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LECTURE

NO EXIT?: OPTING OUT, THE CONTRACTUAL THEORY OF THE CORPORATION, AND THE SPECIAL CASE OF REMEDIES

John C. Coffee, Jr.*

Aloof and insular as corporate law often seems, it cannot remain uninfluenced for very long by developments in the mainstream of American civil law. In that mainstream, there is today flowing a strong, swift current called "tort reform." As currents go, this one is remarkably broad and perhaps a little shallow, but on it floats a number of diverse legislative proposals — ceilings on liability, restrictions on attorneys' fees, greater reliance on alternative methods of dispute resolution, restrictions on

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* Adolf A. Berle Professor of Law, Columbia University Law School. The author wishes to acknowledge helpful comments from Professors Victor Brudney, Merritt Fox, Ronald Gilson and Richard Shell, as well as from the Pomerantz panelists: The Honorable Stanley Sporkin, United States District Judge for the District of Columbia and the Honorable Joseph Grundfest, Commissioner, Securities and Exchange Commission. Because the author is serving as Reporter to the American Law Institute for the Remedies Section (Part VII) of its Principles of Corporate Governance: Analysis and Recommendations, it should be understood that this article represents only the author's position and is not intended to express the views of the ALI or his fellow Reporters.

joint and several liability and contribution, and the curtailment of punitive damages. All of these proposals flow from the same wellspring: a broad public perception that there is today a liability crisis, which has increased the volume of litigation, dried up the availability of liability insurance, and exposed many to the threat of bankrupting litigation. The accuracy of this perception of a liability crisis is open to serious question, but is largely beyond the scope of this article — in part, because the perception itself may be the important phenomenon, one that can become self-fulfilling.

This public perception of a liability crisis has already begun to influence the development of American corporate law. By one recent tabulation, over half the states have enacted legislation since 1986 to shield corporate directors from liability for breach of the duty of care. Although several different approaches have been used to shelter corporate officials, the most popular reform has been a form of statute, first enacted by Delaware, that authorizes shareholders to adopt a charter provision that "opts

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2 For example, a series of recent Supreme Court decisions seem to have the one common denominator that the plaintiff's attorney always loses. See Evans v. Jeff D., 106 S. Ct. 1531 (1986) (upholding fee waiver as a condition of settlement); Marek v. Chesny, 473 U.S. 1 (1985) (expanding scope of Rule 68 to deny fee award for post-settlement offer efforts where outcome less favorable than settlement offer); Pennsylvania v. Delaware Valley Citizens' Council, 106 S. Ct. 3078 (1986) (denying multiplier or bonus in fee award determination for special skill or success of attorney), modified on reh'g, 107 S. Ct. 3078 (1987) (denying risk multiplier to plaintiff's attorney).

The American Law Institute (ALI) has begun several projects to consider alternative approaches to mass tort class actions. For their first effort, see ALI, Preliminary Study of Complex Litigation (Draft Report for Council, December 1, 1986). The Reagan Administration has also endorsed proposals to reduce both jury awards and plaintiffs' attorneys' fees. See Pear, Administration Submits Plan To Reduce Damage Awards, N.Y. Times, May 1, 1986, at B9, col. 1.

3 See, e.g., Galanter, Reading the Landscape of Disputes: What We Know and Don't Know (And Think We Know) About our Allegedly Contentious and Litigious Society, 31 U.C.L.A. L. Rev. 4 (1983) (suggesting that the flurry of contemporary litigation should be viewed in light of evolving social conditions).

4 See Investment Responsibility Research Center, More than Half of the States Offer Director Liability Protection, 4 IRRC Corporate Governance Bulletin No. 5, at 155 (Sept./Oct. 1987). Interestingly, the rapidity with which 27 states have enacted legislation in little over a year is probably the most telling argument against a broader right to opt out of the normal rules of corporate governance, because it suggests that there is little barrier to changing those rules, given the competitive market for corporate charters. However, I think the case of director liability statutes is unique and largely a response to a perceived sudden crisis surrounding the availability of liability insurance. Other possible private ordering variations will not affect as many corporations and so will not elicit the same legislative stampede.
out” from the common law’s rules on due care liability. This idea that shareholders can contract out from the common law and adopt a different regulatory regime derives in turn from an increasingly important academic perspective on corporate law — popularly known as the “contractarian” theory of the corporation — which sees state-enabling statutes as simply providing a model form contract (in effect a statutory Blumberg’s form) from which shareholders may deviate as they choose. This Article will focus on the confluence of these two trends: the movement toward “tort reform” and the growing acceptance of the contractarian theory of the corporation.

At this confluence, a third trend toward “tort reform” has begun to gather momentum, but has not yet reached the corporate field: the Alternative Dispute Resolution (ADR) movement. Predictably, this movement will also intersect with the contractarian view of the corporation because proponents of ADR (or at least those who like the outcomes it produces) will favor charter provisions under which most intra-corporate disputes would be handled by arbitration, thus denying a plaintiff access to the courts through a derivative action. Can a corpora-

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7 For the bible of this new movement, see S. Goldberg, E. Green & F. Sander, Dispute Resolution (1985). For an effective critique of some of its many underexamined premises, see Merry, Disputing Without Culture (Book Review), 100 Harv. L. Rev. 2057 (1987).

8 Rash as this prediction may have seemed when I made it at the Pomerantz Lecture, it has already been fulfilled. The Center for Public Resources, a New York-based organization dedicated to alternative dispute resolution, has begun to draft a model proposal. Franklin, Courthouse Closed?: Required Mediation of Shareholder Suits
tion do this? Two recent Supreme Court decisions, which this Article will examine, now makes this at least a plausible scenario.9

The common denominator in these recent trends in tort reform — i.e., the elimination of liability for due care violations, and the possible substitution of arbitration for the derivative action — is that the legitimacy of each rests upon the view we take of private ordering. How deferential should a court be to a charter amendment approved by widely dispersed shareholders of a public corporation? Of course, when the specific charter provision has been clearly authorized by the legislature, little doubt exists about the validity of this type of contracting out from the common law.10 Here, the legislature clearly has made the common law norm a default rule from which shareholders are free to opt out.

But what if there is no such legislative statement? Interestingly, the recent Delaware statute that is the prototype for this wave of legislation appears to have borrowed its charter amendment technique from the American Law Institute’s (ALI) Corporate Governance Project, which had published an earlier Discus-


10 Some recent decisions have invalidated ceilings on liability in other contexts on seventh amendment grounds. See, e.g., Boyd v. Bulala, 647 F. Supp. 781, 788-89 (W.D. Va. 1986) (invalidating ceiling on medical malpractice liability). This issue is beyond the scope of this article, and in any event would only change the kind of opting out device that would be used, because the duty of care can itself clearly be constitutionally modified or abolished. Although the validity of the Delaware statute is not in serious doubt, its construction may be.

Del. Gen. Corp. Law § 102(b)(7) contains several ambiguous exceptions. It authorizes:

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provisions shall not eliminate or limit the liability of a director (i) for any breach of the director’s duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under section 174 of this Title, or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this subsection to a director shall also be deemed to refer to a member of the governing body of a corporation which is not authorized to issue capital stock.
sion Draft that concluded that a majority of the shareholders could reduce, but not eliminate, financial liability for due care violations through charter provisions.\textsuperscript{11} Thus, the ALI draft goes further than Delaware in one important respect: It would permit shareholders, even in the absence of specific statutory authority, to deviate from the common law’s standards through charter amendments, at least to the limited extent of placing a ceiling on the financial liability of officers and directors for what might loosely be termed ordinary negligence.

Yet, if shareholders have this power to adopt such “free-standing” departures from the common law not clearly authorized by statute, the slope obviously becomes slippery as to where this power stops. Indeed, the question arises: Why can’t they also adopt charter amendments that abolish all forms of liability, including that for the duty of loyalty, or charter provisions that expressly permit corporate officials to engage in insider trading or to usurp corporate opportunities?\textsuperscript{12} Some would answer this question by saying that shareholders are too rational to ratify such amendments; hence, there need be no limits on their authority. Others who doubt the efficacy of shareholder voting believe that shareholders will ratify almost anything placed before them in a proxy statement; they then would reject any departures from the common law not authorized by statute. The arguments on both sides of this question need not be restated here, but the more interesting question is whether there is any

\textsuperscript{11} Delaware amended its statute on July 1, 1986 to add subsection (b)(7) to section 102. The ALI’s proposed charter limitation provision was first set forth in a printed, widely circulated document in Discussion Draft No. 1, published in 1935. A later typewritten version of the current version of section 7.17 was made available to the Corporate Laws Committee of the Delaware State Bar Association that drafted subsection 102(b)(7). See note 15 infra. Although it is always speculative to infer what precedents persuaded a committee, members of that committee have informed this author that they were influenced by the ALI proposal and that they had previously been discussing changes in Delaware’s indemnification statute in order to “shield” directors from the impact of Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985). The ALI Discussion Draft appears to have been the only policy proposal seeking reduction in directors’ due care liability that antedates the decision in Smith v. Van Gorkum.

\textsuperscript{12} Some commentators would wholly privatize the law of insider trading and allow corporations to license such trading by officers in their stock. See Macey, From Fairness to Contact: The New Direction of the Rules Against Insider Trading, 13 Hofstra L. Rev. 9, 39-47 (1984). As this article will explain, I strongly disapprove of such charter provisions and believe they should not be upheld, because of the unproductive uncertainty they create.
coherent intermediate position. Can we find criteria by which to define a boundary line, separating those areas where contracting out from the common law's basic norms should be permitted, even in the absence of specific authorizing legislation, from those components of corporate law that should be viewed as mandatory in character?

This article will suggest that at least a partial answer to this question can be found by taking the idea of the corporation as a contract more seriously than have the contractarian theorists, who tend to have a highly reified idea of contract. To do so requires that we examine actual contract law, where courts have developed a number of doctrines by which to restrict opportunistic behavior by those who propose a contractual modification. If we are looking for standards by which to judge charter amendments that seek to opt out of the normal rules of corporate governance or fiduciary duties, this body of law limiting contractual modifications supplies, I believe, a better guiding analogy than do vaguer references to the murky law on unconscionability or contracts of adhesion. In both the case of the contractual modification and the charter amendment, an ambiguous or not clearly understood term may permit the party who proposed the modification or amendment to behave in a manner that is inconsistent with the expectations of the other party or shareholders. Contract law has responded to this problem by developing equitable limitations that look to whether the risks addressed by the modification had been earlier allocated or whether instead they were new and unforeseen. If corporate law is to follow contract law, this analogy suggests that attempts to opt out from the "default" rules of corporate governance look very different (and more suspicious) if they occur at midstream (and are to be effected by charter amendment) than if such opting out occurs at the formation of the firm. Other analogies to existing contract law, in particular Uniform Commercial Code section 2-719, suggest that courts should not simply defer to a charter amendment that opts out, but should ask if hypothetical

13 For an illuminating overview of the rationale for restricting contractual modifications, see Muris, Opportunistic Behavior and the Law of Contracts, 65 MINN. L. REV. 521 (1981). Professor Muris chiefly focuses on certain implicit terms (such as a good faith requirement) that courts often discover in contracts and argues that these terms are really intended to deter opportunism by the party who proposes the modification.

14 See notes 40-41 infra.
bargainers could sensibly reach such an arrangement. Such a focus on hypothetical bargaining is very different from either total deference or hostility to opting out.

Because general concepts are best introduced with specific illustrations, this article will use two specific proposals — section 7.17 of the ALI's Principles of Corporate Governance and the proposed substitution of an arbitration remedy for the derivative action — as stalking horses by which to approach the larger issues of private ordering and opting out in the context of the public corporation. To be sure, limitations on due care liability are a far easier "reform" for most to accept than the possible substitution of arbitration (or other alternative means of dispute resolution) for judicial remedies. This latter case forces us to examine from a more skeptical angle how prepared we are to permit opting out and, more generally, the degree to which we consider corporate law to be only enabling in character.

I. SECTION 7.17: DUE CARE AND "EXCESSIVE DETERRENCE"

Section 7.17 of the ALI's Principles of Corporate Governance: Analysis and Recommendations essentially provides that shareholders may adopt, and courts should give effect to, a charter provision limiting the liability of corporate officers and directors for certain violations of the duty of care.15 When applicable,

15 ALI, Principles of Corporate Governance: Analysis and Recommendations § 7.17 (Tent. Draft No. 7, 1987) [hereinafter ALI Draft]. The section reads as follows:
Limitation on Damages for Certain Violations of the Duty of Care
(a) If a failure by a director [§1.08] or an officer [§1.22] to meet the standard of conduct specified in § 4.01 did not
(1) involve a knowing and culpable violation of law by the director or officer; or
(2) enable the director or officer, or an associate [§ 1.02], to receive a benefit that was improper under Part V; or
(3) show a conscious disregard for the duty of the director or officer to the corporation under circumstances in which the director or officer was aware that his conduct or omission created an unjustified risk of serious injury to the corporation; or
(4) constitute a sustained and unexcused pattern of inattention that amounted to an abdication of the defendant's duty to the corporation, damages for the violation should be limited to an amount that is not disproportionate to the compensation received by the director or officer for serving the corporation during the year of the violation.
(b) A limitation on damages complying with § 7.17(a) may be implemented by
(1) an enabling statute that authorizes the inclusion of a limitation on
section 7.17 permits liability to be reduced to a floor set at the compensation the defendant receives from the corporation during the year (or years) of the violation. Thus, if a director receives $20,000 in fees for performing his duties as a director, this amount will also represent his maximum liability for a "simple" due care violation, even if the actual damages proximately caused by the violation of the duty of due care were $10,000,000.

In effect, section 7.17 allows the shareholders to substitute a different and far more modest measure of damages for the traditional tort measure of damages (i.e., all damages proximately caused by the tort), which in the past the common law has used in derivative actions. In this light, it addresses the adjectival law (the measure of damages) more than the substantive law (the nature of the duty).

However, section 7.17 does address the nature of the duty, because it carves out some violations of the duty of care as to which its ceiling does not apply. Specifically, clauses (a)(1) through (a)(4) of section 7.17 identify certain more egregious violations as to which no exculpation or mitigation of damages is authorized. As a result, if section 7.17 were to be accepted by courts, it would reflect both a partial recognition that common law rules may sometimes be modified through private ordering and at the same time a statement that there must be limits on this ability to "contract out." Still, even if section 7.17 does then reflect a specific instance of an intermediate position, how can we generalize its conclusion that there are both permissible and

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Id.


17 See note 15, supra. It should be noted that these exclusions roughly parallel Del. Gen. Corp. Law. § 102(b)(7), but are somewhat narrower and more precise in their coverage. For a discussion of the differences, see ALI Draft, supra note 15, at 43-46.
impermissible deviations from the common law?

On the simplest level, the prevailing law is that shareholders can adopt any provision in the certificate of incorporation that is not against public policy. This statement is tautological and leads only to a further question: How do we determine when a particular provision exceeds the boundaries of public policy? Arguably, if financial liability is reduced or eliminated, the incentive to comply with the duty of care would decrease. Conversely, there are obvious justifications for a ceiling on due care liability, which suggest that efficiency gains can be realized by contracting out from the common law. Briefly, five distinct policy justifications can be advanced for the position reached in section 7.17.

First, there is the danger that excessive exposure to liability — whether that exposure is real or only perceived — will cause directors to flee the board. This danger has been pointed to many times in the past, but only recently has there been any empirical evidence to corroborate it. In 1985, the percentage of outside directors on the boards of the one thousand largest industrial corporations dropped from 63.2% to 57.5%, according to Heidrick & Struggles. This was the first decline in this figure since 1966, the year Heidrick & Struggles first began tabulating board composition. Similarly, a recent study by Korn/Ferry International found that 20% of all corporations surveyed had been turned down by a prospective director; many had been rejected more than once. Although different scenarios may explain what caused this vector change in board composition, one cannot be indifferent to it, unless one takes the doctrinaire view that board composition is irrelevant because outside directors are either ineffectual or usually subject to disabling conflicts of interest.

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18 Compare Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107 (1952) (stockholders may agree to a charter provision which permits interested directors to be counted towards a quorum) with Irwin v. West End Dev. Co., 342 F. Supp. 687, 701 (D. Colo. 1972) (exculpatory charter provisions may limit liability of interested directors but may not be interpreted as a license to steal). The line between the two cases appears to involve the potential for fraud.
21 Some commentators doubt that the outside director plays more than a symbolic role that legitimates the exercise of managerial power. See Brudney, The Independent Director — Heavenly City or Potemkin Village, 95 Harv. L. Rev. 597 (1982). See also H. Geneen, Managing 250-61 (1984) (doubting that outside directors play any significant
Second, there is a fairness argument: the duty of care imposes broad monitoring responsibilities upon directors and, although the law protects corporate officials by according them the generally ample protections of the business judgment rule, that doctrine contains a hidden reef — unless the director has informed himself adequately with respect to the matter at issue, the business judgment rule does not, in its standard formulation, apply. Because ill-advised economic decisions (whether to expand production, increase debt, undertake acquisitions, restructure the firm, build the Edsel or make substantial loans to Brazil) can produce astronomic losses, there is a curious irony here that the duty of care, if violated, will typically yield much higher damages than the duty of loyalty. Yet, in the due care case, the culpability of the actor is much lower; negligence is certainly considerably less reprehensible than predatory self-dealing or fraud. When the level of damages does not correspond even roughly to the actor’s level of culpability, intuitive notions of fairness tell us that something is wrong. This is doubly so when the law in this area has little compensatory role to perform (as I would assert that it does not in this area, given the high transaction costs associated with derivative litigation).

Simply put, shareholders do not look to directors’ pockets as a source from which to recover economic losses, nor do directors accept any role as insurers when they come on the board. Moreover, the equation between the shareholder and the traditional tort victim breaks down even further when we look at the plaintiff’s side of the equation: shareholders typically hold diversified portfolios, while the tort victims of medical malpractice cannot similarly diversify away their risks. Thus, the standard tort analysis fails to provide an appropriate analogy both because (1) the corporate director is not an entrepreneur who incorporates into the price he charges some premium for the risk he assumes, and (2) the shareholder-plaintiff is unlike the typical tort plaintiff whose injuries cannot be mitigated through diversification. In this light, deterrent, not compensatory, objec-

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role under current board structures). Although I agree that information overload and other constraints place realistic limits on what independent directors can accomplish, I find this view too cynical.

22 For the classic statement of this procedural requirement to the invocation of the business judgment rule, see Casey v. Woodruff, 49 N.Y.S.2d 625 (1944).
tives should underlie the duty of care, and they can be satisfied by damages far below the level that the standard tort measure permits.

A third justification underlying section 7.17 begins from the standard nullification thesis that is well known to students of the criminal law. Just as the English jury of the eighteenth century was believed to be reluctant to convict the poacher, even when he was caught in the act, because it considered the penalty (typically, capital punishment) too severe for the crime, so also are courts likely to distort the substantive law of the duty of care if they believe the penalties are disproportionate. From this premise, it follows that the awarding of more modest damages might result in the substantive duty being enforced more evenly and effectively. Today, judicial opinions concerning the duty of care frequently display a disingenuous quality, as the court first announces a high standard of expected performance but then finds some ad hoc reason to justify dismissal.

A fourth reason grows out of the current liability insurance crisis. One way to view section 7.17 is as an attempt to restore an equilibrium. In the recent past, whatever their theoretical exposure, directors relied on their insurance policies, which effectively reduced their liability to the policy's minimum deductible (and any co-insurance provision). Today, if insurance is not available, or if the exceptions to the policy seem to overwhelm its coverage, a charter provision reducing due care liability to the director's fees roughly reinstates the prior status quo. In effect, directors are not substantially more, or less, exposed to loss than in the recent past, but the cost of insurance is saved. Ar-

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23 For a brief discussion of this nullification hypothesis, see ALI Draft, supra note 15, at 31, 57. In this light, it is relevant that directors of publicly held corporations receive relatively modest fees in proportion to their overall income and wealth. According to a 1983 survey by Arthur Young & Co., the average compensation, including fees for attending meetings, received by directors of publicly held firms was $14,230. See ARTHUR YOUNG & CO., ORGANIZATION AND COMPENSATION OF BOARD OF DIRECTORS, at 27 (Table 20). This figure rises to $34,300 for directors of companies with annual revenues exceeding $5 billion. See KORN/FERRY INTERNATIONAL ANNUAL SURVEY, Wall St. J., June 14, 1985, at 7, col. 1.

24 In the wake of several large payouts by insurers, the insurance industry dramatically increased premiums on "D&O" insurance in 1985. One survey found that "D&O" premiums rose on average 362% during 1985. See Table, KORN/FERRY INTERNATIONAL, Wall St. J., Mar. 21, 1986, at 31, col. 3. See also Hilder, LIABILITY INSURANCE IS DIFFICULT TO FIND NOW FOR DIRECTORS, OFFICERS, Wall St. J., July 10, 1985, at 1, col. 6; LEWIN, DIRECTOR INSURANCE DRYING UP, N.Y. Times, Mar. 7, 1986, at D1, col. 3.
guably, section 7.17 then restores only the former equilibrium, while in contrast those recent statutes that permit the total elimination of liability place the board's directors in a better position than they were in before the recent liability insurance crisis. In this light, there is something intellectually dishonest about using the liability insurance crisis to make the insured better off than if he had low cost insurance. At most, this crisis justifies an equitable intervention intended to restore the prior status quo.

A final justification for section 7.17 is that it suffices to meet the law's real objective in the due care area, namely, an adequate deterrent threat. In the case of the corporate officer, the measure of liability — one year's salary — is likely to be a significant percentage of the realistic net worth of most corporate officials. In the case of the director, the measure of one year's director's fees does not amount to the same threat, but the exceptions set forth in section 7.17 deny the availability of the ceiling when the director's conduct falls within them. As a result, a director is given only an expanded margin for error, not immunity for egregious misbehavior. In any real world setting, a director will remain conscious of the litigation risk that his conduct, viewed retrospectively by a possibly unsympathetic fact-finder, may seem to fall within the exclusions set forth in section 7.17 (in particular, either the "recklessness" exception in section 7.17(a)(3) or the "abdication" exception of section 7.17(a)(4)). To be sure, this same point can be made about the Delaware statute and other similar recent statutes, because their "good faith" requirement creates a similar litigation risk that defendants must discount. The result is that deterrence remains because even a small litigation risk of high financial liability should be adequate to deter most forms of shirking. Perhaps the best parallel here is the impact of the scienter requirement imposed by the Supreme Court for Rule 10b-5 actions in *Ernst & Ernst v. Hochfelder*. Although the change from negligence to scienter undoubtedly made a difference and tilted the litigation

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25 See notes 10 & 11 supra.
26 425 U.S. 185, 201 (1976) (requiring proof of scienter, rather than negligence, to support an action under Rule 10b-5). This decision left open, however, whether proof of "recklessness" would suffice to show scienter, but subsequent decisions have found such proof to be sufficient.
balance in favor of the defendant, experienced plaintiffs’ attorneys quickly found imaginative ways by which to plead scienter. The net result was to reduce the settlement value of Rule 10b-5 litigation, but not to spell its demise. Similarly, duty of care litigation may be chilled by section 7.17, but not eliminated, as the real impact is to force plaintiffs to settle on the basis of their ability to prove “recklessness” or some other exception to section 7.17’s modest ceiling.

In terms of public policy, the central issue then is: How much deterrence is needed? Any sensible answer depends on what we expect directors to do. If a realistic view is that directors should serve as monitors and not as the actual decision-makers, then focusing deterrence, as section 7.17 does, on conscious indifference, abdication, and illegality seems to me to correspond to this monitoring model of the director’s role.

Having stated these justifications for a ceiling on damages, let me now distance myself from them. My claim is not that the foregoing arguments are clearly superior to all the possible counter-arguments. Indeed, if the common law rule were as bad as the foregoing discussion suggests, over time courts probably would either modify the rule or develop collateral doctrines (e.g., restrictive procedural rules or affirmative defenses) that weaken it. But this would take time. During this interim, the case for private ordering is that the parties can recognize their own self-interest more quickly than the courts. That there are defects in the private ordering process (as Professor Brudney properly points out) does not mean that there are not also strengths. If so, why should private ordering be wholly dependent in this context on express legislative authority for departures from the common law? This claim may sound so modest and uncontroversial as to approach the trivial. Yet, before we defer uncritically to the norm of private ordering, we must ask what distinguishes this deviation from the common law from other, more dubious departures — for example, a charter amendment authorizing insider trading by corporate officials as a form of managerial compensation. The real challenge then may be to articulate why opting out should not always be permissible.

II. PERSPECTIVES ON THE CORPORATION: PRICING VERSUS BARGAINING

Let me approach the central problem of line drawing in the
time honored way of all law professors by first sketching two po-
lar positions and then offering my own "reasonable" intermedi-
ate compromise. This tactic of preempting the middle ground
also allows me to juxtapose two basic perspectives on corporate
law that have many adherents but that are in my judgment ulti-
mately unsatisfactory.

A. The Contractarian Perspective

The first perspective, which I will term the contractarian
perspective, has been most forcefully advanced in a series of ar-
ticles by Judge Easterbrook and Professor Fischel. In their view:

The code of corporate law is a standard form contract for issues of
corporate structure. To the extent [that legal rules] anticipate the
desires of the contracting parties, these off-the-rack principles reduce
the number of items to be negotiated and the costs of negotiating
them.27

In short, corporate legal rules exist, it seems, simply to reduce
transaction costs. Corporate law offers a model form contract;
shareholders are free to buy "off-the-rack," as it were, at J.C.
Penney's or to pay more for individualized tailoring at Brooks
Brothers. From this perspective, statutory corporate law can be
seen as only a set of "default" rules that fill in the void where
the parties have not chosen to write their own contract in more
detail. In this light, it is unsurprising that Judge Easterbrook
challenged the Reporters at the 1986 Annual Meeting of the
American Law Institute to permit such contracting-out explic-
itly.28 Except in a few limited areas, such as section 7.17 and the
corporate opportunity doctrine, where we do permit shareholder
action to reduce the scope of the legal obligation that would oth-
otherwise exist,29 we have largely declined his invitation. While I do

27 Easterbrook & Fischel, Voting in Corporate Law, 26 J. of L. & Econ. 395, 401
(1983).

28 See ALI, PROCEEDINGS OF THE 63RD ANNUAL MEETING 412-13 (1987). Judge Eas-
terbrook argued that portions of the duty of loyalty could be made inapplicable to a
specific corporation's officers and directors by a shareholder vote. After an extended dis-
cussion of this contractarian view of fiduciary duties, a motion was made and passed to
refer the discussion to the Reporters for further study.

29 See ALI Draft, supra note 15, § 5.09 (permitting, for example, disinterested direc-
tors or shareholders to approve a "standard of the corporation," which term includes a
bylaw, under which certain transactions "that could be expected to recur in the ordinary
course of business of the corporation" may be entered into without specific board or
not speak for my fellow Reporters, I would consider this article to be my reply.

B. The Consensualist’s Position

Some commentators reject the contractarian perspective as oversimplified — in effect, an interesting intellectual thought experiment that has few empirical referents in the real world of complex institutional structures and high transaction costs. Probably the most articulate of these critics has been Professor Victor Brudney who, in a 1985 article in the Columbia Law Review, dismissed the claim that private bargaining can restrain management self-dealing and shirking as mere “rhetoric.” Strong echoes of Berle and Means can be clearly heard in his analysis: stockholders are too dispersed to take effective coordinated action; they lack the requisite information and the necessary institutional mechanisms to bargain effectively; outside directors are too compromised and insufficiently motivated to be effective monitors. In short, the relationship between investors and managers within the large firm is not governed by anything resembling a market, and it “stretches the concept of ‘contract’ beyond recognition to use it to describe either the process of bargaining or the arrangements between investors of publicly held corporations and either theoretical owners first going public or corporate management.”

If the notion of contract is, at bottom, grounded on the bargain principle, Professor Brudney seems to me to be correct in concluding that the corporate charter should not be analogized to a contract because there is little opportunity for individualized bargaining between investors and managers. Even most contractarians would concede this, but their reply brings us to the nub of the matter. Contractarians acknowledge that investors never negotiated the terms of the corporate contract with managers, but they answer that the market nonetheless “priced” those terms. Investors’ consent to those terms is then implicit in

shareholder approval). In effect, this provision authorizes a limited amount of self-dealing as to which specific board approval is not required if the transaction is authorized generally by such a “standard of the corporation.”


31 Id. at 1412.
their decision to purchase the stock at the market price. Unfairness, they would argue, only results when the investor pays for something that he does not get; thus, so long as there is disclosure of what the investor is not getting, no unfairness can result.

Professor Brudney will have none of this. He dismisses this use of market terminology stating, "[T]his reference to the market appears to suggest that in some metaphorical sense aggregate decisions by investors over time embody a mechanism for implementing free and informed individual choice." Here, then, is the core dispute: one side demands individual consent, which can only be demonstrated by actual give-and-take bargaining; the other considers the market and its pricing mechanism as an adequate surrogate for individual bargaining.

Note, however, that from either perspective, section 7.17 seems objectionable. To a contractarian, it seems inconsistent to allow some contracting out from the common law's standards but then to place boundaries on the permissible range of such departures. Section 7.17 clearly does this because it permits shareholders to reduce liability only to a minimum level equal to the corporate official's fees or salary, but not to eliminate all liability for a simple due care violation (as Delaware now permits). It also specifies in some detail certain varieties of misconduct for which there may be no reduction of liability. To contractarians, these restrictions offend their sense that the corporate charter is simply a private contract among consenting adults. Conversely, to the consensualists, section 7.17 seems even more deplorable because it arguably trivializes a fiduciary duty that numerous judicial decisions have addressed.

As the Reporter thus caught in the crossfire between those who say section 7.17 goes too far and those who say it does not go far enough, I find the positions of both sides to be extreme. Pricing is not the same as bargaining, but the consensualists have not adequately explained why. In particular, I believe that Professor Brudney has pointed to the wrong reasons for ob-

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32 Id. at 1420.

33 Professor Brudney has described a predecessor version of section 7.17 as "apparently designed to assure directors . . . of substantial, if not total, freedom from any enforceable obligation to investors with respect to their inputs in conducting the enterprise." Id. at 1410 n.19. He suggests that the adoption of this provision was a retreat in the face of the "intense campaign by the fuglemen of corporate management" (an apparent reference to the Business Roundtable). Id.
jecting to pricing as a substitute for bargaining; the problem is not that the decisions of shareholders cannot be analogized to those of participants in a market (indeed, they can be), but that all markets have their inherent weaknesses and characteristic reactions to the problem of quality uncertainty. Usually, these imperfections are described as problems of "imperfect information." Imperfect information is, however, a portmanteau concept that needs to be unpacked. Shareholders may have an imperfect understanding of the terms in the corporate charter, of the risks that it allocates, of the differences between the charter terms that various firms are offering, or of the likely impact that a difference in terms will have on managerial behavior (which behavior is, of course, also restrained to an uncertain extent by non-legal forces, such as the need to preserve reputational capital). Similar problems exist in many consumer markets, but there is an important distinction between the market for charters and the markets for most consumer goods. This difference is essentially that the major risks are endogenous. That is, although the consumer in the market for new cars may also have difficulty in distinguishing the reputation for quality of many manufacturers, the consumer in the corporate securities markets must face the problem that any material deviation in charter terms may affect future managerial behavior. This consumer is not buying a durable consumer good whose present quality he can ascertain if he investigates fully, but a future stream of earnings that may be diverted, wasted or misappropriated by managers who may be able to exploit some special discretion that these terms give them. In short, these risks are harder to foresee because they depend on future contingencies and future management personnel. Information about these risks is not only more costly, it approaches the unknowable.

This claim that there is a unique kind of quality uncertainty

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25 Of course, it is arguable that opting out from any fiduciary duty or remedial provision "signals" that the firm intends to overreach the consumer (or shareholder) in exactly this area. This view that a warranty or a disclaimer of a warranty "signals" the quality of a firm has been stated many times in the general commercial literature. See Grossman, The Informational Role of Warranties and Private Disclosure About Product Quality, 24 J.L. & Econ. 461, 470-77 (1981). But it is also possible that the firm is only "signalling" its reservations (accurate or inaccurate) about the costs, accuracy, and error rate of some legal remedies.
concerning the market for corporate charters and that such special contractual provisions are more likely to change managerial behavior does not lead inexorably to the conclusion that special contracting is therefore illicit. The consensualists have not adequately recognized the costs of their position. If one says that only individualized bargaining can suffice to justify a departure from the common law, and if such individual bargaining is generally infeasible, this position may freeze the common law in place and, thus, amounts to a prescription for stasis and stalemate.

C. A Critique of the Contractarians

The usual criticisms of the contractarian position are that high information costs and collective action problems render shareholders "rationally apathetic." Although I agree that contractarians systematically tend to minimize these problems, these criticisms take us only so far and do not necessarily justify a prophylactic rule against all departures from the common law. They need therefore to be supplemented by two other criticisms, one legal and one economic.

My first criticism is that the contractarians have pushed their private contract analogy too far because they have failed to understand modern contract law, and in particular the legal restrictions on contractual provisions that limit remedies. They thus have reified the concept of contract and not examined how these doctrines are actually applied in most commercial contexts. My second and more general objection is that externalities can arise from an unconstrained right to opt out — in particular, a "lemons market" effect seems likely that should have an adverse impact on not only the shareholders of the subject company but on the market for corporate securities generally. Ultimately, these two criticisms dovetail and support a position under which courts would uphold only those departures for which a credible scenario can be presented explaining why rational shareholders would wish to depart from the common law's norms.

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36 For a concise discussion of these themes, see R. CLARK, CORPORATE LAW 390-92 (1986).
1. Doctrinal Objections

One ironic generalization seems justified about those economists who view the firm as a private contract: they often seem to ignore modern contract law in favor of an almost nineteenth century, stereotypical notion of what contract law permits. In fact, commercial law places some important boundaries on the ability of parties to a contract to limit the remedies available for its enforcement. Under the U.C.C. section 2-719, the parties may agree on limitations or restrictions on remedies, or may provide for substitute remedies, but only so long as the modified remedy would not “fail of its essential purpose.” Why does the U.C.C. say this? Possibly, the answer is that the U.C.C. assumes that, in this area, information costs are higher for the layperson. Or, it may believe that if the parties have agreed upon an ineffective or illusory remedy, one party has been overreached and the result is therefore “unconscionable.” Alternatively, its premise may be that there has been a mutual mistake or even a failure of consideration. Whatever the rationale, the U.C.C. places important limits on the permissible range of “contracting out” from its own remedies, even in this quintessential world of face-to-face bargaining.

A fortiori, if one cannot agree to ineffective remedies in face-to-face bargains, an analogy to contract law hardly supports permitting the same to be done in the corporate context, where transaction and information costs are higher and collective action problems confound bargaining. In this light, the U.C.C.'s position that remedies may be modified by private arrangements, but not rendered illusory, furnishes an apt analogy for what has been attempted in section 7.17. In essence, section 7.17 modifies the remedy for a breach of the duty of care, but the justification for this modification is that the residual threat of liability that it preserves does not permit the remedy to “fail of its essential purpose.” Of course, some may respond that the

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37 U.C.C. § 2-719(2). Basically, the subject of remedies is uniquely singled out for this protection against contractual overreaching. Although no equivalent statutory rule restricts contractual provisions relating to the character, price, or quality of the goods (except for the general and vague limitation on unconscionable contracts), U.C.C. section 2-316(1) does effectively restrict attempts to contract out from express warranties. This rule forbidding disclaimers of express warranties is probably founded on concerns about consumer confusion if the contract could seemingly give with one hand and take away with the other. Uniquely, section 2-719 forbids even clear and unambiguous limitations.
remedy, as so modified, now does fail of its essential purpose; others may claim that the remedy would not fail even if all damages were abolished, but these are issues of application, not rationale.

This analogy to the U.C.C. has its limits and arguably can be outflanked, unless we recognize more generalized policies underlying the U.C.C.'s special rule that remedies may not be emasculated. For example, what if a clever draftsman of the corporate charter were to seek not to change the remedy, but to modify the substantive duty. That is, suppose a charter provision defines the duty of care not in terms of its typical objective formulation (i.e., the standard of care that the "reasonable person in a like position would exercise"), but rather in terms of a wholly subjective formulation (i.e., a duty to "act in good faith and for a corporate purpose"). The new Virginia statute uses just such a subjective standard. Assume, for example, that the charter amendment sought to abolish the corporate opportunity doctrine, and no statute gave explicit authority for such a modification. At present, the case law indicates that any charter amendment that directly conflicts with statutory law or a clearly established common law rule will probably be invalidated as against public policy. But a convincing rationale for this public policy barrier to contracting out has yet to be given in the face of the new intellectual attack by the contractarians.

In my view, the best rationale for the public policy limitation should be the prospect of managerial opportunism. The risk of such opportunism is greatest when the charter provision is added by an amendment that shareholders do not fully under-

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38 VA. CODE ANN. § 13.1-690 (1985) (defining director's duty of care in terms of "his good faith business judgment of the best interest of the corporation"). This appears to be an entirely subjective standard and thereby would eliminate liability for negligence that was not accompanied by bad faith. See IND. CODE ANN. § 23-1-35(2) (Burns Supp. 1986) ("The breach or failure to perform constitutes willful misconduct or recklessness.").

39 See, e.g., State ex rel. Cochran v. Penn-Beaver Oil Co., 34 Del. 81, 143 A. 257 (1926); Abercombie v. Davies, 35 Del. Ch. 599, 123 A.2d 893 (1956); Smith v. California Thorn Cordage, Inc., 129 Cal. App. 93, 18 P.2d 393 (1933). But see Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107 (1952) (upholding deviations from common law where no potential for fraud created). Note, however, that even in Sterling, which is a more permissive decision than earlier cases, there is a focus on the potential for fraud that parallels U.C.C. section 2-719's focus on the remedy's essential failure to serve the intended purpose.
To guard against contractual modifications that one party is either coerced or tricked into accepting, the Restatement (Second) of Contracts imposes equitable limitations that ask if the risk being responded to was within the reasonable anticipation of the parties at the time they originally entered into the contract. Under such a test, one could arguably abolish the corporate opportunity doctrine at the formation of the firm, but not through a later charter amendment, unless it could be shown that some risk or event was unanticipated that justifies the change. Conversely, it is certainly arguable that charter provisions limiting due care liability are a response to unanticipated events (or events that were only remotely foreseen), such as the liability insurance crisis or new case law imposing stricter standards of due care liability. The U.C.C.'s limitations on remedy modification can thus be seen as but a special sub-species of this general rule limiting modifications.

2. Historical Objections

Historically, American corporate law has never regarded the corporation as simply a private contract. Although corporate law has moved far from its original position, which saw corporations as quasi-public bodies, to become a largely enabling body of law, most state statutes remain mandatory on at least a num-

40 See Muris, Opportunistic Behavior and the Law of Contracts, 65 MINN. L. REV. 521 (1981) (viewing several well known doctrines of contract law as chiefly intended to deter or prevent opportunistic modifications of contracts).

41 See Restatement (Second) of Contracts § 89(D)(9) (modifications are valid if "fair and equitable in view of circumstances not anticipated by the parties when the contract was made"). Comment (b) to this section then adds that "[t]he reason for modification must rest in circumstances not 'anticipated' as part of the context in which the contract was made, but a frustrating event may be unanticipated... if it was not adequately covered, even though it was foreseen as a remote possibility." See also Muris, supra note 40, at 538-39.

42 Some historical research by economists suggests that corporate law originally perceived the corporation to be purely a private contract. See Butler, General Incorporation in Nineteenth Century England: Interaction of Common Law and Legislative Processes, 6 INT'L REV. OF L. & ECON. 169, 170-71 (1986); Forbes, Limited Liability and the Development of the Business Corporation, 2 J. OF L. ECON. & ORGAN. 163 (1986). Among professional historians, however, the private corporation in American history is generally seen as having evolved from a quasi-public institution; indeed, until the early 1800's, little difference was recognized between private and municipal corporations. See L. FRIEDMAN, A HISTORY OF AMERICAN LAW 188-95 (2d ed. 1955); H. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970 (1970).
ber of important points. Nor have recent statutory developments moved uniformly in the direction of a purely enabling body of law.

Interestingly, judicial oversight appears to have been more exacting precisely in those contexts where the individual owners have been the most able to frame their own legal rules. Particularly in the case of the partnerships and close corporations, courts seem to have been stricter in the enforcement of fiduciary duties than in the case of publicly held corporations; transactions that would likely have been upheld in the case of publicly held firms have been struck down in the case of closely held firms. Initially, this may seem paradoxical because state legislatures have granted closely held corporations considerable freedom to deviate from the usual housekeeping rules of standard corporate governance.

Yet, there may be a coherent explanation for this oversight. Courts may grant greater flexibility to closely held firms, but condition this additional discretion on a more exacting standard of loyalty. Why? Part of the explanation may be that participants in closely held firms do not have access to a securities

43 Most corporate statutes contain mandatory features requiring, for example, annual reports to shareholders, specifying supermajorities for certain fundamental corporate changes (such as a merger or liquidation), establishing fiduciary duties and legal remedies, limiting permissible dividends and other distributions, regulating the issuance of shares, and restricting indemnification.

44 Most recently there have been several waves of state takeover statutes that have resulted in a new layer of mandatory restrictions. Representative of this new "second generation" of takeover statutes is N.Y. Bus. Corp. Law § 912 (McKinney 1986) (prohibiting corporate combinations for five years after a hostile takeover and regulating the terms of subsequent mergers). I discuss these new statutes elsewhere. See Coffee, Shareholders Versus Managers: The Strain in the Corporate Web, 85 Mich. L. Rev. 1, 93-103 (1986). For a review of the movement toward an "enabling" body of corporate law, see Branson, Countertrends in Corporation Law: Model Business Corporation Act Revision, British Company Law Reform, and Principles of Corporate Governance and Structure, 68 Minn. L. Rev. 53 (1983).

45 See, e.g., Wilkes v. Springside Nursing Home, 370 Mass. 842, 353 N.E.2d 657 (1976); Donahue v. Rodd Electrotype Co. of New England, Inc., 377 Mass. 578, 328 N.E.2d 505 (1975); Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964). These cases, by discovering new fiduciary duties, give minority shareholders in a closely held firm far more protection against exploitation than would have likely been afforded a shareholder in a widely-held public corporation (who has the protection of access to the market).

It seems improbable that the Donahue and Wilkes decisions in particular would have been decided the same way if the corporations had been publicly held. Compare Donahue and Wilkes with Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964) (permitting a selective repurchase).
market as an escape mechanism; they thus are more exposed to potential exploitation. But another broader explanation may be that the corollary of the need for greater flexibility is also the need for closer judicial monitoring. In this view, the freedom to modify the rules of the game has limits that courts implicitly understand, even if they seldom articulate them. This assertion that there is a non-negotiable component to corporate law does not preclude opting out, but places limits on it, and sees judicial oversight as the corollary of this flexibility. Also, the right to opt out carries an unstated premise: if you do not do so, you have even more clearly accepted the traditional ground rules.

3. Economic Objections

Bad history can sometimes make good law. Thus, it does not resolve matters to argue that the new learning among contractarians is wrong when it asserts that the private corporation was actually understood by earlier generations to be a private contract to which the state was only a nominal party. Even if this contractarian thesis is wrong historically, it still may have a powerful normative appeal. Its core normative argument is that when investors get what they pay for, there is no unfairness. Thus, if the pricing mechanism works, it matters not that the promoters have promised very little.

What, if anything, is wrong with this argument? Professor Brudney has challenged it essentially on the grounds that the pricing will be inaccurate.\(^46\) In his rich, provocative article, he has offered a list of reasons why in his judgment market pricing cannot substitute for actual bargaining. In particular, he emphasizes: (1) that there is a systematic informational asymmetry between investors and managers that favors the latter; (2) that stock prices are more affected by factors relating to the systematic risk of a security than to “firm specific” factors; and (3) that the risks of fiduciary mismanagement cannot be accurately anticipated (in part because new risks constantly arise).\(^47\)

These arguments strike me as largely true, but not dispositive. Accurate pricing can occur in a market even in the face of significant informational asymmetries so long as enough sophis-
ticated investors understand the contract terms that are being offered. More importantly, there is, I believe, a better way to make the point at which Professor Brudney is clearly driving. Accurate pricing does not alone eliminate the potential for "unfair" wealth transfers from shareholders to managers; nor does accurate pricing alone produce allocational efficiency. Why is this so? A price can be "accurate" in a technical sense and yet reflect the considerable uncertainty that exists about the term being priced. This is because an "accurate" price may simply reflect the range of uncertainty as to the likely amount of managerial misappropriation of corporate returns to which shareholders are legally entitled. For example, if there is a 50% risk that a particular management will somehow divert 30% of all future returns to their firm, risk neutral investors should rationally discount the value of such a corporation's shares by 15%. This penalty may or may not be borne by those who originally sold the shares, but either way the discount will prove inadequate for some firms, because for these the risk will prove to be 100%.

The point will be examined in more detail in a moment, but its central implication is that for pricing to be an adequate substitute for bargaining, it must lead to something else — something that economists call "bonding." Bonding is essentially a mechanism by which the agent guarantees his performance to the principal. Managers, as agents, can bond themselves by voluntarily placing themselves in a position where they will lose more than investors if specified events or conditions (such as opportunistic behavior) occur. In theory, for example, managers could accept a management compensation formula geared to the "firm specific" component of the corporation's stock price after subtracting out the systematic risk component. Thus, they would have "bonded" themselves not to shirk responsibility because their salary would be directly correlated to the firm's performance.

Yet, when we look to the real world, we can observe very

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49 For a description of how such a contract could be designed so that the executive's compensation is tied to the market's evaluation of his firm and not simply to stock price levels generally, see Note, The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs, 37 Stan. L. Rev. 1147 (1985).
few, if any, instances of anything approaching such bonding behavior. Stock options only superficially resemble bonding and generally fail to align managerial and shareholder interests, both because they rise and fall in value based on general stock market levels (i.e., their value correlates more with systematic risk) and because, if the stock price falls, management may simply cause the board to cancel the old options and issue new ones at a lower price.

This absence of observable bonding in areas where economic theory would predict its prevalence has been noticed by others. In his study of insider trading, Professor Michael Dooley searched for evidence of bonding, monitoring, or signaling devices that could assure investors that management was not engaged in insider trading or otherwise exploiting the informational asymmetries that favor it. Finding none, he concluded that therefore investors were not significantly concerned about insider trading practices. However, as others have pointed out, this finding is equally consistent with another hypothesis: that managers lack sufficient incentive to install monitoring and bonding controls because their own economic welfare is not correlated closely enough with the firm's stock price performance to justify installation of such devices that are personally costly. Is this alternative hypothesis realistic? I think it is, at least with respect to some areas where control of managerial conflicts of interest would be particularly costly to managers.

Recent empirical research, particularly that by Professors Michael Jensen and Kevin Murphy, finds that executive compensation in fact is not closely tied to the firm's stock perform-

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50 Dooley, Enforcement of Insider Trading Restrictions, 66 Va. L. Rev. 1, 44-55 (1980). For a more general view that true bonding is seldom observed in practice, see Brudney, supra note 30, at 1422-23 & n.49.


52 I recognize that some forms of monitoring controls have long been standard, such as the use of independent auditors and outside directors, even though they are not legally mandated. See Watts & Zimmerman, Agency Problems, Auditing, and the Theory of The Firm: Some Evidence, 25 J.L. & Econ. 613 (1983). The absence of such controls is, however, clearly visible to most at very low search costs. Much higher search costs must be incurred with respect to potential conflicts over compensation formulas, insider trading practices, and takeover defensive tactics (particularly in the last case where some resistance may be beneficial, but successful resistance is a financial disaster for shareholders). See Jarrell, The Wealth Effects of Litigation By Targets: Do Interests Diverge in a Merger?, 28 J.L. & Econ. 151 (1985).
Specifically, Jensen and Murphy found that the typical chief executive officer's salary plus bonuses changes less than two cents for every thousand dollar's change in the equity value of the firm. Such a finding is almost the converse of what economic theory would predict and also suggests why little bonding is in fact observable: Managers need not bond themselves if agency costs are sufficiently high to permit them to structure their own compensation formulas in a manner that leaves them relatively indifferent to the firm's stock price performance.

The relevance of this absence of bonding to the question of the extent to which pricing can substitute for bargaining is best explained by focusing on what the market does when it estimates the impact of a risk on the firm's future returns. Essentially, the market views a risk as a probability dispersion. Economists model this process of risk evaluation in terms of two variables: mean and variance. One estimates the probability dispersion for the corporation's expected future returns by assigning probabilities to all possible outcomes. The weighted average of all these possibilities gives us a mean value. To know the impact of the specific risk being priced on the probability dispersion for the corporation's future returns, we also have to measure the degree of uncertainty surrounding our judgment. Variance is the statistical measure of this uncertainty; in effect, it measures the distance from the mean of the probability dispersion to its extremities.

Assume for the moment that shareholders could focus on the risk of fiduciary abuse and could accurately estimate both its impact on mean value and variance. Thus, they could accurately "price" the reduction in expected returns caused by the potential for fiduciary abuse. Yet, there is likely to be substantial uncertainty (and hence a high variance) about this expected reduc-

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54 Id. at 12 ("CEOs receive average raises of less than a penny (94c) for each $1,000 of increased shareholder wealth and get pay cuts of less than a penny when shareholders lose $1,000"). When stock ownership is also factored in, this figure jumps, however, to $1.41 per $1,000 increase or decrease in stockholder wealth.

tion for a variety of reasons: shareholders do not know how managers tend to exploit the new discretion conferred on them; secret profits and transactions are possible; managements change over time as new teams succeed older ones; the need to preserve reputational capital varies over time and may sometimes stay the hand of those who could divert assets; other social controls and personal morality may also restrain opportunistic behavior; new opportunities for unfair self-dealing may arise in the future — after all, abuses such as “greenmail” were simply not known twenty years ago. Nor can shareholders simply assume the worst, because other social controls and personal morality will restrain many (and probably most) managers. All these factors make it difficult to estimate the expected loss within a narrow range. As a result, a stock price can be “accurate” in the sense that the price accurately measures the range of this uncertainty, but a potential for unfairness can remain because of the substantial variance in expected future corporate returns makes it possible for management to profit by behaving worse than was expected. Only when bonding mechanisms induce managers to reduce that variance does the potential for unfairness dissipate.

The foregoing analysis is oversimplified and unrealistic in several respects that require qualification. First, the assumption that the market evaluates the risk of fiduciary abuse on a firm specific basis needs re-examination. Much more likely is that the market makes this judgment not on a firm-by-firm basis but generically across a range of similarly situated stocks. Only those firms (notably few, I believe) that can credibly distinguish themselves from the herd through signaling, monitoring, or bonding will be separately and individually “priced.” Given this view of fiduciary misconduct as at least in part an aspect of systematic risk, the experience of one firm in which one group of investors is deceived or mistreated by one team of venal managers will necessarily impact on the evaluation of the risk of fiduciary abuse for the class as a whole. In short, there will be external effects, because bad managers will raise the cost of capital to good managers, unless the latter can credibly signal their higher virtue. This last exception seems a small one, because the managerial cast is constantly changing and publicly disclosed information provides little basis for assessment.

Another criticism of the foregoing analysis is that it is trivi-
alized by the fact of shareholder diversification. If shareholders hold diversified portfolios, they should not care much about firm specific risk, particularly given the generally modest losses (on a per share basis) that fiduciary misconduct can cause. However, if the risk is really a systematic one (because all firms must incur agency costs), diversification is no longer a satisfactory remedy. More importantly, arguments about unfairness can easily be translated into arguments about allocative efficiency. When managers receive secret profits or are able to divert assets through undisclosed self-dealing, the prospect of inefficiency is high, in part because managers are escaping the discipline of the market. Indeed, even in the case of the better than average firm, there is a similar allocational inefficiency because this firm’s cost of capital is too high. Overall, because investors who face high uncertainty demand a higher return than those who do not, the inability of the market to estimate the risk of loss in this area with precision results in an unnecessary and socially inefficient increase in the average cost of capital experienced by all firms. In short, there is an externality.

Initially, my point then is that the pricing mechanism is far from a perfect substitute for bargaining in those circumstances where there is likely to be substantial uncertainty associated with the term being priced. In contrast, in actual bargaining, greater certainty is obtainable; the parties can include warranties, provide for monitoring and auditing procedures, can utilize bonding devices that reduce the uncertainty associated with the risk of agent misbehavior. In short, bargaining blends naturally into bonding. But pricing does not lead as naturally to this result. The great organizational distance that separates investors from managers complicates the process of bonding. Managers cannot make detailed representations and warranties to the market in the same way they can to a handful of investors. Rather, they must attempt to make broad and somewhat crude signals that may not be fully credible. Nor can one management team credibly signal the considerable uncertainty that surrounds the future team of managers that eventually will replace it. Absent credible bonding, pricing can be “accurate” but it still impounds the considerable uncertainty that surrounds future behavior of managers who have interests that potentially conflict with those of the shareholders.

What explains the puzzling relative absence of bonding?
Several answers suggest themselves. The explanation given earlier that overly crude compensation formulas leave managers with little incentive to bond is only a partial explanation. Additionally, there is the risk factor. Managers make relatively poor risk bearers because they have a much greater and non-diversifiable investment in the firm in the form of human capital. This helps explain why managers cannot afford to take their entire salary in the form of stock options or a similar compensation formula that rewards them only to the extent that they outperform the stock market. Still, even this thesis does not explain why managers do not bond against the risk of fiduciary misconduct, which is in theory within their own control and hence does not involve risk. One answer here may be that for such a guarantee to be effective, each manager would have to guarantee not only his personal performance but also that of his fellow and future managers as well. Vicarious liability in such a form is always distasteful and involves risks managers may not feel they can bear. Finally, there is the basic truth that the technology of bonding is not well developed. How does one prevent insider trading through private bonding? At least to this author, the answer is not clear, and almost certainly any effective proposal would be very costly.

The bottom line to this analysis emerges if these arguments lead us to conclude that (1) managements can seldom convey assurances to investors that the latter deem reliable that the former will not engage in opportunistic self-dealing, and (2) the market evaluates corporate managements largely on a generic basis in appraising the risk of fiduciary misconduct. Given these conclusions, economic analysis suggests that "rational" managers will find it personally costly to be more honest than average. This is a familiar issue in economics, sometimes called the "market for lemons" problem. A "lemons market" arises if there is uncertainty about the quality of a product and no competitor can find a means of assuring consumers that its product has above average quality. As a result, rational competitors will reduce their investment in product quality, because they cannot

56 See text accompanying note 52 supra.
recover their costs from this competition through receipt of a higher price. By analogy, if those managements that intend to perform above the "average" standard in terms of their fiduciary responsibilities cannot obtain a higher price for their shares in return for doing so, they should rationally regress to the mean. In theory, a "race to the bottom" should begin, and the mean value may slowly sink. Similarly, if substantial uncertainty surrounds the "opting out" process and the market has difficulty evaluating the quality of such charter amendments or management's future intentions regarding them, then "bad" (or low quality) amendments will begin to drive out "good" ones.

Where does this analysis lead us in policy terms? Obviously, it suggests that we cannot rely on market efficiency alone because accurate pricing does not alone eliminate unfairness or produce optimal allocational efficiency. If pricing does not discipline managers adequately, a conclusion that Professors Jensen and Murphy's research seems to underscore, because they find compensation formulas to be largely unrelated to stock performance, and if bonding works better in theory than in practice, then a case exists for mandatory controls in order to discipline managers. From this perspective, some components of standard corporate law, whether ex ante controls, such as the monitoring board, or ex post controls, such as the derivative action, should be beyond the scope of the shareholder's power to opt out, at least in the case of the publicly held corporation. Statutory corporate law should then be seen as more than simply a baseline "default" set of rules; rather, the case for a partially mandatory character rests as much on considerations of allocative efficiency as of fairness, because uncertainty results in a higher cost of capital throughout the economy as a whole.

This last claim that opting out can cause an externality, namely, a higher cost of capital, needs to be qualified in one important respect. Although opting out can produce greater investor uncertainty and hence a higher cost of capital, its impact will largely be limited to those firms that do opt out. That is, the market will discount the expected future returns of such firms differently because it has little experience with how managers can or will behave under these altered legal rules, but this uncer-

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58 See notes 53-54 and accompanying text supra.
tainty should not affect the stocks prices of those firms that observe the traditional "default" rules of corporate governance. In short, there will be two separate equilibria: one for those corporations that opt out, and another for those that accept the default rule. Thus, the "lemons market" effect should be limited to those firms that do opt out. Hence, the third party effects are limited to other firms that opt-out, and only those shareholders who approve opt-out provisions (and their successors) will be affected — arguably, by the consequences of their own actions.

Yet, because shareholder consent can often be obtained by a variety of threats and/or special inducements (including special dividends or recapitalizations that effectively bribe shareholders with their own money), issues of fairness (and allocative efficiency) remain. Unless the corporation opts out at or before the time it first "goes public," it is unlikely that the entrepreneurs who founded the firm will "pay" for the increased uncertainty that opting out causes by receiving a reduced price for their shares. In a management controlled firm, any loss will thus be borne instead by the existing shareholders, and if the managers own only a small percentage of their firm's stock, this cost will largely fall on others. In short, mid-stream charter amendments present the context where the problem of opportunism is most acute.

Whatever one thinks of the contractarian position in the abstract, special difficulties arise when the focus shifts to remedies. This is because the very idea of contract presupposes a promise that is enforceable — that is, a promise for whose breach the law provides a remedy. To this extent, private ordering involves an irreducible level of reliance on the state to enforce promises between private parties through its courts or other legal institutions. Although private enforcement procedures (such as arbitration) are imaginable, these also ultimately depend on the courts to enforce and validate them. Thus, we are taken back full circle

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60 Some theorists have suggested that contracting parties could design self-enforcing remedies that do not require judicial action. See, e.g., Williamson, Credible Commitments: Using Hostages to Support Exchange, 73 AMER. ECON. REV. 519 (1983). Such theorists usually presuppose that the parties are repeat players who expect continued future dealings. Because few corporations return with regularity to the stock market to seek equity capital, I doubt this precondition applies to the corporate context.
to our earlier focus on U.C.C. section 2-719 and its emphasis on a minimum effective remedy as the test for whether a departure from the normal default rules is valid. Ultimately, the more we call the corporation a contract, the more we must look closely at the limits on permissible modifications of contract remedies.

4. “Gimme That Old Time Religion”: A Critique of the Consensualists

If private contracting cannot be trusted because of the high information and transaction costs associated with collective shareholder action (as its critics assert), what alternative do they offer? If I read Professor Brudney correctly, his position would be that, at least absent unanimous consent, strict fiduciary principles must govern. He recognizes that society thereby sacrifices the potential gains that might arise from efficient deviations from the law’s traditional strictures, but in his view, this is the necessary price for assuring investors of the fidelity of managers whom they cannot closely monitor or discipline. This is an uncertain trade-off; the costs may exceed the benefits. Moreover, it is also a prescription for stasis in a world that is rapidly changing.

My problem with Professor Brudney’s analysis is that a demonstration that movements away from the common law’s baseline may be biased does not in any way validate the adequacy of the baseline position. Are the common law’s rules on due care efficient? Do they express shareholder expectations? The historical truth is probably that the common law largely borrowed its original corporate law rules from the law of trusts because of the paucity of available alternatives. This was understandable and perhaps even inevitable, but still the world of trusts and corporations co-exist uneasily at best. The corporation is an entrepreneurial, risk-taking organization, while the trust device was classically used to preserve capital. The trustee was thus supposed to be risk averse, and the law of trusts certainly encouraged him to be. Given trust law’s bias towards conservatism, a tension was inevitable between doctrine and environment, which tension American common law came to reconcile through the creation of the business judgment rule.

In this light, although the consensualists may be on firm ground in criticizing the contractarian theory of the corporation, the footing gets slippery when they tacitly assume that the in-
feasibility of actual bargaining means that the pre-existing common law standards must control. If it is a fallacy to assume that pricing amounts to consent, it is an equivalent fallacy to assume that shareholders have consented to the pre-existing legal norms. In principle, they may be simply ignorant or indifferent. Put differently, just as it is doubtful that private contracting out of the common law will fulfill the shareholders's expectations, so is it also doubtful that their expectations coincide with the common law rules that history dealt them. In short, while the "rhetoric of contract" may legitimate excessive managerial discretion, "fiduciary rhetoric" could equally justify unthinking devotion to anachronistic legal dogma.

Where then are we left? If contracting out is suspicious, and if the baseline legal norms are also open to challenge because claims as to their efficiency and congruence with shareholder expectations seem unsupported, we need some anchoring point upon which to rest a theoretical foundation. One approach that others have suggested utilizes a hypothetical bargaining game. To do this, one asks: What would rational shareholders have agreed upon in a world of low transaction costs? What rules would they reach as to self-dealing, permissible takeover defensive tactics, or due care liability? My own guess is that the rules they would reach would pretty closely approximate the existing law of fiduciary duties with respect to self-dealing, but might be quite different with respect to due care liability and takeover defensive tactics.

Why? Let's walk through such a bargaining game as a heuristic exercise. As our starting point, we can assume that rational bargainers would first identify a risk and then determine the best risk bearer with respect to it. This resembles the standard Calabresian approach to tort law issues under which one seeks the best cost avoider. One such risk is, of course, the risk of negligent business decisions. Almost certainly, directors are poor risk bearers here because they cannot diversify and may have difficulty in obtaining insurance; equally important, the full costs here include the cost of excessive risk aversion, which shareholders bear if directors are made too risk averse. Argua-

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bly, however, rational bargainers would still place some of the cost of negligent decisions on directors in order to avoid a moral hazard problem. In contrast, no ceiling would be likely for duty of loyalty violations, because managers are the best cost avoiders with respect to losses resulting from self-dealing and secret profits. Indeed, investors would confront great and socially wasteful uncertainty if they were asked to bear that risk; that is, we would again confront the “lemons market” problem earlier discussed. Hence, this approach suggests a stricter judicial attitude toward attempts to vary those default rules that define the duty of loyalty than those that specify the duty of care.

In rebuttal, some will respond, as has Professor Brudney, that this approach is too indeterminate to prove anything. For example, others may engage in the same hypothetical bargaining and emerge with the different conclusion that directors should be liable up to, say, ten, fifteen, or twenty-five percent of their personal assets. Still, even if this hypothetical bargaining approach is admittedly indeterminate by itself, this problem is largely cured by the specificity that actual charter amendments supply. In reality, the court is called upon to decide not what outcome rational bargainers would reach, but rather whether a persuasive case exists for believing that they could reach the specific outcome embodied in the actual charter provision before it.

When one turns to the specific context of remedies, what kinds of bargains can we imagine being struck? Conceivably, shareholders might believe that (1) market forces alone were sufficient to enforce managerial diligence, (2) legal remedies had a high error rate that could make management excessively risk averse, or (3) the costs of legal remedies, such as the derivative action, were unnecessarily high in comparison with remedies that could be designed through private ordering. Alternatively, if they believed that the duty of care was not, itself, substantively meaningful, they might be prepared to trade this right away in return for managerial concessions on some other point. Finally, because arbitration is a private proceeding without public or press access, it is arguable that shareholders might prefer such a substituted remedy to protect corporate privacy. These possible justifications are not frivolous, but they seem overbroad if they also leave the duty of loyalty unprotected.

One last problem with the consensualists’ position is that it
forces us to rely on legislative revisions that impact on all shareholders, including those of firms that would not have opted out. In the recent legislative stampede to enact limitations on liability for due care violations, some states (for example, Indiana) have in effect abolished the old strict duty of care norm across the board, while others (for example, Delaware) permit opting out from that rule. The second approach seems preferable, because it creates less uncertainty. In theory, only those corporations that in fact opt out incur the cost of greater uncertainty; in reality, this may not be quite the case because of the risk of future amendments, but the impact of uncertainty still should be much smaller on those firms that do not opt out. In contrast, Indiana’s approach subjects all shareholders to greater uncertainty. To be sure, this difference may not be empirically measurable because the term being priced may have too little impact on share value, but at least in theory we confine the greater uncertainty to a subclass of corporations under a Delaware “opting out” approach.

III. ARBITRATION AND CHARTER AMENDMENTS

In the wake of recent state legislation, limitations on due care liability are already a fait accompli. The issue for the future is just now emerging in the wake of two 1987 Supreme Court decisions: Can charter amendments provide for arbitration and thereby preclude a derivative action? In Shearson/ American Express v. McMahon, the Court held that a provision in a brokerage agreement providing for arbitration of any controversy relating to the customer’s account precluded a suit based on Rule 10b-5. Without explicitly overruling Wilko v. Swan, which had found claims arising under the Securities Act of 1933 not to be subject to compulsory arbitration, the Court indicated that the burden is on the party opposing arbitration to show that Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue. Apparently, Wilko is henceforth to be read as barring arbitration only where arbitration is inadequate to protect the substantive rights at issue — a

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64 346 U.S. 427 (1953).
conclusion that the Court has indicated it will not easily reach.

Potentially even more significant in its possible impact on the corporate context was the Court's holding in *Perry v. Thomas*\(^6\) that an arbitration agreement may be enforced in federal court pursuant to the Federal Arbitration Act, even though state law provides that such an agreement could not preclude a judicial action.\(^6\) In effect, *Perry* seems to hold that the Federal Arbitration Act preempts state statutory law conferring express rights of action. The potential implications of this holding for corporate governance seem both astonishing and fundamentally at odds with the Supreme Court's repeated emphasis in a series of decisions that corporations are creatures of state law.\(^6\)

Together, *McMahon* and *Perry* will encourage the proponents of alternative methods of dispute resolution to propose charter amendments under which all internal corporate disputes should be resolved through arbitration. Arguably, both the derivative action and some actions based on Rule 10b-5 could be either preempted or precluded by an agreement to arbitrate set forth in the corporation's certificate of incorporation and, in theory, accepted by shareholders when they acquired their shares. Moreover, although arbitration as used in the securities industry to resolve customer/broker disputes has always been conducted under the oversight of the stock exchanges and the SEC, which have established industry-wide arbitration panels, no similar level of oversight exists with respect to private corporations.

Within the brokerage industry, arbitration has received mixed reviews in terms of its fairness to the plaintiff.\(^6\)


\(^{6}\) Section 229 of the California Labor Code provided that actions for the collection of wages may be maintained "without regard to the existence of any private agreement to arbitrate." CAL. LAB. CODE § 229 (West 1971). The majority opinion by Justice Marshall found the provision to be preempted by section 2 of the Federal Arbitration Act. *Perry*, 107 S. Ct. at 2526-27; see 9 U.S.C. § 2 (1970). Strong dissents by Justices Stevens and O'Connor pointed out that the purpose of the Federal Arbitration Act was never to preempt state law, but to provide a simplified means of enforcement of arbitration agreements that were valid under state law. 107 S. Ct. at 2527-28 (Stevens and O'Connor, JJ., dissenting). As Justice O'Connor effectively argued, there is a fundamental inconsistency between *McMahon* and *Perry* because *McMahon* framed a test where arbitration was enforceable unless there was a clear legislative intent to preclude the waiver of a judicial forum and precisely such an intent is apparent in the California legislation.


\(^{6}\) Compare Fletcher, *Privatizing Securities Disputes Through the Enforcement of Arbitration Agreements*, 71 MINN. L. REV. 393 (1987), with Brown, Shell & Tyson, *Arbi-
nents of arbitration point out that in the brokerage area most cases are resolved within the same year in which they are filed, that arbitration panels grant damages to roughly half of all customers who arbitrate their securities complaints, and that damage awards equal, on average, about half the amount requested. Opponents, however, cite statistics showing that seventy-eight percent of those who receive damages recover sixty percent or less of the amount they said they had lost — thus suggesting that the fifty percent victory ratio is deceptive. In overview, there are obviously points to be made on both sides.

More importantly for our purposes, arbitration in the securities industry has a unique procedural twist that corporations are almost certain to copy if they begin to insert arbitration provisions into their charters: the plaintiff generally has no role in selecting the arbitrator, as does the plaintiff in arbitration under the American Arbitration Association’s rules. Instead, under the Uniform Code of Arbitration governing most securities proceedings, industry panels hear the plaintiff’s claims. Although these panels are appointed by the National Association of Securities Dealers or the stock exchanges and must contain a majority of “public arbitrators,” this term includes lawyers and others who work for firms that represent the brokerage industry. Here then lies the rub: at present, a majority or all of a panel may consist of lawyers or brokers who directly practice in the securi-

References:


Glaberson, When the Investor Has a Gripe, N.Y. Times, Mar. 29, 1987, at B1, col. 4 (citing data compiled by Professor David A. Lipton of Catholic University involving 40 randomly selected cases — a comparatively small data base).

Under the Uniform Code of Arbitration, adopted by all the major stock exchanges, the investor may demand an arbitration panel made up of a majority from outside the securities industry. Uniform Code of Arbitration, R. 607(o)(2) (as adopted by New York Stock Exchange) (reprinted in Arbitration Rules, 2 New York Stock Exchange Guide (as amended, June 18, 1986)) [hereinafter Uniform Code of Arbitration]. See Fletcher, supra note 68, at 451-52. The parties also each have one peremptory challenge and unlimited challenges for cause. Critics claim, however, that the Uniform Code of Arbitration employs a very relaxed definition of “outside the securities industry” and that the panels have a pro-industry bias. See Glaberson, supra note 70, at col. 4 (quoting such critics). See also Richards v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 64 Cal. App. 3d 899, 904, 135 Cal. Rptr. 26, 28 (1976) (criticizing New York Stock Exchange arbitration procedures as unfair).

ties industry and possibly have an engrained antipathy for plain-tiff-shareholders. In short, an issue of "structural bias" arises here that resembles the similar issue surrounding the performance of the special litigation committees.\textsuperscript{73}

Predictably, if arbitration were authorized as a remedy that the corporate charter could make exclusive for at least some range of cases, many corporations will seek to provide for arbitration by either a panel of disinterested directors or by some other panel of management-appointed experts. Arguably, the doctrinal leap is not that great from current law in New York and Delaware, which generally permits a committee of disinterested directors to reject a derivative suit and thereby foreclose substantive judicial review, even of egregious self-dealing.\textsuperscript{74} In fact, however, the leap is significant because judicial review of an arbitration decision is virtually non-existent, whereas it is open to a court in cases where a board or special litigation committee rejects the action either to find that demand was excused or that procedural errors were made by the board or committee in conducting its review.\textsuperscript{75} Today, the special litigation committee operates under at least the potential oversight of a court, while an arbitration panel does not.

In any event, the experience to date with special litigation committees has not been happy and shows that such committees, once appointed, almost invariably decide to reject the action and recommend its dismissal.\textsuperscript{76} For exactly this reason, the


\textsuperscript{74} For the leading cases, see Zapata Corp. v. Maldonado, 430 A.2d 779, 22 ALR 4th 1190 (1981); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); see also commentators cited at note 73 supra.

\textsuperscript{75} The "demand required/demand excused" distinction was formalized by the Delaware Supreme Court in Aronson v. Lewis, 473 A.2d 805 (Del. 1984). In cases where demand is excused (on somewhat elusive criteria), the court may review the substantive justifications for dismissal. See, e.g., Joy v. North, 692 F.2d 880 (2d Cir. 1982). Also a court may review the special litigation committee's work where its "good faith" or the "procedural adequacy" of its investigation are not shown. See Hasan v. Cleveland Realty Investors, 729 F.2d 372 (6th Cir. 1984).

\textsuperscript{76} See Cox, supra note 73, at 963 (survey finding no case in which the litigant has failed to recommend dismissal against incumbent directors). See, e.g., Joy v. North, 692 F.2d 880 (2d Cir. 1982) (the committee permitted the action to continue against certain former executive officers).
ALI Corporate Governance Project has sought to generalize a requirement of substantive judicial review. If such committees were instead reconstituted as arbitration panels, they might represent an even more biased fact-finder — one that from the plaintiff’s attorney’s perspective resembled the jury Daniel Webster faced in Stephen Vincent Benet’s short story. Thus, it is easy to fear that an unholy coalition of naive, “touchy-feely” believers in ADR, and more hard-headed, but deeply conservative, representatives of corporate managements might combine to eliminate shareholders’ access to effective litigation remedies. The former may be innocently seeking to extend mediation procedures, which may work well within an interacting community, to a context where there is no community and where shareholder action is already hobbled by serious “free rider” problems; the latter believe that litigation against corporate management is inherently undesirable and often extortionate. Together, they could achieve much mischief.

Against this backdrop, it may seem strange that my remaining comments will seek not to bury arbitration but to preserve some role for it. Arbitration does have potential advantages: (1) lower cost, (2) relative speed, and (3) expertise. Only in Delaware can the litigants probably expect a state trial court to have the same sophistication and expertise as an arbitration panel. Presumably, both sides would agree in a hypothetical bargaining game between equal antagonists that if the delay and costs of the remedy to each could be decreased then such a change should be adopted. Yet, expertise can easily blend into bias — or, at least, into an unconscious predisposition against the plaintiff as an outsider and usurper of the board’s role. Thus, the challenge is to design an arbitration remedy that preserves the basic (if not always well realized) function of a judicial remedy: namely, an external monitoring body having both expertise

77 See ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.08 (Tent. Draft No. 6, Oct. 10, 1986). This author is serving as the Reporter to the ALI for the remedies section of its Corporate Governance Project.

78 This conclusion does not necessarily follow, however, if the antagonists lack equal financial resources or if there is a litigation cost advantage favoring one side. Both these factors may be present (and partially offsetting) in much derivative litigation. 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, 701-04 (1986).
and sufficient distance from the participants to be capable of disinterested judgment. In principle, there is no reason why arbitration under the rules of the American Arbitration Association, which assure at least one neutral arbitrator, is not capable of approximating this result; however, on the level of practice, I believe the difficulties of designing such a remedy are considerable.

In its favor, arbitration may even be capable of providing shareholders greater access to external monitoring. The inherent rationale of an arbitration remedy is to permit the arbitrators greater flexibility and informality because of their relative expertise. Both by tradition and logic, the remedy is not constrained by the same procedural issues of standing that today constrain the derivative action. Here, a key trade-off comes into view. By its inherent logic, arbitration should be a flexible remedy, and thus it should not be limited by most of the standard restrictions that guard the derivative action much like the sand traps surrounding the eighteenth hole on a championship green. In particular, it is arguable that an arbitration panel should not be subject to the limitations of the demand rule, the contemporaneous ownership requirement, special pleading rules, security for expense bonds and similar requirements. This means that if the corporation elected to adopt an arbitration remedy, it should not also be able to avail itself of a special litigation committee or to reject demand and claim that the plaintiff was thereby not entitled to proceed with arbitration. In short, an arbitration remedy, as so conceived, would generally reach the merits of the dispute early on, while this happens rarely in derivative litigation today.

Yet, even if logic suggests such a trade-off, there is little reason to expect managements to give up the protection of these doctrinal obstacles. Predictably, corporate managements will seek to have it both ways — to preserve the demand rule and utilize arbitration only in terms of the limited role for judicial review preserved under such a rule. This likelihood frames the central question: Under what circumstances should an arbitration remedy be upheld? To reach an intelligent answer, it is useful next to survey the legal and economic obstacles to an effec-

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79 For an overview of the limitations on standing to bring a derivative action, see ALI, supra note 77, at §§ 7.02-.04.
tive corporate arbitration remedy.

A. Legal Objections

To date, courts have been more hostile than receptive to provisions (usually contained in a stockholders’ agreement) that seek to require that intra-corporate disputes be submitted to arbitration. The following legal objections to an arbitration provision have either been raised already or may be raised in the foreseeable future.

1. Sterilization of the Board. A provision requiring arbitration may be thought to infringe on the universal provision in corporation codes that “the business and affairs of the corporation shall be managed by, or under the direction of, its board of directors.” A number of courts have so held, typically in cases where the arbitration provision in a stockholders’ agreement was invoked to resolve a dispute over business plans, dividend payments, or the dismissal of an officer.80 Conversely, one well known New York case, Matter of Vogel,81 seems to go the opposite way and at least provisionally permit the arbitration proceeding to continue, but Vogel is probably better explained by the fact that the two parties constituted all the shareholders of the corporation. Thus, Vogel is in the tradition of earlier New York cases, such as Clark v. Dodge,82 which have upheld substantial deviations from the usual model of corporate governance in the context of closely held firms where there had been unanimous consent to the special provision.83

Still, if the objection to arbitration is that it “sterilizes” the

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83 Outside of New York, there are even stronger authorities. See Glazer v. Glazer, 374 F.2d 390 (5th Cir.), cert. denied, 389 U.S. 831 (1967); Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964).
board, a carefully drawn charter provision may be able to avoid, or at least minimize, any infringement on the board's authority. For example, if the arbitrator were denied any authority to grant injunctive, equitable, or other prospective relief, but could simply award damages for the breach of a fiduciary duty, the board would incur no more intrusion into its zone of autonomy than if the plaintiff instead went to court. Alternatively, the provision could deny the arbitration panel any ability to re-consider or reverse business decisions to the extent that they were protected by the business judgment rule. To be sure, new problems are raised by any such proposal to deny the arbitration panel the ability to grant some forms of relief (i.e., injunctions), because courts are apt to read such an exclusion as meaning that the plaintiff could then sue in court for this relief. Predictably, plaintiffs would include a claim for injunctive relief and thereby seek to overcome the desired exclusivity that the provision was intended to achieve. Still, the basic idea seems correct. If arbitration were focused solely on redressing violations of fiduciary duties, it should not be seen as infringing upon, or "sterilizing," the board.

2. Conflict with Express Statutory Policies. In the case of an arbitration provision applying to a dispute between a broker and a client, the justification first offered for enforcing arbitration was that Rule 10b-5 was an implied judicial remedy, not one expressly authorized by the legislature; hence, the substitution of an arbitration remedy did not conflict with an express legislative policy. McMahon did not place significant weight on this distinction between express and implied remedies, but in-

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84 Of course, a statute could also overcome this obstacle. For example, the Arizona statute permits the certificate of incorporation to provide "for arbitration of any deadlock or dispute involving the internal affairs of the corporation." Ariz. Gen. Corp. Law § 206 (1977). Broader statutes that simply authorize arbitration in all controversies that might be the subject of an action at law or a suit in equity have been narrowly construed by courts not to permit interference with the board's discretion in matters of business policy. See, e.g., Matter of Burkin (Katz), 1 N.Y.2d 570, 136 N.E.2d 862, 164 N.Y.S.2d 898 (1956) (the removal of a director is a power to be exercised by stockholders and is not a proper subject for arbitration).


86 Most commentators had criticized the Court's suggestion in Scherk that a line
stead focused on whether the legislative intent was to confer a judicial remedy in all cases (which question it answered in the negative). In this light, the fact that the right to bring a derivative action is codified in most jurisdictions (i.e., it is an express statutory right) carries less weight after *McMahon* than it had earlier seemed to when prior decisions upholding arbitration clauses were making such an express/implied distinction. Still, numerous state court decisions have invalidated charter provisions that appear to conflict with statutory provisions in the state's corporations code. Such an express conflict arguably is present at least in those jurisdictions where the derivative action is statutorily codified.

At this point, *Perry v. Thomas* becomes the critical precedent and suggests that state corporation statutes that conflict with arbitration provisions in the corporate charter could be preempted by the Federal Arbitration Act. Before *Perry*, such a conclusion would have been virtually unthinkable, given the prior emphasis placed by the Court on the primary role of the states in regulating corporate governance. After *Perry*, it still seems a bizarre result but one which the Court's reasoning clearly supports. Perhaps if such a case arose, the Supreme Court would belatedly recognize the wisdom of the dissenting opinions in *Perry* by Justices Stevens and O'Connor. Still, such a case may never arise because state corporate codes do not expressly preclude compulsory arbitration, as did the statute invalidated in *Perry*. Thus, courts can duck the issue of *Perry*'s scope by reading any statutory provision authorizing a derivative action as not intended to preclude arbitration.

Actually, this may be the correct interpretation because most statutory provisions were probably intended simply to codify the prior common law or to limit shareholder standing to sue. That is, state statutes codifying the derivative action typically could be drawn between express and implied causes of action and compulsory arbitration upheld with respect to the latter. *See McMahon*, 107 S. Ct. at 2347 n.2 (Blackmun, J., dissenting) (noting that "[c]ommentators, almost uniformly, have rejected the 'colorable argument' " that a distinction could be drawn between express and implied causes of action for purposes of arbitration). As Justice Blackmun's dissent notes, the majority retreated to a more defensible position in *McMahon* that largely overrules *Wilko*, 107 S. Ct. at 2346.

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87 *See* note 39 *supra*.
89 107 S. Ct. at 2527 (Stevens, J., dissenting); *id.* at 2528 (O'Connor, J., dissenting).
confer jurisdiction on courts to hear a derivative action and then set forth at great length various procedural restrictions on the shareholder's standing to maintain an action, such as, for example, contemporaneous ownership, security for expense bonds, and verification requirements. Thus, their primary purpose seems to be to constrain the common law's remedy by restricting standing, and hence, the conflict between those statutes and an arbitration provision seems less serious.

3. Vested Rights. Although state corporation statutes typically set forth a broad power to amend the corporate charter, even with respect to the rights of outstanding shares, the case law originally placed some limits on this power by considering some rights to be "vested." Thus, the issue arises as to whether the holder of outstanding shares can be divested of his right to sue by a charter amendment. Today, this doctrine of vested rights has been largely superseded by class voting requirements, a possible appraisal remedy, and a limited judicial review for fairness. Still, some jurisdictions might conclude that the shareholder's right to sue cannot be eliminated by a charter amendment with respect to outstanding shares, except (i) pursuant to explicit legislation, or (ii) with the consent of the shareholder then holding the shares.

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90 See, e.g., Keller v. Wilson & Co., 21 Del. Ch. 391, 190 A.2d 115 (1935) (accrued dividends a "vested right" that could not be modified); A.C. Frost & Co. v. Coeur d'Alene Mines Corporation, 60 Idaho 491, 92 P.2d 1057 (1939) (nonassessable shares could not be changed to assessable shares); State ex rel. Swanson v. Perham, 30 Wash. 2d 368, 376, 191 P.2d 689, 694 (1948) ("vested right" to elect directors by non-cumulative voting technique was beyond power of legislature to modify for existing corporations, notwithstanding "reserved power"). But see Seattle Trust & Sav. Bank v. McCarthy, 94 Wash. 2d 605, 610, 617 P.2d 1023, 1028 (1980) (overruling Swanson). Vested rights theory is today largely a fossilized remnant because of the ease with which corporations can evade limitations on impermissible charter amendments by merging with a wholly owned subsidiary. See Bove Community Hotel Corp., 105 R.I. 36, 249 A.2d 89 (1969). Still, some limitations remain. See Halloran, Equitable Limitations on the Power to Amend Articles of Incorporation, 4 Pac. L.J. 47 (1973).

91 Several cases have invalidated the retroactive imposition by a majority vote of transfer restrictions on non-consenting shareholders. See, e.g., Sandor Petroleum Corp. v. Williams, 321 S.W.2d 614 (Tex. Civ. App. 1959) (state law authorizing corporations to reasonably restrict sale and transfer of stock did not authorize cancellation of previously unrestricted stock). But see Tu-Vu Drive-In Corp. v. Ashkins, 61 Cal. 2d 283, 391 P.2d 828, 38 Cal. Rptr. 348 (1964) (this decision permitting retroactive change was legislatively reversed by section 204(b) of the California Corporations Code). A number of states legislatively preclude transfer restrictions, even as applied to subsequent transferees, unless the holder at the time of the restriction's adoption consented. See, e.g., Joseph A. Seagram & Sons, Inc. v. Conoco, Inc., 519 F. Supp. 506 (D. Del. 1981). It is
A further refinement on this question is whether any such substitution of remedies could apply retroactively with respect to causes of action that arose prior to the adoption of the charter provision (even if no suit was commenced). By analogy, Delaware's recent authorization of charter provisions limiting damages for due care liability applies only prospectively and does not "limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective." This is a more than trivial point because many derivative actions involve a long-standing course of conduct extending back over many years.

4. Lack of Mutuality. In the case of the standard arbitration clause used in the securities industry, the clause binds both broker and client to accept arbitration. This may not be possible in the corporate setting, where the defendant is not necessarily another shareholder who has consented to arbitration in advance. In effect, the defendant has an option: to accept arbitration, or to resist it and be sued in court. Can the plaintiff be compelled to accept arbitration when the defendant is not? Probably, the plaintiff can be so compelled, because the requisite consideration to support the plaintiff's implicit agreement to accept arbitration can be found in the agreements of the other shareholders in the corporation also to accept arbitration. In this view, the shareholders have mutually pledged to use arbitration, if possible, to save time and expense for their corporation. This amounts to a bilateral contract. Moreover, defendants will probably prefer to accept arbitration (at least if they perceive this forum to be more favorable), and the lack of mutuality may appear to be a matter of history once a defendant moves to compel arbitration in response to a derivative action against him. Still, the parallel between securities industry arbitration and the corporate setting is far from exact.

A related question is whether a valid and binding agreement to arbitrate, enforceable against all shareholder plaintiffs, can be

uncertain whether this judicial hostility to diminution of an existing shareholder's rights applies only to transfer restrictions (which the common law disfavored as a restraint on alienability). For cases upholding retroactive changes in other contexts, see, e.g., LaRoche v. Vermont Federal Bank, FSB, 626 F. Supp. 1157 (D. Vt. 1985); Wilson v. Cherokee Drift Mining Co., 14 Cal. 2d 56, 92 P.2d 802 (1939).

92 See DEL. GEN. CORP. LAW § 102(b)(7) (Michie Supp. 1987) (quoted at note 10 supra).
created by a provision in the corporate charter. Although corporate law clearly considers the corporate charter to be a contract, the technical question here is whether the law of arbitration would similarly recognize such a provision as creating an agreement to arbitrate based only on the implied-in-fact acceptance of the shareholder.\textsuperscript{93} Is such constructive acceptance sufficient? Absent such an agreement, judicial remedies cannot be preempted even under \textit{Perry}\textsuperscript{94} because the Federal Arbitration Act would defer to state law on this issue.\textsuperscript{95} Divergent answers are possible, and states might even be able to legislate the conclusion that no enforceable agreement arose based simply on a charter provision, thereby outflanking \textit{Perry} and avoiding preemption.

5. \textit{Procedural Adequacy}. One of the more common complaints from customers dissatisfied with arbitration proceedings brought by them against their brokerage firm has been their inability to obtain discovery of materials in the defendant's possession.\textsuperscript{96} Yet, at least in broker/client disputes, the client has some record of the securities transactions in his account. In contrast, the problem of obtaining adequate discovery grows by an order of magnitude when arbitration is substituted for a derivative action, because the shareholder can establish the unfairness

\textsuperscript{93} This question has probably been answered in the affirmative for close corporations, where arbitration is frequently used. In most instances, however, the agreement to arbitrate was separately executed and signed by the shareholders and was not simply inserted by a charter amendment adopted by a majority of the shareholders. See, \textit{e.g.}, Application of Vogel, 25 A.D.2d 212, 268 N.Y.S.2d 237 (1st Dep't 1966), 	extit{aff'd}, 19 N.Y.2d 589, 224 N.E.2d 738, 278 N.Y.S.2d 236 (1976). The public corporation, however, is a far different entity, and arguments about implied-in-fact acceptance seem more tenuous within this context.

\textsuperscript{94} In \textit{Perry}, 107 S. Ct. at 2527 n.9, the Court assumed that there was a valid agreement to arbitrate, but for the state statute forbidding compulsory arbitration.

\textsuperscript{95} Section 2 of the Federal Arbitration Act provides that an agreement to arbitrate is valid and enforceable as a matter of federal law "save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2 (1985). \textit{See also Perry}, 107 S. Ct. at 2527 n.9. Thus, state law seemingly can govern the issue of whether a contract ever arose, so long as it does not uniquely attempt to nullify the Federal Arbitration Act.

\textsuperscript{96} For representative statements by plaintiffs' attorneys that they are routinely denied adequate discovery in securities brokerage arbitration disputes, see Glaberson, \textit{supra} note 70. \textit{But see} Fletcher, \textit{supra} note 68, at 453-54 (criticizing this view as a myth). \textit{See also} Stroh Container Co. v. Delphi Industries, Inc., 783 F.2d 743, 761 (8th Cir.), \textit{cert. denied}, 106 S. Ct. 2249 (1986) (criticizing arbitration system as "an inferior system of justice").
of a self-dealing transaction only by obtaining access to books and records in the corporation’s possession. Although no legal rule necessitates that discovery must be restricted in arbitration proceedings, it must at least be recognized that discovery procedures are underdeveloped and informal in the arbitration context and that this factor favors the defendants, who will tend to be corporate officials. Unless adequate procedural rules can be developed to assure the plaintiff’s need for discovery, a basis exists for a court finding such a charter provision to be against public policy.  

6. Collateral Estoppel and the Problem of Collusive Settlements. A derivative suit, like a class action, is a representative action in which the judgment or settlement binds all other shareholders from raising the same or similar claims on behalf of the corporation. American corporate law, therefore, requires that any settlement of a derivative action be judicially approved. However, if an arbitration proceeding were substituted by charter amendment for a derivative action, would this same result follow? That is, would the decision by an arbitration panel collaterally estop other shareholders? Should preclusive effect be accorded to an arbitration decision or can such effect be conferred only by a judicial order. Of course, if other shareholders were also required to bring their action before the same arbitration panel, this point may seem academic because there would be no incentive for other shareholders to bring the same suit

87 Relatively few decisions have struck down a charter provision as simply against public policy, but such decisions exist. See, e.g., Greene v. E.H. Rollins & Sons, Inc., 2 A.2d 249 (Del. Ch. 1938).

88 See Fed. R. Civ. P. 23.1; see also ALI, supra note 77, § 7.13 (reviewing rules in various states).

89 Until recently, many assumed that the findings of an arbitrator were not entitled to preclusive effect in another proceeding brought by a different party; in theory, only the court’s order gave rise to preclusive effect. However, the Supreme Court’s recent decision in University of Tennessee v. Elliott, 106 S. Ct. 3220 (1986), suggests that the law may be in flux in this area. In Elliott, the Court accorded preclusive effect to the fact findings made by an administrative law judge in a state agency in an employment discrimination case, thereby denying the plaintiff access to a judicial trial de novo. Id. at 3226. Although a private arbitrator can easily be distinguished from an administrative law judge, it is possible that courts would reach a similar compromise, giving preclusive effect to the fact findings made by the arbitrator, but reserving the authority to review the legal conclusions drawn from these facts. For a general overview of the preclusion issue in arbitration, see Shell, Res Judicata and Collateral Estoppel Effects of Commercial Arbitration, 35 U.C.L.A. L. Rev.  (forthcoming in 1988).
before the same panel. The other side of this coin is even more troubling. If a single shareholder can in effect preclude other shareholders from litigating the same action in the corporation's name, a considerable danger arises of collusive settlements. In fact, under such a system, the best strategy for a defendant who has engaged in unfair self-dealing may be to arrange for such a spurious action to be brought and adversely decided. Alternatively, the defendant may be able to bribe the plaintiff's attorneys by agreeing to exchange a high fee award for a low or nominal settlement. This danger of collusion has long surrounded the derivative action, but in consequence the law has developed a variety of safeguards: shareholders must be given notice of any proposed settlement, the settlement hearing must be public, objecting shareholders may seek to intervene, and, finally, the court must approve both the settlement and the fee award to the plaintiff's attorneys. Whether these protections are adequate can be questioned, but the informal nature of arbitration proceedings is inconsistent with this need for procedural safeguards to assure that the action is aggressively litigated and that any settlement reflects a true adversarial discounting of the litigation odds.

Collusive settlements are not the only means by which a corporate recovery can in effect be diverted. Suppose the plaintiff brings not a derivative action, but a direct action, thereby seeking not a corporate recovery, but an individual one. From the plaintiff's perspective, styling the action as a direct one permits him to settle for personal relief — perhaps the corporation will buy back his shares at a premium with the approval of the arbitration panel. The very flexibility of the arbitration process along with its lesser public visibility, encourages and invites such novel outcomes, but from a public law perspective, such individual settlements mean that the plaintiff has abandoned his role as a private attorney general for the other shareholders. To be sure, this result can also occur in court-litigated cases, but there an elaborate body of law has been developed to distinguish di-

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100 For a discussion of this problem and examples of the way in which collusion can occur without explicit agreement, see Coffee, The Unfaithful Champion: The Plaintiff As Monitor in Shareholder Litigation, 48 L. & CONTEMP. PROB. 5 (1985).

101 The line between direct and derivative actions is often obscure and many transactions can give rise to both direct and derivative causes of action. See ALI, supra note 77, § 7.01 (commentary and Reporter's Notes).
rect from derivative actions. In the informal setting of arbitration (or similar alternative dispute resolution procedures) it is easy to forget that the plaintiff has a public law role.

To sum up, the simple truth is that existing arbitration mechanisms were never designed to substitute for collective proceedings, such as the class or derivative action, in which the interests of numerous persons are aggregated. An accommodation between arbitration procedures and the class action has yet to be reached or even realistically addressed, because the proponents of alternative dispute resolution persist in seeing legal adversaries as participants in a small communal group who are truly seeking a negotiated solution and reconciliation. In fact, plaintiffs are seeking nothing of the kind; they are participants not in a community, but a market. In such an anonymous environment, they are more likely to want not therapeutic reconciliation, but adequate general deterrence.

7. Statutory Precedents on Opting Out: Are they a Negative Pregnant? In section 620 of its Business Corporation Law, New York has adopted a common form of close corporation statute. A corporation may adopt virtually any provision relating to its internal governance (including presumably a system of arbitration), provided that (1) the provision is adopted by a unanimous shareholder vote, and (2) the corporation's shares are not "listed on a national securities exchange or regularly quoted in an over-the-counter market . . . ."102 Arguably, such a provision represents an insurmountable barrier to experiments with arbitration in the case of publicly traded corporations (at least in the case of those corporations incorporated in New York and states with similar provisions). On the other hand, the New York statute does not by its terms forbid all deviations from the traditional norms of corporate governance, but only any provision that "improperly restricts the board in its management of the corporation"103 — in effect, those provisions that "sterilize" the board or delegate the board's authority to a shareholder. As noted earlier,104 an arbitration provision can be designed with a

102 N.Y. Bus. Corp. Law § 620(c) (McKinney 1986). Subsection (b) of section 620 permits the corporate charter to contain provisions that would otherwise be prohibited, provided unanimous shareholder consent is obtained for the amendment.
103 Id.
104 See text accompanying note 84.
scope which extends only to asserted breaches of fiduciary duty and not to matters of business policy. Still, the policy underlying section 620 seems to be that shareholder consent is less meaningful and more easily manipulated in the case of publicly held corporations.105

Another example of a statutory precedent that authorizes opting out in a manner that by implication constrains self-help attempts are those recent exculpatory statutes (most notably Delaware Gen. Corp. Law § 102(b)(7)) that authorize the abolition or limitation of due care liability by charter provision.106 Arguably, the message of these statutes is that some fundamental deviations may violate public policy, unless legislatively authorized, given the jurisdiction's use of a legislative mandate for prior major deviations. A similar example in an earlier era might be the now universal state statutes authorizing corporate indemnification and insurance of directors and officers. Still, even if this line of argument is accepted, it still does not tell us at what point a particular deviation becomes so fundamental as to require legislative authorization. Another counter-argument is that all these decisions were simply legislative attempts to resolve the chaos created by judicial hostility to, and invalidation of, earlier attempts at private ordering.

B. Economic Objections

In principle, the derivative suit is an efficient answer to the “free rider” problem.107 Because share ownership tends to be dispersed in the public corporation, no single shareholder may have an adequate incentive to undertake the costs necessary to monitor management or to enforce its duties to the corporation. After all, a million dollar loss to the corporation represents only a thousand dollar loss to a one percent shareholder who will thus

105 If the only concern were that shareholders might be unfairly surprised by a midstream change, the unanimity requirement of N.Y. Bus. Corp. Law § 620(b) is sufficient to deal with this concern; nonetheless, section 620(c) adds the additional requirement that the shares not be traded. Probably, the concern here is that newly formed companies could be taken public by promoters without shareholders understanding the special restrictions on their shares. This concern applies equally to all important deviations from the prevailing common law rules.

106 See note 10 supra.

107 For a fuller discussion of this problem as it applies to class and derivative litigation, see Coffee, supra note 78.
have little incentive to restore this corporate loss when ninety-nine percent of the benefit will accrue to his fellow shareholders. Only if such a shareholder can equitably tax his fellow shareholders for his litigation costs can we expect adequate private enforcement, even if the legal duties are optimally framed and the likelihood of success on the merits is nearly certain. The derivative suit achieves this equitable proration of costs (and in effect thereby taxes the free rider) by requiring the corporation to reimburse the successful litigant for his reasonable attorneys’ fees. Historically, the successful plaintiff’s attorney could expect to receive twenty to twenty-five percent of the total recovery.\textsuperscript{108}

In contrast, in arbitration, fee awards are typically more discretionary.\textsuperscript{109} As a result, although the plaintiff’s attorney who undertakes such cases serves in effect as a bounty hunter, arbitration’s discretionary approach to fee shifting denies him the incentive necessary to make this system of entrepreneurial law enforcement work. Moreover, in arbitration, the plaintiff may face liability for the defendants’ costs and legal fees.\textsuperscript{110} Because these costs will typically be higher, there is potentially a forbidding disincentive here, which could be deliberately manipulated by the draftsmen of such a charter provision.

Still another problem with arbitration is that it does not yield legally relevant precedents.\textsuperscript{111} Litigation has third party ef-


\textsuperscript{109} Many state arbitration statutes forbid or severely limit the award of attorneys’ fees. Section 10 of the Uniform Arbitration Act provides that “unless otherwise [agreed], the arbitrators’ expenses and fees, together with other expenses, not including counsel fees, incurred in the conduct of the arbitration shall be paid as provided in the award . . . .” Some state courts have read this language to bar fee awards even when the underlying liability statute mandates a fee award. See, e.g., Floors, Inc. v. B.G. Danis of New England, Inc., 380 Mass. 91, 401 N.E.2d 839 (1980).

\textsuperscript{110} Typically, the arbitration agreement will authorize the arbitration panel to allocate the panel’s fees as the panel deems appropriate. Yet, if a corporate charter provision could authorize arbitration, there seems no legal obstacle to requiring the losing side to pay the winning sides’ legal expenses; the result is the British rule on fee shifting, and this would amount to a substantial deterrent to the filing of class or derivative actions, given the asymmetric stakes facing the plaintiff’s attorney. See Coffee, \textit{supra} note 78.

\textsuperscript{111} Arbitration also minimizes publicity because the proceedings can be conducted in private; in contrast, evidence admitted at trial cannot be withheld from the press, at least absent extraordinary circumstances. See Seattle Times v. Rhinehart, 467 U.S. 20 (1984). Defenders of corporate privacy will see this as an advantage, while those who
ffects, and desirably so, because the legal precedents thereby generated guide others. Precedents are in this light a positive externality, which may justify the fact that society subsidizes the public costs of litigation. Absent new precedents, the law's evolution stops, and a static body of case law becomes regressive as new conditions and problems appear. Still, for the immediate future, the risk seems small that arbitration will be universally adopted and, in the interim, a steady supply of precedents will continue to be generated in cases involving firms that did not opt for arbitration.

Some will advance an even broader political objection to private ordering. The purpose of legal remedies, they might argue, is to subject the corporation to public accountability and external monitoring — namely, the sunlight of public disclosure in order to foster responsibility to other constituencies. For purposes of this Article, I would prefer to sidestep the issue of whether public disclosure is always a virtue and corporate privacy always a vice. Yet, whatever view is taken, private ordering can accommodate it, by specifying some level of press access and public disclosure with respect to the proceeding.

IV. AN EVALUATION: THE NEED FOR QUALITY CONSTRAINTS ON OPTING-OUT

The foregoing survey has noted some of the legal rules that courts have had to fashion to make the derivative action work. Few, if any, would claim, however, that the result is an optimal remedy on which private ordering could not improve. The point of this survey is not that the common law is efficient, but rather that any internal contracting process that sought to design a privatized substitute for the derivative action would have to write an extremely detailed contract and would have to develop and rely upon largely untested procedures. Such a process entails very high information costs for investors and is subject to opportunistic manipulation by managers at a variety of low visibility junctures. For each procedural stage that any private contract must address (for example, the rules relating to notice, standing, approval of settlements, attorneys' fees, prohibitions of

believe, as does Justice Brandeis, that "sunlight is the best disinfectant," will think otherwise.
collusive settlements, the role of the board and distinctions between direct and derivative actions), small differences in technical language could mean the difference between an effective and an illusory remedy. It may not be worth the market's time to monitor these differences closely in advance of a particular transaction or event that gives them significance. Moreover, because management has little incentive to subject itself to litigation in any form, we should expect that it will exploit its de facto control over the process of formulating amendments to the corporation's charter and bylaws. It can do this both because high information costs shelter it from an adverse market reaction and because its own compensation tends not to be closely tied to the firm's stock price in any event.

These reasons would probably lead "consensualists" to favor a rule forbidding "contracting out," both in this procedural area as well as in substantive law areas. At most, they might accept the idea of an arbitration remedy in the close corporation context (which, I agree, is the most likely setting for its initial development, given the potential cost savings it may afford the smaller firm). Still, a compromise is possible that falls somewhere between the positions of the contractarians and the consensualists. Put simply, this compromise is to permit only a limited and quality-constrained form of "contracting out." If the subject matter of corporate law is too complex to have confidence in private ordering — that is, if we expect shareholders to be "rationally apathetic" either because the information costs are too high or the expected benefits to diversified shareholders are too low — we could limit the range of choice by formulating model provisions that corporations could adopt knowing in advance that courts would enforce them. The theory here is simply that model provisions reduce both the transaction costs and uncertainty associated with relational contracts.112 Section 7.17 is one example of such a provision; an even better known example is the ABA's Model Debenture Indenture.113 More generally,

112 For the view that standard form terms reduce uncertainty, see Goetz & Scott, Principles of Relational Contracts, 67 Va. L. Rev. 1089, 1095-1100 (1981).

113 American Bar Foundation, Commentaries on Indentures (1971). The utility of such model form provisions drafted by a reliable body has been recognized by the courts. See, e.g., Broad v. Rockwell Int'l Corp. 642 F.2d 929, 943 (5th Cir.), cert. denied, 454 U.S. 955 (1981); Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1048 (2d Cir. 1982), cert. denied, 460 U.S. 1012 (1983).
stock exchange rules have mandated equal voting rights among common shareholders, annual audit requirements, and restrictions on certain takeover defensive tactics. From these sources — ALI, ABA, the major stock exchanges — standard form contractual provisions would acquire a judicial gloss further reducing uncertainty.

Consider then a set of model arbitration procedures developed after intensive study by the ABA or ALI and approved in more general terms by the New York Stock Exchange for its listed companies. The SEC would also have a failsafe role under its responsibility for approving amendments to stock exchange rules. Given such multiple review, it seems overly cynical in my judgment to insist that the resulting model form provisions would significantly prejudice stockholder interests.

Thus, the compromise I would propose requires neither that we swallow whole the rhetoric of private ordering nor insist upon the unrealistic constraint of unanimous consent as a precondition to contracting out; rather, what I would recommend might be termed “quasi-private ordering.” Put simply, where major deviations from the traditional norms of corporate governance are to be adopted — such as either a ceiling on due care liability, or an arbitration provision that would foreclose access to the courts — the corporation should be required to sustain the burden of proving that the amendment was not against public policy. Elusive as this public policy standard is, it would mean showing that the provision was not vulnerable to opportunistic manipulation. Generally, the corporation could meet this standard by adopting a model provision draft by a representative group, such as the ABA or ALI. In effect, opting out should be limited to a choice among quality-controlled alternatives. Section 7.17 illustrates such a model provision on which a court might rely if approved by shareholders.

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115 Under section 19(c) of the Securities Exchange Act of 1934, 15 U.S.C. § 78s(c) (1982), the SEC is authorized to “abrogate, add to, and delete from . . . the rules of a self-regulatory organization . . . as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization . . . or otherwise in furtherance of the purposes of this Chapter.” The SEC has recently asserted this power in the “one share, one vote” controversy by promulgating Proposed Rule 19c-4.
This reliance on model provisions would not be the exclusive means of satisfying this burden (for example, unanimous consent should also suffice), but in these other cases, the burden should be on the proponents of the departure to show that the modification was prompted by unforeseen new circumstances. In effect, this carries forward section 89(D) of the Restatement (Second) of Contracts to relational contracts, such as the corporation. A more permissive standard should apply to provisions in the original certificate of incorporation, but in the case of amendments this burden should be a substantial one in the case of major deviation, at least when the provision seemingly exposes shareholders to a risk of managerial opportunism.

Predictably, some will reply that the limited menu my proposal affords shareholders infringes on their autonomy and depends too heavily on the fortuitous availability of previously prepared model provisions. Yet, the desire to undertake a major deviation from the traditional rules of corporate governance arises relatively infrequently and usually in a collective shift as the result of some exogenous change or event, such as the recent perceived liability crisis. Thus, it should not overtax the resources of our respected legal institutions to undertake the task of studying and preparing such model provisions.

My perspective can usefully be contrasted here with that of the contractarians. They see statutory corporate law as a model form from which shareholders may depart at will. With them, I recognize that “off-the-rack” rules may not fit all sizes or shapes of corporations, but unlike them I acknowledge the legitimacy of the consensualists’ concern about special tailoring: that the tailor will cut the cloth to serve the interests of those who pay him — i.e., corporate management. Nonetheless, it is a false dichotomy to see the choice as all or nothing. The intermediate position is to develop a multiplicity of model forms, all carrying a reputable brand name.

To be sure, when there are multiple brands to choose from, it will be management, not the shareholders, who will probably make that choice. Opportunism in the choice of brands is to be expected, just as it also occurs in the choice of the jurisdiction of incorporation. Still, so long as we trust the label, as I believe most of us would in the case of model provisions drafted or approved by the major stock exchanges or the ALI, the magnitude of any loss caused by managerial discretion to choose among
quality brands seems in all probability to be small. In all likelihood, any provision adopted by such a body will be more balanced and sensible than many of the recent corporate law amendments that have been hurriedly rushed through unsuspecting legislatures over the last two years. To sum up, private ordering works best when the choice is between quality brands and worst when the customer confronts the door-to-door salesman. Social experiments with contracting out should begin with the development of more quality brands.

Lest my meaning be misconstrued, I should emphasize that I do not think a court must defer to any model charter provision that carries the reputational capital of some bar association. Rather, I suggest that judicial inquiry should focus on the central questions: (1) Does the provision represent a bargain that we can credibly believe rational shareholders might strike among themselves or with managers and the other participants in the corporation?; (2) Does the substituted or limited remedy fail of its essential purpose?; (3) Is any clearly expressed legislative policy violated?; and (4) Can shareholders price the departure or does it involve risks that are too uncertain for the pricing mechanism to work without creating unproductive uncertainty? Opting out then needs to be quality constrained, but neither forbidden nor blindly accepted.

To sum up this debate in a slogan, the contractarians advise you to trust the price; the consensualists, to trust nothing. I submit there is a sensible compromise: Trust the brand name, not the price! Informed shoppers look at the label, and so might informed courts.