NOT BY CONTRACT ALONE: THE CONTRACTARIAN THEORY OF THE CORPORATION AND THE PARADOX OF IMPLIED TERMS

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Abstract: Contractarians argue that a business corporation is a nexus of incomplete contracts, and that specific corporate law provisions, including those regarding directors' fiduciary duties, are transaction cost-reducing default terms that would have been negotiated had the contracting parties addressed them explicitly. Contractarians further argue that in cases of disputes, the role of courts is to fill the gaps in these incomplete contracts using the same kind of the hypothetical bargain approach that underlies corporate law. This paper argues that the efficiency theory of contract underlying the hypothetical bargain logic fails to describe how courts treat implied contractual terms in the real world because it conflicts with the will theory of contract the courts will typically adhere to. This 'paradox of implied terms' reveals a number of additional weaknesses of the contractarian story regarding the nature of corporations, the functions of corporate law and the essence of fiduciary duties.

Keywords: contractarian paradigm, corporate law, hypothetical bargain, efficiency theory of contract, will theory of contract, paradox of implied terms, entity shielding, fiduciary duties

Contents

1. Introduction

This paper proposes a critique of the so-called 'contractarian' or 'contractual' theory of the corporation developed mainly in the 1980s and early 1990s by a group of economics-trained lawyers building on Henry Manne's (1965, 1967) pioneering economic analysis of corporate law. The central claim is that the corporation is a nexus of (incomplete) contracts between directors, shareholders, employees, suppliers, customers and other stakeholders (Jensen and Meckling, 1976; Fama, 1980; Posner and Scott, 1980; Klein, 1982; Fama and Jensen, 1983; Butler, 1989; Easterbrook and Fischel, 1991; Macey, 1993; Utset, 1995; Butler and Ribstein, 1995).[1] All parties consent to their places in the nexus, and craft the mutually beneficial contractual arrangements that best suit their relationship-specific needs. Corporate law enables this bargaining process by supplying transaction cost-reducing standard form terms that the parties would have chosen had they addressed them explicitly, and in cases of disputes courts fill the remaining gaps using the same hypothetical bargain logic.

The impact of this approach on corporate law discourse and teaching in the US was such that by the end of the 1980s, as Lewis Kornhauser (1989: 1449) observed, it was clear to both 'critics and advocates … that a revolution, under the banner 'nexus of contracts," ha[d] … swept the legal theory of the corporation'. The contractual theory was accorded 'the weight of scientific truth' (Bratton, 1989: 409) and provoked what Brian Cheffins (2004: 493ff) has described as a genuine Kuhnian paradigm shift. Yet while it currently remains the dominant school of thought among academic corporate lawyers in America (e.g., Bainbridge, 2002a; Macey, 2008; Ribstein, 2010; Hill and McDonell, 2016), the contractual theory has been the target of a healthy stream of criticism.

Unlike much of the existing critique, the paper does not dwell on the theoretical matters. It does not focus on the 'mandatory vs enabling rules' distinction around which the US debate originally revolved (Brudney, 1985; Coffee, 1989; Eisenberg, 1989), or centre on the 'public vs private ordering' distinction characteristic of recent discussions in the UK (Moore, 2013; 2014; Attenborough, 2016). The paper also does not seek to undermine the currently dominant shareholder primacy norm from a progressive perspective (Blair, 1995; Mitchell, 1995; Greenfield, 2006; Stout, 2012), or attempt to inform ongoing discussions of corporate governance reform. Instead, it proposes a novel critique rooted firmly in the legal tradition which stems, more specifically, from an examination of the way courts function.

It is trite that the formal relations, including contracts, must be underpinned by enforceable legal obligations. It is equally trite that legal obligations must find their form in legal doctrine,[2] which imposes a number of innate requirements that are inherent to any mature legal system. These are inevitable and independent of any given ideology, in the sense that the

[1] In this paper we focus on what we take to be the fundamental assumptions and central claims of the contractarian paradigm, ignoring minor differences between various versions of the approach and setting aside the bulk of its applications to various aspects of corporate law, securities regulation and other related matters.

[2] We use the term 'legal doctrine' to refer to the principles, rules or standards arising from and used in judicial opinions and rulings. This definition differs from that of the Continental tradition in which the term refers to the body of professional writings devoted to systematizing and interpreting valid or positive law.

same restrictions in doctrine arise whether the outlook the state and its courts have is interventionist or *laissez-faire*, or whether that outlook is pro- or anti-regulation. In short, this is a 'rule of law' argument.

When applied to the contractarian theory, this results in what we call the 'paradox of implied terms', which can be roughly stated as follows. Given that contracts are incomplete, whenever courts must adjudicate disputes, they must attempt to fill those gaps, as contractarians argue. The courts do this through doctrine, specifically the doctrine of implied terms. Implied terms are those that the parties would have agreed had they thought about them. Holding parties to their contracts even where these are imperfectly or incompletely expressed (and thus have gaps) is indeed an important imperative for the courts. But it conflicts with the courts' other imperatives, namely the risk of imposing contractual liability on a party who cannot be taken to have consented it and the risk of uncertainty and the excessive litigation that would bring. Courts will refrain from implying terms when the latter imperatives dominate. While the imperative to hold parties' to their bargains is rooted in consent, so it the imperative to refuse to imply terms. Herein lies the paradox.

We argue that this paradox of implied terms sheds light on a number of other weaknesses of the contractarian paradigm which have to do with such key questions as the nature of the corporation, the functions of corporate law and the essence of fiduciary duties. More specifically, we ask if entity shielding, a central feature of the corporation, can be created by contract and supplemented by court-implied terms. We find that it cannot. We then ask what kind of body might potentially be created by implication. Finally, we show that the paradox of implied terms supports the view that fiduciary duties cannot be reduced to contract. But we first need to clarify the main claims of the contractual theory of the corporation we wish to focus on. We begin by breaking the theory down to its several component parts to show how these fit together in the contractarian narrative.

2. The Contractarian Paradigm

To say of a corporation that it is a nexus of contracts, as Frank Easterbrook and Daniel Fischel (1989: 1426) explained, is to refer, in shorthand form, to 'the complex arrangements of many sorts that those who associate voluntarily in the corporation will work out among themselves'. Whether they involve suppliers of capital or suppliers of labour or any other stakeholder, all these arrangements are bound by express or implied agreements: 'some may be negotiated over a bargaining table. Some may be a set of terms that are dictated by [a party] and accepted or not … Some may be implied by courts or legislatures trying to supply the terms that would have been negotiated had people addressed them explicitly' (Easterbrook and Fischel, 1989: 1428).

The main ingredients of the contractarian paradigm, captured in these statements by the two authors who 'led corporate legal theory up the mountain of contract' (Bratton, 1992: 180) and did the most to set the terms of the new rhetoric of corporate law scholarship in America with 'their analysis of hypothetical contracting in a broad variety of situations' (Ayres, 1992: 1419), can be broken down as follows.

2.1 Two Explanatory Strategies

Contractarians reject the old grant theory of corporations, according to which the key features of corporations (separate legal personality, perpetual existence, limited liability) are public or state concessions of privileges. Business corporations are, according to contractarians, a species of contract, like other voluntary human associations. This claim is substantiated in one of two ways (and often in both). The first strategy involves the use of carefully selected historical examples which show, as Paul Mahoney (2000: 873-874) put it, that features of 'corporateness' have been, and therefore can be, 'created by contract, supplemented perhaps by other common law devices such as trusts or agency.'

For instance, it is argued, the fact that in England joint-stock companies, which exhibited all or most of the features of corporations, were formed under partnership law in the period between the Bubble Act 1720 and the Joint Stock Companies Act 1844, demonstrates that statutory intervention has not always been needed to create corporate-like entities.[3] Significantly, as Robert Hessen (1979), Gary Anderson and Robert Tollison (1983) and others have argued, Parliament's choice to extend incorporation to joint-stock companies in 1844 did not alter the fundamentally contractual essence of these firms. Nor did it involve the creation or concession of new privileges or rights. But it did reduce some of the contractual costs involved.

These considerations pave the way for the contractarians' second strategy, which is to appeal to both the economic theory of the firm and the economic theory of contract in order to demonstrate that the contractual theory of the corporation is merely an 'application of modern economic analysis,' as Henry Manne (1981: 689) and many others have argued (Posner and Scott, 1980; Fischel, 1982; Klein, 1982; Baysinger and Butler, 1985; Johnston, 1993; Ulen, 1993). The rhetoric of scientific legitimacy, particularly to the extent that it lends support to Manne's (1967: 284) claim that 'market forces rather than legal ones have dictated [the] organization and structure' of corporations, is an important feature of the contractarian corporate lawyer's strategy of persuasion.

2.2 The Economic Theory of the Firm

Theorists of the firm from Armen Alchian and Harold Demstez (1972) to Steven Cheung (1983) argue that, just like market exchanges will only occur if there are gains from trade, individual resource owners will only join forces with others in the pursuit of some common objective only if the expected joint surplus is greater than the sum of what could have been otherwise achieved individually. To the extent that each party is free to take their business elsewhere, there is no coercion but only a meeting of the minds: relations between all and any of the parties involved are the result of voluntary agreements.[4] If the joint surplus is to be maximized, a set of agreements that no one will wish to change must somehow be reached.

If reaching such a set of agreements were costless there would be no reason for individual resource owners to take the relevant transactions out of the marketplace and set up a firm,

[3] This point has been acknowledged by non-contractarian legal historians such as Paddy Ireland (1996), Joshua Getzler and Mike Macnair (2005), and others.

[4] Within the firm there is 'no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people' (Alchian and Demsetz, 1972: 777).

because resources would tend to gravitate, as Ronald Coase (1960) famously argued, to their most valued uses.[5] But transaction costs – which include the *ex ante* costs incurred in the process of finding suitable partners, negotiating and drafting agreements, as well as the *ex post* costs associated with executing and policing the resulting contracts – are not zero, and can in fact be substantial enough to outweigh the benefits of certain transactions (that would have been observed in a zero-transaction cost world). Since transaction cost-reducing arrangements are therefore valuable, the comparative assessment of such arrangements is required.

Indeed, the fact that one observes several forms of association between resource owners suggests that there is competition between the various forms of contractual arrangements available. As Alchian (1984: 47) put it, 'competition occurs in forms of organization and contracts.' The forms best suited to a large variety of needs and circumstances tend to perform better than alternatives, and through a process that Demsetz (1996: 489) called 'propagation by imitation' tend to ultimately survive. The selection process, or 'market test against potential alternatives', to use Michael Jensen and William Meckling's (1976: 357) words, ensures that, in the long run, the observed characteristics of contractual arrangements underlying various forms of business associations are the result of competitive market forces.

One such form of contractual arrangement involves the delegation by resource owners 'to a central agent, for some period of time, specific rights to direct their assets in production in return for a payment' (Eggertsson, 1990: 48). By greatly reducing the number of requisite contracts involved in the organization of production, contractual centralization reduces transaction costs, and is thus a key source of mutually beneficial efficiency gains. This is what Coase (1937) suggested was the main ingredient of the economic nature of the firm, from which follows Jensen and Meckling's (1976) famous 'nexus of contracts' expression.

But whereas for Coase the central agent was the 'entrepreneur' and the 'employer', and for Alchian and Demsetz it was the firm's 'owner', Jensen and Meckling (1976: 311) claimed that a 'legal fiction', by which they meant the separate corporate person or legal entity, serves as 'a nexus for contractual relationships among individuals'. This central agent, they warned, exists only in contemplation of law; it is not really an agent with the capacity to have autonomous objectives or responsibilities.[6] The 'multitude of complex relationships (i.e., contracts) between the legal fiction … and the owners of labor, material and capital inputs and … consumers' is ultimately a complex set of contractual relationships between real people.

2.3 Incomplete Contracts and the Role of Courts

The distinction between firms and markets, from this perspective, is less important than the fact that the contractual specification of individual rights and obligations determines how costs and benefits will be allocated among the participants. Of course, as subsequent developments in transaction cost economics by Oliver Williamson (1985a) and others have shown, contracts, particularly those governing long-term relations, or what Victor Golberg (1980) referred to as 'relational exchange', will always be to some degree incomplete, given the transaction costs of

[5] This logic underlies the so-called 'Coase theorem', which Guido Calabresi (1968: 68) has clarified as follows: 'if people are rational, bargains are costless, and there are no legal impedients to bargains, tranasctions will *ex hypothesis* occur to the point where bargains can no longer improve the situation.'

[6] A recurring idea among contractarians is that, being merely sets (albeit, centralized) of contracts between individuals, corporations cannot be said to have rights, duties, liabilities or responsibilities, any more than corporations can be said to bear costs or benefits. All costs, benefits, rights and liabilities are borne by individuals.

drafting very detailed agreements, the limitations of language and the impossibility to foresee all future contingencies.

Whether contractual incompleteness is attributed to the impossibility of perfect foresight or the deliberate will of the parties (Schwartz, 1992a; Berheim and Whinston, 1998; Maskin and Tirole, 1999; Tirole, 1999), an implication of the fact that parties to a long-term contract are typically unable to write what economists call 'complete state-contingent contracts' is that contracts will often need to be renegotiated as unforeseen contingencies arise. The prevention of opportunism at the renegotiation stage is therefore of paramount importance (Williamson, 1985b; Hart and Moore, 1988; Hart, 1988).

Another implication is that the question of who gets to decide on courses of action when these have not been specified in the initial contract is brought to the centre stage. The concept of authority, as Oliver Hart (1996) has argued, only becomes meaningful in this context. After all, if parties were able to write a complete state-contingent contract that specified all aspects of the transaction in advance, it would be unclear what 'being in charge' or 'having the final say' might mean. This is particularly relevant in the context of an incomplete employment contract.

More generally, when the proper course of action is the object of a dispute between the parties, it may be up the courts to supply the missing contractual terms (Schwartz, 1992; Hermalin and Katz, 1993; Hadfield, 1994; Cohen, 2000; Posner, 2004; Shavell, 2006; Listokin, 2010).[7] In doing so, courts will typically rely on 'default rules' of contract law which specify the parties' obligations in the absence of any explicit agreement to the contrary (Ayres and Gertner, 1989; Craswell, 1992; Riley, 2000; Schwartz and Scott, 2003). A key transaction-cost reducing function of contract law, which serves its role of facilitating the movement of resources into their most valuable uses, is to supply a set of standard terms that the parties would have had to negotiate explicitly.

The job of courts is not simply to hold parties to their promises, but also to supply the welfare-maximizing contractual terms that the parties would have agreed to had the transaction costs of incorporating the relevant provisions been sufficiently low (Goetz and Scott, 1981). The adoption of such a 'hypothetical bargain' approach (Charny, 1991), sometimes referred to as the 'market-mimicking' approach (Craswell, 2000), is essential if courts are to 'complete incomplete contracts' (Masten, 2000: 32) in a manner that gives effect to the parties' intentions, the assumption being that parties will always have intended to make themselves better off.

Of course, since court intervention is itself costly and may involve errors, in the sense that courts may frustrate rather than give effect to the parties' intentions, contracting parties may wish to incur the transaction costs of additional specifications of performance. On the other hand, when transaction costs are high and contracting parties have good reason to believe that the likelihood of courts committing errors is low, contracts may be incomplete by design. As Richard Posner (1986: 82) explained, even for foreseeable contingencies 'it may be cheaper for the court to "draft" the contractual terms necessary to deal with the contingency if and when it occurs'.

[7] This strand of the economics of contract literature differes from the earlier models which assumed that courts mechanically enforce the agreements brought before them (Hart and Holmström, 1987; Laffont and Matrimort, 2002; Bolton and Dewatripont, 2004).

2.4 The Triviality of Corporate Law

These considerations apply to every contract that is included in any given nexus of contracts. As Easterbrook and Fischel (1991: 16, emphasis in original) explained, with the exception of tort liability, '*everything* to do with the relation between the firm and the suppliers of labor (employees), goods and services (suppliers, contractors) is contractual'. Moreover, the corporate form is itself contractual: 'the articles of incorporations typically allow changes to be made by bylaw or majority vote', which are forms of contractual choice, and 'any remaining terms of the corporate arrangements are contractual in the sense that they are the "presets" of fallback terms specified by law' which 'become part of the set of contracts just as provisions of the Uniform Commercial Code become part of commercial contracts when not addressed explicitly' (Easterbrook and Fischel, 1991: 16).[8]

As Jonathan Macey (2008: 7) put it, 'business organizations in general, and corporations in particular, are standard form contracts'.[9] Like contract law, corporate law merely supplies transaction cost-reducing default terms that would have been agreed had the contracting parties addressed them explicitly, and that parties are free to opt out of in order to craft the arrangements or rules that suit their relationship-specific needs. It follows, to use Stephen Bainbridge's (2008: 31) words, that 'mandatory corporate law rules generally are trivial, in the sense that they are subject to evasion … or are rules almost everyone would reach in the event of actual bargaining'.[10] A number of implications follow for specific governance-related issues, and most notably for an economic understanding of the fiduciary duties of officers and directors, who in effect are at the nexus of the corporation's contracts (Bainbridge, 2002b).

There is nothing special or moral about fiduciary duties, such as the duty of loyalty or the duty of good faith. A fiduciary relation, Easterbrook and Fischel (1993: 427) explained, is merely 'a contractual one characterized by unusually high costs of specification and monitoring.' Given that the concept of fiduciary duties would be meaningless in a world where comprehensive state-contingent contracts could be written (Hart, 1993; Easterbrook and Fischel, 1993; MacIntosh, 1993; Rosenberg, 2004; Sitkoff, 2011; Gold, 2012; Alces, 2013), fiduciary duties, which can always be opted out of (Butler and Ribstein, 1990; Macey, 1993), are transaction-cost reducing devices that act as alternatives to elaborate promises.

Like other rules of contract law, the 'socially optimal fiduciary rules' (Easterbrook and Fischel, 1991: 92) mandated by corporate law approximate the bargains that principals and agents would have reached had these been possible to achieve and enforce at little or no cost. And like in other cases of dispute over the proper course of action in relation to events not covered in a contract, it is up to the courts to supply the terms that would have been bargained for. Simply put, fiduciary duties are 'gap-fillers by which courts resolve disputes falling through

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[8] For example, 'the corporation's perpetual existence' provided by corporate law merely 'obviates the need for a special agreement limiting withdrawal or dissolution' (Posner, 1986: 369).

[9] Macey (2008) elaborated: 'contracts inform the content of statutes and other non-contractual corporate law because of the universal acceptance of the norm that corporations themselves are contracts, and that the role of law is to strengthen and facilitate the contracting process among participants to the corporate enterpise'.

[10] Bernard Black (1990: 544) gave four reasons for the 'triviality hypothesis': 'First, some mandatory rules would be universally adopted anyway, assuming people thought about them … They are mandatory, but the mandate has no bite. Second, some rules can be avoided by advance planning … Third, as times and circumstances change, some rules … will soon be changed … Finally, some mandatory rules are simply unimportant – they cover situations that occur so rarely, or matter so little.'

the cracks of incomplete contracts' (Bainbridge, 2008: 68), regardless of the identity of those to whom the duties are owed.

The function of fiduciary duties is to prevent agents from opportunistically expropriating their principals, and when unforeseen contingencies lead the parties to defer to judicial adjudication, the courts '*must* use the hypothetical contract approach' if they are to 'protect principals from their agents' (Easterbrook and Fischel, 1993: 431, emphasis in original) while maximizing the parties' welfare. To be sure, Easterbrook and Fischel (1993: 45) acknowledged, 'creating hypothetical contracts is difficult' because judges often have less information than the parties. But when bargaining costs are particularly high court-mandated remedies may be preferable.

Ultimately, contractarians argue, competitive forces in what Manne (1965) famously called the 'market for corporate control' weed out efficiency-reducing behaviour on the part of officers and directors, since lower-performing corporations become vulnerable to the threat of takeover (Fischel, 1978; West, 1982; Jensen and Ruback, 1983; Carney, 1984; Ruback, 1994; Romano, 1999; McChesney, 1999; Macey, 2008; Ribstein, 2010). Indeed, market forces of this kind shape the particular form and content of corporate governance practices, with the implication that governance rules currently in operation must have passed the market test against potential alternatives.

3. The Paradox of Implied Terms

One can see why the claim that legislators promote and courts enforce market-mimicking rules is intuitively appealing to anyone subscribing to the view that the actions of self-interested individuals in well-functioning markets ensure that resources are allocated to their most valued uses through voluntary exchange, and that social welfare in maximized as a result. But 'the intuitive appeal of the argument', as Kornhauser (2000: 88) observed, 'does not substitute for secure analytical foundations'. In what follows we argue that the analytical foundations of one of the pillars of the contractarian paradigm, namely the claim that courts fulfil their gap-filling role with an eye on the parties' welfare-maximization objective, are far from secure.

We show how the market-mimicking gap-filling role assigned to courts is likely to conflict with the courts' other imperatives in a mature legal system. Indeed, when a court is asked to supply missing contractual terms it is in effect asked to rewrite a bargain by manufacturing consent, but this puts it in a position of implying a term which may not have been truly consented to, undermining the very basis of contractual liability. The resulting paradox of implied terms weakens the contractarian's claim that, with the exception of tort liability, everything to do with corporations is derived from express or implied consent.

3.1 Assumptions of the Contractarian Paradigm

Contractarians reject the suggestion made by several critics (Clark, 1985; Eisenberg, 1999; Joo, 2002; Greenwood, 2005; Greenfield, 2009) that their use of the term 'contract' is too loose to correspond to the legal understanding of an actual, legally enforceable reciprocal promise or agreement, and should therefore be seen as merely an anti-regulatory metaphor. As Easterbrook and Fischel (1991: 15-16) explain, the contracts involved in corporate ventures, namely the ones they are interested in, are 'real contracts', as opposed to the 'unreal contracts' which crop

up in political and philosophical debates. Contrary to the terms of the fictitious 'social contract', which is nothing more than a rhetorical device, the express or implied terms of the agreements struck by the real participants in the corporation can be examined, as can their enforcement by the courts. We take Easterbrook and Fischel literately.

The claim that courts will give effect to the private ordering the parties desire, and will second-guess it when that desire is not expressly spelled out, is actually based on two underlying philosophies of contact (Trebilcock, 1993; Kraus, 2004). The first, which can be traced back to the formative cases of English contract law toward the end of the Commercial Revolution (Baker, 1971; Atiyah, 1979; Oman, 2016), is that the state, and its courts, value individual liberty, and have a moral commitment to the enforcement of reciprocal promises made by autonomous individuals. This idea is captured in the old 'autonomy' or 'will theory of contract' (Cohen, 1933; Radin, 1943; Raz, 1977; Fried, 1981; Barnett, 1986), which sits well with the general philosophical commitments of contractarians.

But since courts, from this perspective, hold parties to their promises retrospectively, being brought into the picture to adjudicate disputes after these have arisen, the will theory of contract cannot explain, as Richard Craswell (1989) argued, the content and function of default rules. On the other hand, by focusing on the *ex ante* optimal or welfare-maximizing default rules of contract law which would have been chosen by the parties had they been able or willing to do so, the 'efficiency theory of contract' (Ayres and Gertner, 1989; Craswell and Schwartz, 1994; Farber, 2000; Schwartz and Scott, 2003) overcomes this deficiency while retaining, in appearance at least, the general philosophical commitment to individual will.

However, a conflict between the will and efficiency theories of contract appears in situations where the parties have written what efficiency theorists would deem to be a bad bargain, in the sense that welfare improvements remain possible. Where a consistent efficiency theorist might argue that the written terms of a contract should not be enforced if courts are able to improve on the outcome that the parties would achieve without their intervention (Anderlini, Felli and Postlewaite, 2011), the will theorist would object that, given the principle that contractual liability must arise from consent, the courts' role is to hold the parties to their expressed bargain, good or bad. The will theorist would feel vindicated by the UK Supreme Court's ruling in *Arnold v Britton* [2015],[11] which held just that.

The tension between the two philosophies of contract was implicitly noted in Henry Butler and Larry Ribstein's (1990: 16-17) discussion of 'hypothetical versus actual bargains'. 'It is … a mistake', they argued, 'to identify the hypothetical bargain approach with the contract theory of the corporation' because the parties' choice to opt out of any default rules supplied by legislators or courts in order to suit their relationship-specific needs should always be prioritised. But while most contractarians would certainly agree with this, at least on the level of general philosophical commitments, the contractual theory of the corporation as actually constructed in the literature relies, quite heavily, on a commitment to efficiency, and therefore to the hypothetical bargain approach.

In an explicit attempt to reconcile the two philosophies of contract, Alan Schwartz and Robert Scott (2003) proposed that the will theory best suits contracts between individuals, while contracts between corporations – arguably the most economically significant set of contracts in a modern market economy – should be regarded and adjudicated in efficiency terms only. The

[11] *Arnold v Britton* [2015] UKSC 36, [2015] AC 1619.

reason, they suggested, was that in the latter case the contracts are between 'artificial persons whose autonomy the state need not respect on moral grounds' (Schwartz and Scott, 2003: 556). This line of reasoning is unpersuasive, and in fact inconsistent with the contractarian narrative, which ultimately holds, as Nathan Oman (2005: 126) observed, that 'contracts between corporations are agreements between actual human beings'.

While the unresolved tension between will and efficiency theories of contracts continues to preoccupy philosophers of law (Kraus, 2001; Benson, 2001; Bix, 2012; Dagan, 2013; Klass, Letsas and Saprai, 2014), it is rarely addressed in the contractarian narrative about corporations, which continues to maintain that the division of labour between legislators, courts and contracting parties is always, and should always be, governed by an efficiency or a transaction-cost reducing imperative. By downplaying the possibility that the legal process may be governed by its own norms and imperatives, which need not coincide with, or be related to, the parties' wealth-maximization objective, or correspond to what the parties would have contracted for, contractarians open the door to a number of objections.[12] We focus on one such objection in particular.

3.2 The Rule of Law, or: 'Law Not Discretion'

There is, of course, a sense in which the contractarian's tendency to take the legal process for granted is justified. Indeed, one of the features of a mature legal system in a democracy, namely a system governed by the rule of law, is that it is possible to do just that, and to get on with business without worrying too much about whether the legal system is capable of supporting such an endeavour. Parties can be confident that the obligations of their counterparties will be met, and that the general principles of law will govern this process. A key contribution of the rule of law both generally, and to contract law specifically, is that it provides a degree of certainty.[13] Legal certainty benefits both wider society, in that it reduces costs and delays, and the courts themselves, because it reduces the number of cases and appeals.[14]

Following the influential expositions of John Locke (1960 [1689]), Montesquieu (1989 [1748]) and Albert Venn Dicey (1885), jurists have long argued that 'rule of law' is shorthand for a number of general principles (Cass, 2001; Tamanaha, 2004; Kramer, 2007; Cortsens, 2017), one of which was expressed long ago in Aristotle's *Politics*: 'the rule of law is preferable to that of any individual' (cited in Solum, 1994). In more recent times, the eminent British judge Thomas Bingham's maxim, 'law not discretion', namely the principle that 'no discretion should be unconstrained so as to be potentially arbitrary' (Bingham, 2010: 54), captured the essence of this idea.

Upholding the rule of law is a function of both the legislature and the courts, but we are concerned here only with the latter. Courts, perhaps more so in common law systems, have the power to create and shape both doctrine and the legal rules within it, and are therefore central

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[12] We do not wish to argue that contractarians ignore completely the matter of the courts' own agenda but only that that contractarians rely on same hypothetical bargain logic to explain it away. For instance, although Macey (2008: 32) acknowleged that 'when judges and lawmakers formulate non-contractual rules of corporate governance they inevitably import their own norms', he argued that this was still done under the belief that this is 'what entrepreneurs and investors … would have contracted for'.

[13] In the absence of the rule of law the lack of certainty implies high transaction costs, and is endemic of underdeveloped economies (North, 2005; Dam, 2006).

[14] *Medcalf v Hall* (1782) 3 Doug KB 112, 99 ER 566. See also the recent speech by Lord Chief Justice Thomas (2016).

players in the emergence of rules which ensure that unconstrained discretion is either minimised or eliminated. This is essential, if like cases are to be treated alike, and if cases are to be decided based on the law and the facts, as opposed to the personal preferences of the judges. Doctrine is rooted in matters of procedure and adjectival law, that is, in the set of rules which facilitate the just application of the substantive rules under which disputes are resolved.

The truism that greater power relative to a counterparty usually enables one to obtain one's desired terms applies, somewhat unsurprisingly, to courts as well. Given that the roles of adjudication and enforcement are assigned solely to courts, they are in a position of dominance. Their word is final, save for legislative revision. Moreover, the courts have their own imperatives. This means that, even if the courts strive to give effect to the parties' intentions and their bargains – as indeed they do – if that conflicts with the courts' own imperatives they are in a position to prioritise those. Consequently some gaps will not, or cannot, be filled.

3.3 The Requirements of Certainty and Necessity

To illustrate, consider a company seeking to profit from a government green grant and special feed-in tariff, which contracts with a supplier to install a wind turbine and connect it to the national grid. Given industry regulations the national grid will not connect the turbine unless it is up to standard. The contract is silent on who is responsible for ensuring this. However, it takes only a moment to work out that the supplier is responsible. They are providing the turbine and it is only they who are in the position to ensure it is up to standard. This is what the parties would have reduced to writing had they thought about it. So far, so good. Clearly, the contractarian would argue, if a dispute were to arise the court would easily complete the otherwise incomplete contract.

Consider now a more complicated real case, *Baird v. Marks & Spencer* [2001],[15] which was a consequence of the changes M&S made to their business following financial difficulties in the late 1990s. Baird Textiles was one of M&S's four trusted clothing suppliers and for some 30 years had supplied 15-18% of M&S's clothing range. This was a large amount of Baird's business and a long-term commitment. In their bid to return to profitability, M&S adopted a business plan that involved ending their relationship with Baird and seeking other suppliers. The contract with Baird was terminated in October 1999. Baird filed proceedings against M&S in January 2000, claiming that the termination was unlawful without a reasonable notice period. Since the contract was silent on this matter, the issue depended upon whether a term that provided for a notice period could be implied.

That, in turn, depended, among other things, on whether the inclusion of a notice period was what the parties would have intended, had they thought about it. The salient facts before the court were these: M&S's philosophy was to carry on doing business with suppliers year after year; the people involved in managing M&S and the suppliers had worked in the spirit of cooperation for a long time; as M&S's business grew through the 1990's many of its suppliers grew at a similar rate. Baird claimed that a reasonable notice period, given this commercial background, was three years, and sought damages in proportion to a reasonable estimation, in light of expected commercial circumstances, of the quantities and prices of the garments what would have been supplied during that time.

[15] *Baird Textiles Holdings Ltd v Marks & Spencer plc* [2001] EWCA Civ 274, [2002] 1 All ER (Comm) 737.

It was not the duration of the notice period that was held to be problematic by the English Court of Appeal. The fatal flaw of the claim was the lack of certainty regarding price and quantity. There were no objective criteria available to assess such things. In the absence of an express agreement to create legal obligations based on these variables there was simply no way for such a term to be implied. Consequently, the immediate termination of the contract without compensation was deemed to be lawful.[16] The court's requirement of certainty, derived from the application of the principles of the rule of law, is an imperative that can trump implied consent.

Although this example is taken from English law, the principle which it illustrates, namely that courts operate under a requirement of certainty, is universal. In England and Wales,[17] New Zealand,[18] Australia[19] and Canada,[20] but not in the US,[21] there is also a requirement of necessity. The contended term must be necessary for the contract to function or for it to have business efficacy. It is also said that it must be the case that if an officious bystander were asked, 'should we make it clear that X is responsible for Y', she would be cut off with a curt, 'of course', because 'it goes without saying'.[22]

In the case of the wind turbine it is beyond doubt that the supplier is responsible for ensuring the relevant safety standards are met. But for more complicated issues the matter may not be so clear. Who is responsible for obtaining the necessary planning consents does not 'go without saying', and the contract can function without it being the supplier. If a necessity standard is also applied, then such a term will not be implied. Instead, there will be no liability for either party to perform that obligation, and any loss will lie where it falls.

3.4 The Paradox

These considerations hint at a more general problem inherent in legal doctrine, which can be usefully expressed in the following manner. The courts wish to give effect to the parties' bargain. To do so, they must imply terms to fill the gaps in the express agreement (imperative 1). But courts must not do so where, given the requirements of certainty and necessity, this is not possible (imperative 2). The courts' internal objectives are to avoid uncertainty and to deter excessive litigation (imperative 3).

The second and third imperatives import the empirical matter of the standard of proof, which, in civil trials, is a low one – only whether the veracity of the contended fact is more likely than not. Facts are thus 'made' by the court as much as found in the process of weighing up the evidence (Roberts and Zuckerman, 2004). The low standard of proof carries the risk that terms will be implied in the absence of full consent. The necessity requirement is a way of mollifying this problem by asking a question that demands imperative and easily verifiable

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[16] Interestingly, there is now a Grocery Supply Code of Practice (2009) for suppliers and creditors in the grocery industry. Article 16(2) requires buyers to give suppliers a 'reasonable notice' to delist.

[17] *The Moorcock* (1889) 14 PD 64 (CA); *Shirlaw v Southern Foundries (1926), Ltd* [1939] 2 KB 206 (CA).

[18] *BP Refinery (Westernport) Pty Ltd v Hastings Shire Council* [1977] HCA 40, (1977) 180 CLR 266 (PC).

[19] *Codelfa Construction Pty Ltd v State Rail Authority of NSW* (1982) 149 CLR 337.

[20] *Energy Fundamentals Group Inc v Veresen Inc* 2015 ONCA 514 (Ontario Court of Appeal).

[21] Restatement of Contract (2d) §223; UCC §§ 1-205, 2-208, 1-303(d).

[22] *Shirlaw* (1939), n.19 above.

evidence, rather than an enquiry into the states of mind of the parties.[23] This is a useful proxy for certainty. In sum, there is clearly a difference between what the court decides – and decide it must, if there is to be an effective system of adjudication – and what the parties agreed to.

The courts must balance these imperatives. To best give effect to the parties' intentions, the law would need to cast off the restrictive tests for implication. This would achieve the first imperative. But rather than achieving the second, it would positively do the opposite.[24] The courts would start rewriting bargains, implying terms the other party might not have consented to, contrary to the second imperative. This would undermine the very basis of contractual liability – consent – itself. Conversely, keeping restrictive tests for implication runs the risk of failing to give legal force to the parties' actual intentions for the bargain.[25] Yet both imperatives are rooted in the same thing – the need for consent. This is the paradox of implied terms, of which Figure 1 below is a schematic representation.

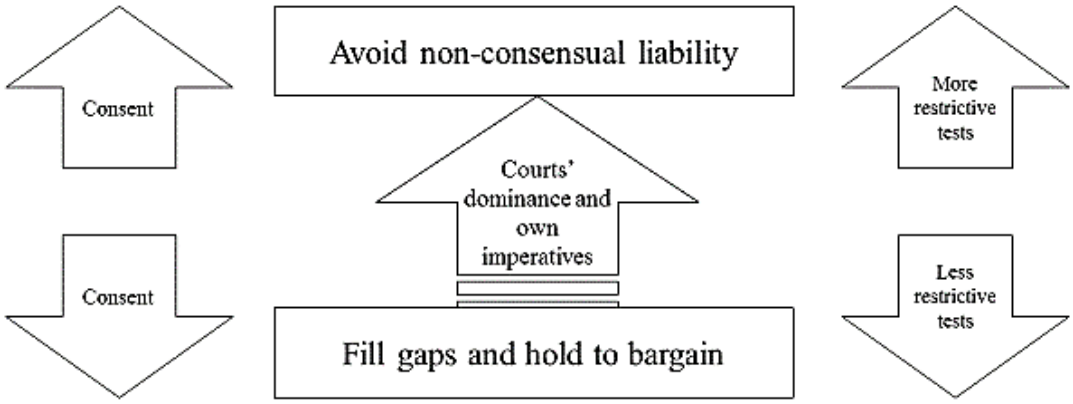

Figure 1 – Schematic representation of the paradox of implied terms

Given it is impossible to achieve both imperatives, courts have applied their own, the third, and concluded that refusing to intervene when there is no meeting of the minds is the lesser evil. Consequently, courts rarely imply terms, and will in fact more often than not refrain from doing so. In other words, courts typically adhere to the will theory of contract rather than the efficiency theory of contract.[26] And in situations where the two conflict, courts will typically prioritise the former. This is because, as Craswell (1989:28–29) himself pointed out, contractual

[23] The English legal system relies on 'objective consent', which is what the parties can be taken to have agreed to from the point of view of a reasonable bystander. See, for instance, *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, [2009] 1 AC 1101. The French system, by contrast, considers the parties' *volonté psychologique*, namely their subjective mental states uninfluenced by such legal rules (Valcke, 2009).

[24] The English courts flirted with an expansion of the doctrine of implied terms, watering down the necessity requirement. See : *A-G of Belize v Belize Telecom Ltd* [2009] UKPC 10, [2009] 1 WLR 1988. Owing to concerns about certainty, the Supreme Court soon moved to reassert the restrictive necessity test. See *Marks and Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd* [2015] UKSC 72, [2016] AC 742.

[25] There are other instances where the courts have ignored the intentions of the parties in favour of legalistic reasons, most dramatically in the doctrine of consideration, which holds that promises are unenforceable unless there is a counter-promise (the consideration) in return. Again, a brief expansion, rejecting this requirement (*Pillans v Van Mierop* [1765] 97 ER 1035, [1765] 3 Burr 1664), was overturned by the House of Lords (*Rann v Hughes* [1778] 2 ER 18, [1778] 7 TR 750).

[26] Courts typically accept Ronald Dworkin's (1980: 578) point that 'counterfactual consent is not some pale form of consent. It is no consent at all'.

doctrine based on consent and the will theory is content-neutral: 'anything more requires a theory that would tell people what kinds of promises they ought to make.' It is not the job of courts to do so.

It important to notice that this is a 'rule of law' argument. The requirements of any well-functioning legal order inherently limits its ability to imply terms and create contracts by manufacturing consent. The alternative is arbitrary justice. It follows that the contractarian paradigm, if taken literally, as contractarians claim it should be, relies on a conception of legal doctrine which fails to come to terms with the way courts function in the real world.

4. Three Central Problems

The claim that courts subscribe to an efficiency theory of contract and therefore imply market-mimicking terms with an eye on the parties' welfare-maximization objective does not rest on secure analytical foundations. This, in turn, points to a number of additional weaknesses in the contractarian story. More specifically, the contractarians' belief that, with the exception of tort liability, everything to do with the corporations is based on from express or implied consent, is disputable.

The corporation, endowed with a separate legal personality thanks to which it has a unified capacity for property, contract and litigation, separate from the individual capacities of its shareholders or directors, is plainly a complex institution. Contractarians have argued that this complex institution is the result of express agreements among the parties, combined with the market-mimicking default terms supplied by corporate law and supplemented by court-implied terms. With the paradox of implied terms in mind, we highlight some of the central problems in this contractual theory of the corporation.

4.1 Entity Shielding

Mahoney (2000: 892-893) has suggested that 'the benefits of treating a business as something separate from its owners are so obvious … that it has never required substantial governmental assistance to achieve', meaning that all features of 'corporateness', including separate legal personality or legal entity status, can be created by contract, supplemented perhaps by other common law devices such as trusts or agency. Taking this statement literally, as Mahoney no doubt intended it to be taken, assume that a number of resource owners have agreed to pool their assets in the hope of achieving a super-additive surplus, and consider what it would take to create a 'corporation' separate from its owners, with the capacity to survive changes in its membership.

A key question which arises is whether the separate pool of assets is separate in any legally meaningful sense. In the absence of statutory asset partitioning (Hansmann and Kraakman, 2000; Kraakman *et al.*, 2009; Blair, 2012; Triantis, 2012), the only way to achieve what Henry Hansmann, Reinier Kraakman and Richard Squire (2006) call 'weak entity shielding' by contract is for the founders of the 'corporation' to get personal creditors to agree to subordinate their claims to those of business creditors, and to credibly promise business creditors that all past and future personal creditors have and will agree to subordinate their claims. To spell out such a complex set of commitments in contracts, which would need to be

done even for the most trivial contracts of supply, would clearly be a transaction-cost nightmare, and the resulting contracts will necessarily be incomplete.

Even if were possible to draft such a complex set of incomplete contracts, one may doubt whether such a set of underlying commitments would be credible and sustainable. Indeed, although the founders and their creditors, both business and personal, might well trust each other individually, but there are likely to be trust issues between these categories of creditors. It is unclear why creditors would be willing to sign agreements changing the priorities between them and limiting their remedies. In any case, with lenders facing such uncertainties, it would be very difficult for such a 'corporation' to pledge property as collateral to raise finance. Other parties might be unwilling to contract for the same reasons. The greater the size of the undertaking, the greater the magnitude of these problems.

Further problems arise in the case of unforeseen contingencies which affect existing contracts with business and personal creditors. While a founder might have agreed priority rules with both personal and business creditors, personal creditors pre-existing the creation of this 'corporation' would not have expressly agreed to such a thing. Under efficiency theories, a creditor could be taken to be contracting in such a world and thus to have implicitly agreed to this. But under the will theory, this is not a safe assumption. On the contrary, that personal guarantees are commonplace suggests it is rational for the personal creditor to desire as many remedies as possible. The courts' conclusion, given the paradox of implied terms, is to refuse imply a term in the event of such uncertainty, and hence no entity shielding can be implied in these circumstances.

A contractarian might object that such an example is facile, and that such routine contracts with intending corporate founders would have standard express terms providing for entity shielding as a matter of course. A perhaps more credible example is one beginning with the use of contracts properly drafted, but subject to a later blunder. Suppose entity shielding agreements exist, and the 'corporation' concludes contracts of service with clients. They then decide to sell their 'corporation' to new owners. While it is possible to assign assets and debts, it is not possible to assign contractual obligations. Thus one would expect the transferring contract to include indemnities providing that the new owners indemnify the founders against contractual claims for non-performance (as, given the transfer of assets, it will no longer be possible, let alone desirable, for the founders to perform).

Should this indemnity be absent (supposing the case of a rushed or negligent transfer of the business), then there is a problem for the founders. If the new owners fail to deliver, a client who had contracted with the founders would have no remedy against the new owners but could sue the founders for non-performance. A contractarian or efficiency theorist would argue that the courts should imply such a term of indemnity into the transferring contract. But again, while it might clearly be efficient to do so, it may be against the will of the new owners. Perhaps the new owners purchased a distressed business, paid a low price for the assets and were not expecting to be burdened with certain obligations to clients. One cannot take them to have consented to such wide liability.

There would also be a problem for the clients. They will have agreed not to execute judgment debts against the personal assets of the founders. If there is no indemnity and the founders have insufficient personal assets, the clients will be without an effective remedy. It is unlikely that the entity shielding agreements will have been drafted foreseeing the transfer blunder and would therefore be silent as to its effect. Once again, a contractarian or efficiency theorist might argue that an exception into the entity shielding arrangements should be implied meaning that the client could execute against personal assets if no indemnity were obtained.

This could be justified by the fact that its absence takes away the justification for entity shielding. Once again, however, it would not have been the will of the founders to submit to this and such a term would not be implied.

As the facts become more complicated, more unforeseen contingencies will arise and it becomes less and less likely that courts will fill the gaps in entity shielding contracts. The point is that if this were a true corporation, created as a result of an incorporation procedure, it would not be up to courts to decide whether and to what extent a separate pool of assets exists under the plainly inadequate mechanism of contract. The founders' capital would be 'locked-in', to use Margaret Blair's (2004) expression, by the very act of incorporation. Indeed, as Hansmann, Kraakman and Richard Squire (2006) argued, corporations are characterized by 'strong entity shielding'. This means that the founders cannot unilaterally withdraw some or all of their share of the pooled assets. Moreover, their personal creditors cannot force a partial liquidation of the assets to satisfy their claims.

Contractarians such as Easterbrook and Fischel (1989: 1426) are mistaken when they argue that 'the arrangements among the actors constituting the corporation usually depend on contracts and on positive law, not on corporate law or the status of the corporation as an entity'. Without corporate law and the status of the corporation as an entity, essential features of the corporation such as capital lock-in and strong entity shielding would need to be achieved by contract and supplemented by the courts. Given the prohibitive transaction costs involved and, more fundamentally, the reluctance of courts of imply the missing terms, these corporate features cannot be created in the absence of corporate law. If even weak entity shielding cannot be implied, strong entity shielding certainly cannot.

4.2 What Implication Would Create

This is not to suggest that contractual implication cannot create anything at all; a body of sorts can indeed by implied. However, what is formed is not a corporation. It is either an unincorporated association or a partnership. This is correct as a matter of law in England. A partnership is 'the relation which subsists between persons carrying on a business in common with a view of profit',[27] whereas an unincorporated association is 'two or more persons bound together for one or more common purposes, not being business purposes'.[28] The latter is the usual arrangement for clubs and societies. Both are implied from the circumstances in the absence of an express declaration.[29]

In both cases, however, there are numerous problems. Title to property is vested in a 'treasurer' or sometimes the officers in an unincorporated association, or the partners in a partnership. There is no separate corporate personality or entity shielding. Consequently, the group would not be able to hold property in its own name. Liability is unlimited (excepting LLPs, which are regulated by statute). If the membership of an unincorporated association falls to one, this last member takes absolute ownership of its property.[30] There are severe problems

[27] Partnership Act 1890, s1(1). In the US, since the Revised Uniform Partnership Act of 1994, a partnership is no longer construed as merely a set of individuals undertaking some common objective with a view on profit but a legal entity in its own right (§201a). In civil law jurisdictions, partnerships are likewise legal entities.

[28] *Conservative and Unionist Central Office v Burrell* [1982] 1 WLR 522 (CA).

[29] Respectively, *Syers v Syers* (1876) 1 App Cas 174 (HL); *Neville Estates Ltd v Madden* [1962] Ch 832 (Ch).

[30] *Hanchett-Stamford v A-G* [2009] Ch 173 (Ch).

concerning the distribution of property upon winding up the association or partnership, most often squabbles over proportions.[31]

One might ask if an expansive approach to implying terms – moving closer to the first imperative of holding parties to their bargains – could produce something closer to a conventional corporation. It is therefore instructive to look at more sophisticated quasi-corporate entities in to see how they worked. Such things have historically been created expressly, with the implication that, given enough adjustment to legal doctrine (and putting aside the criticisms of expanding the doctrine of implied terms), they could be created impliedly in a contractarian process.

In England, before the Companies Act 1844, it took a Royal Charter or a private Act of Parliament to create a body corporate. This process was expensive and cumbersome. It was more convenient to engage in clever drafting and create companies of a kind purely privately (Gower, 1983; Blumberg, 1986; Ireland, 1996; Getzler and Macnair, 2005). The result was known as a 'deed of settlement company'. A deed created a body of sorts, with the facility for 'shareholders' to subscribe and unsubscribe from it. This provided for some degree of alienability of shares and thus the ability to raise capital. But in truth it was more like a partnership than a corporation. Liability, again, was unlimited. Since shareholders were in legal terms partners, mere investors were liable too. While the deed of settlement could limit the liability of the subscribers *inter se*, it could not limit their liability as against third parties because of the privity problem.

In court proceedings, there were severe procedural difficulties. The absence of true separate legal personality and the presence of unlimited and – crucially – joint liability was compounded by the fact that *all* relevant parties originally had to be joined as defendants.[32] Even on the abrogation of such a rule, there was still a difficult decision regarding who to join as a defendant. That depended on who was worth suing because they had the means to pay. The question of law concerned who was liable for a given wrong: only then-present members, or future members too. The problems of allocation of liability discussed above were not removed by the deed of settlement company.

In more recent times, under the law of Delaware, where there has been an imperfect attempt to create a corporation in good faith, the courts may recognise a *de facto* corporation, which in effect means that the court treats the corporation as if validly formed (Cahn and Donald, 2010; Loewenstein, 2013).[33] Although US corporate law is moving away from this concept simply because it has become easier to form corporations, one might therefore argue that the courts can and do imply the relevant contracts and construct a body corporate accordingly.

At the very least, this is a *sui generis* situation where, unusually, all the relevant details have been reduced to writing on the appropriate instruments. Implication is therefore possible since the problem of uncertainty does not arise (and an exception to the requirement of necessity can been crafted). However, the better explanation, given the artificiality of this concession, is that the doctrine of the *de facto* corporation is one that merely remedies defects in form and is not concerned with implication at all. It is a rule of law, justified by any public policy argument

[31] A rather colourful example is *Joyce v Morrissey* [1999] EMLR 233 (CA), concerning whether the members of the pop group *The Smiths* were equally entitled to the profits equally or if different proportions could be inferred from conduct ultimately based on the worthiness of their contributions.

[32] *Van Sandau v Moore* (1826) 1 Russ 441, 38 ER 171.

[33] *Cleary v North Delaware A-OK Campground, Inc* (No 85C-OC-70, Del Super Ct 09/12/1987).

the court adopts. A relevant policy argument, according to Andreas Cahn and David Donald (2010: 142), is the desire that the market does not suffer a loss of trust because of a technical defect in incorporation.

Moreover, it is not a universal rule. It does not exist in England and is not covered in the US Model Business Corporation Act. In England, the conclusive nature of the certificate of incorporation means these issues rarely come up, but do so in the case of unlawful purposes or if the body is a trade union. The corporation is then treated as a nullity (Drury, 1985). Claimants would then have to have recourse to the law of unjust enrichment. These rules are policy-led and vary between jurisdictions. For this reason, and for the conceptual reason that the purpose of this law is to remedy defective form, *de facto* corporations are not explicable in terms of consent.

4.3 Contract and Fiduciary Duties

Another key feature of the corporation is the imposition of fiduciary duties on directors (and indeed on other employees if their responsibilities warrant them). These are typically not specified in contracts of employment, so if they are to exist, they would have to arise through implication (Easterbrook and Fischel, 1991: 92).

The argument here is complex. Fiduciary and other trust obligations arise and endure even if there is no consent to them, including where the contractual terms positively show a lack of consent to them. This is contrary to the paradox of implied terms. A contractarian would immediately suggest that the paradox is therefore wrong, and that this is the empirical evidence which shows it. It follows, the contractarian would reason, that contract can stretch far and is capable of supporting the contractarian theory of the corporation. However, if one stands by the paradox of implied terms – because the first principles reasons that leads to it are strong enough – there is another conclusion, namely that fiduciary duties arise *outside* of contractual principles and are not rooted in consent. The corporation, therefore, cannot be wholly created from contract because of fiduciary duties.

The strongest evidence for the non-contractual nature of fiduciary duties is that there is a monolithic 'irreducible core' of the duty of loyalty that cannot be excluded, no matter how hard the parties try (Brudney, 1997; Fitzgibbon, 1999).[34] While ordinarily express terms prevail over implied ones for the obvious reason that express terms are the primary exposition of intent,[35] this is not the case for fiduciary duties.

Consider the quotidian case where a fiduciary takes a commission on management activities. An undisclosed commission is an unlawful secret commission, contrary to the no-profit rule (benefiting from one's fiduciary office without authorisation). To escape sanction there must be fully-informed consent to the commission. While in a non-fiduciary relation it is possible to stipulate 'a reasonable commission', in a fiduciary relation the precise details must be disclosed: 'full and frank disclosure of all material facts'.[36]

If the contract attempts to displace this duty via contractual terms, there are two possible outcomes. First, the diminution in responsibility is such the fiduciary duty is wholly eliminated.

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[34] *Armitage v Nurse* [1998] Ch 241 (CA), at 253.

[35] *Marks and Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd* [2015] UKSC 72, [2016] AC 742.

[36] *New Zealand Netherlands Society 'Oranje' Inc v Kuys* [1973] 1 WLR 1126 (PC).

For instance, in *Chan v Zacharia* [1984], the court suggested that '[i]t is conceivable that the effect of the provisions of a particular partnership agreement … could be that any fiduciary relationship between the partners is excluded.'[37] Second, there would still be a fiduciary relation, and in this example, disclosure would still be required, overriding the express term. This is because there is an irreducible, indivisible core of fiduciary obligation that cannot be broken up by consent.[38]

Fiduciary law does not then adhere to the parties' intention and brings its own norms and remedies. Fiduciary duties may be influenced by the law of contract, in that contractual terms delimit the scope of the fiduciary's responsibility,[39] but is not controlled by them. It is true that this point is not a 'rule of law' argument. A mature legal system might not have fiduciary duties. Nonetheless, in common law jurisdictions they exist, and if they are to operate as they do, they must arise outside of the realm of contractual norms and principles. In these particular legal systems, fiduciary duties are non-contractual, operate often in opposition to consent, and therefore are incompatible with the contractarian paradigm.

5. Conclusion

Corporate law is not trivial in the key sense that it constitutes the group as a corporation. Although private interests may initiate the process of creating a corporation is it the legal system of corporate law that completes the process and gives it legally-binding force. So much is the conventional anti-contractarian position.

The distinctive feature of this paper is it adds a new argument to support this position. One latent demand of contractarian theory, that the courts' gap-filling function is sufficient to support the contractual creation of a corporation, does not comport with how the courts actually operate. It is true that, because contract is founded on consent, the courts wish to hold the parties to their bargains. But it is also the case that, because of a lack of certainty, the courts cannot always imply terms because of the risk of imposing liability contrary where a party did not consent to it. This is the paradox we have illustrated. The courts want to, but cannot, hold their parties to their true bargains.

While this is an ideological position in a sense, it is not a political ideology on the range of libertarianism to a more regulatory outlook. It is a universal corollary of the rule of law, a set of minimal standards that apply to any mature legal system in a democracy no matter what its ideology.

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[37] *Chan v Zacharia* (1984) 154 CLR 178 (HCA), at 196.

[38] A Canadian court has said that '[t]he fiduciary duty transcends these terms and it is abhorrent for contractual terms to abrogate that duty' (*Penner v Yorkton Continental Securities Inc* [1996] AWLD 456 (Alberta Court of Queen's Bench), at 90.

[39] *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 (HCA).

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