himself, remained the focus of the anti-regulatory counter-attack (Winter, 1978; Hessen, 1979; Weidenbaum, 1979). Hostility towards the American corporate system was still very present, and the critique of the "giant corporation," which Nader represented, remained a rallying point. Ronald Reagan's election in late 1980 did not alter this state of affairs. Regulation by agencies such as the SEC was still a real possibility, and it was unclear how the ALI Corporate Governance Project would lean.

These questions were addressed at a major conference on corporate governance organized at UCLA in early-1981, where Jensen warned an audience of academics, executives, and industry professionals that when reformers and their political allies called for managers to pursue social responsibilities, what they really wanted was "control over the use of the wealth currently owned by the parties to the contracts that make up the corporation" (Jensen and Meckling, 1983: 300). The argument was next presented at a Rochester symposium on "Controlling the Giant Corporation" under the title "Reflections on the Corporation as a Social Invention" (Meckling and Jensen, 1982), which circulated as an IIER pamphlet prior to its publication in the *Midland Corporate Finance Journal* (Meckling and Jensen, 1983), a bank-sponsored review addressing the business community. It, too, lamented the vulnerability of stockholder rights

JM76 and the Economics of Corporate Law

Meckling retired in mid-1983. He did not attend the Hoover Institution conference on "Corporations and Private Property" organized in late 1982 to mark the fiftieth anniversary of Berle and Means (1932), which the organizers presented as the erroneous source of Nader's views. Jensen and Manne, as well as Daniel Fischel and Frank Easterbrook, two early stars of the economics of corporate law, were present.[35] In the resulting special issue of the *Journal of Law and Economics*, Fama and Jensen (1983a, 1983b) showed how contractual arrangements mitigated agency costs and protected shareholders' residual claims. Meanwhile, the *Journal of Financial Economics* ran a symposium on "The Market for Corporate Control: The Scientific Evidence" to take stock of what was known about the market forces involved (Jensen and Ruback, 1983).

Both issues highlighted the close connections between the latest economic thinking on corporations and the best available scientific evidence. In the early 1970s, the emphasis on this connection was a defining feature of Manne's dispute with Nader.[36] As his testimony at the 1976 hearings revealed, he believed that progress in the economic understanding of the corporation and the corporate system more generally had yet to permeate the popular or journalistic debate, as well as the legal writings on the subject. Manne took it upon himself to ensure that matters did not remain in that state.

The bulk of his efforts went into the promotion of economic tools and

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[35] Means also attended. Other attendees included Demsetz, Fama, Robert Hessen, Benjamin Klein, Douglass North, George Stigler and Oliver Williamson.

[36] It was likewise a central characteristic of his debate with Berle in the 1960s.

techniques among lawyers, judges and other legal professions. In 1971, while still at Rochester, Manne launched a series of summer Economics Institutes for Law Professors, at which the principles of economics taught primarily by Alchian and Demsetz were applied to various topics, including corporations. These courses served as a blueprint for subsequent training programs offered by the Law and Economics Center (LEC) he set up at the University of Miami Law School on his arrival in 1974. Over the next few years, the LEC offered economics training for law review editors, Congressional staff aides, government officials and federal judges (Butler, 1999; Gindis, 2019).

Among other efforts to rectify popular beliefs, the LEC's widely-distributed *Corporate Issues Sourcebook*, a collection of digestible essays by Manne, Benston, Demsetz and others, gave students, executives, investors and the public a quick understanding of "modern thinking about the economics of the corporate enterprise" (Manne, 1978: xiv). Almost every chapter presented the reformists' evidence as anecdotal. Readers were warned against political conceptions of corporations, and referred to JM76 on the nature and benefits of corporations. When the LEC launched an Advanced Course on Corporate Governance and Financial Markets at Emory in 1982, it was only natural for Meckling, and later Jensen, to be among the instructors. JM76's place in the new field of the economics of corporate law had by then been secured.

Hence Richard Posner and Kenneth Scott's (1980) *Economics of Corporation Law and Securities Regulation*, which first assembled the field's main strands in the form a reader designed as a teaching tool for corporate law professors, opened with excerpts from Coase (1937), Alchian and Demsetz (1972) and JM76 on the economics of the firm.[37] This was followed by readings on corporate social responsibility and the race to the bottom argument which portrayed Nader, Galbraith and others as ignorant of both the preceding material and Dodd and Leftwich's (1980) empirical study, an extract of which was provided. The book's subsequent treatment of insider trading, disclosure requirements, dividend policy, fiduciary duties, and investor protection was infused with the concept of agency costs, and strongly supported the Manne's (1967, p. 284) conjecture that "market forces rather than legal ones have dictated [the] organization and structure" of large corporations.

The research programme he had called for throughout the 1960s was finally taking shape. When he started out, Manne (1962) could only observe that little was known about the economic forces at work. The empirical evidence supporting what became known as the efficient market hypothesis soon allowed him to argue that the market for corporate control helped curb managerial discretion (Manne, 1965). He then turned his attention to the economics of securities regulation (Manne, 1969), but he left things there, and "never produced," as Gordon Tullock (1969: 291, emphasis in original) lamented, "his *General Theory of Corporations*."

In its absence, Manne's project could not really get off the ground. Indeed, there were only rudimentary things to say about corporate law. For example, Posner's (1973) *Economic Analysis of Law* attempted to apply transaction cost analysis to corporate law. It introduced Coase's theory of the firm but, realizing it was not designed to explain corporations, relied mostly on the black box view. Basic assumptions about conflicts of interests and a suitable comparative institutional

[37] JM76 still appears as a key reading in the opening section on the economics of the firm in the latest anthology (Hill and McDonnell, 2016).

analysis were missing. While Alchian and Demsetz (1972) initiated work along these lines, it was JM76's agency cost-minimization perspective that provided the appropriate framework and captured a detailed array of relevant trade-offs. The theory of the firm it proposed was general, applicable to any legal form of the firm.

JM76 offered Manne's project a theory of its main object of analysis. It also provided a theory of ownership structures that was readily combined with the idea that market forces helped protect shareholder interests. The final element that Manne's project needed was supplied by the Dodd and Leftwich study of jurisdictional competition, which showed that the content of corporate law itself was also driven by market forces. Over the course of the 1980s, a new generation of corporate lawyers trained in economics integrated these ideas to propose that the function of corporate law was to help private parties reduce agency and other contracting costs.[38] This proposal had a profound impact on the trajectory of corporate law scholarship, and shaped what would become the ALI Principles of Corporate Governance in the early 1990s (Cheffins, 2013).

A distinctive feature of this literature, culminating with Easterbrook and Fischel's (1991) *The Economic Structure of Corporate Law*, was the systematic reference to JM76's definition of firm. By the end of the 1980s, as one observer noted, the impact in law schools had been so strong it was clear to both critics and advocates that "a revolution, under the banner 'nexus of contracts,' … swept the legal theory of the corporation" (Kornhauser, 1989: 1449). In the process, as another put it, the 'core notion' that the firm is a legal fiction was accorded "the weight of

[38] Besides Easterbrook, Fischel, Posner and Scott, this group included Barry Baysinger, Henry Butler, Ronald Gilson, William Klein, Jonathan Macey, Joel Mofsky, Larry Ribstein, Fred McChesney, Roberta Romano and Ralph Winter.

scientific truth: it [was] received in the legal literature as an ontological discovery with immediate and significant implications for corporate law discourse" (Bratton, 1989: 409). Jensen, by then at Harvard, had already turned his attention to other matters.[39]

5. Conclusion

JM76's definition of the firm as a legal fiction which serves as a nexus for a set of contracts among individuals sits well with the theory of the firm narrative inherited from Coase while at the same time being at odds with it. The official history of JM76 offers few explanations as to why such an unusual definition was adopted. This paper has argued that the definition makes sense once the socio-political context within which JM76 was written is taken into account. Furthermore, it has shown that when Jensen and Meckling got immersed in the public debate about corporate responsibility and regulation in the late 1970s and early 1980s, their message that private corporations were unlikely to survive additional regulatory burdens followed from their definition of the firm.

The insight that behind the legal fiction were vulnerable stockholders, who not only had to deal with opportunistic managers but also bear the costs of corporate regulation, was mobilized in the economics of corporate law literature developed in the 1980s. In effect, JM76 provided a theory-of-the-firm foundation for this literature's central claims that market forces had moulded existing corporate

[39] Jensen moved to Harvard Business School in 1984 on a part-time basis, before making a definite move in 1989. From 1984 he focused on mergers and executive compensation.

features, and that any proposed regulation had to be assessed in light of its effect on agency and other contracting costs. Part of the reason why scholars involved in provoking a paradigm shift in the legal understanding of corporations had a lasting influence on the corporate governance debate was that they were able to claim that their work was grounded in the latest economic science.

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