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THE CORPORATE PERSONA, CONTRACT (AND MARKET) FAILURE, AND MORAL VALUES

THOMAS LEE HAZEN*

Over the past twenty years, economic analysis has had a profound impact on the reformulation of current legal doctrine. In the context of corporate governance law, adherents to the Chicago school of economics attack the fiduciary model, arguing that it interferes with the market for corporate control and thus impedes profit maximization. Viewing the corporation as simply a nexus of contracts, these scholars would eliminate the fiduciary paradigm and substitute a contract model for corporate governance under which corporate constituents could bargain freely with one another to define their rights and responsibilities.

Professor Hazen rejects the argument that application of contract theory to corporate law justifies the total annihilation of fiduciary principles in the area of corporate governance. He points to the flaws of the contract model, in theory and in practice, and to its failure to recognize that the corporation is more than purely an economic entity, but a powerful social and political institution as well. Although he acknowledges that contractarian analysis provides useful insight into the modern definition of the corporate persona, Professor Hazen concludes that complete reliance on the allegedly "neutral" contract model is unsound; instead, to compensate for the unequal bargaining strength between parties to the corporate contract, the proper formulation of the corporate paradigm must include, rather than reject, societal values embodied in traditional fiduciary principles.

I. INTRODUCTION

The business corporation is a form of doing business wherein the shareholders pool their money into a common enterprise. In the absence of statute, this type of business organization would be a partnership. In a partnership, each partner is jointly liable for the debts and obligations of the partnership.¹ Furthermore, in the absence of contractual restrictions, each partner has managerial authority.² By contrast, when investors pool their funds into the corporate form they enjoy limited liability. In addition, corporate statutes contemplate a centralized management. Thus, the business and affairs of a corporation are managed under the direction of the board of directors³ which is elected by the

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1. UNIF. PARTNERSHIP ACT § 15(b) (1914).

2. See, e.g., *id.* § 9.

3. E.g., CAL. CORP. CODE § 300(a) (West Supp. 1983); DEL. CODE ANN. tit. 8, § 141(a) (1983); REV. MODEL BUSINESS CORP. ACT § 8.01 (1984).

shareholders.⁴ Officers of the corporation, who are appointed by the directors, carry on the day-to-day management of the company.⁵ Except in the case of closely held corporations,⁶ this centralization of management generally results in a separation of ownership from control of the corporation. Thus, subject to a few exceptions,⁷ corporate managers have virtually complete power over the shareholders' investment. To protect against management self-dealing and to assure the achievement of the shareholders' goals (which generally amount to some form of wealth maximization), the law traditionally has recognized that corporate managers stand as fiduciaries vis-à-vis the shareholders.

Given the wide dispersal of shareholder voting power in large companies, in most cases shareholder control is illusory. Management can perpetuate itself: incumbent managers typically nominate the directors, who in turn appoint the officers. While this situation appears to call for strict enforcement of managers' fiduciary obligations, the law and scholarly commentary have been moving in the opposite direction based on the argument that fiduciary principles impede profit maximization. For example, under the fiduciary paradigm, managers may be able to perpetuate their own positions and thereby fend off hostile bidders who might actually increase the maximization of shareholder wealth. Thus, many commentators argue that the fiduciary model interferes with the free market; the check against inefficient management of large corporations is said to be the market for corporate control rather than the fiduciary paradigm. To the extent that management is inefficient in managing a company's assets, the market will devalue the shares, rendering the company an attractive takeover target. As such, many observers posit that the market provides management an incentive to manage efficiently.⁸ By the use of various entrenchment techniques, however, corporate managers have found ways to thwart takeovers without necessarily improving their managerial skills. Also, because the leveraged financing boom made takeovers much easier, corporate raiders shifted their focus from poorly managed companies to companies with a sufficient cash flow to support the large financing costs.⁹

The current genre of economic analysis argues that the fiduciary paradigm of corporate governance should be replaced by a contract model under which the various corporate constituents can contract freely with one another and thereby define their own relative rights and responsibilities. This contractarian model is not merely theoretical. Indeed, it has influenced some significant

4. See, e.g., DEL. CODE ANN. tit. 8, § 141(b) (1983); REV. MODEL BUSINESS CORP. ACT § 8.03 (1984).

5. See, e.g., DEL. CODE ANN. tit. 8, § 142 (1983); REV. MODEL BUSINESS CORP. ACT §§ 8.40-8.41 (1984).

6. In closely held corporations there frequently is an identity of owners and managers.

7. There are some major transactions that require shareholder approval. For example, corporate statutes generally preserve a shareholder vote for mergers and sales of substantially all the corporation's assets not in the regular course of business. See REV. MODEL BUSINESS CORP. ACT §§ 11.03, 12.02 (1984). Charter amendments, including changes in the number of authorized shares, generally require shareholder approval. See *id.* § 10.03.

8. See *infra* notes 189-91 and accompanying text.

9. The collapse of many highly leveraged companies and the junk bond market in general has demonstrated the questionable wisdom of this easy money environment.

changes in the law in this direction.¹⁰

This Article examines the demise of the fiduciary principle in corporate governance and argues that it should be strengthened rather than vitiated. Although the contractarian model has surface appeal (as is the case with many economic models), it cannot withstand a hard-look analysis. Even on a theoretical level, the current version of the contract model fails because its application to corporate law does not logically call for the abandonment of the fiduciary model. Furthermore, in constructing their model of corporate governance, the contractarians do not abide by traditionally recognized contract principles; instead, they present theoretical models that fail when practically applied. This Article argues that a proper application of contract principles includes, rather than rejects, fiduciary principles in corporate law.

The discussion begins in Section II with a brief overview of the roles of economic analysis in general and other trends in current legal scholarship. The examination of the basis of the fiduciary paradigm in Section III is followed by a discussion of the contract model both in theory and in practice in Section IV. Section V analyzes the shortcomings of the contract model in terms of legal theory. The Article continues, in Section VI, with a discussion of the role of values in the law as it relates to the contractarian model. Section VII then briefly reviews two other models of corporate structure that also point to the limitations of the contract model. Finally, the Article concludes that, although the contract theory provides useful insight to corporate law, it is flawed because it purports to justify the annihilation of the role of fiduciary principles.

II. AN OVERVIEW OF THE ROLE OF ECONOMIC ANALYSIS AND CURRENT LEGAL SCHOLARSHIP

The contract model of corporate governance is part of a larger economic analysis. Contractarian analysis constitutes only one in a series of assaults by the Chicago economists upon traditional notions of law. In many ways, this form of economic analysis has provided insight into the ways in which law in general has developed. It also has provided a method for testing traditional rules of law against one hypothesis of the proper role of the law. While economic analysis undoubtedly is helpful, it does not provide the complete answer to all of our problems. Furthermore, economic analysis, like any paradigm, brings with it its own biases and shortcomings.

Economists—primarily from the Chicago school—have challenged traditional legal doctrine in various fields of law. Many of these economists claim that the law should take its direction from a value-neutral economic analysis.¹¹

10. *E.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (1983) (permitting charter provisions limiting or eliminating director liability for breaches of the duty of care); see *infra* text accompanying notes 33-37.

11. See, *e.g.*, McChesney, *Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg*, 89 COLUM. L. REV. 1530 (1989); see also Butler & Ribstein, *Opting Out of Fiduciary Duties: A Response to The Anti-Contractarians*, 65 WASH. L. REV. 1 (1990) (arguing that contractual theory and economic literature support unrestricted private ordering of corporate management's duties).

Some observers argue that economic analysis essentially is descriptive and that any normative effect is secondary.¹² Rejecting principles of natural law, traditional legal realism, and formalism, economic analysis mainly purports to describe legal doctrine.¹³ Some of its proponents also argue that economic analysis results in positive normative consequences. In short, the supposedly neutral principle of economic efficiency¹⁴ is said to be a better guiding light than previous bases of legal theory.¹⁵ Saying that the answer lies in "efficiency," however, does not end the matter, as there are different perceptions of what the term "efficiency" means. For example, some economists frame their analyses in terms of Pareto optimality,¹⁶ while others adhere to the Kaldor-Hicks model.¹⁷

Economic analysis tells us that even if we value efficiency as the goal of a productive economy and of business regulation, rules of law are necessary. Specifically, rules of law are needed to counteract market failure. Like the term "efficiency," however, market failure can be defined several ways. For example, market failure may occur when transactions do not result from meaningful consent of both parties.¹⁸ Alternatively, market failure can be defined purely in terms of "efficiency" and "rationality" as the economists use those terms.¹⁹

12. R. POSNER, *ECONOMIC ANALYSIS OF THE LAW* § 2.1 (2d ed. 1973). *But see* Kronman, *Wealth Maximization as a Normative Principle*, 9 J. LEGAL STUD. 227, 228-29 (1980).

13. *E.g.*, R. POSNER, *supra* note 12, § 2.1. Posner would classify his economic analysis as legal realism insofar as legal realism says that law is not distinct from policy. On the other hand, he departs from legal realism insofar as it proclaims that law is not a science.

14. For a discussion of two types of efficiency models, see *infra* notes 16-17; *see also* Coleman, *Efficiency, Exchange and Auction: Philosophic Aspects of the Economic Approach to Law*, 68 CALIF. L. REV. 221 (1980).

15. The focus on efficiency as a goal is really a variation on utilitarian philosophy. Indeed, one commentator suggests that equating shareholder wealth maximization with the proper outcome stems from a "crude sort of utilitarianism." Stone, *Corporate Social Responsibility: What it Might Mean if it Were Really to Matter*, 71 IOWA L. REV. 557, 570 (1986).

16. As one commentator explains:

Any discussion of Pareto efficiency must begin with definitions of Pareto optimality, Pareto superiority, and Pareto inferiority. To claim that resources or goods are allocated in a Pareto-optimal fashion is to maintain that any further reallocation of resources will benefit one person only at the expense of another. An allocation of resources is Pareto superior to an alternative allocation if and only if no person is disadvantaged by it and the lot of at least one person is improved. An allocation of resources is Pareto inferior to another if there is a distribution of Pareto superior to it. The concepts of Pareto superiority and optimality are analytically connected in the following way: A Pareto-optimal distribution has no distributions superior to it.

J. COLEMAN, *MARKETS, MORALS AND THE LAW* 71-72 (1988).

17. Again, as explained by Professor Coleman:

A redistribution of resources is Kaldor-Hicks efficient if and only if under the redistribution the winners win enough so that they could compensate the losers. The notion of Kaldor-Hicks efficiency does not require that the winners actually compensate the losers. In effect, a redistribution is Kaldor-Hicks efficient if and only if it is a "possible" Pareto-superior position.

Id. at 84; *see also* Coleman, *supra* note 14. The suggestion that it is unnecessary to actually compensate the losers has influenced much of the law and economics writing. *See, e.g.*, R. POSNER, *supra* note 12, § 2.1.

18. *See* Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741, 743-44 (1982).

19. For example, one commentator defines market failure as follows:

Within the rational choice perspective, rational cooperation is a response to market failure. Market failure in turn is simply the failure of agents acting on purely individually maximizing strategies to secure a Pareto optimal or collectively rational outcome.

Some observers claim that when legal rules designed to counteract market failure involve redistribution, those rules are inconsistent with a rational view of the law when rationality is defined in terms of market efficiency. As Professor Coleman has explained:

Legal rules are a species of rational constraints—the components of a scheme of rational cooperation. Constraints cannot be rational for all actors if they are entirely *redistributive* in character. Such constraints improve the welfare of some only at the expense of others. Consequently, a set of legal rules designed to move resources along the Pareto frontier from one optimal outcome to another could not be rational for each agent. Thus, the view that law or politics is entirely redistributive, in this sense, is incompatible with the rational choice perspective.²⁰

The mere fact that a rule of law is redistributive and therefore may not reflect the rational choice of each agent does not mean that the rule is without justification.²¹ Redistribution may be necessary to counteract an imbalance that otherwise would exist. As discussed below,²² the absence of meaningful consent in the corporate setting creates a sufficient imbalance to warrant interference with the freedom of contract model.

Economic analysis is in fact only one of several new schools of legal scholarship. Other scholarly trends have appeared, at least in part, in response to the law and economics scholarship. For example, over recent years critical legal theorists (colloquially known as “crits”) have become quite prolific. Critical legal theory provides useful insight into corporate law analysis to the extent that it tells us that law must be “contextualized.”²³ Critical legal theorists dismiss law and economics as addressing only one aspect of the problem. This type of attack on the legal economists has gone far beyond the critical legal studies movement. In fact, a number of writers who formerly seemed committed to law and economics have since recognized the need to consider the lessons to be

Coleman, *Afterward: The Rational Choice Approach to Legal Rules*, 65 CHI.-KENT L. REV. 177, 179 (1989) [hereinafter Coleman, *Afterward*]; see also D. GAUTHIER, *MORALS BY AGREEMENT* 21-69 (1986) (analyzing utility, preference, and rational choice); Coleman, *supra* note 14, at 221-23 (testing various law and economic concepts); Kraus & Coleman, *Morality and the Theory of Rational Choice*, 97 ETHICS 715 (1987) (examining the relationship between morality and rationality).

20. Coleman, *Afterward*, *supra* note 19, at 179.

21. The proponents of law and economics say that economic analysis leads to the proper result when there are low transaction costs. In such a case, the market is said to bring the transaction to the optimal decision and guides the parties to a rational choice. In a market transaction the agreement of both parties results not only in individual rationality but also in collective rational choice. *Id.*

22. See *infra* text accompanying notes 155-66.

23. In order to “contextualize” a given subject it must be viewed in terms of every context in which it exists. For example, relying simply on economic concepts ignores the other contexts in which the corporation must be considered. Some critical legal theorists take their position too far and dismiss all of corporate law as additional evidence of a politically corrupt system. For criticism of such an extreme approach, see Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865 (1990); see also Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85 (1990) (exploring influence of interest groups on court outcomes).

learned from other branches of the social sciences.²⁴ There is thus a growing recognition that an economic analysis of the law can benefit from the teachings of other social science disciplines.²⁵

How does a contextualized approach apply to the field of corporate law? First, we must not forget that corporations are not simply economic institutions; they are also political and social institutions. There is much legal scholarship today that underscores the importance of relationships in defining and understanding the law.²⁶ The entire law of corporations was built upon the complex relationships formed within the corporate setting. The fiduciary paradigm developed at least in part because of these relational interests.

III. THE FIDUCIARY PARADIGM OF CORPORATE GOVERNANCE

A. *The Basis of the Fiduciary Paradigm*

As noted at the outset of this Article, shareholders entrust the success of their investment to corporate managers who control the corporate assets. It has long been a basic tenet of corporate law, reflected in the case law²⁷ and in the view of commentators,²⁸ that corporate managers owe a fiduciary obligation to the corporation and to its shareholders.²⁹ Traditionally, there have been two prongs of corporate managers' fiduciary duty. First is their duty of loyalty. The potential for conflicts of interest in the modern business world led the law to recognize that corporate managers may have interests that do not always coin-

24. See, e.g., Ellickson, *Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics*, 65 CHI.-KENT L. REV. 23 (1989).

25. See, e.g., A. ETZIONI, *THE MORAL DIMENSION: TOWARD A NEW ECONOMICS* (1988); Ellickson, *supra* note 24; Sunstein, *Legal Interference with Private Preferences*, 53 U. CHI. L. REV. 1129 (1986).

26. For example, the power model and the communitarianism theory are based on relationships. For a discussion of the power model of the corporation, see *infra* text accompanying notes 252-73; and, for a discussion of communitarianism, see *infra* text accompanying notes 246-51.

27. See, e.g., *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 729-30 (Del. 1988) ("The exercise of this managerial power is tempered by fundamental fiduciary obligations owed by the directors to the corporation and its shareholders."); *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986) ("In performing their duties the directors owe fundamental fiduciary duties of loyalty and care to the corporation and its shareholders."); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984) ("fundamental fiduciary obligations to the corporation and its shareholders"); *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939) ("While technically not trustees, [directors] stand in a fiduciary relation to the corporation and its stockholders."); *Schwarzwaelder v. German Mut. Fire Ins. Co.*, 59 N.J. Eq. 589, 590 (N.J. 1899) ("the fiduciary duty which [directors] owe to the members of the corporation"); *Attorney General v. Utica Ins. Co.*, 2 Johns. Ch. 371, 389 (N.Y. 1817) ("[T]he persons who, from time to time, exercise the corporate powers, may, in their character of trustees, be accountable to this Court for a fraudulent breach of trust.")

28. H. W. BALLANTINE, *BALLANTINE ON CORPORATIONS* § 114 (1927); H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 325 (3d ed. 1983); W. KNEPPER & D. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* § 1.06 (4th ed. 1988); Dodd, *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Uhlman, *The Legal Status of Corporate Directors*, 19 B.U.L. REV. 12 (1939).

29. For a statute that sets forth this principle explicitly, see N.C. GEN. STAT. § 55-35 (repealed by N.C. GEN. STAT. § 55-8-30 (1990)) ("Officers and directors shall be deemed to stand in a fiduciary relation to the corporation and to its shareholders."). With the adoption of the Revised Model Business Corporation Act, it is unfortunate that the new North Carolina Act no longer speaks explicitly in terms of management's fiduciary obligations. See *infra* note 33 (discussing REV. MODEL BUSINESS CORP. ACT § 8.30 (1984)).

cide with the interests of the shareholders. Because managers control the shareholders' assets, managers must place the corporation's and the shareholders' interests above their own.³⁰ Borrowed from trust law, the duty of loyalty is firmly ingrained in both the case law³¹ and statutes.³² The duty of loyalty is based on a shareholder supremacy model under which the interests of the directors must yield to their obligations to the shareholders.

The second prong of managers' fiduciary duty is their duty of care. Because managers are entrusted with the shareholders' property, they are held to a standard of reasonable care in dealing with that property.³³ This obligation arises irrespective of whether the directors have a self interest in the transactions in question.

A corollary to the duty of care is that, in the absence of a conflict of interest, there is a presumption that directors have validly exercised their business judgment. This "business judgment rule," which has existed for more than 160 years,³⁴ requires courts to defer to a director's judgment in passing on the validity of his or her decision making. The rule thus insulates directors from liability for lack of care in all but the most egregious cases.³⁵ Moreover, fear of substantial liability led many legislatures to reduce or otherwise limit statutorily the directors' duty of care.³⁶ Notwithstanding the recent wave of scholarly literature and legislative backlash, however, in light of the dearth of decisions imposing liability,³⁷ it cannot fairly be said that the directors' duty of care has unduly

30. For an excellent analysis of the rise of conflict of interest rules, see Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 *BUS. LAW.* 35 (1966).

31. *See id.* at 53-57.

32. *E.g.*, DEL. CODE ANN. tit. 8, § 144 (1983) (transactions in which directors have an interest); REV. MODEL BUSINESS CORP. ACT § 8.31 (1984) (director conflict of interest). In fact, the conflict of interest rules are so firmly ingrained that the Delaware charter opt-out provision, which permits limitation of corporate managers' liability to the corporation, does not apply to conflict of interest situations. DEL. CODE ANN. tit. 8, § 102(b)(7) (1983).

33. The duty of care has many statutory formulations. *See, e.g.*, CAL. CORP. CODE § 309(a) (West 1983) ("A director shall perform the duties of a director . . . in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."); N.Y. BUS. CORP. LAW § 717(a) ("in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances"); REV. MODEL BUSINESS CORP. ACT § 8.30(a) (1984) ("A director shall discharge his duties as a director, including his duties as a member of a committee: (1) in good faith; (2) with the care an ordinarily prudent person in like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation").

34. *See Percy v. Millaudon*, 8 *Mart.* 68, 77-78 (La. 1829).

35. *See generally* D. BLOCK, N. BARTON & S. RADIN, *THE BUSINESS JUDGMENT RULE* (2d ed. 1988) (describing the contours of the rule). Although a number of decisions discuss the duty of care, most have arisen in the context of alleged breaches of the duty of loyalty. There have been only a handful of cases invoking the duty of care in the absence of a conflict of interest. *Bates v. Dresser*, 251 U.S. 524, 530 (1920); *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985); *Francis v. United Jersey Bank*, 87 N.J. 15, 45, 432 A.2d 814, 829 (1981); *Hun v. Cary*, 82 N.Y. 65, 79 (1880); *O'Connor v. First Nat'l Investors' Corp.*, 163 Va. 908, 927, 177 S.E. 852, 860 (1935); *cf. Barnes v. Andrews*, 298 F. 614, 618 (S.D.N.Y. 1924) (finding director negligence but denying liability due to failure to prove a causal connection between the director's inattentiveness and the corporate loss).

36. *E.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (1983); *see generally* Hazen, *Corporate Directors' Accountability: The Race to the Bottom—The Second Lap*, 66 N.C.L. REV. 171 (1987) [hereinafter Hazen, *The Second Lap*] (examining statutory provisions decreasing corporate director liability).

37. *See Hazen, The Second Lap, supra* note 36, at 171 n.5.

fettered the discretion of corporate management.

Over the past twenty years, the fiduciary model of corporate governance has come under attack. On the theoretical level, economists proffer a contractarian view of the corporation as a substitute for the traditional fiduciary model.³⁸ The economists tend to take what might be called a paradigmatic historical view: that the theory of the firm has had various paradigms over time and that each new paradigm replaces its predecessor. A helpful approach would seem to be to view each paradigm as providing additional insight to the problem of understanding the corporate persona. The contractarian paradigm certainly adds insight into the proper role of law in corporate regulation. Viewing contractarianism as a justification for the elimination of fiduciary obligations, however, is a mistake.³⁹

Unfortunately, the movement away from a fiduciary paradigm of corporate governance has not been limited to theoretical discourse. The 1984 revision of the Model Business Corporation Act ("revised Model Act") omits from the text of the statute any reference to the directors' fiduciary duties.⁴⁰ The drafters of the revised Model Act noted that this omission was not intended to change the current law relating to directors' and managers' responsibility. Rather, the reformulation was designed to eliminate unhelpful analogies to the law of trusts.⁴¹ As others have shown, however, the trust analogy has been very useful.⁴² Furthermore, the elimination of an express fiduciary obligation may well lead courts to unduly relax directors and managers obligations.

The reason for using the word "fiduciary" in the context of corporate managers' duties is to draw an analogy to trust law. At the same time, however, it is necessary to recognize that corporate managers (as "trustees") should and can take risks that ordinary trustees cannot. For example, although the goal of a traditional trust instrument is capital preservation and slow growth with adequate provision for a desired income stream,⁴³ corporate managers, by contrast, are encouraged to be less risk averse than trustees in their pursuit of economic gain for the corporation.⁴⁴ The fact that fiduciary concepts have a different ap-

38. See *infra* note 74.

39. For an example of a middle-of-the-road view, see the discussion of Professor Coffee's approach in the text accompanying *infra* notes 76-85; see also Coffee, *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989) [hereinafter Coffee, *Balance*] (characterizing corporate law as both enabling and mandatory).

40. REV. MODEL BUSINESS CORP. ACT § 8.30 (1984). It is not clear, however, whether the source of this change was the practicing lawyers involved in the drafting process or the Chief Reporter, Professor Robert Hamilton, himself an academic. See Goldstein, *The Relationship Between the Model Business Corporation Act and the Principles of Corporate Governance: Analysis and Recommendations*, 52 GEO. WASH. L. REV. 501 (1984).

41. As the official comments explain: "Section 8.30 does not use the term 'fiduciary' in the standard for directors' conduct because the term could be confused with some of the unique attributes and obligations of a fiduciary imposed by the law of trusts, some of which are not appropriate for directors of a corporation." REV. MODEL BUSINESS CORP. ACT § 8.30 official comment (1984).

42. *E.g.*, Dodd, *supra* note 28, at 1158-60.

43. See RESTATEMENT (SECOND) OF TRUSTS §§ 176, 181, 227 (1959); G. G. BOGERT & G. T. BOGERT, HANDBOOK OF THE LAW OF TRUSTS §§ 99, 101 (5th ed. 1973); A. SCOTT & W. FRATCHER, THE LAW OF TRUSTS §§ 176, 181, 227 (4th ed. 1987 & Supp. 1990).

44. See, *e.g.*, W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1041

plication in the trust setting does not mean that they should be discarded completely when evaluating corporate paradigms.

B. *An Historical Perspective*

It is a serious mistake to view the corporate entity apart from its historical development.⁴⁵ The contract paradigm of corporate existence is far from a new one.⁴⁶ Observers have long recognized that the corporation is a series (or nexus) of contractual relationships.⁴⁷ The current contractarian view, however, disregards the fact that the sovereign is a party to this corporate contract.⁴⁸ The history of the corporate form makes this fact clear.⁴⁹

The original impetus for corporate regulation was spurred by forces that result in public law generally,⁵⁰ rather than the private law focus that is seized upon by the contractarians. Under the contractarian view of corporate law, the various participants in the corporation do not differ "in the slightest degree from ordinary market contracting between any two people."⁵¹

Corporate regulation developed out of the concern for the antisocial impact of corporations. It was recognized that the corporation could be a "socially useful instrument of economic growth."⁵² As one commentator observed long ago:

A private corporation is a voluntary union of persons, joined together by written articles of association or incorporation under legislative authority, or by special statute on proper application to the legislature to accomplish some pecuniary or ideal purpose authorized

(Perm. ed. 1986); H. HENN & J. ALEXANDER, *supra* note 28, § 242; Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52 (1987).

45. See Bratton, *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989). As Professor Bratton explains, the contractarian model is not as novel as some would have us believe: "[M]any of the component notions of the new economic theory have been around since the seventeenth and eighteenth centuries and therefore are not 'modern.'" *Id.* at 1482-1485.

46. See, e.g., J. ANGELL & S. AMES, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE 36 (3d ed. 1846); H. TAYLOR, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS HAVING CAPITAL STOCK § 448 (1884).

47. See *infra* notes 73-74 and accompanying text.

48. The sovereign's role in contract relations has been discussed exhaustively elsewhere. See, e.g., M. COHEN, PROPERTY AND SOVEREIGNTY AND THE BASES OF CONTRACT LAW AND THE SOCIAL ORDER 41, 69, 102 (1938); H. HART, THE CONCEPT OF LAW 77-96 (1961); H. KELSEN, PURE THEORY OF LAW §§ 36-40 (1967); Bratton, *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 438 (1989); Hale, *Coercion and Distribution in a Supposedly Non-Coercive State*, 38 POL. SCI. Q. 470 (1923); Ratner, *Corporations and the Constitution*, 15 U.S.F. L. REV. 11, 21, 27 (1980-81).

49. See, e.g., French, *The Corporation as Moral Person*, 16 AM. PHIL. Q. 207, 208 (1979). Roman law defined "person" as the individual subsistence of a rational nature. This definition supports the fictional theory of corporate personality. See F. HALLIS, CORPORATE PERSONALITY xiii (1930).

50. See Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201.

51. Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 777 (1972).

52. J. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780-1970, at 47 (1970).

by the governing body of a state.⁵³

The basic distrust of the corporate form resulted in a system under which any entity desiring to do business in corporate form had to make an individualized application to the sovereign.

Prior to general corporation laws, the state granted corporate charters on an individual basis.⁵⁴ The corporation, then, was based on a contract between the entrepreneurial participants and the sovereign. It might fairly be said that the individual chartering approach challenged the American ideal of individualism. Because corporate charters depended upon special acts of the legislature, the corporate form was not equally available to all. This inequity changed with the enactment of general corporation acts. These statutes rendered the corporate form available to anyone who complied with the requisite formalities. With the increasing number of applications for corporate charters, the states adopted an assembly-line approach under which a corporate charter need only comply with the template provided in the corporation law, rather than be individually crafted.

The advent of generalized corporate laws did not alleviate the distrust of corporations. As evidence of this distrust, many corporate laws limited the size of corporations.⁵⁵ As explained by Justice Brandeis:

[T]here was a sense of some insidious menace inherent in large aggregations of capital, particularly when held by corporations. So, at first, the corporate privilege was granted sparingly; and only when the grant seemed necessary in order to procure for the community some specific benefit otherwise unattainable. The later enactment of general incorporation laws does not signify that the apprehension of corporate domination had been overcome. The desire for business expansion created an irresistible demand for more charters; and it was believed that under general laws embodying safeguards of universal application the scandals and favoritism incidental to special incorporation could be avoided. The general laws which long embodied severe restrictions upon size and the scope of corporate activity, were, in part, an expression of the desire for equality of opportunity.⁵⁶

Until the early twentieth century, most corporate statutes did not give corporations the power to merge with one another; a special act of the legislature was

53. S. THOMPSON, COMMENTARIES ON THE LAW OF PRIVATE CORPORATIONS § 2 (2d ed. 1908).

54. See, e.g., H. BALLANTINE, CORPORATIONS § 8a (rev. ed. 1946) ("Formerly, when a corporation was to be organized a private bill had to be introduced in the legislature, referred to a committee, passed through both houses and signed by the governor of the state."); C. ELLIOTT, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 20 (3d ed. 1900); R. STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS § 20 (1936); Bratton, *supra* note 45.

55. Restrictions included limitations on the amount of capital as well as limitations upon the scope of a business corporation's powers and activities. *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 549-557 (1933) (Brandeis, J., dissenting). According to Justice Brandeis, "The removal by the leading industrial States of the limitations upon the size and powers of business corporations appears to have been due, not to their conviction that maintenance of the restrictions was undesirable in itself, but to the conviction that it was futile to insist upon them." *Id.* at 557 (Brandeis, J., dissenting).

56. *Id.* at 549 (Brandeis, J., dissenting).

required for corporations to merge.⁵⁷ The limitations on the size of corporations, including the absence of a general authorization for corporate mergers, was based on distrust of big business. Limitations on corporate size exemplify the rich historical tradition of corporate law as public law.⁵⁸ Some observers claim that the demise of the ultra vires doctrine⁵⁹ in corporate law reflected a decreasing public focus and concomitant privatization of corporate law.⁶⁰ Corporate charters traditionally state the corporate purpose. Any activity that does not further the corporate purpose as articulated in the charter is said to be ultra vires. The decline of the ultra vires doctrine during the twentieth century has been seen as a recognition of the entity theory of corporateness.⁶¹ The decreasing significance of ultra vires in corporate law also can be viewed as simply a realization that there is no reason for the state to limit corporate purposes, but in other respects the public regulatory aspect of corporate law remains.⁶²

C. *Is Managerial Independence Enough?*

As noted earlier, the primary attack on the fiduciary paradigm is that it interferes with efficient capital growth. The economic assault, however, has not been the only basis of attack upon the fiduciary paradigm. Another approach challenges the fiduciary model as unrealistic.⁶³ Some commentators suggest that the courts have replaced the fiduciary norm with a duty of independence.⁶⁴ Professor Cox has amply demonstrated that the claim that a director is independent simply because he or she may be disinterested in a particular transaction is highly questionable.⁶⁵ Indeed, a substantial body of literature recognizes

57. For example, the New Jersey legislature did not enact its first merger statute of general application until 1893. Act of Mar. 8, 1893, ch. 67, 1893 N.J. Laws 121. Delaware's first general merger statute appeared in 1899. Act of Mar. 10, 1899, ch. 273, § 54, 21 Del. Laws 445, 461. Other states were much later. *E.g.*, Act of Feb. 27, 1925, ch. 77, § 1, 1925 N.C. Sess. Laws 81. Wisconsin did not permit mergers until 1947. See *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 506 (7th Cir. 1989). Although not embodied in the state corporate laws, in 1890 the Sherman Antitrust Act established prohibitions against monopolization and contracts in restraint of trade. 15 U.S.C. §§ 1, 2 (1988).

58. See, e.g., J. HURST, *supra* note 52, at 98.

59. The advent of the implied powers doctrine and all-purpose clauses in corporate charters has combined with the elimination of the ultra vires defense by the corporation to actions by third parties. See, e.g., H. HENN & G. ALEXANDER, *supra* note 28.

60. See, e.g., Millon, *supra* note 50.

61. Horwitz, *Santa Clara Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173, 221 (1985) ("[T]he demise both of the ultra vires doctrine as well as of constitutional restrictions on foreign corporations was an expression of the triumph of the natural entity theory.").

62. Consider, for example, the statutory restrictions on dividends and other corporate distributions. See, e.g., DEL. CODE ANN. tit. 8, §§ 170, 173 (1983).

The entire system of legal capital was constructed not to protect the primacy of shareholders but rather to protect outsiders, namely creditors. In protecting creditors, the law also necessarily protected the interests of employees in maintaining a going concern. While the Revised Model Business Corporation Act has eliminated the capital system, it nevertheless puts constraints on corporate distributions. REV. MODEL BUSINESS CORP. ACT § 6.40 (1984).

63. See Haft, *Business Decisions By the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1 (1981) (suggesting that boards of directors can benefit from a behavioralist analysis of decision making).

64. *E.g.*, Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1444 (1989).

65. Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implica-*

the inherent structural bias of directors.⁶⁶ The evidence of structural bias may simply be another way of recognizing that managers and shareholders have divergent interests.⁶⁷ Thus, it is doubtful that a requirement of independence can give adequate protection to corporate interests other than those of its managers.⁶⁸

IV. CORPORATION AS CONTRACT

A. *The Contractarian Model—A Synopsis*

The current fashion among economists is to eschew the fiduciary model of corporate structure in favor of a contractarian approach.⁶⁹ One aspect of the contractarian view is that the law should impose the minimum amount of interference on freedom of contract.⁷⁰ More accurately, the contract model of corporate existence is derived from a basic value judgment that, in general, governmental interference and protectionism should yield to freedom of contract. According to Professor Eisenberg,⁷¹ the contract model fails, at least in the case of a publicly held corporation, because shareholder consent is an illu-

tions of Corporate Cohesion, 48 LAW & CONTEMP. PROBS. 83 (Summer 1985); Cox, *Heroes in the Law: Alford v. Shaw*, 66 N.C.L. REV. 565, 580 (1988) (suggesting that a court is better suited than an independent committee of directors to determine whether continuation of a derivative suit is in the best interests of the corporation); Cox, *Compensation, Deterrence and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 783-88 (1984) (discussing the derivative suit as a means of achieving deterrence of management misconduct and compensation for such misconduct to the injured parties in cases involving either violations of the duty of loyalty or the duty of care); Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 962 (arguing that a reviewing court should carefully scrutinize a special litigation committee's assertion of independence and recommendation, making its own evaluation of whether a derivative suit is in the corporation's best interest).

66. See authorities cited *supra* note 65.

67. Cf. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 9 (1986) ("Economic theory suggests that shareholders and managers have struck an implicit contract.")

68. Professor Palmiter suggests the following relevance of a duty of independence:

What then does a duty of independence do? It provides standards for judicial review of corporate decision making in contexts in which neither abstention nor full-blown intervention is warranted. It operates when interest is inferable or even clear but at the same time countervailing shareholders' interests argue for judicial caution. It operates when the premises of the fiduciary model suggest that directors should be capacitated as monitors, and it provides the best means of juggling the underlying tensions of the mixed-motive cases. The evolving standards in the takeover and special litigation cases make this clear: they are neither care nor loyalty standards—they are standards of independence. It is time to abandon the business judgment and fairness rhetoric and to focus critical attention on the contractarian, efficiency, and prudential premises of the fiduciary model. A duty of independence bridges the gap in these areas between the academic literature and the case law.

Palmiter, *supra* note 64, at 1462.

69. See generally Bebchuk, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989) (discussing opting out of the rules of corporate law by adopting charter amendments).

70. It is possible to reach a noninterventionist conclusion from other perspectives as well. See, e.g., Barach & Elstrott, *The Transactional Ethic: The Ethical Foundations of Free Enterprise Reconsidered*, 7 J. BUS. ETHICS 545 (1988) (One of the primary reasons that free enterprise works is the transactional ethic. Mutually beneficial interests, which both require and promote the Golden Rule, must be a goal of free enterprise with minimal outside intervention.)

71. See *infra* text accompanying notes 155-66.

sory concept. Consent is an essential element of classical contract doctrine⁷² and thus the absence of consent is fatal to a contractarian analysis.

The latest version of the contract theory of corporate existence, which had its genesis in 1937,⁷³ takes the position that the corporate structure consists of a nexus of contracts, leaving the various constituents free to negotiate their own terms.⁷⁴ Thus, the fiduciary model imposes restraints on that freedom of contract insofar as it limits the extent to which managers can favor their own interests over those of the shareholders. The contractarians suggest that by permitting managers and shareholders to define their relative rights and obligations, a more efficient firm will emerge than would be the case where managers' decisions are guided by a predetermined set of fiduciary obligations. Increased

72. See, e.g., P. ATIYAH, *THE RISE AND FALL OF FREEDOM OF CONTRACT* 408 (1979).

73. In 1937, Coase published his article *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937), which described the firm as an organized way of minimizing the transactions costs of contracting and pricing. Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 *A.M. ECON. REV.* 777 (1972), is frequently credited as the origin of the contractarian view of the corporation. See Butler & Ribstein, *The Contract Clause and the Corporation*, 55 *BROOKLYN L. REV.* 767, 770-77 (1989). The corporation, however, has long been recognized as a nexus of contracts. See *infra* note 141.

One commentator aptly observed that many of the component notions of the new economic theory have been with us since the seventeenth and eighteenth centuries. See Bratton, *supra* note 45, at 408 n.3.

74. As explained by one commentator:

In this model, the firm is a "nexus of contracts" or a market place where the various constituencies contract for their own protection. The entrepreneurial concept of the firm is rejected. *Ownership of the firm disappears as a meaningful concept under this model because no one can own a "nexus."* Shareholders are merely parties to one contract that comprises the firm. Moreover, control of the firm is shared among various constituencies. Control is reflected in the terms of various contracts entered into by individuals. According to this model, it makes little sense to focus upon shareholders' "ownership" and control when various constituencies share control. It also makes little sense to speak of "corporate" social responsibility because the firm is only a "nexus." Various constituencies can obtain the protection they need by bargaining for contract terms.

Dallas, *Two Models of Corporate Governance: Beyond Berle & Means*, 22 *U. MICH. J.L. REF.* 19, 23 (1989) (emphasis added).

Other commentators also addressed the nexus of contracts model and other aspects of firm ownership and control. See e.g., Alchian & Demsetz, *supra* note 73; Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 *J.L. & ECON.* 375 (1983); Easterbrook & Fischel, *Close Corporations and Agency Costs*, 38 *STAN. L. REV.* 271 (1986); Easterbrook & Fischel, *Corporate Control Transactions*, 91 *YALE L.J.* 698 (1982); Easterbrook & Fischel, *Voting in Corporate Law*, 26 *J.L. & ECON.* 395 (1983); Fama, *Agency Problems and the Theory of the Firm*, 88 *J. POL. ECON.* 288 (1980); Fama & Jensen, *Agency Problems and Residual Claims*, 26 *J.L. & ECON.* 327 (1983); Fama & Jensen, *Separation of Ownership and Control*, 26 *J.L. & ECON.* 301 (1983); Fischel, *The Corporate Governance Movement*, 35 *VAND. L. REV.* 1259 (1982); Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 *CORNELL L. REV.* 261 (1986); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305 (1976); Klein, *Contracting Costs and Residual Claims: The Separation of Ownership and Control*, 26 *J.L. & ECON.* 367 (1983); Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 *YALE L.J.* 1521 (1982); Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. LEGAL STUD.* 251 (1977). For discussion of the transaction cost approach, see O. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (1975); O. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975); Williamson, *Corporate Governance*, 93 *YALE L.J.* 1197 (1984); Williamson, *The Economics of Organization: The Transaction Cost Approach*, 19 *J. ECON. LIT.* 548 (1981); Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 *J. ECON. LIT.* 1537 (1981); Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 *J.L. & ECON.* 233 (1979).

efficiency in turn increases the potential for shareholder wealth maximization—a goal generally recognized as paramount in corporate existence. Although wealth maximization clearly is the proper goal of business corporations, it does not necessarily follow that government regulation that imposes limits on that goal is inappropriate. Moreover, although it is appropriate to view the corporation as a series of contracts, this paradigm does not provide an answer to all questions concerning the proper scope of governmental regulation of corporations.

B. *Drawing the Distinction between Mandatory and Permissive Norms*

The essence of the contractarian view is that corporate law is (and should be) enabling and should not impose mandatory strictures on activity. The observation that state corporate laws are largely enabling is not new.⁷⁵ The fact that corporate laws permit the participants great flexibility to define their relative rights and duties by contract (*i.e.*, in corporate charter provisions) does not mean, however, that mandatory rules (at least at the margin) are unwarranted.

Recognizing this point, Professor John Coffee rejects a pure contractarian notion;⁷⁶ nevertheless, he borrows from contract analysis. Coffee distinguishes between concepts of fiduciary duty and the contract notion of good faith.⁷⁷ He views fiduciary duty and good faith as part of a continuum. Good faith defines the floor for contractual dealings generally, whereas fiduciary duty sets higher standards applicable in certain relationships.⁷⁸ Professor Coffee maintains that the contract law principle that a party cannot by contract eliminate his or her obligation of good faith⁷⁹ should apply in the corporate context.⁸⁰ Coffee would

75. *E.g.*, Latty, *Why Are Business Corporation Laws Largely "Enabling"?*, 50 CORNELL L.Q. 599 (1965).

76. Coffee, *Balance*, *supra* note 39, at 1620-22; Coffee, *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOKLYN L. REV. 919, 932 (1988). Professor Coffee takes the position that the contractarian hypothetical bargaining model actually undermines contract formation. Because courts will fill the gaps in arrangements in order to maximize wealth (*i.e.*, by adding what a reasonable person would bargain for), the contractarian model discourages actual bargaining. Also, the contract approach allows departures from the norm without taking into account the distribution of gains.

77. *See supra* note 76; *see also* De Mott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879.

78. Coffee, *Balance*, *supra* note 39, at 1653-64.

79. *E.g.*, U.C.C. § 1-203 (1987) ("Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."); *id.* § 1-102(3) ("The effect of provisions of this Act may be varied by agreement . . . except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement, but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable."); RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."); J. CALAMARI & J. PERILLO, *THE LAW OF CONTRACTS* §§ 11-38 (3d ed. 1987); 3 A. CORBIN, *CONTRACTS* § 570 (1960 & Supp 1990); Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 371 (1980). For an early formulation of this view, see *Industrial & Gen. Trust Ltd. v. Tod*, 180 N.Y. 215, 225-26, 73 N.E. 7, 9-10 (1905); *cf.* *VTR, Inc. v. Goodyear Tire & Rubber Co.*, 303 F. Supp. 773 (S.D.N.Y. 1969) (holding that the parties could expressly consent in the contract to particular conduct that would have been barred by the duty of good faith).

80. Coffee, *Balance*, *supra* note 39, at 1653-64.

establish traditional fiduciary duties as the default provision in the corporate contract and would permit the parties to opt out.⁸¹ This renegotiation, he maintains, would result in a redistribution of gain and thus place the burden on corporate managers to adequately compensate the shareholders for any relaxation of the fiduciary standard.⁸² Under Professor Coffee's model, shareholders could agree by contract (*i.e.*, by amendment of the corporate charter) to limit or eliminate the directors' duty of care.⁸³ On the other hand, Coffee would not permit a charter provision that would allow the managers to trade on inside information (or otherwise steal from the company). Such a provision would represent an attempt to contract away the duty of good faith.⁸⁴ A corollary to Professor Coffee's position is that it may be appropriate for courts to change the default rules over time, but only to expand fiduciary obligations in favor of shareholder interests. Expansion of the duties would not unduly inhibit management, which would still be free to propose an opt-out.⁸⁵

C. Corporation as Contract—Some Recent Developments in the Law

In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,⁸⁶ the Delaware Supreme Court marked a victory for the shareholder supremacy model. The essence of the shareholder supremacy paradigm is that when managers' interests conflict with those of the shareholders, managers must yield to the shareholders. *Revlon* can also be viewed as at least a partial victory for free market economists. The court in *Revlon* ruled that once a company is for sale, the directors are not free to consider interests relevant to members of the corporate constituency other than the shareholders. Thus, for example, the workers, consumers, and long-term health of the business are not proper factors for management to con-

81. *Id.* at 1659.

82. This is where Professor Eisenberg's criticism comes into play. To the extent that the shareholder voting process is flawed, it is not meaningful to talk in terms of bargained-for contract terms. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1480 (1989). Coffee, however, borrows from recent contract theory in arguing that shareholder consent can be meaningful. Coffee concedes that management has an advantage over shareholders in the bargaining process, but he proffers an information forcing standard as the solution. Coffee, *Balance*, *supra* note 39, at 1623, 1679-80; cf. Ayres & Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 95-107 (1989) (calling for penalty default rules to diminish management's advantages over shareholders in the bargaining process). According to Coffee, management always has inside information and, of course, management controls the proxy process. Thus, managers would be forced to provide adequate information.

83. This, of course, is permitted by the law of many states that have followed the lead of Delaware. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988); see e.g., CAL. CORP. CODE § 204(a)(10) (West 1977 & Supp. 1989); N.J. STAT. ANN. § 14A:2-7(3) (West 1969 & Supp. 1989); N.Y. BUS. CORP. LAW § 402(b) (McKinney Supp. 1990); N.C. GEN. STAT. §§ 55-2-02(b)(3), 55-8-30(e) (1990). For a criticism of this approach, see Hazen, *The Second Lap*, *supra* note 36, at 179-82.

84. Professor Coffee proposes that the default rule be a high fiduciary standard. He would permit transaction-specific opt-outs (e.g., a charter provision that would prohibit mergers for a five-year period), but would not permit a blanket clause (e.g., "managers are free to trade on inside information") because the latter would violate the duty of good faith. *But see* Eisenberg, *supra* note 82, at 1474-80 (concerning the ineffectiveness of shareholder consent as a safeguard in opt-out cases).

85. Coffee, *Balance*, *supra* note 39, at 1681.

86. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); see Johnson, *supra* note 23 (recognizing the two conflicting strains in corporate law: management discretion versus shareholder autonomy); Loewenstein, *Toward an Auction Market for Corporate Control and the Demise of the Business Judgment Rule*, 63 S. CAL. L. REV. 65, 102 (1989).

sider.⁸⁷ To the extent that the market is an efficient and effective arbiter of value, it seems reasonable to require the directors to conduct an auction for the company rather than determine the successful control acquirer according to the values (and perhaps self interest) of incumbent management. However, others might argue that *Revlon* represents an interference with the free market to the extent that it interferes with the "contract" between the directors and shareholders that otherwise would permit the directors to use their judgment in deciding to fend off an unwanted offer.

Revlon followed on the heels of the Delaware Supreme Court's earlier decision in *Smith v. Van Gorkom*,⁸⁸ which set the stage for the auction rule, although imposing liability for breach of a fiduciary duty. In *Van Gorkom* the court held that, in recommending a sale to a third party, the disinterested directors failed to meet their standard of care by, among other things, neglecting to adequately test the market as to the maximum price that would be attainable for their shareholders. These two decisions were based on economic rather than traditional fiduciary considerations. The traditional fiduciary paradigm would have permitted the directors to exercise their judgment in evaluating the offer. Potential conflicts of interest would have been accounted for by placing on the directors the burden of proving the fairness of the transaction. The *Van Gorkom* opinion hinted and the *Revlon* decision expressly held that maximization of shareholder wealth is the only consideration when a corporation is for sale.

State lawmakers throughout the country reacted strongly to these two decisions. First, many states, desiring to limit the effect of *Van Gorkom*, enacted charter opt out provisions that enabled directors to limit or eliminate entirely their liability for duty of care violations.⁸⁹ Such an approach constitutes legislative acceptance of the contractarian model and in the process gives short shrift to the fiduciary paradigm.⁹⁰

Not all legislative responses, however, are consistent with the contract model of the corporation. Other state legislatures responded to the *Van Gorkom*

87. Note, however, the following statutes all of which expressly permit directors to consider such factors: IND. CODE ANN. § 23-1-35-1(d) (Burns Supp. 1989); ME. REV. STAT. ANN. tit. 13-A § 716 (Supp. 1989); OHIO REV. CODE ANN. § 1701.59 (Anderson Supp. 1989); 15 PA. CONS. STAT. ANN. 1721 (Purdon Supp. 1990).

88. 488 A.2d 858 (Del. 1985).

89. These statutes were modelled on the Delaware statute enacted in response to the *Van Gorkom* decision. DEL. CODE ANN. tit. 8, § 102(b)(7) (1986); see also MASS. ANN. LAWS ch. 156B, § 13(b)(1.5) (Law. Co-op. Supp. 1990); N.C. GEN. STAT. § 55-2-02(b)(3) (1990). For discussion of the recent duty of care developments and legislative responses, see Bradley & Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989); Hazen, *The Second Lap*, *supra* note 36.

It is significant that not all recent state legislation favors a contractarian approach. Quite to the contrary, many states have enacted antitakeover legislation that is designed to favor management. As explained by Judge Easterbrook:

We have not been elected custodians of investors' wealth. States need not treat investors' welfare as their *summum bonum*. Perhaps they choose to protect managers' welfare instead, or believe that the current economic literature reaches an incorrect conclusion and that despite appearances takeovers injure investors in the long run. Unless a federal statute or the Constitution bars the way, Wisconsin's choice must be respected.

Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496, 502 (7th Cir. 1989).

90. See Hazen, *The Second Lap*, *supra* note 36, at 179-82.

decision by enacting statutes that expanded the basis for corporate decision-making.⁹¹ Under these laws, corporate directors are permitted (although not mandated) in making their decisions to take into account members of the corporate community other than the shareholders. For example, in deciding whether to support a proposed buyout, managers may consider interests of the employees, customers, suppliers, and creditors, or even the economy of the state and nation and "community and societal considerations."⁹² The primary motive underlying these statutes has been the legislatures' concern for preserving jobs within their state.⁹³ Regardless of the motivation for such statutes, this legislative response evinces a reinforcement of the fiduciary paradigm as opposed to the contractarian approach taken by other states. Of course, many economists and other observers will argue that this type of legislative response simply adds another factor to the contractarian model. Corporations are still free to select their state of incorporation, and this selection becomes simply another clause to be negotiated in the corporate contract,⁹⁴ so long as there are states that have not similarly modified their corporate law.

A parallel legislative development was the proliferation of various antitakeover statutes.⁹⁵ One variety of these antitakeover statutes (commonly known as "control share statutes") requires a vote by disinterested shareholders before a new shareholder with substantial share ownership can have voting rights.⁹⁶ Another variety is the so-called "best price" approach, which prohibits two-tiered offers in the absence of a shareholder vote by requiring that an offeror pay a tender offer or merger price as high as any price it has paid for shares in the past.⁹⁷ A more recent variety is the "business combination" statute, which provides for a waiting period between an acquisition of shares and a subsequent merger into the acquiring company.⁹⁸ These anti-takeover statutes represent

91. *E.g.*, IND. CODE ANN. § 23-1-35-1(d) (Burns Supp. 1989); ME. REV. STAT. ANN. tit. 13-A, § 716 (Supp. 1989); OHIO REV. CODE ANN. § 1701.59 (Anderson Supp. 1989); 15 PA. CONS. STAT. ANN. § 1721 (Purdon Supp. 1990).

92. OHIO REV. CODE ANN. § 1701.59 (Anderson Supp. 1989).

93. *See, e.g.*, Hazen, *The Second Lap*, *supra* note 36, at 176-77; Hazen, *State Anti-Takeover Legislation: The Second and Third Generations*, 23 WAKE FOREST L. REV. 77, 108-09 (1988) [hereinafter Hazen, *State Legislation*]; Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987).

94. *See, e.g.*, Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365, 372-73; *see also* Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179 (1985) (arguing that whether a state has permissive corporate laws plays a factor in determining which firms tend to locate there); Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861 (1969) (characterizing the Delaware Corporation law as a commodity sold on the open market).

95. *See, e.g.*, Hazen, *State Legislation*, *supra* note 93, at 78-88.

96. *E.g.*, IND. BUS. CORP. LAW § 23-1-17-1 et seq. (Burns Supp. 1986). The United States Supreme Court upheld the constitutionality of the Indiana statute in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987).

97. *E.g.*, MD. CORPS. & ASS'NS CODE §§ 3-602, 3-603 (1989) (defining best price to include the price paid during the past two years); N.C. GEN. STAT. §§ 55-75 to -79 (1987) (best price not defined). In addition to its best-price requirement, the Hawaii statute requires that a bidder offer to purchase all of the target company's shares. HAW. REV. STAT. § 417E-2(3) (1976).

98. *E.g.*, DEL. CODE ANN. tit. 8, § 203 (Supp. 1988); N.Y. BUS. CORP. LAW § 912 (McKinney Supp. 1990); WIS. STAT. ANN. § 180.725 (West Supp. 1989). The decisions to date have upheld the constitutionality of these statutes. *See Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496 (7th Cir. 1989) (Wisconsin statute); *BNS, Inc. v. Koppers Co.*, 683 F. Supp. 458 (D. Del.

further evidence of legislative aversion to a free market approach in terms of an unregulated market for corporate control. In fact, a contractarian attack has been made on such statutes, claiming that they interfere with the contract rights of the corporate participants and therefore violate the constitutional prohibition against impairment of contract obligations.⁹⁹

Some of the legislative responses to *Van Gorkom* and most of the responses to takeovers illustrate a well-intentioned (but perhaps misplaced) legislative concern for the corporate community beyond simply shareholder or management supremacy. As such, these responses support a fiduciary paradigm rather than a contract paradigm of corporate governance. Of course, the charter opt-out provisions, discussed earlier, represent a contrary movement in the legislatures away from fiduciary principles in favor of the contract model. One explanation for legislatures' apparent inconsistency is that they are influenced in part by special interest groups lobbying for corporate management and by the law firms that represent management. There can be little doubt that this is at least a partial explanation. A further explanation might be that, as a general proposition, legislatures believe that although the fiduciary paradigm is the appropriate one, at times it may be necessary to impose limitations on these fiduciary principles. Thus, many states have found it desirable to have limited director liability for fiduciary duty breaches as a pragmatic solution—for example, to attract good outside managers.¹⁰⁰ Furthermore, the charter opt-out provisions are not a wholesale rejection of the fiduciary paradigm. These provisions limit monetary liability for duty of care violations, yet they both retain the availability of injunctive relief and disallow the contracting out of duty of loyalty violations.¹⁰¹

A recent twist in the development of Delaware corporation law occurred with the watershed decision in *Paramount Communications, Inc. v. Time, Inc.*¹⁰² The *Time* decision demonstrates a return to the fiduciary model notwithstanding the Delaware legislature's previous move toward a contractarian model.¹⁰³ The *Time* decision is also significant in that the Delaware court retrenched from the shareholder supremacy model that it earlier had adopted in *Revlon*.

The *Time* litigation arose out of Time, Inc.'s response to a hostile bid by Paramount. Warner Communications had approached Time, Inc. with a

1988) (Delaware statute); *RP Acquisition Corp. v. Staley Continental, Inc.*, 686 F. Supp. 476 (D. Del. 1988) (same); *City Capital Ass'n v. Interco, Inc.*, 696 F. Supp. 1551 (D. Del.), *aff'd*, 860 F.2d 60 (3d Cir. 1988) (same).

99. See Butler & Ribstein, *The Contract Clause and the Corporation*, 55 BROOKLYN L. REV. 767 (1989); see also Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257 (1985); Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71 (1989); cf. Rock, *Antitrust and the Market for Corporate Control*, 77 CALIF. L. REV. 1365 (1989) (arguing in favor of using the antitrust laws to maintain competition in the market for corporate control).

100. This is the articulated rationale for charter opt-out statutes. See, e.g., Hazen, *The Second Lap*, *supra* note 36.

101. See, e.g., the statutes cited *supra* notes 32-36.

102. 571 A.2d 1140 (Del. 1990), *aff'd* [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. 1989).

103. See DEL. CODE ANN. tit. 8, § 102(b)(7) (1986).

merger proposal. Paramount intervened by offering \$175, and eventually offered \$200 per share for the Time stock—a price far in excess of the estimated value of the proposed Warner/Time merger share exchange. Under *Revlon*,¹⁰⁴ Time management might have appeared bound to accept the Paramount offer or, alternatively, to seek a higher offer. Time responded, however, by making a cash offer for Warner. Because Time had decided to remain independent (albeit a completely different company after the Warner acquisition), it was free to embark on the acquisition even though in the process, shareholder wealth maximization was sacrificed.¹⁰⁵ How could management justify the Warner acquisition when it resulted in a company valued approximately thirty percent below the \$200 per share price offered by Paramount? One rationale (arguably consistent with the shareholder primacy model) is that, considering the long term, Time shareholders would fare better by holding on to their Time/Warner stock than by selling their shares to Paramount.¹⁰⁶ The chancery court relied on Time management's right to focus on the long-term interests of the company in upholding their decision to reject Paramount's offer.¹⁰⁷ On appeal, however, the Delaware Supreme Court declared that the lower court had been "unwise" in placing "undue emphasis upon long-term versus short-term corporate strategy."¹⁰⁸ The court explained:

Two key predicates underpin our analysis. First, Delaware law imposes on the board of directors the duty to manage the business and affairs of the corporation. Del. C. § 141(a). This broad mandate includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability. Thus, the question of "long-term" versus "short-term" values is largely irrelevant because directors, generally, are obliged to charter a course for a corporation which is in its best interests without regard to a fixed investment horizon. Second, absent a limited set of circumstances defined under *Revlon*, a board of directors while always required to act in an informed manner, is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover. In our view, the pivotal question presented by this case is: "Did Time, by entering into the proposed merger with Warner, put itself up for sale?"¹⁰⁹

104. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

105. Once it became apparent that the Time-Warner deal was likely to succeed, the Time stock dropped, trading a little above \$140 per share. This amounted to a price 30% below the price that the Time shareholders would have realized under the Paramount offer. As this Article went to press, less than one and a half years after Paramount's offer, Time-Warner, Inc. stock was trading in the \$70 range.

106. The rationale was thus that the short-term profits should take a second chair to the long term. However, it is clear from the perspective of the Time shareholders' short-term investment objectives that the Paramount offer was in their best interest.

107. [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. 1989).

108. *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1150 (Del. 1990).

109. *Id.* The court went on to remark in a footnote: "[W]e endorse the Chancellor's conclusion that it is not a breach of faith for directors to determine that the present stock market price of shares is not representative of true value or that there may indeed be several market values for any corporation's stock. We have so held in another context." *Id.* at 1150 n.12 (citing *Smith v. Van Gorkom*, 488 A.2d 858, 876 (Del. 1985)).

Only if the corporation is "for sale" does the *Revlon* duty not to interfere come into play. On the other hand, if the corporation is not "for sale," then managers may invoke the business judgment rule to fend off a hostile bidder according to the test laid down in the court's decision in *Unocal Corp. v. Mesa Petroleum Co.*¹¹⁰ Under the *Unocal* test, directors may employ defensive measures if they can prove that: (1) there was a reasonable basis for perceiving a threat to corporate policy and effectiveness, and (2) the defensive measures adopted were reasonable in relation to the perceived threat.¹¹¹

The threat posed by the Paramount offer, as articulated by Time management, was that it would have meant an end to the existing Time entity and "corporate culture" of that entity. The directors maintained that the Paramount offer and the business combination that would have followed were not necessarily best for other Time, Inc. constituencies such as its employees and consumers. The Delaware courts agreed with Time management's right to determine the company's future. In the course of its decision, the Delaware chancery court emphasized the fact that after the Time-Warner combination, the new entity would preserve Time's corporate culture. The Warner acquisition properly was viewed as a publishing company's desire to expand its presence in the entertainment industry.¹¹² The chancery court thus viewed the Time-Warner combination as consistent with Time's long-term plans whereas the acquisition of Time by Paramount would have meant an end to Time.¹¹³ As noted above,¹¹⁴ the Delaware Supreme Court did not agree with the Chancellor's emphasis on long-term rather than short-term goals. The court nevertheless upheld the decision because otherwise the court would be "substituting its judgment for what is a 'better' deal for that of a corporation's board of directors."¹¹⁵

The *Time* decision can be seen as a rejection of an efficiency model in favor of other values. Focusing on market efficiency and shareholder wealth maximization arguably would have led the court to block the Time-Warner combination, or at least give the Time shareholders a choice in the matter. Once the Warner deal was announced the market reacted unfavorably. The market reacted to Time's announced merger with Warner by pricing the Time stock significantly below the level of Paramount's offer. Efficiency is supposed to maximize wealth without regard to distributive issues. Under an efficiency model, the higher price that would have been realized under the Paramount offer should have gone to the Time shareholders. By entering into the Warner

110. 493 A.2d 946 (1985); see also *Mills Acquisition Co. v. Macmillan*, 599 A.2d 1261, 1285 n.35 (Del. 1988).

111. *Unocal*, 493 A.2d at 955. The court in *Time* reaffirmed this test and explained that the directors satisfy the first prong of the *Unocal* test by "demonstrating good faith and reasonable investigation." *Time*, 571 A.2d at 1152; see also *Gilbert v. El Paso Co.*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. ¶ 95,303 (Del. S. Ct. 1990) (applying *Unocal* test and upholding negotiated second tender offer from bidder after unsuccessful search for a white knight).

112. Previously, Time had entered the entertainment industry as evidenced by its earlier acquisition of HBO cable television.

113. It might be argued, however, that the effect on Time of acquiring Warner meant that the new Time was substantially different from the old.

114. See *supra* text accompanying note 108.

115. *Time*, 571 A.2d at 1153.

deal, however, the Time management deprived its shareholders of this opportunity. One could easily have imagined the Delaware court saying that Time management's interference with the Paramount offer violated the principles that had been laid down in *Revlon*. Nevertheless, the Delaware Court of Chancery was willing to place a value on management's ability to exercise what arguably was believed to have been its fiduciary obligation to watch out for all corporate interests, not just those of the Time shareholders. The Delaware Supreme Court, while not endorsing those sentiments, nonetheless was willing to defer to the judgment of Time management.

Perhaps the fiduciary model is not the best explanation for the *Time* decision. The power model provides an alternative explanation for the decision. The Delaware courts have historically upheld the rights of management over the interests of shareholders.¹¹⁶ When viewed in this light, *Revlon*, which held that management must favor the interests of the shareholders when their corporation is for sale, limits management's otherwise dominant position in the power model. In contrast, *Time* favors management in the power struggle for control of the corporation by letting management retain its control at the cost of a higher exit price for the shareholders. This more cynical view of the decision is bolstered by the supreme court's action in simply deferring to the judgment of Time management, which certainly stood to gain by fending off the Paramount offer and thereby retaining their managerial positions. Regardless of the rationale one may choose to explain the *Time* result, clearly it cannot be based on economic efficiency.

V. SOME FALLACIES UNDERLYING STRICT CONTRACTARIANISM

A. *The Corporate Contract and Fiduciary Duties are Not Incompatible*

The generalized corporation acts¹¹⁷ did not change the fact that the corporate charter is a contract between various constituents of the corporation and the state. When corporate existence is recognized by the Secretary of State's acceptance of the articles of incorporation for filing¹¹⁸ (or, alternatively, by the issuance of a certificate of authority¹¹⁹), the contract is formed. Not only is there an *inter se* contract between and among all of the corporate constituents, the corporate charter also represents a contract with the state. Although it may be an anathema to say this in certain circles of academic economists, the state's interest in the corporate contract requires us to view the corporation in its political and social context. As pointed out earlier, although profit maximization is a proper corporate goal, it is necessary to factor in the social and political costs rather than let the balance sheet be determined solely by dollars and cents.¹²⁰

116. See, e.g., Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Comment, *supra* note 94.

117. See *supra* text accompanying notes 54-56.

118. E.g., CAL. CORP. CODE § 200 (West 1977 & Supp. 1989); DEL. CODE ANN. tit. 8, § 106 (1983); N.Y. BUS. CORP. LAW § 403 (McKinney 1990).

119. E.g., ILL. ANN. STAT. ch. 32, para. 2.15 (Smith-Hurd 1985).

120. See, e.g., Camenisch, *Profit: Some Moral Reflections*, 6 J. BUS. ETHICS 225 (1987) (Profit is

As explained in an excellent article by Professors Kaen, Kaufman, and Zacharias.¹²¹

The intellectual roots of financial agency theory are most likely to be found in the classic American liberal as opposed to civic republican tradition. The liberal tradition emphasizes the instrumentalism of property and property rights for achieving democratic ends rather than the equitable distribution of property for development purposes. This tradition also believes that individuals act in their own self interest and seeks, therefore, to organize economic activity and institutions so as to use this self interest in the pursuit of economic efficiency.

It is in this liberal tradition that a justification for arguing that managers should be held accountable to shareholders can be found. Without this—or some other—normative value context there simply is no compelling political reason to be the least bit concerned with efficiency. Efficiency is a means; it is not a value and social/political debates are about values.

This distinction between efficiency as a means and efficiency as a value is unlikely to cause problems for a positivist economist who is primarily interested in explaining how things work. However, as soon as the word “management” is appended to “financial,” the luxury of claiming that one is working in a value free context is no longer available. Even more suspect is any claim that managers’ responsibilities are limited to purely matters of economic efficiency. This question is a political question and is to be debated in a political arena.¹²²

Acceptance of a contractarian model thus does not necessarily result in the elimination of fiduciary duties. The one form of doing business that has always been recognized as contractual is a partnership. Unlike the corporate form, the partnership form of doing business does not depend upon statutory authority;¹²³ instead, partnerships are governed by the law of agency and the law of contracts.¹²⁴ It is axiomatic that in the partnership relationship the partners owe each other the highest of fiduciary duties.¹²⁵ This point is illustrated by Judge Cardozo’s famous pronouncement:

Joint adventurers like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the stan-

not the central focus of business ethics. When we focus on profits, we are “raising the question of the moral legitimacy of the business system itself. That is quite a different enterprise.”); Kaen, Kaufman & Zacharias, *American Political Values and Agency Theory: A Perspective*, 7 J. BUS. ETHICS 805 (1988) (as explained in the abstract: “Historically, economic efficiency was not a value or end in itself but merely a means by which more fundamental social goals might be achieved.”).

121. Kaen, Kaufman & Zacharias, *supra* note 120.

122. *Id.* at 818.

123. *See generally* 1 A. BROMBERG & L. RIBSTEIN, *PARTNERSHIP* (1988).

124. *Id.*

125. *See generally* 1 A. BROMBERG & L. RIBSTEIN, *supra* note 123, § 607.

dard of behavior.¹²⁶

The rule thus has developed that although partners are free to define their relative rights and duties by contract, they nevertheless remain subject to high fiduciary standards.¹²⁷ This is the rule imposed by the common law, without any enabling statute. The corporate form takes the argument one step further. There is no such thing as a common-law corporation. Corporate existence depends wholly upon compliance with applicable corporate enabling laws. The state, as a precondition to corporate existence, is free to interfere in the entrepreneurs' contractual relationship. The fiduciary obligation of corporate managers has long been one of these requirements imposed by the state.¹²⁸

The analogy to partnership law is strongly embedded in the law of closely held corporations. The courts and the commentators long have recognized the importance of permitting participants in close corporations to stray from certain statutory norms of corporate existence.¹²⁹ For example, courts frequently tolerate the absence of corporate formality more readily in the close corporation setting than a strict reading of the corporate law might seem to permit.¹³⁰ Similarly, courts will enforce shareholder agreements¹³¹ and permit limitations on director authority and discretion in the closely held corporation setting that they would not accept in a comparable public corporation.¹³² Again, as with a general partnership, the trade-off for permitting more leeway in contract is the imposition of higher fiduciary obligations.¹³³ Contractarians would impose the same freedom of contract in the publicly held context without the concomitant fiduciary duty. This result simply ignores the basis of corporate law in our tradition.

126. *Meinhard v. Salmon*, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (1928).

127. See 1 A. BROMBERG & L. RIBSTEIN, *supra* note 123.

128. See *supra* notes 27-68 and accompanying text.

129. See, e.g., *Galler v. Galler*, 32 Ill. 2d 16, 203 N.E.2d 577 (1964); F. O'NEAL & R. THOMPSON, *CLOSE CORPORATIONS* (3d ed. 1986); Cary, *How Illinois Corporations May Enjoy Partnership Advantages*, 48 NW. U.L. REV. 427 (1953); Hornstein, *Stockholders' Agreements in the Closely Held Corporation*, 59 YALE L.J. 1040 (1950).

130. See, e.g., *Galler*, 32 Ill. 2d at 31-32, 203 N.E.2d at 586. The courts not only will protect contractual rights but also "reasonable expectations." See *Meiselman v. Meiselman*, 309 N.C. 279, 307 S.E.2d 551 (1983); *Matter of Kemp & Beatley*, 64 N.Y.2d 63, 473 N.E.2d 1173 (1984) (finding "oppressive" conduct by the majority in interfering with the minority's "reasonable expectations"); *Stefano v. Coppock*, 705 P.2d 443 (Alaska 1985); cf. *Baker v. Commercial Body Builders, Inc.*, 264 Or. 614, 507 P.2d 387 (1973) (conduct of majority did not rise to the level of "oppression").

131. DEL. CODE ANN. tit. 8, § 218(c) (1983); N.C. GEN. STAT. § 55-7-31 (Supp. 1990); REV. MODEL BUSINESS CORP. ACT § 7.31 (1984). *But cf.* *Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling*, 29 Del. Ch. 610, 53 A.2d 441 (1947) (upholding shareholder vote pooling agreement but refusing to grant specific performance).

132. *E.g.*, *Clark v. Dodge*, 269 N.Y. 410, 199 N.E. 641 (1936); N.C. GEN. STAT. § 55-7-31(b) (Supp. 1990).

133. See, e.g., *Comolli v. Comolli*, 241 Ga. 471, 246 S.E.2d 278 (1978); *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975); *Cain v. Cain*, 3 Mass. App. 467, 334 N.E.2d 650 (1975); *Meiselman v. Meiselman*, 309 N.C. 279, 307 S.E.2d 551 (1983); see also N.C. GEN. STAT. § 55-7-31(b) (Supp. 1990) (providing that if an agreement permits shareholders (or others) to act as directors, they are held to the same obligations and duties that normally attach to directors).

B. Freedom of Contract and the Free Market

The contractarian model of the corporation derives from the bargaining and free market paradigm. This paradigm is used in turn as an excuse for eliminating mandatory rules of fiduciary duty.¹³⁴ This view, however, ignores a significant fact: the corporate form, by its very nature, represents an interference with the free market because in a free market consumers can bargain over whether the owners of an enterprise are held personally liable for the debts of the enterprise. By taking on the corporate form the owners are clothed with limited liability.¹³⁵ Third parties dealing with a corporation, of course, are free to enter into contracts with the owners of a business in order to hold them personally accountable; however, this suggestion is not practical except in the case of certain closely held corporations.¹³⁶ The veil of limited liability and separate entity are real benefits given to the corporation but in exchange for what? Because the corporate franchise has long been viewed as resulting from a contract between the members of the corporation and the state that grants the charter,¹³⁷ the state is not only free but perhaps obligated to exact a quid pro quo in return for the corporate privilege.¹³⁸ By recognizing the corporate franchise, the state permits interference with the free market in the form of the corporate enterprise. Applying the contractarians' own bargaining model, where is the consideration? What is the quid pro quo that society exacts for granting this special privilege to corporations? As discussed more fully below,¹³⁹ an examination of the history

134. See, e.g., Easterbrook & Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989).

135. See, e.g., H. BALLANTINE, CORPORATIONS § 127 (rev. ed. 1946); H. HENN & J. ALEXANDER, *supra* note 28, § 73; N. LATTIN, LATTIN ON CORPORATIONS § 11 (1970).

136. Cf. Hazen, *The Decision to Incorporate*, 58 NEB. L. REV. 627, 631-35 (1979) (discussing the fact that in start-up closely held enterprises, third parties may not be willing to extend credit without the personal guarantees of the owners).

137. See, e.g., G. FIELD, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 28 (1877).

A Charter or legislative act of incorporation is usually a mere offer or tender of the corporate privileges contained in it The sovereign authority cannot compel persons to become a private corporation. They can only become such by their voluntary consent.

In other words:

By accepting a charter the incorporators subject themselves to duties which, without their consent, the state could not have imposed upon them. Accordingly the grant and acceptance of a charter are held to constitute an act whereby the actors have expressed their intention to occasion legal relations between them; that is to say, a contract has been made to which the state is a party.

Id. § 449; see also W. COOK, A TREATISE ON THE LAW OF CORPORATIONS HAVING A CAPITAL STOCK § 492 (7th ed. 1913) (footnotes omitted):

The charter of a corporation having capital stock is a contract between three parties, and forms the basis of three distinct contracts. The charter is a contract between the state and the corporation; second, it is a contract between the corporation and the stockholders; third, it is a contract between the stockholders and the state.

Id.; see also H. HENN & J. ALEXANDER, *supra* note 28, § 78; R. STEVENS, *supra* note 54, § 7.

138. See, e.g., W. CLARK, HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS § 27 (1897).

It is essential to the existence of a private corporation that there shall be an agreement between the incorporators and the corporation, creating a contractual relation between them There is no contract between individual members in the formation of a corporation. The contract is between each individual member and the whole body of members in their collective capacity, represented by the corporation.

Id.

139. See *infra* text accompanying notes 143-46.

of corporations suggests that it is reasonable to exact compliance with a public regulatory structure over corporate conduct as the quid pro quo of the exchange.¹⁴⁰ Stated differently, although the corporation is a nexus of contracts, the terms of those contracts necessarily incorporate by reference the rules of law imposed by the state in exchange for granting the corporate privilege.¹⁴¹

As discussed previously,¹⁴² the clearest form of business association that is based on contract is a partnership,¹⁴³ and it is elementary that partners owe to each other the highest fiduciary obligation.¹⁴⁴ Partnership law, as mentioned earlier, is comprised of contract and agency principles. Nevertheless, the courts recognized that a partner's management authority over partnership assets calls for the imposition of fiduciary responsibilities. Accordingly, it should not be surprising that correlative obligations exist in the corporate setting.¹⁴⁵ Courts have long recognized that the panoply of fiduciary obligations is a necessary buffer against the power that management could otherwise wield as a result of their positional advantage in the bargaining process. As explained by the Delaware Supreme Court more than half a century ago:

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only to affirmatively protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of

140. See, e.g., S. THOMPSON, COMMENTARIES ON THE LAW OF PRIVATE CORPORATIONS § 2 (2d ed. 1908) (quoted in the text accompanying *supra* note 53).

141. See, e.g., H. TAYLOR, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS HAVING CAPITAL STOCK § 448 (1884):

[T]he constitution of a corporation, besides being the group of legal rules which manifest themselves in legal relations in respect of the corporate enterprise, always embodies a contract among the corporators, and sometimes a contract between the corporation and the state. To say that it embodies a contract between the corporators means that it embodies the terms of an agreement whereby the parties have expressed their intention of occasional legal relations which are manifestations of the rules of law composing the very constitution which embodies the contract.

Id.

142. See *supra* text accompanying notes 123-24.

143. As commentators have observed:

There is an obvious and striking difference between a company established for private hazard and profit by an act or charter of incorporation, and an ordinary co-partnership. The latter is simply a voluntary contract, or the result of such a contract, whereby two or more persons agree to combine their property or labor, or both, for the purpose of a common undertaking. . . . But this definition greatly falls short of a company established as a body corporate, which, though originating in a voluntary contract, is the result not only of that, but of its confirmation by special legislative authority. This confirmation is indispensable to enable the parties to the compact to sue and be sued, as a company, by a general name, to act by a common seal, and to transmit their property in succession.

J. ANGELL & S. AMES, *supra* note 46, at 36 (footnotes omitted).

144. E.g., *Meinhard v. Salmon*, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (1928).

145. See *supra* text accompanying notes 27-68.

profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers.¹⁴⁶

Thus, more than fifty years ago, the Delaware Supreme Court recognized that the selfish instincts of corporate management must be curbed by fiduciary principles. The contract model fails to safeguard against "economic man's" rational self-interest when embodied in corporate managers' bargaining with their shareholders.

Another problem with the contractarian model of corporate conduct is that it fails to take account of fairness considerations. Contracts entered into from unequal bargaining positions are neither fair nor rational.¹⁴⁷ Thus, courts, as a matter of contract law, will police unfair bargains when failure to do so would be "unconscionable."¹⁴⁸ Economists tend to label arguments based on claims of fairness as irrational or value laden. Economists evaluate transactions in terms of efficiency and productive transfers of wealth.¹⁴⁹ Generally, an "unfair" transaction is one in which the distribution of wealth is not as we would have it. As noted earlier, basing a system of law purely on redistributive justice is not efficient.¹⁵⁰ Some observers have argued that bargains which might be characterized as "unfair" also can be rational since these transactions do not necessarily result in unproductive transfers of wealth.¹⁵¹ The essence of this economic argument is that efficiency and optimality of transactions do not depend upon who are the winners and who are the losers. In other words, an economic analysis of the law might lead to the conclusion that efficiency should be determined without regard to distributive justice.¹⁵² Under this view that efficiency is not concerned with distributive justice, unfair bargains could be upheld so long as they involve productive transfers. Presumably, it is in this way that those who promote a contractarian view of the corporation are able to ignore the unequal bargaining position of the parties and the fact that under the contractarian model,

146. *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (1939).

147. D. GAUTHIER, *supra* note 19. Gauthier's analysis is summarized by Professor Coleman as follows:

- (1) Bargaining is rational only if compliance is rational.
- (2) Compliance is rational only if the bargain outcome is fair.
- (3) Therefore, bargaining is rational only if it is fair.
- (4) Therefore, rational bargains must be fair bargains.
- (5) Therefore, bargaining from whatever unfair advantages one may have *ex ante* is not rational. (The reason: Bargaining from unfair positions yields unfair outcomes with which it is not rational to comply. But if it is not rational to comply, then it is not rational to bargain).

J. COLEMAN, *supra* note 16, at 316; *see also* Kraus & Coleman, *supra* note 19 (discussing the rational choice framework and its relationship to moral theory in light of Gauthier's analysis).

148. *E.g.*, U.C.C. § 2-302 (1989); RESTATEMENT (SECOND) OF CONTRACTS § 208 comment c (1979); *see infra* notes 266-67 and accompanying text. Fairness as a limitation on the enforcement of contracts is not a new concept. For an interesting discussion of eighteenth century principles of fairness as a limitation on the enforcement of contracts, *see* M. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1780-1860*, at 161-210 (1977).

149. *See supra* text accompanying notes 11-21.

150. *See supra* text accompanying note 20.

151. J. COLEMAN, *supra* note 16, at 323.

152. *See, e.g.*, R. POSNER, *supra* note 12.

managers are able to exert power over the shareholders' assets without having to pay an adequate quid pro quo.

C. *The Failure of the Contract Model to Adequately Understand Contract Law*

Professors Brudney and Eisenberg take the contractarians to task, insisting that the fiduciary paradigm is the proper one.¹⁵³ Their attacks are properly premised on the incongruity of the contract analogy because of the absence of meaningful consent of the parties on *both* sides of the bargain.

As Professor Brudney aptly expressed, in the context of a publicly held concern, the dispersion and diversity of shareholders makes it anomalous to impute to them the same type of bargaining ability as that held by parties to an individually negotiated contract.¹⁵⁴ Professor Eisenberg elaborates on this point by pointing to the inadequacy of the shareholder voting system as a basis for recognizing shareholder *consent*.¹⁵⁵ It is elementary contract law that the enforceability of a contract is dependent upon a finding of freely bargained-for mutual consent.¹⁵⁶ Clearly, the relative power positions of the various corporate constituencies denies them equal bargaining power when dealing with corporate management. It thus makes little sense to talk in terms of consent with regard to certain types of contractual arrangements within the corporation.

Professor Eisenberg approaches the inadequacy of shareholder consent within the confines of three different corporate settings: existing public corporations, corporations about to go public, and closely held companies.¹⁵⁷ Eisenberg

153. Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1407-08 (1985); Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989). For other attacks on the contractarian model, see Anderson, *Conflicts of Interests: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738 (1978); Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989); Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U.L. REV. 542 (1990); Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375 (1988); Coffee, *Balance*, *supra* note 39; Cox, *Reflections on ex ante Compensation and Diversification of Risk as Fairness Justifications for Limiting Fiduciary Obligations of Corporate Officers, Directors, and Controlling Shareholders*, 60 TEMP. L.Q. 47 (1987); Millon, *supra* note 50.

154. As Professor Brudney explained:

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

Brudney, *supra* note 153, at 1406 (footnotes omitted). This fact has long been recognized: "Some writers and some of the cases say that there must be an agreement between the members, creating a contractual relation between them, but this is inaccurate. There is no contract between individual members in the formation of a corporation." W. CLARK, *supra* note 138, § 27.

155. Eisenberg, *supra* note 153, at 1474-80. Professor Eisenberg's thesis is a development of his earlier work on corporate structure. See M. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* (1976).

156. RESTATEMENT (SECOND) OF CONTRACTS § 17 (1981); E. FARNSWORTH, *CONTRACTS* §§ 2.2, 3.1 (1982); Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741, 752-54 (1982).

157. "[S]hareholder consent to rules proposed by top managers in publicly held corporations

contends that in the publicly held corporation, the proxy system is imperfect for several reasons. He points to four limitations on the legitimacy of shareholder consent. First, in public corporations, management control of the proxy machinery produces only *nominal consent*.¹⁵⁸ Second, shareholder action is frequently a *consent tainted by conflict of interest*, based upon an institutional bias.¹⁵⁹ Eisenberg notes that institutions own approximately half of the shares in publicly held companies.¹⁶⁰ Even aside from institutional bias, this means that many individual shareholders will not get a say in the corporation's governance. For example, the Securities and Exchange Commission rules provide that when a shareholder gives his or her proxy to management, unless the shareholder gives specific instructions to the contrary, management may vote the shares as it sees fit.¹⁶¹ Furthermore, under the New York Stock Exchange rules governing the voting of shares held in street name, the registered shareholder (the institutional holder) may vote as it pleases if the beneficial owner (the true shareholder) has not given instructions within ten days of the request for instructions.¹⁶² Third, Eisenberg points out that frequently the inequality of power within the corporation results in *coerced consent*.¹⁶³ For example, any management proposal to limit or eliminate the traditional fiduciary duty rules involves inherent conflicts of interest between the shareholders and directors. It goes without saying that management will favor its own interests. Fourth, Eisenberg refers to *impoverished consent*:

For example, shareholders may vote for a rule proposed by management even though they would prefer a different rule, because the proposed rule is better than the rule it replaces and management's control over the agenda effectively limits the shareholders' choice to the existing rule or the proposed rule.¹⁶⁴

Professor Eisenberg does not take the position that shareholder consent is meaningless. He concludes, however, that in a public corporation, shareholder consent is meaningful only at the margins—that is, to safeguard against clearly detrimental proposals.¹⁶⁵

Consent is no more meaningful in a firm that is about to go public than it is in a firm that is already publicly held. Contractarians argue that in initial public offerings an informed market values the securities in accordance with the terms of the contract provisions embodied in the corporate charter. Eisenberg takes

may be either nominal, tainted by a conflict of interest, coerced or impoverished." Eisenberg, *supra* note 153, at 1474. In the context of a corporation about to go public, it is unlikely 1) that variations in fiduciary rules would be accurately reflected in the initial offering price, and 2) even if they were, that investors would be aware of the variations and able to properly evaluate them. *Id.* at 1515-24.

158. *Id.* at 1474-76.

159. *Id.* at 1476-77.

160. *Id.* at 1476.

161. 17 C.F.R. § 240.14a-4(b)(1) (1988).

162. NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL §§ 402.06(B)(b)(1) & (D) (1983).

163. Eisenberg, *supra* note 153, at 1477; see also Dallas, *supra* note 74 (constituencies, other than the shareholders, can gain control by "bargaining").

164. Eisenberg, *supra* note 153, at 1477.

165. *Id.* at 1479-80.

issue with this proposition by pointing out that, among other things "[i]t is no more likely that buyers in an initial public offering would know of variations in core fiduciary and structural rules than that buyers of insurance policies will know the fine print in their policies."¹⁶⁶

Other commentators have observed the fallacy of the assumption made by many economic writers that individual actors know legal rules.¹⁶⁷ Professor Bebchuk makes the point that even if the initial corporate charter properly can be viewed as purely a private contract, charter amendments cannot because there is no efficient mechanism for compensating existing shareholders for any transfers accomplished by the charter amendment.¹⁶⁸

The lack of meaningful consent in many aspects of the manager/shareholder relationship is undeniable. This limitation on the concept of shareholder consent, in turn, must be viewed as a limitation on the contract model of corporate governance.

D. *The Death of Contract*¹⁶⁹ and the Corporation as Contract

Another deficiency of the contractarian model is its failure to recognize the trend of contract law during the twentieth century. The contractarians are, of course, correct in pointing to the impact of economic analysis;¹⁷⁰ however, they ignore the fact that the rigidity of many contract doctrines has been ameliorated by developments in the law of promissory estoppel and restitution.

Promissory estoppel is based on reliance rather than a bargained-for exchange.¹⁷¹ Promissory estoppel arises when there is no contractual basis for enforcing a promise. Frequently the absence of a contract will result from the lack of consent to a bargain.¹⁷² The essence of promissory estoppel is to recognize the reliance interest when necessary to avoid injustice.¹⁷³ Accordingly, the doctrine gives force to promises that otherwise would be unenforceable "if injustice can be avoided only by enforcement of the promise."¹⁷⁴ Although the development and expansion of promissory estoppel has not gone without

166. *Id.* at 1521.

167. See Ellickson, *A Critique of Economic and Sociological Theories of Social Control*, 16 J. LEGAL STUD. 67, 81-84 (1987).

168. See Bebchuk, *supra* note 153, at 1823, 1825-29.

169. See G. GILMORE, *THE DEATH OF CONTRACT* (1974).

170. Consider, for example, the increasing acceptance of the efficient breach analysis. *E.g.*, Linzer, *On the Amorality of Contract Remedies—Efficiency, Equity, and the Second Restatement*, 81 COLUM. L. REV. 111 (1981); Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341 (1984). For an excellent critique of the efficient breach approach to contract remedies, see Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947 (1982).

171. See, *e.g.*, Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611 (1988).

172. Often this arises in a case of a gratuitous promise where consideration is lacking. *E.g.*, *Rickets v. Scothorn*, 57 Neb. 51, 77 N.W. 365 (1898); *East Providence Credit Union v. Geremia*, 103 R.I. 597, 239 A.2d 725 (1968); Boyer, *Promissory Estoppel: Principle from Precedents* (pts. 1,2), 50 MICH. L. REV. 639, 873 (1952).

173. RESTATEMENT (SECOND) OF CONTRACTS § 90 (1981). A similar formulation appears in the first Restatement. RESTATEMENT OF CONTRACTS § 90 (1932).

174. RESTATEMENT (SECOND) OF CONTRACTS § 90 (1981).

criticism,¹⁷⁵ the doctrine is firmly embedded as a complement to contract law. Furthermore, since promissory estoppel's inception, its influence has expanded. Originally the doctrine of promissory estoppel was thought to be available only in a limited number of contexts, none of which involved ordinary commercial dealings.¹⁷⁶ Over time, the clear trend has been to extend promissory estoppel to the commercial world.¹⁷⁷ For the same reasons that promissory estoppel is invoked if necessary to avoid injustice when the contract law is inadequate to protect expectations, fiduciary obligations must be invoked in the corporate context in order to make up for the unfortunate results that would follow from a purely contractual approach. As one court explained, "promissory estoppel . . . is an attempt by the courts to keep remedies abreast of increased moral consciousness of honest and fair representations in all business dealings."¹⁷⁸

Another doctrine used to ameliorate the failure of the contract paradigm is that portion of the law of restitution, alternatively referred to as an action in quasi contract, contract implied-in-law, *quantum meruit*, and unjust enrichment.¹⁷⁹ Similar to promissory estoppel, recovery in restitution is not based on a bargain or market-based exchange but rather on the necessity of avoiding injustice. As explained by one court, "[t]he key words are *enrich* and *unjustly*."¹⁸⁰ The law of contracts thus is supplemented by two doctrines—promissory estoppel and restitution, both of which are based upon principles of justice. Both promissory estoppel and restitution are grounded in relational interests and interactions between the parties that go beyond the typical contract bargain, yet promissory estoppel and restitution are integral parts of current contract law. It is anomalous to talk about a contract paradigm without considering these supplemental doctrines. Transporting the contract paradigm into the corporate setting, therefore, is not inconsistent with recognition of fiduciary obligations.

175. *E.g.*, G. GILMORE, *supra* note 169, at 61-72.

176. It was typically said that promissory estoppel was available only in the following situations: promises within the family, promises to make a gift of land, promises in connection with gratuitous agencies and bailments, and charitable subscriptions. J. CALAMARI & J. PERILLO, *CONTRACTS* § 6-2, at 275-82 (3d ed. 1987); E. FARNSWORTH, *supra* note 156, § 2.19, at 89-98 (1982).

177. *E.g.*, *Drennan v. Star Paving Co.*, 51 Cal. 2d 409, 333 P.2d 757 (1958); *Warder & Lee Elevator, Inc. v. Britten*, 274 N.W.2d 339 (Iowa 1979); *Feinberg v. Pfeiffer Co.*, 322 S.W.2d 163 (Mo. App. 1959); *East Providence Credit Union v. Geremia*, 103 R.I. 597, 239 A.2d 725 (1968). *But see James Baird Co. v. Gimbel Bros.*, 64 F.2d 344 (2d Cir. 1933) (upholding the traditional view that promissory estoppel is not available in a commercial setting). *See generally* Knapp, *Reliance in the Revised Restatement: The Proliferation of Promissory Estoppel*, 81 COLUM. L. REV. 52, 53 (1981) (revisors of the Restatement recognized expansion of promissory estoppel and acted in accordance with the trend).

178. *People's Nat'l Bank of Little Rock v. Linebarger Constr. Co.*, 219 Ark. 11, 17, 240 S.W.2d 12, 16 (1951); *see also* *Chapman v. Bomann*, 381 A.2d 1123 (Me. 1978) (promissory estoppel will be used to prevent a party from using a statute to defraud another party).

179. *See, e.g.* D. DOBBS, *LAW OF REMEDIES* §§ 4.1, 4.2, at 222-40 (1973); E. FARNSWORTH, *supra* note 156, § 2.20, at 98-104.

180. *Callano v. Oakwood Park Homes Corp.*, 91 N.J. Super. 105, 109, 219 A.2d 332, 334 (1966); *see also* *Paschall's, Inc. v. Dozier*, 219 Tenn. 45, 50-59, 407 S.W.2d 150, 152-56 (1966) (court remanded for determination of whether the defendant had been unjustly enriched).

*E. The Problem of Tunnel Vision*¹⁸¹ in *Economic Analysis*

A basic flaw in the contractarian approach is that it is based on a model of the corporation purely as an economic institution. It would be absurd, of course, to try to minimize the significance of the corporation as an economic institution or to lose sight of the proposition that the driving force behind a corporation is the profit motive.¹⁸² Not all economists agree, however, that economic modeling requires that profit maximization be the primary goal.¹⁸³ Furthermore, as illustrated more than fifty years ago in the writings of Berle and Means, the fact remains that the corporation is also a political and social institution.¹⁸⁴ The Berle and Means model of corporate governance flows from the premise that shareholders are in the best position to maximize profits.¹⁸⁵ As Berle and Means explained:

[A] society in which production is governed by blind economic forces is being replaced by one in which production is carried on under the ultimate control of a handful of individuals. The economic power in the hands of the few persons who control a giant corporation is a tremendous force which can harm or benefit a multitude of individuals, affect whole districts, shift the currents of trade, bring ruin to one community and prosperity to another. The organizations which they control have passed far beyond the realm of private enterprise—they have become more nearly social institutions.¹⁸⁶

The Berle and Means analysis focuses on the struggle for power between shareholders and managers, thereby departing from Professor Dodd's focus on social responsibility.¹⁸⁷

Berle and Means suggested that the wide dispersion of ownership in public corporations effectively removed control from the shareholders. Berle and Means feared that corporate managers, no longer restrained by shareholder control, would not be motivated primarily by their duty to make profits for the

181. See Leff, *Economic Analysis of Law: Some Realism About Nominalism*, 60 VA. L. REV. 451, 452 (1974) ("[W]hat pressures in contemporary legal scholarship might be responsible for the appearance, now, of four hundred pages of tunnel vision and, assuming one could answer that, why this particular tunnel?").

182. Identifying the profit motive as a primary driving force of corporate policy does not answer the question; it merely reshapes the question. The various models of corporate structure have yet to grapple with the problems of whether the yardstick is properly calibrated in terms of long-term or short-term goals.

183. *E.g.*, J. GALBRAITH, *THE NEW INDUSTRIAL STATE* 125-27, 166-78 (1967) (arguing that the stated goal of industrial organizations is profit-maximization is "pure myth"; their actual goal is survival, autonomy, and economic growth).

184. A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 299-302 (rev. ed. 1968).

185. *Id.*; see also Dent, *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881 (concluding that control of proxy voting should be taken away from management and given to largest shareholders in public corporations); Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation*, 64 COLUM. L. REV. 1458 (1964) (analyzing the historical debate between Dodd and Berle and concluding that Berle's thesis is the most desirable).

186. A. BERLE & G. MEANS, *supra* note 184, at 46 (footnote omitted).

187. Professor Dodd believed that corporate managers hold their powers in trust not only for the shareholders but for members of the corporate constituency, including employees and customers. See Dodd, *supra* note 28, at 1154-57; Weiner, *supra* note 185, at 1459-61.

corporation and thus for the shareholders.¹⁸⁸ Other commentators support rather than decry the separation of ownership from control.¹⁸⁹ These proponents herald the divorce of ownership from control in public corporations as an opportunity for more efficient corporate operation. They suggest that the market for corporate control will keep managers efficient, lest the low price of a poorly or inefficiently managed company render it an attractive takeover candidate.¹⁹⁰ According to this argument, corporate managers will maximize profits as a matter of their own preservation.¹⁹¹ This paradigm, however, does raise questions as to balancing the long-term versus short-term interest of the firm and its investors. As pointed out earlier, short-term maximization of corporate wealth may be at the expense of workers' jobs and future productivity of the business.

The Berle and Means view as a paradigm of corporate governance undoubtedly has faded in popularity. Some observers, including the contractarians, have challenged some of the premises of the Berle and Means analysis. For example, Berle and Means set forth a trustee paradigm for analyzing behavior of public corporations that employs microeconomics to explain the behavior of management (rather than shareholder-run) corporations.¹⁹² More recently, John Ken-

188. See, e.g., Hazen & Buckley, *Models of Corporate Conduct: From the Government Dominated Corporation to the Corporate Dominated Government*, 58 NEB. L. REV. 100, 109 (1978). Professors Jensen and Meckling picked up where Berle and Means left off. See Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). As explained by Professor Coffee:

[T]hey recognize the potential conflicts that arise between managers and shareholders once share ownership becomes dispersed; the utility-maximizing agent, they acknowledge, does not necessarily have an incentive to act in the best interests of his principal. Accordingly, the principal will have to incur costs to monitor the agent's performance and will pay less for shares in the corporation in proportion to the magnitude of the "agency costs" that must be so incurred. At this point, Jensen and Meckling make their distinctive contribution: It is in the agent's interest, they argue, to convince investors that the firm will have an institutional structure which will minimize agency costs (a term that includes both the expenditures incurred to reduce managerial misappropriation and shirking plus the irreducible minimum of such losses). . . . Following Jensen and Meckling, neoclassical economists have tended to assume that market forces alone will result in the installation of the optimal level of monitoring devices and incentive systems that bring agency costs down to an irreducible minimum. At this minimum level, no additional dollar spent on internal controls or incentive compensation will yield an equivalent reduction in managerial opportunism or shirking.

Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 25-26 (1986).

189. E.g. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 260-61 (1967).

190. *Id.* at 265-66.

191. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1541 (1982); Morrissey, *Defensive Tactics in Tender Offers—Does Anything Go?*, 53 TENN. L. REV. 103, 108 (1985).

192. Kaen, Kaufman & Zacharias, *supra* note 120. Two schools of thought emerged: "a theoretical 'managerialist' school and a revealed preference 'behaviorist' school." *Id.*; see also Cyert & Hedrick, *Theory of the Firm: Past, Present, and Future, An Interpretation*, 10 J. ECON. LIT. 398 (1972); Machlup, *Theories of the Firm: Marginalist, Behavioral, Managerial*, 57 AM. ECON. REV. 1, 4-6 (1967); Bommer, Gratto, Gravander & Tuttle, *A Behavioral Model of Ethical and Unethical Decision Making*, 6 J. BUS. ETHICS 265, 268-73 (1987) (Decision makers' social, government and legal, work, professional and personal environments are among the factors that influence ethical and unethical behavior in organizations.).

neth Galbraith suggested that, left unfettered, corporate managers will not produce the best results for society.¹⁹³

One failure of the Berle paradigm and, later, the Galbraith analysis is that these models do not address the balance of power between managers and shareholders in deciding how best to distribute the corporate profits.¹⁹⁴ Coase took the position that these decisions were essentially economic in nature.¹⁹⁵ He further explained that business organizations resulted from efforts to lower the transaction costs of market coordination.¹⁹⁶ Under the Coase theorem, if there are no transactions costs, then distributional rules are unimportant because efficiency will lead to the proper outcome.¹⁹⁷ It is clear, however, that there are transaction costs to allocation or reallocation of corporate rights and duties. Thus, distributive problems are a proper concern even under an economically rational model. As Professor Coleman explains:

Legal rules are responses to market failings. Within a rational choice framework (in which economics is ultimately imbedded), inefficiency creates an opportunity for rational cooperation. Rational cooperation exists in agreement to and compliance with a set of constraints on individually maximizing strategies. A large number of such constraints, which differ from one another in their distributive dimension, can in theory produce efficient outcomes. Rational cooperation requires an agreement upon a set of such constraints. Thus, rational co-

193. J. GALBRAITH, *supra* note 183, at 95.

194. According to Kaen, Kaufman & Zacharias:

Left unaddressed in both the Galbraith and Berle critique is the question of whether the reinvestment of corporate earnings represented a new question of whether reinvestment of corporate earnings represented new investment by the company's stockholders, and, if so, what role the stockholders should have in deciding whether they wanted management to reinvest their earnings or receive cash dividend payments or, for that matter, even liquidate the company.

Kaen, Kaufman & Zacharias, *supra* note 120, at 812-13.

195. See, e.g., Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960) [hereinafter Coase, *Social Cost*]. In other words:

Coase concluded that the firm replaced the market—price mechanism—for organizational efficiency reasons and not for technological ones. The size of the firm was, therefore, an economic decision variable and the key question relating to firm size became whether "At the margin, the costs of organizing within the firm will be equal either to the costs involved of organizing in another firm (our emphasis) or to the costs involved in leaving the transaction to be 'organized' by the price mechanism."

Kaen, Kaufman & Zacharias, *supra* note 120, at 813 (quoting Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 404 (1937)); see C. BARNARD, *THE FUNCTIONS OF THE EXECUTIVE* (1938, 15th printing 1962); J. COMMONS, *LEGAL FOUNDATIONS OF CAPITALISM* (1924); F. KNIGHT, *RISK, UNCERTAINTY, AND PROFIT* (1965); Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 404 (1937) [hereinafter Coase, *Nature of the Firm*].

196. See Coase, *Nature of the Firm*, *supra* note 195, at 386.

197. See Coase, *Social Cost*, *supra* note 195. As explained by Professor Coleman:

One way of stating Coase's theorem—the one that is thought to have the most relevance to law-and-economics—is: Given traditional assumptions of substantial knowledge, perfect rationality and the absence of both transaction costs and income effects, the assignments of legal entitlements in cases of two-party incompatible land uses will be neutral as to the goal of allocative efficiency.

J. COLEMAN, *supra* note 16, at 69 (footnotes omitted); see also French, *The Extended Coase Theorem and Long Run Equilibrium*, 17 *ECON. INQUIRY* 254, 256 (1979) (Coase's theory is proper when applied to property rights assignments but not when applied to liability).

operation requires the merger of the distributive with the productive aspects of legal practice.¹⁹⁸

Coleman thus suggests that efficiency "is not necessarily what rational parties demand from legal rules themselves."¹⁹⁹

As noted above, the Berle and Means analysis fails to address how profits should be distributed or deployed. In addition, the Berle and Means approach does not explain sufficiently how the obligation to shareholders factors into the total calculus of managerial decisions.²⁰⁰ First, Berle and Means focused on shareholder primacy. Some observers claim that, under such a model, there is no room for social responsibility.²⁰¹ Similarly, under the Berle and Means approach, managers are asked to favor the interests of shareholders over other corporate constituencies. For example, as a result of the ruling in *Revlon*, it is now the law in Delaware that unless management has decided to try to keep the company independent, management's sole obligation is to maximize shareholder profits.²⁰² The court reasoned that once a company's management has decided that the company is for sale, then the directors' focus must shift from the best interests of the corporation to the best interests of the shareholders solely in terms of their short-term investment objectives. Presumably, the court in *Revlon* decided that once target company management has decided that it can no longer keep the company independent, it no longer has any say in the future of the business. Such a ruling should be heralded by the contractarians as it promotes the goals of efficiency.

Has the current wave of contractarians forgotten about the lessons of the 1929 market crash and subsequent Great Depression? It is no great revelation that the Great Depression was not simply an economic event—its political and social consequences were severe. Perhaps an even more pertinent question is whether much of the current basis for analysis unjustifiably eschews principles of fair play in favor of an efficiency model.

Many efficient market proponents who claim to be value-neutral scoff at terms such as fairness, fiduciary duties, and justice. Alternatively, economists claim that fairness is defined in terms of efficiency and rational economic decisions.²⁰³ What many of these proponents fail to perceive is that their paradigm

198. J. COLEMAN, *supra* note 16; Coleman, *Afterward*, *supra* note 19, at 182-83.

199. Coleman, *Afterward*, *supra* note 19, at 190.

200. See, e.g., Dodd, *supra* note 28, at 1152-53; Weiner, *supra* note 185, at 1462; see also Hazen & Buckley, *supra* note 188, at 106-11 (examining perspectives on social responsibility of the private corporation).

201. E.g., T. LEVITT, *THE THIRD SECTOR, NEW TACTICS FOR A RESPONSIVE SOCIETY* (1973); Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1 (1979); Friedman, *The Social Responsibility of Business is to Increase its Profits*, N. Y. Times, Sept. 13, 1970, § 6, at 32; see also Millon, *supra* note 50; Nesteruk, *Corporations, Shareholders, and Moral Choice: A New Perspective on Corporate Social Responsibility*, 58 U. CIN. L. REV. 451 (1989) (discussing the relationship between corporate responsibility and moral decision making).

202. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 176 (Del. 1986) (striking down "lock-up" option whereby target manager agreed to sell corporate assets to a "white knight" to rebuff a hostile bidder); see *supra* text accompanying notes 86-87; see also Gilson & Kraakman, *What Triggers Revlon*, 25 WAKE FOREST L. REV. 37, 37-38 (1990) (arguing that *Revlon* should apply whenever a proposed transaction would shift control of the company).

203. See, e.g., D. GAUTHIER, *supra* note 19.

merely substitutes their values for those of others.²⁰⁴ At least one leading law and economics devotee has conceded that his views include the position that efficiency is defensible as a moral principle.²⁰⁵ The difficulty with concepts such as fairness and justice is that many people find them intuitively to be a part of every calculus, yet they have difficulty articulating why in an intellectually satisfying way.²⁰⁶

VI. THE ROLE OF VALUES

A. *The Contractarian Analysis and Values*

A fallacy of the economic analysis is its contention that it is value-neutral. Numerous commentators have shown that the laissez-faire results advocated by the economic movement are no less value laden than the theories they decry.²⁰⁷ For example, the bias of the economists who advocate deregulation of insider trading should be readily apparent.

Originally some economists took a deregulatory position on insider trading by arguing that when corporate insiders trade on inside information, their purchases or sales help push stock prices in the right direction.²⁰⁸ However, these economists have never explained adequately why this was more efficient than simply making a public announcement. They might respond that because premature announcement of information could hurt the corporation, mandatory disclosure is not the appropriate approach. In the face of economic evidence that the volume of insider trading was not sufficient to have a significant impact on the market,²⁰⁹ the economic justification of insider trading shifted to one of an efficient method by which management could establish their own compensation.²¹⁰ However, if efficiency is the goal, would it not be more efficient to have corporations sell this valuable information? The purchaser of the information would be able to retain his or her profit, and the corporation, not its managers, would receive the benefits of the sale.²¹¹ Another way in which the economists'

204. See Bratton, *supra* note 48; Shapiro, *Richard Posner's Praxis*, 48 OHIO ST. L. REV. 999 (1987); see also Hazen, *Management Buyouts and Corporate Governance Paradigms*, 25 WAKE FOREST L. REV. 1 (1990) (recognition of the problems identified by Berle and Means would reemphasize fiduciary obligations of corporations that would facilitate a healthier investment climate).

205. E.g., Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487, 500-02 (1980).

206. See, e.g., Leff, *supra* note 181, at 482 ("I admit that it is not easy these days to be a moralist *marqué*, when what it is that one lacks is any rational and coherent way to express one's intuitions.").

207. For a criticism of the positivistic prejudices of the Chicago school of law and economics, see B. ACKERMAN, *RECONSTRUCTING AMERICAN LAW* 46-94 (1984). Within the context of corporate law, some economists have argued that efficiency requires the legitimization of trading on inside information. However, as Professor Cox explains, the economists' own argument can be used as an argument against insider trading. See Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School"*, 1986 DUKE L.J. 628.

208. See H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966).

209. See, e.g., Cox, *Insider Trading Regulation and the Production of Information: Theory and Evidence*, 64 WASH. U.L.Q. 475, 492-99 (1986).

210. See, e.g., Carney, *Signalling and Causation in Insider Trading*, 36 CATH. U.L. REV. 863, 897-98 (1987).

211. See Cox, *supra* note 207; see also RESTATEMENT OF RESTITUTION § 200 (1937) (a fiduciary

own argument undercuts their analysis is that if insider trading were to be unregulated and hence encouraged, who would invest in the market? The market then could not be called efficient because price would not be based on the assimilation of all publicly available information, but simply upon the insiders' decision of whether they wanted to continue to own their corporation's stock. Thus, even by their own analysis, the economists who advocate the permissibility of insider trading cannot support their own position. Furthermore, as with the case of other economic analysis of corporate law, the view that would permit insider trading ignores commonly accepted concepts of fairness.²¹²

B. Aggregate Versus Entity: The Relevance of Philosophy and Moral Theory in Defining the Corporate Persona

Over the course of the history of the corporation, a debate has continued as to whether a corporation is a separate entity or whether it is merely an aggregate of its constituents.²¹³ The debaters are not limited to legal theorists. Philosophers have engaged in a similar inquiry with regard to whether the corporation is a morally accountable individual.²¹⁴ Certainly, these debates provide insight into the ways in which corporations are and should be governed. The aggregate/entity dichotomy can be helpful in analyzing both corporate internalities and externalities by providing a forum for examining the relationship among the various participants in the corporate enterprise as well as the relationship between the corporate participants and third parties. Some commentators have suggested that the ongoing popularity of the legal concept of corporation as aggregate or entity can help explain the movement of corporate law away from public regulation to a system of private law that focuses primarily upon the allocation of power (and responsibilities) between the shareholders and managers.²¹⁵ This focus on shareholder or management supremacy has been questioned, first by the writers of the 1930s,²¹⁶ then by the commentators of the 1970s²¹⁷ and more recently by critical legal scholars.²¹⁸

who acquires property through the use of confidential information holds the property as a trustee); Hazen, *Corporate Insider Trading: Reawakening the Common Law*, 39 WASH. & LEE L. REV. 845 (1982) (exploring relevance of common law theories to insider trading); cf. *Diamond v. Oreamuno*, 24 N.Y.2d 494, 498-99, 248 N.E.2d 910, 912, 301 N.Y.S.2d 78, 81 (1969) (court ordered insiders to disgorge their profits from insider trading, reasoning that as agents of the corporation, any profits from the trading belonged to the principal).

212. See, e.g., Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979); Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967). Although it is an hyperbole, which like most hyperboles means it proves too much, the argument that supports insider trading in the name of efficiency can be analogized to Jonathan Swift's satiric essay, "A Modest Proposal" which presented the position that infanticide and cannibalism could be justified in the name of efficiency; see Hazen, *Commentary*, 36 CATH. U.L. REV. 987, 993-96 (1987).

213. See, e.g., W. ANDERSON, *LIMITATIONS OF THE CORPORATE ENTITY—A TREATISE OF THE LAW RELATING TO THE OVERRIDING OF THE CORPORATE FICTION* § 31 (1931); G. HORNSTEIN, *CORPORATION LAW AND PRACTICE* § 12 (1959); R. STEVENS, *supra* note 54, § 936.

214. See *supra* text accompanying notes 184-86.

215. See Millon, *supra* note 50.

216. See, e.g., Dodd, *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

217. E.g., C. STONE, *WHERE THE LAW ENDS* (1975); R. NADER, M. GREEN & J. SELIGMAN,

Early courts and commentators recognized that the corporation was an "artificial being" possessing its own "individuality."²¹⁹ Historically, viewing the corporation as an entity helped distinguish it from the partnership wherein the partners, unlike corporate shareholders, do not enjoy limited liability.²²⁰

Some observers contend that the Berle-Dodd debate on the proper focus of managerial responsibility²²¹ has had implications for the entity/aggregate debate. They suggest that the shareholder supremacy proponents' rejection of the social responsibility paradigm reflected a rejection of the entity theory of corporate existence in favor of an aggregate theory that focuses on the shareholders' property rights.²²² Viewed in this way, the contractarian analysis is a natural progression from the Berle and Means shareholder supremacy model.

The contractarian model views the corporation as simply an aggregate of its individual constituents. This view is a departure from the traditional one of the corporation as a separate entity. As discussed above,²²³ one of the errors of the pure contractarian approach is that it views the corporation solely as an economic institution, a view which fails to recognize the fact that corporations are also political and social institutions. Scholarly commentators in the fields of philosophy and political theory have written on the theory of the firm. A brief excursion into these disciplines will illustrate the insufficiency of the current economic analysis of corporate form and intracorporate obligations.

Moral theory is consistent with an economic view of corporateness.²²⁴ Moreover, there is an interrelationship between ethical theory and the law.²²⁵ Indeed, it is not antithetical to speak of ethics and business.²²⁶

TAMING THE GIANT CORPORATION (1976); Blumberg, *Politicalization of the Corporation*, 51 B.U.L. REV. 425 (1971). These writers were primarily interested in democratizing the corporation among all of its constituents.

218. See, e.g., Singer, *supra* note 171; see also Morrissey, *Toward a New/Old Theory of Corporate Social Responsibility*, 40 SYRACUSE L. REV. 1005, 1035-36 (1989) (suggesting that the corporate purpose be framed in terms of "ethical and beneficent corporate conduct" in addition to the profit motive).

219. *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 636-37 (1819) (Marshall, J.); see also J. ANGELL & S. AMES, *TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE 1* (10th ed. 1875) (stating that a corporation is "for certain purposes, considered as a natural person"); cf. R. STEVENS, *supra* note 54, at § 936 ("a realistic approach toward law is tending to substitute for the ancient theory that a fictitious person exists apart from the members for the theory that the members themselves have a dual legal personality. The latter theory is not modern. It is not revolutionary.").

220. See *supra* texts accompanying notes 1, 123-27 (discussing the partnership).

221. See *supra* notes 184-87 and accompanying text.

222. See Millon, *supra* note 50.

223. See *supra* notes 117-206 and accompanying text.

224. It is incorrect to say that markets by their very nature are amoral or immoral, although many of their participants act either amorally or immorally. H. ACTON, *THE MORALS OF MARKETS* 19 (1971).

225. Ethics and law are both normative systems. Each system can interfere with profits. McCarty, *Business, Ethics and Law*, 7 J. BUS. ETHICS 881, 881-84 (1988).

226. See, e.g., Abratt & Sacks, *The Marketing Challenge: Towards Being Profitable and Socially Responsible*, 7 J. BUS. ETHICS 497, 501-03 (1988) (business can be profitable and socially responsible at the same time). But see GASKI, *DAUGHTER TERRITORY: THE SOCIETAL MARKETING CONCEPT REVISITED* (1985). Professor Gaski observes differently:

The "social marketing" concept, or the view that marketing has a greater social responsibility than just satisfying customers at a profit, is an erroneous and counterproductive idea.

Corporations and Moral Agency. Moral philosophers define actors as moral agents. Within this framework, much has been written as to whether a corporation is a moral agent separate and apart from its constituents. One school of philosophical thought takes the position that the corporation is a moral agent.²²⁷ The moral agency approach finds parallel support in the long-standing recognition in the law that the corporation is a distinct legal entity.²²⁸

Another school of thought takes the position that the corporation (or any organization, for that matter) is merely an aggregate of its participants.²²⁹ Under such a view, the various individuals are their own moral agents and the corporation has no separate individual responsibility.²³⁰ This aggregate paradigm seems to comport with the contractarian model of corporate obligations. In fact, the contractarian model of the corporation has been characterized as "a novel and sophisticated" version of the aggregate paradigm.²³¹ By focusing on a privatized system of relationships, the contractarian view carries forward the aggregate paradigm's normative tradition.

For marketers to attempt to serve the best interests of society is not only undemocratic but dangerous as well.

Id.

227. See, e.g., French, *supra* note 49, at 209 (French points out that the legal aggregate theory is contrary to the view held by courts and legislatures.); see also Goodpaster & Matthews, *Can a Corporation Have a Conscience?*, 60 HARV. BUS. REV. 132, 133-35 (1982) ("Organizational agents such as corporations should be no more and no less morally responsible (rational, self-interested, altruistic) than ordinary persons. . . . If a group can act like a person in some ways, then we can expect it to behave like a person in other ways."); Goodpaster, *The Principle of Moral Projection: A Reply to Professor Ranken*, 6 J. BUS. ETHICS 329, 330-32 (1987) (enlarging upon the moral agenda of management and the corporation as a participant in ethical transactions).

228. *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 636-37 (1819) (Marshall, J.); see also J. ANGELL & S. AMES, *supra* note 219, at 1 (defining corporation through its rights and obligations).

229. See generally Lewis, *Collective Responsibility*, 23 PHILOSOPHY 3 (1948) (placing blame for collective action on collective agencies can be used as an excuse to let the guilty individuals "off the hook"). It is significant that Lewis's observation was made shortly after the rise and fall of Nazi Germany.

230. As explained by a leading commentator, "Legal aggregate theory of corporations holds that the names of corporate bodies are only umbrellas that cover (but do not shield) certain biological persons." French, *supra* note 49, at 209; see F. HALLIS, *CORPORATE PERSONALITY* (1930). There may be some support for this view in scattered cases. For example, in *Daimler Co., Ltd. v. Continental Tyre and Rubber Co.*, 2 A.C. 307, 340 (1916), the House of Lords adopted the aggregate theory by stating that the individuals and corporate persona are *in pari materia* and the acts of corporations are "attributable only to human beings." In so ruling the House of Lords reversed the Court of Appeals, which had held that a corporation is a person created by statute and thus had a separate personality from its members.

It has also been suggested that since individuals freely choose organizational association, they cannot disassociate themselves from the harmful consequences of collective acts. Because individuals benefit from the acts of a corporation, they never act completely impersonally. There is usually latitude for an individual to exercise moral judgment when considering collective acts. Flores & Johnson, *Collective Responsibility and Professional Roles*, 93 ETHICS 537 (1983); see also Thompson, *Collective Responsibility and Professional Roles*, 5 J. BUS. ETHICS 151, 154 (1986) ("[M]oral agency can be collective, individual, or both. Flores and Johnson give some initial guidelines for evaluating situations in which individuals are responsible, but the final answer will depend upon the place of individual's actions within the decision structure of the collective as well.").

231. Millon claims that the aggregate theory has dominated corporate law since the 1930s and has been interpreted to mean that corporate law should focus only on the welfare of the shareholders. However, this is a rather narrow view of the law in the mid and later part of the twentieth century. As pointed out elsewhere, corporate law did not lose its public thrust. See Millon, *supra* note 50.

However, even if one accepts an aggregate view of corporateness, the contractarian's death knell for fiduciary accountability is not a necessary conclusion. When entering into contracts with one another, the various corporate actors are assuming various reciprocal obligations.²³² The aggregate that comprises the corporation consists of various components, including employees.²³³ The contractarians do not deny that there are corporate constituencies beyond the shareholders. They claim, however, that these constituencies can protect themselves through contracting.²³⁴

The continued viability of the fiduciary model among other things will determine the extent to which corporations (and hence corporate managers) have a duty to be socially responsible citizens in society. As discussed above, the corporate form exists solely by virtue of the state.²³⁵ The corporate form brings with it limited liability, a benefit that otherwise would have to be bargained for between businesses and the third parties with which they deal. Because the state provides the corporate franchise, a bargaining model would call for consideration flowing the other way. The consideration flowing to the state is the ability to impose public regulation on corporate conduct. The traditional fiduciary model of the corporation gives the shareholders not only the protections of limited liability but also makes them the beneficiaries of the fiduciary obligations of the corporate managers. Consistent with this framework is the argument that, as part of the bargain with the state that gives the shareholders these benefits, the shareholders (and in turn the corporation) must recognize that they are responsible members of the community. As such, the contract can be said to include obligations to constituencies other than the shareholders.

There is an ongoing debate over the extent to which corporations have an obligation to be socially responsible citizens.²³⁶ Viewing the corporation as an aggregate does not undermine the notion that corporations have an obligation to

232. It has been suggested that organizations want decision makers who can deal with value considerations arising from ethical issues:

The tenets of "values clarification" and "values analysis" suggest that the following guidelines can provide a basis for resolving values conflicts within the individual and between the individual and the organization. Organizational members must:

- (1) be active in developing and defending their own positions,
- (2) be challenged to probe deeply the justifications for human choices, especially their own,
- (3) confront standards and points of view that counter their personal perspectives,
- (4) be encouraged and enabled to assume the role of someone with a contrasting point of view, and
- (5) wrestle with problems that have no simple solutions.

Coye, *Individual Values and Business Ethics*, 5 J. BUS. ETHICS 45, 46 (1986); see also R. MORRILL, *TEACHING VALUES IN COLLEGE* 4-8 (1980).

233. See, e.g., C. Stone, *supra* note 217; Singer, *supra* note 171, at 618-23; Summers, *Codetermination in the United States: A Projection of Problems and Potentials*, 4 COMP. CORP. LAW & SEC. REG. 155, 170 (1982).

234. E.g., Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 174.

235. See *supra* text accompanying note 54.

236. See, e.g., C. STONE, *supra* note 217, at 74-118; R. NADER, M. GREEN & J. SELIGMAN, *supra* note 217, at 258-60; Blumberg, *supra* note 217, at 457-61; Hazen & Buckley, *supra* note 188.

be socially responsible citizens.²³⁷ If the aggregate theory is accepted, then corporate managers necessarily owe obligations not only to various constituencies within the corporation (for example, shareholders and employees), but also to the community at large.

The economists' laissez-faire conclusion is a product of a rational system of decision making that views efficiency or profit-maximization as the end goal. The fact that a corporation is an entity does not necessarily mean that it must act in accordance with moral principles. In the first place, the economists' efficiency model derives from a utilitarian philosophy that established efficiency as a moral principle.²³⁸ As explained by Richard Posner, "Bentham's utilitarianism, in its aspect as a positive theory of human behavior, is another name for economic theory."²³⁹ On the other hand, it may appear that an efficiency model is based on rationality rather than morality. John Ladd analyzed the legitimacy of such a rationalist approach to organizational behavior.²⁴⁰ He argued that under principles of organizational behavior, corporations cannot act as a matter of moral principle.²⁴¹ Ladd then described what he sees as a paradox, contending

237. According to one commentator:

Ultimately, a theory of Corporate Strategy must take into account the values of individuals engaged in collective economic action. . . . In principle, this is an obligation borne by all parties to the operation of the common marketplace. In specific application, this duty can be manifest in the form of an institutional contract binding the firm's agents and relevant constituents to respect the rights of all parties to a transaction or series of transactions. These rights are those necessary for the pursuit of socially-effective economic projects. In summary, we might expect the Invisible Hand to emerge clasped in the grasp of the Willing Handshake, a viable avenue, I propose, to effective collective action, through attention to human rights.

Gilbert, *Corporate Strategy and Ethics*, 5 J. BUS. ETHICS 137, 149 (1986).

238. See, e.g., Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165, 1208-18 (1967); see also R. POSNER, *supra* note 12 at 4 ("Efficiency is a technical term: it means exploiting economic resources in such a way that human satisfaction as measured by aggregate consumer willingness to pay for goods and services is maximized. Value too is defined by willingness to pay.")

239. R. POSNER, *supra* note 12, at 357.

240. Ladd, *Morality and the Ideal of Rationality in Formal Organizations*, 54 THE MONIST 488 (1970).

241. Ladd's approach has been summarized as follows:

1. Corporate, military, and governmental organizations are formal organizations.
2. A formal organization is a decision-making structure characterized by:
 - a. a goal or set of goals,
 - b. the concept of an organizational (or "social") act or decision whereby an individual, as an agent for the organization, makes decisions for and on behalf of the organization,
 - c. a hierarchical structure of authority for establishing and implementing organizational decisions, and
 - d. a standard of rationality according to which the rational organizational act is the one that best achieves the organization's goal(s).
3. The only way moral principles could enter into organizational decision making is by either being organizational goals or limiting operating conditions.
4. All limiting operating conditions are factual conditions.
5. Moral principles are not factual conditions.
6. Moral principles are not organizational goals.
7. Therefore, organizational decisions cannot be based on moral principles.

Long & Snoeyenbos, *Ladd on Morality and Formal Organizations*, in BUSINESS ETHICS 61 (M. Snoeyenbos, R. Almeder & J. Humber eds. 1983).

that the rational model of organizational behavior²⁴² creates a moral schizophrenia on the part of individuals within an organization because the individuals who are the organizational actors and decision makers do have moral principles. These principles in turn create a conflict with the amorality of the firm.²⁴³ On the one hand, if organizations give up the idea of rationality, Ladd maintains that we cannot find the most efficient solutions to our problems. On the other hand, "if we give up the standard of ordinary moral conduct, then in effect we destroy ourselves as moral beings and reduce our relationships to each other to purely mechanical and materialistic ones."²⁴⁴ Notwithstanding Professor Ladd's approach, viewing the corporation as a separate entity does not negate the fact that a corporation must be mindful of its effects upon the community in which it exists. As an entity, a formal organization can be as much a moral agent as an individual.²⁴⁵

Even if one accepts the aggregate view of organizational obligations, the history of corporations in our tradition justifies a less individualistic and more communitarian approach.²⁴⁶ The aggregate view departs from what has been the legal norm for corporations since their inception. One of the chief attributes of the corporate personality in the eyes of the law is that it always has been viewed as an entity, separate and apart from its members.²⁴⁷ In contrast, a partnership traditionally has been viewed as an aggregate of the partners,²⁴⁸ although even the partnership is recognized as a separate entity for some purposes.²⁴⁹ Thus, assuming for the moment that those who would not attribute any moral agency to organizations generally are correct, the law has always taken a contrary view with regard to corporations.

Communitarianism as a theory of individual morality denies the existence

242. Cf. Tversky & Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. 'S251 (1986) (challenging the rational-actor model for individuals); see also Kelman, *Consumption Theory, Production Theory, and Ideology in the Coase Theorem*, 52 S. CAL. L. REV. 669, 678-85 (1979) (claiming the Coase theorem fails to account for that fact that people treat opportunity cost income differently than realized income); cf. Schelling, *Self-Command in Practice, in Policy, and in the Theory of Rational Choice*, 74 AM. ECON. REV. 1 (1984) (discussing the phenomena of "anticipatory self-command").

243. Ladd, *supra* note 240, at 500-01.

244. *Id.* at 512.

245. See, e.g., Almeder, *Morality in the Marketplace*, in BUSINESS ETHICS 84 (M. Snoeyenbos, R. Almeder & J. Humber eds. 1983); Almeder, *The Ethics of Profit: Reflections on Corporate Responsibility*, BUS. AND SOC'Y 7 (Winter 1980); Gilbert, *supra* note 237.

246. Communitarianism is a philosophy that is said to offer an alternative to individualism. See, e.g., M. SANDEL, LIBERALISM AND THE LIMITS OF JUSTICE 147-54 (1982). It has been suggested that a communitarian approach to corporate law has some implications for corporate conduct. First, the corporation is not simply an aggregate of its constituents, it has its own personality. Second, as a member of a broader community, the corporation has "broader ethical and philanthropic concerns" than the profit motive. See Morrisey, *supra* note 218, at 1035-38 (suggesting that the corporate purpose be framed in terms of "ethical and beneficent corporate conduct" in addition to the profit motive).

247. See, e.g., G. FIELD, *supra* note 137, § 449.

248. 1 A. BROMBERG & L. RIBSTEIN, *supra* note 123, § 103.

249. For example, statutes that set forth the appropriate methods for service of process generally treat the partnership as an entity. Also, the tax laws treat the partnership as an entity for some purposes. *Id.*

of neutral principles.²⁵⁰ Instead, it focuses on the relationship of the individual to the community (which consists of an aggregate of individuals). However sound or unsound the status of communitarianism as a theory about individual morality, if we believe that there is a morality applicable to corporations, then it must be communitarianism. Recognizing the corporation as a moral agent does not negate the fact that the firm does consist, at least in part, of an aggregate of individuals.²⁵¹ Furthermore, as a moral agent, the corporation owes certain obligations not only to its constituents but also to the community in which it operates.

Even if the corporation is an aggregate rather than a morally responsible individual, the aggregate of individuals that makes up the corporation is a community. Under principles of communitarianism, the utilitarian analysis that supports current economic contract theory of the firm cannot withstand scrutiny as the ultimate paradigm.

VII. OTHER MODELS OF CORPORATE EXISTENCE

A. *The Power Model of Corporations*

In a recent article, Professor Lynne Dallas sets forth a power model of corporate structure.²⁵² According to the power model, corporate relationships can be explained best as power struggles between various coalitions within the corporate entity.²⁵³ The essence of the power model is apparent from its comparison to the contract model.²⁵⁴ In the contract model, the firm is viewed as a nexus of contracts and is reactive to its environment. By contrast, the power model is based on power coalitions that are proactive with respect to the firm's environment.²⁵⁵ The contract paradigm portrays management as an agent of the firm. Under the power model, management is the embodiment of the dominant coalition.²⁵⁶ The contractarians describe the goal of the corporation as

250. See, e.g., M. SANDEL, *supra* note 246, at 59-65, 147-54; Regan, *Community and Justice*, 1985 WIS. L. REV. 1073. This, of course, is a rejection of Rawls' approach. See J. RAWLS, *A THEORY OF JUSTICE* (1971).

251. In fact, it might well be said that this is a situation wherein the whole exceeds the sum of its parts.

252. Dallas, *supra* note 74, at 25-29 (1988); see also C. LINDBLOM, *POLITICS AND MARKETS* (1977); Gordon, *Macaulay, Macneil, and the Discovery of Solidarity and Power in Contract Law*, 1985 WIS. L. REV. 565; Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus"*, 75 NW. U.L. REV. 1018 (1980).

253. See Dallas, *supra* note 74, at 31 ("Firm behavior results from a contest for control among power coalitions comprised of groups of individuals in specific relationships to the firm and with each other."); W. SCOTT, *ORGANIZATIONS: RATIONAL, NATURAL AND OPEN SYSTEMS* 248 (1981) (The power model "presumes that intradepartmental conflict is not primarily a product of error, ambiguity, and ignorance but results from quite fundamental divergences in group interests; and that the struggles are not concerned simply with the means but concern the goals to be served by the organization."); see also R. CYERT & J. MARCH, *A BEHAVIORAL THEORY OF THE FIRM* (1963); H. MINTZBERG, *POWER IN AND AROUND ORGANIZATIONS* (1983); J. PFEFFER & G. SALANCIK, *THE EXTERNAL CONTROL OF ORGANIZATIONS: A RESOURCE DEPENDENCE PERSPECTIVE* (1978); Tomlinson, *Economic and Sociological Theories of the Enterprise and Industrial Democracy*, 35 BRIT. J. SOC. 591, 602 (1984).

254. Or efficiency model.

255. Dallas, *supra* note 74, at 29.

256. *Id.*

profit maximization,²⁵⁷ while the power model recognizes that the corporation embodies multiple inconsistent goals.²⁵⁸ Contractarians rely solely on competition in the market as the determinant of corporate structure and behavior, whereas the power model recognizes various sources of power.²⁵⁹ In contrast to holding up contract as the essence of the management shareholder relationship, the power model speaks in terms of "co-optation," a process by which management utilizes the shareholders to provide legitimacy for its power base.²⁶⁰ Finally, while the contract model views the board of directors as a monitoring device,²⁶¹ the power model views the board as a "tool" of internal coalition.²⁶²

The efficiency model is rooted in a sort of economic Darwinism and natural selection. In contrast, the power model views the corporation within its social, cultural, and political context.²⁶³

The power model demonstrates the contract model's failure to perceive the ways in which the various corporate constituencies relate to one another. It has long been recognized that the various corporate constituencies have divergent interests.²⁶⁴ The contract model assumes that bargaining is the most efficient way to reconcile these differences. Under a contract model, the quid pro quo (or consideration) in contract formation provides adequate compensation for the losers in the allocation of power. The power model demonstrates that the various constituencies do not come to the bargaining table with equal bargaining power. Not only is the bargaining unequal, it is wholly one-sided in favor of management. Traditional contract law utilizes various doctrines such as unconscionability²⁶⁵ to police bargains that have not been reached as a result of arm's length bargaining. The doctrine of unconscionability has not gone without its critics, however. These critics claim that it represents an unwarranted interference with freedom of contract.²⁶⁶ The courts, in point of fact, generally refrained from interfering except in the extreme case in which it cannot fairly be said that the parties bargained for and thus actually consented to the bargain.²⁶⁷

257. And, correlatively, cost minimization.

258. Within this framework, the power model also works towards increased autonomy and discretion of the various power coalitions. Dallas, *supra* note 74, at 29.

259. *Id.*

260. *Id.* In other words: "The relationship between shareholders and management in a large public corporation is then one of formal cooptation. The purpose of formal cooptation is to provide a 'front' or 'aura of respectability' for the powerholder." *Id.* at 95; see P. SELZNICK, *TVA AND THE GRASSROOTS: A STUDY IN THE SOCIOLOGY OF FORMAL ORGANIZATION* 260 (1949).

261. Dallas, *supra* note 74, at 29.

262. *Id.*

263. *Id.* at 97-98.

264. See, e.g., A. CONARD, *CORPORATIONS IN PERSPECTIVE* (1976).

265. See, e.g., U.C.C. § 2-302; RESTATEMENT (SECOND) CONTRACTS § 208 comment c (1979); Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741, 752-54 (1982); Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485 (1967).

266. See, e.g., Epstein, *Unconscionability: A Critical Reappraisal*, 18 J. L. & ECON. 293 (1975); Schwartz, *Seller Unequal Bargaining Power and the Judicial Process*, 49 IND. L.J. 367, 369 (1974). Some critics have attacked the doctrine of unconscionability "as a cover for smuggling notions of distributive justice into the judicial process." E. FARNSWORTH & W. YOUNG, *CONTRACTS—CASES AND MATERIALS* 393 (4th ed. 1988).

267. E.g., *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965) (cross collateralization clause of revolving credit account remanded for determination of unconscionability);

Of course, not all unequal bargains will (or should) be invalidated.²⁶⁸ In most cases, the market and not the judiciary is the appropriate forum for allocating rights in a bargained-for exchange. In other words, the "right" to enter into a bad bargain is one element of the freedom to contract. On those occasions, however, when courts are faced with a clearly one-sided bargain, they nevertheless are reluctant to interfere because of their view that the matter is more properly a concern for the legislature.²⁶⁹ However, courts will interfere in an appropriate case. When carried from the law of contracts to the realm of corporate law, the contract paradigm calls for a correlative function of policing the bargain. In this regard, it must not be forgotten that the corporation is a creature of statute. The corporate franchise thus is conditioned upon the state imposing limits on corporate activity and power arrangements among the various corporate constituencies. Just as contract doctrine has interposed various policing devices in the context of unequal bargaining power, the fiduciary obligation has a similar necessary role in defining relationships with the corporation.

Recent Delaware decisions demonstrate how the courts have struggled over the proper allocation of power between managers and shareholders. As discussed more fully above,²⁷⁰ in *Revlon v. MacAndrews & Forbes Holdings, Inc.*,²⁷¹ the Delaware Supreme Court held that once a corporation is "for sale," management's responsibility is limited to value maximization for the shareholders by seeking (or at least not interfering with the quest for) the highest price for their shares. More recently, in *Paramount Communications, Inc. v. Time, Inc.*,²⁷² the Delaware Court of Chancery, in a decision that was affirmed by the supreme court, held that management could respond to a hostile bid by acquiring another company without violating the *Revlon* principle.²⁷³

The power model demonstrates that the relative power positions of the various corporate constituencies justifies some interference with the unfettered recognition of what some economists describe as the contract rights of corporate management. The essence of the contract model is freedom of contract. Freedom of contract is meaningful only to the extent that the parties can be said to be acting out of uncoerced consent. Recognition of the relative power positions of the various corporate constituencies belies unrestrained notions of freedom of contract within the corporation. Freedom of contract should be recognized only

Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 161 A.2d 69 (1960) (disclaimer of warranty for personal injury to consumer held unconscionable and hence unenforceable).

268. *E.g.*, O'Callaghan v. Waller & Beckwith Realty Co., 15 Ill. 2d 436, 155 N.E.2d 545 (1958) (upholding exculpatory clause releasing landlord from liability for his negligence).

269. *Id.* at 441, 155 N.E.2d at 547; *see generally* Dawson, *Economic Duress—An Essay in Perspective*, 45 MICH. L. REV. 253 (1947) (surveying the development of the law of duress).

270. *See supra* texts accompanying notes 86-110, 202.

271. 506 A.2d 173 (Del. 1986) (striking down "lock-up" option whereby target manager agreed to sell corporate assets to a "white knight" in order to rebuff a hostile bidder).

272. [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. 1989), *aff'd*, 565 A.2d 280 (Del. 1989).

273. By entering into a defensive merger, Time's management effectively defeated the hostile offer by Paramount. The Paramount offer was to purchase Time shares at a price far in excess of either the pre or post defensive merger price. Accordingly, the Time/Warner deal effectively stopped the Paramount offer and thereby interfered with an auction for the Time shares.

to the extent that it can fairly be said that the terms of the agreement are not the result of management's coercion of the other corporate constituencies.

B. *The Contractarians and Critical Legal Analysis*

Economic analysis is only one of three current strains in legal scholarship. Two other emerging camps are the critical legal theorists²⁷⁴ and feminist scholars.²⁷⁵ In large part, the "crits" and the feminist writings arose in reaction to the Chicago school of economic approach to the law. One does not have to be a devotee of either of these two doctrinal schools, however, to appreciate that each can provide us with alternative perspectives on long-standing problems. Although there has not been a substantial body of critical legal theory or feminist writing in the area of corporate law, these doctrinal positions can provide some useful insights. For example, the lesson from critical legal analysis is that we must view law as contextualized.²⁷⁶ As such, an awareness of the role of corporate law as both public and private law is crucial.²⁷⁷ By viewing corporations in their historical, political, and social context, one can see that the contract model is far from a new development.²⁷⁸ Furthermore, a proper understanding of contract law shows that it is concerned with more than merely deregulation and laissez-faire economics. For example, as discussed above,²⁷⁹ fiduciary principles have been an important part of contract law, especially within the context of business organizations (whether in the form of partnerships or corporations). Feminist scholars suggest that, because relationships form an important part of human conduct, the law should put more emphasis on relationships than upon abstract principles.²⁸⁰ A feminist analysis of corporate law would reveal that over time the relational aspect of the corporate entity has been recognized in various ways.²⁸¹ Because the corporate form consists of a

274. For some representative scholarship dealing with critical legal theory, see *CRITICAL LEGAL STUDIES* (A. Hutchinson ed. 1989); *THE POLITICS OF LAW: A PROGRESSIVE CRITIQUE* (D. Kairys ed. 1982); M. KELMAN, *A GUIDE TO CRITICAL LEGAL STUDIES* (1987).

275. See, e.g., Scales, *The Emergence of Feminist Jurisprudence: An Essay*, 95 *YALE L.J.* 1373 (1986).

276. See *supra* note 274.

277. Millon, *supra* note 50.

278. See, e.g., W. CLARK, *supra* note 137, § 73, at 202 ("it is now settled beyond any controversy that the charter of a private corporation is a contract within the meaning of the constitution"); C. ELLIOTT, *supra* note 54, § 24; W. MORAWETZ, *A TREATISE ON THE LAW OF PRIVATE CORPORATIONS OTHER THAN CHARITABLE* § 255 (1882); S. THOMPSON, *COMMENTARIES ON THE LAW OF PRIVATE CORPORATIONS* § 2 (2d ed. 1908); see also Bratton, *supra* note 45, at 1472-73:

History . . . shows that contract always has held a constitutive place in corporate legal theory. . . . Historically, contract has had an equal, or more often subordinate, position in corporate legal theory — a position closely grounded in and responsive to economic practice. . . . It [the contract model] constitutes a significant innovation in neoclassical microeconomic theory. But, outside that limited methodological context, it is merely the latest in a long series of attempts to describe and justify the phenomenon of collective production in individualist terms.

279. See *supra* text accompanying notes 143-46.

280. See, e.g., Scales, *supra* note 275, at 1384-88 (discussing the incompatibility of "rights based" (male) and "care based" (female) approaches).

281. However, the feminists nevertheless would decry the combative, confrontational approach of the law. See *id.*

number of relational interests, the law quite properly has focused on fiduciary as well as contract principles in defining the corporate paradigm.

This Article does not suggest that critical legal theory or feminist analysis should form the basis for revamping our corporate law. At least some strains of these two schools of legal analysis can be useful. Similarly, I am not suggesting that adherents to a law and economics analysis have not made significant contributions. Indeed, economic analysis must play a significant role in shaping our corporate law. However, that principle is quite different from saying that economic analysis mandates a contractarian *laissez-faire* model of corporate law.

VIII. CONCLUSION

Clearly, economic analysis has had a profound effect on the law. Within the past twenty years, adherents to the Chicago school of economics have forced a reevaluation of many doctrinal aspects of the law. Like any paradigm, economic models are useful for testing hypotheses upon which the law is built. The economic model, however, does not (and cannot) provide all of the answers to the question of how the law should be formed.

The role of economic analysis within the context of corporate law bears out the above-mentioned observations. Because corporate law regulates business, economic analysis must play a significant role in defining our view of the corporation and, in turn, our view of the proper focus of corporate law.

The contractarian model of the firm is not new and, within limits, may be helpful in deciding upon the proper scope of business regulation. The paradigm of the corporation as a nexus of contracts can prove to be valuable, but only to the extent that it can fairly be said that the various parties in fact have consented to the agreements that comprise the firm. As the power model indicates, the relative power positions of the various corporate constituencies call for some moderation of the contract model. The essence of the contract model is freedom of contract. Freedom of contract is meaningful only to the extent that the parties can be said to be acting out of uncoerced consent. The fiduciary paradigm is a necessary limitation on the right to contract within the corporate setting. This limitation on freedom of contract is warranted because of the recognition of the relative unequal power positions of the various corporate constituencies. The fiduciary principle also is applicable because a corporation is not only an economic institution but is also a powerful political and social institution. As such, the corporate paradigm must be evaluated in light of societal values rather than the allegedly neutral²⁸² economic model. Finally, corporate managers make decisions concerning the deployment of the shareholders' capital. Corporate managers are in fact managing other people's money.²⁸³ This is yet a further reason for retaining the fiduciary paradigm.

282. As discussed earlier, economic analysis can be as value laden as any other disciplinary focus. Thus, the current wave of economic thought has a deregulation bias in order to uphold freedom of contract.

283. See L. BRANDEIS, *OTHER PEOPLES' MONEY* (1913).