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### Cover Page Footnote

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# ASSAULT ON ANOTHER CITADEL: ATTEMPTS TO CURTAIL THE FIDUCIARY STANDARD OF LOYALTY APPLICABLE TO CORPORATE DIRECTORS

*DOUGLAS M. BRANSON**

## INTRODUCTION

OVER the last twenty years, corporation law has become increasingly enabling.[1] Under the modern view, corporate statutes represent no more than standard form contracts. State statutes set forth off-the-rack rules that govern corporations' internal affairs unless the incorporating parties have provided otherwise in articles of incorporation, bylaws or comprehensive shareholders' agreements. The modern corporation statute's sole function is to approximate the corporate structure the incorporating parties would have bargained for, absent transaction costs.[2] Gone are the days when corporate laws contained numerous substantive Do's and Don'ts.

The question that arises is what brackets should exist around the movement toward private ordering. Traditionally, the venerable common law fiduciary duties of care and of loyalty have limited individuals' freedom to act within corporations.[3] Common law fiduciary duties have

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1. This modern era might be said to date from the 1967 revision of the Delaware General Corporate Law. Professor Folk, a reporter of the 1967 Delaware revision, has noted that "[a]lmost without exception, the key movement in corporation law revisions is towards ever greater permissiveness. . . . Explicitly positing an objective of 'flexibility,' statutory revisers in the most recent period have usually sought to enlarge the ambit of freedom of corporate management to take whatever action it may wish." Folk, *Some Reflections of a Corporation Law Draftsman*, 42 Conn. B.J. 409, 410 (1968).

2. *See infra* notes 92-95 and accompanying text.

3. The most cited reason for eliminating substantive content from corporate statutes has been the backup of common law fiduciary duty. For example, in the exposure drafts leading to the 1985 revision of the influential American Bar Association Model Business Corporation Act, the existence of fiduciary duty was the principal argument used to support removal of restrictions on corporate directors' powers, *inter alia*, to approve loans to officers and directors, to redeem common shares, to issue shares for future services or promissory notes, to eliminate preemptive rights, to amend articles of incorporation without shareholder vote, to revalue corporate assets, and to declare dividends and make distributions. *See* Branson, *Countertrends in Corporation Law: Model Business Corporation Act Revision, British Company Law Reform, and Principles of Corporate Governance and Structure*, 68 Minn. L. Rev. 53, 70-72 (1983).

Courts, too, have held fiduciary duty to be the boundary. For example, in the area of corporate combinations, courts have held that contract terms such as "no shop," "best operated to strike down transactions even when no discrete statutory prohibition has intervened.[4] As corporate law has become increasingly enabling, however, fiduciary duty has taken on another purpose: the delineation of the boundaries beyond which parties to an incorporated venture, or a majority of them, cannot go in private ordering arrangements.

Heightened in its importance, fiduciary duty is now threatened by a movement toward permitting corporations to opt out of liability for directors' breaches of the duty of care. Noted commentary has even recommended abolition of the common law duty of care altogether.[5] From 1986 to 1988, well over thirty states amended corporation statutes to permit individual corporations to opt out of liability for duty of care violations.[6] The directors of corporations that opt out are no longer liable in damages for negligence. To varying degrees, these statutes constitute a de facto abolition of the duty of care.[7]

More troubling, however, august authority has advocated elimination of the duty of loyalty by permitting shareholder majorities to remove fiduciary duty limitations upon self-dealing transactions by corporate managers.[8] Although no state has followed this recommendation, a re-

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efforts" and "cancellation fee" cannot override the responsibility of target company directors to act in the best interests of the corporation. *See infra* notes 77-79 and accompanying text.

4. *See, e.g.*, Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 407-08 (Del. 1985) (fiduciary duty prevented directors' issuance of shares to employee stock ownership plan in order to perpetuate themselves in office); Rabkin v. Philip A. Hunt Chemical Corp., 498 A.2d 1099, 1107 (Del. 1985) (fiduciary duty invoked to block transaction even though by reverse implication contract between related parties permitted challenged transaction); Giuricich v. Emtrol Corp., 449 A.2d 232, 239 (Del. 1982) (shareholders' right to vote cannot be frustrated by perpetual shareholder deadlock that entrenches existing board of directors); Petty v. Penntech Papers, Inc., 347 A.2d 140, 143 (Del. Ch. 1975) (fiduciary duties prevented redemption of shares to perpetuate control even though articles of incorporation authorized redemption).

5. *See, e.g.*, Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 Cornell L. Rev. 261, 262-63 (1986) (imposition of liability rules may not be desirable); Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 Stan. L. Rev. 927, 937 (1983) (legal duty rule should be abolished).

6. *See infra* notes 30-31 and accompanying text.

7. *See* Ind. Code Ann. § 23-1-35-1(e) (West Supp. 1987); Wis. Stat. Ann. § 180.307 (West Supp. 1988); *infra* note 31. At least one state has changed the standard itself from that of an objective, reasonable person to a purely subjective standard. *Compare* Va. Code Ann. § 13.1-690(A) (1985) ("A director shall discharge his duties as a director . . . in accordance with his good faith business judgment of the best interests of the corporation.") *with* 2 Model Business Corp. Act Ann. § 8.30(a), at 926 (3d ed. 1985) ("A director shall discharge his duties . . . with the care an ordinarily prudent person in a like position would exercise under similar circumstances."). *See generally* Comment, *Limiting Corporate Directors' Liability: Delaware's Section 102(b)(7) and the Erosion of the Directors' Duty of Care*, 136 U. Pa. L. Rev. 239, 269-72 (1987) (Virginia and Indiana statutes present drastic changes in the standard of care itself rather than in limitation of director liability).

8. *See, e.g.*, N. Wolfson, The Modern Corporation 151 (1984) (duty of loyalty a "weak basis . . . on which to rest the legitimacy of the government of the mega-corporation"); Fischel & Bradley, *supra* note 5, at 290-91 (duty of loyalty inadequate to prevent

cent Model Business Corporation Act amendment by the American Bar Association does attempt to go part of the way.[9]

Without articulated brackets around private ordering, the legal boundary presumably is simple majoritarian shareholder rule,[10] which recent events in the political sphere have brought under scrutiny.[11] In the political realm, constitutions not only impose structure but also restrict the authoritarianism of majority rule. Although the analogy of corporation statutes to constitutions may be flawed, the parallels between economic and political associations are numerous enough to warrant a comparison.[12]

This Article focuses upon proposals to permit corporations to opt out of applicability of the common law duty of loyalty to corporate officials.[13] Part I of this Article discusses the recommendations and enactments that have permitted corporations to opt out of liability for violations of fiduciary duty, and compares the economic and legal distinctions between the duties of care and loyalty. Part II shows that a corporate world devoid of the duty of loyalty will resemble a spoils sys-

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any but the most obvious breaches); *see also infra* notes 15-26 and accompanying text (comments of Judge Easterbrook).

9. *See* Committee on Corp. Laws, *Changes in the Model Business Corporation Act—Amendments Pertaining to Director's Conflicting Interest Transactions*, 43 Bus. Law. 691, 695-96 (1988); *infra* notes 57-61 and accompanying text.

10. Some jurisdictions still require a two-thirds shareholder vote to amend articles of incorporation. *See, e.g.*, Ala. Code § 10-4-149 (1987); Alaska Stat. § 10.10.110 (1985). The decided trend, however, is toward requiring a mere majority. *See, e.g.*, 3 Model Business Corp. Act Ann. § 10.03(e), at 1168.1 (3d ed. 1985) (unless the MBCA, articles of incorporation or board of directors requires otherwise, majority vote of those "entitled to be cast" is sufficient to amend articles of incorporation).

11. *See* Dworkin, *The Bork Nomination*, New York Review of Books, Aug. 13, 1987, at 3, 10 (Supreme Court nominee criticized because his "reading of the Constitution . . . flirts with the radical populist thesis that minorities . . . have no moral rights against the majority at all.").

12. Under the contractarian view of corporate law, unbridled majoritarian rule does not exist because corporations and their managers operate in markets. Market forces limit majoritarian rule and act as adequate brackets around private ordering arrangements. *See infra* notes 97-100 and accompanying text.

13. In accord with the modern view of corporate law generally, opt out proposals for various forms of corporate regulation have become widespread. SEC Commissioner Joseph Grundfest proposed that target companies be permitted to opt out of application of the SEC's tender offer regulations. *See* Concept Release on Takeovers and Contests for Corporate Control, Exchange Act Release No. 23,486, [36 SEC Docket 230, 237-38] (July 31, 1986); Victor, *A Brash Young SEC Commissioner*, Nat'l L.J., Nov. 10, 1986, at 1, 30. The SEC later reported that of twenty-seven commentators, only four "generally expressed support for self-governance exemptions to the tender offer rules." *Summary of Comments Relating to Takeovers and Contests for Corporate Control*, Fed. Sec. L. Rep. (CCH) ¶ 84,112, at 88,573 (Mar. 1987).

Some legal scholars have advocated that individual companies be able to opt out of application of the insider trading prohibition to transactions in their shares. *See, e.g.*, Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 Hofstra L. Rev. 9, 39-47 (1984) (advocating the "proper subject of contract" test); Haddock & Macey, *A Coasian Model of Insider Trading*, 80 Nw. U.L. Rev. 1449, 1462 n.28, 1468 (1986) (implicit or explicit contracts between a firm and its insiders should be enforced).

tem in which the only safeguard against self-dealing by management is shareholder majority rule. Part III of this Article explains the inadequacies of the theoretical, market-oriented basis for the movement towards permitting corporations to opt out of fiduciary duty. Finally, Part IV presents another argument in favor of retaining the duty of loyalty, the mini-state view of corporations. This Article concludes that proposals of the American Bar Association and others to negate the duty of loyalty are contrary to well established notions of morality and fairness. The assault on the citadel of fiduciary duty must cease.

## I. THE ASSAULT ON FIDUCIARY DUTIES

### A. *The ALI Principles of Corporate Governance: Judge Easterbrook and the Duty of Loyalty*

On Friday, May 16, 1986, in the ballroom of the Mayflower Hotel in Washington, D.C., the members of the American Law Institute[14] spent the day debating the provisions of Tentative Draft Number Five of the Institute's *Principles of Corporate Governance: Analysis and Recommendations.*[15] Tentative Draft Number Five contains provisions which codify the common law fiduciary duty of loyalty.[16] Late in the afternoon, the reporter for Tentative Draft Number Five reached section 5.09, "Effect of a Standard of the Corporation."[17] The reporters intended the section to permit corporate boards of directors, by a "standard of the corporation,"[18] to delegate approval procedures for certain conflict of interest situations.

Under section 5.09, a particular corporation's internal rules could permit the board to delegate implementation of its conflict of interest decisions to a board committee or a single executive likely to have no interest in the matter.[19] A corporate decision-maker below the board of directors

14. The Author is an elected member of the American Law Institute and was present at the May 16, 1986, Institute proceedings.

15. Commenced in the early 1980s, the American Law Institute Corporate Governance Project now consists of eight tentative drafts. *See* Principles of Corporate Governance: Analysis and Recommendations (Tent. Draft No. 8, 1988). *See generally* Perkins, *The ALI Corporate Governance Project in Midstream,* 41 Bus. Law. 1195, 1196 (1986) (brief history of the American Law Institute Corporate Governance Project).

16. In his opening remarks that day, the reporter for Tentative Draft Number Five, Mr. Marshall Small, had retitled these provisions "the duty of fair dealing." *See* Principles of Corporate Governance: Analysis and Recommendations 15 n.* (Tent. Draft No. 7, 1987) [hereinafter Corporate Governance VII].

17. *See* American Law Institute, Proceeding of the 63d Annual Meeting 407 (1986) [hereinafter ALI Proceeding]. Tentative Draft Number Five contains fourteen sections. *See* Principles of Corporate Governance: Analysis and Recommendations §§ 5.01-5.14 (Tent. Draft No. 5, 1986) [hereinafter Corporate Governance V]. The reporter for Part V had jumped ahead from § 5.06 to § 5.09, *see* ALI Proceeding, *supra*, at 407-08, returning to consideration of the omitted sections after the discussion of § 5.09, *see id.* at 434.

18. " 'Standard of the corporation' means a valid certificate or by-law provision, or board or shareholder resolution, regulating corporate governance." Corporate Governance V, *supra* note 17, § 1.30.

19. *See id.* § 5.09.

level could, for example, review disclosure and accept or reject an officer's or director's proposal to "enter into a transaction with the corporation that is of a specified type that could be expected to recur in the ordinary course of business."[20] To husband the board's resources, intracorporate standards could vary from established conflict of interest procedures.[21]

At that point in the proceeding Judge Frank Easterbrook of the United States Court of Appeals stepped to a microphone.[22] Judge Easterbrook believed that, under section 5.09, corporations could vary from or indeed do away with application of all the principles enunciated in sections 5.02 to 5.08.[23] For example, with regard to a subject debated at length by Institute members that afternoon, Judge Easterbrook thought that, by adopting a standard of the corporation, disinterested directors could ratify past conflict of interest transactions. This ratification would be the equivalent of the advance approval the ALI corporate conflict of interest procedures contemplated.

Continuing, Judge Easterbrook also suggested that, under section 5.09, a corporation's shareholders could vote to amend its articles of incorporation to exempt that corporation's directors and officers from all or part of the common law fiduciary duty of loyalty. For example, amendments to the articles could carve out an area of the corporation's business as not being a corporate opportunity for executives of that company, and thus not subject to conflict of interest analysis and rules against usurpation or diversion. Judge Easterbrook indicated that some procedural protections might be in order, such as requiring approval of a majority of sharehold-

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20. In its entirety the section then provided:

> If a director or senior executive relies upon a standard of the corporation that authorizes a director or senior executive to:
>
> (a) enter into a transaction with the corporation that is of a specified type that could be expected to recur in the ordinary course of business; or
>
> (b) advance his pecuniary interests by using his corporate position or corporate property in a specified manner that is not unlawful and that could be expected to recur in the ordinary course of business;
>
> and the standard was authorized by disinterested directors or disinterested shareholders, following disclosure of the type of transaction or conduct intended to be covered by the standard, the standard is to be deemed equivalent to an authorization of the action by disinterested directors or shareholders under §§ 5.02 (transactions with the corporation), 5.03 (compensation of directors and senior executives), or 5.04 (use of corporate position or corporate property), as the case may be.

*Id.* § 5.09 (cross-references omitted).

21. *See id.* § 5.09 comment, at 148.

22. *See* ALI Proceeding, *supra* note 17, at 411-13.

23. Sections 5.02 to 5.08 are titled as follows: 5.02 Transactions with the Corporation; 5.03 Compensation of Directors and Senior Executives; 5.04 Use of Corporate Position, Non-Public Information Concerning the Corporation, or Corporate Property; 5.05 Corporate Opportunities; 5.06 Competition with the Corporation; 5.07 Transactions Between Corporations with Common Directors and Senior Executives; 5.08 Conduct on Behalf of Associates of Directors or Senior Executives. *See* Corporate Governance V, *supra* note 17, at xiv.

ers at two successive annual meetings to adopt an opt out amendment to articles of incorporation.[24]

Following Judge Easterbrook's comments, several corporate counsel took the floor. They had not envisioned what Judge Easterbrook suggested section 5.09 could do, but they wholeheartedly supported his interpretation.[25] Upon motion made and passed, the house referred the subjects of standards of the corporation and opting out of the fiduciary duty of loyalty to the reporters for further study.[26]

### B. *Delaware Section 102(b)(7): The Parade to Opt Out of Duty of Care Liability*

The first authoritative provision enabling corporations to opt out of fiduciary duty was a Delaware statute relating to the duty of care rather than the duty of loyalty. On July 1, 1986, Delaware amended its general corporation law to provide that an optional provision in articles of incorporation could limit or exclude corporate directors' liability for any breach of the duty of care,

> provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; . . . or (iv) for any transaction from which the director derived an improper personal benefit.[27]

Delaware thus enacted an opt out statute, but one substantially different from that Judge Easterbrook envisioned in proposed ALI section 5.09. Most important, the Delaware opt out statute applies only to breaches of the duty of care.[28] Additionally, a corporation may elect to opt out only

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24. *See* ALI Proceeding, *supra* note 17, at 414 ("The reason for two successive annual meetings is because a change of this sort can be very serious and it would allow the opportunity for a proxy fight at the second meeting." (comments of Judge Easterbrook)).

25. Some in the academy have made suggestions similar to Judge Easterbrook's. *Cf.* N. Wolfson, *supra* note 8, at 68 (empirical analysis of the corporate opportunity doctrine should reveal "the obvious possibility" that legal costs outweigh the benefits of retaining the duty of loyalty); Fischel & Bradley, *supra* note 5, at 290-92 (little difference between corporate law duty of care and duty of loyalty and any reform proposal based on these rules is "highly suspect").

26. *See* ALI Proceeding, *supra* note 17, at 427 (motion made); *id.* at 433 (motion passed). Subsequently, the ALI drafters shaded § 5.09 a bit toward what Judge Easterbrook desired, adding that under a standard of the corporation a corporate official may also

> (c) take advantage of a specified type of corporate opportunity of which the director or senior executive becomes aware other than (i) in connection with the performance of his functions as a director or senior executive . . . or (iii) through the use of corporate information or property; or
>
> (d) engage in competition of a specified type; . . . .

Coprorate Governance VII, *supra* note 16, § 5.09.

27. Del. Code Ann. tit. 8, § 102(b)(7) (Supp. 1988).

28. *See id.*

for directors and only for liability for money damages.[29]

Since 1986, over thirty states[30] have followed Delaware's lead, a few permitting much broader exclusions from duty of care liability than did Delaware.[31] This trend began in the 1987 annual meeting season, when American corporations in great number sought to implement the law's new liberality by seeking shareholder approval for opt out provisions in articles of incorporation.[32]

For the most part, other states have followed Delaware's lead, not

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29. Corporate officers' liability may not be limited or excluded under the provision and, as to directors or officers, injunctions against violation of the duty of care may still be obtained. *See* Sparks, *Delaware's D & O Liability Law: Other States Should Follow Suit*, Legal Times, Aug. 18, 1986, at 10, col. 1, 4.

30. *See* Ariz. Rev. Stat. Ann. § 10-054(A)(9) (Supp. 1988); Ark. Stat. Ann. § 4-27-202(B)(3) (Supp. 1987); Cal. Corp. Code § 204 (a)(10) (West Supp. 1989); Colo. Rev. Stat. § 7-3-101(1)(u) (Supp. 1987); Ga. Code Ann. § 14-2-171(b)(3) (Supp. 1988); Idaho Code § 30-1-54(2) (Supp. 1988); Iowa Code Ann. §§ 491.5(8), 496A.49(13) (West Supp. 1988); Kan. Stat. Ann. § 17-6002(b)(8) (Supp. 1987); La. Rev. Stat. Ann. § 12:24(C)(4) (West Supp. 1989); Mass. Gen. Laws Ann. ch. 156B, § 13(b)(1-2) (West Supp. 1988); Mich. Comp. Laws Ann. § 450.1209(c) (West Supp. 1988); Minn. Stat. Ann. § 302A.251(4) (West Supp. 1989); Mont. Code Ann. § 35-1-202(2)(a)(v) (1987); Neb. Rev. Stat. § 21-2035(2) (Supp. 1988); Nev. Rev. Stat. § 78.037(1) (1987); N.J. Stat. Ann. § 14A:2-7(3) (West Supp. 1988); N.M. Stat. Ann. § 53-12-2(E) (Supp. 1988); N.Y. Bus. Corp. Law § 402(b) (McKinney Supp. 1989); N.C. Gen. Stat. § 55-7(11) (Supp. 1988); Okla. Stat. Ann. tit. 18, § 1006(B)(7) (West Supp. 1989); 42 Pa. Cons. Stat. Ann. § 8364 (Purdon Supp. 1988); R.I. Gen. Laws § 7-1.1-48(B)(6) (Supp. 1988); S.D. Codified Laws § 47-2-58.8 (Supp. 1988); Tex. Rev. Civ. Stat. Ann. art. 1302-7.06(B) (Vernon Supp. 1989); Utah Code Ann. § 16-10-49.1 (Supp. 1988); Wash. Rev. Code § 23A.12.020(10)(d) (Supp. 1989); Wyo. Stat. § 17-1-202(c) (1987); *see also infra* note 31. *See generally* Radin, *The Director's Duty of Care Three Years After* Smith v. Van Gorkom, 39 Hastings L.J. 707, 744-54 (1988) (complete compilation and discussion of duty of care statutes); Note, *The Limitation of Directors' Liability: A Proposal for Legislative Reform*, 66 Tex. L. Rev. 411, 439-40 & nn.157-58 (1987) (partial statutory compilation); Comment, *supra* note 7, at 242 nn.12-13 (same).

31. Indiana and Wisconsin, for example, simply abolished director liability for duty of care violations. *See* Ind. Code Ann. § 23-1-35-1(e) (West Supp. 1987); Wis. Stat. Ann. § 180.307 (West Supp. 1988). These provisions are self-implementing: no amendment of articles of incorporation need be undertaken, although individual corporations may reinsert a duty of care in articles of incorporation or bylaws. For other statutes that abolish duty of care liability, see Fla. Stat. Ann. § 607.1645 (West Supp. 1988); Ohio Rev. Code Ann. § 1701.59(D) (Page Supp. 1987); Va. Code Ann. § 13.1-690A, C (1985).

Some statutes differ from the Delaware amendment in that they do not contain explicit exceptions for duty of loyalty violations. *See* Neb. Rev. Stat. § 21-2035(2) (Supp. 1988); Nev. Rev. Stat. § 78.037(1) (1987); N.Y. Bus. Corp. Law § 402(b) (McKinney Supp. 1989); N.C. Gen. Stat. § 55-7(11) (Supp. 1988); 42 Pa. Cons. Stat. Ann. § 8364 (Purdon Supp. 1988).

32. *See* Crossen, *Companies Ask Holders to Limit Boards' Liability*, Wall St. J., Oct. 7, 1986, at 35, col. 3; *Many Delaware Corporations Moving to Limit Directors' Liability*, 18 Sec. Reg. & L. Rep. (BNA) No. 49, at 1784-85 (Dec. 12, 1986).

The limitation on directors' liability, which opt out statutes made possible, resulted from the crisis in Director and Officers' (D & O) liability insurance, which was part of the general corporate liability insurance crisis in the mid-1980s. Adding fuel to the fire, in Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), the Delaware Supreme Court held liable for $20 million distinguished directors who had negligently approved the chief executive officer's proposal to sell the company. The *Van Gorkom* decision precipitated further escalation of the insurance crisis. These events are fully reviewed in Note, *supra* changing the standard of director conduct but merely permitting corporations to opt out of liability for violations by their officials.[33] Since the standard of conduct remains the same, plaintiff shareholders can still obtain injunctive relief in corporations electing the opt out provision.[34] Moreover, because severe forms of negligence rising to the level of conscious disregard are akin to intentional conduct, in all probability these shareholders will continue to be able to obtain damage recoveries for the corporate treasury whenever directors have been reckless.[35]

### C. *Distinctions Between the Duty of Care and the Duty of Loyalty*

The common law has always drawn "a sharp distinction" between

> allegations of director misconduct involving breach of trust or self-dealing . . . and allegations of simple breach of fiduciary duty/waste of corporate assets . . . . The distinction between "mere" bribes and bribes coupled with kickbacks to the directors makes a great deal of sense, indeed, is fundamental to . . . the preservation of state corporate

note 30, at 411; Comment, *1986 Ohio Corporation Amendments: Expanding the Scope of Director Immunity*, 56 U. Cin. L. Rev. 663 (1988); Comment, *supra* note 7, at 244-61.

In the early 1980s, several D & O insurers paid off large, publicized claims. *See* Hilder, *Risky Business: Liability Insurance is Difficult to Find Now For Directors, Officers*, Wall St. J., July 10, 1985, at 1, col. 6 (reporting, *inter alia*, one insurer's payment of $25 million in shareholder suit against managers of Wickes, Inc.). Several companies, mainly large banks experiencing loan losses, sued their former officers and, therefore in effect, their own D & O insurance carriers for large amounts. *See id.* (Bank of America and Chase Manhattan Bank); *see also* Lewin, *Director Insurance Drying Up*, N.Y. Times, Mar. 7, 1986, at D-1, col. 3 (same). Takeover activity increased dramatically, with the risk that disgruntled shareholders could sue directors who had defeated a takeover bid.

Insurers reacted in several ways. They made coverage unavailable to a number of companies at any price. In coverage they did continue, they broadened exclusions. For example, an insured against insured exclusion elevated the possibility of the corporation itself claiming under the policy. *See* Lewin, *supra*, at D-4; Hertzberg, *Insurers Beginning to Defuse Coverage on Directors, Officers in Takeover Cases*, Wall St. J., Jan. 20, 1986, at 3, col. 2. Last of all, insurers raised premiums dramatically, sometimes to ludicrous heights. Faced with a hostile takeover, one corporation found its $70 million policy at a $140,000 annual premium cancelled and $100 million replaced coverage available at a $6.6 million premium. *See* Hilder, *supra*, at 1, col. 6 (Unocal Inc.).

33. *See supra* note 30 and accompanying text. Virginia is an exception. *See supra* note 7 and accompanying text. Indiana and Wisconsin have adopted opt in rather that opt out statutes. *See supra* note 31 and accompanying text.

34. *See supra* note 29 and accompanying text.

35. Under statutes such as Delaware's, directors remain liable for "intentional misconduct." *See supra* note 27 and accompanying text. However, "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-94, n.12 (1976) (holding that mere lack of reasonable care cannot ground damage recovery under SEC Rule 10b-5). In the securities law area, the federal courts have held that conduct which is "highly unreasonable" and an "extreme departure from the standards of ordinary care" is equivalent to intentional conduct, allowing recovery of damages. *See* Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977) (quoting Franke v. Midwestern Dev. Auth., Fed. Sec. L. Rep. (CCH) ¶ 95,786, at 90,850 (W.D. Okla. 1976)). *See generally* M. Steinberg, Securities Regulation: Liabilities and Remedies § 7.02 (1985) (most courts find "highly reckless" conduct to be intentional for purposes of SEC Rule 10b-5).

law.[36]

Other examples of sharp differences in treatment of the two duties abound. For one, the business judgment rule may shield from judicial scrutiny business decisions or errors in judgment by directors. Yet the rule never shields from scrutiny transactions or decisions about which colorable claims of self-dealing have been made.[37] As a second example, the standards for ratification of directors' past acts vary depending upon whether mere mismanagement or self-dealing has been alleged.[38]

Chicago School law and economics scholars, however, discern a difference in degree but not in quality between conduct the duty of care regulates and conduct the duty of loyalty governs. In economic terms, the distinction between fiduciary duties is thought to be strained:

> [I]t is extremely misleading to talk about conflicts of interest as only paying yourself an above market rate of compensation. There are many other types of conflicts of interest . . . . We talk about a few of them—consuming excess leisure, not concentrating hard. The various permutations are infinite. A conflict of interest is always present. Duties of care and of loyalty are simply different manifestations of the inherent conflict of interest in an agency relationship. Building on that, we do not see any basis for having a completely different set of legal rules . . . .[39]

A majority of states' corporation laws permit a corporation, or a majority of its shareholders, to dispense with the liability of corporate officals

36. Gaines v. Haughton, 645 F.2d 761, 776-78 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982). The court further argued that

> [m]any corporate actions taken by directors in the interest of the corporation might offend and engender controversy among some stockholders. . . . The tenor of a company's labor relations policies, economic decisions to relocate or close established industrial plants, . . . decisions to develop (or not to develop) particular natural resources or forms of energy technology . . . are just a few examples of business judgments . . . which may nonetheless cause shareholder dissent and provoke claims of "wasteful," "unethical," or even "immoral" business dealings. . . .
>
> Absent credible allegations of self-dealing by the directors . . . we hold that director misconduct of the type traditionally regulated by state corporate law need not be disclosed in proxy solicitations for director elections.

*Id.* at 778-79 (footnotes omitted).

37. *See* Principles of Corporate Governance: Analysis and Recommendations § 4.01(c)(1) (Tent. Draft No. 4, 1985); Arsht, *The Business Judgment Rule Revisited*, 8 Hofstra L. Rev. 93, 115-18 (1979).

38. *Compare* Smith v. Brown-Borhek Co., 414 Pa. 325, 200 A.2d 398 (1964) (ratification of general directorial mismanagement permitted) *with* Aronoff v. Albanese, 85 A.D.2d 3, 6-7, 446 N.Y.S.2d 368, 371 (2d Dep't 1982) (ratification of self-dealing not permitted). *See generally* R. Clark, Corporate Law § 5.3.2, at 178-79 (1986).

39. *Edited Transcript of Proceedings of the Business Roundtable/Emory University Law and Economics Center Conference on Remedies Under the ALI Proposals: Law and Economics*, 71 Cornell L. Rev. 357, 368 (1986) (remarks of Daniel Fischel); *see also* Fischel & Bradley, *supra* note 5, at 290-91 (distinction between duty of care and loyalty is "not at all clear.").

to the corporation for violations of the duty of care.[40] Under the economic analysis, then, the law also should permit opting out of applicability of the duty of loyalty.

The common law has always differentiated between the two. The common law distinction between the duty of care and the duty of loyalty is rooted in the degree to which a breach of either duty involves fault, a concept economics does not recognize. Duty of care analysis is negligence analysis, dealing with directors' nonfeasance or misfeasance. Under the guise of the latter, duty of care claims become the vehicle by which shareholders raise claims of ineptitude or lack of skill, as well as lack of diligence,[41] often in the context of conscious decision-making. The generic term used for duty of care questions is not simply negligence, but mismanagement.

In contrast, the duty of loyalty deals with purposeful conduct of a venal, opportunistic sort. In the common law hierarchy of fault, duty of loyalty violations rank high, while duty of care claims rank low.[42] Economists do not seriously discuss this traditional distinction between the degrees of fault involved.[43]

Another distinction between the duties of care and loyalty lies in the ability of directors to control developments. Financial problems of the corporation can be caused by market forces not within the directors' control. Yet those losses can result in a duty of care claim of director liability. Opportunistic behavior by corporate officials is a different matter. Only directors and officers themselves cause duty of loyalty violations. Directors are in the best position to control such behavior by fellow directors and officers. They certainly are in the best position to rein in their own venal tendencies.

The economic view that there is no distinction between the duties of care and loyalty is severely flawed because economists ignore the element of fault that in law distinguishes mere negligence or misfeasance from intentional self-dealing. Moreover, even some practitioners of economic analysis of law do not embrace erasure of the distinction between the duty of care and the duty of loyalty.[44] Market forces do not adequately

40. *See supra* notes 30-31 and accompanying text.

41. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (directors approved sale of public company in two hour meeting without even seeing documents or reports); Hun v. Cary, 82 N.Y. 65 (1880) (directors held liable for constructing new bank building while bank was in precarious financial position).

42. Ironically, with duty of care claims the fault may be small yet the damages may be great, out of all proportion to the fault involved. Losses in a publicly held corporation may run to hundreds of millions of dollars. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (discussed *supra* note 32). In duty of loyalty cases, the fault may be regarded as severe but the damages for which the director is held accountable may be relatively limited, say, return of perquisites found to be excessive. *See* Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 Duke L.J. 895, 898.

43. *See* Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 Colum. L. Rev. 1403, 1432 n.76 (1985).

44. *See, e.g.*, Carney, *Controlling Management Opportunism in the Market for Corpo-*

police opportunistic behavior. Market forces will not deter the "one shot" large defalcation or embezzlement.[45] On a lesser scale, information costs or market failure may prevent share prices from fully reflecting the extent of managers' opportunistic behavior.[46]

### D. *The Erosion of Conflict of Interest Standards and the ABA's Attempt to Eliminate the Duty of Loyalty*

#### 1. Background of Corporate Conflict of Interest Statutes

Statutes have governed the duty of loyalty since the 1930s.[47] Prior to that time, under the common law, interested director and other conflict of interest transactions were voidable unless, based upon full disclosure, a disinterested director approved the transaction and the transaction was fair to the corporation.[48] The duty of loyalty statutes have cut the three pronged common law test in two, making it disjunctive rather than conjunctive. A conflict of interest transaction may be approved upon *either* disclosure and a disinterested director vote *or* fairness.[49]

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*rate Control: An Agency Cost Model*, 1988 Wis. L. Rev. 385, 390 ("courts have a role to play in settling up with opportunistic managers"); Goetz, *A Verdict on Corporate Liability Rules and the Derivative Suit: Not Proven*, 71 Cornell L. Rev. 344, 350 (1986) ("Contract methodology suggests that [lawyer-economists] are too quick to condemn the distinction between the duty of care and the duty of loyalty as one that is artificial.").

45. *Cf.* Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Studies 251, 278-80 (1977) (advocating return to "fairness rule" because market forces do not protect shareholders from "one shot" raids by management on corporate assets).

46. *See, e.g.*, Allen, *Posner Agrees to Formation of a Panel on Pay, Transactions Within His Empire*, Wall St. J., June 30, 1987, at 5, col. 1 (attempt to rein in extensive course of self-dealing over many years by chief executive of several publicly held companies).

47. A good general primer in the area is Bulbulia & Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards?*, 53 Notre Dame Law. 201 (1977). In 1933, California passed the first statute regulating interested director transactions. *See id.* at 204 & n.28.

48. *See, e.g.*, Schnittger v. Old Home Consol. Mining Co., 144 Cal. 603, 78 P. 9 (1904) (finding no fraud where directors did not disclose that they had loaned money to the corporation, but transaction made under authority of corporation which sustained no detriment); Jacobson v. Brooklyn Lumber Co., 184 N.Y. 152, 76 N.E. 1075 (1906) (increase in assets of corporation is no defense in a derivative action for depletion); *cf.* Gottlieb v. The Mead Corp., 72 Ohio L. Abs. 353, 137 N.E.2d 178 (C.P. 1954) (decision is exclusively for board of directors in absence of bad faith, gross negligence or willful dissipation of corporate assets), *aff'd*, 72 Ohio L. Abs. 283, 134 N.E.2d 857 (Ct. App. 1955). *See generally* Marsh, *Are Directors Trustees?: Conflict of Interest and Corporate Morality*, 22 Bus. Law. 35, 39-40 (1966) ("a contract between a director and his corporation was valid if it was approved by a disinterested majority of his fellow directors and was not found to be unfair or fraudulent").

49. *See* Bulbulia & Pinto, *supra* note 47, at 202. Arguably, at that point the duty is no longer one of loyalty but merely one to refrain from damaging the corporation. Fairness to the corporation connotes as its opposite damage or a likelihood of damage to the corporation. Thus, under modern statutory fairness tests, a corporate official's duty has become mere avoidance of harm to the principal. This should be contrasted with the aspirational duty of loyalty or of "undivided loyalty," which the common law exalted. *See* State *ex rel.* Hayes Oyster Co. v. Keypoint Oyster Co., 64 Wash. 2d 375, 381, 391

The effect of corporate compliance with those statutes varies. Frequently, compliance with the statutory procedure shifts the burden of proof.[50] If the corporation complies with the proper procedure, then the party attacking the interested director transaction has the burden of proving the transaction unfair to the corporation.[51] If the corporation fails to follow the procedures outlined, then the party seeking to uphold the transaction, usually the corporation and the interested director, has the burden of proving the transaction fair.[52] This shifting of the burden of proof, coupled with the division of the common law test into a disjunctive one, substantially lessens a complaining shareholder's chance of success in a claim of breach of the duty of loyalty.[53]

Other statutes purport to be more authoritative. These statutes provide simply that an interested director transaction is not voidable if, upon full disclosure, disinterested directors approved it, or the transaction was fair.[54] On their face, then, such statutes seem completely to immunize a transaction that ostensibly disinterested directors approved, no matter how outlandish or injurious to the corporation the transaction might be.

In *Fliegler v. Lawrence*,[55] the Supreme Court of Delaware held such a literal reading of these statutes itself to be outlandish. The court stated "[section 144] merely removes an 'interested director' cloud when its

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P.2d 979, 983 (1964) (fidelity of the agent and not mere prevention of injury to the corporation has traditionally been the law's goal). For example

> [an] allegation of damages to the corporation . . . has never been considered to be an essential requirement for a cause of action founded on a breach of fiduciary duty. This is because the function of such an action, unlike an ordinary tort or contract case, is not merely to *compensate* the plaintiff for wrongs committed . . . but . . . "to *prevent* [wrongs], by removing from agents and trustees all inducement to attempt dealing for their own benefit in matters which they have undertaken for others . . . ."

Diamond v. Oreamuno, 24 N.Y.2d 494, 498, 248 N.E.2d 910, 912, 301 N.Y.S.2d 78, 81 (1969) (citation omitted) (emphasis in original) (quoting Dutton v. Willner, 52 N.Y. 312, 319 (1873)); *accord* Heit v. Bixby, 276 F. Supp. 217, 226-27 (E.D. Mo. 1967) (reviewing Missouri cases).

50. *See, e.g.*, Calif. Corp. Code § 310(a)(3) (West 1977) (if transaction not approved by proper statutory procedure, then party asserting validity of the transaction has burden of showing it was just and reasonable); Ill. Ann. Stat. ch. 32, ¶ 8.60(b) (Smith-Hurd 1985) ("person asserting validity [of the transaction] has the burden of proving fairness unless" statutory procedures for authorization, approval or ratification followed); Wash. Rev. Code § 23A.08.435(2) (Supp. 1989) (same).

51. *See* Cohen v. Ayres, 596 F.2d 733, 740-41 (7th Cir. 1979); Fliegler v. Lawrence, 361 A.2d 218, 221 (Del. 1976); Durfee v. Durfee & Canning, Inc., 323 Mass. 187, 199, 80 N.E.2d 522, 527 (1948).

52. *See* Corporate Governance V, *supra* note 17, § 5.02(b); *see, e.g.*, Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 599 (1921) (placing burden on corporation to show fairness once plaintiff proved harm); Lewis v. S.L. & E., Inc., 629 F.2d 764, 768-70 (2d Cir. 1980) (same); Mayflower Hotel Stockholders Protective Comm. v. Mayflower Hotel Corp., 173 F.2d 416, 427 (D.C. Cir. 1949) (same); Fliegler v. Lawrence, 361 A.2d 218, 221 (Del. 1976) (same).

53. *See* Bulbulia & Pinto, *supra* note 47, at 225-26.

54. *See* Corporate Governance V, *supra* note 17, § 5.02; *see, e.g.*, Del. Code Ann. tit. 8, § 144 (1983); 2 Model Business Corp. Act Ann. § 8.31 (3d ed. 1985).

55. 361 A.2d 218 (Del. 1976).

terms are met and provides against invalidation of an agreement 'solely' because such a director or officer is involved. Nothing in the statute sanctions unfairness to [the corporation] or removes the transaction from judicial scrutiny."[56] Although the court ultimately found the transaction's terms fair, *Fliegler*'s message was clear: the duty of loyalty cannot be circumvented merely by use of intracorporate conflict of interest procedures.

### 2. The ABA's Attempt to Negate the Duty of Loyalty

The ABA amendments to the Model Business Corporation Act laboriously seek to eliminate even the small chance of fairness review provided by *Fliegler*. If full disclosure has been made and disinterested directors[57] have approved the transaction, the statute precludes judicial review of the transaction.[58]

Seeming to circumscribe its operation, however, the statute's narrow definition of "conflicting interest transactions"[59] excludes many transactions that, by common sense, usually involve conflicts of interest.[60] This

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56. *Id.* at 222.

57. The Model Business Corporation Act terms disinterested directors as "qualified directors." For purposes of the amended section of the statute "qualified directors" are those directors not having any interest in or relation to the conflicting interest transaction. *See* Model Business Corp. Act § 8.62(d), *reprinted in*, Committee on Corp. Laws, *Changes in the Model Business Corporation Act—Amendments Pertaining to Director's Conflicting Interest Transactions*, 43 Bus. Law. 691, 710 (1988).

58. According to the Model Business Corporation Act:

> A director's conflicting interest transaction may not be enjoined, set aside, or give rise to an award of damages . . . in a proceeding by a shareholder or by or in the right of the corporation, because the director, or any person with whom or which he has a personal, economic, or other association, has an interest in the transaction, if: (1) directors' action respecting the transaction was at any time taken in compliance with section 8.62.

*Id.* § 8.61(b), at 703-04.

Section 8.62 provides that a conflicting interest transaction must be approved upon full disclosure and an affirmative vote, either by a majority of (but not less than two) qualified directors, or by a "duly empowered committee of the board." *Id.* § 8.62(a), at 709. This section further provides that, if the director seeking to engage in a conflicting interest transaction cannot disclose the conflict (for example because of duty of confidentiality), then § 8.62(a) is satisfied if the director in question discloses to the board his conflict as well as whatever limitations may exist and takes no part in the deliberations or vote. *See id.* § 8.62(b), at 709.

59. The statute states that a "conflicting interest" arises if, at the time of a transaction involving the corporation, the director knows that he, a person related to him, or an entity in which he has a controlling, agency, partnership or similar interest, has a financial interest in the transaction such that "the interest would reasonably be expected to exert an influence on the director's judgment if he were called upon to vote on the transaction." *Id.* § 8.60(1), at 696-97.

60. For example, the comment to § 8.61(a) states:

> If a plaintiff charges that a director had a conflict of interest with respect to a transaction of the corporation because the other party was his brother-in-law, the answer of the court should be: "No. A brother-in-law, as such and without more, is not included in section 8.60(3) as a related person—and under section 8.61(a), I have no authority to reach out farther." If a plaintiff contends that

sleight of hand is misleading because the statute further provides that, if a common sense conflict of interest transaction is not a statutory "conflicting interest transaction," then the transaction is not reviewable at all, regardless of whether disinterested directors approved the transaction.[61]

In attempting to eliminate this relatively small chance of a fairness review,[62] the business lawyers who served on the committee have bartered continued erosion of the common law duty of loyalty in exchange for a small amount of additional transaction certitude in business dealings. In attempting to construct a set of "bright line" rules,[63] the committee has substituted for lofty general principle a stationary target that sharp, amoral, or unscrupulous corporate officials can see and narrowly avoid. Thus the committee and the Model Business Corporation Act amendments rob the duty of loyalty of any of the remaining aspirational quality with which it has traditionally been infused.[64]

### 3. The ABA's Unconvincing Reasoning: The Lowest Rather Than the Highest Common Denominator in Business Morality

The Model Business Corporation Act drafters' reason for eliminating judicial review is completely unconvincing: "It is important to keep firmly in mind that it *is* a contingent risk we are dealing with—that an interest conflict is not in itself a tort or a crime or injurious to others."[65] Generations have thought otherwise. When charged with responsibility for the affairs or property of others, unfaithfulness is one of the most serious moral failures of all. As Mr. Justice Stone warned:

> [W]hen the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that "a man cannot serve two masters". . . . No thinking man can believe that an economy built upon a business foundation can permanently endure without some loyalty to that princi-

> the director had a conflict of interest in a corporate transaction because the other party is president of the golf club the director wants desperately to join, the court should respond: "No. The only director's conflicting interest on the basis of which I can set aside a corporate transaction . . . is a financial interest as defined in section 8.60."

*Id.* § 8.61(a) comment, at 705.

61. *See id.* § 8.61(a), at 703.

62. The paucity of reported appellate decisions evidences this. The cases in which courts have proceeded to a fairness review, despite intracorporate procedures having been followed, are very few in number. Besides Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976) (discussed *supra* text accompanying note 55), most frequently mentioned case is Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952).

63. *See* Committee on Corp. Laws, *supra* note 57, at 693 (American Bar Association's justification for amending Model Business Corporation Act is to create a set of "bright line" rules).

64. *See supra* note 49 and accompanying text (traditional common law view of duty of loyalty).

65. Committee on Corp. Laws, *supra* note 57, at 693 (emphasis in original).

> ple. . . . [T]hose who serve nominally as trustees, but relieved, by clever legal devices, from the obligation to protect those whose interests they purport to represent, corporate officers and directors who award to themselves huge bonuses from corporate funds . . . , suggest how far we have ignored the necessary implications of that principle. The loss and suffering inflicted on individuals, the harm done to a social order founded upon business and dependent upon its integrity, are incalculable.[66]

The Model Business Corporation Act drafters neglect to disclose just how remote is the chance of the fairness review they fear. In the last decade, derivative suits based solely upon alleged breaches of fiduciary duty have had only a minuscule chance of seeing the full light of plenary judicial proceedings.[67]

Even if a corporation has failed to follow proper conflict of interest procedures, with the advent of the special litigation committee in the late 1970s, most corporations will be able to stave off a fairness review—even after a complaining shareholder has filed suit—by appointing a special litigation committee composed of a few new disinterested directors. If the committee recommends that the court dismiss the filed action as not in the corporation's best interests, and if the committee has been sufficiently diligent in the investigation leading to a dismissal recommendation, then under the business judgment rule, the court will dismiss the pending action without examining its merits.[68]

The reduced risk of judicial review heightens, not lessens, the need for fairness review of interested director transactions in some cases. The reduced risk of judicial review also tips the balance toward retaining some aspirational content and away from the purported need for more certainty in the corporate duty of loyalty area.[69]

The new American Bar Association initiative to limit the duty of loyalty's operation carries too far the developments that began with the advent of special litigation committees. Those developments continued with statutory facilitation of duty of care opting out amendments in arti-

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66. Stone, *The Public Influence of the Bar*, 48 Harv. L. Rev. 1, 8-9 (1934) (remarks of Mr. Justice Stone at the dedication of the University of Michigan School of Law Quadrangle).

67. *See* Alford v. Shaw, 72 N.C. App. 537, 548, 324 S.E.2d 878, 886 (1985), *modified*, 320 N.C. 465, 358 S.E.2d 323 (1987). *See generally* Branson, *The American Law Institute Principles of Corporate Governance and the Derivative Action: A View From the Other Side*, 43 Wash. & Lee L. Rev. 399, 401-08 (1986) (analyzing obstacles and concerns of plaintiffs' attorneys in derivative actions); Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 Nw. U.L. Rev. 96, 145-46 (1980) (criticizing judicial opinions that expand directors' power to terminate shareholder derivative suits).

68. Essentially, modern day use of the device dates from two cases, decided within weeks of one another. *See* Burks v. Lasker, 441 U.S. 471 (1979); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). An earlier case is Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976).

69. *See supra* note 63 (stated purpose of amendments to Model Business Corporation Act); *supra* note 49 (traditional common law statement of duty of loyalty).

cles of incorporation. The recent American Bar Association amendments fail to recognize the traditional common law distinction necessary for statutory treatment of the duty of loyalty rather than the duty of care. With the myopic vision born perhaps of lawyers too focused on particular clients and particular goals, the American Bar Association drafters also fail to recognize the ultimate counter-productivity of the interested director statute they propose for adoption by the states.

## II. LIFE IN A CORPORATE WORLD DEVOID OF THE DUTY OF LOYALTY

### A. *Constitutional Model of the Relationship Between Corporations and Corporate Law*

Some have viewed corporation law and the corporate charter as analogous to constitutions, but for private rather than public enterprises.[70] Just as constitutions direct the structure of political bodies, corporate laws and charters organize and delegate governance to what the English term the "organs" of the company.[71] As governments do, corporations have chief executive officers. To a degree, boards of directors resemble legislatures for particular institutions. Laws and charters delegate and assign various functions to these organs. More importantly perhaps, constitutions place limits on what government, which in reality is the representative of a plurality or a majority in a society, can and cannot do. A constitution forbids a majority, or even a supermajority, from exceeding certain limits.[72] Even in a democracy, majority rules but it does not rule absolutely.

Constitutional theory supports these views. Were the majority in a political jurisdiction to adopt ordinances providing for invidious discrimination in their society they might run afoul of constitutional provisions forbidding such activity. If they could muster the necessary votes,[73] however, the majority or supermajority could amend the constitution to remove the textual obstacles in their way. But the majority's effort to amend the constitution would not matter under the view that there exists

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70. *See* M. Eisenberg, The Structure of the Corporation: A Legal Analysis 1 (1976). In the same manner a constitution can be viewed as a corporate charter in a more global sense.

71. *See* L.C.B. Gower, Gower's Principles of Modern Company Law 17-21 (4th ed. 1979).

72. *See, e.g.*, R. Dworkin, Law's Empire 373-79 (1986); *see also id.* at 376 ("constitutional rights are designed exactly to prevent majorities from following their own convictions about what justice requires"); *id.* at 256-57 ("A particular judge may think . . . that political decisions should mainly respect majority opinion, and yet believe that this requirement relaxes and even disappears when serious constitutional rights are in question.").

73. A constitutional amendment may be proposed by a two-thirds vote of both houses of Congress or by application of two-thirds of the states meeting in convention. In either case, the further requirement is ratification by three-fourths of all the states, by legislature or by convention, as specified by the proposed amendment. *See* U.S. Const. art. V.

an irreducible minimum, a core which even a supermajority cannot take away. Lord Coke spoke of "common right and reason" and denounced laws which are "repugnant"—not repugnant "to" any articulated precept, but simply "repugnant."[74] Often such analysis comes close to an outmoded natural law treatment of the subject,[75] discredited in a positivist world which for constitutional analysis requires specific textual references. Nonetheless, credible arguments exist that even a supermajority cannot alter certain fundamental or core principles.

In corporate law, the notion that an irreducible core of shareholders' rights exists finds frequent expression. In many cases, contrary to economists' nexus or web of contracts approach,[76] courts find that contract cannot override fiduciary duty. Alternatively, courts find that any contract incorporates fiduciary duty as an implied term. Thus, a court has held that a contract to maintain incorporators in office as directors does not override the "inherent right to remove a director for cause, for implicit in any agreement to maintain a particular director in office is that director's duty to fulfill faithfully the requirements of his office."[77] In interested director transactions, courts have held that not even disinterested director approval "[s]anctions unfairness to [the corporation] or removes the transaction from judicial scrutiny."[78] In the area of corporate combinations, "no shop," "best efforts," "cancellation fee" and other contractual provisions designed to favor one takeover partner over another cannot override the duty of target company directors to serve the best interests of shareholders and of the corporation.[79]

In corporation law, fiduciary duty, or some part of it, is this irreducible minimum or core that even a supermajority cannot take away.[80] Opting

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74. Dr. Bonham's Case, 77 Eng. Rep. 646, 652 (C.P. 1610), *discussed in* R. Berger, Congress v. The Supreme Court 349 (1969).

75. *See, e.g.*, J. Wilson, *Comparison of the Constitution of the United States, with that of Great Britain* in 1 The Works of James Wilson 309, 329 (McCloskey ed. 1967) (judges are bound to obey "natural or revealed law, proceeding from divine authority" and to pronounce acts contrary thereto void).

76. *See infra* notes 92-95 and accompanying text.

77. Springut v. Don & Bob Restaurants of Am., 57 A.D.2d 302, 305, 394 N.Y.S.2d 971, 973 (4th Dep't 1977).

78. Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976); *accord* Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 419-20, 241 P.2d 66, 74 (1952). This feature of the corporate landscape is one that the ABA Committee on Corporate Laws wishes to change. *See supra* notes 62-64 and accompanying text.

79. *See, e.g.*, Great W. Producers Co-op. v. Great W. United Corp., 200 Colo. 180, 187, 613 P.2d 873, 879 (1980) (board that had pledged best efforts did not have to recommend offer to shareholders when intervening events had occurred); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986) (injunction against lockup option, no shop contract clause and cancellation fee agreement to favored suitor upheld); ConAgra, Inc. v. Cargill, Inc., 222 Neb. 136, 154, 382 N.W.2d 576, 586 (1986) (fiduciary duty overrides best efforts clause in favor of first offeror).

80. It may be that fiduciary duty is a core, but a reducible one. In turn, inside that core the irreducible minimum is the appraisal remedy, which on the occurrence of certain triggering events such as statutory merger gives the minority shareholder the right to have a court appraise her shares and to receive that amount in cash. *See, e.g.*, 3 Model

out arrangements, or proposed interested director immunity statutes, however, facilitate reduction of this core beyond what right and reason should permit. Applying a wardhealer's analogy, opting out of fiduciary duty will result in a spoils system, or some version of it. Extreme moral hazard, self-enrichment, tolerance of extreme ineptitude, or nepotism will result.[81]

### B. *Fiduciary Duty Viewed as a Limit on Majority Rule*

In corporate law, majority—meaning majority of the shares—usually rules.[82] Yet some traditional discrete corporate law commands, espe-

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Business Corp. Act Ann. § 13.02, at 1371-73 (Supp. 1988) (greatly increased number of triggering events under Model Act).

81. Older corporation law cases held some statutory rights so fundamental that neither subsequent shareholder action nor subsequent statutory amendment could affect preexisting corporations, even despite the state's reservation of the power later to amend the statute. *See, e.g.*, State *ex rel.* Swanson v. Perham, 191 P.2d 689, 694 (Wash. 1948) (straight voting for directors found to be "valuable vested property right" not affected by later statute's introduction of cumulative voting), *overruled*, Seattle Trust & Sav. Bank v. McCarthy, 94 Wash. 2d 605, 611, 617 P.2d 1023, 1027 (1980).

Recent cases have abandoned that point of view. Not only do subsequent statutory provisions bind existing corporations, but also the will of a shareholder majority, or two-thirds, as the case may be, can take away certain features or shareholder rights long regarded as fundamental. *See, e.g.*, Mobile Press Register, Inc. v. McGowin, 271 Ala. 414, 426-27, 124 So. 2d 812, 823-24 (1960) (preemptive right held not to be a vested right); Hanks v. Borelli, 2 Ariz. App. 589, 592, 411 P.2d 27, 30 (1966) (renewal of corporate charter from territorial days subjected corporation to cumulative voting requirement not in existence at the time of incorporation); *Seattle Trust & Sav. Bank*, 94 Wash. 2d at 611, 617 P.2d at 1027 (preemptive right not a vested right). Statutory rights, no matter how fundamental, are no longer considered vested rights that cannot be taken away, whether the right involved is the preemptive right to shares or the right to cumulate votes in the election of directors. Hence, as a matter of statutory corporation law no irreducible core or minimum can be said to exist.

The very reason that vested rights have seen their demise, however, is because the emphasis has shifted from whether certain rights had been vested to whether management or majority shareholders had gone too far in eliminating rights, thereby breaching their fiduciary duties to the minority. This shift from a hard and fast limitation on majority rule to a more flexible fairness analysis took place in a number of areas, including elimination of preemptive rights, cumulative voting and arrearages on preferred stock dividends. *See, e.g.*, Bove v. Community Hotel Corp., 105 R.I. 36, 44, 249 A.2d 89, 94 (1969) (dividend arrearage). Thus a shift in the mode of analysis has occurred, not an abandonment of the core of fundamental rights. Fiduciary duty, rather than some statutory rights regarded as vested, became the new core or minimum that even a majority could not take away. An early piece articulating this shift is Latty, *Fairness—The Focal Point in Preferred Stock Arrearage Elimination*, 29 Va. L. Rev. 1 (1942); *see also* Halloran, *Equitable Limitations on the Power to Amend Articles of Incorporation*, 4 Pac. L.J. 47 (1973).

82. This has been juxtaposed to rule by a majority of shareholders rather than shares. *See generally* Ratner, *The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote,"*, 56 Cornell L. Rev. 1 (1970). Moreover, approximately a dozen and a half jurisdictions require a two-thirds rather than majority approval of organic changes such as a merger, sale of assets, dissolution or amendment of articles of incorporation, although the trend is toward majority vote on all matters. *See supra* note 10.

cially fiduciary duties, serve as limits upon unbridled majority rule.[83] Even a majority of shares cannot authorize incumbent corporate managers to enrich themselves at the corporation's expense through excessive salary payments and other perquisites. A majority should not be able to license the managers to buy and sell property to the corporation with no possibility of an external review or other check or balance.

These statements find clearest expression in cases involving shareholders' attempted ratification of interested director transactions or other alleged duty of loyalty violations.[84] In *Gottlieb v. Heyden Chemical Corp.*,[85] the Supreme Court of Delaware found that the majority did not rule absolutely: "An unconscionable deal between directors personally and the corporation they represent could not become conscionable merely because most of the stockholders were either indifferent or actually in sympathy with the directors' scheme."[86]

A further set of cases limits the majority in their ability to ratify interested director transactions or compensation schemes that amount to waste of corporate assets. Waste of corporate assets, these cases hold, cannot be ratified except by unanimous shareholder consent.[87] Even a majority's action before the fact, rather than after the fact as with ratification, runs up against limits. When a majority of the shares has adopted provisions in the articles of incorporation intended to authorize directors to engage in conflict of interest transactions, courts have been willing to give those provisions only limited weight.[88] As one court

83. Common examples might include statutory provisions that forbid the loan of corporate funds to officers and directors altogether or at least without specific shareholder approval. *See, e.g.*, Alaska Stat. § 10.05.213 (1985) (flat prohibition); Cal. Corp. Code § 315(g) (West Supp. 1989) (approval of disinterested shareholders required); Neb. Rev. Stat. § 21-2045 (1987) (flat prohibition); *cf.* Del. Code Ann. tit. 8, § 143 (1983) (approval of directors sufficient if they believe "such loan . . . may reasonably be expected to benefit the corporation"). Another example is the preemptive right. Corporate officers and directors cannot issue shares for cash to themselves or their associates without first offering minority shareholders the opportunity to maintain their proportionate ownership and control interests. *See, e.g.*, 1 Model Business Corp. Act Ann. § 6.30, at 458 (3d ed. 1985) (25 jurisdictions grant the preemptive right subject to limitation or denial in articles of incorporation); *cf.* Revised Model Business Corp. Act. § 6.30(a)-(b) (1984) (preemptive right does not exist unless provided for and, in the latter instance, still does not apply to shares issued to corporate officers and directors).

84. *See, e.g.*, Schreiber v. Bryan, 396 A.2d 512, 518 (Del. Ch. 1978) (most ratification must be unanimous); Continental Sec. Co. v. Belmont, 206 N.Y. 7, 18, 99 N.E. 138, 142 (1912) (same); *cf.* Claman v. Robertson, 164 Ohio St. 61, 72, 128 N.E.2d 429, 436 (1955) (majority approval would suffice).

85. 90 A.2d 660 (Del. 1952).

86. *Id.* at 665.

87. *See* Michelson v. Duncan, 407 A.2d 211, 223 (Del. 1979) (even majority cannot ratify indiscriminate award of stock options to managers); Schreiber v. Bryan, 396 A.2d 512, 521 (Del. Ch. 1978) ("waste of corporate assets is incapable of [stockholder] ratification without unanimous stockholder consent"); Saxe v. Brady, 40 Del. Ch. 474, 479, 184 A.2d 602, 605 (1962) (allegation that advisory fees paid by investment company and ratified by shareholders not upheld).

88. *See, e.g.*, Spiegel v. Beacon Participations, Inc., 297 Mass. 398, 417, 8 N.E.2d 895, 907 (1937) (such a provision gives "no immunity to . . . directors . . . . But it exonerates

stated concerning limits on the majority's ability to discard or weaken the duty of loyalty, "[e]xculpatory provisions of corporate articles create no license to steal."[89]

Only short pause is needed to demonstrate why restrictions on majority rule are necessary as a practical matter. Questions of morality aside, restrictions are essential to attract investors to entrust money to the common enterprise a corporation often represents.[90] Without a limit on the majority's ability to self deal, that is, to expropriate to itself the minority's contribution to the venture, no sensible individual would invest in any incorporated venture. At least, no individual would invest in a corporation without first negotiating contractual protections that approximate what the duty of loyalty provides. In most instances, transaction costs prevent such negotiations from taking place.[91] Without minority investors, far fewer common enterprises could or would be launched.

Absent the constraints of fiduciary duty, majority rule represents a spoils system in which the party that obtains working or numerical voting control has unbridled opportunities for its own self-aggrandizement. The other parties to the enterprise have no protection against the ineptitude or self-dealing of the manager, save possibly through the ballot box. If the managers or those they represent do have numerical control, the ballot will be of no avail. Majority not only rules, it rules absolutely.

## III. THE CONTRACTARIAN MODEL: THE THEORETICAL UNDERPINNINGS OF THE OPT OUT MOVEMENT

### A. *The Contractarian's Reply to the Majoritarian Model*

#### 1. The Contractarian's Model

The contractarian model has provided the justification for the modern trend toward liberalizing corporate statutes and enabling incorporating parties to define for themselves their organizational structure. Under this view, corporate law's only function should be to facilitate citizens' organization of their business affairs at the lowest possible cost.[92] Hence,

them from adverse inferences which might otherwise be drawn against them."); Everett v. Phillips, 288 N.Y. 227, 237, 43 N.E.2d 18, 22 (1942) (such a provision "has the effect of exonerating the directors, at least in part," but not totally; court reviews transactions on the merits despite charter provision).

89. Irwin v. West End Dev. Co., 342 F. Supp. 687, 701 (D. Colo. 1972) (majority shareholder president ordered to return to the corporation a salary he voted himself), *modified on other grounds*, 481 F.2d 34 (10th Cir.), *cert. denied*, 414 U.S. 1158 (1973).

90. *See* Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. Rev. 738, 776 (1978).

91. In most cases the principal transaction costs are attorneys' fees.

92. *See, e.g.*, Anderson, *supra* note 90, at 781-82 ("corporation codes can [provide efficiency and fairness] by providing standardized rules to govern shareholder-management relations"); Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U.L. Rev. 913, 944 (1982) ("Apart from minimizing transaction costs and possibly facilitating the operation of market forces that discipline management, corporation law has little role to play.").

a corporate statute might provide specific and general guidelines for organizational structure, as well as rules and principles that would constrain managers of the business in the conduct of its affairs. Ideally, however, any enterprise should be free to adapt such rules to its particular situation through contractual arrangement.[93]

To the contractarian, corporation codes and fiduciary duties serve only to approximate the terms of incorporation that organizers ordinarily would agree upon, absent transaction costs.[94] In most cases, transaction costs will prevent the parties from negotiating their own arrangement. Thus, many organizers of enterprises will not be able to utilize the latitude contractarian statutes bestow upon them. Instead, perhaps with a variation or two, parties to an entrepreneurial or other effort will plug into the corporation code's model, which approximates the bargain they would have reached by contract anyway.

The contractarian reply to the model of majority rule is that the majority does not rule absolutely because corporations do not function in a vacuum. As business enterprises, corporations function in market milieus in which market forces constrain and discipline corporate directors and managers far more quickly and efficiently than fiduciary duties and lawsuits based upon alleged violations of them ever could.[95]

### 2. The Free Market as Superior Regulator

The detritus of corporate regulation that has accumulated over the years purports to regulate in the interests of creditors and shareholders. Contractarians, however, doubt the efficacy of regulation to correct perceived abuses. They argue that, if any abuse is prevented, its prevention generates great cost.[96] Regulatory rules not only carry direct compliance costs, for example attorneys' fees, but they also stifle innovation and risk taking incentives that will most efficiently produce the goods and services that society desires.

Contractarians believe, of course, that market forces monitor management and prevent abuses more effectively than can legislators or judges. First, they argue that a competitive product market rewards efficient corporate management with greater sales and profits, while high cost management would lose profits long before corporate law fiduciary duties could operate.[97]

Second, the market for corporate control, first described in 1965 by

93. *See, e.g.*, R. Posner, Economic Analysis of Law 369-72 (3d ed. 1986).

94. *See* Fischel, *supra* note 92, at 944.

95. The contractarian approach views the incorporated firm as nothing more than a "nexus" or "web" "of contracts" among providers of capital, managers, lenders, labor, suppliers and consumers. *See* Brudney, *supra* note 43, at 1411-20; Fischel, *supra* note 92, at 917-19.

96. *See* Anderson, *supra* note 90, at 788-89.

97. *See* F. Scherer, Industrial Market Structure and Economic Performance 38-41 (2d ed. 1980).

Dean Henry Manne,[98] operates as a check on inefficient or self-dealing managers. Assuming the marketplace will discount share prices to reflect inefficiency or self-dealing, wealthy investors who snatch up shares at the reduced price will demand reforms within the company, make a tender offer for shares, or otherwise proceed to vote out the inefficient managers and replace them with more productive ones.[99]

A third market force superior to judicially or legislatively imposed restraints is management's reputational stake. To enhance career mobility, managers must cultivate reputations for efficiency. Inefficiency inherent in shirking and opportunism at the expense of the corporation imposes agency costs on managers' firms. In turn, this impugns the reputation of those firms' managers. According to contractarian philosophy, agency cost theory and the market for managers are significant regulators of behavior within the corporate world.[100]

The abrogation of confining legal rules, the contractarian argues, will give freer play to market forces which are better regulators of conduct.[101] Uninhibited by legal rules unilaterally imposed, managers will engage in the optimum amount of risk taking, producing better returns for shareholders and greater output for society as a whole. Therefore, the contractarian concludes, a particular firm's shareholders, or a majority of them, should be able to amend articles of incorporation to restrict or eliminate application of the duty of loyalty to that firm's officers and directors. Markets and the forces within them will prevent anything resembling a spoils system from developing.

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98. *See* Manne, *Mergers and the Market for Corporate Control,* 73 J. Pol. Econ. 110, 113 (1965).

99. Regulation of tender offers requires that share prices decline by a further amount equal to the costs of regulation before the market for corporate control can operate. For that reason, some scholars have advocated complete repeal of federal and other regulations. *See, e.g.,* Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers,* 57 Tex. L. Rev. 1, 24-26 (1978). *But see* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer,* 94 Harv. L. Rev. 1161 (1981) (regulation should exist to prohibit target company managers from utilization of any takeover defenses). The Supreme Court, however, has facilitated further impediments to the market for corporate control's operation by recently upholding a second generation of state tender offer statutes. *See* CTS Corp. v. Dynamics Corp. of Am., 107 S. Ct. 1673 (1987). *But see* Romano, *State Takeover Laws: Constitutional but Dumb,* Wall St. J., May 14, 1987, at 26, col. 4-6.

100. The seminal piece is Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. Fin. Econ. 305 (1976); *see also* Fama, *Agency Problems and the Theory of the Firm,* 88 J. Pol. Econ. 288 (1980). A recent summary of this neoclassical and other economists' models is contained in Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web,* 85 Mich. L. Rev. 1, 25-35 (1986).

101. *See* N. Wolfson, *supra* note 8, at 64-65, 72. Near complete freedom to opt out, the contractarian model which supports it and much of economic analysis's contribution to the corporate area seem almost calculated to legitimate corporate management's demands for freedom from all regulatory constraint. For that reason, many centrists who find value in economic analysis suspect the contractarian model and its extreme implications. Others openly criticize it for its "apologist" content and origins. *See, e.g.,* Brudney, *supra* note 43, at 1415-20.

### 3. Efficient Stock Markets and the Majoritarian Model

The spoils system analogy may be extreme, but in any case, the contractarian would reply, if a spoils system does come into being, stock markets are efficient. Efficient stock markets reflect developments in companies and markets almost instantaneously, so much so that investors can succeed as well in the stock markets by choosing a portfolio of stocks at random as by laborious research into companies and industries.[102]

Thus, the contractarian model accepts the potential for absolute majority rule because share prices will reflect the development of a spoils system in a company. Those who invest unaware of a corporation's mismanagement are not harmed because they have purchased at a price that already reflects the mismanagement's effects. Moreover, risk-taking investors may purchase shares of companies in which opting out has become a means for mismanagement or opportunism and whose shares the market has discounted. Finally, where mismanagement occurs, the shareholder can minimize his losses by selling at the market price. Exiting by way of the market rather than bringing lawsuits based on breaches of fiduciary duties is the shareholder's most cost-effective and fastest recourse.[103]

The contractarians' final argument is that investors' portfolios should be diversified to minimize the effect of any losses on particular investors.[104] Diversification, not lawsuits based on fiduciary duties, protects the shareholder or investor from any mismanagement that opting out of fiduciary duty in an individual corporation may facilitate.

In sum, the contractarian model relies on the assumption that market forces, such as the market for corporate control and the market for managers, minimize mismanagement better than fiduciary duties do, and facilitate the informed risk-taking and competition a global economy requires. If mismanagement does occur, other market phenomena protect investors or minimize harm to them, again in a way which, the contractarian believes, fiduciary duties never could.

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102. *See generally* J. Lorie, P. Dodd & M. Kimpton, The Stock Market: Theories And Evidence (2d ed. 1985); B. Malkiel, A Random Walk Down Wall Street (4th ed. 1985).

103. For example, one commentator has noted that "[i]f they become dissatisfied with the performance of management the best thing [for shareholders] to do is sell. During the past 20 years, there have always been many profitable corporations into which they could switch their bets at the cost of two commissions." Hetherington, *Fact and Legal Theory: Shareholders, Managers, and Corporate Social Responsibility*, 21 Stan. L. Rev. 248, 253 (1969).

104. *See, e.g.*, Easterbrook & Fischel, *Corporate Control Transactions*, 91 Yale L.J. 698, 713 (1982) ("the existence of diversification—not its employment—supports our argument"); Fischel, *The Corporate Governance Movement*, 35 Vand. L. Rev. 1259, 1268 & n.27 (1982) ("the option of diversification, an option available to every investor, greatly minimizes investors' concern with financial collapse").

### B. *A Reply to the Contractarian View*

While the contractarian view may make good economic theory, the view does not reflect actual conditions in the stock or corporate control markets. The efficiency of stock markets is, at best, attenuated. Stock market price adjustments radical enough to invoke the market for corporate control are infrequent and may in fact be inadequate to correct mismanagement without resort to legal channels.[105] Finally, many shareholders may be unable or unwilling to liquidate devalued stock or to diversify their portfolios. The contractarians have ignored these facts and, in so doing, have threatened the safeguard that fiduciary duties provide to shareholders.

For example, stock markets may be efficient as to widely traded, New York Stock Exchange (NYSE) listed stocks, but perhaps even then not to the degree legal economic theorists have presumed.[106] As to less-active segments of the NYSE list, the American and regional stock exchanges and the over-the-counter markets, market efficiency attenuates.[107] Share prices may not reflect the reality of what is occurring within companies or industries, or may not do so with any rapidity.

As to whole categories of companies no share market or a very limited one exists. For these somewhat closely held and quasi-public companies,[108] it is doubtful that share prices accurately reflect reality. Yet in all forms in which it has been enacted or proposed, erasure of fiduciary duty is not limited to efficient markets or even to companies whose shares are publicly held.[109] Opting out and statutory negation of fiduciary duty is as much a possibility in small and quasi-public corporations as it is in *Fortune* 500 companies.[110]

Even when efficient share markets exist, the market for corporate control—the contractarians' second theory for permitting directors to opt out of fiduciary duties—operates only in a roughhewn manner. Thus,

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105. *See* Brudney, *supra* note 43, at 1431; Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan. L. Rev. 819, 839-40 (1981).

106. *See, e.g.*, Gordon & Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. Rev. 761, 770-96 (1985); Wang, *Some Arguments that the Stock Market Is Not Efficient*, 19 U.C. Davis L. Rev. 341, 376-77 (1986).

107. *See* Wang, *supra* note 106, at 357 & nn.38-39.

108. This category could be defined as those companies with from 1 to 1000 shareholders. *See, e.g.*, Conard, *The Corporate Census: A Preliminary Exploration*, 63 Calif. L. Rev. 440, 456-60 (1975). A 1970 estimate of the number of such corporations was nearly 1,730,000, or 99.8 percent of all incorporated entities in the United States. *See id.* at 458 table 6.

109. None of the opting out statutes thus far adopted has limited itself to publicly-held or similar companies. *See supra* notes 27-35 and accompanying text.

110. Of course, in the very small company the opportunity better exists for adoption of an opt out provision to be characterized as truly the volitional act of the owners. In the case of a charter amendment, knowingly adopted by a unanimous shareholder group, opting out may be said to be a voluntary act that harms no one. The difficulty again is that none of the existent opt out statutes or proposals limit the device's use.

share prices must not only reflect self-dealing, but they must also decrease considerably before the market for corporate control operates.[111] Much damage can be done to investors' perceptions and the process of capital formation before the market for corporate control rides to the rescue. Fiduciary duty, suits based upon it and the deterrent they pose can operate in a more precise, surgical fashion.

Similarly, it is unrealistic to view market liquidity as the shareholders' best protection against breach of fiduciary duty losses. In many companies no market for sale may exist. If there is a market, it may be an illiquid one. Hence, the shareholder who suspects mismanagement cannot sell or can do so only at great cost.

Last of the contractarians' suggested protections for shareholders against possibly deleterious effects from loss of fiduciary constraints is portfolio diversification. Recent empirical research has shown, however, that even among middle and upper level managers of publicly held companies, stock portfolios are far less diversified than ordinary prudence dictates.[112] Aside from managers and employees, other categories of firm specific[113] investors exist. These non-diversified investors may be residents of the community in which the corporation operates or simply long term investors in so-called opportunity companies.[114] Although on the surface non-diversification may be unwise, upon closer examination identification with particular companies may serve other values society wishes to promote. Employee loyalty to the enterprise, a greater employee stake in the enterprise's efficiency, and a stable, longer term shareholder base are values which from time to time are given more than lip service.[115] At a minimum, market or other forces produce firm specific shareholders in significant numbers and the phenomenon cannot be gainsaid.[116] Without the protection of portfolio diversification, those investors should have the protections fiduciary duty provides.

Firm specific shareholders should not be subjected to the absolute majority rule an opt out world might produce. With a non-diversified in-

111. *See, e.g.*, Brudney, *supra* note 43, at 1421-23 (explaining theoretical and operational limitations of market for managers); Scott, *supra* note 5, at 939 ("[W]hile managers are always monitored by the market for corporate control . . . that monitoring still leaves them with a rather generous outer bound on the extraction of added personal gain. Proxy contests and takeover bids are risky and expensive . . . .").

112. *See, e.g.*, Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & Econ. 375, 388 (1983); Demsetz & Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. Pol. Econ. 1155 (1985).

113. *See generally* Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 Va. L. Rev. 1257, 1285-88 (1985).

114. " 'Opportunity companies' are those companies whose present assets and earnings may be insubstantial but whose longer term growth prospects are perceived to be the reverse, such as so-called high technology companies." Branson, *supra* note 67, at 426 n.151.

115. *See* Coffee, *supra* note 100, at 67-73; *see also infra* note 119 (recitals of so-called second generation takeover statutes).

116. *See* Demsetz, *supra* note 112, at 388-89.

vestment portfolio, employment with the same company in which they have invested significant amounts of funds, and residence in the same community in which that corporation operates or is a dominant force, some shareholders' lives are more inextricably bound up with the fate of a company than they are with any political or governmental entity. In the latter realm, of course, the majority has long been prevented from ruling absolutely by restraints more limiting than mere common law fiduciary duties.

## IV. Corporations: Mini-States or Purely Economic Entities?

In the 1970s, would-be corporate law reformers from Ralph Nader to John Kenneth Galbraith stated that large corporations had become public entities and should be regulated by the state as such, perhaps much like local governmental entities. Seemingly without much thought on the matter (other than perhaps whether or not their assertions had popular appeal), these reformers advocated intrusive regulatory schemes such as federal chartering of corporations[117] or nationalization of large companies.[118] Those proposals were a far cry from a much more modest proposal to retain common law, or at least state of the art, fiduciary duties.

Arguments against opt out and other fiduciary duty proposals are also based upon a more modest view of corporations than that of the 1970s reformers. Urging some traditional legal protection, in addition to market protection, against absolute majority rule is far removed from the 1970s reform advocates' position that corporate law should articulate management's responsibilities to workers, consumers, suppliers or communities in which the corporation operates, in addition to requiring such things as clean air and clean water.[119] Nonetheless, some of the debates of that time are relevant to the present issue of whether the law should in

117. *See* R. Nader, M. Green & J. Seligman, Taming The Giant Corporation (1976); Henning, *Federal Corporate Chartering For Big Business: An Idea Whose Time Has Come?*, 21 De Paul L. Rev. 915 (1972); Schwartz, *Federal Chartering of Corporations: An Introduction*, 61 Geo. L.J. 71 (1972).

118. *See generally* J. Galbraith, Economics and the Public Purpose 220 (1973) ("public ownership is indispensable . . . in important parts of the market system where inability to deploy power and to command resources is the problem").

119. Corporate managers today want many of these notions written into state law, principally to legitimate tender offer defenses that are not in shareholders' best interests but may be in some other constituency's interests. For example, Ohio permits a director to consider the interests of "employees, suppliers, creditors, and customers," "[t]he economy of the state and the nation," and "[t]he long-term as well as short-term interests of the corporation . . . including the possibility that these interests may be best served by the continued independence of the corporation." Ohio Rev. Code Ann. § 1701.59(E) (Anderson Supp. 1987). Similarly, the Wisconsin statute provides:

> In discharging his or her duties to the corporation and in determining what he or she believes to be in the best interests of the corporation, a director or officer may, in addition to considering the effects of any action on shareholders, consider the following: (1) The effects of the action on employees, suppliers and customers of the corporation. (2) The effects of the action on communities in

some respects treat corporations as mini-states and import some constitutional content into corporation law, or whether the society would be better served by treating companies as purely voluntary associations serving purely economic ends.[120]

The issue has been framed by

> comparing a shareholder to a citizen of Connecticut, for instance. If the latter does not like the action of his governor or his legislators, either he can attempt to vote them out of office . . . or he can leave the state. Changing governors or a state assembly is a difficult process at best, however, and since leaving the state would involve changing jobs and moving spouse and children, no real alternatives are available. The shareholder's situation is drastically different. Shares can be sold easily at the first sign of significant management incompetency or dishonesty . . . . Alternatively, shareholders may consider waging a battle to change management, although this is an expensive and difficult strategy . . . .[121]

For significant numbers of shareholders, however, dissociating themselves from a company may be nearly as difficult as leaving the state. These shareholders may be employees as well as investors in the company. They may be residents of cities and towns in which the company operates or long-term shareholders who have formed an attachment or loyalty to that particular company. For these shareholders, "voting with their feet" may not be an adequate or palatable alternative. Voting with their feet also may run counter to other values that should be fostered, such as loyalty to particular enterprises, to equity investment, and to the corporate sphere generally. Although arbitragers perform useful functions, viewing corporations solely as economic entities leads to an investment world populated solely by arbitrager-like investors. The benefit from permitting the elimination of traditional common law safeguards such as fiduciary duty may not exceed the cost in terms of, among other things, the lack of legal protections for shareholders who choose not to sell or whose portfolios are not adequately diversified.

These may not be issues for corporate law at all. The timelessness of these issues, however, points to their character as normative questions rather than as issues of positive economics.[122] Ultimately, the question

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> which the corporation operates. (3) Any other factors the director or officer considers pertinent.

Wis. Stat. Ann. § 180.305 (West 1987 & Supp. 1988).

120. Those issues were involved in the Berle-Dodd debate of the 1930s. *See* Berle, *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049 (1931); Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 Harv. L. Rev. 1365 (1932); Dodd, *For Whom Are Corporate Managers Trustees?*, 45 Harv. L. Rev. 1145 (1932); Dodd, *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable*, 2 U. Chi. L. Rev. 194 (1935).

121. N. Wolfson, *supra* note 8, at 46.

122. *See* M. Friedman, *The Methodology of Positive Economics*, in Essays in Positive Economics 3, 4 (1953) ("Positive economics is in principle independent of any particular ethical position or normative judgments. As Keynes says, it deals with 'what is,' not with

of what legal protections a group such as minority shareholders should have becomes a question of public choice. A cost-benefit or other economic analysis may be very useful and illuminating, but such analysis is most often only the penultimate and not the ultimate step. Society might decide that despite the costs and the benefits, for reasons such as notions of fundamental fairness, moral standards or "common right and reason," basic protections such as fiduciary duty should be retained as mandatory. These are, however, fundamental questions that can only be argued, not answered, in a law review article.[123]

## CONCLUSION

Proposals to negate large portions of the common law duty of loyalty applicable to corporate directors and managers are worrisome. That is especially so when, in the interest of expediency and certainty in business dealings, those proposals find adherents such as the august American Bar Association Committee on Corporate Laws. The public interest and not the interests of corporate clients must always guide such groups in their deliberation. Apparently, they have not.

Proposals largely to negate even the fiduciary duty of loyalty thus are seeing the full light of day. Implementation of those proposals will result in raw majoritarian rule of American business corporations. Such supremacy for majoritarian rule will impede the process of capital formation and will not be adequately checked by markets and forces operating within them. Over and above purely economic considerations, the moral hazard thus created for corporate managers and the moral revulsion created among members of the investing public and others in society will be phenomena of profound socio-political significance. A relatively stringent and rigid common law duty of loyalty should be maintained as the bedrock beneath and the brackets around the movement toward private ordering in the affairs of American business corporations.

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'what ought to be.' "). While economists seem able to differentiate between the two, a tendency of lawyer-economists is to treat all questions as positive. Lawyer-economists treat economics as a natural science whose laws are immutable rather than as the highly useful but social science it really is. *See, e.g.*, SEC Advisory Committee on Tender Offers Report of Recommendations, [Extra Ed.] Fed. Sec. L. Rep. (CCH) No. 1028, at 116-17 (July 15, 1983) (statement of Frank Easterbrook & Gregory Jarrell) (those who oppose economic analysis viewpoint resemble those through the ages who have questioned "science," who do not "sully their hands with data," and whose armchair empiricism "impeded economic thought in the same way other 'common-sense' assessments impeded astronomy, chemistry, physics and biology.").

123. *Cf.* N. Wolfson, *supra* note 8, at 147-48 (reliance on "ministate" and "governmental analogy," as well as upon duties of care and loyalty rather than upon a purely economic view is "seriously deficient in a . . . fundamental sense.").