1989

Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role

John C. Coffee Jr.
Columbia Law School, jcoffee@law.columbia.edu

Follow this and additional works at: https://scholarship.law.columbia.edu/faculty_scholarship

Part of the [Business Organizations Law Commons](#)

Recommended Citation

John C. Coffee Jr., *Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989).

Available at: https://scholarship.law.columbia.edu/faculty_scholarship/27

This Article is brought to you for free and open access by the Faculty Publications at Scholarship Archive. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Scholarship Archive. For more information, please contact scholarshiparchive@law.columbia.edu.

THE MANDATORY/ENABLING BALANCE IN CORPORATE LAW: AN ESSAY ON THE JUDICIAL ROLE*

*John C. Coffee, Jr.***

INTRODUCTION

A half-filled glass of water can be described as either half full or half empty. The structure of American corporate law—partly enabling, partly mandatory in character—can be viewed in much the same way. Some commentators see American corporate law as primarily composed of mandatory rules that the shareholders themselves cannot waive or modify.¹ In their view, this mandatory component compensates both for the absence of true bargaining among the parties and for the inevitable divergence of interests between the principals (the shareholders) and their agents (the managers and directors). Conversely, other commentators, to whom this Article will refer as “contractarians,” see corporate law as primarily composed of waivable “default rules,” which the law provides as a model form contract in order to reduce the transaction costs of contracting.² Under this view, the

*Copyright © John C. Coffee, Jr. 1989.

** Adolf A. Berle Professor of Law, Columbia University. In writing this draft, I have benefited from discussions with Bernard Black, Jeffrey Gordon, William Klein, Jonathan Macey, Henry Monaghan, Mark Roe and Robert Thompson. None bears responsibility for the views expressed herein.

1. The leading spokesman for this position is Professor Victor Brudney. See, e.g., Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 *Colum. L. Rev.* 1403, 1410–11 (1985). Professor Melvin Eisenberg's prior work would also place him under this general heading. See M. Eisenberg, *The Structure of the Corporation: A Legal Analysis* 1–6, 316–20 (1976). In his contribution to this Symposium, Professor Eisenberg acknowledges that some contractual modifications of default rules are possible, but he considers the core of corporate law, including the law pertaining to fiduciary duties, to be mandatory. See Eisenberg, *The Structure of Corporation Law*, 89 *Colum. L. Rev.* 1461, 1462 (1989). Professor Deborah DeMott has also recently taken a strong mandatory position. See DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 *Duke L.J.* 879, 915–23 (1988). I will not attempt to divide the rest of my professorial colleagues into two camps, but, lest I appear to be feigning neutrality, I would acknowledge that I am closer to the mandatory end of the continuum, although clearly not as close as those listed above. However, I argue that what is most mandatory is not a particular rule, but rather the use of courts as an *ex post* dispute resolution mechanism to resolve those issues and contingencies that the inevitable incompleteness of the corporate contract leaves open. The critical issue is what criteria should guide courts in the exercise of their gap-filling responsibility. In this Article, I argue that courts should perform their *ex post* role by seeking to create *ex ante* incentives for the disclosure of private information. That is, courts should construe the fiduciary constraints of corporate law strictly unless the parties have opted out from them in a fashion that permits accurate pricing of the departure. This position is, I argue, both different from and superior to the traditional contractarian and anticontractarian positions.

2. Among lawyers, the leading proponents of the enabling perspective are Judge

parties are free to "opt out" of these "off-the-rack" rules if they wish to strike a different bargain that is more individually tailored to their specific circumstances.³

Contractarians thus view corporate law as simply a modest extension of contract law, while their opponents regard the analogy between contract and corporate law as descriptively inaccurate. Both sides reach their respective positions because of a shared assumption that mandatory legal rules are "anticontractarian"; that is, the description of the corporation as a contract (or as a "nexus of contracts") implies for both sides that the law should permit shareholders to write or amend the corporate contract in virtually any way they see fit. Because the anticontractarians believe that shareholders should not be permitted to opt out from the mandatory core of corporate law, they tend also to resist the contract law analogy. As a result, they have tended to overlook the degree to which modern contract law itself contains important mandatory elements.

Once the debate between the contractarians and their opponents has been joined in this fashion, its focus has generally shifted from law to economics and, more specifically, to the question of whether market forces provide an adequate substitute for actual bargaining. Although the issue of how well the market prices corporate governance terms can certainly be sensibly debated,⁴ an exclusive focus on economics ignores an important feature common to all forms of long-term relational contracts: namely, that courts have invariably played an active and indispensable role in monitoring and interpreting such agreements.⁵

Frank Easterbrook and Professor Daniel Fischel. See Easterbrook & Fischel, *Corporate Control Transactions*, 91 *Yale L.J.* 698, 700-03 (1982); Easterbrook & Fischel, *Voting in Corporate Law*, 26 *J.L. & Econ.* 395, 401-03 (1983); Fischel, *The Corporate Governance Movement*, 35 *Vand. L. Rev.* 1259, 1264 (1982). For an economist's view, see Cheung, *The Contractual Nature of the Firm*, 26 *J.L. & Econ.* 1, 3-6 (1983). Professor Jonathan Macey is usually associated with this camp, since he argues that the corporate charter could authorize insider trading. See Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 *Hofstra L. Rev.* 9, 62-63 (1984). Of course, no legal writer has suggested that corporation law is exclusively mandatory or exclusively enabling. The issue is rather whether they see the glass of water as half full or half empty.

3. As Professor Fischel has phrased it, "corporate statutes provide a set of standard-form terms, but firms are generally free to alter these terms in their charters or by-laws." Fischel, *Labor Markets and Labor Law Compared with Capital Markets and Corporate Law*, 51 *U. Chi. L. Rev.* 1061, 1063 (1984). For the fullest statement of their views on opting out, see Easterbrook & Fischel, *Voting in Corporate Law*, *supra* note 2, at 402-04.

4. Indeed, I have explored this question before. See Coffee, *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 *Brooklyn L. Rev.* 919, 941-50 (1988).

5. The term "relational contract" was coined by Professor Ian Macneil. See I. Macneil, *The New Social Contract: An Inquiry into Modern Contractual Relations* 71 (1980); Macneil, *The Many Futures of Contracts*, 47 *S. Cal. L. Rev.* 691, 720 (1974). Such a contract is used to govern a long-term relationship in which all contingencies and

Indeed, the feasibility of such contracting probably depends upon the parties' ability to rely upon the courts to play such a role. In this light, analogizing the corporation to a long-term contract may suggest not that the mandatory features of American corporate law are vestigial remnants of an earlier era that was hostile to private ordering, but rather that these provisions are analogous to similar legal rules that restrict opportunism in other areas of complex, long-term contracting. Put simply, the more closely one looks at long-term contracting, the more one realizes that judicial involvement is not an aberration but an integral part of such contracting.

The intent of this Article is not simply to defend the proposition that some mandatory component to corporate law is thus inevitable, but also to understand where the line should be drawn between the mandatory and enabling components. Unfortunately, no contributor to the Symposium has undertaken a comparative examination of the mandatory/enabling balance in the corporate law of jurisdictions other than the United States, but a fair generalization is that the law of Great Britain and other Commonwealth countries is far more mandatory in character than is ours.⁶ Does this mean that their law is less efficient (as proponents of deregulation would seemingly have to predict)? Such a prediction is oversimple because it misses a key tradeoff: to the extent that American courts have permitted greater contractual freedom in corporate law, their relative tolerance has been coupled with greater judicial activism in reading implied terms into the corporate contract and in monitoring for opportunism. Thus, the issue of contractual freedom is inextricably entangled with the issue of institutional competence. Do we rely on prophylactic rules allowing little or no departure

performance standards cannot be specified in advance. See Goetz & Scott, *Principles of Relational Contracts*, 67 Va. L. Rev. 1089, 1092 (1981). Legal academics writing in this tradition, which borders closely on the field of transaction-cost economics, see Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & Econ. 233, 238 (1979), have argued that relational contracts are necessarily incomplete and tend to function as a governance mechanism for future modifications of the parties' rights and duties. These writers have also assumed that in relational contracts, the parties have substantial freedom to modify any model form contract provided by the state (i.e., to opt out), although courts will monitor such modifications. See Goetz & Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 Calif. L. Rev. 261, 266-67 (1985) [hereinafter Goetz & Scott, *Limits*].

6. For example, fiduciary law in Great Britain has been read to restrict any attempt by directors of a target company to employ defensive tactics that are common in the United States. See *Hogg v. Cramphorn Ltd.*, [1967] 1 Ch. 254, 268-70 (1963). British law also closely regulates all mergers and acquisitions, requiring at least the formal winding up of the company and the appointment of a liquidator. See *Companies Act*, §§ 572-605 (1985). For an overview of the laws of Commonwealth countries in this regard, see DeMott, *Comparative Dimensions of Takeover Regulation*, in *Knights, Raiders, and Targets: The Impact of the Hostile Takeover* 398, 408-18 (J. Coffee, L. Lowenstein & S. Rose-Ackerman eds. 1988).

from the statutory baseline? Or do we counterbalance contractual freedom with *ex post* judicial review?

A historical perspective frames the issue similarly. Even the most casual observation reveals that the fiduciary strictures of American corporate law—presumably, corporate law's most mandatory inner core—have changed dramatically over this century.⁷ In truth, corporate law has been in flux throughout American history, and the fact that the supposedly mandatory core of corporate law has shrunk significantly presents a problem for those who wish to justify its nonwaivable status. If it has changed in the past, why should it remain static in the future? More importantly, attempts to justify its mandatory core on the ground that any alternative structure would expose shareholders to unconscionable risks must face the fact that alternative configurations to corporate law exist in other countries and have existed in the United States over the last century.⁸

Who then is right—the contractarians or their critics? This Article answers that both are right and both are wrong, because both have misstated the problem. In this Article's view, contractual innovation can be reconciled with a stable mandatory core of corporate law if we recognize that what is most mandatory in corporate law is not the specific substantive content of any rule, but rather the institution of judicial oversight. Judicial activism is the necessary complement to contractual freedom. In short, because such long-term relational contracting is necessarily incomplete, the court's role becomes that of preventing one party from exercising powers delegated to it for the mutual benefit of all shareholders for purely self-interested ends. Indeed, that courts will at some point intervene is intuitively understood by the bar. In drafting the corporate contract, lawyers rely less on the model form provided by the legislature than on their expectation that courts will prevent either side from taking "opportunistic" advantage of the other.⁹ That is, the

7. For example, from a starting point that held that interested director transactions were voidable without regard to their fairness, American corporate law has changed during this century so that today the burden of proving unfairness is on the plaintiff (at least if disinterested director approval is obtained after full disclosure). See Marsh, *Are Directors Trustees: Conflict of Interest and Corporate Morality*, 22 *Bus. Law.* 35, 36–50 (1966).

8. On this basis, I would disagree with Eisenberg's contribution to this Symposium, which seeks to define the minimum elements or rights that rational shareholders would demand. See Eisenberg, *supra* note 1, at 1460–66, 1480–81. In my view, there are potentially many different combinations of statutory rights and judicial oversight that could be equally and adequately protective of shareholders. The mandatory/enabling balance in various jurisdictions may sensibly differ to the extent that the level of judicial activism also is adjusted to complement these differences.

9. I expect this conclusion about the nature of the judicial role will not come as an insight to the practicing bar. At the outset of the American Law Institute's Corporate Governance Project, which has sought to codify in Restatement form the essential rules of corporate governance, Ray Garrett, a former SEC Chairman and the first Chief Reporter for the project, argued that the specific statutory provisions in corporate law

parties contract in the shadow of the law, knowing that courts will not seek simply to enforce the contract as written, but will to some uncertain extent serve as an arbiter to determine how the powers granted to management by the corporate charter may be exercised under unforeseen circumstances.¹⁰

The immediate relevance of this point about the judiciary's central role in relational contracting is that it provides a means by which to mediate between the contractarians and their opponents. However skeptical one is of the ability of shareholders to evaluate charter provisions that deviate from traditional fiduciary standards, the often-cited barriers of high information costs and collective action problems do not apply with the same force to the court. From its *ex post* perspective, a court can more easily determine if opportunistic advantage has been taken of the minority. Yet, if courts are to play such a mediating role, the rationale for their power to intervene and reform the corporate contract becomes especially important.

Several distinct rationales are possible. First, the traditional rationale argues that all corporate powers are held in trust, and thus the fiduciary relationship that exists between corporate officials and their shareholders justifies close judicial scrutiny.¹¹ Second, one can dispense with the fiduciary rhetoric and adopt an academically popular approach, known as "hypothetical bargaining," which assumes that, in all forms of contracting, when a term has been left out of an otherwise complete agreement, a court should attempt to discover what term rational parties would have agreed upon had they focused on the matter.¹² Under this approach, the parties will be deemed *ex post* to have consented *ex ante* to the term that would have been most rational for them to specify; in short, rationality implies consent.

mean little. What is important, he said, is the general standard in corporate law by which all self-interested actions of management can be judicially reviewed. See Garrett, *The Limited Role of Corporation Statutes*, in *Commentaries on Corporate Structure and Governance: The ALI-ABA Symposiums 1977-1978*, at 95, 101-02 (D. Schwartz ed. 1979). Garrett recognized that courts are imperfect monitors and that class actions were often compromised by the self-interest of plaintiff's attorneys, but he believed that statutory provisions were secondary in importance to the judicial role. In more modern terms, Garrett can be seen as defending the proposition that the courts' *ex post* monitoring role is a substitute for a fully complete contract which provides for all possible contingencies.

10. A classic statement of this position was delivered by Adolf Berle in 1931. See Berle, *Corporate Powers as Powers in Trust*, 44 *Harv. L. Rev.* 1049 (1931). In the opening sentence of that article, Berle argues that "all powers granted to a corporation or to the management of a corporation, . . . whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears." *Id.* at 1049. Of course, this view anticipates that courts will be the principal enforcement mechanism. It is perhaps the earliest expression of the view that the corporate charter is a necessarily incomplete contract, which must be supplemented by judicially administered rules of interpretation.

11. See *id.*

12. See R. Posner, *Economic Analysis of Law* 79-85 (3d ed. 1986).

Proponents of hypothetical bargaining assume that rational parties would agree *ex ante* on whatever provision maximized value, even if the resulting gains were to be unequally distributed. Indeed, carried to its logical extreme, this perspective would justify a term that actually reduced value for one side if it increased value for the other side by a more than offsetting amount. Nothing that we know about the real world suggests that individuals are actually so risk neutral as to behave in a fashion that is indifferent to the distribution of gains and losses. If in fact parties do not bargain only to reach the efficient outcome, then courts would ignore important issues of distributive fairness if they performed their gap-filling role by falsely assuming that the parties desired only to maximize aggregate wealth. Still, it is not clear that the parties would bargain so as to split all gains equally.

How then should courts behave when they are asked to fill in an omission in the corporate contract? This Article's answer is three-fold.

First, the optimal default rule is not the rule that either maximizes wealth or reflects what rational parties would have intended, but rather the rule that best compels each party to reveal to the other its intended use of discretionary powers. The rationale for such a "coercive" default rule is that it forces those possessing private information to disclose it to the market—and hence results in more accurate pricing. In short, hypothetical bargaining is inferior to actual bargaining, and thus that default rule is best which creates *ex ante* incentives to reveal how one intends to utilize the discretion one is accorded. Second, courts should behave as they do in other forms of relational contracting by recognizing that there are mandatory minimum standards of corporate law, which include a duty of good faith and protections against unconscionable provisions.

Finally, courts should uphold opt-out provisions that deviate from traditional fiduciary standards only when they can find that the term has been accurately priced. Pricing is a critical concept, because it implies that shareholders have been compensated in the form of a lower cost for their shares for any managerial (or majority shareholder) power or right that would not be permitted under traditional fiduciary standards. Yet, given the informational asymmetries and collective action problems that are inherent to the corporate context, there is reason to doubt the market's ability to price accurately the impact of innovative charter provisions that confer potential power on managers to behave opportunistically. For these reasons, this Article will submit that accurate pricing requires specificity; that is, the actual operation of the provision must be relatively clear and specific and not simply confer on management a right to behave in a way that market forces or moral standards would usually constrain.

These three approaches—the moral approach of traditional fiduciary law, the wealth maximizing approach of hypothetical bargaining, and the information-revealing approach of "coercive" default rules—

differ significantly in terms of their hostility to contractual innovations and experimentation. Under the first approach, the justification for judicial intervention is essentially grounded on moral considerations: once managers or directors are deemed to be trustees, it follows that they must subordinate their self-interest to that of their beneficiaries, the shareholders. This approach then allows courts to articulate mandatory norms of conduct, which govern most intracorporate relationships, whether or not the actors themselves have such expectations or wish them to apply. In contrast, under the second or "hypothetical bargaining" approach, the justification for intervention becomes not fairness, but efficiency. Because it would be too costly for the parties to provide for every remote contingency in their contract, it makes more sense for them to delegate to a court the task of drafting the appropriate contractual term on an *ex post* basis when and if the contingency arises.¹³ Proponents of this view expect the court in exercising its gap-filling responsibility to look not to the common morality, but to how rational parties would have allocated the risk in order to minimize their joint costs and realize the greatest aggregate profit.¹⁴

Uniquely, the third approach begins not with the special context of corporate law, but with contracting generally. Its premise is that rigorous fiduciary duties make excellent default rules. Also, in the absence of certain judicially administered mandatory terms, such as a duty of good faith, the costs of contracting would be vastly increased, uncertainty would reign and litigation would become more likely. These third-party effects justify a certain minimum level of judicial paternalism, but it is founded more on social welfare considerations than on a particular moral view of what the rights of the parties in a particular relationship must be. Beyond this mandatory minimum, the parties are free to contract around those fiduciary norms that require selflessness, but not around those that seek to prevent fraud and opportunism. However, such departures from the default rules of fiduciary duty must be sufficiently specific and bounded to permit the departure to be accurately priced.

This Article argues that both the first and second approaches de-

13. Goetz and Scott give as an example of how this delegation occurs in the familiar "best efforts" term in contract clauses. By using such a term, the parties empower the court to determine and enforce standards that they cannot specify in advance. See Goetz & Scott, *Principles of Relational Contracts*, *supra* note 5, at 1114-17. Goetz and Scott also suggest that the implied fiduciary obligation in other settings should be interpreted similarly. *Id.* at 1126-30.

14. Easterbrook and Fischel define "[s]ocially optimal fiduciary rules" as those that "approximate the bargain that investors and agents would strike if they were able to dicker at no cost." Easterbrook & Fischel, *Corporate Control Transactions*, *supra* note 2, at 702. Even assuming that investors would want their agents to pursue the aggregate wealth maximization of investors, rather than equal treatment, *id.* at 702-04, I believe that investors would still want their agents to permit unequal treatment only when and to the extent that aggregate wealth maximization truly required such unequal treatment.

scribed above suffer from serious deficiencies. The problem with traditional fiduciary theory is its hostility to all forms of contractual innovation. By defining all senior corporate officials as fiduciaries and then insisting on a fixed normative content for that term, it overprescribes. If the purpose of a relational contract is to provide the framework for some future modification of the contract's terms, a fiduciary theory that insists on exclusivity—that there is, and can be, only one form of relationship (namely, principal and agent) between shareholders and managers—seems inconsistent with this purpose. Ultimately, the result is to freeze the corporate form, like a fly in amber, so that it cannot evolve to meet the external changes currently sweeping the business world.

In the case of hypothetical bargaining, serious problems exist concerning both its efficiency and its distributive impact. Even its doctrinal justification for *ex post* review is shaky in the corporate context, because in theory the court may reform the contract only when it finds that there is an omitted term.¹⁵ Yet, because the corporate charter is the extreme example of a relational contract, it does not attempt to specify all the parties' expectations. Rather, it seeks only to establish a governance mechanism—in effect, dealing more with process than substance. Thus, the corporate contract may appear complete on its face, without any obvious omissions or gaps for a court to fill.¹⁶

To date, the debate between the first two approaches has not advanced very far, because both sides have committed the same mistake of confusing the descriptive and the prescriptive. The anticontractarians have accurately pointed out that fiduciary law evolved independently of the law of contracts and so is not logically governed by bargaining principles.¹⁷ Yet, even if the contractarians have been too quick to present their economic model of what corporate law should become as a positive model of what it has been, the anticontractarians are not thereby excused from providing a normative rationale for the mandatory component in corporate law. If the key issue is when and why contracting out of fiduciary norms should be permitted, then it is no more a justification than it was in Holmes' time to state what the rule

15. Although Easterbrook and Fischel argue that the most sensible approach to defining the scope of fiduciary duties is to ask what the parties would have rationally bargained for with respect to an unforeseen contingency, the court clearly may not ignore the explicit elements of the parties' bargain. Otherwise, private ordering would be swallowed by judicial activism. Only when a court can decide that a term is "missing" from the contract may it supply a term. See Farnsworth, *Disputes over Omissions in Contracts*, 68 Colum. L. Rev. 860, 873-76 (1968).

16. Given that fiduciary law supplies the "default rules" for the contracting process, I believe that it will not be easy for courts in this context to find omissions in the corporate charter. In short, opting out is different from hypothetical bargaining, because it presents the court with a term that has been impliedly accepted, unless there is an express provision negating it. See *infra* notes 244-254 and accompanying text.

17. See DeMott, *supra* note 1, at 880-82.

was during the reign of Henry IV. In short, history does not supply a normative argument. More importantly, even if it is clear to most that some mandatory component to corporate law remains necessary, historically based arguments cannot tell us what the content of that component should be in an economic environment increasingly dominated by sophisticated institutional investors.

The basic premise of this Article is that, from a policy perspective, the permissibility of deviations from the traditional standards of corporate law should be judged primarily in terms of the competence of courts or other agencies to monitor these departures and prevent opportunism. From this perspective, the traditional objection of the anticontractarians that shareholders cannot adequately protect themselves is not responsive to the contractarian position. Even if well-known collective action problems and high information costs hobble shareholder democracy, this objection still ignores the potential role of courts as a mediating force that can reconcile contractual innovation with protection from opportunism. Still, before placing such a significant bet on judicial competence, one would like some evidence that courts can halt the erosion of fiduciary duties and have done so in the past. In this light, this Article is essentially an inquiry into the judicial capacity to find and hold such an intermediate position.¹⁸ In the end, it finds the evidence mixed, and recommends a more restrictive standard than will satisfy hard-core contractarians.

Historically, courts have regularly patrolled the troubled boundary between the mandatory and enabling components of corporate law and, over the last century, have repeatedly confronted attempts to "contract out" of statutory norms. To be sure, corporate law is not unique in this regard, because courts also have over the same period been faced with contractual innovations in other areas of the law that

18. Admittedly, even if such an intermediate position is discernible and courts could enforce it, this resolution will not be satisfactory to many. At its deepest level, the debate over contracting out involves a philosophical conflict about the ends of private law. While the contractarians see corporate law as exclusively intended to promote private ends, the anticontractarians tend to view the fiduciary component of corporate law as expressing a public morality, one broadly applicable to a variety of relationships based on trust and confidence. Thus, the contractarians favor the "hypothetical bargaining" approach because it presents the court in its least intrusive or regulatory guise as a body that is simply seeking to determine what the parties would have done had they focused on a problem. Conversely, the anticontractarians are uncomfortable with any theory that makes fiduciary obligations enforceable only because those subject to them have implicitly consented; such a premise makes morality rest excessively on the consent of those regulated. Certainly, it would be a curious view that the validity of the criminal law rested on the consent of criminals.

While the anticontractarians ultimately resist the corporation-as-contract analogy, because they fear erosion of the communitarian ethic that they find in fiduciary theory, I will later suggest that fiduciary morality is in some respects outdated, bounded by its preindustrial origins, and even hostile to the interests of employees and agents. See *infra* notes 182-93 and accompanying text.

were designed to outflank cumbersome or obsolete statutory structures.¹⁹ What is more surprising, however, is that in the now voluminous debate over the legitimacy of "contracting out," no one appears to have surveyed these earlier instances. If one could assert that courts have regularly upheld such contractual departures in the past, this data would at least inform the debate, and possibly force those who believe contracting out is wholly illegitimate to re-examine their positions.

In fact, the data is not clear-cut, and the number of examples is limited. The relative infrequency of cases involving a formal effort to contract out of the mandatory aspects of corporate law is probably attributable to two factors: (1) at least for the last half-century, it has been easier to avoid the undesired mandatory features of American corporate law by migration to a more "friendly" jurisdiction of incorporation, and (2) many mandatory features of corporate law are simply too negligible in their impact to justify avoidance measures. Nonetheless, a review of those cases dealing with true contractual departures is instructive, because it shows both that courts have permitted some deviations and rejected others and that the trend in judicial decisions has been toward greater tolerance.

This Article attempts to understand how courts might and should respond to innovative departures from the traditional norms of corporate governance. Part I examines judicial responses to prior attempts to depart from the statutory baseline through charter and bylaw provisions. It will argue that the issues involved in "contracting out" are less novel than they first appear and that courts have faced similar issues on a number of occasions over the last century, with very diverse reactions. Following Part I's historical tour, Part II shifts to a comparative focus and considers the extent to which analogous mandatory minimum standards are also embodied in the law of contracts. Although the law of

19. An excellent example of a tolerant judicial response to a contractual innovation that attempts to avoid a cumbersome and costly formal legal process is the judicial acceptance of the "Totten Trust" as a substitute for a will and the probate process. A Totten Trust is a trust created by the deposit of funds (typically in a bank account) by one person as trustee for another. The trust remains revocable during life, but on the depositor's death passes to the other party. As a practical matter, people of modest economic means could use joint bank accounts in this fashion to escape the need for lawyers, wills or probate. Judicial acceptance of this evasion of the Statute of Wills was undoubtedly motivated by policy considerations. See *In re Totten*, 179 N.Y. 112, 125-26, 71 N.E. 748, 752 (1904); *Murray v. Brooklyn Sav. Bank*, 258 A.D. 132, 133-34, 15 N.Y.S.2d 915, 917-18 (1939).

The idea that courts will reinterpret statutory policies in light of new circumstances and frequently shrink the scope of "obsolete" policies is not a new one and has been observed in a variety of other contexts. Cf. *Langevoort, Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 Mich. L. Rev. 672, 729 (1987) ("new assumptions of the transitional banking marketplace [have resulted in] the conscious judicial pruning" of obsolete banking regulatory statutes). Such practices represent not hypothetical bargaining, but interstitial judicial law making of a familiar kind.

contracts and the law of fiduciary duties evolved separately, their separate origins may only make more important any fundamental convergence between these two bodies of law with respect to mandatory standards. In particular, Part II will assess the degree of convergence that has occurred between the duty of good faith in the law of contracts and the duty of loyalty in fiduciary law.

Part III then attempts to specify the standards courts should use in determining whether to accept a contractual innovation that departs from the traditional rules of corporate governance. Finally, Part IV focuses more generally on the process of statutory interpretation and asks when, if ever, courts should make new mandatory rules or change old "default" rules. Here, it is necessary to evaluate the economist's view that a court construing a contract should apply a "hypothetical bargaining" approach. The ambiguities in this approach, at least in the corporate context, are substantial, but Part IV suggests that the greatest defect of the approach is its unexamined focus on what the parties "would have wanted," instead of on how to make them bargain for what they do want. This discussion intersects with an important contemporary debate over *stare decisis* and statutory interpretation between those who believe courts should read statutes as reflecting "private deals" among competing interest groups, which compromises should be respected by courts, and those who believe that statutes should be read as "public regarding" unless otherwise clearly demonstrated.²⁰

I. A SHORT HISTORY OF "OPTING OUT"

The contemporary debate over the validity of corporate charter provisions that conflict with, or at least depart from, the established norms of corporate governance is unique only in its self-consciousness. In fact, this debate has had a number of antecedents over the last century, but because these earlier battles were fought over specific, narrow issues, not the broader, more abstract questions of private ordering and market failure, their relevance has largely escaped attention.

If one asks at the outset whether courts are capable of invalidating a charter provision adopted by the shareholders without any procedural irregularity, the answer is clearly yes. Cases easily can be cited in which unorthodox provisions have been invalidated on grounds that they conflicted with a statutory policy²¹ or even a policy founded only

20. For a discussion of the rival approaches of Judge Easterbrook and Professor Macey, see *infra* notes 257-62 and accompanying text.

21. For example, in 1940, the Delaware Supreme Court invalidated a corporate charter amendment that authorized the holders of the Class A stock (which consisted of only 5,000 shares out of a total of 700,000 otherwise identical outstanding shares) in effect to veto, through a 40% vote, the choice of any director elected by all the shareholders. *Aldridge v. Franco Wyoming Oil Co.*, 24 Del. Ch. 349, 350, 14 A.2d 380, 381 (1940). The court construed this provision as requiring two elections, one by all the

on common-law norms.²² In many of these cases, the degree of conflict was at most oblique, and the court's sense of public policy was probably determinative.²³ On the other hand, at least when special justifications

shareholders and another by the Class A stock to ratify or disapprove the choice of the majority. *Id.* at 352, 14 A.2d at 381. The court found the provision to be invalid as lacking any legislative authority. *Id.* Of course, it would have been possible to approximate the same result by giving the Class A stock 20 votes per share, although such a provision would have amounted to granting voting control to the Class A stock and not simply a veto power. In principle, it can be argued that the greater should subsume the lesser, and that a result that can be reached by one route should not be precluded by another, less drastic, route.

Other decisions that have invalidated special voting arrangements include *Smith v. California Thorn Cordage, Inc.*, 129 Cal. App. 93, 98-99, 18 P.2d 393, 395 (1933) (invalidating contract requiring at least three directors to exercise corporate powers); *Abercrombie v. Davies*, 35 Del. Ch. 599, 611, 123 A.2d 893, 900 (1956) (invalidating provision allowing shareholders to usurp role of board in managing close corporation), modified, 36 Del. Ch. 102, 125 A.2d 588 (1956), *rev'd* on other grounds, 36 Del. Ch. 371, 130 A.2d 338 (1957); *State ex rel. Ross v. Anderson*, 31 Ind. App. 34, 45, 67 N.E. 207, 211 (1903) (charter provision may not cancel annual election of directors); *Benintendi v. Kenton Hotel, Inc.*, 294 N.Y. 112, 117, 60 N.E.2d 829, 830-31 (1945) (invalidating bylaw requiring unanimous consent of shareholders to elect directors).

22. *State ex rel. Cochran v. Penn-Beaver Oil Co.*, 34 Del. 81, 87, 143 A. 257, 259 (1926) (*en banc*) (invalidating restriction that effectively denied shareholders' common-law right to inspect corporation's books and records).

23. Such policy preferences have sometimes wavered unpredictably, however. The case law on voting trusts in particular shows the degree to which judicial attitudes have shifted back and forth. Early decisions often invalidated voting trusts as against public policy on the debatable ground that any "arrangement that permanently separates the voting power from stock ownership nullifies . . . the annual submission of the question of the management of the company to the stockholders." *Warren v. Pim*, 66 N.J. Eq. 353, 397, 59 A. 773, 789 (N.J. 1904); see also *Shepaug Voting Trust Cases*, 60 Conn. 553, 579-80, 24 A. 32, 41 (1890) (policy that stock ownership must control management and property of corporation is frustrated if stockholders "surrender all their discretion in the important matter of voting"). Beginning in the early twentieth century, the majority of courts upheld voting trusts. See, e.g., *Bullivant v. First Nat'l Bank*, 246 Mass. 324, 333, 141 N.E. 41, 44 (1923); *Carnegie Trust Co. v. Security Life Ins. Co.*, 111 Va. 1, 28-30, 68 S.E. 412, 421-22 (1910); see also *Massa v. Stone*, 346 Mass. 67, 74-75, 190 N.E.2d 217, 222-23 (1963) (describing prior case law).

Still later, the field was preempted by statutes, and courts ruled that voting trusts derived their validity solely from the statute (in short, a "mandatory" view of corporate law). See, e.g., *Perry v. Missouri-Kansas Pipe Line Co.*, 22 Del. Ch. 33, 45, 191 A. 823, 828 (1937). The issue then became whether an agreement that disclaimed being a voting trust was one in substance and hence invalid if it had not complied with the statutory requirements applicable to voting trusts, which included disclosure to the other shareholders. In one well-known case, the Delaware Supreme Court reversed the Chancery Court and invalidated a shareholders' agreement by which six minority shareholders pooled their stock in a common escrow to form a 54% block to be voted by supermajority vote of agents appointed by each of the six shareholders. *Abercrombie v. Davies*, 36 Del. Ch. 371, 386, 130 A.2d 338, 347 (1957). Ruling broadly that the agreement "divorced" voting rights from beneficial ownership, *id.* at 381, 130 A.2d at 344, the Delaware Supreme Court invalidated the arrangement, notwithstanding its understandable purpose of forming a coalition to prevent the largest individual shareholder, a major oil corporation, from obtaining control, *id.* at 375, 130 A.2d at 341.

Several years later, the Delaware Supreme Court upheld another arrangement that

were present, courts have also tolerated extraordinary departures from the statutory pattern, including wholesale delegations of power to management that virtually eliminated the role of shareholder voting.²⁴ In general, courts have been more willing to accept a contractual innovation when they have sensed that the law from which it departed had become obsolete. Thus, at a time when the common law required a unanimous shareholder vote before certain corporate actions could be taken (e.g., a merger or sale of all the firm's assets), several decisions upheld charter provisions authorizing such transactions on a lesser per-

"divorced" beneficial ownership from voting rights. See *Lehrman v. Cohen*, 43 Del. Ch. 222, 222 A.2d 800 (1966). To resolve an intercorporate dispute between two families, the charter had been amended to create a third class of stock, which would elect the pivotal fifth director on the board. Only one share of this class was issued, and it lacked dividend and other distributional rights. *Id.* at 226-27, 222 A.2d at 803. In short, it was without economic value, but it served as a vehicle by which the corporation's long-time attorney could be elected to the board to prevent deadlocks. Did this arrangement also amount to an impermissible divorce of voting rights from beneficial ownership? The Delaware Supreme Court upheld the arrangement on the highly technical distinction that the other shareholders had diluted their voting power, but had not divested it. *Id.* at 231, 222 A.2d at 806. In all likelihood, the court saw that the prime evil that the statute intended to prohibit—secret undisclosed voting blocs—was not implicated by this obviously open and unanimous arrangement.

24. An extreme case is *Union Trust Co. v. Carter*, 139 F. 717 (W.D. Va. 1905). In that case, the charter provided that for the first six years of corporate existence the shareholders would have no voting rights and the directors named in the original articles of incorporation would continue in office and exercise all powers. On a proposed sale of the corporation's assets (which normally would have required a shareholder vote), the court upheld these unusual arrangements in view of both the corporation's financially distressed condition and the special charter provision. *Id.* at 730-32. The court deemed the provision to have been an advance ratification by the shareholders of any "act of the board of directors not fraudulent in character." *Id.* at 731. Questionable as this decision is, it at least seems to recognize a good faith or fraud exception to its concept of advance ratification by charter provision.

A more recent example of judicial tolerance of contractual departures from the usual norms of corporate governance in the area of shareholder voting is supplied by *Providence & Worcester Co. v. Baker*, 378 A.2d 121 (Del. 1977). There, a railroad's certificate of incorporation, as adopted originally in 1844, provided that each common shareholder had one vote per share for its first 50 shares, but thereafter only one vote per 20 shares for all shares over 50. Penn Central, a shareholder that held 28% of the railroad's stock but that was limited to 3% of the total voting power, challenged the validity of this provision, claiming that Delaware General Corporation Law section 151(a) required that all shares of stock within the same class have uniform voting rights. *Id.* at 122. The Chancery Court accepted this argument and invalidated the provision, but the Delaware Supreme Court reversed, finding that the general provision in section 212(a) permitting charter provisions that departed from the norm authorized even this unusual departure. *Id.* at 124, rev'g 364 A.2d 838 (Del. Ch. 1976). *Providence & Worcester Co.* is then an illustration of a court giving a "thin," rather than a "thick," interpretation to a statutory policy (here, that of section 151(a)) and therefore upholding an arguably inconsistent charter provision. Possibly, the court believed that the original parties' intent was to operate the railroad as a leased line serving all the other railroad shareholders, and not as an independent profit-maximizing enterprise. Cf. cases cited *infra* notes 209-13 (upholding similar charter provisions).

centage vote.²⁵ Courts also appear to feel less constrained about upholding a provision opting out from a rule founded on the common law than one departing from a statute, because in the former case the principle of legislative supremacy presents less of an obstacle.²⁶

When courts have been confronted with a novel charter provision, the claim has usually been made that it was authorized by the standard residual provision in the enabling corporate statute that permits the charter to contain any provision not contrary to law for the regulation of the corporation's business.²⁷ The reactions of courts to such residual clauses have differed widely. A 1905 New Jersey case, *Audenried v. East Coast Milling Co.*,²⁸ involved the validity of a "housekeeping" charter provision that permitted the board to act by a unanimous written resolution of its directors, instead of at a formal meeting. The New Jersey Vice Chancellor responded to this seemingly mild departure from the norm as if the shareholders had sought to usurp the legislature's powers:

If the power to legislate as these incorporators have legislated exists, it must be found in the [residual clause permitting] "any provision creating, defining, limiting and regulating the powers of directors."

Under this clause, it is insisted that the legislature has granted the right, not only of creating, defining, limiting and regulating the powers of the corporation, but also the right to authorize the directors to exercise the powers thus established according to any method the incorporators may see fit to adopt, although the power to do this is not granted in express terms. I do not so interpret these words The method of exercising the power created must conform to settled legal principles, unless it be otherwise distinctly authorized by the legislative act. No such express authority is conferred by this act, and it ought not to be inferred from ambiguous expressions.

To hold that the legislature of our state, by the adoption of our General Corporation act, intended to confer upon individuals an indefinite power of legislation, would require the

25. See, e.g., *Butler v. New Keystone Copper Co.*, 10 Del. Ch. 371, 383, 93 A. 380, 385 (1915); *Traer v. Lucas Prospecting Co.*, 124 Iowa 107, 116-19, 99 N.W. 290, 293-94 (1904). On the other hand, the New Jersey courts refused to uphold action by a unanimous written consent of the directors (instead of at a board meeting), although other states had authorized such action by statute. See *Audenried v. East Coast Milling Co.*, 68 N.J. Eq. 450, 59 A. 577 (Ch. 1904).

26. The Supreme Court has recently indicated that greater deference should be given to decisions interpreting a statute than to common law precedents in determining when to overrule a questionable precedent. See *Patterson v. McLean Credit Union*, 109 S. Ct. 2363, 2369 (1989). The principle of legislative supremacy clearly underlies this differential in treatment.

27. See, e.g., *State ex rel. Cochran v. Penn-Beaver Oil Co.*, 34 Del. 81, 87, 143 A. 257, 259 (1926); *Audenried*, 68 N.J. Eq. 450, 59 A. 577.

28. 68 N.J. Eq. 450, 59 A. 577.

adoption of a liberality of construction which the act does not warrant, and which upon every known principle is contrary to public policy.²⁹

Audenried shows the ultra-orthodox hostility to innovation, even in innocuous housekeeping rules, of an age skeptical of the corporation. Its equation of private ordering by shareholders with usurpation of legislative power seems overstated today, but at the time sounded a theme that resonated with other courts. Several decades later, in *Aldridge v. Franco Wyoming Oil Co.*,³⁰ the Delaware Supreme Court used very similar language in invalidating an unusual voting provision, which gave one class a de facto veto power over the election of directors:

The Legislature is the source of power. That branch of the Government defines the public policy of the State with respect to corporate control. If the extraordinary power conferred on the Class A stock is to be upheld, some provision of the law must be found which, either by express words or necessary intendment, authorizes the creation of the power. It is sufficient to say that the right conferred on the special class of stock, in the guise of a voting right, is not within the intendment of the law as it is now written³¹

This language comes perilously close to saying that anything not clearly permitted is forbidden. Yet, as the idea took hold that corporate law should be primarily enabling in character, judicial attitudes quickly shifted. A dozen years later, the Delaware Supreme Court announced a very different and far more permissive standard. In *Sterling v. Mayflower Hotel Corp.*,³² the court upheld a charter provision that enabled an interested director to be counted for quorum purposes, and, in so doing, stated that

the stockholders of a Delaware Corporation may by contract embody in the charter a provision departing from the rules of the common law, provided that it does not transgress a statutory enactment or a public policy settled by the common law or implicit in the General Corporation Law itself.³³

In substance, this statement adopts a permissive presumption allowing the parties to depart from the usual default rules, unless they contravene the "plain meaning" of a statute or the policy implicit in either a statute or a common-law rule. As a result, the real question becomes the latitude of discretion courts possess in determining the

29. *Id.* at 467, 59 A. at 584; see also *First Nat'l Bank v. Drake*, 35 Kan. 564, 11 P. 445 (1886) (similarly rejecting board resolution procedures not expressly permitted by statute).

30. 24 Del. Ch. 349, 14 A.2d 380 (1940).

31. *Id.* at 352, 14 A.2d at 381.

32. 33 Del. Ch. 293, 93 A.2d 107 (1952).

33. *Id.* at 313-14, 93 A.2d at 118; see also *Martin Found., Inc. v. North Am. Rayon Corp.*, 31 Del. Ch. 195, 202, 68 A.2d 313, 316 (1949) (corporation's quorum provision lawful despite departure from common law).

"policies" underlying these rules. Recent experience shows that the Delaware courts have been willing to accept truly novel departures from prior law—such as the "poison pill" or the delegation of the board's authority to a special litigation committee³⁴—when they have understood the background context and reasons for the departure.

This Part will survey five such prior episodes: (1) the disputes during the first quarter of this century over charter provisions that introduced novel forms of corporate securities; (2) a similar controversy several decades later over charter provisions that allegedly "sterilized the board"; (3) the judicial treatment of charter provisions that sought to nullify the practical effect of cumulative voting statutes; (4) the judicial reaction to exculpatory provisions; and (5) the current controversy over whether "flip-in" poison pills "discriminate" among shareholders of the same class.

Before exhuming these long buried disputes, a brief word is in order about the status of American corporate law at the end of the nineteenth century. Two mandatory doctrines stood out. First, a central aim of corporation statutes was creditor protection.³⁵ This was accomplished through legal capital rules that regulated the degree to which shareholder capital could be withdrawn from the corporation.³⁶ Second, American corporate law was highly skeptical of majority rule. It

34. For a discussion of the recent poison pill cases, see *infra* notes 139–49 and accompanying text. The other major innovation that the Delaware courts have accepted—rightly or wrongly—in the last decade is the special litigation committee, a body of independent directors to which the corporation's authority to seek dismissal of a derivative action can be delegated. See *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). In contrast, other jurisdictions have been less ready to defer to this internal technique for dispute resolution. See *Miller v. Register & Tribune Syndicate Inc.*, 336 N.W.2d 709, 718 (Iowa 1983); *Alford v. Shaw*, 320 N.C. 465, 471, 358 S.E.2d 323, 327 (1987).

35. Corporation statutes then (and to a lesser extent still today) regulated the character of the consideration for which stock could be issued and required that the firm make a representation to its creditors as to its equity capital on its balance sheet. The elaborate body of law surrounding par value was thus primarily designed to protect creditors. Most corporation statutes no longer require a corporation to place a par value on its shares, because at a relatively early point, corporations learned to trivialize this representation to creditors by using a very low par value. For an overview of this body of law, which is now largely a vestigial remnant, see B. Manning, *A Concise Textbook on Legal Capital* 16–26 (2d ed. 1981).

36. In 1824, Justice Story announced that a corporation's equity constituted a trust fund for its creditors, and thus could not be withdrawn from the firm. See *Wood v. Dummer*, 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,944). This new rule lacked precedent in the prior English case law, but reflected the skepticism then prevalent in the United States about use of the corporate form. As a result, if dividends were paid out of funds not covered by the firm's accumulated and undistributed earnings, a trustee could recover these dividends from the stockholders. This rule was quietly abandoned over time. One of the first fissures in its foundation came in 1899 when the Supreme Court held that the dividend could not be reclaimed if the shareholder received it in good faith and the corporation was solvent at the time it was paid. See *McDonald v. Williams*, 174 U.S. 397 (1899). This decision was arguably a response to new commercial realities,

considered some rights to be so fundamental that even a supermajority of shareholders, or a subsequent statutory change, could not abolish them.³⁷ Such rights were said to be "vested" property rights. Thus, at common law, "fundamental" amendments of the corporate charter required unanimous consent,³⁸ a requirement that greatly restricted the scope of private ordering. Indeed, it seems fair to conclude that the corporate charter was not truly a relational contract at this stage, because in most cases, terms of the parties' relationship were not susceptible to modification without unanimous consent. Yet, during the first half of the twentieth century, courts, and later legislatures, first softened and then eventually abandoned both these doctrines.³⁹ Although the "vested rights" doctrine and legal capital rules enforced a truly mandatory system of corporate law from which shareholders could not depart, the gradual abandonment of these doctrines cannot be accu-

including the expanded shareholder base of many corporations, which made courts less eager to enforce aggressively the creditor protection rules of an earlier era.

37. For an overview of the rise and partial fall of the "vested rights" doctrine, see Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 *Geo. L.J.* 1593, 1601-27 (1988). For one of the last gasps of this doctrine, see *State ex rel. Swanson v. Perham*, 30 *Wash. 2d* 368, 376, 191 *P.2d* 689, 694 (1948) (right to vote on a noncumulative basis was a vested right that subsequent cumulative voting statute impermissibly infringed). The decision has since been judicially overruled. See *Seattle Trust & Sav. Bank v. McCarthy*, 94 *Wash. 2d* 605, 610-11, 617 *P.2d* 1023, 1027 (1980); see also *Mobile Press Register, Inc. v. McGowin*, 271 *Ala.* 414, 426-27, 124 *So. 2d* 812, 823-24 (1960) (preemptive right held not to be a vested right). As late as 1951, however, a Pennsylvania court found that a majority of the shareholders of a corporation could not amend a bylaw restricting share transferability, although legislatively authorized to do so, because the bylaw had created a vested right that could only be abolished through unanimous shareholder action. See *Bechtold v. Coleman Realty Co.*, 367 *Pa.* 208, 213-15, 79 *A.2d* 661, 663-64 (1951). For an overview of this doctrine's vestigial status, see Halloran, *Equitable Limitations on the Power to Amend Articles of Incorporation*, 4 *Pac. L.J.* 47 (1973).

38. See 12B *W. Fletcher, Cyclopedia of the Law of Private Corporations* § 5776 (rev. perm. ed. 1984). Courts could avoid the impact of this doctrine if they found that the charter amendment was only "auxiliary" or "incidental." The line between "fundamental" and "auxiliary" amendments was uncertain (and probably relatively discretionary with the individual court). *Id.* During the late nineteenth century, some courts showed an increased tolerance for charter amendments that expanded the scope of the corporation's permissible purposes. See, e.g., *Durfee v. Old Colony & Fall River R.R.*, 87 *Mass. (5 Allen)* 230 (1862) (upholding charter amendments permitting railroad to extend its lines and raise new capital therefor, in spite of prior decisions considering such amendments to be fundamental); *Buffalo & N.Y. City R.R. v. Dudley*, 14 *N.Y.* 336, 354-55 (1856).

39. Professor Bratton has recently surveyed the judicial abandonment of the legal capital rules and concluded that it came at least partially in response to a judicial recognition that the law was obsolete, because creditors were no longer exposed to loss from opportunistic behavior by shareholders. As he sees it, courts realized that the new managerially dominated corporations of the late nineteenth century would not be dissolved, but would be run by professional managers with a view to stability and long-run gain. See Bratton, *Corporate Debt Relationship: Legal Theory in a Time of Restructuring*, 1989 *Duke L.J.* 92, 106-07.

rately portrayed as simply a transition from a mandatory to an enabling rationale for corporate law. Rather, as the vested rights doctrine died, it was replaced by the idea that those controlling the corporation owed a duty of fairness to the minority.⁴⁰ In effect, the trade-off was that the majority obtained the right to amend the corporate charter (and thereby to obtain needed flexibility), but the majority's power to exercise control was subjected to a fiduciary constraint that they exercise their new power only for ends reasonably related to shareholder wealth maximization. By the 1920s, one can find the Delaware Supreme Court comfortably explaining that the power to include special provisions in the certificate of incorporation did not embrace the power to cancel the shareholders' common-law rights.⁴¹ Such rights could be reasonably regulated by certificate provisions, but they could be abolished only by statute. By the 1940s, the doctrine of vested rights was finally laid to rest in the major commercial jurisdictions.⁴² The next several case studies are snapshots of this transition as it progressed.

A. *Vested Rights and Charter Provisions Relating to Corporate Securities*

Several distinct issues relating to corporate securities were vigorously disputed during the first decades of this century: whether corporations could issue a stock without or below par value; whether a charter amendment could create a new senior security having preferential rights to the existing shareholders; and whether outstanding stock could be altered by a charter amendment in a manner that adversely affected its holders. Over a half century, the prevailing answer to all these questions shifted from no to yes.

1. *Par Value and the Consideration for Shares.* — One recent commentator has found that the "par/no par" issue was the most frequently

40. Professor Branson has accurately observed that the transition involved a substitution, rather than simply an elimination of the mandatory element in corporate law. See Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 *Fordham L. Rev.* 375, 392-93 (1988). A seminal article discussing this shift in judicial emphasis is Latty, *Fairness—The Focal Point in Preferred Stock Arrearage Elimination*, 29 *Va. L. Rev.* 1 (1942). For a case illustrating the transition, see *Bove v. Community Hotel Corp.*, 105 R.I. 36, 44-45, 249 A.2d 89, 94 (1969) (upholding dividend arrearage elimination).

41. See *State ex rel. Cochran v. Penn-Beaver Oil Co.*, 34 Del. 81, 87, 143 A. 257, 259 (1926). In *Cochran*, the certificate provided that the shareholders' ability to inspect corporate records was at all times subject to the board of directors' permission, which had been withheld. The court found that the board could reasonably regulate access, but not withhold it, even if a majority of the shareholders had so provided.

42. See, e.g., *Davison v. Parke, Austin & Lipscomb, Inc.*, 285 N.Y. 500, 509, 35 N.E.2d 618, 622 (1941) (upholding amendment of articles of incorporation to eliminate cumulative preferred share dividend arrearages); *McNulty v. W. & J. Sloane*, 184 Misc. 835, 840-42, 54 N.Y.S.2d 253, 259-60 (Sup. Ct. 1945) see also *Federal United Corp. v. Havender*, 24 Del. Ch. 318, 332-44, 11 A.2d 331, 338-42 (1940) (merger used to eliminate accrued cumulative preferred dividend arrearages).

debated corporate-law issue in law reviews during the early 1920s.⁴³ Dead as this issue seems today, no clearer illustration can be given of the limited efficacy of some mandatory rules. By simply inserting a nominal par-value, for example, \$.01 per share, the original purposes of the par value requirement could be trivialized, as shares could be issued at widely divergent prices and equity capital could be effectively withdrawn from the firm through capital surplus dividends. Because the original requirement that shares have a par value was indisputably intended as a mandatory rule, the abandonment of this rule represents a clear example of a judicial decision that a policy had become obsolete.⁴⁴ Historically, as courts came to realize that the rationale underlying par value was illusory, they gradually became more tolerant about permitting deviations from its strict requirements.

As early as 1891, in *Handley v. Stutz*,⁴⁵ the Supreme Court upheld the issuance of stock at below par value where the market value of an insolvent company's stock had sunk below its par value. In *Stutz*, investors had purchased \$45,000 in par value of the common stock of an insolvent coal company along with \$45,000 in face amount of its bonds for a total cash payment of \$45,000.⁴⁶ Obviously, the stock was issued at below its par value, probably as an equity "kicker" or throw-in to make the purchase of the bonds more attractive. The Supreme Court easily could have required strict adherence to the traditional rule invalidating watered stock, particularly given the general distaste that courts have shown for bonus shares. Yet it did not. Instead, it focused on the economics of the transaction and essentially recognized that if a stock's market value fell below its par value, the corporation would be precluded from issuing shares.⁴⁷ Thus, a rule designed to protect creditors and shareholders could potentially become a legal trap for the unwary that could have counterproductive results.⁴⁸

One year after *Stutz*, a proposal was made in the New York Legislature to permit the issuance of stock without par value, which proposal eventually resulted in the enactment in 1912 of the first legislation au-

43. McChesney, Intellectual Attitudes and Regulatory Change: An Empirical Investigation of Legal Scholarship in the Depression, 38 J. Legal Educ. 211, 233-34 (1988).

44. According to some commentators, courts recognized that the potential for opportunism had diminished by the late 1890s, because the large railroad and steel corporations of that era could not be fraudulently liquidated overnight and their assets passed out to shareholders as dividends so as to defraud creditors. See Bratton, *supra* note 39, at 106-07. I suspect this thesis overstates, but the fear of shareholder opportunism may have been less rampant than it was at earlier moments in American history.

45. 139 U.S. 417 (1891).

46. *Id.* at 420-21.

47. See *id.* at 430.

48. Of course, the problem could have been as easily solved by lowering the par value of the shares, but the validity of such an amendment was probably also unclear in 1891.

thorizing stock without par value.⁴⁹ During the next decade, several other states, including Delaware, followed New York's lead either through similar legislation or court action.⁵⁰ Although no case has been found in which the parties sought to opt out and provide for stock without par value in the absence of statutory authorization, a related question of the public policy limits on charter provisions arose when corporations chartered in "no par" jurisdictions applied for licenses to do business in states requiring par value. At the time, a foreign corporation's right to do business in another jurisdiction was not clearly established, and admission was seen mainly as a matter of administrative grace. Because the original purpose of par-value stock was to protect creditors, it would have been understandable for a host jurisdiction to have considered its own public policies implicated by the admission of such a foreign corporation. Nonetheless, in *State ex rel. Standard Tank Car Co. v. Sullivan*,⁵¹ when a Delaware corporation having stock without par value applied to do business in Missouri, the Missouri court found that, although its own laws did not permit "no par" stock, par value "is not an essential feature of a business corporation."⁵² The court added that it saw "nothing inherently fraudulent or *contra bonos mores* in that species of stock or in corporations organized with it."⁵³ In this light, the fact that the issue of opting out did not explicitly arise more often in the past may be primarily attributable to our federal system of fifty-odd jurisdictions. Those that wished to use the novel provision could simply incorporate in a state that permitted it.

A second original purpose of the par-value requirement was to ensure that each shareholder paid the same amount for his shares. In 1882, Victor Morawetz stated this rule in his famous treatise on corporations: "[E]very stockholder must contribute a proportionate part of the capital of the company."⁵⁴ Courts quietly abandoned this rule during the early twentieth century, and today there is no dispute that shares can be simultaneously offered (at least when accompanied by full disclosure) to different shareholders at different prices.⁵⁵ The pattern

49. See Current Legislation—Shares Without Par Value, 21 Colum. L. Rev. 278, 279 (1921).

50. Wickersham, The Progress of the Law on No Par Value Stock, 37 Harv. L. Rev. 464, 464–65 (1924); Current Legislation, *supra* note 49, at 279 & n.11.

51. 282 Mo. 261, 280, 221 S.W. 728, 734 (1920).

52. *Id.* at 280, 221 S.W. at 734; see also *North Am. Petroleum Co. v. Hopkins*, 105 Kan. 161, 165, 181 P. 625, 627 (1919) (permitting foreign corporation with no par stock to do business in the state).

53. *Sullivan*, 282 Mo. at 286–87, 221 S.W. at 737.

54. V. Morawetz, A Treatise on the Law of Private Corporations Other Than Charitable § 374, at 377 (1882).

55. See *Atlantic Refining Co. v. Hodgman*, 13 F.2d 781, 789 (3d Cir. 1926); *Bodell v. Gen. Gas & Elec. Corp.*, 15 Del. Ch. 119, 128–29, 132 A. 442, 446 (1926), *aff'd*, 15 Del. 420, 430, 140 A. 264, 268 (1927); *Milberg v. Baum*, 25 N.Y.S.2d 451 (App. Term 1941) (*per curiam*). However, courts will review the circumstances of contemporaneous issuances at different prices for indications of unfairness. See H. Henn & J. Alexander,

here is similar to that observed with respect to charter amendments: a prophylactic rule yielded over time to a standard of judicial review for unfairness.

Much the same pattern characterized the gradual judicial abandonment of "trust fund" theory and also the doctrine of preemptive rights. Dating from the decision of Justice Story in *Wood v. Dummer*,⁵⁶ in 1824, the trust fund theory essentially held that the capital contributed by shareholders to a corporation in return for their shares constituted a trust fund for the benefit of creditors. The entire concept of par value was simply a means of implementing this theory through a mechanical rule for measuring the size of the trust fund. By the late nineteenth century, some decisions had begun to substitute a narrower fraud theory for the trust fund in order to limit liability to those instances in which a creditor could have relied upon a misrepresentation about the corporation's capital.⁵⁷ However, the general skepticism toward promoters underlying the "trust fund" theory survived in a more limited rule that shares could not be issued for certain kinds of potentially overvalued consideration.⁵⁸ In many jurisdictions a statutory rule survives today that shares cannot be issued for either notes or future services, on the theory that the value of such consideration is often illusory.⁵⁹ Yet, this rule caused practical problems and often proved to

Laws of Corporations § 168 (3d ed. 1983); Note, Judicial Control Over the Fairness of the Issue Price of New Stock, 71 Harv. L. Rev. 1133, 1135-37 (1958).

56. 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,944). Essentially, *Wood v. Dummer* was a judicially created invention to prevent shareholders from removing their capital from the corporation so as to render it insolvent and defraud creditors. See B. Manning, supra note 35, at 46; L. Friedman, A History of American Law 199 (2d ed. 1985).

57. See, e.g., *Hospes v. Northwestern Mfg. & Car Co.*, 48 Minn. 174, 198-99, 50 N.W. 1117, 1121 (Minn. 1892) (holders of bonus stock only liable to creditors who believed that the stock represented actual capital). Conceptually, there were a number of problems with considering the corporation's assets a trust fund. In particular, it was difficult to see how creditors who advanced their funds to the corporation before the issuance of "watered" stock were in any way injured by the later issuance, since they had not relied on the additional capital so contributed. Thus, in *Hospes*, the Minnesota Supreme Court rejected the "trust fund" concept and replaced it with a misrepresentation or fraud theory, which applied only to subsequent creditors who might have so relied. 48 Minn. at 194-96, 50 N.W. at 1119-20; *Easton Nat'l Bank v. American Brick & Tile Co.*, 70 N.J. Eq. 732, 739, 64 A. 917, 919-20 (N.J. 1906).

58. Where the "property" received for shares was valued in terms of its future earnings potential, rather than its current "actual cash value," a famous New Jersey decision found the shareholders liable for receipt of watered stock. See *v. Heppenheimer*, 69 N.J. Eq. 36, 53, 61 A. 843, 850 (Ch. 1905). According to the court, the term "property" was limited to "something visible and tangible." *Id.* at 43, 61 A. at 846. This hostility to intangible forms of property eased as the twentieth century witnessed the growth of new industries based on such property. See *Pipelife Corp. v. Bedford*, 37 Del. Ch. 467, 145 A.2d 206 (1958) (recognizing value of nonexclusive license as basis for issuance of shares, but still finding some overvaluation and hence partial liability).

59. See, e.g., N.Y. Bus. Corp. Law § 504(b) (McKinney 1986). For a survey of statutes and cases on the issuance of shares for promissory notes, see 11 W. Fletcher, supra note 38, §§ 5194-5196 (rev. perm. ed. 1986).

be a "trap for the unwary."⁶⁰ Courts appear to have sensed this point, because recurrently over the last thirty years they have grafted exceptions onto the seemingly rigid and unqualified statutory rule.⁶¹ In one of the first of these modern cases, *Petrishen v. Westmoreland Finance Corp.*,⁶² the Pennsylvania Supreme Court established a shareholder-consent rule: shares could be issued for future services when all shareholders consented.⁶³ At first glance, this result comes very close to treating the statutory norm as only a default rule, but, in reality, this decision and the other judicial exceptions are probably better read as a judicial response to statutory obsolescence. Today, the original prophylactic rule has shrunk through judicial reconstruction into a considerably thinner rule that looks to the likelihood of actual abuse.⁶⁴

Preemptive rights provide an excellent illustration of a rule that was once mandatory, but evolved into a default rule.⁶⁵ Although recent

60. As Professor Herwitz has pointed out, the restriction on the issuance of shares for future services complicates the problem faced by some companies in laterally hiring senior executives who want an immediate equity position. However, since the problem can be avoided through such standard evasions as the use of no par stock, stock options and loans to finance executive stock purchases, the restrictions have become merely a trap for the unwary. See Herwitz, *Allocation of Stock Between Services and Capital in the Organization of a Close Corporation*, 75 Harv. L. Rev. 1098, 1111 (1962).

61. See, e.g., *Burch v. Exploration Data Consultants, Inc.*, 33 Colo. App. 155, 159, 518 P.2d 288, 290 (1973) (shares may be issued for promissory note of shareholder if share certificate is pledged as security for loan); *Highlights for Children, Inc. v. Crown*, 43 Del. Ch. 323, 328, 227 A.2d 118, 121 (1966) (treasury shares may be issued for consideration that would not support original issuance); *Doyle v. Chladek*, 240 Ore. 598, 609-11, 401 P.2d 18, 24 (note upheld as consideration, provided shareholder remained liable for "water" in stock), modified and reh'g denied, 240 Ore. 613, 403 P.2d 381 (1964). Some decisions, however, continue to apply the old prohibition rigorously. See *United Steel Indus., Inc. v. Manhart*, 405 S.W.2d 231, 232-33 (Tex. Civ. App. 1966) (stock issued for future services cancelled).

62. 394 Pa. 552, 147 A.2d 392 (1959).

63. *Id.* at 557-58, 147 A.2d at 395. The logic of this position seems curious: why should a rule intended to protect creditors, not shareholders, be subject to waiver by shareholders, whose only mutual aim may be to overreach their creditors? The statute in *Petrishen* seemed unambiguous and prohibited the issuance of shares "except for money, labor done or money or property actually received." *Id.* at 557, 147 A.2d at 395. Thus, *Petrishen* is probably founded on a judicial recognition that the statutory policy was obsolete.

64. Many courts no doubt still will invalidate stock issued for notes, but none are likely to pierce through form to substance if the corporation lends the funds to the prospective shareholder and receives a note in return for this indebtedness. Hence, to this degree at least, the downsizing of the old rule supplies a paradigm of the judicial thinning process.

65. For an overview of the statutory law on preemptive rights, see H. Henn & J. Alexander, *supra* note 55, § 175. No state today appears to preclude the use of a charter provision to cancel preemptive rights, and in many states preemptive rights arise only if they are expressly provided for in the corporate charter. Originally, preemptive rights were considered a mandatory doctrine, which could not be modified by contract. See *Eidman v. Bowman*, 58 Ill. 444 (1871); *Gray v. President, Directors and Co. of the Portland Bank*, 3 Mass. 363 (1807). Exceptions to this rule began to develop in the last half

changes have been statutory, courts began in the nineteenth century to relax the doctrine by recognizing a number of exceptions to the rule.⁶⁶ Again, the pattern is one of a policy-motivated judicial shrinkage of a rule, not deferral to shareholder choice—at least until the legislature made the rule a default one.

2. *The Issuance of Senior Securities.* — In 1879, the New York Court of Appeals, in *Kent v. Quicksilver Mining*,⁶⁷ considered whether an existing corporation had the authority to amend its certificate of incorporation to authorize a senior class of preferred stock. The Quicksilver Mining Company's certificate of incorporation granted it only a vague general authority "to make such bylaws as it may deem proper to enable it to carry out the objects of the corporation, and the same to alter, amend, add to or repeal at their pleasure, provided such bylaws are not contrary to the statute or the charter."⁶⁸ Relying on this authority, Quicksilver had amended its bylaws to allow the conversion of its common stock, upon the payment of five dollars per share, into a new class of preferred stock carrying a seven percent dividend.⁶⁹ This simple fact pattern presents a paradigmatic issue: does the general authority to amend the corporate contract authorize the taking of an action that adversely affects some existing shareholders? Specifically, can the legal relationship among shareholders be significantly revised without their unanimous consent? Although in 1879 the court did not see the issue in these general terms, it did recognize that those shareholders unable or unwilling to pay the conversion fee would be effectively prejudiced by being subordinated to those that paid.⁷⁰ Thus, it enjoined the amendment, holding that the power to amend the bylaws did not imply a power to impair the "vested rights" of the common stock.⁷¹

Although vested rights theory substantially predated the decision in *Kent*,⁷² the decision was to haunt the subject of charter amendments for decades. Until well after the turn of the century, courts repeatedly rejected attempts to alter a security's terms as an impairment of vested

of the nineteenth century. See *Ohio Ins. Co. v. Nunnemacher*, 15 Ind. 294 (1860). *Nunnemacher* appears to treat preemptive rights as a default rule. It held that an ambiguous provision empowering directors to make bylaws "for the management and disposition of the stock of the company" and to increase capital stock "in such manner as to them shall seem best" up to \$200,000 cancelled any right shareholders had to preemptive rights. *Id.* at 296.

66. In his classic nineteenth century hornbook on corporate law, Morawetz viewed preemptive rights as mandatory, but then listed occasions when they did not arise under then existing case law. Most notably, he recognized that treasury shares were exempt, citing cases showing that courts had already relaxed the rule to some degree. See V. Morawetz, *supra* note 54, § 350, at 354 (citing *Page v. Smith*, 48 Vt. 265 (1876)).

67. 78 N.Y. 159 (1879).

68. *Id.* at 162.

69. *Id.* at 164–65.

70. *Id.* at 190.

71. *Id.* at 181.

72. See Hovenkamp, *supra* note 37, at 1601–27.

rights, usually without examining the fairness of the transaction.⁷³ Similarly, decisions in this era restricted charter amendments that expanded the corporate objects expressed in the articles of incorporation.⁷⁴ This concept of vested rights thus essentially froze the corporation's capital structure and denied the corporation the flexibility to pursue new objectives or to issue new classes of securities not authorized at the moment of corporate formation. Beginning in the decade between 1910 and 1920, however, courts began to free corporate law from the straitjacket of vested rights theory. Decisions gradually permitted the authorization and issuance of new classes of securities not in the original certificate of incorporation.⁷⁵ Other decisions permitted the corporation to expand its purposes and objectives without a unanimous vote.⁷⁶ Later, the Delaware courts would trivialize the vested rights doctrine by inventing the doctrine that changes which would have been impermissible if accomplished by a charter amendment were valid if effected by merger.⁷⁷ This doctrine of "independent legal significance" proved the *coup de grace* to vested rights theory.

3. *Redeemable Stock.* — Redeemable preferred stock became common sometime after 1910.⁷⁸ Its appearance caused a variety of problems for courts. A few decisions invalidated the corporation's repurchase as a disguised dividend, which was illegal because it failed to comply with the state law limiting dividends.⁷⁹

Redeemable stock also raised a unique problem: could management expel dissident shareholders by redeeming their securities pursuant to a broad charter provision? Some cases have upheld this result, but the Delaware courts have generally resisted it. For example, in *Petty v. Penntech Papers Inc.*,⁸⁰ a charter provision provided that the corporation could "at any time or from time to time redeem the whole or any part of the Series A Preferred."⁸¹ Broad as this provision was, the Delaware Chancery Court found that it was limited by Delaware's

73. For a relatively late use of the doctrine to bar the alteration of a redemption price, see *Yoakam v. Providence Biltmore Hotel Co.*, 34 F.2d 533, 543-44 (D.R.I. 1929).

74. See *Atlanta Steel Co. v. Mynahan*, 138 Ga. 668, 668, 75 S.E. 980, 980-81 (1912); *Colgate v. United States Leather Co.*, 75 N.J. Eq. 229, 239, 72 A. 126, 130 (N.J. 1950).

75. See *In re Sharood Shoe Corp.*, 192 F. 945, 948 (D. Minn. 1912); *Salt Lake City Auto. Co. v. Keith-O'Brien Co.*, 45 Utah 218, 223-26, 143 P. 1015, 1017-18 (1914).

76. *Williston v. Michigan S. & N. Ind. R.R. Co.*, 95 Mass. (13 Allen) 400, 401-02 (1866); *Durfee v. Old Colony & Fall River R.R. Co.*, 87 Mass. (5 Allen) 230, 248 (1862); *Buffalo & N.Y.C. R.R. Co. v. Dudley*, 14 N.Y. 336, 354-55 (1856).

77. See *Federal United Corp. v. Havender*, 24 Del. 318, 333-35, 11 A.2d 331, 338-39 (1940); see also *Hottenstein v. York Ice Mach. Corp.*, 136 F.2d 944, 953 (3d Cir. 1943) (applying Delaware law).

78. *Jones, Redeemable Corporate Securities*, 5 S. Cal. L. Rev. 83, 83 (1931).

79. See, e.g., *Duddy-Robinson Co. v. Taylor*, 137 Wash. 304, 242 P. 21 (1926).

80. 347 A.2d 140 (Del. Ch. 1975).

81. *Id.* at 142.

mandatory rules of fiduciary duties under which management was denied the right to use corporate funds to entrench itself in office.⁸² Thus, *Petty* supplies a paradigm of the modern alternative to vested rights theory: namely, the recognition of an implied contractual term. In economic parlance, the case reveals an unconscious judicial methodology paralleling hypothetical bargaining. By reading a fiduciary restraint into the contract to limit the opportunistic use of an open-ended term, the Delaware Chancery Court in effect concluded that shareholders would have done this had they focused on the question. Doctrinally, the essence of this approach involves the distinction between the validity of a power and the propriety of its use in a given case. Since at least the 1920s, Delaware courts have consistently held that a lawfully delegated power may not be used for an invalid purpose.⁸³ In the close corporation context at least, New York courts have gone even further, reading a condition into the contract requiring not only that an "independent business objective" be shown to justify actions which will adversely affect minority shareholders, but also that "such objective could not have been accomplished substantially as effectively by other means."⁸⁴

B. "*Sterilization of the Board*"

One of the key features that distinguish a corporation from a partnership is centralized management; virtually all of a corporation's legal power is consolidated in its board of directors. These directors in turn owe a fiduciary duty of undivided loyalty to the corporation. Hence, simply on doctrinal grounds, it is unsurprising that courts have disfavored, and often invalidated, any attempt to bind or predetermine the discretion of these quasi-public servants through contractual or charter

82. *Id.* at 143.

83. See *State ex rel. Cochran v. Penn-Beaver Oil Co.*, 34 Del. 81, 86-87, 143 A. 257, 259 (1926) (charter provision subjecting shareholder inspection rights to board's discretion interpreted to permit only reasonable restrictions); see also *Greene v. E.H. Rollins & Sons, Inc.*, 22 Del. Ch. 394, 400, 2 A.2d 249, 252 (1938) (provision that non-employee must surrender share at below market price invalid unless related to successful operation of the business so as to make it "reasonable"). Courts in other jurisdictions have, however, permitted selective redemptions. See, e.g., *Lewis v. H.P. Hood & Sons, Inc.*, 331 Mass. 670, 675, 121 N.E.2d 850, 853 (1954).

84. *Schwartz v. Marien*, 37 N.Y.2d 487, 492, 335 N.E.2d 334, 338, 373 N.Y.S.2d 122, 127 (1975). *Schwartz* dealt with an attempt to issue a block of stock so as to upset a long-standing 50/50 allocation of voting power between two rival factions in a closely held corporation. *Id.* at 489-90, 335 N.E.2d at 336, 373 N.Y.S.2d at 125. Although the procedures followed complied with all statutory requirements, the New York Court of Appeals invalidated the stock issuance, ruling that "not only must it be shown that [the issuance] was sought to achieve a bona fide independent business objective, but as well that such objective could not be accomplished substantially as effectively by other means" *Id.* at 492, 335 N.E.2d at 338, 373 N.Y.S.2d at 127. This severe standard has been used only with respect to control allocation issues in closely held firms, but it illustrates how far courts can go in reading implied conditions into the contract.

arrangements. After all, if fiduciaries have a duty to exercise their best judgment under the circumstances, it follows logically that this duty could not be delegated to others. Accordingly, until well after midcentury, voting agreements that sought to bind the voting discretion of directors were generally deemed to violate public policy and therefore to be invalid.

The cost of this mandatory rule was often unfair surprise to shareholders in close corporations, who suddenly found that perfectly understandable and reasonable contractual arrangements were invalid because they ran afoul of this prophylactic rule that the board's discretion could not be infringed. When a minority shareholder attempted to place some limitations on the board's discretion in order to protect itself from the tyranny of the majority, courts regularly struck down this contractual limitation on the ground that it unlawfully interfered with the "statutory norm" that directors possess unfettered discretion. A well-known illustration of this principle is the decision in *McQuade v. Stoneham*,⁸⁵ which invalidated a shareholders' agreement under which two shareholders agreed to vote in their capacity as directors to pay a modest salary to one of them as an officer.⁸⁶ Today, most students of corporate law recognize that little erosion of the norms of corporate governance would have resulted had the agreement been upheld, and on similar facts other decisions have so concluded.⁸⁷ *McQuade* thus presents the hardest case for the anticontractarian to explain why shareholders should not have been able to contract around an overbroad statutory norm. Effectively, the case implies that minority shareholders could not rely upon private contracting to protect their interests, but instead would be compelled to depend on the mandatory fiduciary duties to which corporate law subjected directors. In effect, this is a classic "one horse, one rabbit" trade because shareholders gave up the certainty of contractual provisions for the uncertain protection of fiduciary duties. Yet, because the business judgment rule virtually immunizes most directorial decisions from judicial review, it is understandable that minority shareholders would prefer the certainty of a contractual provision.

85. 263 N.Y. 323, 189 N.E. 234 (1934).

86. *Id.* at 328, 189 N.E. at 236; see also *Smith v. California Thorn Cordage, Inc.*, 129 Cal. App. 93, 98-99, 18 P.2d 393, 395 (1933) (invalidating contract to form committee to control corporate finances as usurpation of directors' powers).

87. For example, according to the Illinois Supreme Court,

Where . . . no injury to a minority interest appears, no fraud or apparent injury to the public or creditors is present, and no clearly prohibitory statutory language is violated, we can see no valid reason for precluding the parties from reaching any arrangements concerning the management of the corporation which are agreeable to all.

Galler v. Galler, 32 Ill. 2d. 16, 30, 203 N.E.2d 577, 585 (1964). But see *Somers v. AAA Temporary Servs.*, 5 Ill. App. 3d 931, 934, 284 N.E.2d 462, 464 (1972) (invalidating attempt by two sole shareholders to adopt bylaw reducing size of the board).

Anticontractarians will probably concede today that *McQuade* was somewhat overwritten and imposed an undesirable rigidity on business planning within the close corporation. But they would reply that the appropriate response was legislative relaxation of the intensity of the rule. Indeed, many states, including New York, have so responded. Under section 620 of New York's Business Corporation Law,⁸⁸ shareholders of a corporation may adopt a provision in the certificate of incorporation that would otherwise be "prohibited by law because it improperly restricts the board in its management of the business of the corporation"⁸⁹ if: (1) it is unanimously approved by all shareholders of record; (2) shares are transferred or issued thereafter only to persons who had knowledge or notice of the provision;⁹⁰ and (3) the shares are not thereafter publicly traded on an exchange or an over-the-counter market.⁹¹ Seemingly, section 620(b) reflects only a parsimonious acceptance of private ordering, even in the context of closely held corporations.

Interestingly, since the adoption of section 620(b) in 1961, considerable litigation has surrounded its interpretation and exclusivity. Although section 620(b) on its face provides only a limited safe harbor and thus affirms the prior law of *McQuade* if agreements are either not set forth in the certificate or not unanimously adopted, decisions have read its policy more expansively. Failure to place the agreement in the certificate has been repeatedly excused.⁹² Indeed, in *Zion v. Kurtz*,⁹³ the New York Court of Appeals, applying Delaware law, upheld an agreement signed by all of the shareholders of a corporation which provided that no "business or activities" of the corporation would be conducted without the consent of a minority stockholder.⁹⁴ The facts of *Zion* presented a difficult pattern in which to uphold the agreement, because the challenged agreement wholly "sterilized" the board and the provision had not been inserted in the certificate (as required by both the New York and Delaware statutes). Nonetheless, impressed by the desirability of encouraging private ordering in the close corporation context, the New York Court of Appeals held that no public policy was offended by the shareholders' agreement and upheld it,⁹⁵ suggesting in dicta that it would reach a similar result under New York law.⁹⁶

Zion may suggest not only a more liberal attitude toward private

88. N.Y. Bus. Corp. Law § 620 (McKinney 1986).

89. Id. § 620(b).

90. Id.

91. Id. § 620(c).

92. See, e.g., *Garson v. Garson*, 105 A.D.2d 726, 481 N.Y.S.2d 162 (1984); *Adler v. Svingos*, 80 A.D.2d 764, 436 N.Y.S.2d 719 (1981), aff'd sub nom. *Garson v. Rapping*, 66 N.Y.2d 928, 489 N.E.2d 765, 498 N.Y.S.2d 796 (1985).

93. 50 N.Y.2d 92, 405 N.E.2d 681, 428 N.Y.S.2d 199 (1980).

94. Id. at 96, 405 N.E.2d at 682, 428 N.Y.S.2d at 200.

95. Id. at 101-03, 405 N.E.2d at 684-86, 428 N.Y.S.2d at 203-04.

96. Id. at 102-03, 405 N.E.2d at 685-86, 428 N.Y.S.2d at 204.

ordering, but also a willingness to relax the statutory attempt to channel private ordering through a prescribed format. Prior to *Zion*, several New York decisions had invalidated arbitration clauses dealing with business policy disputes on this same sterilization ground.⁹⁷ Although these cases are now of doubtful validity, *Zion* was still a 4-3 decision, in which the dissenters would have struck down the provision (under both New York and Delaware law) precisely because the agreement did not comply with the statutory procedures specified by Delaware.⁹⁸ In the wake of *Zion*, the obvious question is how many more procedural shortcomings a court will tolerate in the next case. Suppose only nine out of ten shareholders of a New York corporation approve a provision, so that the unanimity provision in section 620(b) is not satisfied, *and* the provision is not inserted in the corporate charter. Would a New York court give effect to this provision, at least if the tenth shareholder was not unfairly surprised?⁹⁹

For immediate purposes, *Zion* shows a court rethinking old law and reinterpreting it in the light of a new statutory policy to uphold contractual arrangements not technically within the protective shelter of the statute. As such, it is a classic illustration of purposive statutory interpretation that looks beyond the statute's narrow statement to its broader policies. At a minimum, it reveals the extent of the discretion that courts possess even in an area littered with old precedents.

C. Cumulative Voting and Its Evasion

Cumulative voting for the election of directors was first mandated by the Illinois Constitution of 1870.¹⁰⁰ Uniquely, it was an exogenous reform, one pressed less by any recognizable corporate constituency than by political reformers. In Illinois, its adoption was instigated by Joseph Medill, then editor of the Chicago Tribune, who had been much

97. See, e.g., *Glekel v. Gluck*, 37 A.D.2d 1, 321 N.Y.S.2d 956 (1971), rev'd on other grounds, 30 N.Y.2d 93, 281 N.E.2d 171, 330 N.Y.S.2d 371 (1980); cf. *Burkin v. Katz*, 1 N.Y.2d 570, 574, 136 N.E.2d 862, 865, 154 N.Y.S.2d 898, 902 (1956) (removal of director nonarbitrable issue); *Long Park, Inc. v. Trenton-New Brunswick Theatres Co.*, 297 N.Y. 174, 178-79, 77 N.E.2d 633, 634-35 (1948) (contractual delegation of managerial power terminable through arbitration invalid because provision completely sterilized board).

98. 50 N.Y.2d at 108-12, 405 N.E.2d at 689-91, 428 N.Y.S.2d at 207-10 (Gabrielli, J., dissenting in part).

99. The answer already may have been given to this question by *GAF Corp. v. Werner*, 66 N.Y.2d 97, 485 N.E.2d 977, 495 N.Y.S.2d 312 (1985), cert. denied, 475 U.S. 1083 (1986). The *Werner* court found that the Federal Arbitration Act, 9 U.S.C. §§ 1-14 (1982), preempted state law and permitted the use of arbitration even in the case of a publicly held corporation to which section 620(b) is by its terms inapplicable. 66 N.Y.2d at 105, 485 N.E.2d at 982, 495 N.Y.S.2d at 317. Thus, arbitration today seemingly can supersede the derivative suit even in the context of the publicly held corporation.

100. Ill. Const. art. XI, § 3 (1870); *Wolfson v. Avery*, 6 Ill. 2d 78, 83, 126 N.E.2d 701, 705 (1955) (citing constitutional provision).

influenced by the views of John Stuart Mill.¹⁰¹ England, however, has never adopted the reform, apparently in the belief that it would only produce unproductive division on the board.¹⁰² Although a number of states followed Illinois in adding such a mandatory provision to their state constitutions, the recent trend has been for states to repeal this provision and make cumulative voting either optional or a default provision that applies only if a contrary provision is not made.¹⁰³

In theory, cumulative voting assures minority representation and a window into the corporation. In reality, the influence of minority directors can be negated in a number of ways, and some well-known standard strategies for evasion exist. For example, assume a nine-person board and a corporation with 1,000,000 shares outstanding. Mathematically, it can be shown that on these facts any person or group holding 100,001 shares can cumulate votes so as to assure election of one director. But change the board's structure either by reducing it to three directors or, more likely, by classifying the board into three classes of three directors, each serving a staggered three-year term so that only three directors are elected each year, and then 250,001 shares (or 25%) are necessary to assure the election of a single director. Does a charter provision adopted to minimize the ability of minority shareholders to utilize cumulative voting and gain board representation frustrate the policy underlying these constitutional provisions? In short, is such a charter provision against public policy?

To date, courts have split on this question, but the majority have found such a charter provision acceptable. An illustrative case is *Bohannon v. Corporation Commission*.¹⁰⁴ The Arizona Corporation Commission had refused to accept for filing the articles of incorporation of a proposed Arizona corporation that had staggered its board in exactly the fashion described above on the ground that it violated the state constitutional provision. Petitioners sought mandamus to compel the filing and, after losing at the trial court level, were successful in the Arizona Supreme Court. Although the appellate court did not accept the proposition that cumulative voting could be wholly neutralized by a charter provision, it was willing to accept some chilling of the right.¹⁰⁵ The court drew a distinction between a staggered board with three directors in each class and a staggered board with only one director in each class. The latter provision, it said, would be "illegal and void as

101. See W. Cary & M. Eisenberg, *Cases and Materials on Corporations* 260 (5th ed. 1980).

102. See Gower, *Some Contrasts Between British and American Corporations*, 69 *Harv. L. Rev.* 1369, 1390 (1956).

103. For example, Illinois and Pennsylvania have repealed their constitutional provisions. See H. Henn & J. Alexander, *supra* note 55, § 189, at 496 n.21. Moreover, the Model Business Corporation Act no longer mandates cumulative voting but simply makes it an optional provision. *Id.* at n.16.

104. 82 *Ariz.* 299, 313 P.2d 379 (1957).

105. *Id.* at 304, 313 P.2d at 382.

coming within the implied prohibition of the constitution.”¹⁰⁶ The court then added: “[B]ut merely because it is possible to circumvent the constitution by one method of staggering directors does not mean that all schemes or plans to that end are within the implied prohibition.”¹⁰⁷ Plainly, this implies that some evasion or infringement is permissible, as long as it is not too much. How much is too much? *Bohannon* represents the more common judicial response: namely, to find that the policy of cumulative voting was not to assure strict proportional representation, but only some opportunity for minority membership.¹⁰⁸ Possibly, the problem for these courts was that there was no effective way to protect cumulative voting. Even if staggered boards were precluded, one could still reduce the size of the board by other means—for example, by a charter amendment,¹⁰⁹ or by removal of the minority director so elected (if removal without cause were authorized).¹¹⁰ Finally, the desired impact of cumulative voting can be nullified simply by holding informal meetings at which the real corporate business is conducted (without the dissident director) and then using the formal meeting as a purely ceremonial occasion.

In this light, the relatively permissive judicial reaction to these evasive tactics can be interpreted as reflecting a judicial willingness to convert a mandatory rule into an optional default rule because courts sensed that the underlying policy was either obsolete or unworkable. At the least, this is an area in which most courts have been content to ascribe modest and circumscribed policies to legislative enactments and have not invalidated private arrangements simply because they fell within the outer penumbra of those policies.

106. *Id.* at 301, 313 P.2d at 381.

107. *Id.* at 302, 313 P.2d at 381.

108. For similar holdings, see *McDonough v. Copeland Refrigerator Corp.*, 277 F. Supp. 6, 8–9 (E.D. Mich. 1967); *Stockholders Comm. for Better Management of Erie Technological Prods., Inc. v. Erie Technological Prods., Inc.*, 248 F. Supp. 380, 388 (W.D. Pa. 1965); *Humphrys v. Winous Co.*, 165 Ohio St. 45, 59, 133 N.E.2d 780, 789 (1956); *Janney v. Philadelphia Transp. Co.*, 387 Pa. 282, 288, 128 A.2d 76, 80 (1956). But see *Wolfson v. Avery*, 6 Ill. 2d 78, 93–95, 126 N.E.2d 701, 710–11 (1955) (staggered board violates Illinois constitutional provision requiring cumulative voting); *State ex rel. Syphers v. McCune*, 101 S.E.2d 834, 838–39 (W. Va. 1958) (bylaw providing for staggered election of directors vitiates voting and is invalid). The earliest cases also were more restrictive of such charter restrictions on cumulative voting. See *Wright v. Central Cal. Colony Water Co.*, 67 Cal. 532, 536, 8 P. 70, 73 (1885).

109. Reduction in board size for this purpose has been upheld. See *Bond v. Atlantic Terra Cotta*, 137 A.D. 671, 122 N.Y.S. 425 (1910), *aff'd mem.*, 151 A.D. 938, 135 N.Y.S. 1101 (1912), *aff'd mem.*, 210 N.Y. 587, 104 N.E. 1127 (1914).

110. Cases have split on the validity of such a removal. Compare *Campbell v. Loew's Inc.*, 36 Del. Ch. 563, 573, 134 A.2d 852, 858 (1957) (removal valid) with *In re Rogers Imports, Inc.*, 202 Misc. 761, 762, 116 N.Y.S.2d 106, 107 (Sup. Ct. 1952) (removal invalid).

D. The Duty of Loyalty and Exculpatory Provisions

Not surprisingly, exculpatory provisions in the corporate charter that attempt to curtail the duty of loyalty have received a very skeptical reception from courts.¹¹¹ Does this imply that fiduciary duties in their traditional form may not be modified by contract? This seems an overstatement, because some modifications relaxing the duty of loyalty at the margin have been accepted by courts.¹¹² In truth, there have been relatively few decisions dealing with board or shareholder actions that exculpated a fiduciary, probably because most states have codified the duty of loyalty in a manner that substantially relaxes the rigor of the traditional rule.¹¹³

Still, there have been some cases in which courts have insisted on a fiduciary ethic that disallows even reasonable claims by corporate officials against their corporations. The most striking example of such judicial action is *New York Dock Co. v. McCollum*.¹¹⁴ *McCollum* found that the New York Dock Company was not required to indemnify the litigation expenses of several of its directors who had successfully defended a derivative action brought against them.¹¹⁵ Because no bylaw or other contractual provision required indemnification, these directors were forced to argue that principles of agency law required that they be reimbursed.¹¹⁶ The court not only rejected the claim that there was a duty to indemnify, but in an important dictum went on to suggest that, even if there had been a contract, it would not be obliged to enforce it.¹¹⁷ Indemnification, it concluded, should be permitted only if the court determined it to be fair and equitable under the circumstances.¹¹⁸

This dictum, which probably overstated the legal restrictions on the corporate power to indemnify,¹¹⁹ caused the New York Legislature to react by passing the first indemnification statute two years later in

111. See cases discussed *infra* notes 114–26 and accompanying text.

112. See *infra* notes 127–31 and accompanying text.

113. The first statutory codification of the duty of loyalty was passed by the California Legislature in 1931. Most such statutes have softened the traditional fiduciary standard, which required both full disclosure and fairness. See Bulbulia & Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards?*, 53 *Notre Dame Law* 201, 204–07 (1977).

114. 173 Misc. 106, 16 N.Y.S.2d 844 (Sup. Ct. 1939).

115. *Id.* at 110, 16 N.Y.S.2d at 848.

116. *Id.* at 109, 16 N.Y.S.2d at 847. Two years after *McCollum*, a New Jersey court found a duty to indemnify on similar facts. See *Solimine v. Hollander*, 129 N.J. Eq. 264, 273, 19 A.2d 344, 348 (1941); see also *In re E.C. Warner Co.*, 232 Minn. 207, 215, 45 N.W.2d 388, 393 (1950) (recognizing common-law right to indemnification).

117. *McCollum*, 173 Misc. at 108, 16 N.Y.S.2d at 847.

118. *Id.* at 109–11, 16 N.Y.S.2d at 847–49.

119. The New York courts later found that there was corporate power to indemnify successful directors pursuant to a contract. See *Bailey v. Bush Terminal Co.*, 46 N.Y.S.2d 877, 880 (Sup. Ct. 1943), *aff'd mem.*, 267 A.D. 899, 48 N.Y.S.2d 324 (1944), *aff'd mem.*, 293 N.Y. 735, 56 N.E.2d 739 (1944).

1941.¹²⁰ Because all jurisdictions today have such statutes,¹²¹ the issue has become academic whether shareholders could relax fiduciary standards in this area. Still, for present purposes, *McCollum*'s relevance lies in its certainty that private ordering in this area was impossible absent judicial oversight and approval. *McCollum* is arguably a last gasp of the mandatory view, which continued to survive in the core area of fiduciary duties even after the demise of the vested rights doctrine.

Yet, did the common law really say that indemnification must be subject to judicial approval? In fact, cases well before *McCollum* had accepted the principle that shareholders could validly authorize indemnification of legal expenses, at least in the case of successful directors and officers.¹²² While these cases dealt with indemnification of expenses (not actual liabilities) by successful litigants, they show courts prepared in principle to allow private ordering to proceed to this modest degree.

Indemnification provisions are but one possible inroad by which core fiduciary duties of corporate law may be modified. Suppose, instead, that shareholders chose a more direct path than indemnification and adopted an exculpatory charter provision that immunized their directors from fiduciary liability. The net effect could be the same as indemnification, and greater to the extent the provision protected against liabilities as well as expenses. Would a court sustain such a provision? Although a few early English decisions upheld exculpatory provisions covering negligence liability,¹²³ American courts clearly have been hostile to most attempts to exculpate with respect to the duty of loyalty. The clearest decision in this regard is *Irwin v. West End Development Co.*,¹²⁴ which refused to give effect to such a provision where the defendant had in effect paid a secret salary to himself.¹²⁵ "Exculpatory provisions of corporate articles create no license to steal," thundered the court.¹²⁶ Still, *Irwin* was an easy case, to which the law of fraud by itself would have given the same answer.

A considerably grayer case is *Everett v. Phillips*.¹²⁷ There, a provi-

120. See H. Henn & J. Alexander, *supra* note 55, § 379, at 613-14 n.11.

121. *Id.* § 380, at 1121.

122. See, e.g., *Bailey*, 46 N.Y.S.2d at 880; see also *Figge v. Bergenthal*, 130 Wis. 594, 631, 109 N.W. 581, 592 (1906) (upholding indemnification of successful directors, partly on grounds of shareholder authorization). In *Griesse v. Lang*, 37 Ohio App. 553, 175 N.E. 222 (1931), the court rejected indemnification because of the absence of shareholder authorization.

123. See *In re City Equitable Fire Ins. Co.*, [1925] 1 Ch. 407; *In re Brazilian Rubber Plantations & Estates, Ltd.*, [1911] 1 Ch. 425.

124. 342 F. Supp. 687 (D. Colo.), *aff'd* in relevant part, 481 F.2d 34 (10th Cir. 1972), cert. denied, 414 U.S. 1158 (1974).

125. *Irwin*, 342 F. Supp. at 701; see also *Abeles v. Adams Engineering Co.*, 35 N.J. 411, 173 A.2d 246 (1961) (contract between corporation and director without stockholder approval unenforceable unless honest, fair and reasonable).

126. *Irwin*, 342 F. Supp. at 701.

127. 288 N.Y. 227, 43 N.E.2d 18 (1942).

sion very similar to that in *Irwin* had been inserted in the charter of the Empire Power Corporation, which seemed to state that no contract or other transaction would be invalidated on grounds of a conflict of interest.¹²⁸ Empire had invested heavily in the bonds of the Long Island Lighting Company, in which Empire's directors held substantial personal equity interests. Claiming that there was no corporate purpose for this self-dealing investment, a shareholder sued derivatively and obtained a judgment at the trial court level. On appeal, the New York Court of Appeals reversed this judgment, after finding that provisions in a corporation's certificate of incorporation or bylaws "may be factors of great weight."¹²⁹

Why was the charter provision in *Everett v. Phillips* a factor that merited "great weight" while a nearly identical provision in *West End Development* was invalidated as a "license to steal"? Several answers can be given to this question. Fraud was lacking in *Everett* because the transaction was open and visible, no clear corporate injury had resulted from the investment and, as the court stressed, the corporation's charter had clearly indicated a purpose to invest in other utility companies.¹³⁰ The last factor may loom the largest because it suggests that if such transactions are disclosed in reasonable detail in advance, some modest contractual modifications of the duty of loyalty may be tolerable. Later, this Article will argue that *Everett* may be read as a case supporting a "transaction specificity" rule.¹³¹ But, in light of *Everett*, one cannot safely predict that all contractual modifications of the duty of loyalty in a corporate charter will be found invalid.

While the duty of loyalty is at the core of fiduciary duties, the duty of care seems more marginal. Would a court therefore uphold a charter provision that attempted to modify this duty? Without sustained attention, the most frequently cited treatise on corporate law confidently opines that a charter provision eliminating due care liability—but not duty of loyalty liability—would be upheld.¹³² The issue, however, seems more complex. Today, the permissibility of exculpatory charter provisions dealing with liability for negligence has been largely established by statute. Since 1986, when the Delaware legislature authorized charter provisions that eliminate due care liability,¹³³ the vast majority of the states have followed in hot pursuit.¹³⁴

128. Id. at 237, 43 N.E.2d at 22.

129. Id. at 233, 43 N.E.2d at 20, rev'g 22 N.Y.S.2d 852 (1940).

130. Id. at 237, 43 N.E.2d at 22 (charter provision "has the effect of exonerating the directors, at least in part, 'from adverse inferences that might otherwise be drawn.'" (quoting *Spiegel v. Beacon Participations*, 297 Mass. 398, 417, 8 N.E.2d 895, 907 (1937))). In effect, the charter provision seems here to have shifted the burden of proof.

131. For a discussion of the transaction specificity rule, see *infra* notes 206–18 and accompanying text.

132. See 3A W. Fletcher, *supra* note 38, § 1047 (rev. perm. ed. 1986).

133. Del. Code Ann. tit. 8 § 102(b)(7) (1988).

134. See Hanks, *Evaluating Recent State Legislation on Director and Officer Liabil-*

For present purposes, however, the more interesting question involves the status of a charter amendment that reduces or eliminates due care liability in the absence of a statutory provision authorizing the amendment. Earlier this year, the American Law Institute (ALI) adopted a Restatement-like provision in its Corporate Governance Project that authorizes charter amendments that cap an officer's or director's liability for duty of care violations at a level that could be as low as such person's annual compensation from the corporation.¹³⁵ However, the ALI rejected proposals that would authorize complete exculpation by charter amendment. Under the ALI formulation, not only must a minimum liability remain, but the charter provision must not apply to liabilities arising out of recklessness, sustained inattention, illegality or duty of loyalty violations. The doctrinal basis for this compromise was borrowed largely from section 222 of the Restatement (Second) of Trusts,¹³⁶ which permits a trustee to relieve himself by contract of liability for negligence, but not for breaches that were in bad faith, intentional or recklessly indifferent to the interest of the beneficiary.¹³⁷ A fortiori, if a trustee can so exculpate himself, why should not a director, whom the law calls at most a quasi-trustee, also be able to do so?¹³⁸

Clearly, the ALI's position does not regard the duty of care as simply a default rule (because some liability is always retained), but it does permit shareholders to cut back the duty of care to a point where as a practical matter it is largely coextensive with the duty of good faith. Implicitly, then, this position supports the proposition that there are universal mandatory minimum standards to all forms of contracting at least as much as it does the idea of a presumptive power to opt out. While no court has yet tested the ALI's position, the nation's preemi-

ity Limitation and Indemnification, 43 *Bus. Law.* 1207, 1243 (1988) ("Since 1985, more than four-fifths of the states have enacted some form of legislation to protect directors from money damages.").

135. See ALI, *Principles of Corporate Governance: Analysis and Recommendations* § 7.17 (Tent. Draft No. 9, 1989). The author serves as a Reporter to this project and was the principal draftsman of section 7.17. Section 7.17 was preceded by several earlier versions that also authorized charter provisions restricting liability. See, e.g., id. § 7.16(h)(3) (Discussion Draft No. 1, 1985).

136. Restatement (Second) of Trusts § 222(2) (1959).

137. *Id.*

138. Critics of this position might respond that face-to-face bargaining is possible with the trustee, but that problems of collective action hobble the shareholders in public corporations who may not so negotiate. See DeMott, *supra* note 1, at 922-23. This overlooks those cases in which exculpatory provisions have been adopted in trust instruments governing profit-sharing plans, business trusts, condominiums and other entities having numerous participants who could not bargain on such a basis. See, e.g., *Morrissey v. Segal*, 526 F.2d 121, 125 (2d Cir. 1975); *Morrissey v. Curran*, 351 F. Supp. 775, 782 (S.D.N.Y. 1972), *aff'd*, 483 F.2d 480 (2d Cir. 1973), cert. denied, 414 U.S. 1128 (1974); *Collins v. Storer Broadcasting Co.*, 217 Ga. 41, 49-50, 120 S.E.2d 764, 769-70 (1961); *Kelley v. Astor Investors, Inc.*, 123 Ill. App. 3d 593, 598-99, 462 N.E.2d 996, 1000 (1984), *aff'd*, 106 Ill. 2d 505, 478 N.E.2d 1346 (1985).

nent law reform body has accepted in principle the idea that some contractual modifications of traditional fiduciary duties are possible.

E. *The Poison Pill*

The recent judicial experience with poison pills strikingly illustrates the contemporary significance of the debate over contractual innovations that depart from traditional norms of corporate law. Courts have split over whether the "flip-in" poison pill violates a common statutory provision that all shares of the same class or series be treated identically.¹³⁹ For example, section 501(c) of the New York Business Corporation Law provides that, subject to limited exceptions in the charter, "each share shall be equal to every other share of the same class."¹⁴⁰ Because the "flip-in" pill enables all shares of the same class except those held by the bidder to purchase shares at a large discount on the occurrence of certain defined conditions, the pill arguably "discriminates" unlawfully against the shares held by the bidder, who alone cannot buy at a discount. Recently, in *Bank of New York v. Irving Bank*,¹⁴¹ New York joined several other states in invalidating a "flip-in" pill on precisely this ground.¹⁴² Conversely, the Delaware Supreme Court and some other courts have reached the opposite result under similar statutory provisions.¹⁴³ The latter courts have found that the "flip-in" pill is not discriminatory in the sense intended by the statute because the disparity caused by the pill is between shareholders, rather than between shares.¹⁴⁴ Thus, for example, the provision has no further effect once the shares held by the bidder are sold to a third party.

At bottom, the key conflict between the New York and Delaware decisions boils down to their different approaches in interpreting a common statutory provision. The New York decision in *Irving Bank* essentially relied on a "plain meaning" rule approach. Giving section 501(c) a literalistic interpretation and finding that the pill did in fact result in unequal treatment, the court enjoined the pill.¹⁴⁵ No consid-

139. For decisions finding the "flip-in" pill to be impermissibly "discriminatory" on this basis, see *Amalgamated Sugar Co. v. NL Indus.*, 644 F. Supp. 1229, 1234 (S.D.N.Y. 1986), *aff'd*, 825 F.2d 634 (2d Cir.), *cert. denied*, 108 S. Ct. 511 (1987); *Asarco, Inc. v. Court*, 611 F. Supp. 468, 477 (D.N.J. 1985). But cf. *Harvard Indus. v. Tyson* [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,064, at 95,294 (E.D. Mich. Nov. 25, 1986) (rejecting notion that poison pill discriminates among shares in same class).

140. N.Y. Bus. Corp. Law § 501(c) (McKinney 1983 & Supp. 1988). For a New York precedent insisting on strict equality among shares of the same class, see *Fe Bland v. Two Trees Mgmt. Co.*, 66 N.Y.2d 556, 489 N.E.2d 223, 498 N.Y.S.2d 336 (1985).

141. 142 Misc. 2d 145, 536 N.Y.S.2d 923 (Sup. Ct. 1988).

142. *Id.* at 148, 536 N.Y.S.2d at 925.

143. *Moran v. Household Int'l*, 500 A.2d 1346, 1346 (Del. 1985); *Harvard Indus.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,294.

144. See, e.g., *Harvard Indus.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,294.

145. *Irving*, 142 Misc. 2d at 150, 536 N.Y.S.2d at 926.

eration was given to whether the disparity in treatment could ever be reasonably related to a legislative purpose underlying the statute. In contrast, the Delaware approach in *Moran v. Household International*¹⁴⁶ was more policy sensitive. Asking whether the pill benefits shareholders, the Delaware Supreme Court appears to have answered: it all depends.¹⁴⁷ Thus, the Delaware courts have framed a more subtle standard that looks both to the circumstances at the time of the pill's adoption and those surrounding its later use to determine if the board's action was "reasonable in relation to the threat posed."¹⁴⁸ This proportionality test implies continuing judicial oversight and once again imports into the corporate contract an additional term: namely, that the powers given to management by the charter be used to promote shareholder interests. In this light, fiduciary restraints constitute not prophylactic prohibitions, but side constraints that limit otherwise open-ended or overbroad contractual provisions. As recent Delaware decisions have shown, the Delaware courts will at some point require that a pill be redeemed.¹⁴⁹

The poison pill provides a paradigm of a novel contractual provision that can arguably be used either to maximize shareholder wealth or to entrench existing management—depending on how it is used. In such a setting, the choice between a plain meaning approach (as New York adopted) or a proportionality test (as Delaware follows) will usually determine the permissibility of the provision.

II. GOOD FAITH AND FIDUCIARY STANDARDS COMPARED

To what extent does the duty of good faith imposed by contract law differ from the duty of loyalty imposed by fiduciary law? Suppose one were to start with a devil's advocate assertion that the core fiduciary duties of corporate law are essentially context-specific applications of contract law's duty of good faith—applications that, to be sure, are the product of much institutional learning and refinement, but still reflect the same basic moral attitudes that apply to general commercial dealing. This assertion quickly encounters a problem: the two bodies of law originated from very different sources, with fiduciary law developing in equity courts and contract doctrines in common-law courts.¹⁵⁰ Still, the significance of this point is open to question. Their differing origins may only make more important their fundamental convergence on some critical questions.

Comparing the two doctrines, one notes immediately several areas of convergence. First, the duty of good faith is clearly a universal and

146. 500 A.2d 1346.

147. See *id.* at 1357.

148. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

149. See *Grand Metro. PLC v. Pillsbury Co.*, 558 A.2d 1049, 1055 (Del. Ch. 1988); *City Capital Assocs. v. Interco Inc.*, 551 A.2d 787, 798 (Del. Ch. 1988).

150. See DeMott, *supra* note 1, at 880–85.

mandatory feature of contract law.¹⁵¹ For example, section 205 of the Restatement (Second) of Contracts states that every contract imposes an obligation of good faith and fair dealing on the parties.¹⁵² Similarly, section 1-203 of the Uniform Commercial Code (U.C.C.) contains a similar provision.¹⁵³ Other, more specific obligations to act in good faith are scattered throughout the U.C.C.¹⁵⁴ Indeed, at least one commentator has concluded that the U.C.C. was deliberately phrased in "open-ended" language in order to encourage courts to interpret its provisions in the "grand style."¹⁵⁵ Second, neither the duty of good faith nor fiduciary duty can be negated by a contractual waiver.¹⁵⁶ Third, neither duty's substantive content is wholly determinable at the time of contracting. Much like fiduciary duty, the duty of good faith is shaped and affected by postcontracting developments.¹⁵⁷ In these three respects—universality, nonwaivability, and survival and evolution throughout the life of the contractual relationship—the duty of good faith at least roughly parallels fiduciary duty.

But what does "good faith" mean? In U.C.C. section 2-103(1)(b), good faith is defined (at least for merchants in sales transactions) to mean "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."¹⁵⁸ This emphasis on reasonable standards seems to state an objective standard, which approximates the duty of care. Similar expressions appear in the case law antedating the U.C.C.¹⁵⁹ Still, as with other seminal terms in the law, it may be easier to define "bad faith" than "good faith." Professor Summers observes that good faith is essentially "an 'excluder' . . . a phrase without general meaning (or meanings) of its own [that] serves to exclude a wide range of heterogeneous forms of bad faith."¹⁶⁰ He then identifies six categories of "bad faith" in contract performance: evasion of the spirit of the deal, lack of diligence and slacking off, willfully rendering only "sub-

151. See Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 Harv. L. Rev. 369, 371 (1980) (citing cases).

152. Restatement (Second) of Contracts § 205 (1979).

153. U.C.C. § 1-203 (1988).

154. *Id.* §§ 2-209 official comment 2, 2-306(2), 2-609 official comment 3.

155. Barnes, *Toward a Normative Framework for the Uniform Commercial Code*, 62 Temple L. Rev. 117, 122-23 (1989).

156. See Burton, *supra* note 151, at 371.

157. See DeMott, *supra* note 1, at 893. Under the U.C.C., "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." U.C.C. § 1-203. This emphasis on a continuing duty during the performance of the contract parallels the continuing obligations imposed by fiduciary duties.

158. U.C.C. § 2-103(1)(b).

159. See *Pillois v. Billingsley*, 179 F.2d 205, 207 (2d Cir. 1950); *M. O'Neil Supply Co. v. Petroleum Heat & Power Co.*, 280 N.Y. 50, 54, 19 N.E.2d 676, 678 (1939); *Wigand v. Bachmann-Bechtel Brewing Co.*, 222 N.Y. 272, 277, 118 N.E. 618, 619 (1918).

160. Summers, "Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code, 54 Va. L. Rev. 195, 201 (1968).

stantial" performance, abuse of a power to specify terms, abuse of a power to determine compliance and interference with or failure to cooperate in the other party's performance.¹⁶¹ These examples cover much of the waterfront of fiduciary duties and in particular suggest that "good faith" includes some of the duty of care as well as that of loyalty.¹⁶²

Other contract theorists have developed a more unified theory of good faith performance, under which its central role arises in contractual arrangements in which one party is accorded substantial discretion to specify certain terms in the contract.¹⁶³ In such a contract, the duty of good faith constrains the discretion-exercising party and protects the other dependent party by preventing the first party from recapturing opportunities forgone upon entering the contract. Of course, this is exactly the position of management, upon whom the corporate charter typically delegates vast discretion and on whom fiduciary law essentially imposes the obligation to use that discretion only for shareholder wealth-maximizing purposes.¹⁶⁴ In this light, Professor DeMott has shown that some well-known corporate fiduciary cases involving a duty to warn could have been equally well decided under the rubric of good faith.¹⁶⁵

The duty of good faith has been used by courts in some corporate cases in which a traditional fiduciary relationship did not exist in order to reach an equivalent result.¹⁶⁶ For example, in *Pittsburgh Terminal*

161. Id. at 232-43.

162. For example, lack of diligence or slacking off is in substance a duty of care violation.

163. For example, in a typical requirements or output contract one party determines the quantity to be sold or purchased, but is subject to a duty of good faith in so doing. See Burton, *supra* note 151, at 380-81.

164. For example, hornbook fiduciary law does not allow directors to compete with their companies. R. Clark, *Corporate Law* 223 (1986). The opportunity to compete can be seen as one that was forgone upon acceptance of a fiduciary position; the duty of good faith under Professor Burton's analysis would not permit this opportunity to be recaptured. Burton, *supra* note 151, at 403.

165. See DeMott, *supra* note 1, at 893. For example, she points out that in one famous case, two corporations shared a common director who was also the controlling stockholder of one of them. See *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 224 N.Y. 483, 485, 121 N.E. 378, 378 (1918). The director negotiated a requirements contract on behalf of his controlled corporation with the other corporation, knowing that its terms gave the former an unfair advantage. See id. at 486-88, 121 N.E. at 378-79. Further, he encouraged the directors of the other company to approve the contract, although he himself abstained. See id. at 487-88, 121 N.E. at 379. As Professor DeMott points out, the injured corporation was essentially exploited by the director's failure to disclose his intention to increase substantially the operation of his mill, thereby expanding its requirements. This easily could have constituted bad faith under the conventional contract law applicable to requirements contracts. See DeMott, *supra* note 1, at 898-99.

166. The prevailing rule in corporate law is that directors do not owe a fiduciary duty to bondholders. See, e.g., *Simons v. Cogan*, 542 A.2d 785, 788 (Del. Ch. 1987), *aff'd*, 549 A.2d 300 (Del. 1988). In the Delaware case that most clearly articulated this rule, the Delaware Supreme Court found that, even if no fiduciary duty was owed, the

Corp. v. Baltimore & Ohio Railroad,¹⁶⁷ the Third Circuit held that an issuer that failed to provide effective notice of a restructuring to holders of its convertible debentures violated the implied covenant of good faith and fair dealing. The corporation, it said, "[a]s a matter of New York contract law, . . . had a duty to speak."¹⁶⁸ This duty to speak is probably not as broad as its classic formulation in fiduciary cases,¹⁶⁹ and there is some evidence that it will be read relatively narrowly in the public corporation context.¹⁷⁰ Still, the area of their overlap seems substantial.

What then are the differences between the two duties? Professor Eisenberg in substance argues that fiduciary duty protects the shareholder's "fair expectations," while good faith focuses more narrowly on the shareholder's contractual rights.¹⁷¹ In the limited context of close corporations that he is discussing, this seems an overstatement both because there are at least some decisions that seem to have considered the shareholder's reasonable expectations to be part of the contractual bargain,¹⁷² and because the source of this "fair expectations" principle

conduct alleged to have been a fiduciary breach might still have been fraudulent, and so it reversed the lower court's dismissal of the action. See *Harff v. Kerkorian*, 347 A.2d 133, 134 (Del. 1975), rev'g 324 A.2d 215 (Del. Ch. 1974). The message appears to be that the duty of good faith will sometimes overlap with fiduciary duties.

167. 680 F.2d 933 (3d Cir.), cert. denied, 459 U.S. 1056 (1982).

168. *Id.* at 941; see also *Van Gemert v. Boeing Co.*, 553 F.2d 812, 814 (2d Cir. 1977) (contractual obligation to debenture holders breached by failure to provide adequate notice of calling of debenture).

169. Under prevailing contract law principles, an obligation may be implied only "in aid and furtherance of other terms of the agreement of the parties." *Sabetay v. Sterling Drug, Inc.*, 69 N.Y.2d 329, 335, 506 N.E.2d 919, 922, 514 N.Y.S.2d 209, 212 (1987). Thus, a duty cannot easily be implied where it would contradict other express terms in the charter, and another term in the charter that the implied term aided or furthered would need to be identified.

170. The Second Circuit has applied the parol evidence rule strictly in interpreting a bond indenture's provision because of the need it perceived for uniformity and certainty in the securities markets concerning the meaning of standard terms. See *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1048 (2d Cir. 1982), cert. denied, 460 U.S. 1012 (1983). This rule, however, seems likely to be applied strictly on these grounds only in the case of a publicly traded company. Thus, because fiduciary duties are usually applied more strictly in the close corporation setting, there is again a parallel between fiduciary duty and the duty of good faith in the similarly varying standards that they apply to public and close corporations. See *Donahue v. Rodd Electrotypes Co.*, 367 Mass. 578, 592-97, 328 N.E.2d 505, 515-17 (1975) ("Stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with [a] strict good faith standard.").

171. Eisenberg, *supra* note 1, at 1468.

172. See *In re Topper*, 107 Misc. 2d 25, 34, 433 N.Y.S.2d 359, 365 (Sup. Ct. 1980) ("These reasonable expectations constitute the bargain of the parties in light of which subsequent conduct must be appraised."). Dissolution cases in New York have also emphasized that an objective standard must be used in determining the shareholder's reasonable expectations. See, e.g., *In re Kemp & Beatley, Inc.*, 64 N.Y.2d 63, 73, 473 N.E.2d 1173, 1179, 484 N.Y.S.2d 799, 805 (1984). In addition, some cases have ruled that only expectations communicated or known to the other side may be relied upon.

is in any event primarily statutory.¹⁷³ Arguably, these cases are best read as evidence that all duties—whether contractual or fiduciary in nature—will be interpreted more expansively in the close corporation or partnership context than in a case involving a simple sale of fungible goods. Nonetheless, it remains true that in the public-corporation context some courts have viewed the duty of good faith restrictively and refused to go beyond the express terms of the contract, even if reasonable expectations seemed to have been frustrated.¹⁷⁴ Thus, while it might be hoped that courts would give a fuller content to the duty of good faith in leveraged buyouts and similar transactions that injure bondholders, a positive account must recognize that both broad and narrow readings have been given to the duty in this context.¹⁷⁵ At present, the law on the meaning of good faith in the bond covenant context is unsettled, but there is at least reason to believe that some bondholders' expectations, recognizable to most objective observers, will not be protected.¹⁷⁶

Overshadowing all these contextual differences, however, is the

See, e.g., *Meiselman v. Meiselman*, 309 N.C. 279, 298, 307 S.E.2d 551, 563 (1983). By emphasizing an objective standard known to the other side, these cases appear to mimic the standards of contract law in order to avoid a subjective body of law.

173. Some 37 states now have an oppression statute, which authorizes dissolution or other relief if the minority shareholder's reasonable expectations are frustrated. Thompson, *Corporate Dissolution and Shareholders' Reasonable Expectations*, 66 Wash. U.L.Q. 193, 206 n.57 (1988). Professor Eisenberg cites the well-known *Meiselman* case as an illustration of differing fiduciary and contractual standards. See Eisenberg, *supra* note 1, at 1468 (citing *Meiselman*, 309 N.C. 279, 307 S.E.2d 551). Yet, as he acknowledges, a North Carolina statute broadly authorizes liquidation when "'reasonably necessary for the protection of the rights or interests of [a] complaining shareholder.'" *Id.* (citing N.C. Gen. Stat. § 55-125(a)(4) (1982)). Thus, it is a false parallel to contrast the narrower standards of contract law with the broader remedies of fiduciary law, when in fact the broader remedy is statutory.

174. See, e.g., *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 957-58 (5th Cir.) (en banc) (postmerger rights of convertible debenture holders limited to express terms of indenture), cert. denied, 451 U.S. 965 (1981); *Gardner & Florence Call Cowles Found. v. Empire Inc.*, 589 F. Supp. 669, 673 (S.D.N.Y. 1984) (rights of debenture holders grounded in clear meaning of indenture), vacated on other grounds, 754 F.2d 478, 480-82 (2d Cir. 1985). But see *Van Gemert v. Boeing Co.*, 520 F.2d 1373, 1383-84 (2d Cir.) (due notice of redemption required to protect reasonable expectations of debenture holders), cert. denied, 423 U.S. 947 (1975).

175. For a discussion of these two rival traditions in interpreting the implied rights of bondholders, see Bratton, *supra* note 39, at 148-49 ("burden of specificity [should be] on the party who seeks to disrupt settled expectations"); see also Bratton, *The Economics and Jurisprudence of Convertible Bonds*, 1984 Wis. L. Rev. 667, 684, 692.

176. Leveraged buyouts, most notably the one undertaken by RJR-Nabisco in 1987, have had a dramatically adverse effect on bondholders, who have in several recent instances brought suit on the theory that a duty of good faith owed them was breached. These cases remain pending at this point. See *Logan & Lamb, Pending Bondholder Suits Could Have Broad Ramifications*, N.Y.L.J., June 5, 1989, at 37, col. 4. In contractual terms, it can be argued that in these cases there was an "omission" in the bondholders' contract because neither side anticipated the possibility of leveraged buyouts at the time the debt was issued. See *supra* note 15.

major dispute separating contractarians from proponents of fiduciary analysis. Put simply, fiduciary law is deeply intertwined with notions of morality and the desire to preserve a traditional form of relationship. One side believes deeply in the moral tradition of the fiduciary relationship, while the other is equally convinced of the justice of its libertarian position that the parties should be the sovereign masters of their own relationship.

What is there then in traditional fiduciary law from which rational parties might wish to deviate? The traditional fiduciary ethic insists that the fiduciary act selflessly.¹⁷⁷ At bottom, the anticontractarians believe not only that beneficiaries desire such a relationship, but that a public morality requires its preservation. Two visions of society here collide: the individualistic, wealth-maximizing view of the economist and the communitarian ethic of the moralist. In contract law, a discretion-exercising party may often act in a self-interested fashion. Good faith and self-interested behavior are not mutually exclusive. Conversely, fiduciary duty's requirement of undivided loyalty permits the fiduciary to consider only the beneficiary's interests. Any unauthorized profit received by the fiduciary must be surrendered to the beneficiary, even if the receipt in no way harms the beneficiary.¹⁷⁸ In Judge Cardozo's famous statement, the fiduciary is "held to something stricter than the morals of the market-place" and must instead abide by "the punctilio of an honor the most sensitive."¹⁷⁹

This central conceptual difference, that a contracting party may seek to advance his own interests in good faith while a fiduciary may not, also helps explain a number of procedural differences between the two duties. For example, the burden is on the fiduciary to prove the fairness of any transaction engaged in with the trust estate, while in a contract case the plaintiff bears the burden of proving that the other contracting party did not act in good faith.¹⁸⁰ Similarly, a party who breaches a duty of good faith is liable for damages that are essentially measured by the victim's losses, while fiduciaries are often liable for the victim's losses plus their own gains, if greater.¹⁸¹

177. For a classic statement of this ethic, see *Bayer v. Beran*, 49 N.Y.S.2d 2, 5 (1944) ("The fiduciary must subordinate his individual and private interests to his duty . . . whenever the two conflict."). If this means that the fiduciary can never consider his own costs, *reductio ad absurdum* results can follow easily. Fiduciary law also has been inherently prophylactic, while contract law has not. See *Rice v. Davis*, 136 Pa. 439, 443, 20 A. 513, 514 (1890) ("The rule is not intended to be remedial of actual wrong, but preventive of the possibility of it.").

178. See *Mosser v. Darrow*, 341 U.S. 267, 272-73 (1951) (holding trustee liable for gains realized by several employees through trading in bonds of the bankrupt firm, even though no actual harm resulted from their activities).

179. *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).

180. See Restatement (Second) of Contracts § 360 comment b (1981). For a discussion of this point, see DeMott, *supra* note 1, at 900.

181. See ALI, Principles of Corporate Governance: Analysis and Recommendations § 7.16 (Tent. Draft No. 9, 1989).

Incomplete as this descriptive account of the differences between the duty of good faith and fiduciary duty undoubtedly is, it is sufficient to frame the central policy question: should the mandatory minimum in corporate law be set at or near the level of the duty of good faith with the fuller, more selfless requirements of traditional fiduciary duty being treated as default rules? Under such a structure, corporate law would by no means be wholly enabling, but some opting out by contractual provision would be permissible. In effect, the zone between the duty of good faith and the higher fiduciary standard of selflessness would become negotiable.

At first glance, such a proposal seems to force one to choose between the perspectives of the economist and the moralist. But this is an oversimplification. One can accept the proposition that morality should play a role in commercial life and still object that traditional fiduciary duties represent, at least in some respects, the wrong morality—one geared to the preindustrial, hierarchical society in which they developed, but not the entrepreneurial and egalitarian society of the late twentieth century. It is not accidental that fiduciary law refers to the employee-agent as the “servant” and the employer-principal as the “master.” What is questionable, however, is whether contemporary law wishes to maintain this hierarchical distinction in a changed and changing business environment.¹⁸²

The normative case for a limited right to “opt out” of some aspects of fiduciary duty can be defended on two grounds. First, the corporation is very dissimilar from the other relationships in which fiduciary law provides the operative and mandatory legal standards. Unlike the relationships between trustee and beneficiary or guardian and ward, the corporation is a long-term entrepreneurial relationship among economic actors whom society wishes to encourage to accept risk. As a relational contract, it is also understood that many of its terms will be modified over its duration. Even more importantly, the modern manager has no realistic alternative but to accept employment within the corporate form of business organization. Because there is no other feasible vehicle for conducting business activity on a sizable scale, the manager is locked into a legal relationship that, at least in theory, cannot be modified. This contrasts with the numerous alternatives to the trust device. For example, an investment manager need not become a trustee for his clients, but can enter into an advisory contract. As a result, by imposing the fiduciary label on corporate managers, we may require an involuntary level of selflessness, at least if we take the concept of fiduciary duty seriously. All this leads to a fundamental point:

182. I have elsewhere criticized the overbreadth of fiduciary duties in the context of rights in information as potentially chilling employee mobility. See Coffee, HUSH!: The Criminal Status of Confidential Information After *McNally* and *Carpenter* and the Enduring Problem of Overcriminalization, 26 Amer. Crim. L. Rev. 121 (1988).

the manager should have a limited but legitimate right to act self-interestedly in some contexts, most notably with respect to corporate control.¹⁸³

Second, shareholders, who are typically diversified, are arguably less exposed to loss than managers, who are largely undiversified and have substantial equity exposed to firm-specific risk.¹⁸⁴ Indeed, it is at least debatable whether the relationship between arbitrageurs, or other short-term speculative holders buying in the secondary market, and corporate managements should be viewed as even resembling the classic form of fiduciary relationship in which one side clearly reposes its trust and confidence in the other. Compared to other legal relationships that are not generally considered to be fiduciary in character and thus are policed by the duty of good faith, the stockholder-manager relationship in the modern public corporation does not at first blush clearly justify more exacting standards of performance. For example, the relationship between a requirements purchaser and its supplier, or between an output seller and its customer, can be one in which the party accorded discretion over the quantity term possesses at least as much power as the corporate manager; the dependent party is at least as vulnerable as the shareholder in the manager-shareholder relationship. In fact, the dependent party in such a requirements or output contract is far less likely to be diversified than the modern shareholder, who is rapidly becoming an institutional investor. Much the same point can be made about the relationship between franchisers and franchisees and a variety of other specialized relationships. Yet, all these relationships are primarily governed by the duty of good faith.

To be sure, the claim that opportunism today is at least potentially bilateral, with shareholders able to breach implicit contracts with management,¹⁸⁵ should not be used to free managers from their obligations to make full disclosure or deal fairly with their corporations. However, the duty of good faith can enforce these obligations. The real issue is whether the law must always seek to do more and always force manag-

183. This point was earlier made by Professor William Klein. See Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 *Yale L.J.* 1521, 1543 (1982). More recently, economists have begun to model corporate governance from the premise that the manager has a legitimate interest in control. See Grossman & Hart, *One Share-One Vote and the Market for Corporate Control*, 20 *J. Fin. Econ.* 175, 176-77 (1988).

184. See Demsetz & Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 *J. Pol. Econ.* 1155, 1159 (1985).

185. For the argument that takeovers can breach implicit contracts by which managers were promised deferred compensation and a "settling up" adjustment, see Knoeber, *Golden Parachutes, Shark Repellents and Hostile Tender Offers*, 76 *Am. Econ. Rev.* 155, 159-61 (1986). I have surveyed this theme elsewhere. See Coffee, *Shareholders Versus Managers: The Strain in the Corporation Web*, 85 *Mich. L. Rev.* 1, 23-24, 73-81 (1986).

ers to subordinate their self-interest to the interests of their shareholders.

Three examples will help illustrate my concerns about the overbreadth of traditional fiduciary ideology. First, consider the position of a CEO of a major corporation who believes his corporation will soon be the target of a takeover. The CEO can, of course, remain passive and accept the takeover, or he can resist, on the ground that he is protecting shareholders from coercion. But can the CEO make his own preemptive leveraged buyout proposal? To be sure, this happens all the time, but is it really consistent with the classic fiduciary ethic under which the fiduciary must not act out of self-interest and should not profit? Only with considerable conceptual strain can the fiduciary's evident self-interest be rationalized. A strict adherence to fiduciary theory might require that the CEO not make his own buyout proposal, but instead propose a financial restructuring or corporate self-tender that would produce precisely the same recapitalized financial structure, without receiving any additional equity. In fact, in the aftermath of the 1988 leveraged buyout proposal by the senior management of RJR-Nabisco, many have questioned whether such transactions are consistent with fiduciary duties. Arguably, managers who perceive a better way to run the firm should be obligated to share their recommendations with the board, not propose to buy the firm in order to profit by putting their ideas into operation.

The problem with insisting on such selflessness in this context, however, is that it ignores the inevitable relationship of risk and return. Restructurings and buyouts necessarily involve a heightened risk of bankruptcy. Diversified shareholders can view the risk with relative equanimity, but undiversified managers, who may have substantial firm-specific human capital invested in the firm, cannot. Thus, heightened risk necessitates a heightened return, or the managerial labor market is thrown into disequilibrium. Moreover, the cost of fiduciary ideology here can be high because, unless the gains from higher leverage can be shared with management, management will predictably not propose such transactions for the corporation on any terms. In this context, if the gains cannot be shared with managers, there often will be no gains.

Second, consider the classic corporate opportunity doctrine. Traditionally, it requires the fiduciary to turn over to the firm certain business opportunities that come to the fiduciary, at least if they fall within an ill-defined zone in which the firm is said to have an "expectancy."¹⁸⁶ Suppose a group of individuals wishes to form a corporation to exploit oil and gas properties within a given region. Assume that one of its

186. See *Miller v. Miller*, 301 Minn. 207, 224-25, 222 N.W.2d 71, 81 (1974) (adopting two-step approach that finds the corporation to have an expectancy in those business opportunities within its "line of business"). For a critique of the confusion inherent in *Miller's* elaborate approach, see Brudney & Clark, *A New Look at Corporate Opportunities*, 94 Harv. L. Rev. 998, 1012-16 (1981).

members, who has unique expertise, will join this venture only if the corporate charter provides that he may continue to exploit business opportunities coming to him in the same area. Should such a charter provision be enforceable when otherwise a given business opportunity presented to him would be deemed by a court to belong to the corporation because of his fiduciary status?¹⁸⁷ If classic fiduciary theory controls, the provision would seem unenforceable. But should that theory control? A selfless theory of fiduciary obligation may simply drive this director off the board.

How different would a good faith standard be? Under a good faith standard, as implemented by a charter provision, corporate officials would still be required to disclose any opportunity that came to them in an official capacity, but opportunities encountered within a personal sphere of behavior would not be similarly regulated. To be sure, there is a cost here because it is difficult to monitor how opportunities are discovered, but a properly drafted charter provision could require disclosure to the board of any opportunity so pursued.

A final example begins with a recent Seventh Circuit decision, written by Judge Easterbrook, concerning the disclosure obligation that a corporation incurs as a matter of fiduciary law in repurchasing its shares from an employee. In *Jordan v. Duff & Phelps, Inc.*,¹⁸⁸ the corporation was entitled, pursuant to a shareholders' agreement, to repurchase the shares of a retiring employee.¹⁸⁹ But was it obligated to disclose to such employee the fact that it was about to enter into a merger at a high premium (with the possible result that he might not then retire)? The Seventh Circuit said yes, based on fiduciary duties that it found the corporation owed to the employee.¹⁹⁰ As a result, the decision has posed a significant practical problem for the bar: does a corporation that reserves the right to buy back its stock under these circumstances surrender its control over the timing of its disclosures? For a corporation with hundreds of such shareholder-employees, an obligation to disclose before repurchasing shares from retiring or de-

187. Cases have divided as to whether such an opportunity presented to a director in his "individual" capacity is a corporate opportunity that must be turned over to the corporation. The prevailing view seems to be that the opportunity must be turned over if it is closely associated with an existing or prospective activity of the corporation. See *Goodman v. Perpetual Bldg. Ass'n*, 320 F. Supp. 20, 37 (D.D.C. 1970); *Rosenblum v. Judson Eng'g Corp.*, 99 N.H. 267, 271-72, 109 A.2d 558, 562-63 (1954); Note, Corporate Opportunity, 74 Harv. L. Rev. 765 (1961). *Judson Engineering* is the prevailing rule today. But see *Weiss v. Kay Jewelry Stores, Inc.*, 470 F.2d 1259, 1270-71 (D.C. Cir. 1972); *Austrian v. Williams*, 103 F. Supp. 64, 79 (S.D.N.Y.), rev'd on other grounds, 198 F.2d 697 (2d Cir.), cert. denied, 344 U.S. 909 (1952).

I agree that *Judson Engineering* provides the optimal default rule, but I would permit some contracting out from it. See *infra* notes 215-18 and accompanying text.

188. 815 F.2d 429 (7th Cir. 1987), cert. dismissed, 108 S. Ct. 1067 (1988). For a critique of this decision, see DeMott, *supra* note 1, at 916-21.

189. See *id.* at 432.

190. See *id.* at 435.

parting employees would eventually force it to reveal important pending developments prematurely in a manner that could injure it. Accordingly, law firms have already drawn up waiver agreements under which the employees waive their right to full disclosure at the time of repurchase.¹⁹¹ But if the disclosure provision is a matter of fiduciary obligation, can the fiduciary ask the beneficiary to waive its right to full disclosure? Would this not constitute another example of impermissible opting out? In all likelihood, courts will uphold such waivers, because the legitimacy of the corporation's need to control disclosure timing seems clear, and such agreements do not appear to be opportunistic attempts to overreach the employee.¹⁹² Yet, in so doing, courts would be essentially equating the duty of good faith and fiduciary duty in this context.¹⁹³

These examples have been intended to suggest that strong utilitarian and even plausible moral justifications support some modifications of traditional fiduciary duties. Counterarguments are, of course, foreseeable. Some may argue that greater tolerance would produce commercial uncertainty, that it would burden the courts, that few innovations have real utility and that skilled draftsmen can avoid most mandatory rules anyway. On a political level, the claim can also be made that arguments for relaxation should be addressed to the legislature, which certainly has responded with alacrity to the corporate lobby's pleas for assistance with respect to other recent issues of corporate governance.¹⁹⁴ Although these arguments have some merit, they

191. See Wander, Pallesen & Kunetka, *Shareholder Agreements: A Disclosure Trap for the Unwary?*, *Insights*, June 1989, at 13-14 (setting forth model waiver provision).

192. Judge Easterbrook is clear that he believes there can be a contractual waiver of the new fiduciary duty he creates. See *Jordan*, 815 F.2d at 436 ("We may assume that duties concerning the timing of disclosure by an otherwise-silent firm also may be the subject of contract."). Also, Illinois law provides that a shareholders' agreement will be upheld unless contrary to public policy. See *Galler v. Galler*, 32 Ill. 2d 16, 22-27, 203 N.E.2d 577, 581-83 (1965) (agreements should be invalidated on grounds of public policy only when court finds clear statutory conflict, fraud or corrupt or dangerous tendencies evident on face of agreement).

193. A fair reading of *Jordan* is that Judge Easterbrook simply found an implied term in the relationship that the stock would not be bought back in an opportunistic fashion. It seems highly doubtful that he intended to attach the full consequences of traditional fiduciary duty to this employer-employee relationship.

194. For example, the vast majority of the states have now enacted legislation authorizing charter provisions that exculpate directors from due-care liability. See, e.g., Del. Code Ann., tit. 8 § 102(b)(7) (Supp. 1988); N.J. Rev. Stat. § 14A:2-7(3) (Supp. 1989). Virtually all of these statutes were passed since the 1985 decision in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). See Hanks, *supra* note 134, at 1209. Such alacrity certainly suggests that political reform of outdated corporate law is possible. Yet the argument that corporations can seek relief from the legislature fails to recognize that lobbying pressure typically develops only for "reforms" numerous corporations want. A true innovation almost by definition will be unable to attract broad political support because there will be no demand for it until experience with it develops.

are really responses to the broader claim that corporate law should be wholly enabling. The freedom here contemplated is marginal and bounded by a duty of good faith and by a requirement of transaction specificity¹⁹⁵ that would leave the law applicable to most traditional self-dealing transactions unchanged. As others have stressed, the duty of good faith reduces the costs of contracting, including the costs of investigating one's prospective partners, negotiating the transaction and bearing risk with respect to the future.¹⁹⁶

At best, calling officers and directors fiduciaries only begins the analysis and sometimes clouds it, unless we focus clearly on the end to be achieved. As observed earlier, the problem with an unqualified hypothetical bargaining approach to the issue of contractual freedom is that it can result in distributive unfairness, even as it achieves allocational efficiency, because provisions that maximize aggregate value can still result in an unanticipated loss for some. Here, the irony must be confronted that an unthinking loyalty to fiduciary ideology can sometimes have the same impact. In particular, corporate control transactions have the potential to visit losses on some, even as they maximize value on an aggregate basis. Thus, if we believe that distributive fairness should remain a constraint on the pursuit of efficiency in one context, consistency requires that it similarly justify charter provisions that conflict with classic fiduciary theory—at least if there is a coherent case that such provisions intend to achieve a “fair” allocation of gains and losses. Properly interpreted, the duty of good faith could largely capture this concept.

III. STANDARDS FOR OPTING OUT

What would a rule look like that permitted contractual innovations that departed from the traditional norms of corporate governance? For committed partisans on both sides of this issue, the answer is easy. The thoroughgoing contractarian would enforce any provision adopted by shareholders, except possibly those adopted under circumstances involving fraud or coercion, while the anticontractarian would tolerate only the most modest deviations from corporate housekeeping rules. But, for those willing to consider an intermediate position, the following proposed “black-letter” rule provides an exploratory vehicle by which to examine possible trade-offs between the desire to permit innovation and the fear of opportunism:

A court should uphold and give effect to a contractual provision that would otherwise be deemed invalid as in conflict with the corporate law of the jurisdiction if and only if:

(1) *the provision does not*

(A) *reduce or restrict the obligation of persons occupying*

195. See *infra* notes 206–18 and accompanying text.

196. See Burton, *supra* note 151, at 393.

- a fiduciary relationship to the corporation to deal fairly and act in good faith; or*
- (B) *conflict with the clear purpose of any statutory provision or with an established public policy intended to protect persons or interests other than shareholders;*
- (2) *either the provision*
- (A) *is sufficiently specific and limited in its application that the parties reasonably could appreciate its likely impact at the time they approved it; or*
 - (B) *amounts to the substitution of an adequate alternative procedure that the parties reasonably could believe would better serve their interests; and*
- (3) *if the provision was adopted by a charter amendment, it was approved by a disinterested majority of the shareholders under circumstances where a rejection of the amendment would not cause them to be worse off than they were prior to the proposal of the amendment.*

In effect, there are five basic limitations stated in this attempted "black-letter" rule: (1) the contractual provision may not reduce the fiduciary's obligations below the level that the duty of good faith would require; (2) the provision must not conflict with the "plain meaning" of any statute; (3) it must have sufficient specificity to permit the parties to "price" the difference between the provision and the normally applicable legal rule; (4) if the provision substitutes a remedy, it must amount to an adequate substitute, rather than simply a waiver; and (5) in the case of a charter amendment, the provision must receive disinterested shareholder approval under circumstances that were not coercive. Each of these proposed elements will be briefly examined.

A. *The Duty of Good Faith*

As previously emphasized, contractual freedom logically can mean no more than the freedom to contract to the extent permitted by the law of contracts. Thus, it follows that no exculpatory provision or other provision should be tolerated that abridges the duty of good faith. Because the U.C.C. defines the duty of good faith to include a duty of fair dealing, a tolerance for innovation does not mean that an officer or director could enter into transactions with the corporation on unfair terms. In effect, little would change in terms of the traditional fiduciary law on self-dealing.¹⁹⁷

197. Clearly, even under a good faith regime, *Irwin v. West End Dev. Co.*, 342 F. Supp. 687 (D. Colo. 1972), *aff'd* in relevant part, 481 F.2d 34 (10th Cir. 1973), cert. denied, 414 U.S. 1158 (1974), would continue to represent the law in its statement that "[e]xculpatory provisions of corporate articles create no license to steal." *Id.* at 701. A closer question would be presented by *Pappas v. Moss*, 393 F.2d 865, 867-68 (3d Cir. 1968), which refused to accept a shifting burden of proof. Already, there is a suggestion in *Everett v. Phillips*, 288 N.Y. 227, 236-37, 43 N.E.2d 18, 22 (1942), that a charter provision could shift a presumption. Under the standards proposed in this section,

B. The "Plain Meaning" Rule and Third-Party Limitations

Legislative supremacy is a basic fact of political life, and thus when the literal text of a statute is clear on its face and is not contradicted by its legislative history, courts may not decline to follow it. Virtually all commentators agree with this assertion, but disputes arise when the literal meaning of the statute is seemingly contradicted by its legislative history. The Supreme Court has recognized that the "plain meaning" rule need not necessarily be followed in such a case.¹⁹⁸ Even more difficult issues of statutory interpretation arise when the claim is made that the legislative intent of a statute can be reinterpreted in light of changed circumstances and later developments.¹⁹⁹

In reality, however, it is difficult to find many cases in which the "plain meaning" of a statute necessarily compelled the invalidation of a charter provision.²⁰⁰ More typically, a process of judicial inference about the statute's policy has provoked the invalidation. The board sterilization cases discussed earlier²⁰¹ provide a useful illustration. In a case such as *McQuade v. Stoneham*,²⁰² it was hardly self-evident that the salary arrangement specified in the shareholders' agreement deprived the board of its legally delegated jurisdiction, and other cases have subsequently reached contrary results.²⁰³ Similarly, the willingness of most courts to tolerate the chilling of cumulative voting through charter provisions suggests that courts need not strain to find conflicts between a statute and a charter provision.²⁰⁴ Hence, because section 1(B) of the rule proposed above essentially requires a frontal conflict between the statute and the charter provision before the latter is invalidated, this restriction will seldom come into play.

The third-party limitation in section 1(B) is also largely self-explanatory. Corporate law contains a few provisions intended to benefit third parties (creditors, employees, etc.). An example is section 630 of

charter provisions could only shift the burden with respect to specific, defined transactions.

198. See, e.g., *INS v. Cardoza-Fonseca*, 480 U.S. 421, 432 n.12 (1987); *United States v. American Trucking Ass'ns*, 310 U.S. 534, 543-44 (1940).

199. See, e.g., Farber, *Statutory Interpretation and the Principle of Legislative Supremacy* (forthcoming 78 Geo. L.J. (1989)) (arguing for a *cy pres* approach to statutory interpretation). Some decisions do appear to have so reinterpreted old statutes. See *Li v. Yellow Cab Co.*, 13 Cal. 3d 804, 532 P.2d 1226, 119 Cal. Rptr. 858 (1975); *Lesbian/Gay Freedom Day Comm. v. INS*, 541 F. Supp. 569 (N.D. Cal. 1982), *aff'd sub nom. Hill v. INS*, 714 F.2d 1470 (9th Cir. 1983).

200. See cases cited *supra* note 21. Even among these cases, some involve a judicial inference either as to the purpose of the statute or the purpose of the charter provision. Cf. *Abercrombie v. Davies*, 130 A.2d 338, 347 (Del. 1957) (finding true purpose of stock pooling agreement to be the creation of an illegal voting trust).

201. See *supra* notes 85-99 and accompanying text.

202. 263 N.Y. 323, 329, 189 N.E. 234, 236 (1934).

203. See *Glazer v. Glazer*, 374 F.2d 390, 404-11 (5th Cir.), cert. denied, 389 U.S. 831 (1967); *Galler v. Galler*, 32 Ill. 2d 16, 33-34, 203 N.E.2d 577, 587 (1964).

204. See *supra* notes 100-10 and accompanying text.

the New York Business Corporation Law, which makes the ten largest shareholders of a New York corporation liable for certain employee wages.²⁰⁵ Obviously, shareholder innovation is less justifiable when the result is to shift costs to absent third parties than when it reallocates costs among the shareholders themselves.

C. The Transaction-Specificity Requirement

In the absence of face-to-face bargaining, pricing is only feasible if the parties can clearly understand what rights are being surrendered and how they will affect particular transactions. The problem here is not just that pricing will be inaccurate in the context of a long-term, open-ended relationship, but also that past behavior and experience may no longer serve as an accurate guide by which to estimate the impact of the provision. For example, consider an exculpatory charter provision, which would free management from certain fiduciary liabilities. The attempt to price its effect *ex ante* is confounded by the fact that its existence may change management's future behavior. The shareholders are in much the same position as the seller of an insurance policy: just as a person insured against property loss may take fewer precautions to preserve the insured property, so might the corporate official who is now protected against due care liability spend less time in monitoring corporate subordinates. In short, there is a moral hazard problem.²⁰⁶

The problem of pricing charter provisions has two sides. First, one cannot accurately price a new corporate governance provision by simply looking to past experience, at least when the adoption of the provision may change future behavior. Insurance companies understand this and solve their problem through minimum deductible and coinsurance provisions, which impose some of the risk on the insured.²⁰⁷ Within the corporate context, the optimal answer is probably bonding provisions by which managers guarantee their performance. To date, although such provisions have been much discussed in theory, they have been seldom observed in practice.²⁰⁸ Conversely, the other side of the problem is that one cannot simply assume the worst and reduce the value of the shares by the maximum possible loss if management (or some other group receiving unreviewable discretion under the char-

205. N.Y. Bus. Corp. Law § 630 (McKinney 1986).

206. The author has discussed this problem elsewhere at greater length. See Coffee, *supra* note 4, at 944-48. Ultimately, the end result may be a "market for lemons."

207. In this regard, remember ALI, *Principles of Corporate Governance: Analysis and Recommendations* § 7.17 (Tent. Draft No. 9, 1989) leaves some financial risk on the director or officer that cannot be exculpated by a charter provision. See *supra* note 135 and accompanying text.

208. Coffee, *supra* note 4, at 942-43; see also Brudney, *supra* note 1, at 1422-23 & n.49 (discussing problems associated with attempts to tie managerial discretion and performance to market mechanisms).

ter provision) were to behave in a totally self-interested way. Most individuals are constrained by a variety of nonlegal forces (e.g., personal morality, market forces, a desire to preserve reputational capital), and thus it would be an excessive discount to assume that the worst will always happen. Thus, whatever the price the market places on such a general provision, it will often be inaccurate.

Transaction specificity is an alternative answer to this problem. When the opt-out provision is limited to a specific transaction, the market can judge more accurately the likely diversion of funds that has been authorized. The difference here is between a pricing process that seeks to estimate the long-term risk that management will divert assets to itself and one that values what is presently being taken. In the latter case, pricing is easier because the risk is effectively 100%, and the market must value only the diverted property itself.

Although transaction-specific departures from the norms of corporate governance thus can be theoretically distinguished from other attempts at contracting out, this point is of only academic significance if courts will not accept such a distinction. Yet, a plausible case can be made that courts intuitively have sensed this distinction, and some decisions clearly have shown more tolerance for deviations from the strict rules of fiduciary duty that were transaction-specific. Two decisions will illustrate:

First, in *Nelkin v. H.J.R. Realty Corp.*,²⁰⁹ several tenants of an industrial building purchased the building in 1941 and entered into a shareholders' agreement permitting occupancy of their space at less than fair rental value. Over time, the property appreciated in value substantially, but half of the tenants moved out for a variety of reasons. Seeking to realize their share of the substantial value of the property upon a sale or liquidation, these ex-tenant shareholders brought suit in 1968 seeking a judicial dissolution. They alleged that the majority was "continuing the existence of the corporation solely for their own benefit and that, therefore, the corporation should be dissolved."²¹⁰ Yet, because the shareholders' agreement clearly contemplated a below-market rent (which was to be charged equally to all shareholder tenants on a square foot basis), the New York Court of Appeals refused to grant dissolution.²¹¹ This result can be justified on the ground that the shareholders clearly and specifically contemplated that they were entering into a ven-

209. 25 N.Y.2d 543, 255 N.E.2d 713, 307 N.Y.S.2d 454 (1969). A similar case is *Breswick & Co. v. Harrison-Rye Realty Corp.*, 2 A.D.2d 769, 770, 154 N.Y.S.2d 625, 626 (1956), *aff'd*, 4 N.Y.2d 685, 148 N.E.2d 299, 171 N.Y.S.2d 81 (1958). There, the charter contemplated a nominal rental for a country club that was in reality organized on a not-for-profit basis.

210. *Nelkin*, 25 N.Y.2d at 547, 255 N.E.2d at 715, 307 N.Y.S.2d at 457.

211. *Id.* at 549, 255 N.E.2d at 716, 307 N.Y.S.2d at 458. Chief Judge Fuld dissented, but not on the ground that contractual provisions cannot modify fiduciary duties. Rather, in his view, the shareholders' agreement contemplated that this nonprofit maximizing arrangement would be continued only so long as all the shareholders re-

ture designed to promote their mutual interests through running the corporation as an industrial cooperative, rather than as a profit-maximizing firm.

A similar case is *In re Reading Co.*²¹² There, at the time they formed the corporation, all the shareholders of the Trailer Train Company understood that it would lease its assets at below-market rentals to its shareholders and would not seek to earn a profit. However, after one shareholder—Reading Company—terminated its railroad operations, it sued to force Trailer Train either to dissolve or to pay dividends. It claimed that Trailer Train's leasing of its cars at below-market rates to its shareholders amounted to unfair self-dealing that justified dissolution. Rejecting this claim, the Third Circuit explicitly recognized that contractual provisions could overcome fiduciary duties:

Under Delaware law the rights of stockholders are contractual, and may be altered by binding agreements between the stockholders and the corporation. A purchaser of stock who thus bargains away part of his rights as a stockholder alters the fiduciary duty of a majority shareholder to him.²¹³

In contrast, courts have been far less receptive to charter provisions that sought to approve in advance all future self-dealing transactions between the corporation and its shareholders.²¹⁴ Such blanket, *ex ante* authorizations simply cannot be priced accurately, because most individuals remain subject to moral constraints, other extralegal forces, and the need to preserve reputational capital. Because individuals thus do not respond to such broad authorizations as if they were a license to steal, accurate pricing is impossible. In short, when legal rules are suspended but nonlegal constraints remain, the result is to create unproductive uncertainty. As a consequence, a legal rule that precludes charter provisions that are difficult to price is both efficient,

mained tenants. *Id.* at 550–51, 255 N.E.2d at 717, 307 N.Y.S.2d at 460 (Fuld, J., dissenting).

212. 711 F.2d 509 (3d Cir. 1983). In an impressive forthcoming article, Professor Robert Thompson also cites *In re Reading* for the proposition that contracting out must be limited to specific transactions. See Thompson, *The Law's Limits on Contracts in a Corporation* (draft of Nov. 1988 on file at Columbia Law Review). While Professor Thompson is basically focusing on the closely held firm, I see no adequate reason to limit opting out to this context, at least when the other elements in my proposed test can be satisfied.

213. *Reading*, 711 F.2d at 519 (citations omitted); see also *Coleman v. Taub*, 638 F.2d 628, 636–38 (3d Cir. 1981) (approving employment contract with majority shareholder containing stock buy-back that otherwise would be considered a breach of the shareholders' fiduciary duties).

214. See, e.g., *Irwin v. West End Dev. Corp.*, 342 F. Supp. 687, 701 (D. Colo. 1972), *aff'd* in relevant part, 481 F.2d 34 (10th Cir. 1973), *cert. denied*, 414 U.S. 1158 (1974); *Abeles v. Adams Eng'g Co.*, 35 N.J. 411, 429, 173 A.2d 246, 255 (1961). These decisions also contrast sharply with cases, such as *Everett v. Phillips*, 288 N.Y. 227, 233–34, 43 N.E.2d 18, 20 (1942), in which the charter authorized self-dealing related to specific intracorporate transactions.

because it reduces the variance of expected shareholder returns and so reduces agency costs, and consistent with morality, because provisions that are open-ended invite greater departures from fundamental morality.

What kinds of departures from traditional norms would be permitted by such a standard? Clearly, the proposed transaction-specificity requirement would not permit charter provisions that, for example, authorized corporate officials to engage in insider trading. On the other hand, this standard would not necessarily be offended by a charter provision that precluded a hostile tender offer. The difference is that the former cannot be accurately priced, because one does not know how much trading insiders would engage in, while the takeover premium can be estimated.

A closer question would be presented by a charter provision that sought to opt out of the corporate opportunity doctrine or to authorize corporate officials to engage in competing businesses.²¹⁵ Such provisions are common in partnerships, including those syndicated publicly. Frequently, real estate or oil drilling limited partnerships are sold publicly containing a provision in the partnership agreement authorizing the general partner to syndicate other offerings to other groups of investors. The result is that the syndicator will become the general partner of two or more competing pools and will face unavoidable issues about how to allocate new business opportunities among these pools (or among the pools and its own business ventures). Typically, the provision will permit the partner to allocate such opportunities as it deems fit.

Would such a provision be enforceable if inserted in a corporate charter? Assume it authorized corporate officials to retain or allocate as they saw fit business opportunities that they received in their individual capacity. Although the case law is sparse, one Second Circuit decision, *Burg v. Horn*,²¹⁶ found no liability on the part of promoters of a corporation that held real estate investments who actively pursued invest-

215. The ALI Corporate Governance Project would permit disinterested directors or disinterested shareholders to adopt a "standard of the corporation" that would permit specified recurring types of transactions to be approved in advance, which otherwise might be deemed corporate opportunities. See ALI, Principles of Corporate Governance: Analysis and Recommendations § 5.09 (Tent. Draft No. 5, 1986). Alternatively, the board could narrowly define the scope of the corporation's business so as to exclude some activities that a director wished to engage in from the corporate opportunity doctrine. See *id.* illustration 6. Thus, there are a variety of means by which decisions functionally equivalent to opting out can be reached or rationalized.

For a discussion of the corporate opportunity doctrine, see Brudney & Clark, *supra* note 186. The authors argue that opting out of the corporate opportunity doctrine should be permissible in the closely held corporation, but not in the publicly held corporation. *Id.* at 1001-02. While I do not doubt that the case for opting out is easier to make with respect to closely held firms, the prophylactic rule proposed by these authors strikes me as overbroad.

216. 380 F.2d 897 (2d Cir. 1967).

ments for their own account that would have been of interest to their corporation.²¹⁷ The court's rationale appears to be that the plaintiff shareholder knew from the outset that the directors would continue to engage in their own business ventures and thus had implicitly consented.²¹⁸ This implicit consent theory is troubling, but the distinctive fact about *Burg v. Horn* was that, because of the small scale of the corporation's operations, the investors likely knew that few additional properties would be directed to their firm by the promoters. In short, the better rationale for the decision was not implicit consent, but the specificity of the transactions contemplated.

Arguably, the *Burg* decision rests on a "what-you-see-is-what-you-get" rationale. If the investors were promised only the specific assets they saw and no assurance was given that the promoters would undertake to provide additional investments, then accurate pricing was possible because there was no expectation of a continuing, open-ended fiduciary relationship between the parties. In contrast, if the parties nonetheless expected such a relationship because of extralegal factors, such as market pressures or the need to maintain reputational capital, then we cannot have the same confidence in the accuracy of the pricing mechanism. In this light, the significance of face-to-face bargaining is less the consent of the investors than our certainty that nothing more was promised or reasonably expected.

D. *Waivers Versus Substitutes*

Even when accurate pricing of the deviation from the normal rules of corporate governance is not possible because the provision will apply across a range of future transactions, a charter provision should be upheld if the parties could reasonably believe that it was an adequate or superior substitute. Conversely, a simple waiver of fiduciary duties should not be upheld, unless it can be shown that it was sufficiently limited to comply with the transaction-specificity requirement discussed above.

Support for this distinction between permissible substitutions and impermissible waivers can be found both in the few corporate law decisions involving attempts to substitute a private for a public remedy and in the law of contracts. The corporate decision most closely on point is *Coleman v. Taub*,²¹⁹ in which the Third Circuit permitted a contractual provision establishing an appraisal-like proceeding before an arbitration panel to take precedence over Delaware's statutory appraisal remedy. *Coleman*'s rationale is, however, complicated by the fact that the Third Circuit did not view the plaintiff as an ordinary shareholder, but rather as one who by contract had relinquished his entitlement to be

217. *Id.* at 900-01.

218. *Id.*

219. 638 F.2d 628 (3d Cir. 1981).

the beneficiary of fiduciary duties.²²⁰ Arguably, the court saw the original relationship between the shareholder and the corporation as not creating the status of a "true" shareholder, that is a participant in the firm's residual earnings. Therefore, it may have been more willing to accept the substituted contractual regime of remedies in lieu of the statutory remedies provided by the jurisdiction. Still, some case law supports the proposition that the shareholders in a close corporation may enter into a buy-sell agreement and make that remedy exclusive, thereby precluding access to the remedies of judicial dissolution or appraisal.²²¹

In the close corporation setting, it is also likely that courts will permit an arbitration remedy to override the shareholder's statutory right to bring a derivative action. Reviewing the recent case law, Professor Thompson has found several decisions in which courts have stayed petitions for involuntary dissolution pending arbitration²²² and one decision in which a court required a plaintiff to arbitrate allegations that essentially amounted to a breach of the duty of loyalty.²²³

Outside the close corporation setting, the issues surrounding the possible substitution of an arbitration proceeding for the derivative action are more complex, and I have reviewed them elsewhere.²²⁴ Two points, however, are relevant here. First, it is difficult to assert that substituting arbitration for a derivative action by means of a charter provision necessarily conflicts with the "plain meaning" or legislative intent underlying any corporation statute. Statutes and policies that forbid contractual provisions that "sterilize" the board are not necessarily offended by such a charter provision, because historically the board has had only a modest role in a derivative action. It has been largely a passive bystander.²²⁵ Similarly, although many state corporation codes expressly authorize derivative actions, these statutes do not necessarily preclude the parties from resorting instead to arbitration. Indeed, the precise analogue of this issue was faced this year by the Supreme Court

220. *Id.* at 637-38.

221. See *Rowland v. Rowland*, 102 Idaho 534, 541, 633 P.2d 599, 606 (1981); *Capitol Toyota, Inc. v. Gervin*, 381 So. 2d 1038, 1039 (Miss. 1980). But see *In re Pace Photographers, Ltd.*, 71 N.Y.2d 737, 747, 525 N.E.2d 713, 718, 530 N.Y.S.2d 67, 72 (1988) (general provision regulating transfer of stock not intended to cover or exclude oppression remedies). For a fuller treatment of this area, see Thompson, *supra* note 173, at 231-32.

222. Thompson, *supra* note 212 (citing *In re Stewart Becker Ltd.*, 94 Misc. 2d 766, 772, 405 N.Y.S.2d 571 (Sup. Ct. 1978); *Kaliski v. Rosenberg*, 34 A.D.2d 626, 309 N.Y.S.2d 245 (per curiam), appeal dismissed, 27 N.Y.2d 727, 262 N.E.2d 674, 314 N.Y.S.2d 534 (1970); *Moskowitz v. Surrey Sleep Products, Inc.*, 30 A.D.2d 820, 292 N.Y.S.2d 749 (1968) (mem.)).

223. *Id.* (citing *Levy v. Joyce Morris, Inc.*, 79 A.D.2d 684, 434 N.Y.S.2d 39 (1980)).

224. See Coffee, *supra* note 4, at 953-70.

225. Arguably, this has changed with the advent of the special litigation committee and the new emphasis placed on demand.

in *Rodriguez de Quijas v. Shearson/American Express, Inc.*,²²⁶ in which the Court overruled a prior decision holding that mandatory predispute arbitration provisions would not be enforced with respect to causes of action based on express provisions of the federal securities laws.²²⁷ *Rodriguez* thus stands for the proposition that an express remedy provision in federal law does not imply a congressional intent to preclude agreements requiring the use of arbitration.

Ultimately, the more serious issue surrounding the attempted substitution of arbitration for the derivative action involves the meaning of an "adequate substitute." A factor that distinguishes the public corporation from the close corporation is that in the former the plaintiff is more likely to be a private attorney general, on whose efforts other shareholders free ride. Imperfect as this system has been,²²⁸ arbitration does not typically seek to resolve more than the individual plaintiff's claim. Thus, for example, if the arbitration process ordered that the individual plaintiff should receive a damage award or have his shares purchased at a premium over market, this relief would benefit him but not those who in the past relied (at least in theory) on his enforcement effort. To be an adequate substitute, then, an arbitration remedy must be redesigned so that it parallels the traditional role of class and derivative actions as a system of quasi-public litigation in which individual litigants serve in a representative capacity for all shareholders.

From a contract law perspective, there is even clearer authority for the proposition that the parties may substitute remedies. Under the U.C.C., the parties may agree on limitations or restrictions on remedies, or may provide for substitute remedies, but only as long as the modified remedy does not, in the U.C.C.'s phrase, "fail of its essential purpose."²²⁹ In short, even if the corporation is viewed as a private contract, the principal commercial statute still places limits on the ability of the parties to substitute remedies by requiring that the modified or substituted remedy be adequate to achieve its purpose. Although the case for judicial paternalism is weakest in the commercial law context, it appears to be recognized even here that contractual innovations which depart from the prevailing rules involve high information costs and present risks of opportunism. But the answer is not to bar contrac-

226. 109 S. Ct. 1917 (1989).

227. *Id.* at 1919-21. In an earlier 1987 decision, *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987), the Court decided that it would enforce a contractual provision requiring arbitration of claims arising under Rule 10b-5, 17 C.F.R. § 240.10b-5 (1988), which is a judicially implied cause of action. *Id.* at 227-38. The Court did not decide the status of claims arising under the Securities Act of 1933, § 12(2), 15 U.S.C. 77l(2) (1986) in *McMahon*, but resolved these in *Rodriguez*.

228. See Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 Colum. L. Rev. 669, 677-84 (1986).

229. U.C.C. § 2-719(2) (1988).

tual innovations; rather, it is to superimpose judicial review for adequacy.

A similar point can be made about waivers—that is, exculpatory provisions that involve no substitution. From a contract law perspective, such a provision may be deemed “unconscionable,” particularly when the provision cannot be adequately priced (either because of its open-ended character or because it is inserted into the charter by an amendment). At bottom, contract law has two inescapable mandatory norms: the duty of good faith and the rule that unconscionable provisions will not be enforced.²³⁰ Difficult as it may be to define the term “unconscionable,” the existence of this important limitation on freedom of contract again reminds us that calling a corporation a contract does not end the debate over whether the governing legal arrangements must contain some minimum mandatory terms.

E. *Charter Amendments*

Innovative provisions departing from the usual norms of corporate governance present a special problem when adopted through charter amendments. As Professor Lucian Bebchuk has pointed out,²³¹ charter amendments are not “priced” by the parties to the corporate contract in the same way as are provisions in the initial charter, because those proposing the amendment do not typically bear the costs if it is value decreasing.²³² Given high information costs and the usual problems of collective action, Bebchuk concludes that shareholders will invest insufficient resources to investigate and verify the likely effect of the amendment, and so value-decreasing and redistributive amendments that transfer wealth from shareholders to managers are possible²³³.

Although there are problems with this “rational apathy” story,²³⁴ feasible answers are available to reduce the coercive power that management has with respect to charter amendments. Often, this coercive

230. See *id.* § 2-302. Good faith is also a mandatory term of contract law, particularly with respect to open terms. See, e.g., *id.* § 2-305(2).

231. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 Harv. L. Rev. 1820, 1829, 1837 (1989).

232. *Id.* at 1829.

233. *Id.* at 1837-38.

234. For one thing, shareholders could rationally learn to vote against all opt-out charter amendments as a standard operating procedure, unless management could credibly bond itself in such a way as to convince shareholders, based on a minimal investment in information costs, that they were not exposed to loss. In short, the shareholders could adopt an automatic rule: “Just Say No.” They would deviate from this rule only if management could show a compelling need for the amendment. This is not an unrealistic posture for shareholders who cannot communicate to adopt, and we observe it to some extent in some political elections. Anecdotal evidence suggests that in many elections involving bond referenda, school budgets or state constitutional amendments citizens routinely vote no, possibly because, in the absence of better information, they are dubious about the value of the proposal. Also, this description may apply to the attitudes of at least some institutional investors toward “shark-repellent” charter amend-

power comes from management's ability to link the proposal with a "sweetener" (such as an extraordinary dividend). Here, the practical answer may be to give shareholders a continuing right to repeal any deviation from the usual norms of corporate governance (prospectively and not retroactively, to be sure) because such a power would enable shareholders to accept the sweetener and then reject the deviation later.

Another partial solution is to look to the origins of the proposed innovation. Was it drafted or recommended by an organization having high reputational capital (e.g., the ALI, the American Bar Association, or the New York Stock Exchange)?²³⁵ To be sure, this is no more than a partial and second-best solution to the problems of collective action and information asymmetry that make opt-out amendments potentially value decreasing to shareholders, but reputational capital can partly alleviate the problem of high information costs.

To sum up, opt-out charter amendments do require closer scrutiny than opt-out provisions in the initial charter. The linked problems of coercion, rational apathy and managerial control over the agenda probably justify some mandatory legal rules. Still, the intermediate course is not to prohibit all opt-out charter amendments, but to require objective judicial review over both their substance and the process of their adoption. The rule proposed in this Article does that and establishes criteria that courts can apply without engaging in subjective assessments of motive or good faith. Finally, when an opt-out provision has been drafted by a body possessing high reputational capital, there is a marginally

ments; indeed, largely for this reason, few managements appear to be proposing such charter amendments today.

The greater problem with charter amendments, in my judgment, lies elsewhere: namely, in the potential for agenda manipulation by management. See generally Levine & Plott, *Agenda Influence and Its Implications*, 63 Va. L. Rev. 561 (1977) (providing empirical evidence that substantive results of group decision making are determined by the agenda and procedures followed). Management can propose amendments that respond to problems also perceived by the shareholders, but that give management excessive discretion. Management's leverage comes from the fact that it can propose the amendment on an "all or nothing" basis and thereby constrain shareholder choice. For example, suppose shareholders believe it is desirable to adopt some form of shark repellent antitakeover provision to protect themselves against a partial bid or a "creeping control" acquisition through open market purchases. Their goal is to force a bidder to make a 100%, any-and-all cash tender offer. Knowing this, management can propose an antitakeover charter amendment that is far more stringent than the shareholders desire. If management is clever, it can confront shareholders with a choice between two unattractive alternatives, of which its proposal is the lesser evil. Of course, the source of management's leverage is that, under most corporation codes, only the board can propose the charter amendment. Yet, even if shareholders had a right of shareholder initiative, it would probably mean little, given the usual problems of collective action and high information costs that make shareholders rationally apathetic.

235. See Coffee, *supra* note 4, at 970-74 (discussing "quality constraints" on opt-ing out).

greater justification for judicial deference to it, but this is a factor to be balanced, not an iron rule.

IV. THE ROLE OF MANDATORY RULES

Ultimately, the issue of when and to what extent a corporation may opt out from the existing rules of corporate governance is but a subset of the larger questions of why the law should impose mandatory rules at all and when it should change them. The answers to these larger questions take us back to theories of statutory construction and how they should affect the standard of judicial review applicable to contracting out.

A. *The Public Costs of Private Innovation*

The basic trade-off proposed by the previous Part was that opting out should be permitted, but only within a zone bounded by the duty of good faith and when either its effect can be specifically priced or a court can determine that the contractual provision represents an adequate substitute for the legal rule that would otherwise prevail. This compromise will strike some as an extremely parsimonious recognition of private ordering and others as overly generous. In defense of this proposed compromise, three basic arguments can be made for restricting the range of private ordering. In the case of each of these justifications, however, the real question is how much intrusion upon private ordering follows if one accepts the argument's premises.

The first justification for mandatory rules follows from the premise of bounded rationality: individuals have limited cognitive powers and cannot, even under ideal circumstances, anticipate all contingencies.²³⁶ Hence, provisions will inevitably be left out of the contract that under conditions of perfect knowledge and rationality would be included. This argument has probably escaped no one's attention in the recent debates over contracting, and it can be dressed up with additional ruffles and flourishes. Relying on work by Kenneth Arrow, which suggests that individuals systematically underestimate future risk, Professor Eisenberg makes the insightful point that parties tend to discount excessively the risk of future exploitation. Also, they tend to base their estimates of risk on a skewed sample drawn from their personal experience.²³⁷ From a cost standpoint, it can also be argued that the attempt to provide for all contingencies is too expensive both in terms of time and legal fees. These points have been embellished enough by earlier

236. These cognitive limitations were first introduced in the economic literature by Herbert Simon and then more fully developed by Oliver Williamson. See Simon, *A Behavioral Model of Rational Choice*, 69 *Q.J. Econ.*, 99, 114 (1955); O. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* 9, 21-26 (1975).

237. Eisenberg, *supra* note 1, at 1465-66. Professor Eisenberg is chiefly relying on Arrow, *Risk Perception in Psychology and Economics*, 20 *Econ. Inquiry* 1, 5 (1982).

writers that it is sufficient to quote a balanced summation of this literature by Professors Hetherington and Dooley: "Given the limitations of human foresight and knowledge, any attempt to describe the majority's duties and obligations precisely is likely to leave the minority vulnerable to some overlooked form of exploitation while, at the same time, seriously impairing the efficiency of the firm by fettering management."²³⁸

But note that these arguments really justify default rules or judicial monitoring, not a prophylactic prohibition on all departures. Bounded rationality necessitates either that a model form contract be offered by the state that provides for those contingencies that the parties are apt to overlook or that courts be authorized to decide how to deal with risks not anticipated by the parties on an *ex post* basis. The fact that humans cannot remember everything hardly implies that they cannot focus on the few special departures that are proposed in a particular contract. Indeed, these will stand out precisely because in order to opt out it will be necessary to contradict explicitly the usual default rule.

A second line of argument has been less frequently made, but possibly makes a more telling point: the process of contracting about a long-term business relationship in which one party must place trust and confidence in another makes it difficult to explore the "downside" possibilities that such party will be defrauded. To focus on such possibilities is to "queer" the deal.²³⁹ This observation goes not to cognitive limits, but to the social processes of contracting, and is probably most obvious in the kind of face-to-face individual negotiations that characterize closely held firms.

A third category of objections to a wholly enabling corporate law focuses specifically on opting out and the problem of externalities. Opting out can impose costs on third parties, which ultimately will be spread throughout society. For example, increasing the range of contractual innovations that may be introduced into the corporate charter affects not only investors in corporations that do opt out, but also those in corporations that do not, because there is always the prospect that their corporation may do so in the future. Today, both investors and securities analysts can virtually ignore the corporate charter and focus exclusively on disclosures that relate to cash flow and breakup value. But this would not be possible if charter amendments were permissible that could potentially redistribute wealth among classes of sharehold-

238. Hetherington & Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 *Va. L. Rev.* 1, 37 (1977); see also Carney, *The Theory of the Firm: Investor Coordination Costs, Control Premiums and Capital Structure*, 65 *Wash. U.L.Q.* 1, 59-60 (1987) (discussing bounded rationality as it applies to formation of the firm).

239. Klein, *supra* note 183, at 1555; see also Thompson, *supra* note 173, at 224 ("A prolonged focus on the 'downside' may seem inconsistent with the mutual trust on which the business must depend.").

ers. Not only would analysts have to evaluate the new provisions in the relatively few companies that did opt out, but they might have to inspect the charters of all other companies to make certain that these charters had only standard terms. Put simply, standardization of contract terms through the use of mandatory legal rules reduces information costs for investors. In addition, public costs would be imposed on the judicial system, as a higher rate of litigation becomes likely in response to ambiguous or novel contract terms. Uncertainty about the interpretation courts would give to novel provisions is also predictable.²⁴⁰ Such costs might be justified if there were compensatory benefits. However, the demand for additional options already may be substantially satisfied by the availability of other jurisdictions of incorporation. In a federal system having free corporate mobility between fifty-odd jurisdictions, the fact that a particular legal option is not available may testify either to its suspect character or to the lack of demand for it. As with Sherlock Holmes's dog that did *not* bark in the night, its omission supplies significant evidence. Given the existing diversity of options available to public corporations, one can reasonably doubt whether significant benefits would be gained from a fuller ability to opt out than that proposed above. One important exception to this generalization, however, is the transaction-specific amendment; here, special, idiosyncratic factors may be at work, and the availability of other legal regimes in other jurisdictions has less relevance.

B. The Efficient Role of the Court: Mandatory Duties Versus Hypothetical Bargaining

If one accepts the initial contention that *ex post* judicial review is a necessary element in efficient corporate governance, the next issue is the methodology the court should follow in performing this role. Here, it is easier to describe what courts have in fact done than the rationale for their role. Delaware case law is particularly clear in the distinction it has drawn between the breadth of the board's authority and the propriety of its exercise of that authority in a given case. In a series of decisions chiefly involving efforts by managers to entrench themselves,²⁴¹ Delaware courts have repeatedly said that actions within the scope of the board's legal authority will nonetheless be overturned if the exercise of that authority was not for a proper purpose. One decision phrased this point particularly aptly, saying in effect that there was an implicit term in the corporate contract: "namely that corporate ma-

240. This point about fear of misinterpretation of a novel term has been made effectively by Goetz and Scott, who argue that such uncertainty will often lead private parties to prefer standardized terms that imperfectly express their desired arrangements. See Goetz & Scott, *Limits*, *supra* note 5, at 266.

241. See, e.g., *Bennett v. Propp*, 41 Del. Ch. 14, 20, 187 A.2d 405, 408 (1962); *Condec Corp. v. Lunkenheimer Co.*, 43 Del. Ch. 353, 230 A.2d 769 (1967); *Petty v. Penntech Papers, Inc.*, 347 A.2d 140 (Del. Ch. 1975).

chinery may not be manipulated so as to injure minority stockholders."²⁴² In short, the concomitant to a broad delegation of authority to management is the obligation to use that delegated authority for value-maximizing purposes.

But how does a court decide when the "corporate machinery" is being misused? Here, two rival methodologies exist. Traditional fiduciary theorists can cite precedents that, either directly or by analogy, establish rules of behavior for virtually any fact pattern that can arise in the corporate context. Whether these fiduciary rules are value maximizing in the aggregate for all the parties is not a principal concern to these theorists because these rules express their moral theory on how persons should behave.²⁴³ Conversely, the proponents of hypothetical bargaining will look only to what maximizes value (from an *ex ante* perspective) for the parties. Under this alternative approach, once it is determined that the contract is silent on any important point, a court should seek to determine what arrangement the parties would have adopted *ex ante* if they, as rational wealth-maximizers, had addressed the question on a fully informed basis.²⁴⁴ This approach will often produce the same result as fiduciary analysis, but at other times it can be very indeterminate. Under the hypothetical bargaining approach, the legal rule that the parties would have adopted on a fully informed basis will be deemed to be the rule that creates the greatest wealth, regardless of its distribution.²⁴⁵ This approach invites the court to engage in an extraordinary range of judicial speculations about what maximizes shareholder value. For example, under this approach, *if* it could be shown that permitting insider trading would create more wealth for managers than it would cost shareholders, hypothetical bargaining would yield the result that the corporate charter should not be read to prohibit insider trading, at least unless a charter provision did so explicitly.

In his provocative commentary following this Article, Professor Macey claims that only the hypothetical bargaining approach can reconcile the tensions between the mandatory and enabling features of corporate law and that there is in fact little difference between hypothetical bargaining and the approach proposed in this Article.²⁴⁶ Yet, the difference is clear: Under my approach, the normal default rules of fiduciary duty would generally govern *unless* the parties have clearly opted

242. *Condec Corp.*, 230 A.2d at 775.

243. This distinction between the moral theory of fiduciary duties and the economic theory of hypothetical bargaining has been well made by Professor Clark. See Clark, *Agency Costs Versus Fiduciary Duties, in Principals and Agents: The Structure of Business* 55, 76 (J. Pratt & R. Zeckhauser eds. 1985).

244. See R. Posner, *supra* note 12, at 79-85.

245. Easterbrook & Fischel, *Corporate Control Transactions*, *supra* note 2, at 702-04.

246. Macey, *Courts and Corporations: A Comment on Coffee*, 89 Colum. L. Rev. 1692, 1694-95 (1989).

out by a valid charter provision that is sufficiently transaction specific that investors can appraise its impact. This approach is deliberately coercive in that it compels those possessing discretion or private information to contract around the default rule and in so doing to reveal their actual intentions.²⁴⁷ Such an approach is very different from one that permits courts to redefine fiduciary duties in all cases according to the criterion of aggregate wealth maximization. The latter approach not only leads to excessive indeterminacy and confusion, but it essentially repeals the principle of stare decisis, which, while not an absolute barrier to legal change, is itself a rule that promotes efficiency and reduces the public costs associated with corporate governance.²⁴⁸

This potential for indeterminacy is graphically illustrated by the differing opinions in *Jordan v. Duff & Phelps, Inc.*²⁴⁹ There, the issue was how to read a buy-sell agreement that required an employee to sell his stock back to the corporation upon his termination of service. Would this provision permit the majority shareholder to cause the corporation to fire the employee and then repurchase his stock at only its book value? In his dissent, Judge Posner said it would and justified this result through a resort to hypothetical bargaining. In his view, a rational shareholder, bargaining from an ex ante position, might well waive all statutory and fiduciary protections that the law affords him and would willingly rely on the company's desire to preserve its reputational capital as his sole protection.²⁵⁰ However, Judge Easterbrook, who wrote the majority decision and who also strongly favors hypothetical bargaining, reached a contrary result by assessing the kind of employment agreement into which rational actors would have entered.²⁵¹ Judge

247. Subsequent to writing this Article, I have found that a draft manuscript by Professors Ayres and Gertner takes a similar position and proposes a general theory of "penalty" default rules. See Ayres & Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, (forthcoming 98 Yale L.J. (Oct. 1989)). I agree with their general theory, but believe that the problem of gap definition is more complicated in the corporate context. See *supra* notes 15-16.

248. Many of the arguments made by Professor Monaghan about the role of stare decisis in constitutional adjudication apply with equal force in this context. See Monaghan, *Stare Decisis and Constitutional Adjudication*, 88 Colum. L. Rev. 723, 744-55 (1988) (emphasizing role of stare decisis in agenda limitation and in political legitimacy of judicial review).

249. 815 F.2d 429 (7th Cir. 1987).

250. *Id.* at 448 (Posner, J., dissenting) (emphasizing willingness of shareholders to "take their chances on their employer's good will and interest in reputation").

251. *Id.* at 436. In this respect, I cannot agree with Professor Macey's contention in his comment to this Article that Judges Easterbrook and Posner disagreed only about fiduciary duties under Illinois employment law. See Macey, *supra* note 246, at 1696 n.12. Judge Easterbrook clearly uses the parties' silence to infer those terms "we are confident that the parties would have bargained for if they had signed a written agreement." *Jordan*, 815 F.2d at 438. This is hypothetical bargaining *par excellence*. If "Rule 10b-5 is murky when securities transactions are consummated with employees," as Professor Macey argues, Macey, *supra* note 246, at 1696 n.12, the root cause is that the majority and the dissent disagree about the underlying nature of the fiduciary duty be-

Easterbrook read an implied fiduciary duty into the relationship; Judge Posner did not. Yet, both judges began from the same starting point. In this light, *Jordan* suggests that hypothetical bargaining supplies only a vague and shifting guide.

In this light, a strong efficiency argument can be made that the parties should be forced to opt out affirmatively from the usual rules of corporate governance, with the court considering only at that point whether any proposed modification meets the test of hypothetical bargaining. A standard rule of construction for contracts is to interpret all ambiguity against the draftsman. Such a rule is efficient because it both minimizes the risk of deliberate deceit by the draftsman and creates an incentive for achieving precision. Clearly, management controls the corporate agenda and, directly or indirectly, is the "draftsman" of any midstream change in the corporate charter. Thus, ambiguity should be construed against management. By permitting opting out but insisting on relatively strict construction of the traditional default rules of fiduciary duty, this Article's approach achieves this result. Its net effect is to create an incentive to be precise and to raise the costs of opportunism, without rejecting all contractual innovations. In addition, greater certainty results because the traditional rules of fiduciary duty are well known and will apply absent express provision to the contrary. To sum up: consider the difference in incentives. Under the hypothetical bargaining approach, a manager can act in a self-interested fashion, hoping later to convince a court that such behavior, if detected and challenged, was efficient because it maximized aggregate wealth and thus was what rational parties would have agreed to. Yet, under a coercive default rule, such conduct is only permissible if authorized by a charter provision. Hence, there is both an increased incentive to disclose and seek approval and a reduced incentive to attempt to make new law through costly litigation.

Two other significant problems with hypothetical bargaining involve its feasibility and fairness. Doctrinally, the triggering condition of hypothetical bargaining is the court's discovery that a term of the contract is "missing" or was somehow "omitted."²⁵² Such omissions do in fact occur in ordinary contracting, but they arguably will be infrequent in the corporate context. This is because the corporate charter is a unique form of contract. Because a detailed specification of all rights, risks and performance standards is not feasible,²⁵³ the corporate charter essentially specifies a governance mechanism for the resolution of future disputes. Basically, corporate law entrusts authority to the board of directors, subject to some judicial oversight, to resolve all future disputes. Thus, unlike other contracts that attempt a more comprehensive

tween employer and employee (which duty must be breached for a Rule 10b-5 violation to occur).

252. See Farnsworth, *supra* note 15, at 879.

253. See *supra* note 5 and accompanying text.

assignment of rights and responsibilities, the corporate contract is usually a relatively simple and short document. In this sense, it is something of a misnomer to speak of terms that are "missing" or "omitted" from the corporate contract. Although omissions can sometimes occur, the corporate charter has its own default rule: Except as specified to the contrary, everything is to be decided by the board (subject possibly to the check of shareholder ratification). How the board uses that power is likely to be the subject of much friction and litigation, but classic fiduciary law long ago filled in this gap in the contract—unless the parties can and do opt out from it.

Finally, there is the issue of fairness. Suppose a term in the contract is sufficiently vague on its face, or obsolete in its policy foundations, as to appear inefficient to the court. Still, its meaning may have been well understood by the parties at the time they bargained. If a court later changes the meaning of this term through the use of the hypothetical bargaining approach, there is a redistributive impact. One side loses something for which it may have bargained; another side may receive a windfall gain. Were the legislature to do this by changing the meaning of a term in a contract to the detriment of one side, Professor Macey probably would see this as an unconstitutional "impairment" of contract.²⁵⁴ Why should the result be any different when a court does the same thing? Put simply, fairness requires that we not disrupt the parties' legitimate expectations lightly, and those expectations tend to be based on the existing state of the law at the time the bargain was struck. Conceivably, the parties sometimes may have no expectations, but if hypothetical bargaining applies only in this case it will have a minor impact.

Does this position imply that no role exists for hypothetical bargaining? On the contrary, there are several roles it can and should legitimately play. First, it supplies the principal constraint on opting out. The test proposed in the preceding section, with its focus on transaction specificity, simply assumes that the parties would not rationally modify the default rules of fiduciary duties unless they could clearly appreciate, or "price," the range of transactions over which different rules would apply. As a constraint, this is a refinement on the hypothetical bargaining standard a court would apply if it found that a term had been omitted from an agreement, but it operates as a check on what the parties have done, rather than as a grant of power to the courts to remake the law. A second, more modest role would arise when a vague term in the corporate statute had no preexisting meaning in the case law on which either side reasonably could have placed expectations. For example, suppose the "oppression" remedy had just been added to the corporate statutes of the first state to adopt this remedy and no

254. U.S. Const. art. I, § 10, cl. 1.

statutory definition of this term had been supplied.²⁵⁵ This would amount to a legislative invitation for judicial lawmaking, and, in such circumstances, there is no conflict between the shareholders' legitimate expectations and efficiency. In this situation, the court's decision would not have any distributive impact that can be considered unfair. In short, when writing on a clean slate, the court may look primarily to the efficiency considerations upon which hypothetical bargaining relies. Finally, there are, no doubt, occasions when the demonstrable inefficiency of a rule can justify overruling it, notwithstanding the principle of stare decisis,²⁵⁶ but such instances are the exception, not the rule.

C. "Private Deals" Versus "Public-Regarding" Legislation

The question of when a court may change the "default rules" of corporate governance necessarily intersects with broader issues of statutory interpretation. The latter context has recently witnessed a lively debate among "law and economics" scholars. On one hand, Judge Easterbrook has advocated an approach to statutory interpretation that assumes that legislation is frequently the product of a "deal" made between the legislature and interest groups that sought or opposed the statute. His view of the principle of legislative supremacy leads him to see courts as the honest enforcer of whatever outcomes emerge from the process of drafting legislation.²⁵⁷ In effect, if the legislature has been "bought," the courts should let it stay bought. In response to this view of legislation as a form of contract, others have answered that courts should read statutes as if they were "public-regarding"—that is, as intended to maximize value for society as a whole.²⁵⁸ Professor Macey has made such an argument from a perspective every bit as hard-boiled as that of Judge Easterbrook and is equally convinced that interest groups determine legislative outcomes and thereby "seek to trans-

255. I discuss this example in more detail at *infra* notes 275–78 and accompanying text.

256. See *infra* notes 271–78 and accompanying text. Obviously, a court is freer to modify common law rules than statutory policies, but even the latter are subject to revision, as the next section explores.

257. See Easterbrook, *The Supreme Court, 1983 Term—Foreword: The Court and the Economic System*, 98 Harv. L. Rev. 4, 15–18 (1984). The view that statutes should be interpreted as legislative deals probably originated with Landes & Posner, *The Independent Judiciary in an Interest-Group Perspective*, 18 J.L. & Econ. 875 (1975).

258. See Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 Colum. L. Rev. 223 (1986). Professors Hart and Sacks would certainly take a similar view. They argue that, in construing a statute, a court "should assume, unless the contrary unmistakably appears, that the legislature was made up of reasonable persons pursuing reasonable purposes reasonably." H. Hart & A. Sacks, *The Legal Process: Basic Problems in the Making and Application of the Law* 1415 (tent. ed. 1958). They add that courts should not construe a statute "in the mood of a cynical political observer, taking account of all the short-run currents of political expedience that swirl around any legislative session." *Id.* at 1414.

fer wealth to themselves from the rest of society.”²⁵⁹ Still, he believes that the judiciary can brake this process by enforcing only those special interest deals that amount to what he terms “open-explicit bargains” or statutes that are explicitly “naked wealth transfers to special interest groups.”²⁶⁰ Thus, he favors a canon of construction that regards legislation as “public-regarding” unless the statute explicitly indicates its intent to favor such a special interest group, because such a canon of construction raises the cost of enacting special interest statutes. In his view, this scheme to raise the cost of special interest legislation is preferable to authorizing courts to invalidate such statutes because it does not raise the same specter of an imperial judiciary able to ignore the majority. For similar reasons, Professor Macey apparently also would favor a canon of construction under which “statutes in derogation of the common law should be strictly construed.”²⁶¹ Obviously, such a presumption would read the common law’s rules on fiduciary duties as controlling unless an explicit legislative intent to disavow them was evident.²⁶²

Although there seems to be a tension in Professor Macey’s work between his view of corporate law as exclusively contractual and his view of the proper approach to statutory construction as “public-regarding,” his view of legislation is clearly preferable to Judge Easterbrook’s legislation-as-contract perspective. In any event, which view one takes can have a profound impact on how many corporate statutes are interpreted. For example, some recent corporate legislation bears all the earmarks of special interest legislation. For example, numerous state antitakeover statutes have been adopted almost overnight at the behest of a single target company.²⁶³ Much the same pattern of breakneck legislation has characterized recent efforts to enact statutes reducing or eliminating directors’ liability for “due care” violations.²⁶⁴

How then should such legislation be interpreted by courts? The opportunities are numerous for courts to engage in interstitial decision

259. Macey, *supra* note 258, at 267.

260. *Id.*

261. *Id.* at 264.

262. Thus, I find Professor Macey’s views in his comment to this Article somewhat inconsistent with his prior position to the extent that he now seems prepared to permit courts to change the default rules without shareholder action.

263. See Davis, Epilogue: The Role of the Hostile Takeover and the Role of the States, 1988 Wis. L. Rev. 491, 493 (describing “fast-track, save a particular corporation” statute, but noting that Wisconsin’s experience was more deliberate); Romano, The Political Economy of Takeover Statutes, 73 Va. L. Rev. 111, 134-38 (state takeover legislation is usually the product of a “putting out fires” legislative response to lobbying pressure from a single constituent). In my view, even where the legislature has sought to be “public-regarding” in its response, most efforts to date in this area have been hasty and ill-conceived, and the legislatures have been generally overreached by the lobbyists.

264. See Hanks, *supra* note 134, at 1243 (since 1985, four-fifths of states have enacted legislation protecting directors from financial liability).

making on questions of policy. For example, should they treat the new Delaware antitakeover statute, which in theory protects shareholders against coercive partial bids and low premium "street sweeps," as a reason for granting less deference to private efforts to prevent such takeovers through poison pills, lockups and similar tactics? If we view this question from Judge Easterbrook's "private deal" perspective, it would be inconsistent to offset the legislature's decision to favor a special interest group—corporate managements and their allies—by tightening the legal restrictions on alternative defense tactics, such as the flip-in pill. Yet, from a "public-regarding" perspective, it may be appropriate to conclude that once the problem of coercive pressure in takeovers has been carefully addressed by the legislature, there is less need for potentially harmful and overbroad private efforts.

The new legislation that permits charter amendments which reduce or eliminate due care liability presents similar issues of statutory interpretation. Many of these statutes contain ambiguous exceptions that make vague references to causes of action for which liability may not be exculpated.²⁶⁵ Others are vague as to whether duty of loyalty liability can also be eliminated. From a "public-regarding" perspective, provisions in derogation of the common law's fiduciary duties should be strictly construed. Conversely, from a "private deal" perspective, one could say that the value of the legislation to the special interest group (here, management) would be vitiated if plaintiffs had only to recharacterize their complaints as duty of loyalty actions instead of duty of care actions.

Operationally, a "public-regarding" approach should posit that a basic purpose of corporate law is to reduce agency costs. (Here, both the traditional fiduciary duty and the hypothetical bargaining approach give similar answers.) Then, except to the extent that the charter or statutory law provides clear answers to the contrary, the court should use this agency-cost-reduction premise as its canon of construction. While the court may not ignore settled precedent or the parties' clearly expressed intent, it can to this extent pursue its concept of efficiency. Indeed, from a positive law perspective, this description is probably a reasonably accurate account of the takeover decisions of the Delaware courts since *Unocal*.²⁶⁶

D. Statutory Cy Pres: *When Can a Court Update a Statute?*

The issue of the appropriate limits on purposive judicial interpretation of statutes is not new,²⁶⁷ but some recent proposals are. For

265. See *id.* at 1237–38, 1240–41.

266. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Grand Metro. PLC v. Pillsbury Co.*, 558 A.2d 1049 (Del. Ch. 1988); *City Capital Assocs. v. Interco, Inc.*, 551 A.2d 787 (Del. Ch. 1988).

267. The classic debate on this issue was between H.L.A. Hart and Lon Fuller in 1958, with Fuller arguing that purposive interpretation could be consistent with Hart's

example, Dean Calabresi has argued that in our contemporary economic and political environment, which he sees as characterized by rapid technological change and legislative stasis, statutes regularly become "obsolete."²⁶⁸ His proposed response is to permit courts to treat an out-of-date statute as a nullity, subject, of course, to the legislature's power to reenact it. Although this challenge to the principle of legislative supremacy has proven too much for most theorists of statutory interpretation to swallow whole, some have recognized merit in Calabresi's analysis and therefore have recommended an intermediate position: namely, that a court is entitled to reinterpret and update a statute's intent in light of new and changed circumstances. Drawing an analogy to the traditional trust law doctrine of *cy pres*, Professor Farber has argued that such an approach is more faithful to the legislature's intent than is rigid enforcement of an out-of-date policy in a radically different world.²⁶⁹ To some degree, this position may rebottle old wine in a new container, because it seems to parallel closely Lon Fuller's well-known position.²⁷⁰

Calabresi's bold formulation is problematic, but in fact the process he advocates may already exist, albeit to a lesser degree. Faced with "obsolete" statutes, courts do reread the statutory policy in increasingly narrow and restricted terms. This phenomenon is observable in the corporate arena as in others. Consider, for example, the old rule that prohibited "sterilization" of the board. Originally, this principle rejected private ordering in favor of mandatory legal duties. Over time, many states adopted a close corporation statute authorizing contractual deviations to protect minority shareholders. Suppose, however, that one state has not and that such a close corporation provision deviating from the common-law is adopted by the shareholders of a corporation incorporated in that state. In this case, the rule, whether statutory or common law, forbidding commercial arrangements that infringe the board's autonomy seems "obsolete" in the Calabresian sense. In such a context, the probability seems high today that such a provision would be upheld.²⁷¹

To take another example, suppose a court is faced with the first generation of poison pills. It understands that coercive takeovers are a possibility and that two-tier, front-loaded bids are a recent development. In light of these changed circumstances, may it modify the long-standing, but seldom examined, rule that all shares of a class must be

concern for fidelity to law. Compare Hart, *Positivism and The Separation of Law and Morals*, 71 Harv. L. Rev. 593 (1958) with Fuller, *Positivism and Fidelity to Law—A Reply to Professor Hart*, 71 Harv. L. Rev. 630, 661-69 (1958).

268. See G. Calabresi, *A Common Law for the Age of Statutes* 1-7 (1982).

269. Farber, *supra* note 199.

270. Fuller, *supra* note 267, at 661-69.

271. *Zion v. Kurtz*, 50 N.Y.2d 92, 405 N.E.2d 681, 428 N.Y.S.2d 199 (1980), is certainly a strong indication that courts will strain to uphold such agreements, absent fraud or secrecy. See *supra* notes 93-99 and accompanying text.

treated equally?²⁷² Essentially, Delaware did so in *Moran v. Household International*²⁷³ and New York declined to do so in *Bank of New York v. Irving Bank Corp.*²⁷⁴ One can debate whether the *Moran* court correctly perceived the reality of the takeover "threat," but it seems clear that New York's approach in *Irving Bank* was to abdicate all questions of policy to the legislature. Ultimately, the best argument for the Delaware approach is that the Delaware courts did not simply defer to private ordering, but rather understood the critical importance of ex post judicial review.

Statutory updating need not result exclusively in the narrowing of statutes. On the contrary, statutes can provide a statement of principles, based on which courts can also update "obsolete" common law. The common law is full of examples in which courts have updated the common law so as to generalize new statutory rules beyond their context. Yet, when a court decides that the common law should mirror the statutory standard, it may be acting in violation of Judge Easterbrook's precept that a court should stick to the terms of the "private deal." To illustrate, the New York case law on involuntary judicial dissolution has long been characterized by divided authority. Some decisions suggest that there is an inherent judicial power to dissolve closely held corporations on a showing of oppression to the minority; some disagree.²⁷⁵ In part to reconcile these cases, the New York Legislature adopted Business Corporation Law section 1104-a,²⁷⁶ which authorizes the holders of twenty percent of the voting stock of a New York corporation other, than a publicly held corporation, to seek judicial dissolution on grounds of oppression. What happens, however, if the holders of only ten percent seek dissolution based on a strong showing of oppression? Should a court read the legislative "deal" as being one that protected management from claims brought by small minority interests, possibly because of a perceived tendency for small shareholders to bring frivolous claims? In fact, New York courts have expanded the remedy, in effect generalizing it beyond its legislative limitations.²⁷⁷ In substance, these courts have taken a "public-regarding" approach, which views the legislature as primarily concerned about a problem (here, oppression of the minority) that they have instructed the courts to solve. If the

272. See *supra* text accompanying notes 139-49.

273. 500 A.2d 1346 (Del. 1985).

274. 112 Misc. 2d 145, 536 N.Y.S.2d 923 (Sup. Ct. 1988).

275. In *Leibert v. Clapp*, 13 N.Y.2d 313, 247 N.Y.S.2d 102 (1963), the New York Court of Appeals created a common-law remedy of dissolution for oppression. But see *Kruger v. Gerth*, 16 N.Y.2d 802, 263 N.Y.S.2d 1 (1965); *Cachules v. Finkelstein*, 279 A.D. 173, 109 N.Y.S.2d 272 (1951) (denying actions for dissolution under general equitable powers of court on ground that the corporation was a creature of statute).

276. N.Y. Bus. Corp. Law, § 1104-a(1) (McKinney 1986).

277. See *Lewis v. Jones*, 107 A.D.2d 931, 932, 483 N.Y.S.2d 868, 869 (1985) (finding that a denial of an adequate remedy to a shareholder who lacks standing under N.Y. Bus. Corp. Law § 1104-a would be a result "abhorrent to the common law").

statute may be regarded as such a legislative instruction, then there is little reason to read its outer limits narrowly or to fear disrupting political compromises.²⁷⁸

Precisely because I approve of such decisions, the question unavoidably surfaces: Is not such a "public-regarding" approach functionally the equivalent of a "hypothetical bargaining" model (of which I was earlier skeptical), at least if one assumes that the law's goals in the corporate context are to maximize aggregate shareholder wealth? Should we not still be concerned about the legitimate expectations of the parties to the corporate contract? Of course, the answer is yes, but the critical issue involves determining the legitimacy of these expectations. Here, an important distinction must be drawn between overruling a legislative policy and implementing it. Overruling must be approached cautiously. In *Patterson v. McLean Credit Union*,²⁷⁹ the Supreme Court recently specified fairly narrow criteria to determine when prior judicial interpretations of statutory policy may be overruled, saying that courts may do so only when "either the growth of judicial doctrine or further action taken by Congress [has] removed or weakened the conceptual underpinnings from the prior decision."²⁸⁰ Although a few earlier corporate precedents, such as those forbidding sterilization of the board, may have become sufficiently archaic as to satisfy these stiff conditions for outright overruling,²⁸¹ such opportunities are relatively rare.

In contrast, judicial activism is more appropriate in implementing a legislative instruction to deal with a problem. Sometimes the legislature will pass a statute with an open-ended, vaguely elastic term. The familiar corporate statute authorizing courts to provide a remedy on a finding of "oppression" is an example of this looser form of statute,²⁸²

278. Judge Easterbrook appears to agree with this conclusion. See Easterbrook, *Statutes' Domain*, 50 U. Chi. L. Rev. 533, 551 (1983).

279. 109 S. Ct. 2363 (1989). *Patterson* did not overrule a prior precedent and thus shows the court using this formulation as a conservative limiting rule of construction.

280. *Id.* at 2370. In addition, it added that precedent may be overruled when it has become "a positive detriment to coherence and consistency in the law, either because of inherent confusion, created by an unworkable decision . . . or because the decision poses a direct obstacle to the realization of important objectives embodied in other laws." *Id.* at 2371.

281. *Zion v. Kurtz*, 50 N.Y.2d 92, 405 N.E.2d 681, 428 N.Y.S.2d 199 (1980), seems an example of a decision recognizing that the old law on sterilization had been weakened by the enactment of a new statute (N.Y. Bus. Corp. Law § 620(b) (McKinney 1986)). See *supra* notes 93-99 and accompanying text. In *Patterson*, 109 S. Ct. at 2370-71, the Court cited as an example of when overruling was appropriate its own recent decision in *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 109 S. Ct. 1917 (1989) (reversing earlier interpretation of federal securities statutes as forbidding mandatory arbitration of claims founded on them). *Patterson*, 109 S. Ct. at 2370.

282. Today, some thirty-seven states authorize involuntary judicial dissolution (or similar relief) of a close corporation on a showing of oppression. See Thompson, *supra* note 173, at 206. Historically, courts required a showing of deadlock, fraud, or active misconduct before they would order liquidation, but over recent years, the new trend

which is essentially a legislative instruction to the courts to solve a difficult, fact-specific problem. When the court is thus called upon to "fill the gap," the line between common-law policy making and statutory construction largely disappears.²⁸³ Nor are the parties to the contract as entitled to have legitimate expectations about the scope of such terms. Indeed, because the statute was, in most instances, enacted long after the time of corporate formation, pursuant to the state's reserved power over the corporate charter, the parties never relied on any previously settled interpretation of the term. More importantly, even shareholders in corporations formed subsequent to the statute's passage or its first judicial construction were on notice that the term's meaning could evolve over time, because the legislature had delegated to the courts the task of solving the problem. Problem solving is a dynamic process, and hence one should not expect the law to remain static.

CONCLUSION

If the new breed of lawyer-economists is to be listened to by courts, they must, in turn, listen to how courts think. How then do courts think about contractual freedom and opting out? Clearly, they do not view statutory corporate law as simply a body of default rules, which shareholders may waive at will. Rather, courts exercise substantial discretion to accept or reject a contractual innovation, depending upon whether they attribute a "fat" or a "thin" policy to the statutory norm asserted to be in conflict with the charter provision. As a statute begins to seem obsolete or superfluous, courts have recurrently shown a willingness to shrink their conception of its underlying policy, but only on a few occasions have courts converted a mandatory norm into a default rule.

This tolerance for innovation is, however, only half the story. The other half is a judicial tradition of construing broad and ambiguous charter provisions to contain implied conditions that the majority not use its powers to exclude or disfavor the minority. As a result, contractual innovation and a judicial power to discover implied conditions are not adversarial theories, but symbiotic ones.

Above all, this Article has been aimed at the fallacy of the excluded middle. Between the position that freedom to opt out will lead to the destruction of fiduciary duties and its polar opposite that restrictions on private ordering prohibit efficient innovations and enforce outdated

has been to order such relief on a showing that the minority shareholders' "reasonable expectations" had been frustrated. This standard of the "reasonable expectations of the shareholders, as they exist at the inception of the enterprise, and as they develop thereafter through a course of dealing concurred in by all of them" was recommended by Professor F. Hodge O'Neal, a leading expert in this field, in his much cited treatise. F. O'Neal, "Squeeze-Outs" of Minority Shareholders § 7.15, at 525 (1975).

283. See Farber, *supra* note 199; Merrill, *The Common Law Power of Federal Courts*, 52 U. Chi. L. Rev. 1, 3-7 (1985).

or overbroad legal rules, there is a middle ground: courts can tolerate and monitor some departures in this area, much as they have done in other forms of contracting. The relevant task for the future then should be to define the area of tolerable departures, rather than to prolong the holy war over opting out. Ultimately, the scope of permissible opting out should be defined principally in terms of one's estimate of judicial competence at monitoring opportunism. Here, there is room for debate, but in this Article's view, courts seem to have done better in dealing with the close corporation than with the public corporation. Because shareholders are generally acknowledged to be more exposed to loss in the close corporation setting,²⁸⁴ this greater judicial willingness to monitor in that context is understandable. Still, active monitoring requires a clear theory of the rights to be protected and the evils to be guarded against. The majority's recurring desire to oust or exclude the minority in the close corporation setting offers an easily understood villain, but management's desire to entrench itself in the public corporation presents a more problematic, lower visibility target. Fewer bright line distinctions exist by which to separate the ordinary world of business judgments from transactions affected by conflicts of interest. Partly because of this skepticism about how well courts will enforce the duty of good faith in the public corporation setting, this Article has recommended a coequal constraint of transaction specificity.

Ironically, the position taken by this Article finds both sides in the debate between the contractarians and the anticontractarians to be partially correct. The contractarians are correct in favoring greater freedom for contractual innovation, and the anticontractarians are equally correct in favoring rigid fiduciary rules. The irony is that prophylactic rules make the optimal default rules because they maximize the incentive to contract around them and, in so doing, to maximize disclosure. Default rules matter—and matter greatly—because they will establish the parties' legal entitlements whenever the transaction costs of modifying them exceed the benefits of a superior rule. In particular, because only those controlling the corporation can propose an innovative charter provision, such innovations are likely to occur only when the benefits flow, at least in part, to them. As a result, innovations will be predictably one-sided, and the rate of innovation will be suboptimal. This argues for judicial activism, both in monitoring novel charter provisions and in redefining the default rules when a superior default rule would favor those lacking access to the charter amendment process. Still, more than default rules are needed, and the mandatory minimum to relational contracting in the corporate context should be defined by the duty of good faith and the requirement of transaction specificity.

284. The usual reasons for this view include not only the absence of a liquid market for their shares, but also the factor of asset specificity. Human assets are invested in the close corporation and cannot be redeployed costlessly because they are to a degree firm-specific. See O. Williamson, *The Economic Institutions of Capitalism* 313 (1985).

What these rules leave open for negotiation and opting out is the zone between fiduciary law's requirement of selflessness and contract law's norm of good faith. Within this zone, if the departure can be accurately priced, neither normative nor economic theories supply adequate reasons to preclude contractual innovations.

This approach combines *ex ante* incentives to disclose with *ex post* judicial monitoring for opportunism. If new and unforeseen circumstances arise, charter amendments are possible, but the court should not rewrite fiduciary law on its own so as to permit managers or controlling shareholders to appropriate all the gains (as they may under a hypothetical bargaining approach on the assumption that rational parties "would have wanted" the wealth maximizing outcome). As new and previously unforeseen circumstances arise, the true contractarian approach is to force the parties to bargain over foreseeable allocations of gains and losses and not for a court to imagine unnecessarily what they would have wanted. Only the minority are entitled to have the court change the default rule in their favor. Those in control should be forced to contract and, in so doing, to reveal their intentions and secure disinterested approval.