



## A nexus of contracts theory of legal entities



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### ABSTRACT

In this paper, we develop a theory that explains why firms are so commonly organized as legal entities that are formally distinct from their owners. A legal entity permits an owner to create a firm as a bundle of contracts that can be transferred to someone else, but only if they are transferred together. This *bundled assignability* allows for a balancing of several potentially conflicting interests. First, the owner who assembles the contracts wants liquidity – that is, the ability to transfer the contracts and cash out. Second, the firm's contractual counterparties want protection from opportunistic transfers that will reduce the value of the performance they have been promised. And third, the owner wants long-term commitments from the firm's counterparties to protect the value of her investments in the bundle. Because transfers of equity interests in a legal entity will generally not be considered assignments of the entity's contracts, entities reduce the contracting costs of creating bundled assignability. We find that owners will prefer bundled assignability when investments in the bundle are alienable from the owner; but when investments are specific to the owner, contracts that prohibit changes of control are optimal.

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### 1. Introduction: what role for legal entities?

In modern economies, firms are commonly organized as legal entities that are separate from their stakeholders, and that can enter into contracts and hold property in their own name. The role of these entities has received little attention in the literature on the theory of the firm, which has focused on relationships among individuals and has largely omitted explicit analysis of entities (e.g. (Coase, 1937; Alchian and Demsetz, 1972; Grossman and Hart, 1986; Hart and Moore, 1990)). Jensen and Meckling (1976) recognize the firm as a contracting *entity*, but offer no explanation for it:

“There is in a very real sense only a multitude of complex relationships (i.e. contracts) *between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output.*”

(Emphasis added.) What, then, is the value of a legal entity as the center of the nexus of contracts? The question is made all the more salient by the ubiquity of firms in the modern economy that use a complicated web of legal entities to own assets that are ultimately under common control. The 100 largest U.S. public companies,

for example, report an average of 243 subsidiaries, not including subsidiaries insufficiently significant to require public disclosure (Squire, 2011). General Electric alone has approximately 1500 separately incorporated subsidiaries, most of which are wholly owned by General Electric. Why are these businesses organized as distinct legal entities, rather than as divisions of the parent company?

We offer answers to these questions that focus on the fact that a firm's most valuable assets are often its contractual rights. Consider, for example, the movie rental company Netflix. The value of Netflix is based largely on its assemblage of contractual relationships. In particular, the DVDs that Netflix rents to its customers are acquired via contractual agreements with the major movie studios. These contracts require Netflix to make a small up-front payment to the studio for each DVD, and then contingency payments based on the number of times the movie is rented. Netflix provides streaming video to its subscribers by licensing content owned by movie studios using similar revenue sharing arrangements. All of the real estate it occupies is owned by other parties and used by Netflix pursuant to long-term leases. Most of its revenues come through its pool of subscriber contracts.<sup>1</sup> In essence, Netflix is a bundle of contracts of which the incorporated legal entity, Netflix, is the nexus in the sense of being a common signatory to all of those contracts.<sup>2</sup>

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<sup>1</sup> See Netflix 10-K, 2008.

<sup>2</sup> Many firms own little to no physical assets at all, as our Netflix example illustrates. Broadway plays offer another conspicuous example. Each play that is

A noteworthy feature of these contractual agreements between Netflix and its counterparties (movie studios, landlords, and customers) is that they are bilateral – that is, they impose upon Netflix both rights and obligations, making the contracts simultaneously both assets and liabilities to the firm. We take as given that firms, for many potential reasons, find it advantageous to acquire inputs and provide outputs by contract, making their counterparties (i.e. their suppliers, employees, landlords, managers, customers, etc.) reliant on the quality of the firm's future performance. A wide variety of contracts share this bilateral feature: common examples include leases, employment agreements, supply agreements, franchise agreements, and intellectual property licenses, to name a few.

It is this two-sided feature of contracts, and the resulting potential for two-sided opportunism, that gives rise to an important role for legal entities in the model we develop in this paper. In conducting business through a business corporation (or any similar form of legal entity, such as a limited liability company, that has transferable ownership shares), the firm's counterparties contract with an artificial person that maintains its identity when its owners change. This allows the owners of the firm to sell their interests freely when they have liquidity needs without requiring that its contractual counterparties consent to an assignment (i.e. a transfer) of their contract to a new owner. If this consent were not given, owners might not be able to realize the value of their specific investments in the firm, due to a holdup problem or a failure in bargaining. And these frictions, in turn, could reduce the incentive of the owners to make non-contractible investments in the firm at the outset.

At the same time, because the legal entity is a common signatory for all the firm's contracts, the owners can limit their own ability to act opportunistically. If allowed to assign contracts individually, the owners could threaten to assign contracts to less creditworthy firms with lower quality inputs. Less creditworthy firms have higher borrowing costs when they finance their assets at fair borrowing rates, so they see an assignment from a more creditworthy firm as an opportunity to obtain cheap financing. This, in turn, exposes counterparties to increased credit risk. Moreover, it might give owners an incentive to separate a bundle of contracts that are worth more together than apart. This opportunism problem can also reduce an owner's incentive to make investments that increase the bundled value of the inputs.

In assembling a legal entity, and ensuring that the individual contracts in the bundle can not be transferred *by the entity*, an owner pledges to her counterparties that, while she may transfer her rights and obligations under the contract to a new owner, she can do so only if the firm's other contracts move along with it. The assembled value of the contracts provides, in effect, important assurance of prospective payment on the liability in question. In short, the entity in our theory provides a low-cost means of achieving *bundled assignability*.<sup>3</sup>

Our analysis uses the same economic forces as in the property rights theory of the firm (non-contractible specific investments in assets), but it also emphasizes financing considerations (the liquidity needs of owners, and the provision of financing by suppliers) as a crucial driving force behind legal entities, in contrast to the

produced is typically formed as a separate legal entity. That entity has contracts with many individuals – including actors, musicians, stagehands, and a director – and also a rental contract with the theater where the work is performed. And of course it has contracts with ticket purchasers. But it rarely holds outright title to physical assets. The firm's net value lies entirely in its assemblage of contracts.

<sup>3</sup> In a companion paper (Ayotte and Hansmann, 2013) we examine assignment clauses in a sample of two classes of commercial contracts (supply agreements and leases) that have the bilateral feature of contracts in our model. We find that (1) bundled assignability is a regular feature of such contracts, and (2) legal entities are the most common means of creating and defining transferable bundles.

exclusive emphasis on assets in most of the theory of the firm literature. It offers insight not only into the economic and legal structure of firms but also into the ways that restrictions on contract assignability are – and should be – affected by changes in the boundaries of the firm.

This work is not the only theory of legal entities that is based on interactions between assets and liabilities. One example is the theory of asset partitioning (Posner, 1976; Hansmann and Kraakman, 2000a,b; Hansmann et al., 2006). Counterparties to the contracts entered into with a given legal entity all have their contractual rights bonded by claims against a single common pool of assets, which consist of the other contractual rights and property rights held by the entity. Those claims, moreover, are made senior to the claims of the owners' other personal or business creditors (by virtue of "entity shielding"). This literature argues that entity shielding can reduce the overall costs of asymmetric information by concentrating creditors' claims on the bundles of assets that the creditors can most easily monitor. Our ongoing work in progress explores the connection between the asset partitioning and bundled assignability features that entities provide.

Another example is Iacobucci and Triantis (2007), which argues that the boundaries of legal entities can be driven by legal constraints requiring that certain decisions, such as capital structure, be made on an entity-wide basis. The resulting incentive to separate assets into different legal entities to achieve more tailoring of liabilities and better managerial incentives must then be set off against the benefits of common control of assets that is provided by a single unified entity. Closer to our work, Blair (2003) focuses on "capital lock-in": by limiting the rights of a firm's owners to withdraw capital from the firm, corporate-type legal entities enhance the reliability of the firm's assets as a bond for long-term investments by the firm's employees, suppliers, creditors, and customers.

## 2. Legal entities and assignability of contracts

A party's rights and obligations under a contract may or may not be transferable (or, as we will somewhat loosely say, assignable<sup>4</sup>) to a third party without the permission of the other party to the contract (Farnsworth, 2004 Ch. 11). For example, the rights of a promisee under a simple contract for payment of a definite sum of money are, as a default rule of contract law, generally presumed assignable. Contracts for labor services, in contrast, are generally presumed nonassignable by the employer. Whatever the default rule of law, the assignability of a contract can generally be altered by a specific provision in the contract itself. For example, although leaseholds are presumed assignable, it is extremely common – as we will demonstrate below – for assignability to be curtailed by a clause in the lease prohibiting the tenant from assigning it without the consent of the landlord.

Even when a promisor's obligations under a contract are transferable to a third party, as a consequence of either a default rule of law or a specific contractual provision, the promisor remains liable to the promisee (the counterparty to the original contract) after those obligations have been transferred to a third party. That is, the original promisor/transferor remains a surety for the transferee's performance under the contract. This residual liability can be avoided only through express agreement by the promisee (either in

<sup>4</sup> When we say that a contract is "assignable," we are using the term a bit idiosyncratically from a legal point of view. In particular, by "assignable" we mean here that the transferee assumes all of the transferor's rights and obligations under the contract, while the transferor gives up all rights and is freed of all obligations. In legal terminology, this is to assume that all of the transferor's rights are assigned, and obligations are delegated, to the transferee, and in addition that the transfer is novated by the counterparty. See the text below.

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