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OPTING OUT OF FIDUCIARY DUTIES: A RESPONSE TO THE ANTI-CONTRACTARIANS

Henry N. Butler*
and Larry E. Ribstein**

Abstract: Professors Butler and Ribstein present an extensive analysis of opting out of fiduciary duties, based on the contractual theory of the corporation and a substantial body of economic literature, as well as a comprehensive response to prominent corporate law commentators who have argued that private ordering of corporate manager duties should be restricted by mandatory legal rules.

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I. INTRODUCTION

Throughout much of the history of corporate law, courts and scholars have debated the nature of the corporation and the proper role of government regulation in internal corporate affairs. Today, the clearest controversy is between the contractarians and anti-contractarians
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about the proper regard for freedom of contract in the corporation. Contractarians view the corporation as a set of private contractual relationships among providers of capital and services.¹ Anti-contractarians argue that the corporation is either not a contract at all, or at least is subject to more intrusive government regulation than other contracts.²

As the contractual theory of the corporation gained support from economists and lawyers in recent years,³ it provoked harsh responses

¹ It is fashionable to refer to the corporation under the private contract approach as a “nexus of contracts.” See Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 3 J. Fin. Analysis 305, 311 (1976) (“The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships . . . .”). This terminology is appropriate as long as it is clearly understood that it does not necessarily imply that the corporation exists as an entity apart from the contracts among its participants. The entity theory appears to support the approach that the “entity” is brought into being, and therefore subject to extensive regulation (either through direct administrative regulation or litigation) by the state. We will eschew language that lends itself to a priori treatment of corporations as different from other contractual relationships. The corporation is, indeed, a bundle of interrelated contractual relationships, but there is no conceptual justification for reifying this interrelationship.

² The anti-contractarian view owes much to the historical concept of the corporation as a concession of the state. For a discussion comparing the contract and concession views of the corporation, see R. Hessen, In Defense of the Corporation (1979). For a discussion of the historical origins of the anti-contractarian view, see infra Section II(A).

from numerous traditional legal scholars. One indication of the influence of the contractual theory is that anti-contractarians have been forced to attack the legitimacy of private ordering as well as the consistency of the economic theories supporting it. This Article demonstrates that the anti-contractarian attack on private contracting is flawed in many respects. But it must be answered to prevent the misconception that the state should have a greater role in corporate governance than in other private contractual relationships.

An important recent battleground of the debate over freedom of contract in the corporation is the question of whether the fiduciary duties of corporate managers should be subject to private ordering through contract or should be to some extent law-imposed and non-waivable. This important policy question has been brought to the forefront by developments in the wake of the Delaware Supreme Court’s unprecedented holding in favor of director negligence liability in *Smith v. Van Gorkom*. Among other reactions to this case, the Delaware corporation law, followed by other state statutes, was amended to permit charter amendments opting out of the director duty of care. Also, the *Smith* case gave new importance to an earlier proposal in drafts of the American Law Institute’s *Principles of Corporate Governance* permitting limitation of director liability by charter amendment.

In this Article, we present a comprehensive response to prominent corporate law commentators who have argued that private ordering of corporate manager duties should be restricted by mandatory rules.

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5. 488 A.2d 858, 864 (Del. 1985).

6. Citations are collected in *Principles of Corporate Governance: Analysis and Recommendations* 275 (Tent. Draft No. 8, 1988) [hereinafter *Principles*].


8. *Principles*, supra note 6, § 7.17 (Tent. Draft No. 9, 1989). Liability limitation was first proposed in *Principles*, supra note 6, § 7.06 (Tent. Draft No. 1, 1982). The current proposal, refined from the original version, was first set forth in *Principles*, supra note 6, § 7.17 (Tent. Draft No. 6, 1986). The American Law Institute’s (“A.L.I.” ‘s) corporate governance project has been very controversial, possibly because of its attempt to go beyond the traditional restatement to include recommendations for changes in the law. Representative samples of the literature include symposia in 71 CORN. L. REV. 261 (1986) and 52 GEO. WASH. L. REV. 557 (1984).

9. Two important articles on which we focus our attention are Brudney, *Corporate Governance, supra note 4*, and Coffee, *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOKLYN L. REV. 919 (1988) [hereinafter Coffee, *No Exit*]. Professor Coffee’s ideas are particularly influential, since he is Reporter for the
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The opposition to private ordering is deeply flawed not only because it is based on a rejection of the contractual nature of the corporation, but also because the critics either ignore, dismiss as irrelevant, or misapply a substantial body of economic theory.

Section II sets the stage for the debate by establishing the basic contractual nature of the corporation. It begins by summarizing the contractual theory of the corporation—the theory that the corporation is the product of private contracts among corporate participants. It then critiques anti-contractarian concepts of the corporation, including the view that the corporation is a privilege or concession granted by the state. The concession view of the corporation is a holdover from the

Remedies Section (Part VII) of the A.L.I. project (although his article, id. at 919 n.*, includes the caveat that he is not speaking for the A.L.I.). Although we do not discuss in detail other articles by Brudney and Coffee, it is fair to say that the anti-private ordering view expressed in the articles we discuss is reflected in their other writings. See, e.g., Brudney & Clark, A New Look at Corporate Opportunities, 94 Harv. L. Rev. 997 (1981) (opposing private ordering of corporate opportunity liability); Brudney & Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 Harv. L. Rev. 297 (1974) (favoring rules allocating merger gains); Coffee, Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response, 63 Va. L. Rev. 1099 (1977) (legal rules may be necessary to supplement internal monitoring devices); Coffee, Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance, 84 Colum. L. Rev. 1145 (1984) [hereinafter Coffee, Regulating the Market] (suggesting that legal regulation may be necessary to supplement the market for control in disciplining managers); Coffee, Shareholders Versus Managers: The Strain in the Corporate Web, 85 Mich. L. Rev. 1 (1986) (indicating need to regulate corporate control market to protect nonshareholder interests); Coffee, The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups, 1988 Wis. L. Rev. 435 (1986).


early history of corporate law and is inconsistent both with current usage and with a formidable body of legal and economics scholarship. Several of the recurrent themes in the criticism of the contractual theory are set forth in preparation for a more specific analysis in later parts.

Section III, which is structured around brief summaries of the market and contractual mechanisms that govern intra-corporate relations, responds to the critics by demonstrating their lack of appreciation for the complementary roles of such mechanisms in aligning managers' and shareholders' interests. Contrary to arguments by critics of private ordering, we demonstrate that the corporate contract includes many mechanisms for protection against managerial misconduct. Moreover, the existence of fiduciary duties and remedies for breach should be viewed as part of this contractual protection rather than contrary to the contractual theory of the corporation. In some situations, the inadequacy of market constraints on managerial conduct may lead the parties to a corporate contract to choose to supplement market controls by contracting for fiduciary remedies.11 Our analysis demonstrates that, even if the parties sometimes determine that liability rules are appropriate, as long as securities markets adequately discipline contractual choices, shareholders should be permitted to opt out of these rules.

Section IV brings economic theory to bear on the issue of enforceability of waivers of managerial duties. Where terms are enforced against shareholders who buy into the corporation after the waiver is enacted, it is clear that the basic question is one of pricing: in light of the Efficient Capital Markets Hypothesis, differences between corporations regarding management duties and the potential for managerial misconduct are reflected in the prices of the securities of those companies. This efficient market pricing provides pressure toward development of optimal contract terms, including the optimal reliance on legal constraints such as fiduciary duties. Nor is there any justification for

10. See R. HESSON, supra note 2; see also Anderson & Tollison, The Myth of the Corporation as a Creation of the State, 3 INT'L REV. L. & ECON. 107 (1983); Butler & Ribstein, Anti-Takeover, supra note 3, at 618–22; Butler & Ribstein, Contract Clause, supra note 3.

11. When we refer to managerial misconduct, we simply mean conduct that is contrary to investor interests. Such “misconduct” may or may not breach express or implied contractual duties. In fact, the extent to which corporate contracts should constrain managerial conduct that diverges from investor interests is an important question in corporate planning. See infra notes 185–186 and accompanying text.

12. See infra Section III(H).

13. See infra notes 138–43 and accompanying text.
refusing to enforce contract terms permitting amendment, since market forces constrain both the scope of the amendment power in the initial contract and the amendment process itself. On the other hand, provisions limiting amendment should also be enforced.

Section V demonstrates that even if one accepts the arguments of anti-contractarians concerning deficiencies in the operation of markets affecting corporate governance, serious questions remain concerning the efficiency of the alternative to private ordering—mandatory terms. Thus, even if the relative merits of private ordering as compared with mandatory rules are debatable, the burden of proof should be on those who advocate regulation of corporate contracts. Anti-contractarians have fallen considerably short of meeting this burden.

Section VI distinguishes mandatory rules under federal and state law. The attacks on private ordering implicitly support federal intervention in the internal affairs of corporations. The anti-contractarians' arguments do not justify the tremendous costs that such intervention would entail.

Section VII sets forth concluding remarks.

II. THE CONTRACTUAL NATURE OF THE CORPORATION

The contractual theory of the corporation states that the corporation is a set of contracts among the participants in the business, including shareholders, managers, creditors, employees and others.¹⁴ The terms of the agency contract include the provisions of state law, which are regarded as a standard form that can be accepted by the parties or rejected either by drafting around the provision or by incorporating in another state.¹⁵ The corporate contract also specifies the extent to which the parties rely on the competitive pressures from capital, product, and managerial labor markets as well as internal incentive structures such as corporate hierarchy, boards of directors and managerial compensation contracts, to force agents to act in their shareholders' best interests.¹⁶ The policy implication is that private parties to the

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¹⁴. The legal corporate governance debate tends to focus on the internal corporate relationship between managers (a term that includes officers and directors) and shareholders.

¹⁵. As discussed in Section VI(D), the role of state law in governance of the corporation is consistent with private ordering under conditions of jurisdictional choice in the market for corporate charters. Conversely, federal regulation of the corporation is consistent with the anti-contractarian position.

¹⁶. These corporate governance mechanisms are discussed infra notes 85–117 and accompanying text.
corporate contract should be free to order their affairs in whatever manner they find appropriate.

An important thread of the anti-contractarian position is the idea that corporate arrangements are sufficiently different from "ordinary" contracts that they deserve to be regulated by the state. This concept of the corporation derives from the concession theory of the corporation, which holds that incorporation is a state-conferred privilege. A corollary of this concept is that mandatory regulation of corporate contracts does not need to meet the same tests of validity as does regulation of "ordinary" contracts. It is therefore important to critically examine at the outset arguments questioning the contractual nature of the corporation.

A. Historical Arguments: The Concession Theory

An important cornerstone of the anti-contractarian view of the corporation is that, in the words of Professor John C. Coffee, Jr., "[h]istorically, American corporate law has never regarded the corporation as simply a private contract." The obvious implication is that the history of corporate law supports increasing government involvement in the corporation today. There are several problems with the historical analogy.

Certainly it is true that very early American corporate law imported from England the then-current theory that the corporation was a creature of state law. This theory was consistent with the fact that early corporations were state-created franchises or quasi-public institutions. Even after the franchise or quasi-public character of corporations became much less important, corporations continued to be created by special legislative acts, thereby preserving the image of state creation. Thus, consistently with the accepted wisdom of the time, the Supreme Court in its 1819 decision, Trustees of Dartmouth College v.
Woodward,\textsuperscript{19} characterized the corporation as an “artificial being, existing solely in contemplation of state law.”\textsuperscript{20}

Throughout the nineteenth century, under the onslaught of increasingly permissive general incorporation statutes, state creation gradually yielded to private formation of the corporation and private ordering of the corporate relationship.\textsuperscript{21} This has, in fact, been the dominant trend in corporate law over the last two hundred years.\textsuperscript{22} As Professor Coffee says, “corporate law has moved far from its original position, which saw corporations as quasi-public bodies, to become a largely enabling body of law.”\textsuperscript{23}

Despite the demise of the state-creation foundation of the concession theory, the courts and commentators continue to pay lip-service to the theory itself. Most importantly, the Supreme Court recently repeated approvingly the ancient dictum from the Dartmouth College case quoted above.\textsuperscript{24} This indicates that the origins of the corporation continue to rule from the grave.

This blind adherence to an outmoded theory does not, however, provide a normative argument against the contractarian view. If the contractual theory of the corporation is subject to credible attack, the

\begin{footnotes}
\item[20] Id. at 636.
\item[21] These developments are traced in Butler, Jurisdictional Competition, supra note 18.
\item[23] Coffee, No Exit, supra note 9, at 939. Professor Brudney, taking a somewhat different tack, argues that the evolution of corporate law from concession to contract merely disconnect[s] the enterprise and its ‘owners’ . . . from dependence upon state authority for their power, and therefore from subjection to state regulation of that power in the interest of consumers, employees, suppliers and the public. The relation of investors, particularly stockholders, to management was not at the core of that conceptual evolutionary process. The current ‘nexus-of-contracts’ rhetoric may be seen as an extension by modern economists of that evolution to the investor-management relationship. Brudney, Corporate Governance, supra note 4, at 1409–10. Brudney offers no authority for this reading of history, in fact conceding that public investors are exempted from private ordering as buyers rather than as owners. Id. at 1409 n.17. Moreover, it is clear that the “conceptual evolutionary process” has embraced all elements of the contractual relationship. See J. Hurst, supra note 22.
\item[24] CTS Corporation v. Dynamics Corp. of America, 481 U.S. 69, 89 (1987). It is important to keep in mind that outside the limited areas of federal supremacy, corporation law is predominantly determined by state courts rather than by the United States Supreme Court. For an attempt to turn the long history of concession-based doctrine into a normative theory of corporate law, see Bratton, The New Economic Theory of the Firm: Critical Perspectives from History, 41 Stan. L. Rev. 1471 (1989).
\end{footnotes}
attack must be on policy grounds, including economic theory, and not by reliance on the past.\textsuperscript{25}

\subsection*{B. Mandatory Provisions in Modern Corporate Law}

Despite shedding their state-creation origins, modern corporate statutes do include many mandatory terms, including voting rules, fiduciary duties and legal capital rules. Some commentators believe that these terms cast in doubt the contractual nature of the corporation.\textsuperscript{26} This conclusion does not follow for several reasons.

First, most apparently mandatory terms are so easily avoided that they are, in substance, optional. If company \textit{A} wants to acquire company \textit{B} but does not want the shareholders of \textit{A} to vote as apparently required by the corporate statute,\textsuperscript{27} it can accomplish the merger by establishing subsidiary \textit{C}.\textsuperscript{28} Corporation \textit{A} may even be able to avoid offering target shareholders “mandatory” appraisal rights\textsuperscript{29} by buying \textit{B}'s assets and liquidating it.\textsuperscript{30} The legal capital provisions of some corporation statutes require payment of dividends out of “surplus,”\textsuperscript{31} but permit manipulation of the surplus account.\textsuperscript{32} These optional terms in mandatory disguise are a sign of the evolution of the corporation from state concession to private contract.\textsuperscript{33}

Second, some apparently “mandatory” fiduciary duties are implied contract provisions that supply terms the parties did not agree on, but which can be avoided by explicit terms.\textsuperscript{34} For example, in \textit{Donahue v. Rodd Electrotype Co. of New England, Inc.,}\textsuperscript{35} the court accorded non-controlling close corporation shareholders access to share buyouts

\begin{itemize}
\item \textsuperscript{25} The substantial body of economic theory supporting the contract view of the corporation is discussed \textit{infra} notes 79–117. For a more extensive argument that corporation law should shed its concession origins and embrace the contract theory, see Butler & Ribstein, \textit{Anti-Takeover, supra} note 3, at 618–22.
\item \textsuperscript{26} See Brudney, \textit{Corporate Governance, supra} note 4, at 1414–1415 n.29; Coffee, \textit{No Exit, supra} note 9, at 939–40; Eisenberg, \textit{supra} note 9, at 1486–87; Gordon, \textit{supra} note 9, at 1553.
\item \textsuperscript{27} See, e.g., \textit{DEL. CODE ANN. tit. 8, § 251(c)} (1983 & Supp. 1988).
\item \textsuperscript{28} See Black, \textit{supra} note 9, citing this as an example of the “triviality” of corporate law.
\item \textsuperscript{29} See, e.g., \textit{DEL. CODE ANN. tit. 8, § 262(a)} (1983 & Supp. 1988).
\item \textsuperscript{31} See, e.g., \textit{DEL. CODE ANN. tit. 8, § 170(a)} (1983).
\item \textsuperscript{32} See, e.g., \textit{id. § 244(g)(4)} (board may increase surplus by reducing capital amounts in excess of par). \textit{See generally B. MANNING, A CONCISE TEXTBOOK ON LEGAL CAPITAL} (2d ed. 1985).
\item \textsuperscript{33} See \textit{supra} notes 17–23 and accompanying text.
\item \textsuperscript{34} See \textit{infra} notes 126–29 and accompanying text (distinguishing implied and imposed contract terms).
\item \textsuperscript{35} 367 Mass. 578, 328 N.E.2d 505 (1975).
\end{itemize}
equal to that enjoyed by controlling shareholders. In light of the limited market for close corporation stock and the difficulty of exit, recognition of such an implied duty is either consistent with actual expectations of the parties, or an appropriate implied standard form provision that anticipates what the parties would have drafted if they had focused on the situation.\(^3\)\(^6\) As such, the duty does not limit opting out as one writer has argued,\(^3\)\(^7\) but is simply part of the parties' contract.\(^3\)\(^8\)

Third, corporations can opt out of even some “mandatory” terms simply by reincorporating in another jurisdiction. For example, a company that finds a Model Act-type “mandatory” appraisal provision overly restrictive can reincorporate in Delaware. In the same way, shareholders can choose “mandatory” terms—perhaps as a check on the amendment power.\(^3\)\(^9\) The evolution of mandatory and non-mandatory provisions can be seen as an outcome of the state competition for chartering,\(^4\)\(^0\) and therefore as an aspect of private ordering. In fact, this is the basic process involved in the evolution from special chartering and strict limitations on corporate powers to the enabling, general-incorporation approach of modern corporation law.\(^4\)\(^1\)

Fourth, the parties to a firm can opt out of terms that are mandatory for all corporations simply by choosing among different investment and organizational forms.\(^4\)\(^2\) For example, the “mandatory” requirement of at least majority shareholder voting on significant corporate transactions can be avoided by disincorporating into a limited partnership.\(^4\)\(^3\) Alternatively, the impact of the requirement can be drastically altered by converting equity into non-voting debt through a leveraged buyout or other restructuring.

In sum, truly “mandatory” provisions are the exception rather than the rule in the law of business associations. The most important

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36. For a contrary view on this specific question, see Easterbrook & Fischel, Close Corporations and Agency Costs, 38 STAN. L. REV. 271, 294 (1986).


38. To see this point, consider what the result in Donahue would have been if all of the parties had explicitly contracted that the corporation could purchase stock owned by controlling shareholders without buying stock owned by the minority.

39. See infra notes 287–90 and accompanying text.

40. See infra notes 308–314 and accompanying text.

41. See supra note 21 and accompanying text.

42. See infra Sections III(A), III(B).

43. Limited partners have only those voting rights granted them by the partnership agreement. See REVISED UNIFORM LIMITED PARTNERSHIP ACT § 302, 6 U.L.A. 300 (1989).
mandatory provisions are the federal securities laws and state provisions that are imposed on existing investors in firms. While these provisions are not trivial, they do not establish the non-contractual nature of the corporation. More importantly, this resort to positive law is no more powerful in refuting the contract theory of the corporation than the resort to history. The anti-contractarian theory is a normative view. As such, it can rest, if at all, on policy, including economic theory.

C. Adhesion and Freedom of Choice: The Formation of the Corporate Contract

Professor Victor Brudney, one of the leading anti-contractarian commentators, has expressed the view that the corporation should not be treated like other contracts because the parties do not enter into the arrangement in the same way as they do other contracts:

[I]t is erroneous to use the term “contract” to describe dispersed stockholders’ relation to the “original owner” or to corporate management, if by doing so the user assimilates the assumptions about parties’ volition and cognition in conventionally bargained and closed buy-sell contracts to the circumstances that attend the connection between purchase or sale of stock and the long term, open ended “contracts” between management and its corporation.

Later Brudney says: “It stretches the concept ‘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.”

These quotes reveal two separate concerns Brudney has about using the “rhetoric of contract” in the corporate setting. First, there is the “volition” problem, giving rise to what Brudney refers to as a contract of adhesion. Second, there is the concern that parties to the corporate contract do not have enough information in order to appreciate and consent to the terms. Both of these objections are unfounded.

44. See infra Section VI.
46. Brudney, Corporate Governance, supra note 4, at 1406 (footnotes omitted).
47. Id. at 1412.
48. For similar concerns, see Clark, Contracts, Elites, supra note 9, at 1718; Eisenberg, supra note 9, at 1477-80.
1. The "Adhesion" Analysis

According to Brudney, shareholders do not freely consent to corporate arrangements as in "conventional" contracts. Rather, dispersed shareholders must accept, without any direct bargaining over details or alternatives, package deals crafted by managers.49 In this respect, Brudney vastly overstates the shareholders' plight. In fact, investors are offered a formidable array of investment alternatives—including corporations with different capital and ownership structures,50 and such diverse investments as limited partnerships,51 mutual funds, money market accounts, real estate, and simple savings accounts. Clearly investors are not forced to accept any particular investment. If contractual volition is lacking—if, as Brudney argues, these are "adhesion" contracts—it is only in the sense that investors do not dicker over individual terms, but accept contractual packages. This wide range of choices among "adhesion" contracts means, in effect, that there is no such thing as an adhesion contract.

Brudney's analysis is deficient because there is no argument here, as has been made, for example, in the consumer product area,52 that consumers are "forced" to accept manufacturers' terms.53 Adhesion in the sense of an absence of individualized bargaining is a common feature in the world of contract, ranging from standardized warranties, leases, trust indentures and employment contracts.54 Thus, Brudney rejects the corporation as contract only by defining "contract" in a special sense of individualized bargaining that would exclude most modern consensual arrangements.55

49. Brudney, Corporate Governance, supra note 4, at 1412–14, 1424, 1437.
50. See infra Sections III(B), III(G).
51. See generally Ribstein, Limited Partnership, supra note 3.
53. We do not assume that there is an enforceability problem even under the very different conditions in the Henningsen-type setting. Among other things, even if all firms adhere to the same standard, that may be because of the efficiency of standardization. See infra notes 56–57 and accompanying text. Only if a firm has market power does a potential argument arise in this respect, and even in that situation the grounds for interference with private ordering are at least questionable.
55. For other arguments that the absence of bargaining is unimportant to the existence of a contract, see Hetherington, Redefining the Task of Corporation Law, 19 U.S.F. L. Rev. 229, 256 (1985); Klein, The Modern Business Organization: Bargaining Under Constraints, 91 YALE L.J. 1521, 1522 (1982).
Aside from being out of step with the general world of contract, the contract advocated by Brudney is not even a superior product. For many reasons, a contracting party does not usually want to "have it my way," but is often willing to accept the manufacturer's or corporation's package. In fact, because sellers often offer the terms they believe buyers will want, it may be impossible to determine who is dictating the terms of a contract by merely identifying the printer of the contract. Although there is always the chance that the terms could be improved through dickering, this is a costly process in terms of time, attorneys' fees, and other transaction costs.

Not only is the extra cost of a customized contract usually not worth the benefit of dickering, but in many situations a standardized contract is a better one: there is more information available concerning a standardized form; important terms have been clarified by interpretation; and error costs and information costs are less than in individually negotiated deals.56 In striking contrast with Brudney's view, Professor Coffee, another leading anti-contractarian, is confident enough about the virtues of "brand name" standard forms that he insists that all contracting around corporate duties be done in this way.57 Thus, even within the anti-contractarian camp, there is considerable support for the proposition that the "adhesion problem" is not a real problem.

2. The Information Problem

Professor Brudney's second concern about using the "rhetoric of contract" in the corporate context is that the average investor lacks


A large degree of uniformity in the language of debenture indentures is essential to the effective functioning of the financial markets; uniformity of the indentures that govern competing debenture issues is what makes it possible meaningfully to compare one debenture issue with another, focusing only on the business provisions of the issue (such as the interest rate, the maturity date, the redemption and sinking fund provisions and the conversion rate) and the economic conditions of the issuer, without being misled by peculiarities in the underlying instruments.

For further discussion of the costs and benefits of standardized contracts, see infra Sections IV(E), V(C).

57. Coffee, No Exit, supra note 9, at 971-74; see infra Section V(C).
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sufficient information about the terms of the package he is buying. Professor Coffee makes a related argument that we cannot rely on the market to efficiently price alterations of director duties, raising questions about the efficiency of the terms themselves. These are really arguments that the corporate contract should not be enforced according to its terms rather than that it is not a contract at all. We return to this issue for an extended discussion in Section IV.

Interestingly enough, Professor Brudney is more willing to accept the contractual nature of bondholder rights as against the residual claimant. This is certainly puzzling, since the same elements of “adhesion” to standard forms would apply in this context, and the same types of “uninformed” investors who buy common stocks also buy bonds. If there is a difference between bondholder and shareholder rights, it is not that one is contractual and the other is not, but merely in the degree to which the rights are specified in the contract. This distinction is not sufficient to support Professor Brudney’s view that shareholders need or deserve greater protections than those afforded to bondholders via contract.

In general, the issue here should not be what is, and what is not, a “contract” in some abstract sense. Concerns about information and adhesion problems in the corporation amount to a conclusion that voluntary arrangements in the corporation are not, like other voluntary arrangements, presumptively efficient. This conclusion depends on the viability of markets in this setting, and is therefore appropriately the subject of economic analysis. The issue cannot be resolved by labels.

60. Brudney, Corporate Governance, supra note 4, at 1414 n.28, 1427–28 n.62.
61. See Bratton, supra note 56, at 699–703 (noting information and sophistication problems affecting bondholders). If there is a difference between bondholders and shareholders it would seem that the former are likely to be even more naive and less informed since they are purchasing the more secure investment. In fact, both bondholders and shareholders are rationally ignorant about their investments. See infra notes 172–74 and accompanying text.
62. McDaniel, Bondholders and Stockholders, 13 J. CORP. L. 205, 233 (1988) (bondholder contract is contingent and explicit while shareholder contract is relational and implicit). Commentators have disagreed concerning whether the bondholder contract should be supplemented by fiduciary duties. Compare Bratton, supra note 56, at 735–39 (arguing for expansive interpretation of the convertible bond contract rather than fiduciary duties) with McDaniel, supra (arguing for fiduciary duties to bondholders). As argued infra Section III(H), fiduciary duties may be regarded as contractual rather than regulatory in nature.
64. See infra Section IV.
D. The Corporation as "Implicit" Contract

Professor Melvin A. Eisenberg argues that the corporation should not be regarded as fundamentally contractual partly because many of the terms governing the corporate relationship are merely "implicit bargains" and not real contracts. An implicit bargain is a term used in labor economics to refer to terms that, like real bargains, involve an economic quid pro quo. They are not "real" contracts because they are enforced by market, rather than legal, mechanisms. For example, Gilson and Mnookin argue that the legally enforceable "up or out" (fire or promote) rule applied to law firm associates bonds the firm's implicit and non-legally enforceable promise not to use its promotion power opportunistically.

The fact that many of the parties to a corporation are governed largely by implicit terms supports rather than undermines the contract theory of the corporation. The choice of implicit and explicit terms is one of many examples of how the parties, if unhindered by legal rules, choose the combination of legal and extra-legal devices appropriate to their relationship. It is a clear nonsequitur to say that because the parties to firms sometimes choose implicit instead of legally enforceable terms they should be forced to submit to mandatory legal rules. More specifically, the parties' choice of market mechanisms to support an implicit promise by managers not to behave opportunistically should not be trumped by mandatory fiduciary duties.

E. Hypothetical Versus Actual Bargains

Some commentators argue for a normative view of corporate law as a hypothetical bargain. Thus, Judge Frank H. Easterbrook and Professor Daniel R. Fischel have written: "Corporate law should contain the terms people would have negotiated, were the costs of negotiating at arms'-length for every contingency sufficiently low . . . .

65. See Eisenberg, supra note 9, at 1487-88; Eisenberg, Golden Parachutes and the Myth of the Web, in KNIGHTS, RAIDERS, AND TARGETS 155, 158 (Coffee, Lowenstein, & Rose-Ackerman eds. 1988).


67. This term is legally enforceable in the sense that it gives the firm the legal right to fire associates without according them a partners' job security.

68. Gilson & Mnookin, supra note 63. More specifically, the "up-or-out" rule prevents the firm from continuing to use the services of lawyers who the firm believes merit partnership without paying them partners' shares of the profits.

69. For other examples, see infra Section III.
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Corporate law almost always conforms to this model. It is enabling rather than directive. 70

Despite the market orientation of this view and the characterization by Easterbrook and Fischel of the hypothetical bargain as “enabling,” their normative view can be inconsistent with the contract theory of the corporation. The problem is that it is one thing to propound a default rule to cover situations not covered in the parties’ contract, and another thing to state a general rule applicable irrespective of contract. 71 For example, Easterbrook and Fischel would mandate a rule of incumbent management passivity in takeovers in order to effectuate the market for control. 72 By contrast, under the contract theory, while the hypothetical bargain is a suitable default rule, the parties should be able to customize management’s power to resist takeovers. 73

It is, therefore, a mistake to identify the hypothetical bargain approach with the contract theory of the corporation. Yet several commentators have done just that, and have then proceeded to criticize the contract theory because the hypothetical bargain approach is inconsistent with it, 74 or otherwise defective. 75 If anything, the defects of the hypothetical bargain approach provide another argument in favor of the contract theory: To the extent that courts and legislators follow this approach in adopting default provisions, it is important to permit the parties to opt out of it in order to escape its defects.

70. Easterbrook & Fischel, supra note 9, at 15; see also Easterbrook & Fischel, Corporate Control Transactions, 91 YALE L.J. 698, 702 (1982).

71. For a discussion of the difference between these two approaches and the problem of enforcing mandatory rules in the form of judicially imposed fiduciary duties, see infra notes 126-29 and accompanying text.


73. See Baysinger & Butler, Antitakeover Amendments, supra note 3, at 1302–03; Haddock, Macey & McChesney, supra note 3, at 716; Ribstein, Takeover Defenses, supra note 3, at 106.

74. See Brudney, Corporate Governance, supra note 4, at 1415 n.29, 1432 n.74 (criticizing the “schizophrenia’ implicit in the contractarian approach”); Clark correctly identifies the hypothetical bargain approach as an example of rulemaking by elites, but then mischaracterizes it as “contractually oriented.” Clark, Contracts, Elites, supra note 9, at 1723; see also Clark, Agency Costs, supra note 9, at 63–71 (characterizing hypothetical bargains as non-consensual).

75. See Clark, Agency Costs, supra note 9, at 63–71 (hypothetical bargain may not be efficient); Gordon, supra note 9, at 1550–51 (characterizing the hypothetical bargain as the “content” premise of contractarianism), 1594 (criticizing Kaldor-Hicks basis of hypothetical bargain).
F. Conclusion: The Basis of the Debate

This Section establishes that there is no a priori reason for subjecting corporate governance to more extensive government regulation than other contracts. The anti-contractarian view can only be sustained on policy grounds, and not by claiming that the corporation is somehow not a “contract.” The following three Sections discuss these policy arguments.

III. CONTRACTUAL CONSTRAINTS ON MANAGEMENT CONDUCT

Opponents of private ordering, in looking at the corporate contract, see significant gaps in shareholder protection from managerial misconduct. For example, Professor Coffee passes off the idea of contractual protection for shareholders by simply noting: “[W]hen we look to the real world, we can observe very few, if any, instances of anything approaching . . . bonding behavior [by corporate managers].”76 This view is clearly mistaken.

We demonstrate in this Section that the corporate contract does, in fact, offer significant protection to investors.77 We evaluate the many

76. Coffee, No Exit, supra note 9, at 942–43. Professor Coffee limits his critique of contractual devices constraining agency problems, id. at 943–44, to management compensation arrangements (see discussion infra Section III(E)), curiously neglecting discussion in this article even of the market for corporate control. For Coffee’s skepticism concerning the effectiveness of the market for control, see generally Coffee, Regulating the Market, supra note 9.

Professor Brudney is similarly skeptical about contractual protection of shareholders. See Brudney, Corporate Governance, supra note 4, at 1421–22, 1426–27, 1429. Like Coffee, he questions the force of individual aspects of investors’ protections from managerial misconduct. For examples of this form of criticism, see id. at 1420–21 (questioning efficacy of market for managers), 1430–31 n.72 (questioning efficacy of “M-form” organization); see infra notes 103–106 and accompanying text. Moreover, as he does in evaluating the contractual nature of the corporation, see supra notes 46–47 and accompanying text, Brudney holds the terms of the corporate contract up to an idealized preconception of what the contract ought to look like. It is a mistake to rely on the contractual protections elaborated in recent agency theory of the corporation, he says, because the resulting relationship does not resemble the principal’s direct, one-on-one control of the agent in the traditional agency relationship. Brudney, Corporate Governance, supra note 4, at 1428. But this misses the point. The question is not whether the public corporation superficially resembles other relationships that are agency in nature under legal terminology, but whether the contract, whatever pigeonhole it is in, optimally protects investors from management misconduct. Moreover, Brudney’s distinction between corporate and other agency relationships is inapt; even in a one-on-one agency, the principal normally does not directly control all of the agent’s actions, but rather relies on disciplinary devices that serve precisely the same function as the market for control.

Finally, Professor Eisenberg, supra note 9, at 1488–1515, extensively discusses the inadequacies of contractual and market constraints on managers’ conduct. See infra note 117.

77. Although analysis of the terms of the corporate contract is not determinative, it is important because demonstrating that sophisticated contractual devices have been developed to deal with a problem provides important circumstantial evidence that markets are operating
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aspects of the corporate contract that constrain managers to act consistently with investor interests. In contrast to anti-contractarian commentators like Professor Coffee, who tend to criticize the effectiveness of individual elements of the corporate contract and aspects of the market forces affecting the corporation, we sample the full range of contracts that have developed to control corporate agency costs. Moreover, in order to give a complete picture, we also analyze the role of fiduciary duties and remedies in the contractual theory of the corporation. While anti-contractarian writers see these duties as mandatory rules that supplement private ordering, under our analysis, fiduciary duties and remedies are actually part of this contract. It follows that shareholders should be free to alter these duties and remedies by agreement.

A. Choice of Organizational Form

Contractual protection against agency costs is not limited to devices within the corporation, but extends to choice of the corporate form of contract over types of contractual organization of economic activity. Other types of organization include economic “firms” such as partnerships, sole proprietorships and joint ventures, and non-“firm” “relational” contracts such as franchises and long-term supply contracts. Individuals choose among types of organization by comparing costs and benefits of forms, including the costs and benefits of

efficiently. We recognize that demonstrating the existence of contractual provisions dealing with agency problems is not the same thing as demonstrating that the development of these provisions is adequately constrained by market forces. If markets do not operate efficiently, regulation may be necessary to produce better contractual protection. As we discuss in Section IV, markets do operate efficiently in this context. Moreover, as we discuss in Section V, it is necessary to avoid the “nirvana fallacy” of assuming that because markets do not operate perfectly, government regulation would be preferable.

78. See supra note 76.
79. “Firm” is used here to refer to the economic concept of coordinating productive activity through a process of hierarchical or bureaucratic decisionmaking rather than through the price system and discrete contracts. The seminal contribution of Coase, supra note 3, explained use of the firm as a way of saving transactions costs such as those of entering into contracts and discovering prices. Later major contributions on the theory of the firm focused on other problems. Alchian & Demsetz, supra note 3, discussed the shirking problem inherent in team production. Others discussed the problems of enforcing contracts, including post-contractual opportunism. See O. Williamson, Markets and Hierarchies: Analysis and Antitrust Implications (1975) [hereinafter Markets and Hierarchies]; The Economic Institutions of Capitalism (1985) [hereinafter O. Williamson, Economic Institutions]; Cheung, supra note 3; Klein, Crawford & Alchian, supra note 3; Williamson, Transaction Cost Economics: The Governance of Contractual Relations, 22 J. L. & ECON. 233 (1979).
80. Relational contracts are, in very general terms, those in which the parties’ obligations are not fully specified at the outset of the relationship as in the “classical” form of contract. The contrast between “classical” and “relational” contracting has formed the basis of the work of
delegating control to agents, so as to maximize their gains from engaging in a particular activity. Thus, we do not observe all economic activity being carried on through one type of organization. Instead, we observe millions of organizations of many types, sizes and structures.

One example of the tradeoffs inherent in choice of form concerns the selection of close versus "open" (sometimes referred to as "public") ownership of the firm.\footnote{See generally Fama & Jensen, Separation of Ownership and Control, 26 J. L. & ECON. 301 (1983) [hereinafter Fama & Jensen, Separation]; Fama & Jensen, Organizational Forms and Investment Decisions, 14 J. FIN. ECON. 101 (1985) [hereinafter, Fama & Jensen, Organizational Forms]; Manne, Our Two Corporation Systems: Law and Economics, 53 VA. L. REV. 259, 278–79 (1967).} In closely held corporations and partnerships, in which all owners generally are active in control of the business, monitoring of agents is less of a problem than in public companies, in which ownership is separated from control. But public ownership has many benefits. Among other things, it permits specialization of capital-raising and managerial functions and development of a public market for the firm's stock. A public market, in turn, accurately values the firm's assets, thereby facilitating value-increasing investments that may not pay off before owners expect to sell out.\footnote{Fama & Jensen, Organizational Forms, supra note 81, at 107.}

The choice between the more intense monitoring of agents in the closely held firm and the advantages of public ownership depends on many factors. The benefits of public ownership may outweigh the costs where decisionmaking is sufficiently complex that monitoring and direct management cannot cheaply be combined in single individuals. Also, a firm may need larger amounts of capital than can be cheaply raised from individuals who are willing to contribute managerial services (as where because of the risk of opportunistic conduct by contracting parties\footnote{See supra note 80.} the firm must own rather than contract for expensive assets).


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In general, therefore, the profusion of forms of productive enterprise—including both the continuum of discrete, relational and firm-type contracts and the various types of firms—can only be explained as responses to the costs and benefits of various forms in particular situations. Prominent factors in these tradeoffs are the costs and benefits of particular ways of giving discretion to and monitoring agents. Managerial abuse could be sharply limited simply by dividing all enterprise into small firms that contract with each other, but this form of organization would pose formidable problems of its own. The profusion of contract types helps show the extent to which agency problems are being dealt with contractually, and raises serious doubts concerning the capacity of government regulation to devise optimal tradeoffs.

B. Capital Market Competition and Capital Structure

In a pathbreaking 1958 article, Franco Modigliani and Merton Miller showed that, under a set of specified assumptions including absence of transaction and information costs, the capital structure of a firm—that is, its selection of the mix of debt and equity financing—is irrelevant to the total value of the firm. This poses a riddle: Why do we observe different capital structures across firms?

One answer to the Modigliani-Miller riddle, given in a landmark article by Jensen and Meckling, involves agency problems and monitoring of managers. A firm’s capital structure can be analyzed as a way of minimizing the costs of conflicts of interests between equity and debt holders, and between management and equity holders. The parties have the incentive to minimize these costs because they affect the cost of equity, debt and human capital. This can be illustrated by

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84. Another illustration of how choice of organizational form reflects tradeoffs of agency costs against other benefits of the form is the selection of the franchise contract rather than fully integrating the sales network within a single business association. See Brickley & Dark, The Choice of Organizational Form: The Case of Franchising, 18 J. Fin. Econ. 401 (1987); Rubin, The Theory of the Firm and the Structure of the Franchise Contract, 21 J. L. & Econ. 223 (1978). Owning all outlets creates agency costs because the central organization must rely on monitoring of employees by remote managers. This problem can be reduced through franchising, because owners have greater incentives to supervise their employees than do non-owner managers. On the other hand, franchising outlets creates the risk that the independent businesses will free-ride on the franchisor’s trademark by economizing on quality. The parties will select the contractual form that optimizes the costs and benefits of the relationship.


considering the conflicts inherent in high equity and high debt capital structures.

A high-equity structure gives substantial discretion to managers to use corporate assets for their own benefit subject to the various monitoring and devices discussed in this Section. Managers may directly benefit themselves at investor expense by appropriating corporate funds for personal use and by retaining earnings beyond what can be profitably reinvested by the company. Moreover, managers, who because of their non-diversifiable human capital and financial investments in the firm may be more risk-averse than the diversified shareholders, may make investments that are less risky than the shareholders would prefer. Equity holders would demand to be compensated for or protected from these risks.87 At the same time, managers may be acting consistently with debtholders’ interests by retaining earnings and avoiding risk. Indeed, the managers’ human capital investment in the firm places them somewhat in the position of subordinated debt holders.

A debt-heavy structure, on the other hand, may be in the equity holders’ interests from a management-monitoring standpoint in the sense that it constrains excess retention of earnings or excessive risk-avoidance by managers.88 On the other hand, such a structure may exacerbate the equity-debt conflict because it encourages equity holders to make highly risky investments that may produce great benefits to the equity holders if they succeed, and losses to the debt holders if they fail.89

Under the Jensen-Meckling view, different capital structures may be responses to the different types of agency problems inherent in

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87. Among other things, a high-dividend policy may align manager and shareholder interests with regard to the level of risk. See Easterbrook, Two Agency-Cost Explanations of Dividends, 74 AM. ECON. REV. 650 (1984). This may explain the long-standing puzzle as to why dividends are paid. See, e.g., Black, The Dividend Puzzle, 2 J. PORTFOLIO MGMT. 5 (1976).

88. See Jensen, Eclipse of the Public Corporation, HARV. BUS. REV. Sept.-Oct. 1989, at 67, 69–70 [hereinafter Jensen, Eclipse] (explaining advantages of “LBO Associations” that rely on heavy leveraging); Jensen, Agency Costs of Free Cash Flow, Corporate Finance and Takeovers, 76 AM. ECON. REV. 323 (1986) [hereinafter Jensen, Agency Costs] (debt, unlike dividends, bonds future payouts). This theory may explain a substantial portion of the premia paid in leveraged buyouts. Similar considerations may explain promises in limited partnerships to maintain a given level of payouts to the limited partners. See Ribstein, Limited Partnership, supra note 3, at 887. Note, however, that the managers may demand to be compensated for taking the insolvency risk inherent in a high debt firm.

89. Technically these risks will be taken on the equity holders’ behalf by managers to the extent that the managers’ interests are aligned with those of the shareholders. On the other hand, as mentioned above, the managers also may act as subordinated debt holders and therefore contrary to shareholder interests.
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different types of firms. Thus, for example, Alchian and Woodward have argued that capital structure may be a function of “plasticity” of assets: the more different uses assets are subject to, the greater the debt-holders’ problems of monitoring the risk level of managers’ decisions, and consequently the higher the cost of a debt-heavy capital structure.

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The above brief discussion only scratches the surface of the complex tradeoffs involved in designing capital structures and related contracts that minimize agency costs. The important point is that the market is responding to agency problems in a more sensitive way than would be possible through mandatory legal rules.

C. Shareholder Voting Rights and the Market for Corporate Control

In a book that has had a profound impact on corporate law, Berle and Means argued that the dispersion and passivity of public corporation shareholders disconnected ownership from control of assets, with potentially serious consequences for the use of corporate property. Consistently with the Berle and Means theory, the importance of the shareholder vote in protecting shareholders also has been minimized by critics of private ordering. As discussed above, Professor Brudney portrays public corporation shareholders as too ignorant of corporate affairs, and helpless to affect them if they were aware of them, to be considered parties to a viable contract. He also says that shareholders are so passive and uninvolved in management that there is a “distortion in characterizing management as their agent.”

A literature has developed over the last twenty years that establishes that the problem is not as great as was feared by Berle and Means and modern opponents of private ordering. This literature accepts the basic Berle and Means characterization of shareholders’ incentives, but recognizes that other mechanisms protect shareholders. Shareholders are, indeed, rationally ignorant in the sense that active and informed participation in corporate affairs would involve large costs of which an individual shareholder could capture only a small portion of

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90. The choice between secured and unsecured lending may be amenable to a similar type of explanation. See Jackson & Kronman, Secured Financing and Priorities Among Creditors, 88 YALE L.J. 1143 (1979); Scott, A Relational Theory of Secured Financing, 86 COLUM. L. REV. 901 (1986); Smith & Warner, On Financial Contracting, An Analysis of Bond Covenants, 7 J. FIN. ECON. 117 (1979).


93. See supra notes 46-47 and accompanying text.

94. Brudney, Corporate Governance, supra note 4, at 1428.
Nevertheless, shareholders are protected from managerial misconduct by, inter alia, their right to vote for directors and on other matters, and their right to sell their shares. Shareholder voting power can be aggregated into a control bloc through purchase of shares by a bidder for control, who thereby acquires sufficient economic interest in the firm to make active monitoring worthwhile. This so-called market for corporate control provides an external source of control over internal corporate affairs, and provides incumbent managers with the incentive to write optimal contracts. If the buyer improves the firm through displacement or other change in management, it reaps a profit as the stock price rises to reflect the improvement.

Although anti-contractarian commentators tend to be skeptical of the role of the tender offer in disciplining managers, considerable evidence supports the importance of this market in protecting against mismanagement. There is also evidence of the continued importance

96. Common shareholders generally have one vote per share of stock and may freely transfer this vote, but only in connection with a sale of the stock. This interrelationship of voting rights and financial interests ensures that voting will be exercised consistently with the economic welfare of the firm. See Easterbrook & Fischel, Voting in Corporate Law, 26 I. L. & ECON. 395 (1983). However, this does not mean that one-share-one-vote is necessarily optimal in all circumstances. See Fischel, supra note 72, at 139-40.
97. The seminal article is Manne, Mergers and the Market for Corporate Control, 73 J. POL. ECON. 110 (1965); see also Easterbrook & Fischel, Proper Role, supra note 72.
98. See Brudney, Corporate Governance, supra note 4, at 1425-26 n.58 (the large premia in takeovers reflect “slack” in market discipline); Coffee, Regulating the Market, supra note 9; Eisenberg, supra note 9, at 1498 (citing the large premia necessary to gain control and the fact that the control market does not effectively discipline takeover defenses).
99. For a review of the evidence, see Jarrell, Brickley & Netter, The Market for Corporate Control: The Empirical Evidence Since 1980, 2 J. ECON. PERSP. 49 (1988); see also R. Gilson, The Law and Finance of Corporate Acquisitions 377-86 (1986); R. Gilson & R. Kraakman, The Law and Finance of Corporate Acquisitions 1989 Supplement 27-42 (1989). Gilson notes some evidence that apparently conflicts with the displacement-of-weak-management hypothesis, including the poor post-acquisition results of acquiring companies. To the same effect, see Eisenberg, supra note 9, at 1499. As noted in R. Gilson, supra, at 385, the conflicting data might be explained by the fact that the existence of a viable market for control, acting as a deterrent force, reduced the availability of poorly performing companies. This, of course, demonstrates the continuing importance of the market for control. Moreover, it is evidence of competition in the market for corporate control resulting in bidders receiving a normal competitive rate of return. But it does not mean that displacement of inefficient management became unimportant as a takeover motive. Even if “synergy” or “bustup” became dominant explanations for more recent takeovers, such explanations of “hostile” takeovers reflect value-increasing changes being made over the objection of intransient managers—a significant market discipline. This is supported by the more recent studies discussed in Gilson & Kraakman, supra.
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of shareholder voting rights which, in light of shareholder passivity, must be largely explicable in terms of the market for corporate control.

Although the market for corporate control is important, exclusive reliance on it to solve all of the potential conflicts of interest associated with the separation of ownership and control is neither justified nor necessary. Thus, it is not a substantial criticism of the contractual theory of the corporation to argue that the market for control alone fails to achieve perfect discipline. Managerial discretion also is constrained by other market and legal mechanisms discussed elsewhere in this Section, including monitoring by large owners and outside board members. While the market for corporate control is therefore properly viewed as a last resort mechanism for correcting excessive managerial discretion, it is the persistent threat of displacement through control transfers that is primarily responsible for reducing the likelihood that shareholders will be harmed by their agents. The market for corporate control provides the glue that holds together the nexus of contracts.

D. Corporate Hierarchy, the Board of Directors, and the Market for Directors

A substantial body of influential theoretical work on corporate management recognizes the importance of the development in the 1920's of the multi-divisional, or "M-form" of organization of large firms, replacing the unitary, or "U-form" of organization. The M-form of organization places responsibility for long-range planning and policy in a separate group of managers from those responsible for day-to-day operations, thus facilitating coherent overall planning for the entire enterprise instead of factional war among subgroups. The overall planning group includes the board of directors. Most importantly for present purposes, the planning group provides internal monitoring of

100. For evidence that voting rights have market value, see Lease, McConnell & Mikkelson, The Market Value of Control in Publicly-Traded Corporations, 11 J. FIN. ECON. 439 (1983). Also, the mere fact that such voting rights have survived more than fifty years after Berle and Means concluded they were meaningless is of some significance.

101. See supra notes 76-78 and accompanying text.

102. For a theory and data as to how the market for control fills gaps left by other monitoring mechanisms, see MORCK, SHLEIFER & VISHNY, ALTERNATIVE MECHANISMS FOR CORPORATE CONTROL (University of Chicago Center for Research in Security Prices Working Paper No. 228, 1988) (on file with the Washington Law Review).

103. See A. CHANDLER, STRATEGY AND STRUCTURE: CHAPTERS IN THE HISTORY OF INDUSTRIAL ENTERPRISE (1962); O. WILLIAMSON, MARKETS AND HIERARCHIES, supra note 79, at 132-54; O. WILLIAMSON, ECONOMIC INSTITUTIONS, supra note 79, at 279-81.
managers by efficiently separating decision management (the initiation and implementation of strategic plans) and decision control (the ratification and monitoring of the strategy formulation and implementation process). The superior efficiency of the M-form of management for many large firms has been empirically validated. There is also empirical evidence indicating that independence of corporate boards can be adjusted in order to improve financial performance, and that there is in fact a systematic relationship between board composition and corporate financial performance.

Some critics of the contract theory wholly ignore the role of the management structure of the corporation in protecting against management misconduct. Professor Brudney, for example, minimizes the role of this device when he echoes the often-expressed concern that outside directors are passive pawns of managers and poor representatives of shareholder interests and questions the effectiveness of monitoring by non-director managers. Brudney and other critics effectively consign to the wastebasket the important work discussed above on the evolution of corporate management forms.

E. Executive Compensation Contracts

Executive compensation is often structured in ways that attempt to solve conflicts between investors and managers by aligning their interests, as through stock options, stock appreciation rights, phantom stock and other mechanisms that tie compensation to market-based performance. Moreover, incentives can be further aligned by

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104. See Fama & Jensen, Separation, supra note 81, at 308.
107. These structures are not mentioned in Coffee, No Exit, supra note 9, who, as discussed supra note 76, relies exclusively on the absence of “bonding”; nor are they mentioned in the catalogue of market constraints on management conduct discussed by Eisenberg, supra note 9.
108. See Brudney, Corporate Governance, supra note 4, at 1421, 1429; see also Brudney, The Independent Director—Heavenly City or Potemkin Village?, 95 HARV. L. REV. 597 (1982).
109. Brudney, Corporate Governance, supra note 4, at 1430–31 n.72 (M-form of management “is not without its problems” including “the problem of ‘who watches the watchdogs’”).
rewarding managerial achievements through payments that constitute a form of ‘ex post settling up.’\textsuperscript{111}

Some critics of the contract theory have emphasized the evidence uncovered by Jensen and Murphy\textsuperscript{112} of the significant disparity between firm performance and the salary of chief executive officers.\textsuperscript{113} Even accepting Jensen and Murphy’s data, there are, as noted above, many other devices for aligning manager and investor incentives and reducing the agency problem. Moreover, Jensen and Murphy speculate that the reason for the disparity between compensation and incentive is that public corporations are not free to set optimal levels of compensation in light of political and union pressures and SEC disclosure rules.\textsuperscript{114} Such pressures increase the need to provide optimal levels of remuneration by means of the kinds of implicit compensation (such as permitting executives to take advantage of “corporate” opportunities) that could be permitted by contracts opting out of fiduciary duties. Thus, the evidence on the compensation issue may point to less regulation of the corporate contract, not more as Coffee argues.

\textbf{F. Markets for Managers}

Corporate managers recognize that they can improve the performance of the firm by reducing agency costs. Managers compete with one another to attain the top positions in their companies, and most promotion decisions are made on the basis of an individual’s productivity. Shareholders benefit as managers attempt to climb the corporate ladder by improving their productivity and impressing their superiors. Moreover, top level managers often increase their salaries by jumping to other firms or threatening to do so. Thus, competition for managerial services, both inside and outside the corporation, encourages managers to act in shareholders’ best interests.\textsuperscript{115}

\textsuperscript{111} Fama, \textit{Agency Problems and the Theory of the Firm}, 88 J. POL. ECON. 288, 296 (1980).
\textsuperscript{113} See Coffee, \textit{No Exit}, supra note 9, at 943–44; Eisenberg, \textit{supra} note 9, at 1490. Professor Coffee, in particular, relies almost exclusively on the Jensen-Murphy study as evidence that contractual constraints on management do not work.
\textsuperscript{114} JENSEN \& MURPHY, \textit{supra} note 112; Professor Jensen contends that incentive compensation in “LBO Associations” is one response to this problem. See Jensen, \textit{Eclipse}, \textit{supra} note 88, at 68–69.
\textsuperscript{115} See Faith, Higgins \& Tollison, \textit{Managerial Rents and Outside Recruitment in the Coasian Firm}, 74 ECON. REV. 60 (1984). Once again, critics of the contract theory complain that this device does not operate perfectly. Eisenberg, \textit{supra} note 9, at 1495, argues that the chief executive officer is not disciplined by the market for managers because he is in his final period, and other managers are chiefly concerned with satisfying the chief executive. Neither assumption
G. Ownership Structure

Ownership structure recently has been identified as playing an important role in the governance of corporations.\(^{116}\) In contrast to the convention of viewing the governance role of residual claimants as that of being "rationally ignorant" of the firm's internal affairs and exiting the firm upon dissatisfaction, some owners of large blocks of shares may have so much of their wealth tied up in a firm that they cannot afford to ignore the governance of the corporation. Monitoring, or the possibility of monitoring, by large shareholders alters managerial behavior and reduces agency costs. Thus, ownership structure is another of the many corporate governance mechanisms that can be utilized in controlling agency costs.\(^{117}\) Of course, in many corporations, the ownership structure is so diffuse that shareholders are truly rationally ignorant, in which case the other governance mechanisms become relatively more important.

H. Fiduciary Duties: Mandatory Rules Versus Freedom of Contract

An important aspect of the contract theory of the corporation, and one that is hotly disputed by the anti-contractarians, is that fiduciary duties are a term of the corporate contract and therefore consensual in nature.\(^{118}\)

The role of fiduciary duties must be understood in the context of contracting problems in long-term contracts. In contracts calling for acts over an extended period by the contracting party, it is costly to anticipate and draft for every contingency. This is the condition of "bounded rationality."\(^{119}\) As Oliver Williamson has said, "[c]omprehensive contracting is not a realistic organizational alternative when provision for bounded rationality is made. If mind is a scarce resource, then economizing on claims against it is plainly warranted."\(^{120}\) Where the benefits (including certainty) of specifying


\(^{117}\) Professor Eisenberg complains that this device alone does not completely constrain managers. See Eisenberg, supra note 9, at 1493–95. Once again, the relevant question is whether the universe of devices, and not each separately, is effective. See supra notes 76–78.

\(^{118}\) See Baysinger & Butler, The Rolé of Corporate Law in the Theory of the Firm, supra note 3, at 180 n.30.

\(^{119}\) This term originated in H. SIMON, MODELS OF MAN 198 (1957).

\(^{120}\) O. WILLIAMSON, ECONOMIC INSTITUTIONS, supra note 79, at 46 (citations omitted).
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duties are significant and the costs are relatively low, a fully contingent contract—that is, one in which the parties’ acts under all contingencies are specified—may result. Where these conditions do not obtain, the parties may seek other alternatives, including relational or governance-type contracts that constrain the parties to act for their mutual benefit.121

Constraints on the parties in relational contracts may take a variety of forms. One alternative is to rely on implied terms, including good faith performance and fiduciary duties.122 These are legally enforceable standard-form provisions that reduce transaction costs by making it unnecessary for the parties to draft for remote contingencies. Another alternative is to forego legally enforceable duties in favor of the kinds of market constraints discussed elsewhere in this Section.

The critical point to understand under the contract theory is that fiduciary duties are not distinct from the contract but are simply one of many drafting alternatives.123 That is so despite the fact that fiduciary duties are imposed on parties who have not drafted around them. Professor Brudney has argued that the fact that the duties are imposed without bargaining indicates that they are mandatory.124 But it is irrelevant that the terms invented by courts, like suits manufactured for potential consumers, are not the product of a bargaining process and may even be contrary to what particular parties would want. If the parties can choose the terms by either accepting them or contracting around them, the result of this choice is a contract. Thus, the question is not how the terms are articulated, but how they apply to the parties.

In selecting between fiduciary duties and alternative constraints, the parties consider both the costs and benefits of fiduciary duties, and at the margin trade off fiduciary duties for other constraints. On the benefit side, it is relevant that the other contractual and market devices discussed in this Section do not operate perfectly. Thus, the parties to corporate contracts may conclude that a judicial remedy is necessary to fill in the gap left by extra-judicial remedies. But the parties also may conclude that the costs of fiduciary duties outweigh their gap-filling benefits. Among other things, fiduciary duties shift risk to

121. See supra Section III(A)-(G).
122. See Burton, Breach of Contract and the Common Law Duty to Perform in Good Faith, 94 HARV. L. REV. 369, 371 (1980); Goetz & Scott, supra note 80, at 1092–93.
123. For a discussion of the similar problem of distinguishing between the CONTRACTUAL duty of good faith and AVOIDANCE of the contract on unconscionability grounds, see Burton, supra note 122, at 371–72.
124. Brudney, Corporate Governance, supra note 4, at 1427 n.60.
managers, who are poor risk-bearers, and expose the corporation to costly litigation. Just as there are imperfect extra-judicial remedies, there are also imperfect judicial remedies. Thus, it is a fallacy to assume that merely because fiduciary duties and remedies are part of the contract in some cases that they are always so, and that shareholders should not be able to opt out of these duties.

That fiduciary duties are part of the contracting process can be seen from their close relationship with explicit contract terms. Because the parties usually cannot and do not specify the entire contract in their promise, the promise is only a “fragment” of the entire understanding between the parties. Discerning the unarticulated portions of an actual agreement may closely resemble the process of making up a contract for the parties that is involved in the recognition of fiduciary duties.

It is sometimes difficult but always necessary to distinguish between interpreting and imposing contract terms. Despite the costs entailed in drafting for all contingencies, the court should not always assume that the parties have adopted the default fiduciary duty term, and should not apply fiduciary duties if the parties have opted out of them.

125. For discussions of the costs of fiduciary duties, see infra Section V(A); Davis, Judicial Review of Fiduciary Decisionmaking—Some Theoretical Perspectives, 80 NW. U.L. REV. 1, 27-29 (1985); Fischel & Bradley, The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis, 71 CORN. L. REV. 261, 262-63 (1986); Ribstein, Takeover Defenses, supra note 3.

126. See Macneil, Many Futures, supra note 56, at 734.

127. For example, it may be difficult to distinguish between resolution of bondholder rights issues on the basis of fiduciary duties or broad interpretation of the indenture. See Bratton, supra note 56, at 695, 738.

128. For a discussion of this problem in the context of takeover defensive moves, see Ribstein, Takeover Defenses, supra note 3, at 105-06.

129. The problem is similar to adding an “omitted term” to a contract. The court must first interpret the contract to determine whether anything was omitted. If there is an omitted term, the court supplies a term that is fair in the circumstances. See Restatement (Second) of Contracts § 204 (1979); Farnsworth, Disputes over Omission in Contracts, 68 COLUM. L. REV. 860 (1968); Speidel, Restatement Second: Omitted Terms and Contract Method, 67 CORN. L. REV. 785 (1982).

This is illustrated by Jordan v. Duff & Phelps, Inc., 815 F.2d 429 (7th Cir. 1987), cert. denied, 108 S. Ct. 1067 (1988). Judge Easterbrook, writing for the majority, held that Duff & Phelps may have had an implied fiduciary duty to disclose an impending merger to a shareholder-employee who was planning to quit, and who on resignation had an obligation to sell his stock to the company at book value. Judge Posner, dissenting, held that such a duty was precluded as a matter of law because the express terms of the contract did not provide for it. Judge Easterbrook seems to have leaned toward an anti-contractarian application of the hypothetical bargain approach. (For the distinction between the hypothetical bargain approach and the contract theory of the corporation, see supra notes 70-73 and accompanying text.) Judge Posner, on the other hand, appears to have recognized that if the parties may be fairly interpreted to have opted
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Professor Coffee, on the other hand, argues that the courts should adopt a general fiduciary duty as a "canon of construction" of corporate statutes and charters in all cases where they are not clear. Armed with this "canon of construction," the court could decide if it should enforce charter provisions whether or not they are consistent with the statute. As should be evident from the above discussion, this approach trumps private contracts, thereby nullifying the parties' sensitive balancing of costs and benefits of fiduciary duties.

Coffee justifies his mandatory rule in part on the ground that courts should interpret statutes as "public regarding" unless they explicitly reflect an interest group deal. In this context, according to Coffee, "public regarding" means that the court "should posit that a basic purpose of corporate law is to reduce agency costs." But Coffee does not explain why the "public regarding" purpose of the statute is not to effectuate private contracts among the parties to the corporation (as distinguished from deals with legislators) or to fill blanks with efficient hypothetical bargains, rather than to mandatorily reduce agency costs whatever the offsetting costs to the parties of doing so. Ultimately, therefore, Coffee's justification for mandatory rules depends on underlying policy factors, particularly including whether

out of fiduciary duties, the court must respect the parties' contract even if such duties appear to be consistent with the court's view of the optimal "hypothetical bargain." Professor Coffee mistakenly concludes that both Judge Easterbrook and Judge Posner applied the hypothetical bargain approach, and that therefore Jordan illustrates the indeterminacy of this approach. Coffee, Mandatory/Enabling, supra note 9, at 1680–81. In fact, only Judge Easterbrook applied this approach, while Judge Posner applied the parties' actual contract.

The courts generally have been more willing to apply express terms of bondholder contracts than of shareholder contracts. See, e.g., Kirschner Bros. Oil, Inc. v. Natomas Co., 185 Cal. App. 3d 784, 229 Cal. Rptr. 899 (1986) (preferred shareholders); Simons v. Cogan, 549 A.2d 300 (Del. 1988) (debt holders); Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986) (debt holders); Rothschild Int'l Corp. v. Liggett Group Inc., 474 A.2d 133 (Del. 1984) (preferred stockholders); Harff v. Kerkorian, 324 A.2d 215 (Del. Ch. 1974) (dismissing complaint by bondholders on fraud and fiduciary duty theories), aff'd in part, rev'd in part, 347 A.2d 133 (Del. 1975) (reversing dismissal of fraud allegations). For other cases in which the courts have refused to read fiduciary duties into the contract in the face of explicit terms, see In re Reading Co., 711 F.2d 509 (3d Cir. 1983) (contract that provided for charging of nonprofit-maximizing rates to shareholders that operated the company's railroad cars precluded action for self-dealing); Coleman v. Taub, 638 F.2d 628 (3d Cir. 1981) (contract that permitted the company to repurchase plaintiff-employee's stock when he was terminated altered the defendants' fiduciary duty to refrain from freezeout mergers).

130. See Coffee, Mandatory/Enabling, supra note 9, at 1685.


132. Coffee, Mandatory Enabling, supra note 9, at 1685.

133. See Ribstein, Takeover Defenses, supra note 3, at 122.

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contract provisions are adequately constrained by markets, rather than on principles of statutory construction.

The above discussion demonstrates that characterizing an issue as one of fiduciary duty does not automatically remove it from the realm of private ordering.\textsuperscript{134} While the question is ultimately one of policy, the fundamentally contractual nature of fiduciary duties means that they should be subject to the same presumption in favor of private ordering that applies to other contracts.

\section{Conclusion}

The foregoing discussion demonstrates that, contrary to the skepticism of critics of the contract theory, numerous aspects of the corporate contract, from choice of organizational form to specific aspects of these forms to corporate law provisions, address and alleviate the risk of managerial misconduct. Indeed, many of the variations between contractual forms can be explained only as ways of optimizing the costs and benefits of dealing through agents in particular situations. This indicates that the corporate contract is robust rather than being so one-sided that it needs a regulatory prop.

A central problem with the anti-contractarian criticisms of the corporate contract is that they often view elements of this contract, such as executive compensation, in isolation, concluding from the fact that one element leaves gaps in protection that shareholders are unprotected. In fact, the corporate contract must be viewed as a whole, with each of the elements reinforcing and closing gaps left by other elements. For example, internal monitoring by independent directors and auditors may not be wholly effective, but they do not have to be in the light of, for example, the market for corporate control.

The view of the corporate relationship presented in this Section should at least establish a presumption in favor of private ordering in the corporation in general and opt-out provisions in particular. As discussed in Section IV, the apparent efficiency of the contract terms is borne out by the efficiency of the capital markets which drives pricing of the terms of corporate contracts.

\footnote{134. That is not to say that opting out of fiduciary duties should always be permitted under a private ordering regime. As discussed in Section VII, infra, there are important issues concerning whether opting out of fiduciary duties is a violation of the parties' existing agreement.}
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IV. THE ADEQUACY OF MARKET CONSTRAINTS ON CONTRACT TERMS

Opponents of private ordering argue that the terms of the corporate contract are priced in a "lemons market" in which there are inadequate incentives to offer optimal protection against managerial misconduct. That is, these critics assert that there is a market failure in the ability of securities markets to accurately evaluate firm-specific corporate governance information, including the risk of managerial shirking or diversion inherent in certain contracts. The important implication of the market's failure to accurately price contract terms is that such terms are suboptimal, and resources are not allocated to their highest value uses. Because of the importance of this argument to the regulatory approach to managerial duties, it is crucial to consider whether it has any validity.

Unlike most areas of legal discourse, where it is unlikely that the correct answer can be "proven," the incorrect application of economics can be demonstrated. The market failure argument, which is an economics argument, contains numerous fatal flaws. Most importantly, the argument is based on a misapprehension of the workings of efficient capital markets. A thorough understanding of the Efficient Capital Markets Hypothesis reveals that securities markets are efficient in the sense that a corporate shareholder gets what he is paying for in both the terms of the contract and the substantive nature of the product, including the quality of management. The ramifications of this powerful fact will be explored throughout this Section, as we demonstrate the fallacy of the market-based arguments of critics of private ordering.

Most of this Section considers market constraints on contract terms applicable to investors purchasing shares after the terms have been set. However, Section IV(F) discusses application of "midstream" amendments to investors as of the time of the amendment. Despite the concerns raised by some critics of the contract theory, no special problems are raised by this situation.


136. See Coffee, No Exit, supra note 9, at 947, 948.

137. Professor Eisenberg argues that certain terms that are "surprising" should be unenforceable even if they are accurately priced. Eisenberg, supra note 9, at 1519. If the provisions are "surprising," it seems to follow that they are not accurately priced. If the provisions are accurately priced even though surprising, it is unclear what policy could justify non-enforcement.
A. Efficient Capital Markets and Corporate Governance Contracts

There is substantial evidence favoring the general efficiency of the securities markets.\textsuperscript{138} Prices of actively traded securities\textsuperscript{139} quickly reflect at least all public information about a company.\textsuperscript{140}

The basic mechanism of market efficiency is that information about a firm continually alters investor expectations about future returns, and hence the prices at which they will sell and buy their securities.\textsuperscript{141}

\textsuperscript{138} Professor Michael Jensen, a leading efficient market theorist, has said that "there is no other proposition in economics which has more... empirical evidence supporting it than the efficient market hypothesis." Jensen, Some Anomalous Evidence Regarding Market Efficiency, 6 J. FIN. ECON. 95, 95 (1978). There has been some criticism of the evidence supporting market efficiency—particularly in relation to allocative efficiency (relating to the value of firms as a whole) as distinguished from speculative efficiency (relating to the value of securities divorced from the assets they represent). For summaries of criticism of the efficient capital markets hypothesis, see Gordon & Kornhauser, Efficient Markets, Costly Information, and Securities Research, 60 N.Y.U. L. REV. 761 (1985); Kraakman, Taking Discounts Seriously: The Implications of " Discounted" Share Prices as an Acquisition Motive, 88 COLUM. L. REV. 891, 898–900 (1988); Summers, Does the Stock Market Rationally Reflect Fundamental Values?, 41 J. FIN. 591 (1986); Wang, Some Arguments that the Stock Market Is Not Efficient, 19 U.C. DAVIS L. REV. 341 (1986). Nevertheless, as suggested by the Jensen quote, the Efficient Capital Markets Hypothesis remains by far the dominant view of the securities markets among financial economists.

\textsuperscript{139} This does not, of course, apply to close corporations. However, the participants in closely held firms contract with each other directly, and so do not need the protection of the securities markets as a constraint on the development of efficient arrangements. That is not to say that fiduciary duties are irrelevant, or even less relevant, in closely held than in publicly held firms, but only that the absence of an efficient securities market in shares of closely held firms does not present a problem with respect to contracting around such duties. As to the differences between close and public corporations, see Manne, supra note 81, at 276–84.

Despite the existence of face-to-face dealings in the close corporation, Professor Eisenberg claims that there is a need for some mandatory duties even in this context because the parties do not give their full attention to long term consequences or fully appreciate the implications of provisions dealing with such consequences. Eisenberg, supra note 9, at 1469–70. This simply restates the "bounded rationality" problem, and ignores the existence of contractual devices for dealing with it. See supra notes 121–22 and accompanying text. Among other things, the "bounded rationality" problem may cause the parties to a closely held firm to rely on statutory or common law default provisions. See Ribstein, A Statutory Approach to Partner Dissociation, 65 WASH. U.L.Q. 357, 410–14 (1987). But this problem does not justify trumping private agreements. Indeed, if anything, refusal to enforce such arrangements increases the difficulty of planning.

\textsuperscript{140} It is commonly accepted that there are degrees of market efficiency depending on the nature of the information. The "strong form" of the theory holds that market value reflects all relevant information; the "semi-strong" that market value reflects all public information; and the "weak form" that market prices move in relation to information rather than according to established patterns of price movement. See Fama, Random Walks in Stock Market Prices, 21 FIN. ANAL. J. 55 (1965).

\textsuperscript{141} Thus, there is substantial evidence that, because of high cross-elasticity of demand over the market for all securities, stock prices do not respond merely to the quantity being sold. See Scholes, The Market for Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices, 45 J. BUS. 179 (1972).
This information reaches investors in a wide variety of ways, including voluntary and mandatory public disclosures by firms, stories in the financial media, reports by securities analysts and disclosures of insider trades.\textsuperscript{142} Even information that is not disclosed may be anticipatorily reflected to some extent in market prices through trades by many uninformed investors.\textsuperscript{143}

The information efficiently reflected in market prices includes the terms of contracts constraining managerial discretion and the prospects that this discretion will be exercised consistently with investor interests.\textsuperscript{144} Any change in these contracts, and any change in or new information about the managers of such a corporation, such as their track records, reputations and the like, will be reported in the financial media. Through the mechanisms of market efficiency, this information is reflected in market price. And because information about contract terms and managers is accurately reflected in market price, investors get what they pay for, and capital is allocated to the most efficient firms.

Finally, it should be noted that even if the anti-contractarians could produce evidence of market inefficiency, this would not necessarily weaken the argument in support of enforcement of corporate contracts. For example, one of the principal arguments against market efficiency is that securities prices do not accurately reflect all available information because they also reflect "noise," or biases of uninformed traders.\textsuperscript{145} But even in a generally "noisy" market, "real" information, including information about the contract terms constraining managers, continues to affect stock prices. While it may be impossible to fully disentangle the effects of "noise" from those of underlying facts, this does not mean that a contract that ignores investor interests will go unpunished in the market. Interestingly, critics of private ordering do not rest their arguments for regulation of the corporate contract on assertions of general market inefficiency.\textsuperscript{146}


\textsuperscript{143} See Verrechia, On the Theory of Market Information Efficiency, 1 J. Acct. & Econ. 77 (1979).

\textsuperscript{144} See Easterbrook & Fischel, supra note 9, at 16–17.

\textsuperscript{145} See Black, Noise, 41 J. Fin. 529 (1986).

\textsuperscript{146} See Brudney, Corporate Governance, supra note 4, at 1422–26 (accepting efficiency of stock markets); Coffee, No Exit, supra note 9, at 941–42 (accurate pricing of securities does not eliminate potential for unfairness).
B. Unsafe at Any Price? The Anti-Contractarians' Arguments Against Effectiveness of Market Constraints

Critics of private ordering argue that general market efficiency does not sufficiently protect investors from the risk of managerial misconduct to eliminate the need for regulation. As we demonstrate in this Section, these arguments reveal serious misunderstandings concerning the operation of financial markets.

1. Market Prices Do Not Reflect Expected Agency Costs

Critics of private ordering assert that there is a problem of "informational asymmetry" preventing information concerning agency problems from being fully reflected in market prices.147 The basic argument is that managers and other insiders always have better information than shareholders, not only about the corporation's financial prospects, but also about the likelihood that managers themselves will engage in disloyalty, shirking or other forms of discretionary behavior that harms shareholders.

Professor James Cox says, "managers know the frequency and amount of harm caused by their misconduct, whereas outside investors do not."148 Similarly, Professor Coffee asserts that firms cannot distinguish themselves regarding expected agency cost, which permits defalcating managers to impose costs on better firms, resulting "in an unnecessary and socially inefficient increase in the average cost of capital experienced by all firms. In short, there is an externality."149 As a result, according to Coffee, investors will overinvest in poorly managed firms, and the quality of management and of corporate contracts will regress to the mean, as in any "lemons" market.150 This is a significant point because, if correct and the costs are large enough to be

147. See Brudney, Corporate Governance, supra note 4, at 1423-24; see also Cox, Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures, 52 GEO. WASH. L. REV. 745, 747-48 (1984) (asserting that there is an "informational asymmetry" problem, but then pointing out that this problem may be addressed by signaling by firms, and not discussing why signaling does not fully address the "informational asymmetry" problem).
148. Cox, supra note 147, at 747.
149. Coffee, No Exit, supra note 9, at 946; see also, to the same effect, Cox, supra note 147, at 752. Coffee's assumption that the lemons phenomenon results in a higher average cost of capital for all firms is revealing. There are winners and losers for this market imperfection, if it exists. Thus, some firms would take advantage of the information asymmetry to lower their cost of capital below what it would be if all information about managerial behavior were reflected in the price. A more charitable assumption is that Coffee means the weighted average cost of capital increases because more firms are losers than are winners as a result of the information asymmetry. This would be plausible but for the fact that the losers can engage in activities designed to convince investors of their integrity.
150. See Coffee, No Exit, supra note 9, at 947, 948.
relevant, it justifies imposing fiduciary duties and derivative remedies even on firms that have reasonably concluded that, for them, the burden of such remedies outweighs their benefit.\textsuperscript{151}

The "externality" argument fails on several counts. First, Professor Coffee fails to distinguish relevant and irrelevant externalities.\textsuperscript{152} The externalities identified by Coffee are most likely irrelevant to an efficiency analysis (which is his mode of analysis at this point) because they are solely pecuniary; they may change prices, but prices still satisfy the efficiency condition of being equal to marginal costs. Thus, Coffee appears to commit the often-observed non-sequitur of saying, "It's an externality, therefore, we better have a law." This is not only logically wrong, but it ignores the costs of the law.

A second problem with the "externality" analysis is that the critics of private ordering have given no reason why the market cannot cope with information about expected agency costs.\textsuperscript{153} Even Professor Coffee has pointed out\textsuperscript{154} that the extent of investor uncertainty (which surely varies across firms) will be reflected in the market price of the stock. Thus, there is no reason why market prices, if they reflect other information (such as constantly changing prospects of a merger), cannot also reflect such matters as the impact of different compensation arrangements, the effect on agency costs of different capital structures,\textsuperscript{155} and the quality of management.

Nor is there a valid basis for distinguishing between charter provisions that generally opt out of fiduciary duties and those that opt out of liability for specific conduct.\textsuperscript{156} Both types of provisions leave uncertainty as to what kind of conduct managers will engage in. Indeed, the market may have an easier time predicting the conduct of

\textsuperscript{151} Thus, the externality argument is used to justify derivative remedy in \textit{Principles}, \textit{supra} note 6, at 13–14 (Tent. Draft No. 9, 1989). Professor Coffee is Reporter for this Part of the A.L.I. project. \textit{See supra} note 9.

\textsuperscript{152} For an excellent discussion of this distinction in the corporate law context, see Haddock, Macey & McCchesney, \textit{supra} note 3, at 723–726.

\textsuperscript{153} Professor Brudney does, in a discussion of whether investors are aware of corporate law changes (see infra Section IV(B)(4)) refer to literature on heuristics that suggests that people tend to be overoptimistic in predicting outcomes. Brudney, \textit{Corporate Governance}, \textit{supra} note 4, at 1418 n.35. But nothing in this literature makes the wholly counterintuitive suggestion that investors (including the professional analysts and financial journalists who play a large role in determining share prices) will generally be overly sanguine about the honesty and dedication of corporate managers.

\textsuperscript{154} \textit{See Coffee, No Exit, supra} note 9, at 942.

\textsuperscript{155} \textit{See supra} note 88 and accompanying text (concerning the reduction-of-agency-cost explanation of premia in leveraged buyouts).

\textsuperscript{156} \textit{See Coffee, Mandatory/Enabling, supra} note 9, at 1664–65, 1667–71 (advocating such a distinction).
an established manager under a general provision than that of a shifting cast of characters under a specific provision. In all events, the market may have even greater difficulty pricing potentially costly fiduciary duties than it does pricing opt-out provisions.

A third problem with the externality argument is that it ignores the fact that a substantial portion of the supposedly “external” costs fall on precisely those who can ameliorate the problem. Honest managers do not sit idly by as dishonest managers of other firms impose costs on them. If investors receive a return based on an unfounded expectation that managers will engage in cheating, or on uncertainty as to whether they will or not, then either they will reap a windfall at the expense of managers who are not cheating up to expectations, or managers who would otherwise be honest will cheat in order to prevent this windfall. It is reasonable to expect that “honest” managers will attempt to capture the benefit of this investor windfall for themselves. Managers can develop a reputation for honesty, employ devices for signalling this honesty, institute internal monitoring through outside directors or auditors, bond the payout of future cash flows by substituting equity for debt, or institute any of the other devices for control of agency costs discussed in Section III. The presence or absence of these devices would be reflected in the market price of the firm’s securities. If shareholders are willing to pay (in the form of a lower return) for these assurances, there is no reason why the managers should not be able to share in this payment in the form of, for

157. In other words, because there is a bargaining interface between investors and managers, managers cannot shift the costs of their mismanagement to investors as, for example, a polluting factory might be able to shift the costs of pollution to its neighbors. See Coase, The Problem of Social Cost, 3 J. L. & ECON. 1 (1960).

158. See Klein, Crawford & Alchian, supra note 3, at 781–88.

159. See Ross, Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory in Issues in Financial Regulation 177 (Edwards ed. 1979). Interestingly, the “informational asymmetries” discussed at notes 147–51, supra, actually work in favor of private ordering since investors’ knowledge of these asymmetries should facilitate signaling by making the signals more credible.

Professor Coffee ignores these devices when he asserts the “managements can seldom convey assurances to investors that the latter deem reliable that the former will not engage in opportunistic self-dealing,” Coffee, No Exit, supra note 9, at 947, and that the “managerial cast is constantly changing and publicly disclosed information provides little basis for assessment,” id. at 945. Moreover, Coffee gives no evidence to support his assertion about the “constantly changing” managerial cast.

The use of resources to signal quality is not, as Professor Coffee argues, “unfairness” or a misallocation of resources worthy of government intervention, Coffee, No Exit, supra note 9, at 946, but rather a private cost that firms decide to bear when they adopt the public corporation form of organization.

160. See supra notes 103–106.

example, higher salary. Moreover, failure to employ these devices increases the firm’s cost of capital and makes it an attractive takeover target. In short, competitive markets will not tolerate honest managers’ being content to pay investors ex ante for cheating the managers will not be doing.

The “externalities” argument is so weak that Professor Coffee himself eventually backs away from it. He notes that investors will price companies that opt out of fiduciary duties lower than those that do not, so that “the ‘lemons market’ effect [of opting out] should be limited to those firms that do opt out.”162 If the market can discern differences between firms that opt out and those that do not, then it must also be able to price other differences between firms, such as particularly reputable managers or strong monitoring procedures.

2. How Expected Agency Costs Affect Stock Prices: Agency Cost as Systematic Risk

Some critics of the contract theory question not only whether agency costs and related matters are reflected in stock prices, but how this occurs. Specifically, they claim that agency cost is systematic rather than firm-specific risk.163 Before discussing and evaluating this important misconception in the anti-contractarian literature, it is necessary to review some basic principles of corporate finance.

The price of a security reflects the net present value of the stream of real cash flows that the firm is expected to generate. Because the future is not certain, expectations about the future cash flows are expressed in terms of a probability distribution—mean and standard deviation. The price of a security depends both on the mean of expected cash flows and on the range over which expected cash flows are dispersed, the latter factor being generally referred to as “variance,” which is the way financial analysts define risk. Since investors are assumed to be risk averse, two securities with identical mean expected cash flows will be priced differently if the variance of the expected cash flows of one security is greater than the variance of the other.164 At the market price, each security will receive a normal, or market, rate of return adjusted for the underlying risk of the cash flows.

162. Coffee, No Exit, supra note 9, at 949.
163. See infra notes 168–69 and accompanying text.
In understanding market valuation of securities, it is important to recognize that investors can reduce variance, or risk, by holding diversified portfolios—that is, collections of assets the risks of which are to some extent complementary. For example, the portfolio risk of two firms, one of which makes swimsuits and the other which makes umbrellas, will be less than the risk of each firm separately, because expected portfolio returns are not dispersed as widely by uncertainty regarding the weather as are the expected returns of each separate firm. However, some risks, such as macroeconomic events like inflation or general recession, inevitably will affect all risky assets; they cannot be “diversified away.” The Capital Assets Pricing Model, the dominant theory of financial valuation, states that the market price of securities will reflect “systematic,” or market-wide, risk (commonly referred to as the stock’s “beta”), which cannot be eliminated by diversification, but not “firm-specific” risk, which can be eliminated by holding diversified portfolios of assets.165

Investor expectations concerning managerial misconduct can affect both the mean and the variance of a security. If, for example, the firm is taken over by a known looter and there are no significant controls in place, investor expectations concerning mean net cash flows will plummet. Risk also may increase because the range of possibilities now includes loss of the shareholders’ investments. Stock prices will fall to reflect the lowered expectations and higher risk. At the new price, new investors in the revalued shares will receive a normal rate of return ex ante. If someone with an unusually good reputation takes over, or controls over misconduct are tightened (such as by the addition of outside board members), mean earnings expectations may increase and variance may decrease. To take an example that is particularly relevant to the present discussion, if the shareholders decide to opt out of all fiduciary duties, investors may conclude that this will sufficiently reduce managers’ incentives to act in the shareholders’ interests; that mean earnings can be expected to fall; and that, with the constraints on management misconduct loosened, the variance of possible outcomes—that is, risk—has increased.166 The lower expected earnings will result in lower share prices.

166. Alternatively, investors may conclude that mean expected earnings will rise now that the company no longer needs to contend with wasteful derivative litigation and managers are freer to exercise their business judgment.

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One further important point should be made about the effect of expected agency costs on stock prices. To the extent that these expectations affect risk, the risk is specific to a particular firm and is therefore not reflected in market price under the Capital Assets Pricing Model. This necessarily follows from the fact that agency costs are a function of the unique management and contractual setting of a specific firm. No market-wide, systematic factor is at work (short of, for example, a universal change in human nature). It follows that the risk can be eliminated by holding a diversified portfolio of securities, that investors are not compensated for bearing the risk, and that share prices accordingly do not reflect this risk.\(^{167}\)

All of this would be remarkable and noncontroversial but for Professor Coffee's assertion that "the assumption that the market evaluates the risk of fiduciary abuse on a firm specific basis needs re-examination."\(^{168}\) Coffee concludes that the risk of fiduciary misconduct is systematic because "[o]nly 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.'"\(^{169}\)

Coffee's argument confuses the distinction between systematic and firm-specific risk with the question of whether variations among firms in mean expected returns are reflected in security prices. As discussed above,\(^{170}\) because the efficient securities markets can distinguish among firms in terms of potential agency costs, stock prices reflect these costs.\(^{171}\) Even if critics of private ordering are correct in disputing market efficiency in this respect, there is still no correlation in the

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167. See Easterbrook & Fischel, Corporate Control Transactions, supra note 70, at 711–14.
168. Coffee, No Exit, supra note 9, at 945. Along similar lines, some writers have correctly noted the difficulty of constructing a portfolio that completely diversifies away agency cost. See Cox, supra note 147, at 748–52; Gordon, supra note 9, at 1595–96. These writers fail to make the critical comparison between the costs of portfolio diversification and of incomplete diversification, and the costs of fiduciary duties remedies.

Professor Cox also argues that portfolio diversification does not address the problems of the nondiversifying investor. Cox, supra note 147, at 752. This ignores the enormous percentage of investing that is done through institutions and mutual funds, thereby predating general mandatory rules on exceptional fact situations.

169. Coffee, No Exit, supra note 9, at 945. If the risk were indeed systematic, it would be reflected in the prices of all securities. Indeed, this is consistent with Coffee's point, discussed supra note 149, that agency costs raise the cost of capital for all firms. However, systematic risk does not impact on all firms identically; the impact depends on the stock's "beta," or sensitivity to market risk.

170. See supra note 144 and accompanying text.

171. Since the price investors pay for their securities reflects any expected reduction in returns resulting from managerial misconduct, the shareholders earn a normal rate of return.
occurrence of managerial and agency problems across firms. It follows that, to the extent that these problems affect risk, the risk is firm-specific and not systematic. In short, the anti-contractarians do not enhance their criticism of market efficiency by recasting it in terms of the Capital Assets Pricing Model.

3. Ignorance of Individual Investors

Some anti-contractarian writers argue that corporate contracts should not necessarily be enforced because individual investors are ignorant concerning the corporate governance arrangements they vote on or invest in. The average investor is, indeed, "rationally ignorant" of such matters. But this ignorance is of no importance regarding investment decisions as long as the efficient market operates to discount information concerning expected agency costs into securities prices. The assumption that individual shareholder understanding of and assent to corporate terms is necessary to legitimate corporate contract terms has engendered the mistaken idea that corporate charter provisions that opt out of fiduciary duties should be periodically resubmitted for shareholder vote. In light of efficient market pricing of contract terms, such repeated votes are unnecessary.

4. Investor Ignorance of Implied Legal Duties

It has been argued against the contract theory that investors generally are not aware at any particular time of the constantly changing law regarding managerial duties. Of course, as discussed above in this Section, the ignorance of individual investors would not be significant if, with the help of market professionals, information about implied duties were efficiently reflected in share prices. But one study suggests that this may not always be the case. This study found no

172. Bebchuk, supra note 9, at 1836; Brudney, Corporate Governance, supra note 4, at 1414–20; Eisenberg, supra note 9, at 1477–80 n.*.
173. See supra notes 93–95 and accompanying text.
174. See Easterbrook & Fischel, supra note 9, at 17–18.
175. Such repeated votes are required under PRINCIPLES, supra note 6, § 5.09 (Tent. Draft No. 7, 1987) to effectuate "standards of the corporation" that authorize interested transactions.
176. Moreover, even if the terms were not efficiently priced and some investors were ignorant of them when they bought in, it is not clear why anti-contractarians would conclude that repeated voting solves the problem in light of their criticisms of the efficacy of shareholder voting. See infra notes 211–217 and accompanying text.
177. See Brudney, Corporate Governance, supra note 4, at 1414–20.
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evidence of abnormal returns in a study of market price reaction to several significant Delaware supreme court cases.\textsuperscript{178}

There are problems with the Weiss and White data. First, at least some of the cases selected may not have had the significant unanticipated effect on Delaware law claimed by Weiss and White. For example, in \textit{Zapata v. Maldonado},\textsuperscript{179} the court adopted a middle-of-the-road position on the power of special litigation committees that might have been anticipated from prior cases.\textsuperscript{180} Second, in light of the huge percentage of publicly traded corporations that are incorporated in Delaware, and the substantial influence of Delaware courts on other states' courts, it is questionable whether any study could accurately determine whether "abnormal" returns resulted from Delaware law changes applicable to all Delaware corporations.

Nevertheless, Weiss and White's conclusion about the effect of case law changes on stock prices should not be completely dismissed. Because of the uncertainty inherent in judicial decisions on fiduciary duties, case law changes are much more difficult for the market to assess than other governance changes. Indeed, this is one of the most important problems with broad fiduciary duties that delegate substantial power over corporate governance to the courts.\textsuperscript{181} But the policy implication is consistent with the contract theory: The parties should be able to opt out of fiduciary duties to avoid costly unpredictability.\textsuperscript{182}

\textsuperscript{178} Weiss & White, \textit{Of Econometrics and Indeterminacy: A Study of Investor' Reactions to "Changes" in Corporate Law}, 75 CALIF. L. REV. 551 (1987). Weiss and White were forced to omit \textit{Van Gorkum} because the supreme court opinion in that case was issued the same day as the chancery court opinion in \textit{Moran}. \textit{Id.} at 568. For a study finding that the \textit{Van Gorkum} case had no effect on the market value of Delaware corporations, but that the passage of 8 Del. Code § 102(b)(7) (the so-called "anti-\textit{Van Gorkum}" provision) had a negative effect, see Bradley & Schipani, \textit{The Relevance of the Duty of Care Standard in Corporate Governance, An Analysis of the Trans Union Decision and Subsequent Delaware Legislation}, to be published in 75 IOWA L. REV., \_ (1990).

\textsuperscript{179} 430 A.2d 779 (Del. 1981).

\textsuperscript{180} For a critique of Bradley & Schipani, \textit{supra} note 178, primarily on the ground of the indeterminate effect of \textit{Van Gorkum}, see \textit{GILSON & KRAAKMAN}, \textit{supra} note 99, at 10-23.

\textsuperscript{181} See Ribstein, \textit{supra} note 3.

\textsuperscript{182} Weiss and White and other anti-contractarians have argued that the lack of price effects from case law changes show that governance provisions generally are not reflected in stock price. See Weiss & White, \textit{supra} note 178, at 589-90; Eisenberg, \textit{supra} note 9, at 1502, 1508; Fox, \textit{The Role of the Market Model in Corporate Law Analysis: A Comment on Weiss & White}, 76 CALIF. L. REV. 1015, 1041-43 (1988). This is an unwarranted conclusion. First, as discussed immediately above, there is a significant difference between case law and other types of governance changes. Second, there is voluminous data showing changes resulting from such changes as (1) poison pills, \textit{Ryngaert, The Effect of Poison Pill Securities on Shareholder Wealth}, 20 J. FIN. ECON. 377 (1988); (2) shark repellents, \textit{DeAngelo & Rice, Antitakeover Charter Amendments and Stockholder Wealth}, 11 J. FIN. ECON. 329 (1983); Linn & McConnell, \textit{An...
In conclusion, because expected agency costs and corporate contracts constraining them are reflected in the prices investors pay for securities, there are no corporate-governance externalities. In the absence of such a market failure, there is no efficiency justification on which to base mandatory rules.

C. Optimal Versus Complete Discipline of Managers

Anti-contractarians attempt to make a case for regulation even in the face of efficient market pricing. They assert that managers are not disciplined by incentive compensation packages or other types of monitoring and bonding devices. Thus, Professor Coffee says:

[\text{A stock price can be "accurate" in the sense that the price accurately measures the range of this uncertainty [of management misdealing], 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.}^{183}]

To similar effect, Professor Brudney says:

[\text{Pricing efficiency . . . is not to be confused with pressure on management to operate efficiently or to maximize shareholder wealth in any given firm. . . . The "efficiency" of the stock markets does not of its own force drive management to compete in limiting its rewards or its power to divert assets, or even to be more effective managers.}^{184}]

The assertion that efficient pricing of agency problems is not enough to ensure development of devices that will eliminate the risk of managerial misconduct may be correct. But it is irrelevant. As the huge body of literature on agency costs and the theory of the firm has demonstrated, there are inevitable costs of delegating power to agents that are constantly traded off against the benefits of doing so.\textsuperscript{185} Thus, the continued existence of agency costs does not alone establish either


183. \textit{Coffee, No Exit}, supra note 9, at 945; see also \textit{id.} at 942.

184. \textit{Brudney, Corporate Governance}, supra note 4, at 1425; see also \textit{Cox, supra} note 147, at 747–48; \textit{Eisenberg, supra} note 9, at 1515.

185. See the discussion of the theory of the firm, supra notes 79–84 and accompanying text.
a problem or a need for regulation.186 "Play" in the contracts constraining managers should not be confused with inefficiency in the creation of these contracts. Even if markets cannot perfectly constrain acts of managers, that does not mean that they cannot discipline the development of agency contracts, the terms of which are readily observable and reflected in market price. As discussed in Section III, the terms of these agency contracts permit both monitoring by markets, including the corporate control and managerial employment markets, and gap-filling fiduciary duties. Thus, the parties' contracts involve deliberate choices between market and legal control of agents. In short, the presence of play in the corporate contract suggests, rather than a failure of contracting, a recognition that the least costly way of dealing with agency costs may be to allow them to be checked by incentive or monitoring devices instead of by liability rules.

D. Comparison with Limits on Non-corporate Contracts

Many critics of private ordering in the corporation attempt to find support for government regulation of corporate contracts by drawing analogies between corporate contracts and non-corporate contracts. For example, Professor Coffee points out that, even accepting the contractual nature of the corporation, contract terms are, in fact, regulated in other contexts. He cites as an example Uniform Commercial Code ("U.C.C.") section 2-719(2), which does not permit limitations or restrictions on Code remedies that would cause the resulting remedy to "fail of its essential purpose." He also could have mentioned, among other things, the general law on unconscionability,187 the U.C.C.'s general provision on unconscionability, section 2-302, and prima facie unconscionability of limitations of consequential damages.

186. That is not to say that the current level of constraints on managerial misconduct is optimal. Rather, the point is that the mere failure of existing devices to eradicate agency costs, absent a showing of facial inadequacy of the terms of the corporate contract (see supra Section III) or of a market breakdown, is not enough to establish a need for regulation. See Baysinger & Butler, The Role of Corporate Law, supra note 3, at 191; McChesney, supra note 45, at 1543.

Perhaps in arguing that the market alone does not fully constrain agency costs, Brudney and Coffee are implicitly returning to their misguided "externality" analysis—that is, the costs of suboptimal contracts are not borne by the misdealing managers. As we discussed supra at notes 157–58, their analysis is incorrect even in a "lemons" market in which a firm's agency costs are not fully reflected in the price of its securities, because managers have the incentive to eliminate this disparity. Generalizing from this discussion, it is clear that, as long as agency problems and devices constraining them are priced efficiently, this will provide incentive to managers to optimize these costs.

in cases of personal injury under U.C.C. section 2-719(3). More broadly, Coffee could have mentioned the entire tort law of products liability, in which contractual limitations have been swept away by characterizing the action as one in tort rather than contract. 188

It is beyond the scope of this Article to debate the serious question as to whether any limitations on freedom of contract are appropriate. Even assuming that some limitations are well founded, legal regulation of the right of contract should be based on particularized circumstances. Superficial analogies like that suggested by Professor Coffee may result in unwarranted extension of regulation of contracts.

The danger of unwarranted extension is particularly acute regarding corporate contracts. Public corporation shareholders may superficially resemble consumers of mass-produced products—dispersed, incapable of bargaining effectively over terms, and uninformed. Such a picture of corporate shareholders emerges from Professor Brudney's analysis. 189 In fact, corporate shareholders may seem even more in need of protection than consumers because the "product" they are buying is complex, described in arcane terms, and difficult to fully evaluate.

Despite this superficial similarity, there are substantial differences between corporate shareholders and consumer product purchasers. First, as Schwartz and Wilde have demonstrated in the consumer product context, 190 a market will reach a competitive, rather than a monopoly, equilibrium as to both price and terms as long as there are a substantial number of comparison shoppers in the market. This result holds even if many buyers accept what one seller offers without shopping. Buyers' search costs are crucial in determining whether comparison shopping is at a sufficient level to drive the market toward a competitive equilibrium. Thus, because price advertising reduces search costs, it is unlikely that a market characterized by such advertising will be noncompetitive. 191 Conversely, where contract terms are


189. See supra notes 46-47 and accompanying text.


Professor Coffee relies on the latter article to support his anti-contractarian position. See Coffee, No Exit, supra note 9, at 935 n.34. As we demonstrate below, this reliance is mistaken.

arcane or obscure, there is a relatively high possibility of monopoly conditions as to contract terms, other things being equal.192

The question of when markets are sufficiently noncompetitive to justify intervention can be complex and difficult in the consumer context.193 But enough has been said about the Schwartz-Wilde analysis to make clear the enormous importance of efficient securities markets in the corporate context. These markets make price information virtually free. Moreover, securities analysts and the financial press perform the function of comparison shoppers in the consumer context.194 The difference is that, while in the consumer context information learned by comparison shoppers cannot be readily communicated to non-shoppers, the efficient market facilitates communication of information learned by analysts and others concerning contract terms. It follows that, even if there are only a few informed participants, the efficient securities markets provide pressure toward competitive terms.

Coffee typically overstates the problems facing shareholders at the same time that he understates the problems in the consumer context. Notwithstanding the circumstances favoring corporate shareholders, Professor Coffee argues that shareholders are actually in greater need of protection than consumers because “in the corporate context ... transaction and information costs are higher.”195 More specifically,

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.196

The purchaser of corporate stock is not buying an “unknowable” future risk of managerial misconduct but, rather, a detailed package that includes monitoring devices (such as outside boards and auditors), incentive compensation and managers with substantial

192. Id. at 661. Schwartz and Wilde conclude that egregious obscurity of terms should be an important factor in whether a court should strike down a contract provision. Id. at 681.
193. Id. at 651–58.
194. See supra note 142 and accompanying text.
195. Coffee, No Exit, supra note 9, at 937.
196. Id. at 935.
reputational investments.\footnote{197} The terms of this package are priced in the efficient market.\footnote{198} The purchaser of an automobile is, on the other hand, buying an intricately complex machine that he will use under many different circumstances (some of which are unforeseeable) over a period of several years. A corporate manager is, indeed, "free" to run off to Brazil or buy the Brooklyn Bridge if he wants to squander his reputation and forfeit deferred compensation. But, by the same token, an automobile can (to use a recent example) defy logic and decide on its own to back up. In short, the information cost problems faced by corporate shareholders, when compared to those faced by consumer product purchasers, are clearly not so daunting as to outweigh the advantages of the efficient market in the corporate setting. Shareholders need to look at only the trading price in order to receive a normal rate of return.

In comparing corporate shareholders with product consumers, it also is important to note that the merger of warranty and tort lines of development in the product area has resulted in abrogation of contract in consumer cases on "tort" grounds, without regard to whether markets are functioning competitively. An illustration of this is prima facie unconscionability in personal injury cases under U.C.C. section 2-719(3). The presence or absence of personal injury has little or nothing to do with whether the contract is the product of market failure. Rather, the situation seems appropriate for the application of "tort" objectives, including risk spreading.\footnote{199} But the risk-spreading justification for extra-contract liability is wholly absent in the corporate setting.\footnote{200} In corporations, as Professor Coffee notes,\footnote{201} it is the shareholders who are the specialized risk-bearers in light of their ability to diversify risk by purchasing a portfolio of stocks.\footnote{202} On the other hand, the managers can neither diversify risk nor, like

\footnote{197} As such, the corporate contract cannot be regarded as an "experience" good for which information can be obtained only by using it. See Nelson, \textit{Information and Consumer Behavior}, 78 J. POL. ECON. 311 (1970); Darby & Karni, \textit{Free Competition and the Optimal Amount of Fraud}, 16 J. L. & ECON. 67, 77-78 (1973).
\footnote{198} See supra note 144 and accompanying text.
\footnote{199} We would strenuously disagree that, in the absence of market failure, tort liability in the product setting is justified.
\footnote{201} Coffee, \textit{No Exit}, supra note 9, at 928.
\footnote{202} Specialization of management and risk-bearing functions is discussed supra notes 81-83.
manufacturers, spread their losses among many customers. Thus, a key argument for abrogating contracts in the consumer product setting is absent in the corporate setting.

In conclusion, the anti-contractarian position is weakened rather than strengthened by the superficial analogy between corporate shareholders and product consumers. None of the circumstances that have been cited in justification of regulation in the consumer product setting justify restricting contracting in the corporate setting.

E. Sorting Costs of Customized Provisions

Professor Coffee contends that the novelty of customized provisions imposes information and litigation costs. Among other things, according to Coffee, in a world of free contract, securities analysts must not only scrutinize financial performance, but also become expert in new types of charter provisions. A related argument by Professor Jeffrey N. Gordon is that uninhibited private ordering actually increases the costs of contract innovation as compared with mandatory terms because investors, rather than the government, would have to screen new types of terms. It seems to follow from these arguments that private ordering should be restricted even if it could be shown that the market does adequately price contract terms.

These arguments are not persuasive. In the first place, it is not clear that the information costs of the new contract terms that would be permitted under a private ordering regime are greater than those the market must already deal with. Securities analysts already rapidly sort a seemingly bewildering amount of information related to firms, including changing economic conditions and new industrial and financial technologies. There is no reason to believe that they would have special difficulty dealing with a few additional types of contract terms.

Second, even if new types of contract terms would impose new information and litigation costs, this does not make a case for mandatory limitation of contract terms because the costs of innovation are internalized. Unless the benefits of innovative terms outweigh the costs, investors will simply refrain from investing in firms with new contract terms if information costs have impeded rapid discounting of

203. It follows from Coffee's and Brudney's analysis that the deterrence basis of tort liability would apply in the corporate context as well because the market alone cannot produce optimal contract terms. This point is, of course, the central argument debated and refuted in this Article.
204. Coffee, Mandatory/Enabling, supra note 9.
205. Id.
206. See Gordon, supra note 9, at 1569-73.
information into price\textsuperscript{207} or if there is an increased potential for costly litigation. Thus, market forces have been primarily responsible for standardization of the terms of bond indentures.\textsuperscript{208} To overcome the costs of innovation, firms and organizations may back new terms with reputational capital. In light of these alternatives, there is no benefit to be served by government screening of terms.

Professor Gordon avoids the internalization point by arguing that customized charter terms impose costs on users of standard forms.\textsuperscript{209} He asserts that a proliferation of new charter terms will decrease testing of standard terms, thereby reducing the usefulness of the standard form. In other words, the standard form is a public good that is threatened by innovation and must be protected by government regulation.

Gordon’s public good argument is deeply flawed. In the first place, Gordon does not say precisely how decreased testing of standard terms reduces whatever certainty and predictability the standard terms have already acquired. This is crucial to Professor Gordon’s externality point, because unless those who have already adopted a standard form are injured, the costs of standard terms are internalized.

A second problem with Gordon’s argument is that mandatory terms are not necessary to preserve a standard form if it would be widely accepted (and therefore frequently tested) voluntarily. Thus, Gordon’s argument would stifle the most valuable form of innovation—the evolution of new terms to replace a standard form that would die if it were not mandated. In sum, instead of preventing externalization of costs, mandating terms on the basis of the “public good” theory would impose significant social costs.

\textbf{F. Charter Amendments}

The basic argument in this Section is that markets effectively discipline corporate contract terms. However, the market discipline discussed to this point is in the form of efficient pricing of terms. This argument superficially does not seem to apply to charter amendments that are applied to existing shareholders. These shareholders bought in on the basis of one contract, and are now subject to another.\textsuperscript{210} Critics of private ordering have argued that the efficiency of the new

\textsuperscript{207} As to the interrelation of the cost of information and degree of market efficiency, see Gilson & Kraakman, supra note 142.
\textsuperscript{208} See infra note 262 and accompanying text.
\textsuperscript{209} See Gordon, supra note 9, at 1567–69.
\textsuperscript{210} See Coffee, Mandatory/Enabling, supra note 9, at 1674.
terms is cast in doubt by the fact that dispersed public corporation shareholders are not adequately protected by the voting process.

Proponents of mandatory terms cite several problems with shareholder voting. First, dispersed public corporation shareholders are rationally apathetic. The potential change in the value of an individual shareholder’s investment in the firm from an amendment normally does not justify a substantial investment in information or in the costs of persuading fellow shareholders to oppose the amendment. Second, management may be able to control the outcome by voting its own shares and by exerting influence on institutional holders friendly to management. Third, managers may structure amendments in such a way as to “coerce” shareholders into voting for amendments that are not in their best interests. For example, it has been argued that shareholders can be “coerced” into voting for dual class capitalizations by being offered a dividend sweetener. The shareholders may weigh the dividend sweetener more heavily than the potential loss of a takeover premium because they assume that their choice is not pivotal. Fourth, the coercion problem is a subclass of the broader problem of “agenda manipulation” by managers. Corporation statutes give managers the exclusive power to decide which amendments are presented to the shareholders. Thus, according to this view, the managers can limit the shareholders’ choice to amendments that will win approval because they are wealth-increasing, but may, among other things, couple desirable with undesirable terms, or confront shareholders faced by an unattractive takeover with the barely lesser evil of a very stringent takeover defense.

211. See Bebchuk, supra note 9, at 1837; Eisenberg, supra note 9, at 1478; Gordon, supra note 9, at 1576.

212. See Gordon, supra note 9, at 1580 (arguing that this reinforces the shareholders’ rational apathy).

213. See Eisenberg, supra note 9. Note, however, that market and legal constraints generally will cause institutions to vote with management only as long as this is consistent with shareholder welfare. Moreover, Eisenberg ignores the fact that the institutional holders’ ties to management, far from “tainting” their votes, increase shareholder welfare by facilitating better monitoring. See Baysinger & Butler, The Role of Corporate Law, supra note 3, at 181.

214. See Eisenberg, supra note 9, at 1477; Gordon, supra note 9, at 1577-80.


216. See Coffee, No Exit, supra note 9, at 45-46.

These arguments are infected by two types of problems. First, they ignore substantial market constraints on shareholder voting. While the average shareholder may have little incentive to acquire information or persuade fellow shareholders to vote against wealth-decreasing amendments, large institutional holders do have such incentives, and increasingly have been exercising their prerogatives. Even if such holders do not control a majority, managers may be unwilling to risk turning the vote on the amendment into a referendum on management that puts the company in "play." Moreover, because an inefficient shareholder decision will reduce corporate share prices, this provides a profit opportunity for an investor to aggregate sufficient stock to change or block the decision.

A second, and even more serious, problem with arguments about defects in shareholder voting is that they assume that mandatory rules are a better solution to these problems than contractual and market constraints. The corporate charter itself limits the extent to which it can be amended. The charter can forestall problems like those discussed above by prescribing general voting procedures or by prohibiting certain types of amendments. For example, if agenda manipulation is a real problem, the charter, at least under a private ordering regime, could liberalize the rules for shareholder-proposed amendments or could prohibit coercive tactics such as dividend sweeteners. Indeed, in light of the state competition for charters, survival of many currently mandatory terms may be explained as a response to the amendment problem. The presence or absence of charter provisions limiting amendment is disciplined by the same markets that constrain other charter provisions. As a result, if liberal amendment provisions open the way to opportunistic amendments, the cost of capital of firms offering such provisions will increase.

Of course, charter provisions limiting amendments are no more likely to operate perfectly than are any other charter provisions. The costs of such restrictions include rigidity and hold-up problems. But the existence of these potential problems does not itself establish

219. The current rule requiring proposal by the board is mandatory. See supra note 217.
220. This implies that changes in such binding commitments may be contrary to the corporate contract. See infra note 290 and accompanying text.
221. See Easterbrook & Fischel, supra note 9.
222. Thus, Professors Bebchuk and Coffee are wrong in asserting that entrepreneurs do not bear the cost of value-decreasing amendments. See Bebchuk, supra note 9, at 1829, 1837; Coffee, Mandatory/Enabling, supra note 9, at 1674.
223. See Gordon, supra note 9, at 1581–86.
that mandatory rules would be any better. Courts and legislators do not have a larger arsenal of weapons against opportunistic amendments than do the parties themselves. The question is whether they are more likely to choose the correct devices. As discussed in the next Section, there is substantial reason to believe that they are not.

V. EVALUATING MANDATORY RULES

The efficient functioning of the securities markets powerfully disciplines the development of optimal corporate contracts. Indeed, contracts reflect sensitive tradeoffs between the costs and benefits of various contract terms. All of this provides strong evidence that government regulation of corporate contract terms is unnecessary. But even if there were a strong case for government regulation due to market failure, this alone would not justify regulation without a further showing that regulation is likely to produce better corporate arrangements than private ordering. In this Section we show the dangers of the "nirvana fallacy"—the naive assumption that regulation will function perfectly if markets do not.

A. The Inefficiency of Mandatory Terms

Critics of private ordering devote much effort to showing that private arrangements, including bonding and incentive compensation, do not substantially constrain management misconduct. They conclude from this that regulation is necessary. The unspoken assumption in their policy recommendations is that mandatory rules are better than results achieved through private ordering. A discussion of a few corporate law rules bearing on the directors' duty of care demonstrates that their assumption is unwarranted.

The directors' duty of care results in imposition of liability for vast amounts for acts that were not intentionally harmful and that by definition did not benefit the directors. The benefit of this duty to the corporation is that it deters careless management. The cost is that it places a substantial business risk on managers who, unlike the shareholders, are unable to reduce the risk by diversification and are

224. See supra Section IV.
225. See supra Section III.
226. For example, in the celebrated case of Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), a negligence action was upheld against directors who ultimately settled prior to a damage determination for $23.5 million, of which the insurance carrier paid only $10 million. Trans Union Corp., Wall St. J., Aug. 2, 1985, at 18, col. 3.
therefore relatively inefficient risk-bearers.\textsuperscript{227} One result may be that the managers act more conservatively than is in the shareholders' interests, in order to reduce the risk of liability. This is obviously a sensitive tradeoff, and it is not inherently obvious that any court's balance will be either correct or even an improvement over the terms drafted by the parties to a corporate contract.

Even recognizing that some duty of care is optimal, there is the additional question of what conduct falls over the negligence line. The courts, in applying the business judgment rule, have demanded adherence to a particular process of decisionmaking. For example, in \textit{Smith v. Van Gorkum},\textsuperscript{228} directors were condemned for agreeing to a price that was substantially in excess of current market value without getting a formal appraisal although, as one dissenting judge forcefully pointed out,\textsuperscript{229} they had substantial business expertise and long experience with the company.\textsuperscript{230} The implication is that courts are able to determine optimal procedures in reaching business decisions. However, as has been argued by Bayless Manning, the question of allocation of directors' time among myriad tasks is itself a sensitive business decision that directors, and not courts, are peculiarly able to make.\textsuperscript{231} And even if the courts actually reach the right results in most cases, their vague rules create ex ante constraints on manager conduct and provide the basis for costly and wasteful litigation.

Apart from the problems concerning the duty of care and its application, there are questions concerning the procedures for holding managers accountable. Should the board be able to decide which suits are prosecuted, or should individual shareholders be given that power through the derivative suit mechanism? Giving total discretion to directors raises the conflict of interest problem. But the derivative remedy can be quite costly, not only in terms of direct litigation and attorneys' fees, but in terms of such indirect costs as demands on managers' time and interference with valuable long-term relations between the managers and the corporation.\textsuperscript{232} Moreover, it is not clear that

\textsuperscript{227} Professor Coffee has forcefully noted this point. See Coffee, \textit{No Exit}, supra note 9, at 928; Coffee, \textit{Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis}, 52 GEO. WASH. L. REV. 789, 801–03 (1984) (also noting that shareholders are relatively poorly situated to prevent mismanagement).

\textsuperscript{228} 488 A.2d 858 (Del. 1985).

\textsuperscript{229} See opinion of Justice McNeilly, 488 A.2d at 894–95.

\textsuperscript{230} For a stinging criticism of the \textit{Van Gorkum} case, see Fischel, \textit{The Business Judgment Rule and the Trans Union Case}, 40 BUS. LAW. 1437 (1985).


\textsuperscript{232} See Fischel & Bradley, supra note 125, at 268–70.
conflict problems are eliminated by taking the decision out of the directors’ hands given the imperfect incentives of plaintiffs’ counsel.233

Finally, even if the procedural problems of a derivative suit are solved, it is not clear if the derivative suit is an appropriate remedy because the benefits of the derivative remedy are unclear. In particular, there are serious questions concerning whether this remedy serves any compensatory role, since many of the shareholders of the corporation at the time recovery is administered are likely to have bought their shares at prices that already reflected the wrong from shareholders whose shares were devalued by the wrong.234

Given the doubts concerning whether either the directors’ or plaintiff’s counsel are the appropriate guardians of the corporate interest, perhaps both could be given a role with the court as the final arbiter as the Delaware Supreme Court decided in Zapata Corp. v. Maldonado.235 But splitting the baby rarely improves her health: the special litigation committee process endorsed in Zapata can consume enormous time and resources before it reaches its tortuous end.236

The problems raised by existing fiduciary law are illustrated by a recent Delaware case involving payment of “greenmail” by managers to bidders for control. The vague business judgment rule leaves questions as to whether a payment to preserve management control is covered by the rule and, if it is, as to the directors’ decision-making process and the substance of the decision. In Polk v. Good,237 a greenmail case finally concluded with supreme court approval of a settlement establishing that the shareholders could decide how certain stock could be voted and that the plaintiffs’ discovery material would be disclosed. Achievement of this momentous result occurred only after preliminary litigation involving whether plaintiff must serve a demand on the board.238 The plaintiff’s attorney received $700,000 in fees plus expenses. It is not hard to imagine why a corporation’s shareholders would seek to opt out of a set of rules producing litigation like this.


234. See Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449, 455 (7th Cir. 1982), cert. denied, 459 U.S. 880 (1982); Cox, supra note 147, at 765-74.


236. For a forceful exposition of this problem, see Chancellor Brown’s opinion in Kaplan v. Wyatt, 484 A.2d 501 (Del. Ch. 1984), aff’d, 499 A.2d 1184 (Del. 1985).

237. 507 A.2d 531 (Del. 1986).

Examples of the problems raised by existing fiduciary law could be multiplied endlessly. But further discussion of these problems is unnecessary to make our point because the anti-contractarian position does not rest on satisfaction with the current law. Professor Brudney sharply criticizes the laxity of current law on managerial diversion of assets and notes the problem of balancing costs and benefits of liability for negligence and diversion of assets. Professor Coffee, the architect of the remedy limitation provision in the A.L.I. project, defends it by noting the problems with current due care liability of directors. Describing the derivative remedy, Coffee says “[t]he result is an optimal remedy on which private ordering could not improve.”

B. Institutional Defects of Legal Rules

Coffee and Brudney argue the deficiencies of corporate markets as evidence against the desirability of private ordering. They therefore implicitly assume that these inherent problems of private ordering are worse than the institutional weaknesses afflicting development of legal rules. But even if markets are deficient, it is necessary to ask whether legal institutions are likely to lead to better results than private ordering. The question is not whether anti-contractarian law professors can think of better mandatory rules than those that currently exist, but whether courts and legislatures are likely to adopt such rules, and then change them in response to changing circumstances.

Insofar as judicially imposed rules are concerned, there are serious deficiencies in the courts’ abilities to formulate governance rules. First, in deciding particular cases, courts are virtually always confronted with bad results. This sample bias causes courts to erroneously assume that the bad result was a product of poor managerial performance. Second, most courts, particularly those outside Delaware, decide corporate cases only sporadically and lack expertise in corporate matters. Third, even if a case is correctly decided, it leads to a result on particular facts that has only uncertain application to other

239. Brudney, Corporate Governance, supra note 4, at 1434–35.
240. Id. at 1443.
241. Id. at 1438–39.
242. See supra note 8.
244. Id. at 970.
245. See Fischel & Bradley, supra note 125, at 265.
cases. Fourth, unlike managers, judges are not inspired to write optimal corporate rules by a proprietary interest or by shareholder monitoring. Fifth, even if the court attempts to formulate a general rule, it is limited in its ability to formulate policy by its own resources and by the nature of the adversarial process. There is, therefore, sound basis for Professor Coffee's statement that "the case for private ordering is that the parties can recognize their own self-interest more quickly than the courts." Both legislative and judicial rulemaking share the institutional problems of generality and stasis. Even a rule that is formulated by an all-wise and disinterested policymaker cannot suit every business equally well, any more than a well-made suit is right for everybody. The literature on the theory of the firm reveals a wide range of organizational forms, each adapted to different circumstances. Organizations that need to own substantial resources or that involve complex decision processes will look very different from smaller, simpler firms, and will adopt very different governance structures. Within general types of organization there are many subvariations, such as whether the resources are specialized to particular uses or whether the firm operates in a regulated industry. Moreover, even a rule that is both initially perfect and initially suited to a particular firm may become imperfect or unsuitable over time as a result of rapidly changing business conditions. Both legislative and judicial rules tend to remain past their welcome.

An additional component of the "nirvana" fallacy concerns the motivations of political agents. Any deficiencies in the behavior of corporate agents vis-a-vis shareholders are minor compared to those of legislators vis-a-vis their constituents. Moreover, throwing corporate governance issues into the legislative arena would only compound

246. See Schwartz & Wilde, *Intervening in Markets*, supra note 190, at 678 (advocating administrative rather than judicial intervention in markets because the stakes in individual cases are seldom sufficient to justify broad inquiry).


248. See supra Section III(A).

249. See the discussion of resource "plasticity," supra note 91 and accompanying text.


251. It is therefore wrong to suggest, as does Professor Bebchuk, supra note 9, that government is better able to solve corporate problems than private parties merely because it may have more resources to apply to potential solutions.

252. R. McCormick & R. Tollison, *Politicians, Legislation and the Economy: An Inquiry into the Interest Group Theory of Government* 6 (1981). Indeed, no one's motivations are beyond question. Because courts may be subject to various types of legislative pressure, it is no solution to broadly leave corporate questions for judicial determination, as
corporate agency problems because managers surely possess a comparative advantage at getting legislation passed. The recent passage of takeover-specific antitakeover statutes illustrates the political problems that can arise when the managers are free to use corporate resources to rewrite corporate governance contracts through the political process.\textsuperscript{253} Failures of private corporate contracts, if such failures exist at all, are surely less costly than attempting to solve these failures by resorting to political markets.

For the above reasons, even assuming a case can be made in this area for market failure, there is substantial reason to believe that a process of evolution of corporate rules through private ordering is preferable to a system of mandatory rules.\textsuperscript{254}

C. Exploring the Middle Ground: Coffee’s “Brand Name” Proposal

Although Professor Coffee squarely recognizes the deficiencies of the current system of corporate rules,\textsuperscript{255} he has sufficient reservations concerning the efficiency of markets that he is not willing to fully endorse private ordering. Instead of choosing either the contractual or the concession theory, Coffee attempts to stake out a “middle ground.” This seems to be more like a political effort to salvage what is left of the anti-contractarian approach to corporation law after a decade of attacks by contract theorists than a true recognition of the merits of the contractual theory. Nevertheless, an analysis of his “middle ground” provides an instructive illustration of the weakness of attacks on private ordering.

Coffee’s “middle ground” solution is to permit opting out of standard duties in the usual case only by means of “brand name” forms developed by the American Bar Association, American Law Institute

\begin{itemize}
  \item \textsuperscript{255}See supra notes 242–44 and accompanying text.
\end{itemize}
or stock exchanges. He justifies this limitation on private ordering on the ground that private contracts would be extremely detailed and untested, resulting in high information costs and the risk of manipulation by managers. His premise is that better results can be achieved by mandatory limitations on what contracts corporations can adopt than through private ordering.

There are serious problems with Coffee’s proposal. In the first place, there are myriad questions of application. What is a “brand name,” apart from the three types of organizations Coffee mentions? What about forms written by the Georgia Bar Association or The Business Roundtable, to name two of the thousands of reputable organizations that might propose standard forms. Undue limitation would stunt the process of development, but attenuation of the definition also would blunt Coffee’s point about reduction of information costs. Also, what is a “form?” Must a corporation adopt an entire form charter, or is a section enough? If a section is enough, what about a subsection or a clause? Limiting the definition sharply reduces flexibility, but expanding it raises information costs.

Assuming Coffee’s idea can be given a manageable shape, there remain substantial problems of mandating reliance on brand name forms. Brand name forms may be costly because they share with judicial decisions and legislation problems of generality and stasis. As Coffee notes, “‘off-the-rack’ rules may not fit all sizes or shapes of corporations.” This problem cannot be readily resolved by developing many standard forms because, as we have noted, the firm is an almost infinite regression on many variables. In order for brand names to even begin to approximate this variety, the selection would have to resemble the display of goods in a large department store, with a consequent loss of the information-cost advantage of brand name forms.

The stasis problem is even more serious, and exists in two dimensions. In the first place, as Coffee notes, the corporate contract, particularly regarding remedies, must be quite detailed. It is unrealistic to expect that any form or set of forms would get these details right on the first try. Only an evolutionary process can succeed, and evolution,
whether by large associations or small committees, is significantly slower than evolution by private ordering. Second, even a perfect form will become imperfect over time as conditions change. Again, evolution is necessary.

Despite these costs of brand name forms, it is likely that many firms will select them under a private ordering regime, as they have done with the American Bar Foundation Model Debenture Indenture,\textsuperscript{261} always weighing the costs against the benefits in a particular situation.\textsuperscript{262} The important question is whether this selection process is likely to be so flawed by managerial opportunism that it would be preferable to mandate brand name forms. This, like other questions concerning the desirability of private ordering, necessitates considering the deficiencies of both the market process and regulation.

As to problems with voluntary selection of forms, it is again necessary to emphasize the importance of efficient market pricing. Like other facts concerning a company, uncertainty and information cost problems of customized forms, as well as the advantages of custom tailoring, will be reflected in the price of a company's stock and affect its cost of capital which, in turn, will constrain optimal selection by managers. It is not enough, therefore, for Coffee to argue that customized forms may be disadvantageous for investors; he also must show that these problems are not reflected in price. He does not attempt to do so, thereby implicitly relying on his general concerns about market pricing. But even if Coffee is correct about the problems of pricing the risk of managerial misconduct, which we dispute,\textsuperscript{263} these arguments do not apply to the form selection process because the adoption or nonadoption of a brand name form is an obvious datum that is readily assimilated into market price. Coffee himself recognizes this general point when he notes that companies that opt out of fiduciary duties are penalized in the market.\textsuperscript{264} If that is so, and we agree with Coffee on this point, then Coffee must explain why there is no penalty for a company that opts out of other standard provisions.

Even if the market does not perfectly discipline form selection, there remains the question whether mandatory reliance on forms would be


\textsuperscript{262} Coffee correctly notes that recognized forms reduce information costs by facilitating efficient market pricing of terms. See Bratton, supra note 56, at 686. They also reduce error and, by reason of broad acceptance by the courts, uncertainty. See Goetz & Scott, supra note 56, at 265–73.

\textsuperscript{263} See supra notes 152–162 and accompanying text.

\textsuperscript{264} Coffee, No Exit, supra note 9, at 948.
any better. One result of the mandatory system is, obviously, to prohibit the use of customary provisions even when a disinterested party would conclude that the benefits of this approach clearly outweigh the costs. Perhaps more importantly, mandatory brand name forms would exacerbate rather than ameliorate problems of management misdealing. The problem is that the form drafting process is subject to manipulation by management-oriented interests. Because individual managers have much to gain from the drafting process, and because they are already organized into coherent groups like the Business Roundtable, they have a distinct advantage over dispersed investors in forming interest groups that will dominate the drafting of brand name forms. While this is an inherent problem with brand name forms, it becomes an intractable one when the defects of self-interested forms cannot be competed away by companies seeking a lower cost of capital by offering customized investor-oriented provisions. In other words, mandatory brand name forms will further politicize the development of corporate law, bringing on all of the defects involved in the political process.

Perhaps the most puzzling aspect of Coffee's brand name proposal is that he does not really seem to be serious about it. In the first place, he would permit companies to adopt customized provisions in some circumstances. The proponent can show that "the modification was prompted by unforeseen new circumstances." Also, "[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." These distinctions do not clearly relate to the concerns about private ordering that prompted the limitation to brand name forms. The distinction for "unforeseen new circumstances" is based on the general

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265. On the relative advantages of forming politically effective coalitions for different size organizations, see J. Buchanan & G. Tullock, The Calculus of Consent 286–88 (1962). In fact, managers' advantages over shareholders in taking collective action have been cited in favor of federal regulation of corporate law, the theory being that managers' advantages are greater at the state than at the federal level. See Anderson, supra note 9, at 789. As discussed infra Section VI(D), federal regulation is an important part of the anti-contractarian agenda.

266. On the politicization of corporate law, see Butler, supra note 253; Macey & Miller, Toward an Interest-Group Theory of Delaware Corporation Law, 65 Tex. L. Rev. 469 (1987); Romano, supra note 253.

267. Coffee, No Exit, supra note 9, at 973.

268. Id.
common law contract rule regarding modifications.\textsuperscript{269} As such, it relates to whether the modification is consistent with the parties' contract, and not to whether private ordering should be sustained.\textsuperscript{270} The original provision distinction also is significant only to whether opt-out violates the parties' contract.\textsuperscript{271}

The second indication that Coffee is not serious about his brandname proposal is that he clearly would not necessarily permit opt-out even by brand name provisions. Rather, he suggests a "judicial inquiry" focusing on the following 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?\textsuperscript{272}

By thus qualifying the brand name approach and indicating his distrust of market constraints on contract terms, Coffee exits the "middle ground" and rejoins the staunch anti-contractarian position.

In general, even if the ambiguities and internal inconsistencies in Coffee's brand name proposal can be resolved, his attempt to capture a middle ground suffers from the same defects as the general arguments against private ordering: it overstates the defects of private ordering and understates the defects of the regulatory approach. In other words, once again succumbing to the "nirvana" fallacy, he incorrectly assumes that because the process of private ordering is not perfect, mandatory brand name forms will be better.

\textsuperscript{269} See id. at 939, 973 (relying on Restatement (Second) of Contracts § 89(D) (1979)). One writer explains this rule as a way of allocating the burden of proof as to whether modification is opportunistic. Muris, Opportunistic Behavior and the Law of Contract, 65 Minn. L. Rev. 521, 550 (1981). It is not clear how Coffee's qualifications concerning "major deviation[s]" and the "risk of managerial opportunism" relate to the qualification concerning "unforeseen new circumstances."

\textsuperscript{270} See infra note 290 and accompanying text.

\textsuperscript{271} It is hard to see how market failure could explain the difference between original provisions and amendments, since each would be equally subject to efficient market pricing.

\textsuperscript{272} Coffee, No Exit, supra note 9, at 974.
D. The Difficulty of Regulating Terms and the Inevitability of Contract

The discussion so far in this Section has assumed that regulation of corporate contract terms is feasible. In fact, formidable practical difficulties attend this type of regulation, even if it was otherwise warranted on policy grounds. The reason is that any regulation that proscribed certain terms would inevitably leave room for substitution of other terms, or at least for a substitution of forms of organization.\textsuperscript{273} Thus, for example, it is unclear how statutes mandating appraisal rights in the event of a "merger" should apply to such merger-like transactions as asset sales\textsuperscript{274} or changes in control or structure.\textsuperscript{275} With regard to substitution of forms, limitations of the voting structure of corporations (i.e., by forbidding dual class common) can be circumvented by forming a publicly traded limited partnership.\textsuperscript{276} The partnership technique would also be available for circumvention of limits on opting out of fiduciary duties.\textsuperscript{277} In general, the possibilities are endless because, as discussed above,\textsuperscript{278} the corporation is part of a continuum of contractual forms that includes not only forms of business organization, but other types of relational contracts. Even the anti-contractarians would oppose limiting the rights of business participants to select the form that is optimal for their business. Leaving many questions for judicial determination\textsuperscript{279} would create intolerable uncertainty. Thus, although opponents of private ordering in the corporation seek to ignore the contractual nature of the corporation, this underlying fact must ultimately be controlling.

\textsuperscript{273} For a discussion noting this problem in the consumer contract area, see Schwartz & Wilde, supra note 190, at 667. Even if limitations on opt-out provisions cannot be completely evaded and therefore are at least partially effective, the substitutability of terms results in considerable confusion and unpredictability, thereby increasing investor uncertainty as brand names necessarily convey less than complete information.


\textsuperscript{275} See, e.g., Pratt v. Ballman-Cummings Furniture Co., 254 Ark. 570, 495 S.W.2d 509 (1973).

\textsuperscript{276} See generally Ribstein, Limited Partnership, supra note 3.

\textsuperscript{277} The Uniform Partnership Act, which applies in this respect to both limited and general partnerships, permits a partner to receive an individual benefit from the firm with the consent of the other partners. \textsc{Uniform Partnership Act} \S 21, 6 U.L.A. 258 (1969). Thus, a partner may be permitted under the partnership agreement to reap personal benefit from partnership opportunities. See Singer v. Singer, 634 P.2d 766 (Okla. Ct. App. 1981). See generally A. Bromberg & L. Ribstein, Bromberg and Ribstein on Partnership \S 6.07(h) (1988).

\textsuperscript{278} See supra Section III(A).

\textsuperscript{279} This is proposed by Coffee, Mandatory/Enabling, supra note 9, at 1685.
E. The Normative Assumption and the Burden of Proof

Once it is recognized that there are serious problems with regulation of corporate contract terms, even the critics of private ordering must confront the question of which position should bear the burden of proof. Professor Brudney recognizes this problem (although not all of its implications) when he accuses contractarians of believing: “that a regime of private contractual arrangements is in some sense ‘natural’ or proper and requires no justification; but government intervention to cure defects in, or remove impediments to, the assumed consensual process is ‘unnatural,’ and is permissible only when justified . . . .”280

But the converse position may be ascribed to those who oppose private ordering. By relying on unsubstantiated assertions that markets are defective and by refusing to compare these defects with those under a system of government regulation of corporate contract terms, the anti-contractarians appear to place the burden on the contractarians to prove that private ordering is warranted. This, of course, will be a difficult burden for contractarians to meet, since any evidence for private ordering under a system characterized by mandatory rules must be hypothetical and speculative.

Nowhere do the anti-contractarians give a coherent rationale for placing the burden on one side or the other. In fact, the approach throughout the law of contract is to presume in favor of private ordering until some type of market failure can be shown. The only reason for departing from this presumption in the corporate context would be if the corporation was not regarded as a contractual relationship. But the dominant trend in corporate law over the last 200 years has been to free corporate law from its state concession origins and treat it as a contractual relationship.281 Therefore, if the general presumption from private ordering is departed from in this context, it must be because of adherence to the historical rather than modern position.

VI. IMPLICATIONS OF PRIVATE ORDERING

This Section extends the analysis of private ordering beyond the general question of whether corporate contracts opting out of fiduciary duties should be enforced to a discussion of precisely what enforcement of such contracts entails. The relevant issues concern interpretation and application of the parties’ agreement and the appropriate roles of federal and state law.

280. Brudney, Corporate Governance, supra note 4, at 1408–09.
281. See supra notes 21–23 and accompanying text.
Corporate Fiduciary Duties

A. Opt-Out Provisions by Unanimous Agreement

It follows from the contractarian position that the parties to a corporation ought to be able to fashion fiduciary duties or remedies at least by means of a provision in the charter or shareholders' agreement that is agreed to by all shareholders as of the time the provision is adopted.\textsuperscript{282} Investors who buy into the corporation after adoption of the provision should be deemed to consent to the arrangement.

The fact that the opt-out provision should be enforced leaves open the question of interpretation. Thus, for example, it is not clear what a court would make of a provision that permitted managers to take any or all corporate opportunities for their benefit. A court might interpolate an implied condition that the manager not take all the good opportunities and leave only the bad ones for the company.\textsuperscript{283} The basis for such an interpolation might be evidence of actual expectations, or a conclusion that without the condition the bargain was so one-sided that it is unreasonable to assume that the parties actually agreed to it.\textsuperscript{284} As long as enforceability hinges solely on interpretation, it is consistent with the contractual theory of the corporation. It is important to emphasize, however, that the court's function is solely one of interpretation. There is no justification for an expansive judicial role in corporate affairs that includes imposing fiduciary duties on all firms as a "canon of construction."\textsuperscript{285}

B. Opt-Out Provisions by Subunanimous Vote

Where opt out provisions are adopted by charter provision or other shareholder agreement\textsuperscript{286} and all current holders do not consent, the contractual theory of the corporation suggests that the question concerning validity is whether the governance rules of the corporation should be interpreted to permit subunanimous consent. Even if the

\textsuperscript{282} As discussed infra Section VI(C), statutory authorization should not be necessary. As discussed in Section VI(D), the opt-out also may take the form of selection of the standard form contract through the state chartering decision.

\textsuperscript{283} See Irwin v. West End Dev. Co., 342 F. Supp. 687, 701 (D. Colo. 1972), aff'd in part, rev'd in part, 481 F.2d 34 144 (1973), in which a provision stating that directors were "hereby relieved from any liability that might otherwise arise by reason of his contracting with the corporation for the benefit of himself or any firm or corporation in which he may in any way be interested" was held not to validate unfair director compensation.

\textsuperscript{284} PRINCIPLES, supra note 6, § 5.09 (Tent. Draft No. 7, 1987) permits variation of self-dealing duties only as to "specified" transactions that are likely to "recur in the ordinary course of business of the corporation." While we would oppose such a rigid limitation, this type of provision may be advisable in order to avoid the interpretation problem discussed in the text.

\textsuperscript{285} See supra note 130 and accompanying text.

\textsuperscript{286} Opt-out by statutory provision is discussed infra Sections VI(C), VI(D).
statute and certificate generally permit amendment by subunanimous vote, this power of amendment has not been applied to provisions concerning transferability of shares. The qualification also may extend to other matters, including amendment of class voting requirements that protect limited-vote shareholders from controlling shareholders. If such a qualification applies to a provision opting out of fiduciary duties, a free contracting perspective indicates that the provision should be enforced. It follows that a statute that imposed an opt-out provision in the face of such a qualification would trump the corporate contract, and would accordingly be unenforceable under the Contract Clause.

The law respecting opt-out is inconclusive. The Delaware statute permits amendment "in any and as many respects as may be desired; so long as its certificate of incorporation as amended would contain only such provisions as it would be lawful and proper to insert in an original certificate of incorporation filed at the time of the filing of the amendment." The certificate may include, among other things, "any provision creating, defining, limiting and regulating the powers of the . . . directors." No statutory provision in Delaware defines the directors' duty of care, although the duty of loyalty is covered in the statute. There is apparently no case law authority expressly permitting opting out of negligence liability, and only mixed authority on opting out of self-dealing liability.

Perhaps there is sufficiently strong investor expectation of the continued existence of some director duties that the shareholders would assume that they could veto complete abrogation of these duties. But shareholders invest with the knowledge of a very broad power of

287. The role of statutory provisions concerning the amendment power is discussed infra Section VI(C). Opting out of statutory limitations through reincorporation is discussed infra Section VI(D).
288. See B & H Warehouse, Inc. v. Atlas Van Lines, Inc., 490 F.2d 818 (5th Cir. 1974); Coffee, No Exit, supra note 9, at 962 n.91. Retroactive share transfer restrictions may also be invalid by statute. See DEL. CODE ANN. tit. 8, § 202(b) (Supp. 1988).
289. See Butler & Ribstein, Contract Clause, supra note 3.
290. See Black, supra note 9. 145
291. DEL. CODE ANN. tit. 8, § 242(a) (1983).
292. Id. § 102(b)(1).
293. Id. § 144.
294. As to opting out of liability for self-dealing, compare Irwin v. West End Dev. Co., 342 F. Supp. 687, 701 (D. Colo. 1972) (broad opt-out provision did not validate unfair director compensation), aff'd in part, rev'd in part, 481 F.2d 34 (1973) with Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107, 118 (1952) (enforcing charter provision that permitted counting interested director toward a quorum, and approving opt-outs that do not violate statute or "public policy settled by the common law"); see also supra note 129 (explicit terms have been held to preclude application of fiduciary duties).
amendment, including as to such important matters as shareholder voting percentages. Moreover, it is essential that the shareholders have flexibility to adapt the contract to changing conditions and to correct erroneous judicial interpretations of the corporate contract, a possible example of which is the tight standard of care articulated in Smith v. Van Gorkom. Therefore, limitations on the shareholders' power to at least adjust director duties probably are not anticipated and should not be enforced unless explicitly set forth in the charter or other agreement.

C. The Role of Statutory Authorization

There is a substantial debate among the Reporters for A.L.I. project as to whether statutory authorization is necessary to validate opt-out provisions, with Coffee supporting the section 7.17 approach of validating opt-outs even in the absence of a charter provision, and the Chief Reporter and Reporter for Part IV insisting on legislative authority. This debate is an example of how the anti-contract position can result in focusing attention on the wrong issue. A statute is not necessary to validate a private contract, although it may reduce costs by providing a standard form or reducing uncertainty as to validity of the provision created by prior case law. Nor is a statute necessarily sufficient to validate an opt out that is contrary to the parties' agreement because such a statute might abrogate the contract in violation of the Contract Clause.

295. See, e.g., Del. Code Ann. tit. 8, § 242(a) (1983) ("corporation . . . may amend its certificate of incorporation . . . in any and as many respects as may be desired").
296. 488 A.2d 858 (Del 1985); see supra notes 228-31 and accompanying text.
297. For a similar discussion from the perspective of the Contract Clause, see Butler & Ribstein, Contract Clause, supra note 3. As noted supra notes 267, 269 and accompanying text, Coffee would apply the general contract limitation on modifications, including an "unanticipated circumstances" qualification. This helps to ensure that one party is not exploiting a bargaining advantage to extract concessions from another. See Muris, supra note 269, at 532–52. However, it may be preferable to enforce the contract, including its amendment provisions, according to its express terms rather than resorting to vague, open-ended limitations on these terms. See Ribstein, Takeover Defenses, supra note 3. Moreover, concerns about opportunism by a contracting party are misplaced where the managers lack voting power or other leverage to force "concessions" from the shareholders. As to the viability of shareholder voting on charter amendments in the context of the financial markets, see supra notes 218–21 and accompanying text.
298. See Principles, supra note 6, at 139–43 (Tent. Draft No. 9, 1989).
299. A permissive opt-out statute should be phrased in "unless otherwise agreed" language to clearly avoid negative pregnant construction.
300. For discussions of the application of the Contract Clause in the corporate setting, see generally Butler & Ribstein, Anti-Takeover, supra note 3; Butler & Ribstein, Contract Clause, supra note 3. The Delaware opt-out provision, Del. Code Ann. tit. 8, § 102(b)(7) (Supp. 1988), for example, might be subject to this problem. The provision is valid only if it merely clarifies an
From both a private law and constitutional perspective, the most offensive statute is one that simply changes the directors' duties for all corporations incorporated in the state. In such a situation, the corporations' agent-principal problem can be exacerbated by the exercise of political power by corporate managers to rewrite agency contracts. These costs of unstable corporate statutes can be reduced but not completely eliminated through competition in the market for state charters. This is an important point, because where private ordering is limited and preempted by statutory mandate, all change will be legislatively imposed on the shareholders. In essence, as already noted, the anti-contractarian reduces to replacing the shareholders' contractual safeguards with the unilateral power of corporate managers working through state legislators.

D. Opting Out By Selecting the State Statute: Federal Versus State Law

Even if one or more state statutes preclude opting out of fiduciary duties, the parties to a corporate contract may be able to enter into an enforceable opt-out provision by incorporating under a state statute that permits opt-out provisions. In light of this observation, it is not surprising that, both expressly and implicitly in their repeated criticism of state law, the anti-contractarians argue in favor of amendment power that existed prior to enactment of the provision rather than enlarging the majority's power to amend the contract. It is not enough to avoid Contract Clause problems to provide, as does the Delaware statute, that a charter provision cannot affect director liability for acts already committed because such a provision might still permit abrogation of the directors' duty for subsequent acts in violation of the initial contract.


The mandatory aspect of such imposed changes is also recognized by Black, supra note 9; Clark, Contracts, Elites, supra note 9, at 1721-22.

302. See supra notes 251-53 and accompanying text.

303. See Butler, supra note 253. As to the chartering market, see infra notes 311-313 and accompanying text.

304. Cf. Coffee, No Exit, supra note 9, at 953, noting that Brudney's approach "forces us to rely on legislative revisions that impact on all shareholders, including those of firms that would not have opted out." Coffee's limited "brand name" regulatory regime is subject to the same criticism. See supra Section V(C).

305. As discussed supra Section III(A), other methods of avoiding "mandatory" terms include changes in form and capital structure.

306. See supra notes 239-44 and accompanying text.
mandatory federal rules as against both mandatory state rules and private ordering.\textsuperscript{307} Conversely, contractarians support state law rules at the same time as they argue for private ordering.

The anti-contractarians' criticism of state law stems from a widely cited 1974 article by Professor William Cary.\textsuperscript{308} Professor Cary argued that states compete for incorporation business by offering terms that appeal to corporate managers. Cary reasoned that managers must prefer low standards and that states would compete by offering managers low standards of care and loyalty. The "race to the bottom" allegedly emasculates shareholders' interests. Delaware has won that race. Under this view, state law is not in any sense the result of a contract vis-a-vis the shareholders. If it is a contract at all, the anti-contractarians argue, it is one between the managers and the state that imposes on shareholders terms that are favorable to managers.\textsuperscript{309} The antidote to inefficient state laws, according to the anti-contractarians, must be preemption of the competition through regulation at the federal level.\textsuperscript{310}

The anti-contractarians' view of state law, like their other criticisms of private ordering, ignores the powerful effects of the financial markets. The same markets that discipline the selection of contract terms,\textsuperscript{311} also discipline the selection of the state of incorporation.\textsuperscript{312} In this view, the selection of the state of incorporation is simply the selection of a particular standard form corporate contract. Thus, although managers are active in the selection of the chartering state and shareholders are passive and rationally ignorant in this process, the shareholders voluntary contract through their purchase and sale of corporate shares. Share prices accordingly reflect incorporation choices, which ultimately provide incentives for managers to choose

\textsuperscript{307} It seems odd that anti-contractarians would support turning over regulation of the corporation to the federal government in light of the historical basis of the anti-contractarian theory, the concession theory, which holds that states "create" corporations. See supra notes 18–20 and accompanying text.


\textsuperscript{309} Professor Eisenberg, supra note 9, at 1509–11, characterizes these terms as "side payments" to managers.

\textsuperscript{310} See, e.g., Cary, supra note 308, at 701; Anderson, supra note 9, at 782, 789–90.

\textsuperscript{311} For a discussion of the operation of the financial markets in this respect, see generally supra Section IV.

corporation statutes that take into account shareholder interests.\textsuperscript{313} Not only is there no "race to the bottom," but it is not even clear that Delaware has "won" in any general sense because different corporations choose different chartering states based on their needs.\textsuperscript{314} It follows that federal regulation of corporate law can only impede the development of efficient state laws and optimal corporate governance contracts.

All of this is not necessarily to say that the competition for state charters produces state laws that perfectly protect shareholder interests. It has been argued, for example, that state law is shaped to some extent to suit the interests of lawyers who dominate the process of corporate code drafting.\textsuperscript{315} If lawyers are favored in code drafting, one reason why this is not competed away in the corporate chartering market is that lawyers are given substantial power within corporations to make chartering decisions. This power cannot be withdrawn without losing some of the advantages of the lawyers' expertise. In other words, the charter-selection process involves the same tradeoffs of agency costs and the benefits of using agents that are involved in other elements of the corporate contract.\textsuperscript{316}

The anti-contractarian criticism of state corporation law is wrong for the additional reason that, while condemning the motivation of state legislators, it ignores the imperfect motivations of agents of the federal government.\textsuperscript{317} While federal legislators and regulators may respond to different interest groups than state legislators, that does not mean that they are immune from interest group pressure.\textsuperscript{318} For example, the S.E.C. arguably protects the interests of its chief "clientele," large investment banking firms, resulting in disclosure rules that

\textsuperscript{313} For a discussion of how adjustments in share prices constrain managers to choose contract terms that protect shareholders, see supra notes 144, 157–61 and accompanying text.

\textsuperscript{314} Baysinger and Butler, The Role of Corporate Law, supra note 3, argue that firms will choose states with "strict" or "liberal" rules in terms of the degree of constraint on managers according to the relative monitoring capacity of the shareholders. Professor Romano argues that firms tend to reincorporate in Delaware if they intend to engage in a specific transaction that is facilitated in that state. Romano, Law as a Product: Some Pieces of the Incorporation Puzzle, 1 J. L. Econ. & Organ. 225 (1985).

\textsuperscript{315} See Macey & Miller, supra note 26. For a theory that state anti-takeover statutes are the result of lobbying of managers of firms that are dominant in their state of incorporation, see Romano, supra note 253.

\textsuperscript{316} See supra notes 79–84 and accompanying text.

\textsuperscript{317} See Eisenberg, supra note 9, at 1512, arguing that federal regulation is superior to state regulation because the Supremacy Clause eliminates the incentive to pay side payments to managers to attract franchise tax revenue. This makes the entirely unwarranted assumption that both state and federal legislators are acting to maximize government's, rather than their own, welfare.

\textsuperscript{318} See Butler, supra note 253.
curb corporate management's monopoly on inside information.\textsuperscript{319} Thus, once again, the anti-contractarians succumb to the nirvana fallacy.

Under the contractarian approach, there is one important qualification to the shareholders' power to choose a standard form. If a corporation is subject to mandatory fiduciary duties, a strong argument can be made that reincorporating in a more permissive jurisdiction by less than a unanimous vote in order to opt out of fiduciary duties would be an improper "end run" around the statutory limitation on the amendment power.

In conclusion, the federal-state law debate is simply a restatement of the private ordering debate. The primacy of state law is compelled by the same arguments that justify reliance on private ordering, including the efficient functioning of the financial markets. The arguments for federal regulation are fueled by the same misconceptions regarding these markets that underlie the anti-contractual position.

\section*{VII. CONCLUSION}

This Article has demonstrated that corporate rules ultimately are and, from an efficiency perspective, should be the product of private ordering, not government regulation. Even where liability rules are appropriate, they should be regarded as standard form contractual provisions that can be drafted around.

Anti-contractarians make a number of critical errors in their arguments against private ordering. First, they begin with the outmoded concession view of the corporation left over from the dawn of corporate law. Second, they overemphasize the need for fiduciary duties by underappreciating the extent of private controls on managerial conduct. Third, they mischaracterize the role of liability rules as a limitation on, rather than part of, corporate contracts. Fourth, they underestimate the power of market forces as a constraint on the development of optimal contracts. Among other things, they erroneously assume that because market forces cannot perfectly discipline managers, it necessarily follows that the market cannot discipline the development of an optimal corporate contract. Fifth, they fail to weigh in the balance the obvious deficiencies of a regulatory approach. Because

\textsuperscript{319} Haddock & Macey, \textit{Regulation on Demand: A Private Interest Model with an Application to Insider Trading}, 30 J. L. \\& ECON. 311 (1986).
the anti-contractarians are blinded by the supposed problems of private ordering, they do not see the real issues concerning opt-out provisions under a private ordering regime, including issues they mistakenly characterize as arguments against private agreements.

In general, it is time that legal commentators of corporations fully recognize the contractual nature of the corporation, leave behind early nineteenth century conceptions of business organization, and stop discussing corporate law issues in terms that reflect political compromise rather than respect for private ordering.