

The Contractual Theory of the Firm as a Normative Business Ethic and its Relationship to Roman Catholic Social Teaching on Economic Life

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Introduction

Although Roman Catholic social teaching offers a well-developed normative business ethic that serves as a basis for justifying some aspects of economic activity and for criticizing others, this business ethic is not comprehensive. In particular, church teaching on economic life fails to comprehend fully the modern corporation, which is the dominant economic institution in present-day capitalism. This omission is understandable in view of a similar focus by economists on markets and the market system at the expense of economic institutions. Theologians with an interest in economic matters have formed their conception of corporations from mainline economists, who have generally been little concerned with institutional forms. Corporate law, which created and sanctioned the corporation as an institution, has provided theologians with a more adequate understanding of the corporate form. However, legal theorists have generally been concerned with the corporation as a legal entity and not with the corporation's economic role, and they have sought the foundation of corporate law in legal principles, not economic analysis.

In recent years, both economics and corporate law have been revolutionized by developments that have brought the two fields closer together. Economists, building on the work of Ronald Coase, have come to appreciate the importance of firms for understanding economic behavior and have succeeded in applying economic analysis to firm structure. As the title of Oliver Williamson's book Markets and Hierarchies suggests, economics has expanded to include the study of hierarchical economic institutions, such as the corporation, and not merely market transactions. Legal theorists have recognized the relevance of economic analysis for the formation of corporate law.

As Frank Easterbrook and Daniel Fischel argue in The Economic Structure of Corporate Law, many distinctive features of corporate law cannot be explained fully by legal principles, such as property rights, but are easily understood from an economic perspective as attempts to develop more efficient governance forms.

These developments have resulted in the contractual theory of the firm, which is now central to financial economics and corporate law. This theory, which views a firm as a nexus of contracts among various constituencies, is a powerful analytical framework that is slowly transforming the conception of the corporation in other academic disciplines, especially sociology and political science. However, the contractual theory has not yet made a significant impact on those fields that study normative questions of business. In particular, Catholic social teaching still assumes a conception of the corporation that derives from the traditional economic and legal literatures. The newer contractual theory offers a normative business ethic that Catholic theologians may or may not find acceptable, but it is imperative for Catholic social teaching on economic life that this theory be understood and its normative implications addressed. A study of the contractual theory by Catholic theologians would be a constructive step towards developing a more adequate conception of the corporation and thereby a more comprehensive normative business ethic.

>This paper is an initial exploration of the possibilities of a relationship between the contractual theory of the firm and Catholic social teaching. As such, it reaches no substantive conclusions but merely suggests directions for further investigation. The starting point for the paper is the article "Business Ethics and the Theory of the Firm" by John Boatright, a philosopher and business ethicist. This article describes the normative structure of the contractual theory and develops a normative framework for analyzing business ethics problems. The first part of the present paper is a summary of the main arguments in "Business Ethics and the Theory of the Firm." In the second part of the paper, Michael Schuck, a Catholic theologian, discusses the contributions that the contractual theory might make to Catholic social thought. The third and concluding section contains some observations by John Boatright in light of Michael Schuck's discussion.

Part I

Main Arguments in

"Business Ethics and the Theory of the Firm"

John R. Boatright

The modern theory of the firm as a nexus of contracts originated in Ronald Coase's seminal insight that firms exist as less costly alternatives to market transactions. In a world of zero transaction costs, economic coordination would be achieved entirely by means of contracting among individuals in a free market. Because of the cost of negotiating and enforcing contracts, however, some coordination can be achieved more

cheaply through firms, which substitute hierarchical decision making for decisions made through markets. Thus, there are two forms of economic coordination--firms and markets--and in theory firms will develop until they reach the optimal mix of hierarchical and market coordination. On a Coasean view, the firm is a market writ small in which parties with economic assets contract with firms to deploy these assets more productively. The reason for deploying assets in a firm instead of the market is to realize the benefits of team production through the reduction of transaction costs; but insofar as assets are firm-specific, their holders will demand certain conditions for their participation.

In the financial articulation of the contractual theory, shareholders become residual risk bearers; that is, they provide capital to a corporation in return for a claim on residual assets. According to finance theory, shareholders are better suited than other constituencies to bear residual risk because of limited liability and the opportunity to diversify. Residual claims also provide strong protection for the assets of shareholders, which are more firm-specific than those of other constituencies and hence less easily protected by fixed claims. Finally, shareholders rationally prefer residual to fixed claims because combining the roles of capital provider and residual claimant is a form of vertical integration that provides more security. The argument for shareholder primacy is completed by contending that only residual risk bearers have the appropriate incentives for making discretionary decisions that maximize the creation of wealth by a firm. Finance theory holds that wealth maximizing decisions are more likely to be made by residual claimants, since they bear the marginal costs and gain the marginal benefits of all new ventures. Thus, in the financial articulation of the firm, the interests of all constituencies are best served by making the shareholders' interests the objective of the firm.

In the legal articulation of the contractual theory, the norm of maximizing shareholder wealth is defended on the grounds that having corporate control--or binding the managers who have control to act in one's interest--is a protection that is of greater value to residual claimants than to other constituencies. Shareholders, therefore, are more willing to pay for the privilege of having their interests be the objective of the firm, whereas bondholders, employees, and other stakeholders rationally prefer different contractual arrangements. The complexity of managerial decision making precludes the possibility of determining in advance the specific decisions that would maximize shareholder wealth. So fiduciary duties are an alternative to explicit contracting that gives management wide latitude in choosing the means for acting in the shareholders' interests.

The contractual theory of the firm is indifferent between alternative financial and legal structures. Through contracting, any constituency or stakeholder group could become the beneficiary of the firm's wealth-creating powers or the fiduciary duties of management. Indeed, this is what happens when corporations become employee-owned or customer-owned. Employees have successfully bargained for representation on the boards of directors, and bond indentures sometimes give bondholders a right to vote on certain risky ventures. When corporations are in distress, creditors take control from shareholders, and the creditors' interests become primary until the firm recovers. Finally,

so-called other constituency statutes permit directors to take nonshareholder interests into account in responding to takeover bids. Although many structures are possible, some are more efficient than others, and over time more efficient structures tend to predominate through a Darwinian struggle for survival. For this reason, holders of the contractual theory in both finance and corporate law contend that making shareholder wealth the objective of the firm best promotes the welfare of society as a whole.

Business ethics problems most commonly involve the treatment of nonshareholder constituencies, which is to say the treatment of employees, customers, suppliers, and other stakeholder groups. The contractual theory of the firm, which assigns a clear role to shareholders, does not neglect nonshareholder interests but treats them differently. The contractual theory assumes that each constituency in a nexus of contracts has firm-specific assets that can be more profitably deployed in team production than in the market. Since firm-specific assets create quasi-rents, which can be appropriated, no constituency will make firm-specific assets available to a firm without adequate safeguards against post-contractual appropriation. All constituencies, therefore, need protection for the firm-specific assets that participation in a firm exposes to the risk of appropriation.

The safeguards for shareholders are the main subject of the financial and legal structure of the firm. That is, shareholders are protected primarily by making their interests the objective of the firm and the subject of management's fiduciary duties. However, nonshareholder constituencies have many means for safeguarding their investment in a firm, some of which are not practical for shareholders. Among these are:

1. Explicit contracts. Thus, bondholders are protected by bond indentures; employees by employment contracts; suppliers by purchase contracts; consumers by warranties, and so on.

2. Implicit contracts. Implicit contracts consist of claims that firms make to stakeholders that are not easily formulated or are left purposely indefinite. Thus, firms are able to attract employees with assurances of continued employment and good working conditions and to maintain good customer relations with promises of quality and service. Implicit contracts generally have no legal standing, but the failure to observe them often has economic consequences, such as the loss of employees and customers.

3. Judicial Interpretations. Disagreements over the interpretation of contracts are adjudicated by courts, which rely on many factors, including the intentions of the parties in making the contract, the agreements that they would have made had they bargained over the disputed points, principles of good faith and fair dealing, and considerations of public policy.

4. Government Regulation. One aim of regulation is to ensure the equitable treatment of all corporate constituencies. Regulation may be classified as substantive, which seeks to impose certain outcomes, and procedural, which create rules by which outcomes are achieved. Although a procedural approach is more in keeping with the contractual theory

of the firm, a substantive approach is not incompatible with the contractual theory, especially insofar as substantive regulation approximates bargains that the parties would have reached in negotiation.

These four safeguards--explicit and implicit contracts, judicial interpretations, and government regulation--are available to shareholder and nonshareholder constituencies alike. The forms that these safeguards take for shareholders are different from the forms of protection afforded to bondholders, employees, consumers, and other constituencies. It does not follow from this fact alone, however, that the safeguards for any stakeholder group are better or worse than those of any other. Indeed, the safeguards for nonshareholder constituencies can be very strong inasmuch as they constitute fixed claims, and the residual claims of shareholders are often regarded as weaker substitutes that address the special contracting problems of shareholders.

Because the residual claims of shareholders make their interests the objective of the firm and the subject of the fiduciary duties of management, it is widely assumed that shareholders are privileged in a way that other constituencies are not. As a result, many critics of corporate governance propose that nonshareholders be made residual claimants like shareholders, which is to say that the objective of the firm and the fiduciary duties of management be expanded to include the interests of other constituencies. However, residual claims may not be the best solution to problems of nonshareholder constituencies. If the overriding problem is how to protect the firm-specific assets of each constituency from appropriation, then the solution is to create claims--either fixed or residual--that provide the best protection. The safeguards for each constituency are potentially a mix of both kinds of claims--and, indeed, they generally do consist of such a mix. Thus, shareholders have some fixed claims in the form of shareholder rights; bondholders have residual claims in the event of liquidation or bankruptcy; and employee pension funds may consist largely of stock in the employing firm, thereby making employees residual claimants.

As a framework for identifying and analyzing many common business ethics problems, the contractual theory focuses our attention on the need to provide adequate safeguards for each constituency's interests. Corporate governance is concerned primarily with protecting shareholder interests, in part because the special contracting problems of shareholders are best met by the residual claims that the law of corporate governance creates. The protection of the interests of other constituencies has been left in practice to a variety of remedies. These remedies include tort law (suing for injury from a defective product, for example), public pressure (such as consumer boycotts to protest labor practices in less developed countries), and political action (including favorable regulation). On the whole, these remedies provide greater protection for the interests of nonshareholders than possible means that give other constituencies a larger role.

Although the contractual theory of the firm provides many means for safeguarding nonshareholder interests, it affords little protection from certain kinds of problems which are regarded as a part of business ethics. The contractual theory is limited, for the most part, to the internal workings of firms and to relations with constituencies, and so the

theory has little application to ethical problems that arise from existing power relations in society, systemic economic changes, or the structure of the economy. In particular, the contractual theory does not address the ethical problems of distribution on the grounds that such matters belong to the political, not the economic realm.

To summarize, the contractual theory of the firm provides the basis for a normative business ethic. The main ethical concern in this theory is the protection of the firm-specific assets of each corporate constituency or stakeholder group in the nexus of contracts firm. Corporate law seeks to protect shareholders' interests primarily by imposing a fiduciary duty on managers to serve the interests of shareholders and by making shareholder interests the objective of the firm. However, many means exist for safeguarding the interests of other corporate constituencies. These means consist mainly of fixed claims, which are not necessarily inferior to the residual claims of shareholders.

Part II

The Contribution of Contractual Theory to

Roman Catholic Social Thought

Michael J. Schuck

Professor John R. Boatright thinks "much is to be gained" by "taking seriously" the contractual theory of the firm as both an apt descriptor of publicly-traded corporations and a useful normative framework for business ethics. By viewing the corporation as a nexus of contracts, Boatright hopes ethicists can better communicate with practitioners in financial economics and corporate law--fields close to the actual structure and processes of corporations. Such communication would "increase the relevance of business ethics research."

No less important to this relevance would be a clear recognition of shareholder wealth as the primary corporate objective. Here too, business ethicists would be in useful dialogue with financial economics and corporate law, fields where commitment to shareholder primacy is considered essential not only to the survival of publicly-traded corporations, but also to "the welfare of society as a whole".

From this description of the firm and affirmation of shareholder primacy, Boatright derives the corporation's fundamental moral responsibility. This responsibility requires that corporate governance assure its contracting constituents (shareholders, managers, workers, suppliers, bondholders, and customers) opportunities to protect their firm-specific assets from "post-contractual appropriation". The key protections against untoward appropriation (further specified as wrongful harms, misallocations, and misappropriations) are explicit and implicit contracts, court protection, and government regulation.

A normative theory of business ethics based on a nexus of contracts view of the corporation and the primacy of shareholder wealth may well open up communication between ethicists, financial economists, and corporate lawyers. But would this theory close off communication between business ethicists and practitioners of Roman Catholic social thought? This question is particularly important for anyone concerned about the character of business education in Roman Catholic affiliated universities.

At first glance, the contractual theory seems antithetical to Roman Catholic social thought. Nexus of contracts language does not imply a notion of the corporation as a human community. As David W. Lutz remarks, this "post-Hobbesian, social contract" approach rests on the false assumption that human organizations are nothing more than an "aggregate of human individuals bound together by a bundle of explicit or implicit contracts." On its face, this aggregate theory of the corporation appears to contradict the more communitarian theory of human organizations characteristic of Roman Catholic social thought.

The primacy of shareholder wealth also seems antithetical to Roman Catholic social thought. Michael Naughton, Helen Alford, and Bernard Brady contend that "[n]o matter how one slices it," making shareholder wealth the primary corporate objective amounts to "materialism". This appears contrary to the Roman Catholic idea that the "fundamental goods of an organization . . . must be ordered toward the more excellent goods of community."

Although fruitful communication between contractual theory business ethicists and practitioners of Roman Catholic social thought seems initially doubtful, this paper argues that this impression is incorrect. Instead, the contractual theory can strengthen Roman Catholic social thought in an area of considerable weakness: the ethics of economic production.

Commentators on the ecclesial documents of Roman Catholic social thought note that while popes and bishops have given much thought to the ethics of economic distribution, similar attention has not been paid to the ethics of economic production. Given that production precedes distribution and that corporate profit-making is vital to production, inattention to these aspects of the modern market system is a serious liability for a social ethic aspiring toward ethical realism.

Historical and theological explanations have long been offered for Roman Catholicism's relative inattention and discomfort regarding corporations and profit-making. Since the early 20th century, Max Weber, Ernst Troeltsch, R.H. Tawney, Amintore Fanfani, and others have made important contributions on this topic. These contributions will not be reviewed here; but two points are added suggesting how contractual theory can strengthen the ethics of production in Roman Catholic social thought. These points concern the nature of publicly-traded corporations and the primacy of shareholder wealth.

Nature of Publicly-Traded Corporations

Practitioners of Roman Catholic social thought commonly discuss the nature of human organizations with the assumption that all organizations are forms of community. The normative implication of this assumption is that all organizations must augment certain personal and social values considered central to the universal purpose of human life. Thus, even before the corporation's particular economic nature is understood, Roman Catholic social ethicists typically assume that a corporation, as an "organizational community," must advance the integral development of the individuals it comes in contact with and the societies within which it operates.

In the scant attention given them in papal and episcopal social documents, corporations receive low marks for meeting this ethical obligation. Pope Pius XI initiated this critique in his 1931 encyclical Quadragesimo anno:

The regulations legally enacted for corporations, with their divided responsibility and limited liability, have given occasion to abominable abuses. The greatly weakened accountability makes little impression, as is evident, upon the conscience. The worst injustices and frauds take place beneath the obscurity of the common name of the corporate firm. Boards of directors proceed in their unconscionable methods even to the violation of their trust in regard to those whose savings they administer.

Fifty-five years later, the U.S. bishops continued these criticisms in Economic Justice for All:

The parts played by managers and shareholders in U.S. corporations . . . need careful examination. . . Corporate mergers and hostile takeovers may bring greater benefits to shareholders, but they often lead to decreased concern for the well-being of local communities . . .

Most shareholders today exercise relatively little power in corporate governance. Although shareholders can and should vote on the selection of corporate directors and on investment questions and other policy matters, it appears that return on investment is the governing criterion in the relationship between them and management.

More than one commentator has remarked that such ecclesial criticisms, while rhetorically brilliant, are empirically naive. How credible are such normative charges when their formulators remain inattentive to the distinctly economic nature of corporations in a modern market economy?

Contractual theory presents a distinctly economic understanding of the corporation. In this theory, a corporation is not a human community teleologically aimed at the integral development of persons and societies. Rather, a corporation is a legally recognized nexus of contracts arranged by human beings for the purpose of minimizing the transaction costs involved in making a living in a market economy. As John Boatright explains, a

corporation is a "market writ small in which parties with economic assets contract with the firm to deploy these assets in productive activity."

The achievements of this productive activity have been phenomenal, though not always acknowledged. "The modern, large-scale corporation," says Manuel Velasquez, "is one of the linchpins that enabled the vast numbers of people living in the West to achieve the standard of living that otherwise would have been available only to the very wealthy." "By virtually any measure," he continues, ". . . the corporate economies of the United States and the industrialized world are fabulously productive." As such, Velasquez calls it "incredible" that the U.S. bishops' letter on the economy "failed to address the productivity of the U.S. economy."

For a more balanced and credible presentation of economic ethics, practitioners of Roman Catholic social thought must probe the source of this productivity. This calls for serious attention to the economic--not just the sociological or the theological--nature of corporations. Contractual theory is useful in this task. In its realistic economic description of the corporation, contractual theory challenges Roman Catholic social ethicists to reconsider their common understanding of human organizations in general and publicly-traded corporations in particular.

Unlike conventional Roman Catholic social thought, the contractual theory does not present the corporation as a community. Corporations are networks of contractual exchanges created to achieve what John Glaser calls a "net organizational good." The primary focus of this good is not the integral development of persons and societies, but "a state of organizational vigor and development that enables the organization to maximize its purpose now and into the future." In short, there can be good organizations--like corporations-- that are not communities.

Conventional Roman Catholic social thought does not possess this category. As noted, this thought links the fundamental nature and function of organizations to the integral development of persons and societies. But where a distinction between personal and social ethics is typically made in Roman Catholic discourse so as to prevent the demands of the common good from utterly absorbing the moral autonomy of persons, no parallel distinction is drawn between personal, social, and organizational ethics. As a result, nothing prevents the personalist and communitarian aspirations of conventional Roman Catholic social thought from absorbing the moral autonomy of organizations. Until practitioners of Roman Catholic social thought make this latter distinction of organization ethics, the integrity of a corporation's net organizational good will remain unrecognized. And until that integrity is recognized, a credible Roman Catholic ethic of production for the modern market system will remain incomplete.

Contractual theory, then, challenges practitioners of Roman Catholic social thought to make a new distinction between a 'commune' and a 'commutatus'--or, a 'community organization' and an 'exchange organization'. By recognizing the moral autonomy of a commutative, exchange organization, Roman Catholic social ethicists have a new

incentive to explore the strictly economic requirements a corporation must satisfy in order to realize its net organizational good.

One of the economic requirements identified by contractual theory is the primacy of shareholder wealth. This is a second point by means of which contractual theory contributes to Roman Catholic ethics of production.

Primacy of Shareholder Wealth

In his classic study of Christian social ethics, Ernst Troeltsch attributed Roman Catholic discomfort with modern market system production to an Aristotelian-Thomistic suspicion over the "whole unaccountable effect of a production which goes on increasing indefinitely." An economic system rooted in the constant drive to make a profit challenges deep Roman Catholic assumptions about economic life, assumptions birthed not in the context of a market system economy, but in the traditional and command systems of the Ancient Hebrew and Roman worlds. Indeed, whenever 18th and 19th century papal documents mention profit-making it is immediately associated with the medieval phrase turpe lucrum ("obscene gain"). By the end of the 19th century, Pope Leo XIII is prepared to accept such key features of the market system as private property and capital, but his social encyclical Rerum novarum remains silent on profit-making. Nineteen years later, Troeltsch observed that Roman Catholic suspicion of profit-making persists, "even when the capitalist system is recognized".

Though more nuanced than in the past, this reticence over acknowledging profit-making as a primary economic requirement of modern market system production continues. In Centesimus annus, for example, Pope John Paul II grants the "legitimate role of profit," but quickly warns against accepting this as the primary "regulator of the life of a business." Rather, profit-making is equal to "other human and moral factors" in understanding the purpose of modern business. In the 1986 pastoral letter on the U.S. economy, this age-old timidity over profit-making appears in the American bishops' nuanced suspicion about the primacy of shareholder wealth. "We do not believe," they write, "that it [shareholder wealth] is an adequate rationale for shareholder decisions."

Again, though rhetorically powerful, this longstanding suspicion of profit-making remains empirically uninformed. Regardless of the abuses which can flow from the constant drive to make profit, the fact remains that such activity is part of the very definition of a modern market system economy.

Unlike conventional Roman Catholic social thought, the contractual theory recognizes the enhancement of shareholder wealth through profit-making as the primary corporate objective. This primacy is economically critical; without it, no motive exists for shareholders to make their assets available for corporate projects. These risky transfers constitute the nerve center of modern market system production. Without potential for increased share value and without protection through limited liability, people would not assume the role of shareholders. Without shareholders the publicly-traded corporation--and the modern market system as a whole--would grind to a halt. As John Boatright

summarizes: "[t]he argument for shareholder primacy is usually completed by contending that only residual risk bearers have the appropriate incentives for making discretionary decisions that maximize the creation of wealth by the firm."

Admittedly, some observers of the modern corporation contend that managers no longer observe the objectives of shareholders. Instead, they seek to advance their own salaries and status. Manuel Velasquez concludes, however, that no empirical evidence exists that "managers seek anything other than the traditional objectives sought by the owners: profits and growth." The problem with managers may be less a decline in their commitment to the primacy of shareholder wealth and more an increase in their unilateral decision-making over how that wealth is to be enhanced.

Roman Catholicism's lingering suspicions have occluded its ability to see the economic centrality of profit-making in general and the primacy of shareholder wealth in particular. Until practitioners of Roman Catholic social thought acknowledge the economic centrality and moral integrity of profit-making, the primacy of shareholder wealth will remain unrecognized. And until this primacy is recognized, the moral autonomy of the corporation will not be understood.

In 1931, after years of internal Roman Catholic debate, Pius XI unqualifiedly affirmed the moral integrity of the modern market system wage contract. According to Oswald Von Nell-Breuning, S.J., this finally eliminated "the demand to replace the wage contract by a social relationship," a demand made at the time not only by socialists but also by "integrist" Roman Catholics. Today, the contractual theory challenges practitioners of Roman Catholic social thought to make a parallel unqualified affirmation of the moral integrity of profit-making and its corporate manifestation in the primacy of shareholder wealth. Until this is done, Roman Catholicism's inattention to the corporation and discomfort over profit-making will hobble efforts at developing a balanced economic ethic.

The moral autonomy of the publicly-traded corporation as a commutative exchange organization and the moral integrity of shareholder wealth as a primary corporate objective are two contributions that the contractual theory makes to Roman Catholic social thought. Both points can strengthen the Roman Catholic attempt at developing a realistic ethics of production for the modern market system, an ethics balanced with its already matured ethics of distribution. Contractual theory encourages greater subtlety in understanding corporations and shareholder primacy. Short of being a community, the corporation need not be relegated to a Hobbesian battlefield. And short of contributing to society's integral needs, the later need not be castigated as materialism.

Clearly, a fully articulated ethics of production would need to address many problems that attend corporations and shareholder primacy. Issues of what is produced, how production is carried out, corporate inefficiencies, and corporate inequalities of power are vitally important. At the same time, the contractual theory may have insights to gain from Roman Catholic social thought on the ethics of contracting.

But none of these issues foreclose the value of dialogue between contractual theory business ethicists and practitioners of Roman Catholic social thought. Such a continued dialogue would only contribute to the quality of business education in Roman Catholic affiliated universities. To this end, John Boatright's work in "Business Ethics and the Theory of the Firm" makes a valuable contribution.

Part III

A Contractual Theory Response to Roman Catholic Social Thought

John R. Boatright

In his assessment of the contribution that the contractual theory of the firm might make to Catholic social teaching on the economy, Michael Schuck observes, first, that theological thinking has focused primarily on ethical issues in distribution and neglected the ethics of production. The contractual theory challenges Catholic social teaching to consider more precisely what corporations ought to be--that is, how they should be financially and legally structured.

To this question, the contractual theory provides no single answer; many different financial and legal structures are possible. Corporations as different as those in the United States, Japan, and Germany, for example, can each be analyzed by means of the contractual theory. However, the theory identifies some key problems that any system of corporate governance must solve and provides a test for whether these problems have been solved satisfactorily. By contrast, the fundamental principle of Catholic social teaching--that any organization, including economic institutions, ought to be ordered so as to promote the common good or human development--is too imprecise to guide the development of a system of corporate governance. The challenge for church theologians, then, is to articulate guiding principles for solving the many problems of corporate governance in accord with the priorities of Catholic social teaching.

In meeting this challenge, theologians must decide whether the contractual theory is an impediment that ought to be rejected entirely or a possible resource for enriching Catholic social thought. Michael Schuck favors the latter course and suggests two specific directions for theological exploration, namely enlarging the conception of an organization to accommodate the economic character of corporations and developing a more adequate conception of profit, or more precisely shareholder wealth maximization, as a corporate objective. Both are constructive proposals. Although their full implementation must be left to theologians, the following response to Michael Schuck's discussion offers some further points about the contractual theory that bear on this theological task.

Corporations and Communities

According to Michael Schuck, the contractual theory "appears to contradict the more communitarian theory of human organizations characteristic of Roman Catholic social thought." Admittedly, the contractual theory is not a communitarian theory, and if Catholic social teaching is inherently communitarian, then these two approaches have incompatible philosophical premises. However, the appearance of contradiction may be ameliorated if not eliminated by the following points.

1. Narrow Focus of the Contractual Theory. The contractual theory is narrowly focused on the financial and legal structure of firms. In financial economics and corporate law, the theory serves as an explanatory and predictive model for addressing a restricted range of technical questions. The contractual theory also has a normative structure from which certain normative conclusions can be derived. Thus, the theory not only explains why, ordinarily, shareholders have control but also why, under most circumstances, they ought to have control. Still, the normative implications are restricted to matters of finance and corporate law. A host of other questions about organizational form and culture are matters of managerial discretion, and they may be answered by appealing to a wide range of considerations. In sum, many features of the modern corporation--including some that Catholic social teaching finds ethically objectionable--are due to factors that unrelated to the contractual theory.

Because of the narrow focus of the contractual theory, corporations may be--and generally are--communities of people who work together for some common end. There is no logical incompatibility in saying that an IBM employee is part of a nexus of contracts by virtue of an employment contract and also a member of the IBM family. Certain features of the financial and legal structure of firms may mitigate against the formation of community. Furthermore, the extent to which corporations are communities is largely a management decision about the best means for achieving the financial objective of a firm. Communitarians might respond that the element of community that is present in corporations is instrumental, but this response begs the question of the purpose of corporation.

2. Flexibility in Ends and Forms. In the contractual theory, the purpose or end of the nexus of contracts firm is not specified in advance, and indeed firms may be organized to pursue virtually any (legal) goal. A single individual may form a nexus of contracts without the benefit of the corporate form in order to accomplish any desired end. Corporate law extends this possibility by enabling groups of individuals to incorporate with certain legal powers and protections, such as unlimited life and limited liability. Typically, the purpose of the corporation is stated in a charter, and the stated purpose may be any goal that is mutually agreeable to the founding parties. In addition, individuals may choose to incorporate as a for-profit or not-for-profit organization. Thus, churches, schools, and hospitals are formed in much the same way as businesses but for different ends.

Corporate law permits a high degree of flexibility not only in the choice of ends but in the forms of corporate governance. In terms of the distinction in corporate law between mandatory, enabling, and default rules, the only binding elements of corporate law are

mandatory rules. Enabling rules, like those for writing wills, dictate only the procedure that must be followed, not any substantive results. In the event that a person dies without a will, the state creates one by default, and corporate law provides similar default rules that parties may avoid by contracting differently. State legislatures have experimented with different forms of corporate governance and have an incentive to provide a legal environment that fits the needs of contracting parties.

Whether business firms are organized for the common good of human development, as communitarians insist, depends, in the contractual theory, on the intent of the contracting parties. If a group of people want such an organization, then there is nothing in the contractual theory that would prevent them from forming a nexus of contracts for that purpose. The contractual theory also permits individuals to pursue private ends in addition to, or in place of, the common good. If human development ought to be the end of an organization, then a nexus of contracts firm that allows each individual to realize his or her private ends should meet this condition--provided, of course, that the ends represent human development. In the contractual theory, firms create opportunities for people to contract and thereby do things jointly that they could not do alone. Because of this feature, nexus of contracts firms are potentially an important means for fostering human development.

Just as the contractual theory does not specify any particular ends for firms, it does not judge whatever ends people seek to pursue. In this respect, the principle of consumer sovereignty extends to the goals of business firms. Generally, the constituencies of a nexus of contracts firm seek economic ends; but other ends may be sought, and in practice people's aims are mixed. Firms themselves are primarily economic institutions, created to provide a product or service, but they also have multiple goals. Some of these goals are explicit goals of the organization, while others are goals that various groups have for the organization. These latter goals may be imposed on firms by a variety of means, including public pressure, government regulation, and the use of economic incentives.

From the point of view of the contractual theory, a mistake of communitarianism is to assume that any goal must be explicitly adopted by an organization when, in fact, organizations simultaneously pursue many goals that have diverse sources. In the contractual theory, every constituency has an opportunity to put forth goals for a business firm and to press for their adoption. Moreover, organizational goals are never fixed but subject to constant evaluation and change. Thus, employees can bargain for better working condition, customers for environmentally sound products, and so on. Corporations exist within a complex of many different kinds of organizations, which serve different ends, so that a goal not met by business enterprises might still be met by other institutions. Consider health care, for example, which is provided in the United States by a mixture of private, corporate, and government programs.

Shareholder Wealth Maximization

The greatest stumbling block in the contractual theory for Catholic social teaching is the primacy of shareholder wealth. Michael Schuck argues that much of the discomfort of Catholic theologians with shareholder wealth maximization derives from lingering suspicions about the justification of profit. Although the debate over profit was officially settled in 1931 by Pius XI, legitimate concern still exists over shareholder wealth as the objective of the firm. This feature of the modern corporation is generally misunderstood, not only by theologians but even by business executives themselves, who seldom tire of citing it. A dispassionate and sophisticated examination of the objective of the firm is sorely needed in theological circles. The contractual theory provides a constructive perspective in the conduct of such an examination.

In the contractual theory, the critical question of the objective of the firm takes the form, who should have control? The assumption is that those who have control will exercise in it their own interests. The contractual theory does not specify who should have control but rather leaves this matter to negotiation among the various groups that contract with the firm. In theory, control could belong to one group or many, and any group could obtain this role. In practice, employees control some firms (employee-owned firms), and customers control others (customer cooperatives). Bondholders have some control rights, such as covenant provisions that require bondholder approval for certain changes. In bankruptcy, creditors take control until a firm is dissolved or returned to solvency. A market for corporate control creates an opportunity for any group to make a takeover bid.

1. The Argument from Finance Theory. Finance theory holds that firms will create the maximum amount of wealth if investment decisions are made by, or more precisely in the interests of, residual risk bearers, no matter which group that is. Risk-bearing, like control, is an essential corporate role that can be widely shared or confined largely to one group. There is a certain efficiency in placing the preponderance of risk on equity holders because of limited liability and the opportunity to diversify as well as the suitability of residual claims for the protection of their assets. However, other assignments of risk and control are possible, including shared risk and shared control. Three points should be observed here.

First, in the contractual theory, decisions about risk and control are formed through bargaining and must be agreeable to all parties. Experience has shown that employees, for example, are loath to bargain for control rights when the price is the assumption of residual risk. Employees have little to gain by replacing fixed-claim wages with uncertain residual claims.

Second, control by groups other than residual risk bearers will result, under most circumstances, in less-than-optimal investment decisions. Such an outcome is not necessarily undesirable because it may reflect a trade-off between efficiency and other values. For example, in both Japan (by tradition) and Germany (by the law of codetermination), employees exercise some control rights without assuming residual risk. The contractual theory is wholly compatible with financial and legal structures that forgo maximum wealth-creation in the pursuit of other values.

Third, the degree of control that residual risk bearers have is directly related to other conditions they they may demand. In particular, capital providers may be less willing to make assets available to a firm that reduces their control rights. For example, the adoption of antitakeover measures often depresses stock price, thus making capital more expensive for firms. Similarly, junk bond debt, which involves greater residual risk than ordinary bonds but without the control rights of common stock, carries higher interests rates, thus increasing the cost to firms of borrowing.

2. The Concerns of Corporate Law. Although the main historical basis of corporate law has been property rights, this rationale was undermined by the separation of ownership and control noted by Adolf Berle and Gardiner Means in their 1932 book, The Modern Corporation and Private Property. Because of the changed nature of corporate property, the traditional rights of ownership no longer serves to justify shareholder control. Berle and Means recognized the possibility that managers could be trustees who operate corporations in the interests of society as a whole, and this position was advocated by E. Merrick Dodd, Jr., in a famous 1932 exchange with Berle in the Harvard Law Review. Dodd saw public opinion and the law moving toward a view of the corporation as "an economic institution which has a social service as well as a profit-making function."

Berle was in full agreement with Dodd's contention that the corporation has a social service as well as a profit-making function, but this service to society requires an immense concentration of resources that must be very carefully restrained. Corporate law has evolved effective means for restraining managerial power by directing managers to act in the interests of the shareholders, but we lack effective means for ensuring that managers serve the interests of society as a whole. And there is no guarantee that managers will exercise their newly-acquired control in any interests but their own. In the absence of effective restraints on managerial power, Berle concludes, ". . .[W]e had best be protecting the interests we know, being no less swift to provide for the new interests as they successively appear." With Berle's warnings in mind, legislators and judges have been reluctant, as a matter of public policy, to free managers from a reasonably strict obligation to run corporations in the interests of shareholders.

Implications for Catholic Social Thought

The modern corporation is an imperfect instrument at best, and ample room exists for reform. To this end, Catholic social thought has the potential for making a valuable contribution.

A necessary first step in this direction is the development of an adequate conception of the modern corporation, and the contractual theory provides a resource for this task that deserves careful consideration.

First, the narrow focus of the theory on the financial and legal structure of firms should force theologians to consider whether the aspects of corporate activity that are incompatible with Catholic social teaching are due to financial and legal structures or to other sources. Many features of American business and many of the differences between

the conduct of business in other countries are due to historical and cultural forces and to managerial decisions that are largely unrelated to matters of finance or corporate law. It would be misguided, therefore, to attempt to correct ethical deficiencies that result from other factors by making changes in the financial and legal structures of firms. Corporate law, in particular, is an unwieldy instrument for addressing specific problems of corporate behavior.

Second, the flexibility in the contractual theory with regard to the ends and forms of corporations provides immense possibilities for achieving the kinds of organizations that would be compatible with Catholic social thought. Even shareholder wealth maximization is not necessarily entailed by the contractual theory, and many control arrangements are possible. Rather than finding fault with the contractual theory, theologians ought to focus their attention on improving the financial and corporate structure of corporations within in the framework of the contractual theory. At issue is whether incremental reform of the existing system of corporate governance or a major reconstruction or reconceptualization of the corporation is needed in order for the corporation to conform to Catholic social teaching. For example, debate has occurred in recent years over such questions as changes in SEC rules to permit coordination among institutional investors and state laws permitting the consideration of other constituencies in takeover bids (so-called other-constituency statutes). The former strengthens, the latter weakens shareholder control. The American Law Institute has been engaged for many years in a study of the reform of corporate governance. The work of the Institution has resulted in a draft statement that includes a proposal on the relation of business ethics to the objective of the corporation. These are issues which Catholic theologians ought to be addressing.

Third, reform of corporate governance is a very serious matter that requires a consideration of the possible consequences. In particular, any system of corporate governance must be mindful of Berle's warning about the dangers of unrestrained managerial discretion. Corporations today command a vast share of the world's assets, and their power is largely beyond direct democratic control. Any diminishment of shareholder control must be offset by some other means for ensuring that managers serve some end other than their own. In addition, any reduction of shareholder control rights must be carefully evaluated for its impact on the distribution of residual risk and the costs of raising capital.