

THE STRUCTURE OF CORPORATION LAW*

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A corporation is a profit-seeking enterprise of persons and assets organized by rules. Most of these rules are determined by the unilateral action of corporate organs or officials. Some of these rules are determined by market forces. Some are determined by contract or other forms of agreement. Some are determined by law.

This Article will consider the legal rules that directly concern the internal organization of the corporation and the conduct of corporate actors.¹ Viewed in terms of their form, these rules fall into three basic categories. *Enabling rules* give legal effect to rules that corporate actors adopt in a specified manner. *Suppletory* or *default rules* govern defined issues unless corporate actors adopt other rules in a specified manner. *Mandatory rules* govern defined issues in a manner that cannot be varied by corporate actors.²

The major purpose of this Article is to develop the normative principles that determine which of the legal rules that concern the internal organization of the corporation and the conduct of corporate actors should be enabling or suppletory, and which should be mandatory. Because the corporation is an economic institution that is owned and managed by human actors, the development of these principles rests for the most part on economic analysis, quantitative data, and the insights of psychology.

In practice, the application of these elements depends largely on the subject matter of the rule and the nature of the institutional setting. In terms of the nature of the institutional setting, I will distinguish between closely held corporations, publicly held corporations, and corpo-

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1. These rules do not exhaust corporation law. For example, some rules of corporation law concern the relationship between the corporation and its organs on the one hand, and the outside world on the other. A leading example is the rule that shareholders have limited liability. Rules of this type often have an indirect effect on the internal organization of the corporation, but will not be considered in this Article.

2. I do not consider in this Article the question which rules that are not mandatory should be enabling rules, and which should be suppletory or default rules. I also do not consider the principles that should govern the content of suppletory or default rules, and what form such rules should take. On these issues, see generally Ayres & Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules* (forthcoming 99 Yale L.J. (1989)).

rations that are about to go public. In terms of subject matter, I will distinguish between structural, distributional, and fiduciary rules. *Structural rules* govern the allocation of decisionmaking power among various corporate organs and agents and the conditions for the exercise of decisionmaking power; the allocation of control over corporate organs and agents; and the flow of information concerning the actions of corporate organs and agents. *Distributional rules* govern the distribution of assets (including earnings) to shareholders. *Fiduciary rules* govern the duties of managers and controlling shareholders. These three types of rules will be referred to collectively as *constitutive rules*, and that term will include both rules determined by law and rules determined by private action.

Part I will consider closely held corporations. In such corporations, constitutive rules are often determined by bargain. Whether the legal rules that govern such corporations should be enabling or supplementary on the one hand, or mandatory on the other, therefore depends in large part on the force and limits of the bargain principle. Given the force of that principle, structural and distributional rules should be enabling or supplementary at the core. Given the limits of that principle, fiduciary rules should be mandatory at the core.

Part II will consider publicly held corporations. In such corporations, constitutive rules are seldom determined by bargain. Whether the legal rules that govern such corporations should be enabling and supplementary on the one hand, or mandatory on the other, therefore depends in large part on the force and limits of noncontractual private ordering. Noncontractual private ordering may have considerable force in the absence of a conflict of interest. Accordingly, top managers should have power to determine the constitutive rules that govern the conduct of the corporation below their level, because it is in both their interests and the shareholders' interest to set such rules in an optimal fashion. In contrast, noncontractual private ordering by agents who have a conflict of interest is normally undesirable. Therefore, top managers in publicly held corporations should not have power to determine or materially vary the core fiduciary and structural rules that govern matters in which their interests may materially diverge from those of the shareholders. Furthermore, because of the defects in the proxy-voting process and the control over that process exercised by top managers, the core fiduciary and structural rules should not be subject to determination or material variation even with shareholder approval.

Finally, Part III will consider corporations that are about to make an initial public offering. Here too, the core fiduciary and structural rules should not be subject to variation, because variations in such rules might not be accurately priced, would be unfairly surprising, would lead to inefficiency in the capital markets, and might well lead to inefficiency in the national economy.

1. CLOSELY HELD CORPORATIONS

I begin with closely held corporations—corporations that have a small number of shareholders, most of whom either participate in or directly monitor corporate management.

A. *Structural and Distributional Rules*

In closely held corporations, shareholders often will bargain out at least some structural and distributional rules. It is a general principle of law that a bargain should normally be enforced according to its terms, without regard to whether it is reasonable or fair. One reason for this principle is that bargains have social utility because they create joint value through trade. Another reason is that a fully informed party is normally the best judge of his own utility or interest and, therefore, of the value to him of a bargained-for performance. The reasons for the bargain principle usually apply to bargains among the shareholders in a closely held corporation concerning the corporation's structural and distributional rules. Accordingly, at its core the law governing structural and distributional rules in closely held corporations should be enabling and suppletory, rather than mandatory.

This is essentially the position taken by modern corporate law. Modern case law has moved in the direction of enabling shareholders in closely held corporations to bargain out their own structural and distributional rules.³ Many of the modern statutes explicitly validate such rules for those closely held corporations that elect special statutory treatment.⁴

At the periphery, however, a special type of mandatory legal rule should apply. The bargain principle is based partly on the proposition that a fully informed party is the best judge of his own utility. If a party is not fully informed, or lacks the sophistication to understand the implications of his bargain, the bargain principle loses some or all of its force. For example, the courts have traditionally refused to apply the bargain principle to liquidated-damages provisions, and instead have reviewed such provisions to determine whether they provided a reasonable forecast of the amount of damages foreseeable at the time the con-

3. See, e.g., *Glazer v. Glazer*, 374 F.2d 390, 411 (5th Cir.), cert. denied, 389 U.S. 831 (1967); *Galler v. Galler*, 32 Ill. 2d 16, 25, 203 N.E.2d 577, 583 (1964); *Tschirgi v. Merchants Nat'l Bank*, 253 Iowa 682, 690, 113 N.W.2d 226, 232 (1962); *Peck v. Horst*, 175 Kan. 479, 486, 264 P.2d 888, 893 (1953), aff'd on rehearing, 176 Kan. 581, 272 P.2d 1061 (1954); *Petruzzi v. Peduka Constr.*, 362 Mass. 190, 193, 285 N.E.2d 101, 102 (1972); *Henderson v. Joplin*, 191 Neb. 827, 831-32, 217 N.W.2d 920, 923-24 (1974); *Sternheimer v. Sternheimer*, 208 Va. 89, 98-99, 155 S.E.2d 41, 48 (1967).

4. See, e.g., Cal. Corp. Code §§ 158, 300(b), 706(a) (West 1977 & Supp. 1989); Del. Code Ann. tit. 8, §§ 341-356 (1983 & Supp. 1988); Model Statutory Close Corp. Supp. §§ 3, 31 (1988), reprinted in 4 Model Business Corp. Act Ann. §§ 1803, 1810, 1845 (3d ed. Supp. 1989).

tract was made.⁵ One major reason for this special treatment is that a contracting party will often fail to give his full attention to liquidated-damages provisions because he will focus on the contract terms governing his performance, which he expects to render, not on the contract terms governing breach, which he does not expect to commit. Furthermore, even if a contracting party does give such a provision his full attention, he will often fail to understand its implications because every contingency under which breach may occur cannot efficiently be conceived of (and indeed may not be conceivable) when a contract is made.

Within the last forty years, contract law has also developed and elaborated the principle of unconscionability, which serves as a limit on the bargain principle where one party's lack of information or sophistication is exploited by the other.⁶ One of the most basic applications of this principle is the concept of unfair surprise, which renders unenforceable a term that one party knew or should have known would violate the other party's fair expectations.⁷

Still another problem, which contract law has only begun to address, involves long-term contracts.⁸ John Stuart Mill, who argued that "laissez faire . . . should be the general practice" and "that every departure from it, unless required by some great good, is a certain evil,"⁹ nevertheless singled out long-term contracts as appropriate for judicial intervention:

[An] exception to the doctrine that individuals are the best judges of their own interest, is when an individual attempts to decide irrevocably now what will be best for his interest at some future and distant time. The presumption in favor of individual judgement is only legitimate, where the judgement is grounded on actual, and especially on present, personal experience; not where it is formed antecedently to experience, and not suffered to be reversed even after experience has condemned it. When persons have bound themselves by a contract, not simply to do some one thing, but to continue doing something . . . for a prolonged period, without any power of revoking the engagement . . . [any] presumption which can be grounded on their having voluntarily entered into the con-

5. See Restatement (Second) of Contracts § 356 (1981).

6. See Eisenberg, *The Bargain Principle and its Limits*, 95 Harv. L. Rev. 741, 769-73 (1982).

7. See, e.g., U.C.C. § 2-302 and Official Comment 1 (1987); *Weaver v. American Oil Co.*, 257 Ind. 458, 464-65, 276 N.E.2d 144, 148 (1971); *Johnson v. United Investors Life Ins. Co.*, 263 N.W.2d 770, 775-76 (Iowa 1978); *C & J Fertilizer, Inc. v. Allied Mut. Ins. Co.*, 227 N.W.2d 169, 181 (Iowa 1975).

8. See *A Schroeder Music Publishing Co. v. Macaulay*, [1974] 3 All E.R. 616, 622 (five- to ten-year assignment of copyright to music publisher with no corresponding obligation to publish is unenforceable).

9. J. Mill, *Principles of Political Economy* 950 (W. Ashley ed. 1961).

tract . . . is commonly next to null.¹⁰

Mill's analysis is now further supported by evidence that there is a tendency to make systematic errors when comparing the value of present benefits and costs with future benefits and costs, and in particular, that there is a tendency to systematically underestimate risks.¹¹ Based on a review of the empirical evidence, Kenneth Arrow concluded, "[i]t is a plausible hypothesis that individuals are unable to recognize that there will be many surprises in the future; in short, as much . . . evidence tends to confirm, there is a tendency to underestimate uncertainties."¹² One reason for this is the representativeness heuristic, a characteristic judgment process in which small samples are often wrongly taken to be representative.¹³ In particular, evidence based on the sample consisting of present events is often wrongly taken to be representative of future events. "The individual judges the likelihood of a future event by the similarity of the *present* evidence to it. There is a tendency to ignore both prior information . . . and the quality of the present evidence, for example, the size of the sample used to present evidence."¹⁴ Another reason is that pallid evidence, such as a statement of probability, is unduly discounted in favor of vivid evidence, such as present events.¹⁵

These problems of systematic error apply with special force to bargains concerning closely held corporations. It is almost impossible for contracting parties to assess adequately the future costs and benefits in a fluid long-term relationship, because the tree of events will branch far beyond the ideas of the future that will be conceived when the contract is made. Furthermore, corporations by their nature involve a form of activity in which uncertainty plays an essential role. Because of the difficulty of predicting and planning for future events and their impact on a business enterprise, an opportunistic shareholder who controls one or more aspects of a closely held corporation will often find ways to exploit bargained-out structural and distributional rules that seemed both fair and complete at the time of the bargain.¹⁶ It is almost impossible to deal adequately with this potential for ex post opportunism by ex ante contracting. Therefore, although the purpose of enforcing bar-

10. *Id.* at 959-60.

11. See T. Jackson, *The Logic and Limits of Bankruptcy Law* 232-40 (1986) (reviewing and synthesizing the literature).

12. Arrow, *Risk Perception in Psychology and Economics*, 20 *Econ. Inquiry* 1, 5 (1982).

13. Tversky & Kahneman, *Belief in the Law of Small Numbers*, in *Judgment Under Uncertainty: Heuristics and Biases* 23 (D. Kahneman, P. Slovic & A. Tversky eds. 1982).

14. Arrow, *supra* note 12, at 5.

15. See R. Nisbett & L. Ross, *Human Inference: Strategies and Shortcomings of Social Judgment* 55-59 (1980).

16. Moreover, closely held corporations involve personal relationships, which give rise to a special type of systematic error:

Typically, [closely held corporations] are founded by individuals who have a

gains is to protect expectations, the full enforcement of bargained-out structural and distributional rules in a closely held corporation may actually violate fair expectations. Accordingly, while the law governing the structural and distributional elements of closely held corporations should be largely enabling and suppletory, corporation law should also provide mandatory rules that empower the courts to override bargains concerning structural and distributional terms when necessary to prevent opportunism and protect probable fair expectations.

Modern corporation law has taken just this position. Both the courts and the legislatures have fashioned mandatory rules that limit the full force of bargains concerning structural and distributional rules in closely held corporations.

Some statutes simply limit the duration of such bargains. This approach has traditionally been taken to voting trusts,¹⁷ and is now taken by a few states, including Delaware, with respect to shareholder agreements.¹⁸

A more widespread approach, reflected in both cases and statutes, provides for judicial intervention when enforcement of bargained-out structural and distributional rules would defeat a shareholder's fair expectations. The case law approaches this problem through the use of fiduciary principles. For example, in *Donahue v. Rodd Electrotype Co. of New England*,¹⁹ the Massachusetts Supreme Judicial Court held that majority shareholders in a close corporation cannot use their voting power to authorize the purchase of shares from one of their number when an equal opportunity is not offered to the minority.²⁰ In *Wilkes v. Springside Nursing Home, Inc.*,²¹ the same court held that majority shareholders in a close corporation cannot use their voting power to take a business ac-

virtually complete identity of interests and strong feelings of trust and confidence for one another.

Time and human nature may cause a divergence of interests and a breakdown in consensus, however. The nature of the enterprise may change so that the once-valued contributions of a shareholder-employee become irrelevant. The shareholder may become incapacitated. Personal relations with dominant shareholders may become strained to such an extent that the minority finds itself ignored. The interest of a deceased shareholder may pass to an heir who is unwilling or unable to participate actively in the business. Or a shareholder may simply come to believe that his talents and capital can be more profitably invested elsewhere.

Hetherington & Dooley, Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem, 63 Va. L. Rev. 1, 2-3 (1977); see also Hillman, Private Ordering Within Partnerships, 41 U. Miami L. Rev. 425, 434-35 (1987) (discussing difficulty of anticipating future events in business relationships).

17. See, e.g., Del. Code Ann. tit. 8 § 218(a) (1983).

18. See id. § 218(c); 2 Model Business Corp. Act Ann. §§ 708-708.1 (3d ed. Supp. 1989) (nine states, including Delaware, impose a ten-year limit; two impose a twenty-year limit).

19. 367 Mass. 578, 328 N.E.2d 505 (1975).

20. Id. at 600, 328 N.E.2d at 519.

21. 370 Mass. 842, 353 N.E.2d 657 (1976).

tion that disadvantages the minority if the purpose of the action could be achieved through an alternative course of action that is less harmful to the minority.²² In *Smith v. Atlantic Properties, Inc.*,²³ a Massachusetts appellate court held that if shareholders in a close corporation abuse a power of control over matters such as dividends or capital improvements, the court can determine the policies that will govern these matters.²⁴

The statutes are equally far-reaching. A number of statutes give the courts authority to dissolve a corporation—and, thereby, any bargains concerning its constitutive rules—if those in control have acted oppressively or unfairly. Under the New York statute, for example, the court can order dissolution if those in control have been guilty of oppressive actions.²⁵ The statute directs the court to take into account whether liquidation is the only feasible means by which the complaining shareholders can reasonably expect to obtain a fair return on their investment.²⁶ In *In re Judicial Dissolution of Kemp & Beatley, Inc.*,²⁷ the New York Court of Appeals said that “oppression,” in the context of such a statute, means “conduct that substantially defeats the ‘reasonable expectations’ held by minority shareholders in committing their capital to the particular enterprise.”²⁸

22. Id. at 851–52, 353 N.E.2d at 663.

23. 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981).

24. Id. at 210, 422 N.E.2d at 804. For additional cases holding that close corporation shareholders owe each other a fiduciary obligation, see *Comolli v. Comolli*, 241 Ga. 471, 475, 246 S.E.2d 278, 281 (1978); *Cressy v. Shannon Continental Corp.*, 177 Ind. App. 224, 229–30, 378 N.E.2d 941, 945 (1978); 68th St. Apts., Inc. v. Lauricella, 142 N.J. Super. 546, 559, 362 A.2d 78, 85 (1976), aff’d per curiam, 150 N.J. Super. 47, 374 A.2d 1222 (1977).

25. N.Y. Bus. Corp. Law § 1104-a (McKinney 1986); see also Cal. Corp. Code §§ 1800(a)(2), (b)(4), 1804 (West 1977). Under the California statute, the courts are authorized to dissolve a corporation on the ground that those in control have knowingly countenanced persistent unfairness toward any shareholders. A petition can be brought on this ground by (i) shareholders who hold at least one-third of the corporation’s shares, exclusive of those owned by persons who have personally participated in the actions under attack, or (ii) any shareholder of a statutory close corporation.

26. N.Y. Bus. Corp. Law § 1104-a(b)(1) (McKinney 1986). The section is confined to unlisted corporations, and a petition for dissolution under the section can be brought only by holders of 20% or more of the corporation’s stock. Id. § 1104-a(a).

Many of the involuntary-dissolution statutes permit the corporation or the noncomplaining shareholders to avoid dissolution by purchasing the shares owned by the complainants at their fair value. See, e.g., Cal. Corp. Code § 2000(a) (West Supp. 1989); N.Y. Bus. Corp. Law § 1118(a) (McKinney Supp. 1989).

27. 64 N.Y.2d 63, 473 N.E.2d 1173, 484 N.Y.S.2d 799 (1984).

28. Id. at 72, 473 N.E.2d at 1179, 484 N.Y.S.2d at 805 (citations omitted). The court continued:

A shareholder who reasonably expected that ownership in the corporation would entitle him or her to a job, a share of corporate earnings, a place in corporate management, or some other form of security, would be oppressed in a very real sense when others in the corporation seek to defeat those expectations and there exists no effective means of salvaging the investment.

The concept of a shareholder's fair expectations in corporation law parallels in part the concept of protecting against unfair surprise in contract law.²⁹ Also relevant is the contract-law doctrine that contracts must be performed in good faith.³⁰ However, the analogy to contract law has limits. Under the concept of unfair surprise, a court may disregard inconspicuous or unclear provisions of a written contract that eviscerate the fair expectations to which the contract's clear and prominent terms give rise, and then enforce the clear and prominent terms.³¹ Under corporation law, in contrast, the court may derive fair expectations not only from a written agreement but from a broad range of circumstances, and may dissolve rather than enforce the shareholder's contract. For example, under the North Carolina statute the courts have power to liquidate a corporation if it "is reasonably necessary for the protection of the rights or interests of [a] complaining shareholder."³² In *Meiselman v. Meiselman*,³³ the court held that a complaining shareholder's "reasonable expectations" are to be ascertained by examining the entire history of the participants' relationship. According to the Court, "[t]hat history will include the 'reasonable expectations' created at the inception of the participants' relationship; those 'reasonable expectations' as altered over time; and the 'reasonable expectations' which develop as the participants engage in a course of dealing in conducting the affairs of the corporation."³⁴

Moreover, although the relevant statutes are rooted in the remedy

Id. at 72-73, 473 N.E.2d at 1179, 484 N.Y.S.2d at 805; see also *Stefano v. Coppock*, 705 P.2d 443, 446 n.3 (Alaska 1985); *Fox v. 7L Bar Ranch Co.*, 198 Mont. 201, 209-10, 645 P.2d 929, 933 (1982); cf. *Meiselman v. Meiselman*, 309 N.C. 279, 298, 307 S.E.2d 551, 563 (1983) (dissolution allowed where "rights and interests of minority shareholders" were violated by majority shareholder); *Masinter v. WEBCO*, 164 W. Va. 241, 251-52, 262 S.E.2d 433, 440 (1980) (breach of fiduciary duty is "'oppressive conduct'"). See generally Thompson, *Corporate Dissolution and Shareholders' Reasonable Expectations*, 66 Wash. U.L.Q. 193, 237-38 (1988) (remedy of dissolution and the reasonable expectations standard form effective substitute for private ordering).

29. See U.C.C. § 2-302 and official comment 1 (1987); Restatement (Second) of Contracts § 208 (1981).

30. See U.C.C. § 1-203 (1987); Restatement (Second) of Contracts § 205 (1981).

31. See, e.g., *Frank's Maintenance & Eng'g, Inc. v. C.A. Roberts Co.*, 86 Ill. App. 3d 980, 991-93, 408 N.E.2d 403, 411-12 (1980); *Collins v. Uniroyal, Inc.*, 126 N.J. Super. 401, 406, 315 A.2d 30, 33 (1973), aff'd, 64 N.J. 260, 315 A.2d 16 (1974); *Gerhardt v. Continental Ins. Cos.*, 48 N.J. 291, 298-300, 225 A.2d 328, 332-34 (1966).

32. N.C. Gen. Stat. § 55-125(a)(4) (1982); see also N.Y. Bus. Corp. Law § 1104-a(b)(2) (McKinney 1986) ("[T]he court . . . shall take into account . . . [w]hether liquidation of the corporation is reasonably necessary for the protection of the rights and interests of any substantial number of shareholders . . ."); Minn. Stat. Ann. § 302A.751, Subd. 3a (West Supp. 1989) ("In determining whether to order . . . dissolution . . . the Court shall take into consideration the duty which all shareholders . . . owe one another to act in an honest, fair, and reasonable manner . . . and the reasonable expectations of the shareholders . . ."); N.D. Cent. Code § 10.19.1-115.3 (1985) (same).

33. 309 N.C. 279, 307 S.E.2d 551 (1983).

34. Id. at 298, 307 S.E.2d at 563; see also *Fox v. 7L Bar Ranch Co.*, 198 Mont. 201, 210, 645 P.2d 929, 933 (1982) ("[C]ourts must determine the expectations of the share-

of dissolution, the courts usually have the power to impose, as an alternative remedy, a revision of constitutive rules that the parties clearly agreed to. In some cases, the statutes explicitly grant such power. The California statute, for example, provides that the court "may make such orders and decrees and issue such injunctions in the case as justice and equity require."³⁵ The North Carolina statute provides that in an action for dissolution the court may cancel or alter any provision in the corporation's articles of incorporation or by-laws.³⁶ Even where such power is not explicitly granted, it may be held to be implied. For example, in *Baker v. Commercial Body Builders*,³⁷ the Oregon court held that although the Oregon statute in terms authorized only the remedy of dissolution, a court also had authority to grant other forms of relief, such as a decree reducing and distributing capital, ordering the declaration of a dividend, or empowering minority shareholders to purchase additional stock on terms set by the court.³⁸ In *In re Judicial Dissolution of Kemp & Beatley, Inc.*,³⁹ the New York court construed the comparable New York statute in a similar way.⁴⁰

B. Fiduciary Rules

Structural and distributional legal rules for closely held corporations should be enabling and suppletory at the core but mandatory at the periphery. In contrast, fiduciary legal rules for closely held corporations should be mandatory at the core but enabling and suppletory at the periphery. The reasons behind these principles are straightforward. The bargain principle assumes that contracting parties are fully informed, or at least not systematically underinformed. Parties who bargain over structural and distributional rules are likely to understand the consequences of their bargain in most cases, at least over the short term, and mandatory rules are therefore needed only as a backstop. However, bargains to relax materially the fiduciary rules set by law would likely be systematically underinformed even over the short term. Even if the shareholders understood the content of the rules whose protection they attempted to waive—which is unlikely—they still could

holders concerning their respective roles in corporate affairs."); Thompson, *supra* note 28, at 218–19.

35. Cal. Corp. Code § 1804 (West 1977 & Supp. 1989).

36. N.C. Gen. Stat. § 55-125.1(a)(1) (1982) (court may cancel or alter "any provision contained in charter or the bylaws"); see also Me. Rev. Stat. Ann. tit. 13-A, § 1123(3)(D) (1981) (same); S.C. Code Ann. § 33-14-310(d)(1) (Law. Co-op. 1976 & Supp. 1988) (same).

37. 264 Or. 614, 507 P.2d 387 (1973).

38. *Id.* at 631–33, 507 P.2d at 395–96.

39. 64 N.Y.2d 63, 473 N.E.2d 1173, 484 N.Y.S.2d 799 (1984).

40. *Id.* at 73, 473 N.E.2d at 1180, 484 N.Y.S.2d at 806. But see *White v. Perkins*, 213 Va. 129, 135, 189 S.E.2d 315, 320 (1972) (dissolution or appointment of custodian are exclusive remedies available to a minority shareholder under the Virginia dissolution statute).

not begin to foresee the varying circumstances to which such a waiver would be applicable. Any such waiver would therefore inevitably permit unanticipated opportunistic behavior.

Some bargained-out fiduciary rules do not present the dangers of systematic error and exploitation. Bargains to change a legal rule that is not congruent with current concepts of fairness or that does not afford any real protection to shareholders, such as the old rules that interested transactions were voidable without regard to fairness or that interested directors could not be counted in determining a quorum, fall into this category.⁴¹ In some cases, a bargained-out fiduciary rule is specific, easily understood, and not easily susceptible to exploitation. A rule that clearly specifies a type of business venture that will not be considered a corporate opportunity may fall in this category.⁴² Similarly, shareholder approval of a specific conflict-of-interest transaction usually does not present the dangers of systematically underinformed consent and exploitation, because the approval relates to a specific event rather than to an unknowable future. In these peripheral cases, bargained-out fiduciary rules should be enforceable.

The law reflects these principles. The core fiduciary rules which govern the close corporation are mandatory,⁴³ but private rules that do not present the dangers of systematic unforeseeability and exploitation—such as rules that allow an interested director to be counted toward a quorum—normally will be given effect.⁴⁴

41. See Marsh, *Are Directors Trustees?—Conflict of Interest and Corporate Morality*, 22 Bus. Law. 35, 39–43 (1966).

42. See *Principles of Corporate Governance: Analysis and Recommendations* § 5.09(c) (Tent. Draft No. 7, 1987). On the other hand, a rule that permitted directors or officers to take opportunities that were derived from corporate information would present the dangers of unforeseeability and exploitation and, therefore, should be unenforceable. See *id.*

43. See *Pappas v. Moss*, 393 F.2d 865, 867–68 (3d Cir. 1968); *Irwin v. West End Dev. Co.*, 342 F. Supp. 687, 701 (D. Colo. 1972), *aff'd* in part and *rev'd* in part on other grounds, 481 F.2d 34 (10th Cir. 1973), *cert. denied*, 414 U.S. 1158 (1974); *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 313–14, 93 A.2d 107, 118 (S. Ct. 1952); *Abeles v. Adams Eng'g Co.*, 35 N.J. 411, 428–30, 173 A.2d 246, 255 (1961).

A number of recent statutes permit the certificate of incorporation to limit or eliminate personal liability of directors for simple duty-of-care violations. See, e.g., Del. Code Ann. tit. 8, § 102(b)(7) (Supp. 1988). Almost all of these statutes, however, are explicitly inapplicable to duty-of-care violations by officers and duty-of-loyalty violations by either directors or officers. See *Principles of Corporate Governance: Analysis and Recommendations* § 7.17, reporter's note 6 (Tent. Draft No. 9, 1989).

44. See *Piccard v. Sperry Corp.*, 48 F. Supp. 465, 469 (S.D.N.Y. 1943), *aff'd per curiam*, 152 F.2d 462 (2d Cir.), *cert. denied*, 328 U.S. 845 (1946); *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. at 313–14, 93 A.2d at 118; *Hackett v. Diversified Chem., Inc.*, 180 So. 2d 831, 834–35 (La. Ct. App. 1965); *Everett v. Phillips*, 288 N.Y. 227, 233, 236–37, 43 N.E.2d 18, 20–22 (1942); *Adams v. Mid-West Chevrolet Corp.*, 198 Okla. 461, 473, 179 P.2d 147, 160 (1947).

II. PUBLICLY HELD CORPORATIONS

I turn now to publicly held corporations, by which I mean corporations that have a large number of shareholders, most of whom neither participate in the management of the corporation nor directly monitor corporate management.⁴⁵ Typically, the number of managerial and nonmanagerial agents is also large, and for reasons of efficiency the business of the corporation is controlled and conducted by these agents. Under these conditions, bargaining among the shareholders, or between managers and the shareholders as a body, is virtually impossible. Accordingly, most of the constitutive rules of such corporations are determined not by contract, but by law or by private bureaucratic rulemaking—for example, by managerial orders, by board or committee resolutions, by board-adopted by-laws, or by board determination of governance terms in preferred stock, stock rights, or debt instruments.

In such corporations, therefore, the principles that determine which legal rules should be enabling or suppletory and which should be mandatory depend on the force and limits of forms of private ordering other than bargain and contract. The force and limits of these forms of private ordering in publicly held corporations, in turn, depend very largely on the impact of the potential self-interest of top managers of such corporations and on the extent to which this impact is controlled by market forces other than bargain and contract.

A. *Divergencies of Interest*

The interests of the shareholders and managers in publicly held corporations converge in many respects: in general, if the shareholders do well, so will the managers. As in any principal-agent relationship, however, the interests of shareholders and managers also diverge. All agents have a potential interest in working at a slack pace and in avoiding the effort and discomfort involved in adapting to changed circumstances, such as the emergence of new technologies. This is the problem known as *shirking*. All agents have a potential interest in diverting the principal's assets to their own use through unfair self-dealing. This is the problem of *traditional conflicts of interest*.

Top corporate managers differ from most other agents, however, in that they are legally and factually autonomous for many purposes. For example, under corporate law the shareholders normally cannot make ordinary business decisions, cannot make major structural decisions unless the directors concur, and cannot remove directors without cause.⁴⁶ Because of this relative autonomy, and the range of discretion

45. Corporations that are about to become publicly held are considered in Part III, *infra*.

46. See M. Eisenberg, *The Structure of the Corporation* 2-5 (1976). Indeed, because of their relative autonomy, some top corporate managers are not agents at all in

that it leads to, top corporate managers have the power to give expression to still a third potential divergence of interest: an interest in maintaining and enhancing their positions even at the shareholders' expense. I will refer to instances of this type of divergence of interest as *positional conflicts*.⁴⁷

Positional conflicts may be expressed in a great variety of ways. For example, top managers may make it particularly difficult for anyone to objectively monitor their performance. They may impose high barriers to their own removal for inefficiency or other reasons. They may seek to increase corporate size as a way to maximize their power, prestige, and salary, even if an increase in corporate size does not increase shareholder wealth. They may seek to maximize the cash and other resources that they command, even when distributions to the shareholders would be more efficient. They may diversify the firm as a means to reduce the riskiness of their human-capital investments, even when diversification of the firm is not in the interest of shareholders because shareholders can diversify their own risks through portfolio management.⁴⁸

In the real world, positional conflicts are much more important

the classical legal sense. See Clark, *Agency Costs Versus Fiduciary Duties*, in *Principals and Agents: The Structure of Business* 55, 58 (J. Pratt & R. Zeckhauser eds. 1985). Top corporate managers are, however, agents in the economic sense, because they are under both a moral and a legal obligation to manage the corporation in the interest of the shareholders. This moral and legal obligation is imposed because the shareholders are the owners of the corporation; because shareholder ownership is a critical element of corporate legitimacy; and because the shareholders' interest that the corporation maximize profits, within broad constraints, is largely coincident with the social interest.

47. The takeover movement is based in part on the results of positional conflicts. A bidder may be able to offer an above-market price for a target because the target's managers have prevented the installation of internal monitoring and removal devices, so that the target is being run by inefficient managers. Or the target's managers may have stressed growth over profits, so that a sell-off of the corporation's businesses (a bust-up takeover) will yield more value than its continued operation. On the other side of the equation, the bidder's management may be motivated by its own taste for size, as evidenced by the fact that bidders appear to make little or perhaps even no gains on acquisitions. See Jarrell, Brickley & Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, *J. Econ. Persp.*, Winter 1988, at 49, 53; Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 *J. Bus.* 197, 198 (1986).

48. See Shleifer & Vishny, *Value Maximization and the Acquisition Process*, *J. Econ. Persp.*, Winter 1988, at 7, 7-9:

Like the rest of us, corporate managers have many personal goals and ambitions, only one of which is to get rich. The way they try to run their companies reflects these personal goals. . . . Much corporate behavior seems best understood in terms of managers running the show largely as they please. . . . [I]n practice, non-value-maximizing behavior seems vastly to exceed what one would expect to observe under optimal incomplete information contracts. A wealth of evidence suggests that managers often take actions that dramatically reduce the value of the firm. . . . [I]t is important to recognize that a manager is likely to take whatever actions he can to make himself more valuable to the firm, and more costly to remove.

than either shirking or traditional conflicts of interest. Most top managers will probably refrain from shirking simply because their self-esteem is tied to hard work and accomplishment. Most top managers will probably refrain from unfair self-dealing simply because they have internalized the rules of social morality. However, self-esteem and morality may often be inadequate to curb positional conflicts.⁴⁹ The top manager's self-esteem often crucially depends on the maintenance and enhancement of his position, and conduct designed to maintain and enhance one's position may not be immoral in any obvious sense.

Of course, many top managers will not act in a manner that reflects positional conflicts, just as they will not work at a slack pace or engage in unfair self-dealing. However, top managers may fail even to recognize that positional conflicts exist. Inefficient top managers are unlikely to believe themselves to be inefficient. Top managers who enhance their positions through corporate growth, diversification, or the like, usually believe (often, but not always, correctly) that their actions are in the interest of the shareholders. Finally, top managers may have more difficulty in taming a taste for maintaining and enhancing their positions than in taming a taste for shirking or unfair self-dealing. It is at least in part through the appetite for position that top managers have achieved their place atop the corporate hierarchy. Thus, not only are moral restraints normally weaker in the case of positional conflicts than in the case of shirking or unfair self-dealing, but avoiding the expression of such conflicts may require the manager to control the very characteristics that put him where he is.

The divergencies of interest between corporate agents and shareholders, and the special problem of positional conflicts, explain why some constitutive rules that govern publicly held corporations should be enabling or suppletory while others should be mandatory. The legal rules that govern the internal organization of the corporation and the conduct of corporate actors *below the level of top managers* should by and large be enabling or suppletory. Top managers have both the self-interest and the power to install constitutive rules that will efficiently determine the roles, coordination, supervision, and monitoring of lower corporate agents and constrain those agents from giving expression to their own interests in preference to the interests of the shareholders.

In contrast, top managers of publicly held corporations have little incentive to adopt rules that put constraints on their own positions. On the contrary, the incentive of top managers may be to insulate themselves from such constraints. The core fiduciary and structural rules that govern material divergencies of interest of top managers in publicly held corporations, therefore, should be neither determined nor subject to material variation by the action of managers or managerial

49. Market forces are also inadequate, as demonstrated below. See Part II.E, *infra*.

organs.⁵⁰ The reason for this principle is not that legislatures or judges know more about such rules than top managers; they may or may not. Rather, the reason is that in this as in other areas of law, agents whose interests may materially diverge from the interests of their principals should not have the power to unilaterally determine or materially vary the rules that govern those divergencies of interest.

B. *The Limits of Shareholder Consent*

This first principle—that the core fiduciary and structural rules that govern material divergencies of interest of top managers in publicly held corporations should be neither determined nor subject to material variation by managers or managerial organs—spills into a second. Such rules should also normally not be subject to determination or material variation even with shareholder approval. Allowing such rules to be determined or materially varied on the basis of shareholder approval would effectively undercut the first principle, because, under current law and practice, shareholder consent to rules proposed by top managers in publicly held corporations may be either nominal, tainted by a conflict of interest, coerced or impoverished.⁵¹

1. *Nominal consent.* — Under current law and practice, an action proposed by managers may be legally deemed approved by shareholders who never consented to it in fact. For example, under Rule 14a-4(b)(1) of the Proxy Rules,⁵² if a shareholder does not designate how he wants to vote on a given issue, management may vote the shareholder's proxy as it chooses, provided the form of proxy states how management intends to vote.⁵³ For many shareholders, the cost of reading and understanding each proposal in the proxy materials will exceed the likely economic effect of any given proposal. For such shareholders, it is rational not to read any proposals.⁵⁴ Shareholders receive a number of management proposals in proxy statements. Because the interests of managers and shareholders converge to a significant extent, and because many proposals relate to housekeeping details (such as approval of auditors), shareholders have reason to believe that the typical management proposal will be value-increasing. Therefore, unless a shareholder holds a very large amount of a given corporation's

50. This does not mean that all constitutive rules that concern top managers should be mandatory. Many or most of the constitutive rules that define and coordinate the tasks of top managers should be determined by private ordering, because many or most such rules do not involve divergencies of interest between top managers and shareholders.

51. Further reasons for this second principle are developed in Part III, *infra*.

52. 17 C.F.R. § 240.14a-4(b)(1) (1988).

53. *Id.*

54. See R. Clark, *Corporate Law* § 9.5.1 (1986); Easterbrook & Fischel, *The Corporate Contract*, 89 Colum. L. Rev. 1416, 1443 (1989); Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 Calif. L. Rev. 1, 43-44 (1988).

stock, he will probably conclude that the expected gains from analyzing all the management proposals he receives will be less than the expected costs. If the shareholder nevertheless signs and returns the form of proxy, solely for the purpose of reelecting incumbent directors, Rule 14a-4 allows management to vote his shares for a proposal of whose terms he was completely ignorant, and as to which he gave no consent.⁵⁵

Similarly, shares that are held of record by a broker or broker's depository are often voted by the broker with no instructions from the beneficial owner. Although the Proxy Rules generally require an institutional holder of record to forward corporate soliciting material to the beneficial owner, they do not prohibit the institutional holder of record from voting the proxy on the beneficial owner's behalf in the absence of instructions from the beneficial owner.⁵⁶ When a beneficial owner's shares are registered in the name of a broker or a brokers' depository, the rules that determine how the broker can vote the shares are those of the stock exchanges and the National Association of Securities Dealers.⁵⁷ The rules of the New York Stock Exchange are dominant in this area, because of the importance of the corporations listed on that exchange and the dollar volume of trading. Under the Exchange's "ten-day rule," a broker can vote shares held in his name even though he has received no instructions from the beneficial owner how to vote the stock and did not inform the owner how he would vote the stock in the absence of instructions, as long as he solicited instructions from the owner at least fifteen days before the meeting and has not received instructions by the tenth day before the meeting.⁵⁸ Brokers receive instructions from the beneficial owners for only half the shares registered in broker name.⁵⁹ Brokers who vote without instructions from owners ordinarily vote in favor of management proposals.⁶⁰

The power of a broker to vote without instructions under the Exchange's ten-day rule is subject to a number of exceptions,⁶¹ but the exceptions fail to cover a number of important matters. For example, within the past several years many states have authorized corporations to adopt certificate-of-incorporation provisions that limit or eliminate directors' liability for breach of the duty of care.⁶² Despite the impor-

55. 17 C.F.R. § 240.14a-4 (1988).

56. Rule 14b-1, 14b-2, 17 C.F.R. § 240.14b-1, 240.14b-2 (1988).

57. See, e.g., New York Stock Exchange Listed Company Manual ¶ 402.06(A), (D) (1986).

58. *Id.*

59. J. Heard & H. Sherman, *Conflicts of Interest in the Proxy Voting System* 22 (1987).

60. *Id.* at 22.

61. New York Stock Exchange Listed Company Manual ¶ 402.06(D) (1986).

62. See, e.g., Cal. Corp. Code § 204(a)(10) (West 1977 & Supp. 1989); Del. Code Ann. tit. 8, § 102(b)(7) (Supp. 1988); N.J. Stat. Ann. § 14A:2-7(3) (West 1969 & Supp. 1989).

tance of such provisions, the Exchange has permitted brokers to vote stock registered in their names on these provisions with no instructions whatsoever from the beneficial owners.⁶³

2. *Consent that is tainted by a conflict of interest.* — Shareholder consent that is not nominal may nevertheless be tainted by a conflict of interest. Approximately fifty percent of the stock in publicly held corporations is owned by institutional investors.⁶⁴ Many institutional investors have ties to management that inhibit voting against a management proposal.⁶⁵ For example, if the trust department of a bank holds the stock of C Corporation in a pension portfolio, and C is also a client of the bank's commercial department, a trust officer will think long and hard before voting against a proposal made by C's management. Indeed, some corporate managers have begun to explicitly request their counterparts in other corporations to pressure pension-fund trustees to take a promanagement stance in casting their votes.⁶⁶ The same problem arises for insurance companies, which, like banks, often have extensive commercial contacts with corporations whose stock they hold in their investment portfolios.⁶⁷ Undoubtedly, institutional investors often vote in the interests of their beneficiaries despite such conflicts, but it seems equally clear that institutional investors often succumb to a conflict of interest in their voting decisions.⁶⁸

Frequently, shareholder voting decisions are based on an even more direct conflict of interest. Managers often have significant holdings in their own corporations, and they are seldom if ever prohibited from voting their holdings in favor of a proposal that advances their own interests.⁶⁹ Even more to the point, in many corporations a controlling block is held by one or more corporate or individual shareholders whose interests may diverge from those of the noncontrolling

63. Telephone conversation with Paul Wyciskala, Managing Director of Operations & Policy Support, New York Stock Exchange, June 8, 1989. An exception is made if material litigation is pending. *Id.*

64. See W. Cary & M. Eisenberg, *Cases and Materials on Corporations* 195-96 (6th ed. 1988) (in 1986, 54% of total equity holdings held by institutional investors).

65. See generally J. Heard & H. Sherman, *supra* note 59, at 40-67; Herman, *Commercial Bank Trust Departments, in Abuse on Wall Street: Conflicts of Interest in the Securities Markets* 23, 72 (Twentieth Century Fund ed. 1980).

66. See J. Heard & H. Sherman, *supra* note 59, at 99.

67. See *id.* at 54.

68. See *id.* at 40-67.

69. The mean inside holding (including options that could be exercised within 60 days) of chief executive officers and their immediate families in 746 corporations, as published in the 1987 *Forbes* Executive Compensation Survey, was 2.42 percent, although the median holding was only .25 percent. What the Boss Makes: The People in Power, *Forbes*, June 15, 1987, at 162, discussed in M. Jensen & K. Murphy, *Performance Pay and Top-Management Incentives*, University of Rochester Managerial Economics Research Center Working Paper No. 89-08, at 14-15 (1989). Obviously, however, many chief executive officers own significantly more than the mean, and many top officers other than the chief executive also have significant inside holdings.

shareholders. In theory, voting by a controlling shareholder can be reviewed on a case-by-case basis under a fairness test.⁷⁰ In practice, however, the costs of bringing a suit based on fairness, and the difficulty of applying that test in this context, would make a case-by-case review of the fairness of votes cast by controlling shareholders an inadequate tool for regulating the conflicts of interest of controlling shareholders voting on variations in core fiduciary or structural rules that they have proposed.

3. *Coerced consent.* — Shareholder consent that is neither nominal nor tainted by a conflict of interest may nevertheless be coerced. For example, management may threaten to withhold approval of an action that is in the shareholders' best interests, such as an increase in dividends, unless the shareholders approve an unrelated management proposal.⁷¹ Or, management may tie a proposal that shareholders might vote down if it stood alone to a proposal that shareholders will clearly favor.⁷²

4. *Impoverished consent.* — Finally, and perhaps most importantly, shareholder consent that is neither nominal, tainted by a conflict of interest, nor coercive may nevertheless be impoverished. For example, shareholders may vote for a rule proposed by management even though they would prefer a different rule, because the proposed rule is better than the rule it replaces and management's control over the agenda effectively limits the shareholders' choice to the existing rule or the proposed rule.

Proposals concerning directors' liability for breach of the duty of care furnish an example. The recently adopted statutes permit adoption of a certificate amendment that either limits such liability or eliminates it entirely.⁷³ The duty of care is an important tool for ensuring managerial accountability. One factor that may have motivated the recent statutes was a great increase in the cost of directors' liability insurance.⁷⁴ Another is the real possibility that liability for duty-of-care violations will be hugely disproportionate both to directors' fees and to fault. This raises an issue not only of fairness but of efficiency, because the prospect of such disproportionate liability may deter qualified persons from accepting outside directorships and may make directors un-

70. Cf. *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 298, 93 A.2d 107, 110-11 (Sup. Ct. 1952) (review of self-interested merger for fairness).

71. This tactic has been especially prevalent in dual-class voting. See *Lacos Land Co. v. Arden Group, Inc.*, 517 A.2d 271, 276-79 (Del. Ch. 1986); Gordon, *supra* note 54, at 48-53. For an analysis of the coercive effect of this tactic, see Ruback, *Coercive Dual-Class Exchange Offers*, 20 J. Fin. Econ. 153, 157 (1988).

72. See, e.g., Inco "Poison Pill" Tested in Canada, N.Y. Times, Dec. 7, 1988, at D8, col. 3 (poison pill and special \$10 dividend combined in a single proposal).

73. See, e.g., Del. Code Ann. tit. 8, § 102(b)(7) (Supp. 1988).

74. See, e.g., Sing, *More Firms Shielding Directors from Suits*, L.A. Times, May 14, 1989, pt. 4, at 6, col. 1 (change in Delaware law permitting liability limitation "triggered in part by the high cost of directors liability insurance").

duly risk-averse. Both the cost and the disproportionality problems could be addressed by certificate amendments that limit directors' liability to a low fixed amount or to an amount equal to directors' fees for one or two years. The certificate amendments proposed by management under these new statutes, however, invariably call for director liability to be completely eliminated, not simply limited. Suppose shareholders believe the best rule would be to limit liability to a reasonable amount, thereby preserving accountability while both reducing insurance premiums and serving the fairness and policy goals that might be frustrated by disproportionate liability. The shareholders might nevertheless vote in favor of a management proposal to eliminate liability, because management control over the agenda effectively restricts the shareholders to a choice between the management proposal or the existing rule, and as between those two rules the management proposal may seem preferable.

More fundamentally, shareholder approval may be impoverished because many shareholders may have a weak, incomplete, or nonexistent understanding of a proposal for which they vote. To begin with, under the Proxy Rules, management can present proposals to the shareholders with a one-sided argument. The Proxy Rules do not enable a shareholder who opposes a management proposal to present the other side of the matter in the corporate proxy statement.⁷⁵ Of course, the management argument cannot be misleading,⁷⁶ but an argument that is not misleading may nevertheless be very one-sided.⁷⁷

Even if the argument for a management proposal is balanced, many shareholders will rationally decide not to read it, for reasons that have already been canvassed.⁷⁸ And even if a shareholder does analyze a particular management proposal and does determine that the proposal would be value-decreasing, he is unlikely to mount a counter-solicitation unless his stake in the corporation is extremely large, because if he prevails other shareholders would not bear any of the costs of the counter-solicitation but would free-ride on most of its benefits.

Of course, the free-rider problem could be addressed by collective action, but the barriers to collective action are extremely high. A communication by a shareholder who seeks to alleviate the free-rider problem by forming a group to share the costs of a solicitation will probably itself be a solicitation subject to the Proxy Rules, unless the shareholder solicits less than eleven other persons to join his group.⁷⁹ Even if a

75. See Rule 14a-8(c)(9), 17 C.F.R. § 240.14a-8(c)(9) (1988).

76. Rule 14a-9, 17 C.F.R. § 240.14a-9 (1988).

77. See, e.g., the proxy statements of Schering Plough Corporation and RCA Corporation, excerpts from which are reprinted in 3 M. Lipton & E. Steinberger, *Takeovers & Freezeouts* G-3, G-20 (1989).

78. See *supra* note 54 and accompanying text.

79. Rules 14a-1(k)(iii), 14a-2(b)(6), 17 C.F.R. § 240.14a-1(k)(iii), 14a-2(b)(6) (1988).

group is successfully formed, shareholders who do not join the group will free-ride on its efforts and will therefore have an incentive not to join.⁸⁰

Initiatives by shareholders are even less likely than counter-solicitations. Under most statutes, an amendment of the certificate of incorporation must be initiated by the board.⁸¹ Accordingly, a shareholder cannot solicit for any change in a corporation's constitutive rules that would require certificate amendment. Instead, he would have to mount a campaign to oust the board, which is extremely expensive and in any event may not be his objective.

Even changes that can be accomplished without a certificate amendment face substantial impediments. Management can solicit proxies against a proposed change in the corporation's constitutive rules at no cost to itself, because it can charge the expenses of its soliciting activity to the corporation.⁸² In contrast, a shareholder who proposes to solicit for a change must bear his own expenses, and will encounter the same free-rider problem and barriers to collective action that confront a shareholder who is considering a counter-solicitation.⁸³ Accordingly, even a very large shareholder in a publicly held corporation is unlikely to solicit for a change in the corporation's constitutive rules unless the change would be exceptionally wealth-maximizing for the shareholders of the individual corporation (for example, the elimination of a poison pill) or would have some sort of precedential value for other corporations in which he holds major investments.

The many limits on the meaningfulness of shareholder consent do not compel the conclusion that shareholder voting is never meaningful. Some individual holders may read the proxy statement and vote their own stock. Some institutional holders have no conflicting ties to management. Many institutional holders that do have conflicts of interest will nevertheless vote in the interests of their beneficiaries, either because of a sense of moral duty or because of legal pressures or pressures to maximize their returns. As a result, management proposals

80. Even if a shareholder's stake is large enough, and the expected negative impact is great enough, rationally to justify some expenditure against the proposal, the expenditure will be less than the optimum amount. See Gordon, *supra* note 54, at 44 n.143.

81. See, e.g., Del. Code Ann. tit. 8, § 242(b)(1) (1983); Revised Model Business Corp. Act § 10.03(a), (b)(1) (1984).

82. See M. Eisenberg, *supra* note 46, at 102-10.

83. Rule 14a-8, 17 C.F.R. § 240.14a-8 (1988), gives shareholders the right to require certain kinds of proposals to be included in the corporate proxy statement. However, the Rule is subject to a number of important exceptions that drastically limit its usefulness to shareholders who propose to solicit for significant changes. For example, under state law, mergers, sales of substantially all assets, amendments to the certificate of incorporation, and dissolution must normally be initiated by the board. Shareholder proposals to effectuate any such transactions would therefore normally be excludable from the proxy statement under Rule 14a-8(c)(1), 17 C.F.R. § 240.14a-8(c)(1) (1988), which permits exclusion of a proposal that is not a proper subject for action by shareholders under state law.

that will have obvious and very large value-decreasing effects are unlikely to be adopted by shareholders, and even proposals that have smaller negative effects may not always be adopted. Furthermore, it is entirely conceivable that with further increases in institutional ownership, and changes in the moral, legal, and financial pressures that affect voting by institutional owners, the significance of shareholder voting will change in the future. Under prevailing conditions, however, the limits on the meaningfulness of shareholder consent are so substantial that allowing those rules to be determined or materially varied by top managers with shareholder approval often would be functionally equivalent to allowing those rules to be unilaterally determined or materially varied by top managers.

C. The Structure of the Law Governing Publicly Held Corporations

The general principle, then, is that in publicly held corporations, mandatory legal rules should govern those core fiduciary and structural areas in which the interests of shareholders and top managers may materially diverge. The content of these rules should reflect the basic types of potential divergence. To deal with traditional conflicts of interest, mandatory rules should impose a duty of fair dealing, should provide for disclosure of self-interested transactions, and should establish an effective enforcement mechanism. To deal with the problem of shirking, mandatory rules should impose a duty of care. As to these matters, the principle that governs publicly held corporations is the same as the principle that governs closely held corporations: fiduciary rules should be mandatory at the core.

In the case of publicly held corporations, however, an additional principle comes into play to deal with positional conflicts, which involve the most serious of the divergencies of interest between top managers and shareholders. In such corporations, core structural rules double as fiduciary rules, because it is structural rules that address positional conflicts. Accordingly, in publicly held corporations core structural rules as well as core fiduciary rules should be mandatory.

These core structural rules fall into several categories. One set of mandatory structural rules should provide for the appointment and monitoring of senior executives by a governing organ (that is, a board of directors) that is elected by shareholders for a limited term of office, a majority of which is composed of members who are independent of the senior executives. A second set should require periodic disclosure of detailed financial data and information concerning material business and legal developments and should provide for institutional mechanisms to ensure that the financial data is reliable. A third set should concern the approval of, and dissent from, transactions that tend to raise positional conflicts. In general, shareholder approval should be required for any transaction in control to which the corporation is a party—that is, any corporate transaction that causes a change in control

of the corporation, its assets, or its business. In the case of major transactions that characteristically involve either traditional or positional conflicts, create a significant potential for overreaching by controlling shareholders, or radically alter the structure of the corporation, dissenting shareholders should have the right to require the corporation to purchase their shares at fair value. A final set of mandatory structural rules should protect the integrity of shareholder voting.

The core mandatory rules should operate to check positional conflicts without preventing advantageous corporate transactions. To this end, the core structural rules should require mechanisms for accountability and disclosure for top executives, shareholder approval of certain transactions, and appraisal rights for certain transactions, but they should not regulate the content of corporate transactions. Because mandatory rules generally should not regulate the content of transactions, distributional rules should generally be enabling, except as required to protect the interests of creditors.

The legal rules that actually govern publicly held corporations correspond reasonably well to the legal rules that should govern such corporations.

Assume, for example, that a given corporation is publicly held, but has less than 500 shareholders and is not required to register its stock under Section 12(g) of the Securities Exchange Act.⁸⁴ Call such a corporation a small publicly held corporation. Suppose first that the corporation is incorporated in Delaware. Although Delaware is usually taken as the apotheosis of enabling states, and indeed has the least regulatory of the major corporations statutes, even under Delaware law the corporation will be governed by a number of mandatory legal rules. For example, the corporation's directors and officers have a duty of loyalty to the corporation that cannot be substantially altered.⁸⁵ The officers have a duty of care to the corporation that cannot be substantially altered.⁸⁶ Any shareholder who owned stock at the time of a breach of the duties of care or loyalty can bring suit against the wrongdoer on the corporation's behalf.⁸⁷ The corporation is required to have a board of directors or some comparable organ.⁸⁸ The term for which a director serves may not be longer than three years, and if the board is classified, one class must come up for election every year.⁸⁹ The corporation must have an annual meeting of shareholders for the election of directors.⁹⁰ The shareholders have a right to inspect a shareholder list

84. Securities Exchange Act § 12(g)(1)(B), 15 U.S.C. § 781(g)(1)(B) (1982).

85. See authorities cited at *supra* note 43.

86. *Id.*

87. Del. Code Ann. tit. 8, § 327 (1983).

88. *Id.* § 141(a).

89. *Id.* § 141(d) (Supp. 1988).

90. *Id.* § 211 (1983).

within the ten days preceding a shareholders' meeting,⁹¹ and a right to inspect the corporation's books and records at any time for a proper purpose.⁹² The corporation's certificate of incorporation may be amended only with the approval of a majority of the outstanding shares.⁹³ Under a variety of circumstances, such an amendment must also be approved by separate classes of shareholders—even classes not entitled to vote under the certificate of incorporation.⁹⁴ The corporation may dissolve or sell substantially all of its assets only with the approval of a majority of the outstanding shares.⁹⁵ Shareholders who dissent from a merger generally have a right to be paid the fair value of their shares.⁹⁶ The shareholders have the power to amend the corporation's by-laws.⁹⁷ And so forth.⁹⁸

In short, a small publicly held corporation will be governed by very extensive mandatory legal rules even in Delaware, which is probably the least regulatory of states. Furthermore, most small publicly held corporations will be incorporated not in Delaware, but in the state in which their principal office is located, because out-of-state incorporation will normally entail somewhat higher costs than local incorporation.⁹⁹ Since most states are more regulatory than Delaware, most small publicly held corporations will be governed by an even more extensive mandatory legal regime than that just described.

Suppose, for example, the corporation is incorporated under a

91. *Id.* § 219(a).

92. *Id.* § 220.

93. *Id.* § 242(b).

94. *Id.*

95. *Id.* §§ 271, 275 (1983 & Supp. 1988).

96. *Id.* § 262.

97. *Id.* § 109(a) (1983).

98. For example, the power to manage the business of the corporation or to supervise its management must be confided in a board or a comparable organ, and cannot be exercised by the shareholders. *Id.* § 141(a). A quorum for directors' meetings may not be less than one-third of the whole board. *Id.* § 141(b). A committee of the board may not be given power or authority to amend the certificate of incorporation or adopt an agreement of merger; may not recommend to the shareholders a dissolution or a sale of substantially all assets; and may not amend the by-laws. *Id.* § 141(c) (Supp. 1988). A quorum for shareholders' meetings may not be less than one-third of the shares entitled to vote. *Id.* § 216. A proxy to vote shares in the corporation may not be made irrevocable unless accompanied by an interest. *Id.* § 212(c) (1983). A voting trust of the corporation's stock may not exceed ten years in duration. *Id.* § 218. Restrictions on the transferability of stock may not be imposed on previously issued shares without the consent of the holder. *Id.* § 202(b). Shareholders are not liable for the corporation's debts. *Id.* § 102(b)(6) (Supp. 1988). Distributions are regulated within broad limits. *Id.* § 170 (1983).

I do not claim that all the rules that are presently embodied in the corporate statutes should be viewed as mandatory, or that all the rules that are presently mandatory should be so. For an exploration of this issue, see Coffee, *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 Colum. L. Rev. 1618, 1618 n.1 (1989).

99. See W. Cary & M. Eisenberg, *supra* note 64, at 98.

state law that is based upon the Revised Model Business Corporation Act. It will then be subject not only to almost all of the mandatory rules that Delaware imposes, but also to many more. For example, the corporation must furnish its shareholders with annual financial statements, which must be prepared on the basis of generally accepted accounting principles if the corporation prepares its financial statements on that basis.¹⁰⁰ An amendment to the corporation's certificate of incorporation that increases the normal quorum or voting requirement must meet the same quorum requirement and be adopted by the same vote as the quorum or vote proposed.¹⁰¹ Shareholders who dissent from a sale of substantially all assets, a merger, or certain types of amendment to the certificate of incorporation normally have a right to be paid the fair value of their shares.¹⁰² And so forth.¹⁰³

Some state statutes impose even more mandatory rules than the Model Act. Under the California Corporations Code, for example, the corporation will be subject to virtually all the mandatory rules of Delaware and the Model Act, and more. All directors must be elected annually.¹⁰⁴ Disclosure requirements are more extensive.¹⁰⁵ Stock-for-stock and stock-for-assets combinations normally can be effected only with shareholder approval.¹⁰⁶ And so forth.¹⁰⁷

So much for the small publicly held corporation. Assume now that a corporation has 500 holders of a class of equity securities and more than \$5 million in assets and thus must register under Section 12(g) of

100. Revised Model Business Corp. Act § 16.20(a) (1984).

101. *Id.* § 7.27(b).

102. *Id.* § 13.02.

103. For example, the corporation may not voluntarily indemnify a director in connection with a proceeding by or in the right of the corporation in which the director was adjudged liable to the corporation, or in connection with any other proceeding charging improper personal benefit to the director in which he was adjudged liable on that basis. *Id.* §§ 8.51(d), 8.58(a). (A court may order indemnification in some such cases if it determines that the director is fairly and reasonably entitled to indemnification in view of all the relevant circumstances. *Id.* § 8.54.) The corporation must report to its shareholders the indemnification of directors. *Id.* § 16.21. The corporation's articles of incorporation must authorize one or more classes of shares that together have unlimited voting rights and one or more classes of shares that together are entitled to receive the corporation's net assets on dissolution. *Id.* § 6.01(b).

104. Cal. Corp. Code § 301(a) (West 1977).

105. *Id.* § 1501.

106. *Id.* §§ 181, 1200, 1201.

107. For example, distributions are more tightly limited. *Id.* § 500.

A small publicly held corporation whose business is based in California may not be able to avoid the force of the California statute by incorporating elsewhere, even if it wishes to do so, because many provisions of the statute are applicable to corporations that do more than half their business in California and have more than half their record shareholders in California, regardless of their state of incorporation. *Id.* § 2115. On § 2115 and its exceptions, see 3 H. Marsh, *Marsh's California Corporation Law* § 24.15 (2d ed. 1982).

the Securities Exchange Act.¹⁰⁸ It will then be subject to a further and very extensive layer of mandatory rules concerning traditional and positional conflicts. For example, the corporation's directors, officers, and other employees may not trade in the corporation's securities on the basis of material undisclosed information.¹⁰⁹ Its directors, officers, and shareholders owning at least 10 percent of the voting securities must give up any profits from short-swing trades even if the trades were not based on inside information.¹¹⁰ The corporation must file annual reports that include annual financial statements audited by an independent public accountant, a management report on the corporation's financial condition and results of operations, and additional disclosures concerning specified matters.¹¹¹ It must file quarterly reports that include quarterly financial data prepared in accordance with generally accepted accounting principles, a management report, and additional disclosures concerning specified matters.¹¹² It must file current reports that describe the occurrence of specified events.¹¹³ Proxies may not be solicited by management unless the shareholders are furnished with a written proxy statement containing specified information concerning the transaction to be acted upon.¹¹⁴ The proxy statement for an annual meeting at which directors are to be elected must make extensive disclosure concerning conflict-of-interest transactions and executive compensation.¹¹⁵ Such a proxy statement must be accompanied by an annual report that includes audited balance sheets for the corporation's last two fiscal years, audited income statements and statements of change in financial condition for its last three fiscal years, and other specified information.¹¹⁶ Shareholders must be permitted to

108. Securities Exchange Act § 12(g)(1)(B), 15 U.S.C. § 78l(g)(1)(B) (1982); Rule 12g-1, 17 C.F.R. § 240.12g-1 (1988).

109. Securities Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1982); Rule 10b-5, 17 C.F.R. § 240.10b-5 (1988).

110. Securities Exchange Act § 16(b), 15 U.S.C. § 78p(b) (1982).

111. Rule 13a-13, 17 C.F.R. § 240.13a-13 (1988), and Form 10-K, 17 C.F.R. § 249.310 (1988). The specified matters include legal proceedings and defaults on senior securities. See 4 Fed. Sec. L. Rep. (CCH) ¶ 31,102 (Apr. 5, 1989).

112. Rule 13a-1, 17 C.F.R. § 240.13a-1 (1988), and Form 10-Q, 17 C.F.R. § 249.308a (1988). The specified matters include legal proceedings, executive compensation, and conflict-of-interest transactions. See 4 Fed. Sec. L. Rep. (CCH) ¶ 31,032 (Apr. 5, 1989).

113. Rule 13a-11, 17 C.F.R. § 240.13a-11 (1988), and Form 8-K, 17 C.F.R. § 249.308 (1988). The specified events include a change in control of the corporation, an acquisition or disposition of a significant amount of assets, and a change of accountants.

114. Rules 14a-2, 14a-3(a), 17 C.F.R. §§ 240.14a-2, 240.14a-3(a) (1988).

115. Schedule 14A, 17 C.F.R. § 240.14a-101 (1988). The proxy statement for such a meeting must also disclose whether the corporation has audit, nominating, and compensation committees, and if so, the number of meetings each committee held during the last fiscal year and the functions it performs. *Id.* Item 7.

116. Rule 14a-3(b), 17 C.F.R. § 240.14a-3(b) (1988).

include a wide variety of proposals in the corporate proxy statement.¹¹⁷ The corporation's form of proxy must identify clearly and impartially each matter or group of related matters intended to be acted upon.¹¹⁸ Shareholders must be afforded an opportunity to specify in the proxy a choice between approval, disapproval, or abstention with respect to each matter or group of related matters, and to withhold authority to vote for directorial nominees.¹¹⁹ A proxy normally may not confer discretionary authority to vote on an issue unless it states in bold-face type how the shares represented by the proxy will be voted on the issue.¹²⁰ A proxy may not confer authority to vote at any annual meeting other than the next annual meeting.¹²¹ And so forth.¹²²

Finally, most very large publicly held corporations are listed on the New York Stock Exchange, which has had a virtual monopoly in the liquid trading market for the stock of such corporations and imposes a variety of constitutive rules on listed corporations. Among other things, corporations listed on that Exchange must have at least two outside directors, must have an audit committee composed of independent directors, and must obtain shareholder approval for most economically significant corporate combinations.¹²³

In short, corporation law taken as a whole—that is, taken to include state law and federal law, and the rules of the New York Stock Exchange as a *de facto* legislator by virtue of its monopolistic power—contains a significant number of core mandatory rules to govern divergencies of interest between top managers and shareholders. And to a significant extent, these are just the mandatory rules that corporation law should contain.

D. Alternative Descriptions of Corporation Law and the Corporation

Three classes of argument may be made against the principle that the fiduciary and structural rules governing material divergencies in interest between top managers and shareholders in publicly held corporations should be and for the most part are mandatory. The first

117. Rule 14a-8, 17 C.F.R. § 240.14a-8 (1988).

118. Rule 14a-4, 17 C.F.R. § 240.14a-4 (1988).

119. *Id.* § 240.14a-4(b)(1) (1988).

120. *Id.*

121. *Id.* § 240.14a-4(d)(2) (1988).

122. For example, under Securities Exchange Act § 14(c), 78 U.S.C. § 78n(c) (1982), Regulation 14C, 17 C.F.R. § 240.14c-1-7 (1988), and Schedule 14C, 17 C.F.R. § 240.14c-101 (1988), a corporation that is registered under Securities Exchange Act § 12(g) must distribute an information statement and an annual report in connection with an annual meeting at which directors are to be elected, even if the corporation is not soliciting proxies.

123. New York Stock Exchange Listed Company Manual ¶¶ 303.00, 312.00 (1983). The monopoly position of the New York Stock Exchange, and with it the Exchange's power to impose constitutive rules, has been weakened, but not yet eliminated, by the development of NASDAQ.

argument, which will be considered in this section, is that both corporation law and the corporation are essentially contractual in nature. One branch of this argument is that *corporation law* is essentially enabling and suppletory—or, as it has been put by Professor Fischel, that “corporate statutes provide a set of standard-form terms, but firms are generally free to alter these terms in their charters or by-laws.”¹²⁴ The second branch of the argument is that the *corporation* is a “nexus of contracts.”¹²⁵ Both branches of the argument are descriptively erroneous.

The characterization of corporation law as a standard-form contract whose terms each firm is generally free to vary is belied by the great number of mandatory rules of corporation law.¹²⁶ It is true that most of a corporation’s constitutive rules will be adopted by private action. That is because most of a corporation’s constitutive rules concern the roles, coordination, supervision, and monitoring of corporate agents below the level of top managers, and such rules should and will be determined by private ordering. (Indeed, many or most of the constitutive rules that define and coordinate the tasks of top managers also should and will be determined by private ordering, because many or most such rules do not involve divergencies of interest between top managers and shareholders.) It is also true that many rules of corporation law are enabling or suppletory rather than mandatory.

What is not true is that corporations are “generally free” to vary the rules of corporation law. Many of the most important rules of corporation law—such as those dealing with unfair self-dealing, insider trading, proxy voting, and disclosure—are largely mandatory, at least for publicly held corporations. It is descriptively inaccurate to characterize corporation law as essentially either enabling and suppletory on the one hand, or mandatory on the other. Furthermore, for reasons

124. Fischel, *Labor Markets and Labor Law Compared with Capital Markets and Corporate Law*, 51 U. Chi. L. Rev. 1061, 1063 (1984); see also Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L. & Econ. 395, 401 (1983) (“The code of corporate law is a standard form contract for issues of corporate structure.”); Fischel, *The Corporate Governance Movement*, 35 Vand. L. Rev. 1259, 1264 (1982) (“Fiduciary duties serve. . . as a standard form contractual term . . .”).

125. See, e.g., Fama & Jensen, *Separation of Ownership and Control*, 26 J.L. & Econ. 301, 302 (1983); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 310 (1976).

126. See *supra* text accompanying notes 5–28, 41–43, 85–123 (setting out some of these rules).

In his comment on this Article, Professor McChesney (like many other contractarians) recognizes that corporation law has many mandatory elements. McChesney, *Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg*, 89 Colum. L. Rev. 1530, 1537 (1989). Having said that, however, he makes the following two wholly inconsistent arguments: (1) Corporation law should be radically reformed, by making it completely enabling and suppletory. *Id.* at 1534–35. (2) Those who propose reforms in corporation law have failed to demonstrate the existence of any problems in corporation law. *Id.* at 1539–40 & n.33 (quoting Fischel, *The Corporate Governance Movement*, *supra* note 124, at 1265).

already discussed,¹²⁷ a body of corporation law that *was* essentially enabling and suppletory would be normatively undesirable.

The characterization of the corporation as a nexus of contracts is also inaccurate. A corporation is a profit-seeking enterprise of persons and assets organized by rules. Some of these rules are determined by contract or other forms of agreement, but some are determined by law, and most are determined by the unilateral action of corporate organs or officials.

The problem with the nexus-of-contracts conception transcends its inaccuracy. For some commentators, the view of the corporation as a nexus of contracts carries heavy normative freight, because, having premised that the corporation is a nexus of contracts, they then argue that mandatory rules are anticontractarian.¹²⁸ Once it is understood that the premise of this argument is incorrect, because the corporation is not a nexus of contracts but an enterprise organized by rules, many or most of which are adopted by the unilateral action of managers, the argument that mandatory rules are anticontractarian falls of its own weight.

To make up for the paucity of real contracts, it is sometimes argued that the corporation consists of a web of "implicit contracts."¹²⁹ The term "implicit contracts" is extremely misleading. It is borrowed from labor economics, and as used in that discipline it refers to relationships that are neither contracts nor bargains.¹³⁰ A contract is a legally enforceable bargain, or, at the least, a legally enforceable promise.¹³¹ In contrast, in labor economics the term *implicit contract* refers to a state of affairs in which a worker chooses to accept a lower wage rate from Firm A than he could get from Firm B, with the expectation that for reasons of self-interest, fairness, or altruism—that is, for reasons other than the sanction of a contract or other legally enforceable obligation—Firm A will provide an advantage that Firm B would not. For example, workers may accept a lesser wage rate at Firm A because they believe, based on past practice, that there is a lower probability of being laid off at Firm A than at Firm B. More generally, "implicit contracts" are relationships that are marked *not* by a real bargain, let alone a legally enforceable commitment, but by a tacit expectation, or at most a tacit understanding. Such relationships are not unique to business; indeed, such relationships are ubiquitous in inti-

127. See *supra* Parts II.A, II.B. Further reasons are developed in Part III, *infra*.

128. See McChesney, *supra* note 126, at 1536.

129. See, e.g., Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, in *Knights, Raiders, & Targets* 77, 85, 107, 110–12 (J. Coffee, L. Lowenstein & S. Rose-Ackerman eds. 1988).

130. See Rosen, *Implicit Contracts: A Survey*, 23 J. Econ. Lit. 1144, 1149 (1985) ("an implicit contract must be interpreted in the 'as if' sense of an explicit one").

131. See Restatement (Second) of Contracts § 1 (1981) ("A contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty.").

mate settings like marriage and friendship. They are relationships in which for some reason—often, some very good reason—legal enforceability and explicit bargaining is deliberately avoided.

It is true that sometimes tacit understandings slide into implied-in-fact promises that do give rise to legally enforceable contracts,¹³² and that sometimes tacit understandings provide a basis for legally enforceable fiduciary obligations.¹³³ These cases, however, involve a metamorphosis of the relationship, because it is a central characteristic of "implicit contracts" that they are *not* legally enforceable.¹³⁴ The use of "implicit contract" terminology in the corporate context screens out real and important differences between laid-down rules and real contracts. Contracts and bargains are forms of private ordering, but they are not the only such forms. "Implicit contracts" are forms of private ordering, but they are not contracts. Most of a corporation's constitutive rules are not determined by law, but neither are they determined by contract.

E. *The Effect of Markets and Other Forms of Private Ordering*

A second class of arguments that might be made against the principles developed so far is that market forces so adequately align the interests of top managers and shareholders and so adequately address the problem of managerial inefficiency that mandatory legal rules to address these issues are unnecessary and indeed undesirable.¹³⁵

132. One unfortunate aspect of the term "implicit contract" is that it phonetically resembles the term "implied contract," while in fact the two terms describe two entirely different concepts. An implied contract may be either a real contract (a contract implied in fact) or a legal obligation that is not contractual but is denominated contractual for purely historical reasons (a contract implied in law). In contrast, an "implicit contract" is neither a real contract nor a legal obligation.

133. See, e.g., *Meiselman v. Meiselman*, 309 N.C. 279, 307–11, 307 S.E.2d 551, 567–70 (1983).

134. I owe this point to Ron Gilson.

135. Those commentators who argue that market forces make mandatory legal rules unnecessary do not claim that such forces completely eliminate the divergencies of interest between managers and shareholders. Rather, they claim that such forces so greatly reduce the divergence of interest between investors and managers that any attempt to reduce the remaining divergence even further by the use of mandatory legal rules would not be worth the costs. See, e.g., Fischel, *The Corporate Governance Movement*, *supra* note 124, at 1265.

Those who make such arguments are often somewhat ambiguous about the role of law. For example, Fischel claims that "[t]he combination of direct monitoring, market forces, and legal rules operate greatly to reduce the divergence of interests between investors and managers." *Id.* at 1265 (emphasis added). However, Fischel characterizes the legal rules as "a standard form contractual term," which "serves as an alternative or a supplement to . . . writing lengthy and complicated contracts." *Id.* at 1264. Presumably, this characterization is intended to mean that the legal rules, like the rules in other standard form contracts, are merely supplementary or default rules. See the statement by Fischel quoted *supra*, text accompanying note 124. If Fischel and other commentators who characterize legal rules as standard form contracts believe that legal rules are

Arguments of this type are on their face both descriptive and normative. They are descriptive insofar as they purport to set forth the outcomes of actual market forces. They are normative insofar as they claim that mandatory rules to govern divergencies of interest are undesirable because dependence solely on market forces would result in more efficient outcomes. None of the most prominent arguments that have been or may be made are persuasive in the present world.

1. *Product Markets*. — At the outset, it is occasionally argued that managers are severely inhibited from pursuing their own interests or acting inefficiently because product markets often will render insolvent any firm that does not minimize costs.¹³⁶ This argument seriously overstates the power of product markets.¹³⁷ Although a highly competitive market may have this effect, an imperfectly competitive market will not quickly convert unfair self-dealing or inefficiency into insolvency.¹³⁸ Most publicly held corporations have sufficient resources and market power to absorb substantial losses resulting from inefficiency, gross miscalculations, or unfair self-dealing.

2. *Management Compensation*. — A more weighty argument is that the interests of managers and shareholders are adequately aligned by executive compensation, because such compensation is closely tied to shareholder gain.¹³⁹ It seems likely that compensation has some alignment effect. Empirical studies have shown that there is indeed a statistically significant relationship on average between shareholder gain, measured by returns to common stock, and executive salaries and bo-

mandatory, their characterization is incorrect but their view of the rules would then be comparable to mine.

136. See Butler, *The Contractual Theory of the Corporation*, 11 Geo. Mason U.L. Rev., Summer 1989, at 99, 114; Dooley & Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 Bus. Law., 503, 526 (1989); Fischel, *The Corporate Governance Movement*, supra note 124, at 1264.

137. Cf. Jensen & Meckling, supra note 125, at 330 ("[T]he existence of competition in product . . . markets will not eliminate the agency costs due to managerial control problems. . . . If my competitors all incur agency costs equal to or greater than mine I will not be eliminated from the market by their competition.").

138. See J. Tirole, *The Theory of Industrial Organization* 277-303 (1988).

139. See, e.g., Coughlan & Schmidt, *Executive Compensation, Management Turnover, and Firm Performance: An Empirical Investigation*, 7 J. Acct. & Econ. 43, 46 (1985):

[T]he existence of competition in capital markets makes the survival of corporations depend on the construction of incentive arrangements which encourage top management to act in the shareholders' interest. Firms which fail to compensate managers in this way will face higher costs and thus will not compete successfully with firms whose managers act in the shareholders' interest.

See also Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U.L. Rev. 913, 919 (1982) ("Various compensation packages such as stock option plans, which cause managers to share the risk bearing function with shareholders, provide managers with an incentive to maximize shareholders' wealth and keep stock prices high.").

nuses.¹⁴⁰ However, "significance" in statistics bears no necessary relationship to the ordinary meaning of significance—that something is important.¹⁴¹ Although the relationship between compensation and corporate performance is *statistically* significant, it is not *economically* significant. Based on a study of 2,214 chief executive officers during 1974–86, Jensen and Murphy determined that on average the chief executive's salary and bonus changed only 1.4 cents for each change of 1000 dollars in shareholder wealth.¹⁴² They illustrate the trivial nature of this relationship as follows:

The [data implies] that a CEO receives an average pay increase of \$31,700 in years when shareholders earn a zero return, and receives on average an additional 1.35 cents for each \$1,000 increase in shareholder wealth. The median annual standard deviation of shareholder-wealth changes for firms in our sample is about \$200 million, so the average pay change associated with a stockholder-wealth change two standard deviations above or below the normal (a gain or loss of \$400 million) is \$5,400. Thus, the average pay increase for a CEO whose shareholders gain \$400 million is \$37,300, compared to an average pay increase of \$26,500 for a CEO whose shareholders lose \$400 million.¹⁴³

Jensen and Murphy also measured the relation between salary and bonus, and change in shareholder wealth based on stock performance, for the present and preceding year, rather than only the present year. This relationship was slightly stronger, but still trivial—2.2 cents, rather than 1.4 cents, for each change of 1,000 dollars in shareholder wealth.¹⁴⁴ If all benefits (other than those related to stock options) are taken into account, and the measurement is based on two years of lagged shareholder wealth rather than one, the relationship still amounts to only 3.3 cents in compensation per 1,000 dollars of change in shareholder wealth.¹⁴⁵

140. See Coughlan & Schmidt, *supra* note 139, at 53–60; M. Jensen & K. Murphy, *supra* note 69, at 5; Murphy, *Corporate Performance and Managerial Remuneration: An Empirical Analysis*, 7 J. Acct. & Econ. 11, 32–37 (1985).

141. See Gould, *Through a Lens Darkly*, Nat. Hist., Sept. 1989, at 16. Gould illustrates: "Mouse tails may be 'significantly' longer in Mississippi than in Michigan—meaning only that average lengths are not the same at some level of confidence—but the difference may be so small that no one would argue for significance in the ordinary sense." *Id.* at 16.

142. M. Jensen & K. Murphy, *supra* note 69, at 5–6.

143. *Id.* at 5–6.

144. *Id.* at 5–7. The relationship between salary and bonus, and three years of lagged shareholder wealth, was little different than the relationship for two years of lagged shareholder wealth. *Id.* at 7.

145. *Id.* at 5, 7.

If it is assumed that all increments in salary and bonus are permanent and that all CEOs will receive the increments until age 70, the average present value of the cash flow resulting from the sum of the change in salary and bonus from the present year until the year of retirement would add or subtract 30 cents per 1,000 dollars to the average chief

Salary, bonus, and benefits are so little related to shareholder gain because managers want it that way. In theory, a chief executive's compensation is determined by the board on the recommendation of an independent compensation committee, which in turn acts on the recommendation of an independent personnel department and (often) an independent outside consulting firm, all without the chief executive's participation. In practice, however, "the chief executive often has his hand in the pay-setting process almost from the first step."¹⁴⁶ Person-

executive's wealth. *Id.* at 8-9. For present purposes, however, these assumptions seem both inaccurate and inappropriate. The assumptions seem inaccurate, because bonuses are supposed to be dependent on performance, and a change in bonus therefore should be transitory, not permanent. (Jensen and Murphy recognize this, but were forced to adopt the assumption because their data source aggregated salary and bonuses.) The assumptions seem inappropriate, because they produce only an average present value for all chief executives and are therefore of no relevance for chief executives who are about to retire, and of limited relevance for chief executives who are close to retirement.

See also Shleifer & Vishny, *supra* note 48, at 10 ("No study we know of indicates that the incentives provided by extant compensation contracts effectively discourage most non-value-maximizing behavior.").

146. Williams, *Why Chief Executives' Pay Keeps Rising*, *Fortune*, April 1, 1985, at 66, 67, see also *id.*, (The CEO "generally approves, or at least knows about, the recommendation of his personnel executive *before* it goes to the compensation committee, and may take a similar pregame pass at the consultant's recommendations too."); Louis, *Business is Bungling Long-Term Compensation*, *Fortune*, July 23, 1984, at 64, 65 ("[T]he reality at most companies is that top management itself usually devises the executive compensation plan—hiring the consultants whose scheme is then ratified by the board of directors and shareholders . . .").

Cf. Crystal, *Where's the Risk in CEOs' Rewards?*, *Fortune*, Dec. 19, 1988, at 62, 62-63:

The implicit message of every broad-based incentive pay plan is, "We're all in this together. When the company prospers, we all do—and when it suffers, we suffer." Trouble is, in many companies that statement is obviously false. With a few notable exceptions, the CEOs suffer little or not at all no matter what happens to the company. . . .

....
How did this odd situation develop? Mainly as a result of several factors operating together:

Many CEOs receive huge base salaries. Remember that base salary is part of the CEO's aggregate remuneration, the part that, for practical purposes, is inert

Many companies' short-term incentive plans begin to generate bonus pools at levels of performance that are ridiculously puny. This writer's study of 100 major companies' bonus plans conducted a few years back showed that the typical company began to generate bonus money once it achieved a triflingly low 6% return on equity. (Last year the median [return on equity] of the FORTUNE 500 was 14.4%.)

Most executive bonus plans allow far too much discretion—and with discretion comes rationalization. It is amazing to see the clarity of vision demonstrated by CEOs and board compensation committees when it comes to spotting uncontrollable events that trigger downturns in company performance—events like rising oil prices, rising interest rates, hurricanes, and so forth. Yet it is equally amazing to see the cloudiness of vision demonstrated by the same CEOs and board compensation committees when it comes to spotting

nel executives who don't recommend what the chief executive officer wants may find that their jobs are at risk; consultants who don't recommend what the chief executive wants are unlikely to be invited back.¹⁴⁷

The value of executive stock options is also related to shareholder gain measured by returns on common stock. Here again, however, the dollar significance of the relationship is virtually immaterial—a change of 15 cents in the value of the chief executive's stock options for each change of 1,000 dollars in shareholder wealth.¹⁴⁸ The value of stock options as a mechanism to align adequately the interests of shareholders and top managers is further limited by the fact that while shareholders invariably lose wealth if the stock price decreases, top managers with stock options may not, because when the price of the stock goes down the board often reduces the option price to match the fall in the market.¹⁴⁹

In short, the argument that the interests of managers and shareholders are adequately aligned by executive compensation is descriptively inaccurate because the dollar amounts involved are trivial or immaterial. Moreover, this argument is based on a fallacy. The fallacy, which runs through a great deal of the literature on the alignment effect of market forces, is that mandatory rules are unnecessary because *on average* the interests of managers and shareholders are adequately aligned by market forces. I shall call this the average-manager fallacy.

The average-manager fallacy reflects a fundamental misunderstanding of the use of statistical evidence in determining whether mandatory legal rules are desirable. A statistically significant relationship between two variables, such as compensation and corporate performance, occurs when there is a high correlation between the two variables. The presence of a material number of cases that are not consistent with the overall relationship will not necessarily preclude a finding of statistical significance. Accordingly, a finding that a relationship between two groups of data is statistically significant—that there is a relationship between the two variables “on average”—may often mask

external events that spark upturns in company performance—events like falling oil prices, falling interest rates, and a booming economy. In the first case, compensation committees almost always cushion the CEO's pay from events that he arguably cannot control. But in the second case, those committees seem to assume that great performance is always a result of CEO brilliance: Therefore pay moves sharply upward.

147. Williams, *supra* note 146, at 66–67.

148. M. Jensen & K. Murphy, *supra* note 69, at 10–11, 45.

149. See, e.g., Cohen v. Ayers, 596 F.2d 733, 735–43 (7th Cir. 1979) (board of directors' decision to terminate and reissue overpriced options does not constitute waste); Michelson v. Duncan, 407 A.2d 211, 219–22 (Del. 1979) (shareholder ratification of plan to issue stock options was adequate to sustain directors' cancellation and reissue of options following sharp decline in stock price); Coffee, No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies, 53 Brooklyn L. Rev. 919, 943 (1988).

the fact that many members of each group are not related in a manner consistent with the underlying relationship. This may not be a problem when statistical techniques are intended to *describe* certain social phenomena, or when prediction is an important objective. However, in determining whether conduct should be *prescribed* or *prohibited* by a mandatory legal rule, it is not enough to say that there is a significant overall relationship. Rather, all cases, including those that are not consistent with the observed relationship, must be taken into account. Conduct may be legally prescribed or prohibited *just because* not all conduct clusters around the norm. For example, even though most parents would send their children to school even in the absence of a legal rule, we prescribe mandatory education for children because some parents will not. Similarly, we make perjury a crime even though most witnesses would tell the truth in any event, because in the absence of a sanction some witnesses would not. Whether conduct should be prescribed or prohibited on the one hand, or left unregulated on the other, depends on a prudential, case-by-case judgment whether the cost of adopting a mandatory rule to govern the conduct of those who will not voluntarily conform to a desired norm exceeds the cost of failing to adopt the rule, and, in that connection, whether a mandatory legal rule will increase voluntary self-regulation by emphasizing the weight that society gives to the norm. This equation cannot be solved by looking only at average conduct.

Applying these principles to corporate law, even if a given market mechanism does align the interests of most top managers and shareholders in a statistically significant and material way, such a relationship does not in itself tell us that mandatory rules are unnecessary. For example, even if the correlation between executive compensation and shareholder gain was both very high and material (which it is not), that would provide only limited help in determining the shape of corporate law unless we also know the extent to which the relationship holds throughout the executive population.

3. *Inside Stock Ownership*. — Closely related to the argument that the interests of shareholders and managers are adequately aligned by executive compensation is the argument that those interests are adequately aligned by managers' inside stock ownership, that is ownership of stock in their own corporations. It is true that managers, or at least chief executive officers, do tend to hold significant dollar amounts of stock in their own corporations. For example, Jensen and Murphy studied 73 chief executive officers of manufacturing companies and found that the officers' inside stock ownership averaged \$4.8 million, or \$8.8 million if shares held as a trustee and by members of the chief executive's family were taken into account.¹⁵⁰ Jensen and Murphy concluded that the value of inside stock held by the average chief executive would change

150. M. Jensen & K. Murphy, *supra* note 69, at 12.

\$1.31 or \$2.40 (depending on the sample) for each \$1,000 change in shareholder wealth.¹⁵¹

Certainly this data establishes that inside stock ownership is often large enough to have some alignment effect. What it does not establish is that inside stock ownership so adequately aligns the interests of the shareholders and managers that mandatory legal rules to control divergencies of those interests are unnecessary. For one thing, the median value of inside stockholdings has been decreasing dramatically. Based on the sample of 73 chief executive officers mentioned above, Jensen and Murphy found that the median value of chief executive officers' inside holdings had dropped from \$3,531,000 in 1969-73 to \$1,178,000 in 1979-83, while the median percentage of the firm owned by the chief executive officer (including members of his family and trusts) fell from .21% to .11%.¹⁵² Similarly, a study comparing the inside holdings of the chief executive officers of the 120 largest corporations in 1938 and 1984 showed a drop in the average percentage of the firm owned by the chief executive officer from .30% to .03%.¹⁵³

Much more importantly, the argument that inside holdings have the effect of adequately aligning the interests of shareholders and managers, like the argument that executive compensation has that effect, reflects the average-manager fallacy. The relevant questions include not simply the magnitude of average or median inside holdings, but the extent to which the relationship holds throughout the population. In fact, the relationship is extremely variable. A study by Jensen and Murphy of the inside holdings of 746 chief executives and their family members found that 40% had inside holdings worth less than \$2.5 million, 20% had inside holdings of less than \$700,000, and some had inside holdings worth less than \$100,000.¹⁵⁴

Moreover, even relatively significant inside holdings will have only a limited alignment effect in the three major areas in which the interests of top managers may diverge from those of shareholders. Take first the problem of unfair self-dealing. Assume that a manager who contemplates unfair self-dealing has a large inside holding. The manager's gain from the unfair self-dealing will nevertheless almost invariably swamp the resulting loss in the value in his stock, because the manager will normally realize the full value of the unfair self-dealing, but will lose only a fraction of the value of his stock. For example, suppose Corporation C has a net worth of \$1 billion, and Manager M owns C stock worth \$10 million. If M unfairly appropriates a corporate opportunity worth \$1 million, he will net \$990,000 even after taking into account the impact of his action on the value of his inside holdings.

151. *Id.* at 11, 13, 45.

152. *Id.* at 40-41. The measurement is in constant dollars.

153. *Id.*

154. *Id.* at 14; M. Jensen & K. Murphy, *Are Executive Compensation Contracts Structured Properly?* 28 (Oct. 14, 1987) (unpublished draft).

Inside holdings also will have little or no effect on efficiency. Few if any inefficient managers are likely to believe themselves inefficient. Accordingly, even the most inefficient managers will typically believe that their actions will increase the value of their inside holdings.¹⁵⁵

Finally, inside holdings will have little or no effect on positional conflicts. Financial gain is only one incentive for top managers. Other and often far more important incentives include the sense of accomplishment, the self-esteem, and the power that accompany a top management position.¹⁵⁶ The combined financial and nonfinancial value that a top manager places on his position is almost certain to swamp any possible loss in his inside holdings that results from actions he takes to maintain and enhance that position, even in the unlikely event that he believes those actions to be value-decreasing.

4. *The Market for Managers, the Prospect of Promotion, and the Risk of Discharge.* — Still another device that is said to adequately align the interests of managers and shareholders, and adequately address the problem of managerial inefficiency, is the market for managers.¹⁵⁷ The idea here is that managers who perform poorly will find it difficult to market themselves.

There is in fact a market for middle and lower managers, although it is somewhat limited because of skill specificity and asymmetric information.¹⁵⁸ However, it is top managers with whom corporation law should be and is concerned, and for these actors the market for managers, such as it is, is of limited relevance. That market is not relevant to the chief executive officer, because he is almost invariably in his final period as a manager.¹⁵⁹ It is of limited relevance to top executives other than the chief executive officer, because their major concern is satisfying the chief executive. It is not relevant to outside directors, because outside directorships are normally sideline activities.

A mechanism related to the market for managers is the prospect of

155. It is sometimes argued that the mere fact that managers invest in their own corporation indicates that they do not intend to exploit investors in the corporation, because if they did, they would invest somewhere else. This argument is one more reflection of the average-manager fallacy, because it assumes that all managers own substantial amounts of stock in the corporations they manage. Furthermore, a manager could exploit a corporation without damaging its essential profitability. Finally, the argument fails to address unfair self-dealing that managers convince themselves is fair, inefficient conduct by managers who believe themselves efficient, and conduct that gives expression to positional conflicts.

156. Cf. the Shleifer and Vishny passage quoted *supra* note 48.

157. See Dooley & Veasey, *supra* note 136, at 526; Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 (1980).

158. The limited mobility of managers is suggested by the fact that the typical chief executive has had only one other corporate employer. M. Jensen & K. Murphy, *supra* note 154, at 33.

159. See *id.* at 31 (most chief executives leave office only after reaching normal retirement age).

promotion. This prospect, however, has no effect on directors or chief executive officers, because they cannot be promoted.

Another mechanism related to the market for managers is the risk of discharge. There is evidence that suggests a relationship between corporate performance and the discharge of chief executives,¹⁶⁰ and undoubtedly the risk of discharge has an alignment effect. However, the relationship between corporate performance and risk of discharge is weak. Because the discharge of a chief executive is usually masked as a voluntary separation, there is little or no evidence concerning discharge as such, but only aggregate evidence on departures for all reasons, including poor health, retirement, death, and takeover. A study by Weisbach of departures for all reasons of chief executives younger than age 64 concluded that in the highest-performing decile of corporations, 3% of chief executives probably would depart in any given year, while in the lowest-performing decile 6% would depart—a difference of only 3 percentiles.¹⁶¹ Similarly, the difference between probable departures for all reasons in corporations whose performance was in the top and bottom quintiles was only two percentiles.¹⁶² The difference between the median corporation and corporations in the lowest decile was also only two percentiles.¹⁶³

Not only is the relation between departures and corporate performance weak, but the uniformity of the relationship is very low. The relation is apparently strongest for chief executives under age 50. For chief executives age 50–55 there is no significant relation.¹⁶⁴ For chief executives age 55–60 or past age 64 the relation is only marginally significant.¹⁶⁵ There is also no significant relation between departures and corporate performance in corporations in which 60% or more of the directors are either insiders or have significant relationships to management.¹⁶⁶

As Jensen and Murphy conclude, “[t]he data suggest that CEOs

160. See Coughlan & Schmidt, *supra* note 139, at 60–65; Warner, Watts & Wruck, *Stock Prices and Top Management Changes*, 20 *J. Fin. Econ.* 461 (1988); see also Weisbach, *Outside Directors and CEO Turnover*, 20 *J. Fin. Econ.* 431 (1988) (boards dominated by outsiders more likely to remove CEO for poor performance than boards dominated by insiders).

161. Weisbach, *supra* note 160, at 440. Warner, Watts & Wruck, *supra* note 160, at 477–79, predicted a difference of 5.3 percentiles between top and bottom deciles, 2.55 percentiles between top and bottom quintiles, and 1.35 percentiles between the median and the bottom deciles. Coughlan & Schmidt, *supra* note 139, at 60–65, found higher spreads—8 percentiles between top and bottom deciles, 5 percentiles between the median and the bottom decile, and 5 percentiles between top and bottom quintiles. See also M. Jensen & K. Murphy, *supra* note 69, at 12–21.

162. Weisbach, *supra* note 160, at 443.

163. *Id.*

164. M. Jensen & K. Murphy, *supra* note 69, at 16–17.

165. *Id.*

166. Weisbach, *supra* note 160, at 435–41.

bear little risk of being dismissed.”¹⁶⁷ This is not surprising. The chief executive can be discharged only by the board, and a majority of board members are often either subordinates of the chief executive or persons who have economic affiliations with the corporation that are under the chief executive’s control.¹⁶⁸ Furthermore, it is often difficult for even the most objective and discerning directors to know whether poor corporate performance can properly be laid at the chief executive’s feet, or is due instead to the decisions of his predecessors, exogenous circumstances, or the inefficiency of middle and lower managers.

5. *The Market for Corporate Control.* — Another market mechanism that has been claimed adequately to align the interests of shareholders and managers, and adequately to address the problem of managerial inefficiency, is the market for corporate control—that is, the takeover market. The now-familiar idea is that if the managers of a corporation act in their own interests rather than the shareholders’ interests, or are inefficient, a third party can make gains by bidding for the corporation’s stock at a price that is above the market price, but below the value the stock would have if the corporation was properly managed.¹⁶⁹

It seems clear that some takeovers are motivated by the inefficiency of the target’s management.¹⁷⁰ Therefore, at least some completed takeovers undoubtedly result in a substitution of more efficient managers for less efficient managers, or of more efficient allocations of resources for less efficient allocations. It also seems likely, although not uncontroversial, that the threat of takeover makes some managers more efficient, or causes some managers to allocate resources more efficiently than they otherwise would.¹⁷¹ Nevertheless, the takeover market neither adequately aligns the interests of managers and shareholders, nor adequately addresses the problem of managerial inefficiency.

To begin with, the takeover market has very little impact on traditional conflicts of interest. A hostile takeover bid cannot succeed unless it includes a premium that is significantly above the market price, partly because all existing shareholders value their stock at a price

167. M. Jensen & K. Murphy, *supra* note 69, at 18.

168. See *Principles of Corporate Governance: Analysis and Recommendations* § 3.04, reporter’s note 3 at 88–89 (Tent. Draft No. 2, Apr. 13, 1984); M. Eisenberg, *supra* note 46, at 144–48, 164–65.

169. See, e.g., Easterbrook & Fischel, *The Proper Role of a Target’s Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1173–82 (1981); Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110, 113 (1965).

170. See Jensen, *Takeovers: Their Causes and Consequences*, 2 J. Econ. Persp., Winter 1988, at 21, 28.

171. The effects of takeovers on managerial efficiency are discussed in Jarrell, Brickley & Netter, *supra* note 47; Shleifer & Vishny, *supra* note 48, at 7, 18; Jensen, *supra* note 170; Scherer, *Corporate Takeovers: The Efficiency Arguments*, J. Econ. Persp., Winter 1988, at 69, 76.

higher than the market price,¹⁷² and partly because the target's managers can create formidable obstacles to a takeover that can be overcome only by a substantial premium over market price. The premium for all takeovers runs between thirty and fifty percent over market price,¹⁷³ and in most cases it is probably impossible to make a successful hostile bid at less than a thirty percent premium. A hostile bidder must also pay very large fees to investment bankers, lawyers, and other professionals. Because of the need to expend these large premiums and fees, a takeover bid will almost never be economically justified if the bidder's only strategy is to end unfair self-dealing by incumbent managers. Furthermore, if a bidder acquires most of a target's stock, and the financial impact of past unfair self-dealing was reflected in the target's financial statements, the target will normally be barred by law from recovering the managers' gains from unfair self-dealing.¹⁷⁴

The takeover market also has only a limited effect on positional conflicts. The threat of takeover will not cause managers to avoid taking actions to maintain and enhance their positions at the shareholders' expense. Indeed, just the reverse has occurred. The threat of takeover has led many managers to cause the adoption of constitutive rules that make their ouster even more difficult than it would otherwise have been. Furthermore, the central problem posed by positional conflicts is the problem of inefficient managers who do not realize they are inefficient, and do their best as they see it. The threat of takeover will not affect the behavior of such managers: they are already doing all they can.¹⁷⁵

Even a manager who knows he is inefficient may not have too much to fear from the threat of a takeover. Takeovers are motivated by a variety of economic factors, of which inefficient management is only one, and not necessarily the most important.¹⁷⁶ As Jensen points out, "[m]ore than a dozen separate forces drive takeover activity, including

172. See Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 *Colum. L. Rev.* 1145, 1187-88 (1984).

173. See Jensen, *supra* note 170, at 22.

174. See *Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R.*, 417 U.S. 703, 710-11 (1974).

175. A distinction may be drawn between operating and resource efficiency. By *operating* efficiency, I mean the ability to manage the resources that the corporation holds in such a manner as to maximize the profits derived from those resources. By *resource* efficiency, I mean the ability to determine what resources the corporation should hold, and how those resources should be financed. The pressure of takeovers normally will not increase a manager's ability to operate the resources that the corporation holds, but it may force him to increase resource efficiency, as by selling off resources the corporation should not hold or refinancing the resources it continues to hold. I use the term "inefficient" in the text to mean operating inefficiency, that is, a failure to manage a corporation's existing resources so as to wring out maximum profits.

176. See Jensen, *supra* note 170, at 28; see also Shleifer & Vishny, *supra* note 48, at 16.

such factors as deregulation, synergies, economies of scale and scope, taxes, the level of managerial competence, and increasing globalization of U.S. markets."¹⁷⁷ A significant portion of the resources devoted to takeovers seems to be directed not at taking over poorly managed corporations, but rather at taking over well-managed corporations. Indeed, it seems likely that in some takeovers the target is better managed than the bidder.¹⁷⁸ Those resources that are directed at poorly managed corporations will probably not be directed at corporations that are managed in only a moderately inefficient way, because replacing a management that is only moderately inefficient will normally not produce sufficient gains to justify the huge premium and out-of-pocket costs required to mount a successful takeover.

In a well-known article,¹⁷⁹ Easterbrook and Fischel argued that managers should be prohibited from engaging in defensive actions against takeovers even if the purpose of the actions was to create an auction and thereby increase the premiums paid to the shareholders, on the ground that the need to pay high premiums interferes with the operation of the takeover market as an interest-alignment and efficiency-monitoring device.¹⁸⁰ This argument has not been accepted by either courts or legislatures. The courts have approved a variety of defenses and the promotion of bidding contests,¹⁸¹ and state legislatures have made takeovers harder rather than easier.¹⁸² Nevertheless, the argument is instructive. The premise of the argument is that if high premiums were eliminated, the takeover market would adequately align the interests of managers and shareholders and adequately address the problem of managerial inefficiency, and would thereby render mandatory legal rules to control these problems unnecessary. The negative implication is that if legal and business conditions result in a regime of high premiums, which they do, the divergencies of interests between managers and shareholders, and the problem of managerial inefficiency, will not be adequately dealt with by the market for managerial control. Instead, these issues must be addressed, at least in part, by mandatory legal rules. Indeed, mandatory rules that help prevent positional conflicts from interfering with the operation of the market for corporate control can be justified on the ground that they act to *protect* the operation of the market.

177. Jensen, *supra* note 170, at 28.

178. See Herman, *The Limits of the Market as a Discipline in Corporate Governance*, 9 Del. J. Corp. L. 530, 536-37 (1984).

179. Easterbrook & Fischel, *supra* note 169.

180. *Id.* at 1174-80.

181. See, e.g., *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1350 (Del. 1985) (defensive action against takeover threat upheld); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (same).

182. See, e.g., Del. Code Ann. tit. 8, § 203 (1983 & Supp. 1988); Ind. Code Ann. § 23-1-42 (Burns Supp. 1989); N.Y. Bus. Corp. Law § 912 (McKinney 1986 & Supp. 1989); Wis. Stat. Ann. § 180.726 (West Supp. 1988).

6. *The Market for Capital.* — Another market-forces argument is that the market for capital will adequately constrain managers from adopting constitutive rules that are in the managers' interests but against the shareholders' interests.¹⁸³ I shall refer to such rules as managerial rules. The idea of the argument is as follows: The adoption of a managerial rule would reduce the price of the corporation's stock. Reducing the price of the corporation's stock would increase the cost of the corporation's capital. Increasing the cost of the corporation's capital will lead either to bankruptcy of the corporation through the operation of the product market or ouster of management through the operation of the takeover market.

An analysis of the effect of the adoption of a managerial rule on the product and the capital markets shows that the capital market is unlikely to adequately align managerial and shareholder interests.

a. *Effect on the Product Market.* — To begin with, a corporation's ability to compete in the product market will not be impaired at all by the adoption of a managerial rule unless its out-of-pocket expenses are increased or its cash flow is reduced. However, many managerial rules are value-decreasing not because they increase present out-of-pocket expenses or decrease cash flow, but because they may lead to reduced profits at some point in the future or create the possibility of a future redistribution of corporate profits from shareholders to managers. Poison pills, for example, are normally value-decreasing only for these reasons. Adoption of a managerial rule may therefore have no present impact on out-of-pocket expenses or cash flow.

Of course, it can be argued that when a corporation that has adopted a managerial rule *does* go into the market to raise capital by the sale of stock, it will find that the price of its stock is lower, and therefore the price it must pay for capital is higher. However, although this impact may have an effect on the takeover market (an issue I consider below¹⁸⁴), a potential impact at some point in the future may have little or no significance to present managers insofar as they are concerned with the ability of the corporation to compete in the product market.¹⁸⁵

183. See Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 Del. J. Corp. L. 540, 556-57 (1984); Fischel, *The Corporate Governance Movement*, *supra* note 124, at 1264; Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Leg. Stud. 251, 275-76 (1977).

184. See *infra* note 201 and accompanying text.

185. In a comment on this Article, Winter criticizes this argument on the ground that

[e]ven if the side payments will have an effect only in the future, investment analysts will know (if true) that the earnings of Delaware corporations are lower in the long run than the earnings of businesses incorporated elsewhere, and this recognition would have a present effect on investors. That effect will necessarily be of significance to managers.

Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 Colum. L. Rev. 1526, 1526-27 (1989). Winter erroneously conflates the operation of the product and takeover markets. I agree that the impact of the valuations of investment analysts

Furthermore, a value-decreasing managerial rule may have little or no impact on out-of-pocket expenses even in the future. To begin with, few publicly held corporations raise capital by issuing new stock. A primary source of capital for most corporations is internally generated cash.¹⁸⁶ Publicly held corporations issue new equity on average only once every eighteen years—"less often than locusts."¹⁸⁷ Between 1973 and 1982, net stock issues provided an annual average of 2.1% of corporate funding.¹⁸⁸ Many corporations almost never issue new equity.¹⁸⁹ To the extent a corporation finances itself from internally generated cash, the capital market will have no significant disciplinary effect through the product market.¹⁹⁰

The capital market may also have no significant disciplinary effect through the product market if a corporation prefers to meet its capital needs by issuing debt, so long as the adoption of a managerial rule has no effect on profits or cash flow through the product market.¹⁹¹

may affect managers through the *takeover* market. However, they will not necessarily affect managers through the *product* market. The difference is important because of the huge premiums that are required to effect takeovers. See *supra* notes 172-174 and accompanying text.

186. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 Mich. L. Rev. 613, 648 (1988) (operating revenues finance an average of 61% of corporate expenditures; corporate borrowing provides 36%).

187. *Id.* at 647.

188. *Id.*

189. *Id.* at 647 n.185.

190. In a comment on this Article, Winter argues that

[t]he cost of internal financing is the opportunity cost or the highest return available from investment outside the firm. If a corporation can earn 15 percent on an outside investment, then the cost of investing internally is also 15 percent.

Winter, *supra* note 185, at 1527. This argument is incorrect insofar as it implies that an opportunity cost is an out-of-pocket cost. An increase in out-of-pocket costs can drive a corporation into bankruptcy in the product market. An increase in opportunity costs cannot.

191. It has been argued that a corporation whose stock price is rising can borrow more, at a lower interest rate, than a corporation whose stock price is declining. See W. Baumol, *The Stock Market and Economic Efficiency* 81 (1969). Certainly there might be a marginal effect on the cost of debt where a lender bases its credit decision on the market value of the corporation's equity, rather than on profits, cash flow, and liquidation values. But

[t]he flaw in the debt-to-equity ratio argument is that it assumes that banks evaluate leverage by measuring debt load against market equity prices, rather than against the value of the corporation's underlying earnings and assets. The bank that readily lends on the basis of high share value unsupported by assets or revenues is unlikely to stay in the banking business long. Nor would rational lenders be deterred by depressed stock prices if the assets and revenues to support the loan exist. Banking literature confirms that lenders prefer to measure risk by comparing outstanding debt against the value of a corporation's underlying assets, rather than the market price of its stock.

Stout, *supra* note 186, at 649-50; see also *id.* at 650 n.202 ("Many of the credit-scoring

Even in the relatively uncommon case in which a publicly held corporation prefers to finance itself by issuing new stock, the capital-market argument has little force. There is strong evidence that many significant changes in a corporation's constitutive rules do not have a statistically significant effect on the price of the corporation's stock. Weiss and White conducted an event study of the effect of seven major Delaware judicial decisions on stock prices of Delaware corporations.¹⁹² Each of these decisions made important changes in significant constitutive rules: one commentator characterized four of the decisions as "radical departures from prior law"¹⁹³ and a fifth as breaking new ground.¹⁹⁴ Yet Weiss and White found that the market reaction to the decisions was almost uniformly not statistically significant.¹⁹⁵ In a comment on the Weiss and White data, Fox pointed out that even if changes in constitutive rules are negatively priced by the market, that pricing would not necessarily be discernible at a statistically significant level under the standard technique used in conducting event studies:

For the price change that accompanies [an] announcement . . . to be considered statistically significant, it must be sufficiently different from zero that one can, with reasonable confidence, reject the "null hypothesis" that the true effect . . . is zero and that the observed change results solely from other chance factors. The "standard error" is a statistically derived estimate of the tendency of these other factors to cause the *observed* price changes to deviate from the *actual* effect . . . on prices. Assume for our example a standard error of 0.65, which is representative of the standard error in the Weiss and White tests. The observed adjusted price change would have to be at least 1.3% before we could reject the null hypothesis with 95% confidence. There is less than one chance in twenty

formulas used by commercial lenders to evaluate the creditworthiness of corporate borrowers do not consider stock price at all. . . . Those credit-scoring models that do consider market equity price consider it as only one out of five or more factors, and a lightly weighted one at that.").

192. Weiss & White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 Calif. L. Rev. 551, 569-602 (1987) (studying effect on share prices of: *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Lynch v. Vickers Energy Corp.*, 429 A.2d 497 (Del. 1981); *Lynch v. Vickers Energy Corp.*, 383 A.2d 278 (Del. 1977)); *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977); *Weinberger v. UOP, Inc.* 426 A.2d 1333 (Del. Ch. 1981), rev'd, 457 A.2d 701 (Del. 1983); *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980), rev'd sub nom. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). The market's reactions to the Chancery and Supreme Court decisions in *Maldonado* were measured separately.

193. Fischel, *supra* note 139, at 942.

194. Fischel, *The Appraisal Remedy in Corporate Law*, 1983 Am. B. Found. Res. J. 875, 894-96.

195. Weiss & White, *supra* note 192, at 582. For one of the seven cases there were statistically significant positive returns to a Delaware portfolio on the fourth and ninth days after the announcement of the decision. *Id.*

The results for a non-Delaware portfolio were generally comparable. *Id.*

that an increase of 0.1% in the actual value of a sample portfolio will be accompanied by an observed change in prices sufficiently large, that is, 1.3%, to be considered statistically significant.¹⁹⁶

Even a managerial rule that does have a measurable effect will not necessarily increase out-of-pocket costs. For example, suppose that because C Corporation has adopted a poison pill, C's stock sells for \$49 instead of \$50.¹⁹⁷ C wants to raise \$500,000 in the capital market for equity. The poison pill will not raise C's out-of-pocket cost of capital: C simply issues 10,204 shares instead of the 10,000 shares it would have issued without the rule. Of course, the value of the stock held by existing shareholders may fall, which may effect C in the *takeover* market, but C's ability to compete in the *product* market will remain unaffected. (Dilution of the value of a corporation's stock is a cost, but the point is that this cost is typically borne by the shareholders rather than the managers, and in any event is not the kind of cost that will have a significant effect in the product market.)¹⁹⁸

Suppose the managerial rule does increase out-of-pocket expenses or reduce cash flow. Because of the slack in most product markets, most corporations would not be at risk of failure in the product market unless out-of-pocket expenses were significantly increased or cash flow was significantly reduced. However, even those managerial rules that do have a measurable effect on stock prices are likely to have only a

196. Fox, *The Role of the Market Model in Corporate Law Analysis: A Comment on Weiss and White*, 76 Calif. L. Rev. 1015, 1036 (1988) (emphasis in original).

197. By way of comparison, Securities & Exchange Commission, Office of the Chief Economist, *The Effects of Poison Pills on the Wealth of Target Shareholders* 30-31 (Oct. 23, 1986), found that the adoption of a poison pill resulted in a negative return of .66% across the entire sample studied. For a subsample of companies where takeover speculation existed at the time the pill was adopted, the negative return was 1.74%. For a subsample of companies subject to takeover speculation that adopted a more effective type of pill, the negative return was 2.21%.

Similarly, Ryngaert, *The Effect of Poison Pill Securities on Shareholder Wealth*, 20 J. Fin. Econ. 377 (1988), found that announcement of the adoption of a poison pill resulted in a negative return of .34% across the sample studied. *Id.* at 391. For a subsample of companies where takeover speculation existed at the time of adoption, the negative return was 1.51%. *Id.* at 391-92. For a subsample of companies subject to takeover speculation that adopted a more effective type of poison pill, the negative return was 2.12%. *Id.* at 393-94.

198. In a comment on this Article, Winter objects that "[t]his hypothetical appears to be based on the assumption that share price is independent of the number of shares issued. That assumption is plainly unsound. If it were correct, C Corporation would issue 39 trillion shares at \$49 instead of the 10,204 Eisenberg postulates." Winter, *supra* note 185, at 1527. This objection is somewhat difficult to understand, because the hypothetical assumes that the corporation only wants to raise \$500,000. Putting that aside, the objection seems to mistake the operation of the takeover market with the operation of the product market. Suppose the corporation issued, say, 102,040 shares. And suppose that the shares were issued at less than \$49. That would affect the corporation in the *takeover* market, but it would not affect the corporation in the *product* market.

relatively small effect.¹⁹⁹ Relatively small effects will not lead to bankruptcy in most product markets, particularly if, as is often the case, the corporation retains earnings and does not reenter the capital markets.²⁰⁰

In short, the adoption of a managerial rule would rarely lead to bankruptcy in the product market, because such a rule would rarely have any present impact on out-of-pocket costs and would often have no significant impact even on future out-of-pocket costs. Any impact that such a rule did have on out-of-pocket costs would normally be swamped by the slack in the product market.

b. *Effect on the Takeover Market.* — Although a managerial rule that has no impact on expenses or current cash flow may have no effect on the corporation's ability to compete in the product market, such a rule may cause the price of the corporation's stock to fall, which in turn could have an effect in the takeover market. But any decrease in the value of a corporation's stock that results from the adoption of a managerial rule will be typically either not measurable or relatively small²⁰¹

199. See *supra* notes 196–198 and accompanying text.

200. See *supra* notes 186–189 and accompanying text.

201. Merritt Fox, in a comment on an earlier draft of this Article, worked out the effect of a small but measurable change on the price of a new issue as follows, employing the hypothetical set out at *supra* notes 196–200 and accompanying text:

[S]uppose a corporation has assets that would produce a permanent cash flow available for shareholders of \$500,000 per year (in other words its gross cash flow is sufficiently large to leave \$500,000 after payment of operating expenses, interest on debt and the cost of purchasing new productive assets to replace those that have worn out during the year). The discount rate is 10%. The value of the equity of this firm, absent the managerial rule, would thus be \$5 million. If there are 100,000 shares, they would be priced in an efficient market at \$50 each. Imposition of the managerial rule reduces the net cash flow to \$490,000, the value of the equity to \$4.9 million and the share price to \$49. If the cash flow is certain in this example, the corporation can continue operating under the managerial rule without the slightest risk of bankruptcy and would have no need to reenter the capital markets. . . .

[A]ssume that the corporation wishes to raise \$500,000 to invest in a project that will produce a net cash flow of \$50,000 (i.e., a market rate of return) and with respect to which the managerial rule will not be imposed. . . . The net cash flow of the corporation after the expansion will be \$540,000 and the value of the equity will be \$5.4 million. If the corporation proposes to raise the \$500,000 by offering 10,204 shares at \$49, the public will willingly pay the price. The value of the equity will be \$5.4 million and \$5.4 million/110,204 = \$49.00.

[A]ssume now that the corporation wishes to raise the \$500,000 to invest in [a new] project but that it plans to extend the managerial rule to these new operations The net cash flow of the corporation after the expansion will be \$539,000 and thus the value of the equity will be \$5.39 million: . . . Set $E = \$5.39$ million (the value of the equity after the investment), $I = \$500,000$ (the amount that must be raised for the new project) and $S = 100,000$ (the number of shares initially outstanding). Take p as the price at which the shares will be offered and [let] n be the number of shares that must be issued at p in order to raise I . An efficient capital market imposes the following conditions:

and relatively small effects on the market price of a corporation's stock will not trigger a hostile takeover because they will be swamped by the huge premium and fees required. Therefore, the capital market, operating through either the product or takeover markets, will seldom if ever prevent managers from adopting managerial rules.

That the financial effects of the market mechanisms considered so far will not in themselves adequately align the interest of managers and shareholders does not mean that managers will act only in their own interest except so far as constrained by law. Many or most managers will probably act in the shareholders' interests, even if not constrained to do so by market mechanisms, because they have internalized the moral principles of corporate stewardship. Those principles, however, have been significantly elaborated and supported by the legal rules that concern the powers and duties of corporate managers. Treating these rules as merely default rules would inevitably weaken the force of the principles they now support.

7. *The Market for Corporate Charters.* — A very different kind of market that is relevant to corporation law is the market for corporate charters. A corporation can incorporate in any state it selects, and under standard choice-of-law rules a corporation's internal affairs are normally governed by the law of the state in which it incorporates.²⁰² Under the rules of state taxation, if a corporation does business within a state, that state may tax the corporation on a basis that reflects the amount of that business, and if a corporation is incorporated in a state, that state may impose a tax for the privilege of incorporation even if the corporation does no business in the state.

Call the latter tax a franchise tax. A small state has a very strong financial incentive to design a corporate-law regime that will sell—that

$$p \times n = I$$

$$E/(n + S) = p \text{ (so that } p \text{ is a market clearing price)}$$

These conditions can be manipulated to get the value of p and n in terms of E , I , and S :

$$E/(n + S) = p = I/n$$

$$(n + S)/E = n/I$$

$$(I/E) \times (n + S) = n$$

$$(I/E) \times S = n \times (1 - (I/E))$$

$$\frac{(I/E)}{1 - (I/E)} \times S = n$$

Filling in the actual values of E , I , and S , $n = 10,224$ shares. Correspondingly, $p = \$48.90$, which is a market clearing price because $\$5.39 \text{ million}/10,224 = \48.90 .

Letter from Merritt B. Fox to author (December 12, 1988) (copy on file at the Columbia Law Review).

202. See Restatement (Second) of Conflict of Laws § 302(2) (1971); see also Davis & Cox v. Summa Corp., 751 F.2d 1507, 1527 (9th Cir. 1985) ("Claims involving 'internal affairs' of corporations, such as the breach of fiduciary duties, are subject to the laws of the state of incorporation."); accord Fry v. Trump, 681 F. Supp. 252, 255-56 (D.N.J. 1988).

is, a regime that will attract incorporation. If the state is successful in attracting incorporation, the resulting franchise-tax revenues can subsidize a large portion of its budget, because the out-of-pocket cost of maintaining such a regime will be negligible while the social and economic costs of any defects in the regime will be borne largely by the citizens of other states. In a large state, franchise taxes are likely to be swamped, and indeed may be legally offset, by revenues from the doing-business tax. Even a large state, however, has an incentive to design a regime that will attract incorporation, because the revenues of the local corporate bar may depend in part on the extent of local incorporation.²⁰³

Normally, it is uneconomical for a closely held corporation to incorporate in a state other than that in which its business is principally based.²⁰⁴ Furthermore, states will normally derive significant franchise-tax revenue only from publicly held corporations. A state that wants to maximize its franchise tax will therefore focus not so much on attracting original incorporation as on attracting reincorporation by corporations that are or are about to become publicly held. In a landmark article,²⁰⁵ William Cary argued that decisions to reincorporate publicly held corporations are effectively made by managers; that Delaware, a small state, has systematically attempted to generate huge franchise-tax revenues—which pay for about one-sixth of its budget²⁰⁶—by designing its corporation law to attract managers; and that Delaware has carried out its design by distorting its corporate law to favor managers, thereby leading a race to the bottom that other

203. See Court's Decision Against Tactic in Takeover Fight Is Upheld on Appeal, *Wall St. J.*, Oct. 5, 1988, at A6, col. 3 ("New York Bar Association wouldn't be happy to see their big clients move to Delaware" in response to New York Court of Appeals decision invalidating some types of poison pills.).

204. A closely held corporation typically is a small enterprise that does most of its business in one state. If a corporation does most of its business in State *A*, but incorporates in State *B*, it is likely to end up paying higher legal fees, because its local counsel will probably be more familiar with the law of State *A* than with the law of State *B*, and therefore will either have to work to overcome its lack of familiarity, or retain local counsel in State *B*, when advising on corporation-law issues. Furthermore, if State *B* is selected, it will be "necessary [for the corporation] to pay not only organization fees and taxes in that state but . . . also [to] qualify the corporation to do business in [State *A*]. This will entail the filing of more papers and the payment of further fees and taxes." W. Painter, *Corporate and Tax Aspects of Closely Held Corporations* 21 (2d ed. 1981). Combined taxes in State *A* and State *B* may well be higher than would state taxes in State *B* alone, depending on the tax regimes of each state. The net result is that "it is generally less expensive, and certainly more convenient, to incorporate locally." W. Painter, *supra*, at 21.

205. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 *Yale L.J.* 663 (1974).

206. See U.S. Dept. of Commerce, Bureau of the Census, *Government Finances—State Government Finances in 1987* at 12 (1988). The figure includes franchise taxes, fees, and charges related to annual reports.

states feel constrained to join.²⁰⁷

A response to Cary's argument was formulated by Ralph Winter.²⁰⁸ Winter agreed that managers of publicly held corporations effectively decide upon the state of incorporation, and that Delaware has systematically designed its law to attract managers. He distinguished, however, between attracting managers and unduly favoring managers, and argued that if Delaware unduly favored managers, shareholders in Delaware corporations would earn lower-than-normal returns and Delaware corporations would therefore have a higher cost of capital. This would either bankrupt Delaware corporations in the product markets or cause the ouster of management through takeover bids, and managers would therefore avoid incorporating in Delaware. Since Delaware is in fact by far the most popular state of incorporation for large publicly held corporations—forty-three percent of New York Stock Exchange firms are incorporated there²⁰⁹—Cary's argument that Delaware has led a race to the bottom must be wrong.²¹⁰ Indeed, Winter argued, the incentive to sell corporate law has actually led Delaware and other states to produce an optimal corporate-law regime,²¹¹ because a state that offers the optimal, value-maximizing regime of corporate law will attract the most incorporation. As two later commentators put it, "managers of a firm take advantage of the competition among states to locate in a state which offers an efficient set of restrictions on the firm, given the firm's anticipated production-investment and financing decisions."²¹² Each state therefore has a market incentive to create the optimal corporate-law regime.

The argument that market forces lead to optimal corporate law—sometimes referred to as corporate federalism—is not inconsistent with the thesis that in certain cases mandatory rules are more efficient than enabling or supplementary rules. Corporate federalism claims that state corporation law will be optimal because the state with optimal rules will sell its law to the most corporations. Corporate federalism, however, does not in itself suggest what mix of enabling, supplementary, and mandatory rules will be optimal.

Nevertheless, the issues staked out by Cary and Winter need to be addressed in any full examination of the structure of corporation law, because these issues concern fundamentals of corporation law, figure actively in the literature that stresses the alignment effect of market

207. Cary, *supra* note 205, at 665–66, 668–72.

208. Winter, *supra* note 183.

209. See Macey & Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 *Tex. L. Rev.* 469, 478 (1987).

210. Winter, *supra* note 183, at 257, 258, 275–76.

211. *Id.* at 290.

212. Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 *J. Bus.* 259, 282 (1980).

forces, and help to explain the structure of corporation law.²¹³

Several commentators have attempted to resolve these issues through event studies designed to measure the effect of reincorporation in Delaware on the stock prices of reincorporating firms.²¹⁴ Such studies have only limited usefulness in this context. Even under Cary's analysis, it would be surprising if the mere announcement of reincorporation in Delaware had a significant negative effect on stock prices. If competition among the states results in a uniformly low-grade regime, as Cary argued it did, the announcement of a shift from one low-grade regime to another would not be a significant event.²¹⁵ Furthermore, Delaware has certain advantages for shareholders, such as a rich case law that increases predictability, that could offset the suboptimality of its rules. Perhaps most important, reincorporation in Delaware often accompanies other developments, such as an initial public offering or the initiation or expansion of a mergers-and-acquisitions program,²¹⁶ and the statistical noise from those developments would be likely to drown out any negative effect resulting from a switch to a less optimal legal regime. Finally, distortions in state law may take the form not of rules that invite exploitation, but of rules that remove checks on positional conflicts. If the managers of a reincorporating corporation are doing a reasonably good job at the time of reincorporation, the negative effect of removing checks on positional conflicts would be exceptionally difficult to value and might well be underestimated because of the representativeness heuristic.²¹⁷ It will be recalled that Weiss and White studied seven major Delaware decisions that changed the constitutive rules of Delaware corporations and found that none produced a statistically significant change in the price of the stock of Delaware corporations.²¹⁸ As Weiss and White point out, this data casts "considerable doubt on Winter's claim that investors' decisions concerning whether to buy the stock of Delaware or non-Delaware companies operate so as to preclude the development of unduly pro-manager systems of corporate law."²¹⁹

213. See *infra* text accompanying notes 226-35.

214. See, e.g., Dodd & Leftwich, *supra* note 212; Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. & Econ. Organization 225 (1985) [hereinafter *Law as Product*]; Romano, *The State Competition Debate in Corporate Law*, 8 Cardozo L. Rev. 709 (1987) [hereinafter *Competition Debate*].

215. See Weiss & White, *supra* note 192, at 555, 559-60.

A corporation might want to switch to Delaware even if Delaware's rules were just as low-grade as those of the present state of incorporation because Delaware's case law is much richer and Delaware has more effectively committed itself to maintaining its regime. See *infra* text accompanying notes 230-31.

216. See Romano, *Law as Product*, *supra* note 214, at 250, 256.

217. See *supra* note 13 and accompanying text.

218. See *supra* note 192 and accompanying text.

219. Weiss & White, *supra* note 192, at 603; see also Fox, *supra* note 196, at 1042-43.

As Fox points out, "[w]hile a decision that [changes] the share value of Delaware

The two most important event studies on the effect of reincorporation in Delaware were conducted by Dodd and Leftwich and by Romano. Predictably, Dodd and Leftwich found that the announcement of reincorporation in Delaware did not have a statistically significant impact on stock prices.²²⁰ Romano found that it had a positive significant effect, but that this effect was driven by the positive returns for firms that switched to Delaware in preparation for engaging in merger and acquisition activity.²²¹ Moreover, Dodd and Leftwich found that on average the firms in their sample had growing supranormal returns until reincorporating in Delaware, but that this growth stopped after reincorporation,²²² a pattern that is consistent with Cary's claim.²²³

Given the limitations of the data, a deeper economic analysis is required. Such an analysis shows that neither Cary nor Winter captured the actual dynamics of the charter market and leads to a position that is intermediate between those of Cary and Winter, although closer to Cary's.

To begin with, Winter's claim that all states have an economic incentive to adopt optimal corporate-law regimes will not withstand scrutiny. The claim is driven purely by the argument concerning the cost of capital—that if a state unduly favors managers, corporations incorporated in that state would either go bankrupt or be taken over. That argument is fatally defective for the reasons set out above:²²⁴ Adoption of rules that are in the interests of managers but not shareholders will not necessarily have any effect on the ability of the corporation to compete in the product market, and any effect they do have is likely to be swamped by the slack in those markets. Adoption of such rules is also highly unlikely to result in a reduction in the value of a corporation's stock that is sufficient to trigger a takeover.

Winter's claim also fails to take account of basic agency-cost principles. Assume, with both Cary and Winter, that the state of incorpora-

firms by 0.1% has effects too small in general to be accompanied by statistically significant price changes the aggregate effect of the decision would be more than \$1 billion." See Fox, *supra* note 196, at 1037–38.

220. Dodd & Leftwich, *supra* note 212, at 266, 272–75.

221. Romano, *Law as Product*, *supra* note 214, at 271.

222. Dodd & Leftwich, *supra* note 212, at 266, 272–75.

223. Cf. Fox, *supra* note 196, at 1043 (footnote omitted):

[T]he Weiss and White results are damaging to the contractual theorists' empirical case against Cary's race to the bottom hypothesis. That case is based on the findings of Dodd and Leftwich that there is no statistically significant price reaction to reincorporation in Delaware. Weiss and White's failure to find statistically significant reactions to cases articulating major changes in Delaware law suggests that Dodd and Leftwich placed too high a burden of proof on Cary. Even if the market accurately evaluates the effects of Delaware reincorporations and these effects are negative in an amount that is economically important in aggregate, reincorporations may not be accompanied by statistically significant price changes.

224. See *supra* note 185–200 and accompanying text.

tion of a publicly held corporation is chosen by its managers, and that the only goal of a state is to maximize franchise-tax revenues. The state can then be viewed as a seller that deals largely with buyers represented by agents. A seller that deals largely with buyers represented by agents will normally maximize its returns if it can make side payments to the agents while providing a product that is acceptable even though not optimal to their principals (not optimal, because by hypothesis the cost of the product includes a side payment to the agent). A familiar example is provided by the airline industry. The airlines sell a significant portion of their tickets to firms, but the choice of airline is usually made by the traveling employee. The airlines therefore offer side payments to employees, in the form of mileage bonuses that are credited to the employees' personal accounts.²²⁵ Competition between airlines results not in optimal prices to buying firms, but in side payments to employees and suboptimal prices to buying firms. Many chain-hotel and auto-rental companies—who, like airlines, deal largely with buyers represented by agents—follow the same course.

A state whose only goal is to maximize franchise-tax revenues will also follow that course. Rather than provide an optimal legal regime to corporate buyers, it will provide side payments to the agent-managers who make the actual decision concerning which state's legal regime the corporation will purchase. These side payments will take the form of managerial rules—rules that are in the interests of managers but not shareholders. The strongest managerial interests concern positional conflicts. A state whose only goal is to maximize franchise-tax revenues will therefore adopt legal rules that facilitate actions by top managers to maintain and enhance their offices. This is exactly the position the Delaware legislature took in the past, by adopting, for example, rules that permit staggered boards, allow economically significant corporate combinations to occur without shareholder approval, fail to require the distribution of information on managerial performance, and fail to regulate proxy voting.²²⁶ Over the past ten or fifteen years, Delaware's

225. At one point, Continental Airlines was paying rebates to employees in cash. *Continental Air's Cash Rebate: Promotion or Kickback?*, Wall St. J., Dec. 5, 1988, at B1, col. 3. Cf. *Travel Agents' Games Raise Ethics Issue*, Wall St. J., Nov. 23, 1988, at B1, at col. 3 (special kickbacks by airlines to travel agents).

226. See Eisenberg, *The Modernization of Corporate Law*, 37 U. Miami L. Rev. 187 (1983).

In a comment on this Article, Winter concludes:

My bottom line remains that, if Professor Cary is right, earnings per dollar of investment in Delaware corporations must be less than earnings per dollar of investment in corporations that do not permit such side payments. Indeed, the entire point of Professor Cary's article was that investors do worse under Delaware law than under other corporate codes. . . . It therefore follows that, unless the market for capital is indifferent to a firm's earnings, Delaware corporations will be at a disadvantage in raising capital. That is a consequence that is hardly likely to maximize Delaware's franchise tax revenues.

Winter, *supra* note 185, at 1528 (footnotes omitted). This misses the agency-cost point.

position on statutory innovations has been moderate, and often even statesman-like.²²⁷ The Delaware legislature has not, however, significantly changed most of the managerial rules Delaware adopted in its bid for primacy prior to that time.

Winter and Cary also significantly oversimplified the nature and dynamics of the charter market. For example, both failed to address the complexity of the states' objectives in framing corporate law. Not all states are motivated solely by the goal of maximizing franchise-tax revenues. Many states are at least weakly motivated by the goal of maximizing the revenues of the local corporate bar.²²⁸ The corporate-law rules that will maximize the revenues of the local corporate bar may differ from the corporate-law rules that will maximize franchise-tax revenues,²²⁹ and the relative weight attached to these differences undoubtedly varies from state to state. Furthermore, legislatures are not private sellers, but public actors. Attracting the business of principals by making side payments to agents is a morally dubious enterprise. For some legislators, public morality will be an important constraint on the willingness to engage in that enterprise. The extent of that willingness also undoubtedly varies from state to state.

Furthermore, Winter and Cary both assumed that the states are like sellers in a perfectly competitive market. In fact, the charter market is not perfectly competitive. As the market has developed, Delaware has come to enjoy both a huge share of the market and a great amount of market power,²³⁰ because it offers attractions (some of which are beneficial to both shareholders and managers) that few other states can now match.²³¹ Among these are a rich body of case-law that facilitates planning and dispute-settlement; a geographical location that makes it easy for most non-Delaware corporate lawyers to consult with the Dela-

Even if the stock prices of Delaware corporations are negatively affected by Delaware law, managers may choose Delaware because the side payments Delaware makes to top managers outweigh the impact on them of that negative effect. Indeed, in a passage that could easily have been written by Cary, Winter himself says:

[A state] takeover statute will . . . [negatively] affect share price and ability of relevant corporations to raise capital [However, losing] one's position as management will seem much less desirable than whatever injury may occur to the corporation as a result of a state takeover statute. Profit maximizing on behalf of the corporation in these circumstances . . . may not be in the economic self-interest of management.

Winter, *supra* note 183, at 288. But the same observation applies to *any* legal rule that will help prevent a manager from losing his position.

227. See Romano, *Law as Product*, *supra* note 214, at 231-42.

228. See Macey & Miller, *supra* note 209, at 491. Cf. *id.* at 472 (bar "most important interest group" driving changes in Delaware law).

229. For example, making it easier to bring derivative suits may increase the revenues of the litigating bar, but diminish the incentive to incorporate in the state.

230. See Macey & Miller, *supra* note 209, at 483.

231. See Romano, *Competition Debate*, *supra* note 214; Romano, *Law as Product*, *supra* note 214.

ware corporate bar; an established corporate address; and various rules, practices, and economic features—particularly its heavy dependence on the franchise tax—that serve as a bond for the faithful continuance of its regime.²³² These features serve as barriers to entry in the charter market.

One result of Delaware's attainment of market share and market power through the past adoption of suboptimal managerial rules is that Delaware now has a special incentive *not* to lead in the adoption of such rules: the desirability of avoiding massive federal intervention in corporate law. The incentives of the federal government on issues of corporate law differ considerably from those of the states. Because of its plenary power under the Supremacy Clause, the federal government has no incentive to compete for incorporation and no need to make side payments to managers. Furthermore, while any given state may view defects in its corporate-law regime as an externality whose effects fall almost entirely on the out-of-state population, the federal government, as the representative of the entire population, and as an entity whose own revenues are significantly based on corporate income rather than on a franchise tax based on nonincome elements, must internalize all defects in corporate law. The federal government therefore has a greater incentive than the states to be concerned with suboptimality. Because such intervention would be costly, the federal government should not and does not intervene to correct every suboptimal rule. If, however, state law became highly suboptimal, the risk of federal intervention would increase.

A state that has had little success in the charter market has much to gain and little to lose by offering innovative side payments. If the side payments attract incorporation, the state comes out ahead; if the side payments stimulate federal intervention, the state is no worse off. In contrast, if comprehensive national rules were established for publicly held corporations, over time Delaware would almost certainly lose a significant portion of its franchise-tax revenues. Therefore, precisely because of its historical success in the charter market, Delaware is more threatened by the possibility of comprehensive federal intervention than any other state. Furthermore, because of Delaware's massive market share, innovative side payments by Delaware are more likely to provoke federal intervention than innovative side payments by any other state. So, having achieved a huge market share in significant part because of its past leadership in offering side payments to managers, Delaware now has an incentive not to lead in the adoption of innovative managerial rules.

232. See Romano, *Law as Product*, *supra* note 214, at 240-42; Romano, *Competition Debate*, *supra* note 214, at 721-23.

Certainly it seems to be the case that within recent years Delaware has become relatively moderate in adopting statutory innovations.²³³ It is no longer fair to say that Delaware is leading the race to the corporate bottom. Undoubtedly, Delaware's current posture is in significant part the result of the moderate views of its present corporate bar. It is nevertheless the case that while Delaware can now afford to be moderate, and even has an incentive to do so, it cannot ignore what other less moderate states may do. If an innovative side payment adopted by other states becomes so well established that Delaware's failure to respond in some way would call into question Delaware's resolve to match the market, Delaware falls under enormous economic pressure to adopt some version of the innovation.

In short, both Winter and Cary oversimplified the nature and dynamics of the market for corporate charters.²³⁴ Cary was right in concluding that a state will not always seek to adopt laws that maximize shareholder wealth. A state whose only goal is to maximize franchise-tax revenues will find it in its interest to depart from an optimal corporate-law regime by making side payments to managers in the form of rules that fail to adequately address positional conflicts. However, Cary was wrong in concluding that Delaware and other states will not take the maximization of shareholder wealth into account. A state whose only goal is to maximize franchise-tax revenues will not depart from optimality *too far*, because, if it does, the value-decreasing effect of incorporating in the state could become so large as to invite takeovers or federal intervention.

Winter, on the other hand, was right in pointing out that states have an incentive to take optimality into account, but wrong in concluding that success in the charter market would turn solely on optimality, and that a state therefore would not deliberately adopt value-decreasing managerial rules in preference to optimal rules.

It can now be seen both why Delaware corporation law has many mandatory elements, and why it is less extensively mandatory than the law of most other states. Delaware law has many mandatory elements,²³⁵ because mandatory elements are part of an optimal regime of corporation law. Delaware law is less extensively mandatory than most other states, because heavily dependent as Delaware has been on

233. See Romano, *Law as Product*, *supra* note 214, at 231-42. Romano studied innovation and responsiveness among all states by tracking the careers of four innovative laws. She found that

[Delaware] leads all states on the responsiveness measure. . . . While it was the first state to enact only one of the four laws under study, it adopted the other three within four to seven years from their introduction in another jurisdiction, and as a result, it unambiguously outpaced the other states [in responsiveness].

Id. at 240.

234. Cf. Romano, *Competition Debate*, *supra* note 214, at 752-53.

235. See *supra* notes 85-98 and accompanying text.

franchise-tax revenues, historically its legislature was more willing than most other states to sacrifice optimality in favor of managerial rules.

It can also be seen why the federal government has intervened in corporation law, and why that intervention is generally limited to publicly held corporations. The federal government has intervened in corporation law because suboptimal state-law rules may affect both the welfare of the citizens of other states and the revenues the government derives from the income tax. Federal intervention is generally limited to large publicly held corporations because suboptimal rules for those corporations raise the most serious welfare and revenue issues for the federal government.

Finally, it can be seen why the New York Stock Exchange has historically regulated corporate governance. At least until recently, the Exchange virtually monopolized the liquid trading markets for the stock of very large publicly held corporations and, therefore, could attract listings from such corporations without making extensive side payments to managers. At the same time, the Exchange has an economic interest in the adoption of rules that maximize shareholder wealth and attract investment in stock. Accordingly, the Exchange has had both an interest in curing defects in state law and the power to do so.

F. The Pricing Argument

There is a third type of argument that may be made against the principle that mandatory legal rules should govern areas in which the interests of shareholders and top managers may materially diverge. This argument proceeds as follows: Under the efficient-market hypothesis, the market accurately prices all constitutive rules. Therefore, if a corporation adopts a constitutive rule that unduly favors the interests of top managers at the expense of shareholder interests, the effect will be impounded in the price of the corporation's stock. Accordingly, a shareholder in a publicly held corporation cannot fairly complain that any given rule unduly favors management interests, because even if it does, the shareholder has gotten what he paid for.

I will call this the pricing argument. The argument differs in three important ways from the arguments based on market forces considered above.

First, those arguments are rooted in an efficiency claim: that market forces adequately align the interests of shareholders and managers, so that mandatory legal rules are unnecessary and indeed costly. In contrast, the pricing argument is rooted in a fairness claim. The argument is not that market forces will adequately align the interests of shareholders and managers, but only that the stock of corporations in which such alignment is lacking will sell at an appropriate discount, so that buyers of the stock will suffer no unjust loss as a result of the lack

of adequate alignment.²³⁶

Second, the market-forces arguments purport to describe the actual effects of existing market institutions. In contrast, the pricing argument is largely hypothetical, because most of the core fiduciary and structural legal rules that govern publicly held corporations are not in fact subject to substantial variation.

Third, the market-forces arguments claim that both existing market institutions both align the interests of top managers and shareholders in publicly held corporations, and address the problem of managerial inefficiency, so adequately that mandatory legal rules to address those issues are unnecessary. In contrast, the pricing argument applies to just those cases in which the constitutive rules of a corporation do *not* adequately align the interests of top managers and shareholders and address the problem of managerial efficiency.

The pricing argument has some force in the case of corporations that are about to go public,²³⁷ but it will not withstand scrutiny in the context of publicly held corporations. The argument is that a shareholder who buys stock cannot fairly complain that the corporation has a suboptimal managerial rule, because even if it does, the shareholder has gotten what he paid for. By its terms, therefore, the argument has no application in cases where there are shareholders who own stock in a corporation *before* a suboptimal managerial rule is adopted, and do not meaningfully consent to the new rule. That would nearly always be the case in corporations whose stock is already publicly held.

III. CORPORATIONS THAT ARE ABOUT TO GO PUBLIC

Assume now that a corporation adopts a constitutive rule just as it is about to go public. Two very different claims can then be made. First, it can be claimed that the pricing argument is now relevant, because all public shareholders will buy their stock after the rule has been adopted. Second, a market-forces claim can be made, along the following lines: Suppose an owner-manager holds all of the corporation's stock, and he intends to sell all his stock to the public and drop his managerial position. He then has every incentive to adopt constitutive rules that will maximize the value of the corporation's stock, and no incentive to adopt rules that will decrease that value.

Admittedly, this is not the typical case. Usually, an owner-manager intends to retain some stock and his managerial position. Even in that case, it can be argued, an owner-manager would not have a financial incentive to adopt managerial rules that would decrease the value of the corporation's stock. Although he would reap the benefit of such

236. Cf. Fischel, *The Corporate Governance Movement*, *supra* note 124, at 1266 ("even if agency costs are substantial . . . shareholders will not be injured if relevant information is incorporated in market prices").

237. See *infra* text accompanying note 238.

rules in his managerial capacity, he would suffer the impact of those rules in his ownership capacity, because the rules would decrease both the value of the stock he retained and the price of the stock he sold.²³⁸ By aggregating the pricing and market-force claims, the argument can be made that corporations that are about to go public should be permitted to vary core fiduciary or structural rules.

This line of reasoning, which I will call the initial-public-offering argument, does not prevail under current law. In general, the core fiduciary and structural rules that are mandatory for publicly held corporations²³⁹ are no less mandatory for corporations that might attempt to vary those rules before going public. An examination of the limits of the initial-public-offering argument shows why this should be so.

To begin with, the argument assumes that such variations, if permitted, would be accurately priced. In fact, however, there is no direct evidence that all such variations would be accurately priced, and some direct evidence that they would not.²⁴⁰ It must be borne in mind that the pricing and market for stock offered in an initial public offering ("IPO") may differ substantially from the pricing and market for stock that is already publicly traded. The price of stock that is already publicly traded is determined by the intersection of the valuations of a huge number of buyers and sellers, whose random biases may tend to cancel one another out.²⁴¹ In contrast, the price of stock offered in an initial public offering is typically determined by negotiation between the corporation and an underwriter on the basis of general market conditions and preliminary expressions of interest by potential investors,²⁴² many of whom would probably be unaware of the corporation's constitutive rules.²⁴³ "Pricing is most difficult for issues of unseasoned stock. In these cases the underwriter has very little guidance as to the market

238. This argument was formulated in Jensen & Meckling, *supra* note 125, at 312-30. Jensen and Meckling carefully restricted their analysis to rules that constrain expenditures on managers' nonpecuniary benefits. They also argued that in some cases the incentive of owner-managers to adopt rules that favored shareholder interests would exceed the incentive to adopt rules that favored managers' interests, *id.* at 325-26, but that argument does not extend to all rules in all cases.

An owner-manager also might set a sufficiently high value on the nonfinancial benefits of maintaining and enhancing his position that he would be willing to accept a lower price for his stock in exchange for rules that protect that nonfinancial interest.

In the balance of this section, I will assume for convenience that a single owner-manager owns all of a corporation's stock. The analysis can be suitably modified where this is not the case.

239. See *supra* Part II. C.

240. See *supra* notes 192-196 and accompanying text (the Weiss and White data).

241. Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 *Va. L. Rev.* 549, 581-82 (1984).

242. See Stout, *supra* note 186, at 651-52.

243. Cf. Coffee, *supra* note 149, at 935 (information concerning risks of managerial exploitation "approaches the unknowable.").

value of the security.”²⁴⁴ The pricing of initial public offerings is marked by extreme uncertainty.²⁴⁵

Accordingly, the price at which IPO stock actually trades reflects the relative lack of power of the mechanisms used to set the price at which such stock is actually issued. On average, there is fifty percent more variation in the price of such stock during a two-week period than the stock market shows in an entire year.²⁴⁶ About half of all initial public offerings are significantly underpriced in relation to the price at which the stock actually trades; about one-fourth are significantly overpriced.²⁴⁷

A related assumption of the initial-public-offering argument is that purchasers of IPO stock will be informed investors who will know of and can properly value variations in core structural or fiduciary rules. In fact, however, it seems likely that many investors in IPO stock are relatively uninformed.²⁴⁸ It is sometimes said that even if that is so, variations in core fiduciary and structural rules would be accurately priced because institutional investors, who would have the ability and incentive to price such variations, purchase a significant amount of IPO stock, and uninformed investors would free ride on their efforts.²⁴⁹ There are several reasons why this is not necessarily true. For one thing, exploitation of a variation in a core fiduciary or structural rule might or might not occur, and if it did occur, would normally occur in the future. Given the difficulty of estimating the probabilities, and the need to discount any future loss by the time value of money, the effort required to price a variation often might not be justified,²⁵⁰ particularly because any single institutional investor will normally be allocated only a limited amount of any given initial public offering.²⁵¹

Moreover, even if an informed investor does set a value on such a

244. R. Brealey & S. Myers, *Principles of Corporate Finance* 306 (2d ed. 1984); see also *id.* at 331 (3d ed. 1988) (“Whenever any company goes public, it is very difficult for the underwriter to judge how much investors will be willing to pay for the stock.”).

245. See Beatty & Ritter, *Investment Banking, Reputation, and the Underpricing of Initial Public Offerings*, 15 *J. Fin. Econ.* 213, 213-14 (1986); Rock, *Why New Issues Are Underpriced*, 15 *J. Fin. Econ.* 187, 188 (1986).

246. Stout, *supra* note 186, at 657; Cf. Ibbotson, *Price Performance of Common Stock New Issues*, 2 *J. Fin. Econ.* 235, 246-50 (1975) (average initial performance of new offering is positive but distribution of returns is skewed).

247. See Weiss, *Initial Public Offerings and the Cost of Information* 18-19 (unpublished PhD thesis, University of Florida, 1988) (excerpt on file at the Columbia Law Review).

248. See Rock, *supra* note 245, at 199; cf. Ibbotson, Sindelar & Ritter, *Initial Public Offerings*, 1 *J. Applied Corp. Fin.* 37, 43 (1988) (asymmetry of information among potential IPO investors).

249. See Gordon, *The Mandatory Structure of Corporate Law*, 89 *Colum. L. Rev.* 1549, 1557 (1989).

250. Black, *Is Corporation Law Trivial?* (forthcoming 84 *Nw. U.L. Rev.* (1989)).

251. See Beatty & Ritter, *supra* note 245, at 215 (“The majority of initial public offerings are subject to . . . quantity rationing.”).

term, it might not always be able readily to introduce that valuation into the price at which the IPO stock is offered. In the case of stock that is already publicly traded, an investor who assigns a negative value to an obscure governance term could in theory profit from that information by selling short and then making a public announcement about the term and its value, which would cause the price of the stock to fall. In the case of initial public offerings, however, even this theoretical possibility may be unavailable. An investor who sold IPO stock short on the basis of its negative view of a governance term would often lose money even if it was right about the term, because on average such offerings are underpriced.²⁵² In any given case, therefore, informed investors might or might not be able to cause the price of IPO stock to be reduced by the negative value of a variation in core fiduciary or structural rules.

Even more important, although institutional investors may buy a significant number of shares of initial public offerings *on average*, it seems likely that there are many initial public offerings in which institutional investors do not play a major role. Many IPOs are too small to be of likely interest to institutional investors. In a sample of initial public offerings from 1975 to 1984, almost sixty percent of the offerings involved firms with sales of less than \$5 million.²⁵³ Some initial public offerings are sold almost exclusively to individual investors.²⁵⁴ One entire class of initial public offerings, closed-end investment companies, is systematically and materially overpriced,²⁵⁵ suggesting that there is a large pool of uniformed buyers to whom entire issues can be sold.²⁵⁶

Another argument sometimes made is that IPO investors will be protected against bad bargains by the interest of the underwriter in developing or maintaining a good reputation.²⁵⁷ Again, this may well be true on average, but there is no evidence that it is true in all or even almost all cases. Reputation is one element that motivates firms, but it is not the only element.²⁵⁸ In particular, underwriters have an interest in obtaining issues to underwrite, and that interest may sometimes re-

252. See *id.*

253. See Ibbotson, Sindelar & Ritter, *supra* note 248, at 42.

254. See Entrepreneur Remains Undeterred by Venture's Failure, *Wall St. J.*, Aug. 21, 1989, at B2, col. 3.

255. K. Weiss, K. Lehn & D. Malmquist, The Post-Offering Price Performance of Closed-End Mutual Funds II (unpublished manuscript, The Office of Economic Analysis, Securities and Exchange Commission, July 1989) (on file at the Columbia Law Review) (closed-end mutual funds suffer an average cumulative index-adjusted return of - 15.054% in 120 days following IPO).

256. Weiss and her colleagues conclude that institutional investors are less active in purchasing shares in the initial public offerings of closed-end funds than in purchasing other IPOs. *Id.* at 23-24.

257. See Gordon, *supra* note 249, at 1558-59.

258. See, e.g., "Highly Confident" Morgan Stanley Backs Out, *Wall St. J.*, Sept. 12, 1989, at C1, col. 4.

quire acquiescing in terms they believe to be inappropriate.²⁵⁹

Even assuming that despite all these problems variations in core fiduciary or structural rules would in fact be priced in an unbiased manner, that would not in itself be dispositive, because investors who purchased such stock without knowing about these variations would often be unfairly surprised. In this connection, Merritt Fox has drawn a useful distinction between lack of bias and accuracy. Market reactions are properly termed unbiased, he suggests, if on average they correctly measure actual changes in share value.²⁶⁰ But, as Fox points out:

lack of bias and accuracy are different concepts. Consider, for example, two investors, X and Y, who forecast the effects of court decisions on share value. Both forecasts might be unbiased, but X would be considered more accurate than Y if the average deviation of X's estimates from the actual effects of the decisions (X's forecast errors) was smaller than the average deviation of Y's estimates.²⁶¹

Under modern contract law, a contract term that is unfairly surprising is unenforceable even if the term is impounded in the contract price. For example, the courts routinely hold that unclear or inconspicuous terms in insurance contracts that violate the insured's fair expectations are unenforceable, without regard to whether the terms lowered the insured's premiums.²⁶² In one typical case, an insurer sold the

259. Compare Limited Partnership Are Often Faltering, to Investors' Dismay, Wall St. J., Aug. 17, 1989, at A1, col. 6:

Many brokers complain that their bosses pushed them to sell questionable partnerships—in many cases, slighting their fiduciary responsibility to investors. Several present and former [Shearson Lehman Hutton] brokers say their bosses warned them not to waste time reading prospectuses, time that would be better spent selling to clients.

....
In California . . . a third of investors' complaints lodged with the Department of Corporations allege that the general partners illegally commingled funds. Many of the syndicators took cash out of profitable partnerships to prop up failing ones Eventually, most of them crashed.

....
Irwin Fisk, the chief investigator in the [Department of Corporations' Southern California branch] says that "we see maybe 50" cases of allegedly commingled funds a year, many of which "result in prosecutions and, usually, in convictions." But often, he laments, "the general partners' right to move money around [among different limited partnerships that they control] is written into the partnership agreement. That's a crazy thing to sign, but investors don't read it."

And, apparently, underwriters don't object to it.

Cf. Municipal Bond Trustees Hit by Growing Criticism, Wall St. J., May 23, 1988, at A21, col. 5 ("A [municipal bond] trustee who sees problems in a planned offering can request changes or decline the role of overseer. But trustees say the field is so competitive that in practice doing so means losing work.").

260. Fox, *supra* note 196, at 1027-28.

261. *Id.* at 1028.

262. See, e.g., *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 274, 419 P.2d 168, 174-75,

owner of a department store a "Bodily Injury Liability" policy to cover premises operation. A term in the fine print of the policy excluded coverage for accidents in elevators on the premises.²⁶³ The exclusion was held unenforceable because it violated the store owner's fair expectations. In another typical case,²⁶⁴ an insurer sold a home owner a home owner's policy that included "Comprehensive Personal Liability (Bodily Injury and Property Damage)." A term in the fine print of the policy excluded injuries to a domestic employee. The exclusion was held unenforceable because it violated the home owner's fair expectations. It has never been thought a defense, in such cases, that in the absence of the exclusion the policy premium would have been higher.

One reason for this rule is that even a term that is priced may be inefficient if information is asymmetrical. For example, suppose there is competition among banks to attract consumers to open checking accounts. Assume that consumers focus primarily on interest rates, which are both the most salient and the most easily understood characteristic of checking accounts. In contrast, many other characteristics, such as the consequences of failing to detect and promptly report embezzlement, forgery, or mistakes in the account, are difficult to explain simply or understand fully, so that typically consumers are rationally ignorant about the terms that define the depositor's liability if these contingencies occur. It is then in the interest of each bank to increase interest rates up to the point where the additional revenue derived by attracting more consumers will equal the marginal cost of the interest rate and all other characteristics of the account.

One way to increase the interest rate is to reduce the costs of other characteristics by setting very unfavorable terms on those characteristics that are both less salient and less easily understood. All prices will then be based on the marginal costs attributable to the accounts. However, many consumers, if fully informed, might prefer to accept a slightly lower interest rate and have better terms on other characteristics, because, for example, they would prefer not to risk the massive loss that they might incur under the terms of the account if they fail to promptly report a forged check, an error, or the like. If so, competition will lead to an inefficient result, because consumers who were fully informed would have placed a higher value on products that they were not offered than on the products that they were offered. Similarly, insurance terms may be unfairly surprising even if the terms are impounded into the price, because the insured would have preferred

54 Cal. Rptr. 104, 110-11 (1966); *Johnson v. United Investors Life Ins. Co.*, 263 N.W.2d 770, 776 (Iowa 1978); *Gerhardt v. Continental Ins. Cos.*, 48 N.J. 291, 300, 225 A.2d 328, 333-34 (1966); *Portella v. Sonnenberg*, 74 N.J. Super. 354, 362, 181 A.2d 385, 390 (1962).

263. *Portella*, 74 N.J. Super. 354, 181 A.2d 385 (1962).

264. *Gerhardt v. Continental Ins. Co.*, 48 N.J. 291, 298-99, 225 A.2d 328, 333 (1966).

paying a bit more rather than incurring the risk that the catastrophic event that the insured wanted covered, and believed would be covered, was in fact not covered.

In much the same way, variations of core fiduciary or structural rules might be both unfairly surprising and inefficient even if impounded into the price. What will be impounded into the price is the average likelihood that managers will exploit such a provision in a manner that will significantly decrease shareholder wealth. This average may be quite small, but many investors may well have preferred not to invest in a corporation whose stock was subject to significant losses as a result of substantial nonbusiness risks.²⁶⁵

It is no more likely that buyers in an initial public offering would know of variations in core fiduciary and structural rules than that buyers of insurance policies will know the fine print in their policies. Furthermore, even if the original buyers knew of the variations, subsequent buyers would not. Stock differs from ordinary consumer goods in that it is intended to be resold in pristine condition. It is not enough to say that original buyers of stock will know of a term if it is foreseeable that subsequent buyers will be unfairly surprised. Most shareholders who purchased a corporation's stock on the open market would be unfairly surprised to learn that the corporation had a rule that permitted senior executives to take corporate opportunities developed through the use of corporate information or assets or a rule that prohibited the board or the shareholders from removing the chief executive from office. If, as a result of such rules, an executive took a corporate opportunity worth twenty percent of the value of the corporation, or the corporation's earnings declined precipitously because of the chief executive's incompetence, it would be no answer to the shareholders to say that

265. See Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 Colum. L. Rev. 1403, 1411 (1985):

[I]f investors in fact are induced to "consent" to conditions of management discretion to serve itself that they do not understand, on price terms they would not accept if they understood the conditions, that [consent] . . . will not effect Pareto superiority or maximize efficiency. If investors understood the terms . . . as rational wealth maximizers they would demand other terms.

Cf. Jensen, *supra* note 170, at 42:

[C]onsider the simple situation in which a principal (stockholder) hires an agent (managers and board of directors) to take some actions on his or her behalf. To effect this arrangement, the principal delegates to the agent a set of decision rights. . . .

The principal may want to delegate a wide range of decision rights to the agent. In no event, however, will it be sensible for the principal to delegate the ultimate control rights to the agent: the rights to hire, fire, and set the compensation of the agent. . . .

If every investor was fully diversified, unfair surprise might be less of a problem, although even in that case some investors might simply be unwilling to take the risk of substantial losses that result from variation in core governance terms, if they knew of the variations. However, there is no strong evidence that all or even almost all stock is held by fully diversified investors.

although they were unfairly surprised by such events, the one-in-two-hundred chance that the events would occur was impounded into the price.

Furthermore, even if variations in core fiduciary and structural rules were known, shareholders would not meaningfully consent to them. Recall that even in closely held corporations, where true bargaining can occur, variations in core fiduciary rules should not be and are not enforceable, because consent to such variations would be systematically underinformed.²⁶⁶ The quality of the consent to such variations would be even weaker in publicly held corporations, where true bargaining is almost impossible, and knowledge of the variation, let alone its meaning and implications, would typically be lacking. In publicly held corporations, the problem of systematically underinformed consent would apply not only to core fiduciary rules, but to core structural rules, because just as core fiduciary rules govern traditional conflicts of interest, so core structural rules govern positional conflicts.

Permitting owner-managers of publicly held corporations to vary core fiduciary and structural rules if they do so before their corporations go public could also lead to inefficiency in the capital markets. The problem is a special case of the market for lemons.²⁶⁷ When the quality of a good is hard to determine, and sellers are likely to know the quality much better than buyers, buyers will only be willing to pay a price, P_{a1} , that reflects average quality. Persons who hold high-quality goods will generally refuse to sell at P_{a1} , since P_{a1} is less than the value of their products. But withholding high-quality goods from the market will drive down average quality and will therefore drive down the price to P_{a2} . This will cause more sellers to withhold, which will drive prices even lower, which will cause even more sellers to withhold, and so on until only low-quality goods are sold. All goods are then properly priced, but total utility is less than it would have been if sellers had been able to reliably signal the quality of their products.

Similarly, if core fiduciary or structural rules were subject to variation by certificate provisions adopted before an initial public offering, some publicly held corporations would be governed by core fiduciary and structural rules that are unduly favorable to top managers and some would not. Persons who proposed to buy stock in a publicly held corporation therefore would either have to expend resources to determine whether the corporation was subject to all the core rules that constrain unfair self-dealing, shirking, and positional conflicts by top managers, or assume that all corporations had adopted variations of those core rules. Either course of action would render capital markets less efficient, because investors would either put less of their money

266. See *supra* text accompanying notes 41-43.

267. See Pindyck & Rubinfeld, *Microeconomics* 592-97 (1989); Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 *Q.J. Econ.* 488 (1970); Coffee, *supra* note 149, at 947-49.

into corporate securities or demand a higher return from such securities, than would otherwise be the case.

Indeed, if the initial-public-offering argument were to be accepted as law, managerial rules might well become the norm. If buyers assumed that all corporations had adopted "average" variations from the core rules that constrain unfair self-dealing, shirking, and positional conflicts by top managers, it would frequently be irrational for an owner-manager who proposed an initial public offering to fail to adopt variations. Assume the following: An owner-manager proposes to make an initial public offering of a large part of his stock, but to retain his top management position. The owner-manager's stock can be sold for \$X per share. This price will not depend on whether the corporation has varied the normal constraints on unfair self-dealing, shirking, and positional conflicts, because buyers, acting on the lemon theory, will assume that average variations have been adopted. Adoption of variations in core fiduciary and structural rules would be worth \$Y to the owner-manager in his managerial capacity. Under these assumptions, the owner-manager, if he is economically rational, will adopt the variations, because if he does, his wealth will be \$X per share plus \$Y, while if he does not, his wealth will be only \$X per share.²⁶⁸

Finally, permitting publicly held corporations to vary core fiduciary and structural rules if they did so before they went public might well lead to inefficiency in the national economy. The American economy is a corporate system, in the sense that control of the economic factors of production and distribution is vested largely in the hands of privately appointed corporate managers. This system is legitimated on three major bases. The first is a belief that the shareholders, as the owners of the corporation, have the ultimate right to control it. The second is a belief that corporate managers are accountable for their performance. The third is a belief that placing control of the factors of production and distribution in the hands of privately appointed corporate managers, who are accountable for their performance and who act in the interest and subject to the ultimate control of those who own the corporation, achieves a more efficient utilization of economic resources than that achievable under alternative economic systems. The initial-public-offering argument is not that owner-managers will always prefer rules that adequately address the problem of managerial inefficiency,

268. The "market for lemons" problem might be ameliorated if corporations could reliably signal whether they had adopted variations from core fiduciary and structural rules. It seems unlikely, however, that an adequate signalling regime could be developed. For one thing, the regime would have to be very complex unless signals could be used only by corporations that had not adopted even a single variation. More important, it would be difficult to make the signals reliably visible in the aftermarket. Because few investors in that market are likely to read the initial prospectus or any other corporate legal documents, probably the only way to ensure the visibility of the signals would be to attach them to the corporation's name—an unlikely prospect even if a simple signal were developed, and an almost impossible prospect if the signals were complex.

but only that they will often be indifferent between rules that do and do not address that problem. If, in pursuit of this argument, publicly held corporations could have governance structures determined by the decisions of owner-managers long gone from the scene who imposed rules that did not constrain positional conflicts, a significant portion of our national economy could eventually come to be vested in the hands of corporations in which inefficient managers were not effectively accountable and could not easily be removed. Such a regime could both jeopardize the efficiency of the economy and put the legitimacy of the corporate system into question.

CONCLUSION

The efficacy of enabling and suppletory rules depends on the institutions of private ordering. These institutions have substantial force. Often, however, they have substantial limits as well, sometimes subsumed under the heading of market failure. Mandatory rules also have substantial limits, sometimes subsumed under the heading of regulatory failure. Determining the balance between the costs and benefits of private ordering and mandatory rules in any given case is a matter for the exercise of prudential judgment, informed by economic analysis, quantitative data, the insights of psychology, and other empirical propositions.

In the case of closely held corporations, where constitutive rules are often determined by bargaining, prudential judgment suggests that the shareholders should be allowed to determine their own rules, subject to the limits on the bargain principle in areas where consent is likely to be systematically underinformed and even bargained-out rules would be subject to opportunistic exploitation.

In the case of publicly held corporations, where private ordering seldom takes the form of bargains, a different calculus prevails. Publicly held corporations have survived and prospered in this country, despite the potential divergencies of interests of top managers and shareholders, because these divergencies have been constrained by market forces, moral principles, and legal rules. Mandatory legal rules do double duty in this regard. They are important not only in themselves, but because they serve to emphasize and make particular the general moral principles of stewardship. It would be a descriptive mistake to think that either corporate law or the corporation is contractual in nature. It would be a normative mistake to think that under prevailing circumstances (including the current rules and practices concerning shareholder voting and the structure of share ownership), publicly held corporations would continue at their present level of success if the legal constraints on traditional and positional conflicts that have contributed to that success were removed.

It is sometimes said that arguments for mandatory rules reflect the Nirvana Fallacy, which consists of believing that just because markets

are not perfect, mandatory rules would be better. It is of course true that just because markets are imperfect does not mean that mandatory rules would be better. However, the converse proposition is also true: just because mandatory rules are imperfect does not mean that markets would be better. Commentators who stress the Nirvana Fallacy are almost invariably themselves guilty of a mirror-image mistake which might be called the Heavenly Market Fallacy. This is the erroneous belief that because regulation is imperfect, any market, no matter how terribly flawed, is heavenly, and therefore to be preferred to a mandatory legal rule. The brute facts are that most markets are not perfect and most mandatory rules are perfect; that even imperfect markets and legal rules may have positive effects; and that the question in any given case is to determine which of these imperfect mechanisms is better, or, if possible, to determine how these two imperfect mechanisms can be shaped to reinforce each other. Taken separately, neither markets, morals, nor law are in themselves sufficient to curb traditional and positional conflicts. Taken together, however, markets, morals, and law have shown themselves capable of achieving that objective.