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ASSESSMENT AND EVALUATION: RETHEORIZING THE EVOLVING RULES OF DIRECTOR LIABILITY

*Mae Kuykendall**

INTRODUCTION

The role of financial liability in imposing a penalty on directors of corporations for breaching a legal duty has become opaque.¹ The rationale for financial liability arising from board service has not been clearly articulated, in that there is no social consensus or academic theory for imposing financial liability.² The legal codes

* Professor of Law, Michigan State University-Detroit College of Law; J.D., Harvard University, 1985; Ph.D., University of North Carolina, 1980; M.A., University of North Carolina, 1972; B.A., University of Houston, 1969. This article is dedicated to the memory of Edith J. Lapidus (1902-1999), an early exemplar of success in law by women. She received her L.L.B. degree from Brooklyn Law School in 1926 and held a Ph.D. from Queens College. She was admitted to the New York Bar in 1927. She practiced law, co-edited legal reference works on corporate and real estate law and taught constitutional law at Queens College. She was honored in her later years by the friendship of Justice Ruth Bader Ginsburg. My friend Jacqueline Lapidus, a poet and writer, is her daughter.

I also wish to thank Peter Kostant for his helpful comments, Carol Parker for her expert reference assistance, Linda Oswald for her secretarial assistance and a sharp editorial eye and Shelby Jean for her valuable research assistance.

¹ See generally Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253 (1999) (arguing that the threat of liability is not necessarily the primary motivating factor in giving corporate actors incentives to engage in good conduct).

² The work contributed by Joseph Bishop reflected the confidence of a prior academic generation in the propriety of liability being imposed on board members who breached a duty to a corporation. See GEORGE THOMAS WASHINGTON & JOSEPH WARREN BISHOP, JR., INDEMNIFYING THE CORPORATE EXECUTIVE: BUSINESS, LEGAL, AND TAX ASPECTS OF REIMBURSEMENT FOR

governing director liability—i.e., rules that qualify its scope and innovate forms of exoneration—have created escape valves to avoid the imposition of liability and to permit advance protection against liability.³ Thus, imposing liability as a way to express corporate norms has become blurred.

Corporations may minimize liability by putting in place sweeping protections for directors, rather than parceling out exoneration through a case-by-case, norm-sensitive review of conduct.⁴ There is a decreasing likelihood that directors will face a financial loss as a result of the transactional or substantive costs created by their breach of duty.⁵ Yet, sufficient exposure remains to make directors aware of the risks of, and forms of protection from, financial liability arising from board service.⁶ Consequently,

PERSONAL LIABILITY 99-100 (1963). But, academic theory has relaxed its assumptions about the need for financial liability as a mechanism of corporate accountability. See Eisenberg, *supra* note 1, at 1253 (arguing that in addition to the “prospect of financial gain,” corporate accountability is achieved through the operation of three types of social norms: “behavioral patterns, practices, and obligational norms”).

³ See ALA. CODE § 10-2B-8.58 (1999); ARK. CODE ANN. § 4-26-814(f) (Michie 1991); DEL. CODE ANN. tit. 8, § 145(f) (1991 & Supp. 1998); FLA. STAT. ANN. § 607.0850(7) (1993 & Supp. 1999); N.M. STAT. ANN. § 53-11-4.1(G) (Michie 1993); N.Y. BUS. CORP. LAW § 721 (McKinney 1986 & Supp. 1999) (providing that any indemnification allowed by the state code shall not be deemed exclusive of other sources of indemnification). See also Mae Kuykendall, *Symmetry and Dissonance in Corporate Law: Perfecting the Exoneration of Directors, Corrupting Indemnification and Straining the Framework of Corporate Law*, 1998 COLUM. BUS. L. REV. 443, 467-81 (1998).

⁴ Kuykendall, *supra* note 3, at 499-501, 507-12.

⁵ See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1012 (1997) (stating that “damage liability is extremely rare”). See also Eisenberg, *supra* note 1, at 1266-67 (minimizing the threat of liability as a factor in achieving higher standards of director and officer conduct).

⁶ See Constance Frisby Fain, *Corporate Directors and Liability*, 18 ALA. L. REV. 417, 417 (1996) (emphasizing the unpredictable nature of director and officer exposure to liability). See also EDWARD BRODSKY & M. PATRICIA ADAMSKI, *LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES AND LIABILITIES*, at v (1984 & Supp. 1999) (stating that “[I]itigation against officers and directors of corporations is commonplace, and possible exposure to substantial liability under state and federal law is of grave concern to people

the art of maximizing protections for directors, justifying the payment of indemnification and reducing the total legal exposure of directors to financial liability is part of the recommended arsenal of any lawyer practicing corporate law.⁷

Because reducing the risk of liability for directors benefits individuals who help make corporate policy—i.e., corporate lawyers—it is tempting to view the evolving treatment of director liability in state corporate codes as arising from forms of rent-seeking.⁸ That is, the interests of corporate directors and the

serving in those positions”).

⁷ JOHN F. OLSON AND JOSIAH O. HATCH, III, *DIRECTOR & OFFICER LIABILITY: INDEMNIFICATION AND INSURANCE*, at xi (1991 & Supp. 1998).

As decisions by corporate managers must be made on matters of great complexity, and under the substantial time pressures of our fast-moving world of the 1990s, directors and officers frequently turn to counsel for advice as to not only what their obligations are, but how they can be protected against the possibility that someone will claim that they have made an erroneous decision or failed to take an action that should have been taken.

Id. See generally E. Norman Veasey et al., *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399 (1987) (characterizing exculpation, indemnification and insurance as part of a sound approach to protecting directors from liability).

⁸ See HENRY N. BUTLER, *ECONOMIC ANALYSIS FOR LAWYERS* 107 (1998) (stating that “legislation is the result of a rent-seeking process in which legislation is ‘sold’ by legislators and ‘bought’ by the highest bidders” and that “[t]he political activity of interest groups . . . is referred to as *rent seeking*, where the excessive . . . profits earned by interest groups as a result of their political activity are referred to as *rents*”) (emphasis added). Rent-seeking is a term mainly used to convey that there are socially wasteful uses of resources by firms that choose to lobby for state policies that cushion them from competition. See Warren J. Samuels & Nicholas Mercurio, *A Critique of Rent-Seeking Theory, in NEOCLASSICAL POLITICAL ECONOMY: THE ANALYSIS OF RENT-SEEKING AND DUP ACTIVITIES* 56-57 (David C. Colander ed., 1984) (reviewing the principal definitions of rent-seeking); *TOWARD A THEORY OF THE RENT-SEEKING SOCIETY*, at ix (James M. Buchanan et al. eds., 1980). Because the term is used in a general manner to mean “the waste of resources in the pursuit of altering legal rights,” see Samuels & Mercurio, *supra*, at 56, the term applies to the activities that create state-sanctioned protocols for transferring wealth to directors and their lawyers.

lawyers who help to write corporate law⁹ have been advanced by amendments to provisions of state corporate codes concerning treatment of director liability. Nonetheless, an impulsively-formed negative view of this law-making, which has reduced the role of liability, runs the risk of unduly simplifying the model by which one accounts for the relatively complex social and economic arrangements relating to the responsibility and accountability of boards of directors. While it readily may be demonstrated that self-interested arguments receive more than their fair share of respect in the policy environment of code-making,¹⁰ it does not necessarily follow that the social product—i.e., amendments to provisions concerning director liability—is a mere expression of rank self-interest.¹¹ The actual degree, extent, and visibility of director

The initial status quo of director liability was influenced by a view of the corporation as an entity with a limited legal capacity to award indemnification to directors. *See* *New York Dock Co. v. McCollom*, 16 N.Y.S.2d 844, 846-47 (Sup. Ct. 1939). Under a strict interpretation of rent-seeking as waste, the best solution would have been to allow market forces to find a solution, and thus, eliminate any opportunity for that waste—i.e., the making and enforcing of contracts, as with insurance, would efficiently spread the risks of loss among the parties. The teaching of scholars who have studied rent-seeking theory is that corporations should avoid spending resources on government intervention to alter a bundle of rights and obligations that are part of the status quo of an activity. James M. Buchanan, *Before Public Choice*, in *EXPLORATIONS IN THE THEORY OF ANARCHY* 36-37 (Gordon Tullock ed., 1972). The historical changes in the rules governing director liability and the labored form of the statutes have arguably been a process of altering rights that diverts resources to a wasteful use.

⁹ Payments by corporate lawyers to lobbyists in an effort to reduce the exposure of directors to financial liability is classic rent-seeking because these payments to lobbyists take resources from purchasing productive investments. *See* Samuels & Mercuro, *supra* note 8, at 63 (explaining that rent-seeking theory criticizes efforts to change rights as wasteful). In addition, lawyers are creating rents for themselves by maintaining a role in the universe of director liability that has no effect on the amount of indemnification provided directors in relation to the misconduct. *See* *TOWARD A THEORY OF THE RENT-SEEKING SOCIETY*, *supra* note 8, at ix.

¹⁰ *See, e.g.*, Kuykendall, *supra* note 3, at 453-54, 502-05 (discussing the corporate process of interest group representation in law-making).

¹¹ *See, e.g.*, Samuels & Mercuro, *supra* note 8, at 61 (explaining that defining a commodity in terms of societal values and selectiveness of identifying an activity as rent-seeking is complex).

exposure to liability is determined by a complex mixture of factors, including: (1) contract; (2) market pressures; (3) organizational environments and culture; (4) code-mandates requiring protection from liability or limiting it; (5) social adaptation to changes in the nature of the board undertaking; and (6) reader strategies in addressing the legal texts involved.

In this Article, I examine alternative ways of explaining the format of the regulatory treatment of director liability. In so doing, I take a relatively agnostic approach, looking for a model that is a good fit for the statutory facts presented by the codes, as implemented in practice. Part I of the Article provides a brief overview of the regulation of director liability by corporate codes. In doing so, Part I examines the remaining vestiges of process integrity in director exoneration statutes and introduces explanations for that process integrity even in the face of a trend of liberalization in director indemnification practices. Part II begins by contrasting the two major competing models of corporate law: the contract model and the anti-managerialist model. Part II concludes that, as a threshold matter, neither contractarianism nor anti-managerialism accounts very well for the form of the director exoneration statutes. Part II, at a descriptive level, offers a variety of functions embedded in, and accounting for the ambivalent form of the policy design for director accountability and exoneration. Among others, these include: (1) the wrong-remedy dyad; (2) the aspirations to organizational integrity; (3) the citizenship claim on corporate directors; and (4) the function of law to offer interpretation and preservation in the form of discursive open-mindedness within a closed culture of business persons¹² and corporate counsel.¹³

¹² See generally James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83 (1985) (proffering the classic statement on the club culture of the corporation).

¹³ See Mae Kuykendall, *Comment on Kostant: Tune in to Hear Stories of Corporate Governance, the Adventures of the Go-Between and More Exciting Tales of Corporate Law*, 28 J. SOCIO-ECONOMICS (forthcoming 2000) [hereinafter Kuykendall, *Comment on Kostant*] (discussing Professor Kostant's view of the role of corporate lawyers as both "brokers of information" and fiduciaries to corporate boards and management) (on file with author).

Part III of the Article considers the rhetorical mish-mash arising out of the analysis of director exoneration statutes. Part III argues that the forms of director exoneration statutes cling to a portrait of discourse that allows outsiders and insiders to engage in evolving exchanges about conduct, yet the contract picture of the corporation proposes a simpler economic exchange driven by the inefficiency of director liability. Part III explains that the mixture of purposes presents a phenomenon particularly resistant to a simple account and provides analysis of the contract model and proposes potential modifications to the contract model. Part IV suggests several hypotheses to help explain the form of director exoneration statutes, including the rent-seeking model, the “team-production” model of the corporation, public relations, law and literature hypotheses and post-modern theory. Part V of the Article examines the variety of policy alternatives underlying director liability, the record of advocacy for director interest and the mildly contradictory aspects of the statutes. In the end, the Article leaves the reader at liberty to adopt her own reading strategy in managing the unruly text of the corporate codes on director exoneration.

I. A BRIEF OVERVIEW OF THE CODE REGULATION OF DIRECTOR LIABILITY

Corporate codes contain provisions that allow corporations to eliminate some portions of director liability.¹⁴ These codes allow corporations to indemnify directors for the expense of litigation, including the amounts of adverse judgments in third party suits. They also allow corporations to purchase insurance that covers some of the litigation costs in defending corporate directors and possible liabilities. The combination of exculpation provisions,

¹⁴ See, e.g., CAL. CORP. CODE § 204(a)(10) (West 1990); DEL. CODE ANN. tit. 8, § 102 (b)(7) (1991 & Supp. 1998); FLA. STAT. ANN. § 607.0831 (1) (West 1993 & Supp. 1999); REVISED MODEL BUS. CORP. ACT § 2.02(b)(4) (1998) (providing that a director’s personal liability to the corporation or its stockholders may be eliminated or limited for breach of fiduciary duty, but not for breach of a director’s duty of loyalty or for acts or omissions not in good faith).

indemnification provisions and insurance has been called the three-legged stool of director protection.¹⁵

Most director exoneration statutes have the following structural elements: (1) a permissive and a mandatory section; (2) a substantive standard for both permissive and mandatory indemnification; (3) process ground rules that identify the appropriate groups for determining requests for permissive indemnification; (4) non-exclusivity clauses that suggest that directors may have rights beyond those enumerated in the code; and (5) rules for the advance of expenses. The actual role of the limiting rules is unclear. Current models of director compensation contracts render corporate code provisions irrelevant in the eyes of some because such contracts frequently exceed available statutory protections.

These director exoneration statutes also have categories of non-indemnifiable expenses, such as adverse final judgments or derivative suit settlements. In general, the statutes try to strike some balance between the needs of directors for adequate protection from financial liability and a sense that the corporation should be protected from improper payments to corrupt directors or for corrupt purposes. The trend has been toward liberal rules that provide directors indemnification from liability to the corporation or its shareholders.¹⁶

¹⁵ See Veasey et al., *supra* note 7, at 400-01 (discussing the change in the dynamics of corporate governance and the resulting problem of outside directors refusing to serve on corporate boards without protection of their personal assets).

¹⁶ See WILLIAM E. KNEPPER & DAN A. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* 649 (4th ed. 1988) (stating that "the trend in the mid-1980's has been to liberalize and expand the scope of indemnification"). The expansion is based on the recognition by courts that indemnification will serve to encourage qualified individuals to serve as corporate directors. *Id.* at 650. Numerous writers may be consulted for further elaboration on the basic structure of exoneration rules. James J. Hanks, however, has been the principal expositor of the emerging model of director liability with respect to indemnification. See generally James J. Hanks, Jr., *Changes to Indemnification and Expense Advance in the Model Business Corporation Act*, 9 *INSIGHTS* 17 (1995) (discussing the new amendments to the Model Business Corporation Act related to indemnification and advancement of expenses for directors and officers); James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability*, 43 *BUS. LAW.* 1207 (1988) (reviewing legislative responses to perceived liability problems) [hereinafter Hanks, *Director and Officer Liability*]. James Cheek also

Notwithstanding this trend toward liberal indemnification, at one time corporations were thought to have only a qualified right to grant indemnification to directors and officers.¹⁷ This traditional view accounts for the fact that corporate codes typically include process ground rules to insure integrity in the decision-making of corporations—i.e., rules to determine whether corporations may grant indemnification to a particular director. These process ground rules specify the make-up of the decision-making body that may grant indemnification in a given instance of director need.¹⁸ The rules about process strengthen the credibility of the statutory conduct standards. Thus, one imagines these rules serving as the Praetorian guard, vigilant to defend the corporate conscience and cast disfavor upon wrongful petitions for indemnification by directors.

These process ground rules and the related concern for disinterestedness in decision-making on directors' accountability are at odds, however, with the trend toward liberal indemnification of directors. These ground rules also are in tension with the loosening

explores the structure of indemnification. See James H. Cheek, III, *Control of Corporate Indemnification: A Proposed Statute*, 22 VAND. L. REV. 255, 257-58 (1969) (contending that the legislatures have failed to provide adequate protection for both directors and shareholders).

¹⁷ See *New York Dock Co. v. McCollom*, 16 N.Y.S.2d 844, 846-47 (Sup. Ct. 1939).

¹⁸ For example, section 145 of the Delaware code provides:

Any indemnification under subsections (a) and (b) (unless ordered by a court) shall be made by the corporation only as authorized in the specific case upon a determination that indemnification of the present or former director, officer, employee or agent is proper in the circumstances because the person has met the applicable standard of conduct set forth in subsections (a) and (b) of this section. Such determination shall be made with respect to a person who is a director or officer at the time of such determination, (1) by a majority vote of the directors who are not parties to such action, suit or proceeding, even though less than a quorum, or (2) by a committee of such directors designated by majority vote of such directors, even though less than a quorum, or (3) if there are no such directors, or if such directors so direct, by independent legal counsel in a written opinion, or (4) by the stockholders.

DEL. CODE ANN. tit. 8, § 145(d) (1991 & Supp. 1998).

substantive standards for indemnification, contract provisions ensuring directors a strong presumption in favor of indemnification and the policy emphasis on making indemnification an empirically mandatory assurance rather than a statutorily permissive possibility.¹⁹ Consequently, the process ground rules or statutory mandate identifying a corporate decision-making body charged with superintending its directors so that such a body may limit its grant of indemnification to directors who deserve to be indemnified is belied by the overall structure of the corporate code, including the non-exclusivity provisions of the code²⁰ and the related culture of corporate law and practice. Thus, as a practical matter, the contract model of director indemnification largely has prevailed in the policy debates over such indemnification in many states, in the Model Business Corporations Act and in the underlying practices by which directors agree to serve.

A. *The Irrelevancy Thesis: Process for What?*

Although the contract model of director indemnification largely has prevailed, the design of the underlying director exoneration statutes is anachronistic in part and schizophrenic in part. This is because the same statutes that retain a *form* of process integrity by holding onto the process ground rules also increasingly incorporate the fruits of contract logic developed by corporate lawyers for advancing the cause of predictability in the personal liability of directors. Indeed, corporate lawyers drafting director exoneration statutes incorporate contract logic and advance predictability by employing indemnification provisions that are not exclusive of other rights—e.g., contract rights—to which a director may be entitled.²¹ As a result, lawyers are able to draft contracts between

¹⁹ See Kuykendall, *supra* note 3, at 510-12 (suggesting that the new standard of indemnification basically exonerates the corporate director from financial risk).

²⁰ See *Pepsico, Inc. v. Continental Cas. Co.*, 640 F. Supp. 656, 661 (S.D.N.Y. 1986) (holding that Pepsico's failure to make an evaluation of the actions of its directors and officers is made irrelevant by the non-exclusivity provisions).

²¹ For example, section 145 of the Delaware Code provides:

directors and their corporations so that such contracts contain presumptions favoring a determination that a director is entitled to indemnification. Yet, while lawyers may be capable of reconciling this presumption of indemnification with the function of a corporate decision-making body designed to produce disinterestedness and integrity, the average observer may see this form of decisional disinterest as irrelevant when contract provisions indemnifying directors reign supreme, or close enough to claim decisional primacy.²²

This irrelevancy thesis is strengthened as the reach of the contract term—i.e., the reservation of a corporate option to deny indemnification—that provides a role for integrity and disinterest to monitor conduct standards grows smaller. The enactment of director exoneration statutes that conform the standard for indemnification to the exculpation provisions of the statutes has diminished the need for a corporate decision-making body to formulate standards of director conduct for which monetary forgiveness is proper. As such, the critical timing issue in the payment of monies

The indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise.

DEL. CODE ANN. tit. 8, § 145(f) (1991 & Supp. 1998).

²² Indeed, one court has held that the procedural form for integrity is rendered irrelevant by the non-exclusivity provisions of New York law. See *Pepsico*, 640 F. Supp. at 661 (holding that *Pepsico's* failure to make an evaluation of the directors' and officers' actions is made irrelevant by the non-exclusivity rule). Such an interpretation of the reach of the non-exclusivity rule may be overly robust. Indeed, since *Pepsico* was decided, the Second Circuit Court of Appeals explicitly has ruled that, under Delaware law, non-exclusivity does not permit a director to enforce a contract right that calls for indemnification without respect to the director's conduct. See *Waltuch v. Conticommodity Serv., Inc.*, 88 F.3d 87, 92-93 & n.8 (2d Cir. 1996) (criticizing *Pepsico* and citing treatise authority casting doubt on *Pepsico*).

Thus, the usual qualification that contracts for indemnification are subject to the public policy limitations implicit in state corporate codes, see KNEPPER & BAILEY, *supra* note 16, at 672, gives life to procedural rules even where a contract right imposes some constraints on the decision-making autonomy of the evaluating group.

has become increasingly less important, given the strong assurances that the advance of expenses will be available.

In addition, state corporate codes help directors in two ways. First, the codes employ liberal provisions that lack standards for advancing expenses resulting from a director's misconduct. Second, the codes mandate payment of these expense advances to directors who are indemnified by contract, even if the contract fails to provide for expense advances as a category of indemnification. The rules for expense advances typically require no security from directors, who are required only to assert a belief that they engaged in conduct triggering indemnification. Indeed, these private indemnification contracts commonly require that the corporation advance funds to the director even before a dispute concerning coverage has been resolved. Thus, a contract right to indemnification carries with it an empirical assurance of monies to conduct a defense, even in the face of opposition by the corporation.

B. The Primacy of Contract and the Compensation Model

The use of contract logic in the universe of indemnification calls into question the value of, and need for, the regulatory format of director exoneration statutes. In those statutes where contract law has become deeply rooted and where private contracts are extensively covered, the option of eliminating the remnants of regulation-derived procedural protections—i.e., the process ground rules—from the statutes is presented. The contemporary view is to recognize indemnification provisions in contracts as a form of compensation. Indeed, directors may ask for indemnification during their contract negotiations. In many instances, directors will benefit from the work of corporate lawyers who were responsible for drafting corporate codes that define corporate interest and director interest as meshing and, thus, limit the likelihood that directors will face liability and assure that directors will receive generous coverage of expenses. This form of corporate code allows contract efficiency to dominate the formation of the contract between directors and corporations, where the notion that directors haggle over terms is mainly metaphorical.

Whatever the merits of the contract haggling metaphor, there is arguably little reason to single out indemnification provisions in

directors' contracts as a category of director compensation that requires a form of unusual process despite the lack of a genuine object upon which such process can be expended. This is because the regulatory penalties for directors who act contrary to the corporate interest has lost support from the corporate bar, has suffered from the loss of a counterweight generated by academic fervor and has been seen as misplaced. The claim that director accountability can be achieved most efficiently by the carrot of compensation and by indirect pressures for improved performance are the influential policy assumptions. Indeed, arguments that justify payments to directors have been persuasive, whereas punitive programs relating to compensation have failed to persuade most commentators. The effort to constrain forms of compensation, including director protection from liability, has become quixotic. Nevertheless, compensation in the form of indemnification is not as certain to be realized, as are other types of payments to directors.

II. THE PRINCIPAL COMPETING MODELS

There are two competing models, the contract model and the anti-managerialist model, that offer comprehensive explanations of the regime governing the financial accountability of directors. These models, however, are seemingly incomplete. In fact, they struggle to account for the form of director liability in corporate law today. That is, neither the contract model, nor the anti-managerialist model satisfactorily explains director liability.

A. *The Contract Model*

The agency cost model of the corporation,²³ along with the related contract-dominant model of corporate governance,²⁴

²³ See generally Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (discussing the impact on corporations caused by general agency costs that arise in any principal-agent relationship).

²⁴ FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 1-39 (1991) (presenting the contract interpreta-

accounts, in part, for the form that director liability rules have taken. Thus, both conceptually and practically, the rules for a director's financial exposure are affected by contract principles and rhetoric.

At a conceptual level, shareholders are conceived of as the persons who may exercise a contract-based choice to create indemnification principles buffering directors from liability.²⁵ The fact that shareholders are apparently responsible for affording directors indemnification is seen as a means to an efficient contractual agreement.²⁶ This view of efficiency has a lengthy pedigree and a strong association with the idea that the corporation's interests are served by the correct pricing of director service.²⁷ In its first expressions, this notion of efficiency overcame the formalistic objection that the corporate interest and the individual interest of directors were entirely separate.²⁸ As the reasoning about the role of contract in corporate governance became more fully developed, this notion of efficiency overcame the legalistic thinking that a breach of the duty of care was a legal wrong that required a remedy in damages. Instead of resorting to

tion of the corporation).

²⁵ See Hanks, *Director and Officer Liability*, *supra* note 16, at 1207, 1233-36 (discussing the liability of directors and the purpose of shielding them from liability).

²⁶ The efficiency involves a correct matching of economic risk to the risk-taking enterprise. If the enterprise bears the risk of its activities, inefficient results of imposing risk on its agents are avoided. Among the inefficiencies of agent liability are the risk that competent directors will be deterred from serving as a board member if there is unrealistic exposure to personal liability for enterprise problems. See Mae Kuykendall, *A Neglected Policy Option: Indemnification of Directors for Amounts Paid to Settle Derivative Suits—Looking Past “Circularity” to Context and Reform*, 32 SAN DIEGO L. REV. 1063, 1091-97 (discussing the allocation of costs between agent and principal in the corporation).

²⁷ DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 1852-54* (5th ed. 1998) (summarizing court decisions conceptualizing indemnification as providing a benefit to the corporation rather than to the director).

²⁸ See KNEPPER & BAILEY, *supra* note 16, at 648 (noting the past reluctance of some courts to allow indemnification unless it could be proven that the litigation has been beneficial to the corporation).

damages, the corporation could create an efficient contract that priced the risk of negligence to the satisfaction of the parties. Thus, the insistence of state corporate codes upon extracting a cost for a legal wrong in our court system gave way to re-conceptualizing a director's conduct as that of a private party to a contract. A party to a contract does not commit a legal wrong that demands outside intervention and correction if the contract provides for a contractual resolution. In fact, that contractual resolution may include advance exoneration, which was purchased by any of the many forms of consideration that a director gives as a party to a private contract with a corporation.

In line with the teaching of contractarian scholars, the law moved in the direction of gap filling, where corporate contracts became the primary source for determining director liability. In recent years, state corporate codes have added gap-filling provisions to protect directors from harsh interpretations of ambiguous contract terms.²⁹ Corporate contract gaps were filled in anticipation of an agreement that likely would be reached by the parties if they should address the term. In effect, corporate lawyers who helped draft corporate codes created the standard terms for contracts in line with the terms that their clients wanted in their individual director contracts. These efforts to insert gap-filling provisions in state corporate codes grew out of the contract roots implanted in these codes around the 1940s, whereby directors' protection from wrongful (and inefficient) imposition of litigation costs could be augmented by further contractual agreement. Notably, non-exclusivity clauses have established that the indemnification provisions within the state corporate code were "not exclusive" of other rights afforded to those who sought indemnification pursuant to "any by-law, agreement, vote of stockholders of disinterested directors or otherwise."³⁰

²⁹ See, e.g., GA. CODE ANN. § 14-2-859 (a) (1994); MICH. COMP. LAWS ANN. § 450.1564b(4) (West 1990 & Supp. 1999); MISS. CODE ANN. § 79-4-8.58(a) (1999) (making advancement of expenses mandatory under a contract providing for mandatory indemnification, unless the contract specifically provides otherwise).

³⁰ DEL. CODE ANN. tit. 8, § 145(f) (1991 & Supp. 1998).

Thus, the creation of a regime of contract law in the field of director liability weaves in and out of the state corporate codes and the individual contracts between directors and corporations. Useful clauses developed for individual contracts find their way into state codes and are seen as enhancements of the contract vision of corporate law. As with other default rules, the rationale for filling gaps to assist directors is not explicit.³¹ A rationale that has been posited for this gap filling is that a well counseled corporate director would receive the most complete contractual protection given the realities of corporate contracting. Thus, this rationale presumes that a shortfall in the protection provided in a director's contract, such as a failure to include advance of expenses as an entitlement to indemnification, could not represent a true contract choice among the parties. Therefore, gap-filling provisions have been seen as an efficient way to ensure true contract choice because by inserting the terms that would be found in carefully drafted contracts these gap-filling provisions favor the general efficiency served by director protection and avoid the cost of court resolution of ambiguous contract terms.³²

The next form that gap filling may take, and thus, perfect the contract logic within state corporate codes could be the imposition of a default contract affording full protection from liability for all directors—i.e., a standard-form contract would be taken from the files of the best corporate counsel and would be incorporated in its entirety into the corporate code. In essence, this would define the terms that corporate lawyers should insert in contracts between directors and corporations. For example, a contract term, such as a presumption that a director's conduct does not preclude indemnification and the requirement of funding her legal costs for seeking indemnification up to the point at which the director's efforts at reimbursement have merit—i.e., no final court disposition has made a determination to the contrary—could be implied from a corporate

³¹ See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87, 91 (1989) (arguing that the rationale for selection of specific default rules is under-developed).

³² See *id.* at 93 (arguing that the purpose of saving the cost of court gap filling is a good basis to choose a default rule in some situations).

code that decided to incorporate a director contract in its entirety.³³ No state corporate code, however, has adopted “contract” protection for directors to that extent. In fact, the only affirmative assistance guaranteeing general protection for directors has been found in mandatory rules. These rules provide that a director must be indemnified if she prevails on the merits.³⁴ Thus, extending indemnification so as to allow a default rule favoring full indemnification, except where the corporation proves to a court it is not merited, would fall within the contract vision that has yet to be realized. This is particularly so given the view that director exoneration is efficient and significant numbers of directors do not enjoy individual contract protection.

Despite the limited scope of the default contract rules assisting directors, the actual significance of a regime of director liability and counter protections is colored by the sophistication of the corporate bar. Indeed, corporate lawyers have developed a contractual regime for some clients, pursuant to the authority of corporations to enter into contracts, that protects directors from out-of-pocket payments for litigation initiated to hold those directors liable for breaching their duty to the corporation.³⁵ In addition,

³³ Michigan Practitioners Form (on file with author).

³⁴ See, e.g., ALA. CODE § 10-2B-8.52 (1990) (providing that “[a] corporation shall indemnify a director who was successful on the merits”); CAL. CORP. CODE § 317(d) (West 1991) (providing for the agent of the corporation to be indemnified for expenses if the agent has succeeded on the merits); DEL. CODE ANN. tit. 8, § 145(c) (1991 & Supp. 1998) (providing indemnification of expenses incurred by a present or former director who has succeeded on the merits); MD. CODE ANN., CORPS. & ASS’NS § 2-418(d)(1) (1993) (providing that “[a] director who has been successful on the merits . . . in the defense of any proceeding . . . shall be indemnified”); REVISED MODEL BUS. CORP. ACT § 8.52 (1998) (providing that “[a] corporation shall indemnify a director who was wholly successful . . . in the defense of any proceeding to which he was a party because he was a director of the corporation”).

³⁵ See, e.g., Michigan Practitioners Form (creating a contract right to indemnification for directors) (on file with author). A practitioner reports, however, that most companies do not have contracts with their directors. Telephone Interview with Cyril A. Moscow, Member, American Bar Association, Committee on Corporate Law (Mar. 15, 1999). Nonetheless, the statutory permission granted in corporate codes, such as in section 145(f) of the Delaware Code, enhance statutory permission for corporations to grant indemnification by

corporations have adopted the “contract-in-gross” offered by statutes that eliminate substantive director liabilities by excising those liabilities when drafting their corporate charters.³⁶ Further, state statutes have conformed indemnification provisions to provisions for the excision of liability,³⁷ which adds to the contract vision that the voluntary adjustment of risk is rational. These statutes infer a preference for liberalized indemnification rules from shareholders opting to limit substantive liability of directors.³⁸

Given the strong vision of contract that has developed in state statutes governing exoneration, contract logic should be the simple explanation of the form taken by rules of director liability. One may reject, however, this simple contract account because the statutes fall far short of imposing the contract solution that is truly efficient and, as a result, liability persists. In fact, the statutes have attempted to preserve a symbolic connection between the regime of director liability and other law functions. These functions include: (1) the preservation of remedies for legal wrongs; (2) the protection of decisional integrity in a socially significant organization, such as a corporation; (3) the insistence on the treatment of corporate directors as citizens subject to forms of rebuke and (financial) punishment for morally significant failures to discharge

obtaining enforceable contract rights and casts a “penumbra” of contract over indemnification. The existing contracts create a template for absorption into the general practice of providing contract-based protections. In addition, some authorities report that corporate adoption of individual contracts is common. *See* OLSON & HATCH, *supra* note 7, at 1-8 (stating that “[i]n recent years many corporations have supplemented the protection provided by corporate charter documents through the approval of individual indemnification contracts for officers and directors”).

³⁶ *See* ARIZ. REV. STAT. ANN. § 10-851(A)(2) (West 1996 & Supp. 1999); CONN. GEN. STAT. ANN. § 33-771(a) (West 1997 & Supp. 1999); NEB. REV. STAT. § 21-20.103(1)(b) (1997); REVISED MODEL BUS. CORP. ACT § 8.51(a)(2) (1998) (permitting a corporation to indemnify a director who engaged in conduct for which broader indemnification has been made permissible or obligatory under a provision of its articles of incorporation).

³⁷ *See* Kuykendall, *supra* note 3, at 409-501.

³⁸ *See* Kuykendall, *supra* note 3, at 489-502 (1998) (reviewing policy changes establishing and expanding exculpation of directors).

their duties; (4) the expressive function of legal decision-making prompted by claims of legal liability; and (5) the preservation, in form, of discursive open-mindedness within a closed culture of business persons and corporate counsel. A purely contract-based regime would minimize each of these functions as distortions of a contract resolution addressing the agency costs of director service because each of these functions relates to a non-contract vision of the corporation as a social entity with social goals transcending economically efficient monetary exchanges. Thus, the contract model alone cannot explain the nature of corporate indemnification statutes.

B. The Anti-Managerialist Model

Director exoneration statutes also contain aspects of an anti-managerialist³⁹ approach to corporate regulation and are easily interpreted as mainly regulatory. Given the combination of code leeway and the actual practices in corporations,⁴⁰ however, anti-managerialism is not a strong check on the granting of indemnification to corporate directors when the board is disposed to grant indemnification. Nonetheless, the effect of anti-managerialism should not be discounted. The effect of anti-managerialism on director exoneration statutes precludes the full incorporation of contract logic into the state corporate codes. The failure of state codes to adopt a default rule that requires maximum indemnification of directors who do not contract for that protection is a legislative choice with an impact.

³⁹ See Kuykendall, *supra* note 3, at 448 & n.7 (describing the judicial rejection of a director's claim to indemnification under an unqualified provision guaranteeing reimbursement, without reference to any standard of conduct, as a clear statement of the regulatory or anti-managerialist norm). See generally William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 NW. U. L. REV. 180 (1992) (referring to the anti-managerialist paradigm).

⁴⁰ See KNEPPER & BAILEY, *supra* note 16, at 673 (suggesting that many contracts, bylaws and charter provisions provide for indemnification "to the fullest extent permitted by law").

The structure of state corporate codes, by failing to establish greater statutory protection for directors who do not make contracts, creates an anti-managerialist result, and not just an open term to be filled in by courts. The state codes essentially create a default rule that is given content by the mandatory requirements of indemnification for directors who are successful in defending themselves in lawsuits⁴¹ and by the nonexclusivity provisions⁴² that invite directors to use “contract” as a device to obtain explicit protection. Indeed, it would be difficult for a director to argue for a non-contract based right to mandatory indemnification, where she did not qualify under the statute for mandatory indemnification. One could, however, conceive of a regime where the default rule was influenced by the general, pro-exoneration interpretive rules⁴³ that presume that directors have an implicit contract right to receive indemnification, unless the corporation can show its conduct fell outside the range of reasonable conduct for which reimbursement should be allowed. Yet, the pro-exoneration tilt of specific protections creates an adverse inference of non-entitlement without a contract or a court victory on the merits. Arguably, the resulting default rule—no right to indemnification without an express contract or success in litigation—requires an inefficient amount of contracting to achieve a contract solution that is most preferred by the parties—i.e., a presumption of indemnification. The existence of some risk not addressed in the contract between directors and corporations may bring an element of uncertainty into the mind of directors. In turn, this uncertainty may influence their decision-making for the corporation.

⁴¹ See, e.g., CAL. CORP. CODE § 317 (West 1990 & Supp. 1999); DEL. CODE ANN. tit. 8, § 145(c) (1991 & Supp. 1998); KAN. STAT. ANN. § 17-6305(c) (1995); MICH. COMP. LAWS ANN. § 450.1563 (West 1990) (requiring corporations to indemnify directors that have been successful on the merits for expenses actually and reasonably incurred in connection with their defense).

⁴² See DEL. CODE ANN. tit. 8, § 145(f) (1991 & Supp. 1998); N.Y. BUS. CORP. LAW § 721 (McKinney 1986 & Supp. 1999) (providing that indemnification provisions are not exclusive of other rights the director may be entitled to under any bylaw, agreement, vote of shareholders or otherwise).

⁴³ See Kuykendall, *supra* note 3, at 457 & n.32 (ascribing to the term “exoneration” a technical meaning at variance with indemnification or reimbursement).

The choice of which risks to contract away is driven by anti-managerialism. Anti-managerialism accounts for significant features of the typical state corporate code and for the overall structure of the exoneration rules. The features of anti-managerialism in the codes include: (1) the requirement of procedural safeguards in creating the decision-making group permitted to grant indemnification;⁴⁴ (2) the general preclusion of indemnification (even pursuant to court order) of certain payments, such as adverse final judgments⁴⁵ or derivative action settlements; (3) the retention of an inchoate policy limitation on indemnification of “bad” conduct, such as conduct not in good faith;⁴⁶ (4) the limitation of code-mandated indemnification to cases where the director prevails “on the merits or otherwise”;⁴⁷ and (5) the limitation of corporate

⁴⁴ Statutes frequently mandate that a determination as to indemnification must be made by one or a combination of the following: (1) a majority vote of directors who are not party to the suit; (2) a committee of directors designated by majority vote, even if less than a quorum; (3) independent legal counsel; or (4) the stockholders. *See* DEL. CODE ANN. tit. 8, § 145 (d)(1)-(4) (1991 & Supp. 1998); N.J. STAT. ANN. § 14A: 3-5(5) (West 1969 & Supp. 1999); TEX. BUS. CORP. ACT ANN. art. 2.02-1(E) (West Supp. 1998); REVISED MODEL BUS. CORP. ACT § 145(d) (1998).

⁴⁵ *See, e.g.*, DEL. CODE ANN. tit. 8, § 145(b) (1991 & Supp. 1998) (providing that indemnification is precluded unless there are surrounding circumstances that the court finds allow for indemnity upon application); N.Y. BUS. CORP. LAW § 721 (McKinney 1986 & Supp. 1999) (providing that indemnification is precluded if the judgment or other final adjudication establishes bad faith or acts that were the result of dishonesty and were material); TEX. BUS. CORP. ACT ANN. art. 2.02-1(J) (West 1998) (providing that indemnification is limited to reasonable expenses actually incurred in connection with the proceeding, if the person is found liable to the corporation or is found to have received a personal benefit).

⁴⁶ *See* DEL. CODE ANN. tit. 8, § 145(d) (1991 & Supp. 1998) (noting that indemnification shall be made only as authorized upon a determination that the person has met the applicable standards of conduct set forth). *See also* *Waltuch v. Conticommodity Serv., Inc.*, 88 F.3d 87, 89-90 (2d Cir. 1996) (interpreting the requirement that a director acted in good faith).

⁴⁷ *See, e.g.*, DEL. CODE ANN. tit. 8, § 145(c) (1991 & Supp. 1998) (requiring indemnification of a director to the extent successful in defending allegations of misconduct); TEX. BUS. CORP. ACT ANN. art. 2.02-1(H) (West Supp. 1998) (requiring indemnification of a director if she is wholly successful in defending against alleged misconduct).

authority to eliminate liability of directors for certain types of bad conduct.⁴⁸ A robust contract regime could function, and undoubtedly would function more efficiently, without the limitations on procedure and substance imposed by the codes and with the assistance of reliable contracts between directors and their corporations. Thus, anti-managerialism restrains the full blossoming of contract in the regime of director liability.

At the same time, the effects of anti-managerialism are limited. The extent of the authority granted in the Revised Model Business Corporation Act ("Model Act") to corporations to cancel liability with the consent of shareholders is substantial.⁴⁹ In the Model Act, the substantive standard of conduct for a director to be eligible for permissive indemnification is no longer tied to a requirement that the director was acting in the honest belief that his conduct was in the best interest of the corporation.⁵⁰ Proponents of shareholder protection, however, are concerned about code rules incorporated into charters by management that enable directors to force a corporation to finance the director's defense to a suit for misconduct filed by the corporation itself, even in circumstances that appear to involve financial high-handedness and personal enrichment.⁵¹ In fact, the effect of anti-managerialism on state

⁴⁸ See DEL. CODE ANN. tit. 8, § 145(d) (1991 & Supp. 1998) (providing indemnification only if a director meets the applicable standard of conduct); MICH. COMP. LAWS ANN. § 450.1562 (West 1990) (providing indemnification only if a director acted in good faith and reasonably believed those acts to be in the best interests of the corporation); TEX. BUS. CORP. ACT ANN. art. 2.02-1(E) (West Supp. 1998) (providing that indemnification shall not be made if a director has been found liable for willful or intentional misconduct in performance of her duty to the corporation). See also REVISED MODEL BUS. CORP. ACT § 8.51(d) (1998) (providing that a corporation may indemnify a director for reasonable expenses incurred in connection with the proceeding, if it is determined that the director has met the relevant standard of conduct).

⁴⁹ See Eisenberg, *supra* note 1, at 1267 (discussing that despite exceptions to their coverage typified by the Delaware statute, the result of the Model Act and shield statutes is to drastically reduce the threat of liability for directors).

⁵⁰ REVISED MODEL BUS. CORP. ACT § 8.51(a)(2) (1998).

⁵¹ See Diane H. Mazur, *Indemnification of Directors in Actions Brought Directly by the Corporation: Must the Corporation Finance its Opponent's Defense?*, 19 J. CORP. L. 201, 204 (1994) (describing New Mexico statutory law, which allows a corporation to pay the director's attorney fees as they are

codes does not have sufficient bite to preclude payments to directors in circumstances that *pure* anti-managerialism would oppose. Indeed, the dream of a purely anti-managerialist approach would be to subject all indemnification decisions to outside review on the grounds that they all are suspect as inside arrangements among cronies.⁵² Yet, most indemnification payments are not contested and are made voluntarily without review by corporate boards. Thus, the fact that indemnification decisions are not monitored, even in the face of the contention by the Committee on Corporate Laws of the American Bar Association that indemnification is a critically important corporate function,⁵³ is a shortfall of the regulatory, anti-managerialist regime and a basis for rejecting anti-managerialism as a strong justification for the regime of liability.

III. CONSIDERING THE MISHMASH

Clearly, the director exoneration statutes retain vestiges of earlier conceptions of the corporation⁵⁴ by requiring positive state specification of process ground rules and by diminishing limits on the corporation's power to indemnify.⁵⁵ Yet, there is a rhetorical mishmash that has produced a substantial liberalization of these

incurred rather than wait until good faith has been demonstrated, and thus, permitting the corporation to bind itself to pay).

⁵² See Cheek, *supra* note 16, at 281 (proposing that a liberal standard for indemnification in derivative suits be used, but the determination be placed in the hands of the judiciary).

⁵³ Committee on Corporate Laws, *Changes in the Model Business Corporation Act—Amendments Pertaining to Indemnification and Advance of Expenses*, 49 BUS. LAW. 741, 749 (1995). See also REVISED MODEL BUS. CORP. ACT § 8.50 introductory cmt. 1 (1998) (stating that “[i]ndemnification (including advance for expenses) provides financial protection by the corporation for its directors against exposure to expenses and liabilities that may be incurred by them in connection with legal proceedings based on an alleged breach of duty in their service to or on behalf of the corporation”).

⁵⁴ See WASHINGTON & BISHOP, *supra* note 2, at 99-100 (setting out the idea of neutral process as a path to reimbursement).

⁵⁵ See Kuykendall, *supra* note 3, at 553-58 (describing how the Model Act's indemnification provisions water down the standards of conduct directors must meet to receive indemnification).

director exoneration statutes even in the face of an overly elaborate and fading regulatory scheme. Seeking alternative explanations for the mixed form of director exoneration statutes requires decisions about the level of theory and the type of evidence to be given emphasis. One can focus on the groups that participate in the making of the policy,⁵⁶ the logical flaws and lack of substantial regulatory purpose in the statutes⁵⁷ and the persuasiveness of the public policy reason advanced in the course of relaxing director liability.⁵⁸ Alternatively, one can focus on the distinct social product that corporate practices and forms constitute, which manifests itself in statutory corporate “mythology.” Either of these focuses, however, directs attention away from the concern of contract law and theory—i.e., the manner in which the law captures efficient solutions to the making and enforcement of bargains.

A. *Analysis of the Contract Model*

In corporate law, the contract model has been absorbed gradually into director exoneration statutes as courts and scholars have come to recognize both that a corporation involves a set of contracts⁵⁹ and that a corporation should not be sheltered from the making and enforcement of contracts among the participants.⁶⁰

⁵⁶ See James J. Hanks, Jr. & Larry P. Scriggins, *Let Stockholders Decide: The Origins of the Maryland Director and Officer Liability Statute of 1988*, 18 U. BALT. L. REV. 235, 242-45 (1989) (describing the business pressure to liberalize Maryland’s indemnification statute as applied by various groups).

⁵⁷ John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 930 (1988) [hereinafter Coffee, *Opting Out*] (referring to the extent of exculpation as being intellectually dishonest because it exceeds its purported premise).

⁵⁸ See generally Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985) [hereinafter Brudney, *Corporate Governance*] (arguing that the contract rationale is unconvincing).

⁵⁹ See EASTERBROOK & FISCHEL, *supra* note 24, at 8-11 (setting out the “nexus-of-contract” theory of corporations).

⁶⁰ See Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 301 (1986) (arguing that close corporation investors’ contracts should be enforced). See also ALA. CODE § 10-2A-307 (1999); DEL. CODE ANN. tit. 8, § 350 (1991) (providing that a written agreement among a majority of stockholders is valid notwithstanding the fact that it may

Courts and scholars also have recognized that formalistic decision-making about the corporation overlooks the reality that the participants strike business arrangements that constitute forms of bargaining from which all benefit.⁶¹

If one takes the contract model seriously and applies it to the form of the rules governing director liability, the retention of an institutional format that appears half-hearted at regulating director misconduct might be seen as a solution to recurring contract failures made possible by the corporate form and related remedial premises. This solution may serve the need of the corporate board of directors for greater protection from the opportunistic behavior of plaintiffs' counsel in shareholder derivative actions.

Some portions of the institutional format of the corporation might be explained as just a response to a systemic contract failure in corporate law. This is because the structure of corporate remedies permits rogue shareholders to try to evade the contract between shareholders and management that is intended to give management freedom to manage.⁶² Standard corporate doctrines of director liability threaten the ability of the board to act with any assurance that a price, in terms of opportunistic litigation, will not be extracted and that inefficiencies as well as personal inconvenience and unfair reputational damage will not result.⁶³ Thus, a

restrict or interfere with the discretion of the board of directors).

⁶¹ See Easterbrook & Fischel, *supra* note 60, at 301. See also REVISED MODEL BUS. CORP. ACT § 7.32 & official cmt. (1998) (authorizing shareholder agreements and listing requirements that must be met by such agreements).

⁶² Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 271-74 (1986) (indicating problems with shareholder enforcement of corporate remedies).

⁶³ The reputational element in directors' overall concern with liability is discussed by Professor Rock, who suggests judicial opinions can have the effect of shaming directors. Rock, *supra* note 5, at 1100. Thus, indemnification formats that not only provide financial relief, but also avert highly visible examinations of behavior that directors believe is not deserving of critical scrutiny, with an implicit agenda of moral blame assignment, may serve the director's interest in avoiding the creation or intensification of unfair losses of both tangible and intangible kinds. Indeed, protective provisions that require court scrutiny to afford financial relief are not especially desirable from the point of view of directors concerned with reputational harm. See, e.g., CAL. CORP. CODE § 2202

corporate code provision with a provenance that at one time sought to balance the regulatory concerns of safeguarding the corporate treasury and enhancing the integrity of decision-making against the business needs for corporations to indemnify⁶⁴ their directors is now better explained as serving the perceived need of a board of directors for protection when it makes decisions in the honest exercise of business judgment.

The forms of procedural integrity are needed to protect directors, not to protect the corporate fisc. Even if the statute could be insincere, the reason is benign, in that efficient decisions need to be wrapped in the comforting form of procedural regularity that confirms the existence of, rather than produces, sound outcomes. The function is one of signaling reassurance to shareholders⁶⁵ and collaterally giving directors the confidence to act as the indemnifying group.

The hypothetical or implicit contract with shareholders might be seen as having a systemic defect that can be addressed with statutory magic. That is, if indemnification decisions are likely to attract lawsuits, the state corporate code can provide structural safeguards for the efficient operation of ordinary contract arrangements, both the specific contracts extending indemnification to directors and the contract-in-gross with the shareholders that places indemnification in the hands of directors. Therefore, contractarian analysis might provide a perspective that addresses the specific institutional format of director exoneration.

The primary puzzle under the contract model is not why the corporate contract tolerates procedural brakes on the operation of contract arrangements, and thus, on the fulfillment of contract expectations, but why the default rule is one of no-indemnification

(West 1990) (stating that “[t]he court in which an action for any such penalty is brought may reduce, remit or suspend the penalty on such terms and conditions as it may deem reasonable when it is made to appear that the neglect, failure or refusal was inadvertent or excusable”).

⁶⁴ See Kuykendall, *supra* note 3, at 484-89 (describing the regulatory balance of the former status quo of indemnification rules).

⁶⁵ See Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1569 (1989) (suggesting that state action can signal shareholders that a corporate term is credible).

in the absence of express contract.⁶⁶ If cancellation of liability is on the whole efficient, boards should be allowed to proceed with discretion, while protected by the cancellation of all liability predicated on wrongful grants of indemnification. While procedural window-dressing may not present serious objections to a contract explanation of director exoneration statutes, an inefficient default rule does present an objection, in that it exposes some directors to primary liability and to liability for administering the contract regime.

One might issue a challenge to public policy-makers to complete the contract project by enacting fully contractual exoneration provisions that enhance shareholder choice through charter provisions that scrap, as obsolete, the principal forms of state mandated constraints on director financial protection and instead remit the parties to substantive limits on contract terms.⁶⁷ If contrasted with a robust policy of indemnification by contract, the persistence of a vestige of process regulation in an essentially post-regulatory regime of director financial liability, even if possible to reconcile contractual indemnification, is not a feature of contract logic. Retaining the forms of process integrity in a regime that emphasizes mutually reinforcing notions of the contract freedom of shareholders and the contract nature of indemnification simply is not necessary.

Assuming that corporate counsel has advocated the “dabs of contract logic” that largely govern the law of director liability in order to serve intellectual honesty and corporate efficiency, any hesitation to put forth a fully realized model of contract does not make sense. This is because a contract model that depends upon the ordinary rules of contract enforcement and the pressures created by the corporate context to justify dispersals of corporate funds under contract agreements best explains the evolution and liberalization of director exoneration statutes.

⁶⁶ See Kuykendall, *supra* note 3, at 454 (describing the acceptance of the argument that directors’ exposure to liability is a problem).

⁶⁷ See Kuykendall, *supra* note 3, at 520-21 (arguing for the elimination of “statutory relics” because elaborate regulations, such as those governing the mechanics of process integrity, do not enhance corporate legitimacy).

In fact, the form of process integrity contained in these statutes may be a defense—both legal and psychological—to allow dispersal of funds by corporate boards to their members without the public responsibility of plenary board action. It may be easier to dispense largesse if one can point to a body nominally charged with husbandry that, in fact, has little choice but to shell out dollars. The form of corporate process integrity in a contract regime may be mainly a *cordon sanitaire* between the board and the defendant directors. Indeed, process integrity may be the investors' spurious savior, or may represent another corporate Potemkin village.⁶⁸

Even if directors benefit from combining contractual resolutions with the vestiges of process integrity remaining in director exoneration statutes, it is not completely accurate to assert that the regime of director liability is a manifestation of contract logic. Rather, it is an expression of attenuated contract and institutional form. Both the anti-managerialist model, which focuses on regulation, and the contract model present anomalies that call for further policy-sensitive, theoretical inquiry about director liability.

B. Potential Modifications in the Defense of the Contract Model

In considering improvements to the form of the rules for director liability, one must examine the intellectual aspiration of the contract theory to provide general insight into the forms corporate law may take, and not merely in justifying specific outcomes.⁶⁹ Indeed, features of contract law might operate efficiently in the area of director liability if set free to do so. Nonetheless, specific failures of a contract regime in the context of director liability must be addressed and the significance of the fact that the contract

⁶⁸ See Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 658-59 (1982) (treating independent directors as a weak substitute for regulation).

⁶⁹ There is disagreement about the extent to which the contract theory has held together as an explanation for the positive law. See Bratton, *supra* note 39, at 191-98 (arguing that contract conception cannot explain different aspects of corporate form).

model provides a poor explanation for the existence of specific rules of director liability must be explained.

While indemnification policy alone may not provide a sufficient basis for choices among alternative theories that purport to provide coherent accounts of the entire body of corporate law, it is a crucial area in which general corporate themes of fiduciary obligation, corporate purpose and modes of accountability converge.⁷⁰ Indeed, the topic, treated as one of complexity and importance by code-writers,⁷¹ demands consideration of conceptual fundamentals for purposes of policy enhancement.

In this regard, the contract model strives to account for the positive law of the corporation.⁷² If it works as an account of corporate law, it will be the "best fit" for the form that the statutory and common law should take. The premise of contractarian theory is that the form of corporate governance law is rational, coherent and utilitarian.⁷³ While various non-conforming phenomena have been accorded explanations as exceptions to the general picture of contractarianism,⁷⁴ these phenomena also have been described as threatening the coherence of the claim that contractarianism offers a comprehensive account of the positive law.⁷⁵

The contract model can offer a degree of explanation, but the form tends to explain by explaining away. Procedural protection provides the opposite of the contract model's apparent functional rationale. The default rule does not match the contracts-in-fact that are made when the corporation and the director negotiate to reach advance agreement. Many directors are subject to a default rule—i.e., exposure to unreimbursed expense—that contract proponents insist is not an efficient result that would arise in

⁷⁰ See Kuykendall, *supra* note 3, at 481-89 (explaining the factors involved in corporate indemnification).

⁷¹ See Committee on Corporate Laws, *supra* note 53, at 749 (describing the provisions for indemnification as complex and important).

⁷² Bratton, *supra* note 39, at 188.

⁷³ EASTERBROOK & FISCHEL, *supra* note 24, at 6-7 (describing the incentives for corporations to adopt profit-maximizing governance structures).

⁷⁴ See, e.g., EASTERBROOK & FISCHEL, *supra* note 24, at 25-34 (discussing the problems caused by inefficient and latecomer terms).

⁷⁵ See, e.g., Bratton, *supra* note 39, at 196 (treating takeover defenses as demonstrating contract failure).

bargaining that was unimpeded by transaction costs. Thus, the positive law fails to respect and incorporate the observable contracting behavior of the parties. Corporate law makes a half-hearted acceptance of contract rationales by permitting substantial contracting to occur at both the corporate level of *en masse* exoneration and at the individual level of contract, while failing to impose the putatively contractarian result on corporations as a default norm vis-a-vis their directors. Therefore, the positive law displays a critical loss of nerve in the degree of its incorporation of contract logic in the indemnification regime.

Nonetheless, there are several salient intellectual alternatives to explain the current statutory regime in contract terms, even given non-contract patterns of corporate law and culture. These include: (1) insistence upon the presence of deep contract realities in the practice of indemnification and, thus, in the corporate legal culture; (2) revision of the contract model; and (3) purification of the underlying statutory data by infusing it with greater contract clarity. The first and second alternatives are discussed in this Part, while the third alternative is discussed in the general discussion of policy alternatives in Part V.

1. The Insistence upon Contract Realities

With regard to finding contract realities, one might point out that the resistance to unconstrained director exoneration is observed in the occasional resistance to full enforcement of a contract right by corporate management⁷⁶ based on a current view of corporate interests. While process integrity exists in the state director exoneration statutes, it is not the source of denials of indemnification.⁷⁷ Rather, ordinary principles of contract that allow a party to a contract to argue against its enforceability on the basis that it

⁷⁶ See, e.g., *Waltuch v. Conticommodity Serv., Inc.*, 88 F.3d 87, 95 (2d Cir. 1996) (denying relief to a corporate employee who was denied indemnification for legal expenses incurred in defending against litigation that arose from his alleged misconduct in his capacity as an employee).

⁷⁷ See *id.* at 94-95 (explaining that the usual reason for denying indemnification is a change in control of the corporation).

violates either some specific principle⁷⁸ or a public policy relating to the subject matter at hand account for denials of indemnification.⁷⁹ Retaining the public policy exception to the enforceability of contracts is consistent with basic contract principles, and is not an unusual limitation on contracting.⁸⁰ Resistance to contract enforcement comes about in the course of the unfolding of the many untold stories of shifting alliances, personal reactions to undue greed, or other serendipitous forces.⁸¹ Thus, such resistance that arises is not a regulatory product but the same phenomenon that drives any effort to disavow or dispute a contract—i.e., a change in assumptions about the relationship governed by the contract,⁸² opportunistic resort to contract doctrines that might

⁷⁸ A flat promise to reimburse for penalties imposed for theft may be deemed unenforceable even under ordinary rules of contract. *See* E. ALLAN FARNSWORTH, *CONTRACTS* § 5.1, at 346 (2d ed. 1990) (discussing public policy as grounds for unenforceability). On the other hand, where the board of directors chooses to reimburse for overreaching by directors, there is no ready armory of legal principles or remedial structure that would routinely defeat the choice. Courts have traditionally decided against creating limits on board action in dispensing corporate funds to insiders or for questionable corporate benefit. *See, e.g.*, *International Ins. Co. v. Johns*, 874 F.2d 1447, 1471 (11th Cir. 1989) (failing to impose limitations on compensation of managers and directors); *Mooney v. Willys-Overland Motors, Inc.*, 204 F.2d 888, 897 (3d Cir. 1953) (failing to impose limitations on corporate charitable gifts); *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 128 N.E.2d 291, 293 (N.Y. 1995) (failing to impose limitations on the expenses of corporate proxy fights). Doctrines of corporate waste, although given lip service, have little genuine bite in corporate controversies. The practical effect of prohibitions on indemnification have always been weak because there is no one available as an adverse party when indemnification decisions are made under most corporate structures. *See supra* text accompanying notes 49-53 (discussing the lack of conduct-based limitations on the indemnification of directors by corporations).

⁷⁹ *See* FARNSWORTH, *supra* note 78, § 5.1, at 346 (explaining that contracts may be unenforceable on the grounds of public policy).

⁸⁰ FARNSWORTH, *supra* note 78, § 5.1, at 346.

⁸¹ *See* Kuykendall, *Comment on Kostant*, *supra* note 13 (arguing that narrative strategies are useful to enrich corporate law).

⁸² *See, e.g., Waltuch*, 88 F.3d at 94-95 (explaining that the usual reason for denying indemnification is a change in control of the corporation).

allow one relief from inconvenient contract terms,⁸³ or a principled objection to enforcement of unconscionable terms.⁸⁴

The fact that resistance to contract enforcement is not a product of regulation has several implications. First, a feature of the anti-managerialist component of indemnification rules is consistent with contract and, thus, need not be viewed as an anomaly. Second, the contract regime should be freed of an inchoate idea of a policy limitation on contracts and remitted to the usual ground rules in contract. A rigorous articulation of the corporate contract model seemingly would argue that there should be sufficient protection through the use of ordinary contract terms that incorporate rules of limited enforceability of invalid contract terms, the availability of policing as a by-product of the standard motivations that arise when contract terms are abused and the shortfalls the market will detect if bad behavior is rewarded in any given corporation to a sufficient extent to affect its market value.⁸⁵ The regulatory feature of the statutes may be dismissed as relatively unimportant formats or rituals that are either at base consistent with contract or harmless. While contractarianism celebrates the investor's capacity to render the opaque transparent and to absorb information and price un sentimentally,⁸⁶ the contract view of the corporate code can shrug off low-cost bells and whistles.

The contract model in its pristine form posits a single explanatory heuristic for corporate law: in a word, contract. The leading expositors of the contract model explicitly downgrade the relevance of the manifestation of the corporation as an institution.⁸⁷ The fact that the institutional form of the corporation creates no results

⁸³ See, e.g., *Manson v. Curtis*, 119 N.E. 559, 562-63 (1918) (illustrating opportunistic use of corporate doctrine to overcome a contract).

⁸⁴ See generally Mazur, *supra* note 51 (describing action against directors brought directly by corporations).

⁸⁵ See EASTERBROOK & FISCHER, *supra* note 24, at 6 (describing market costs of poor governance terms).

⁸⁶ See, e.g., EASTERBROOK & FISCHER, *supra* note 24, at 97 (stating that "[m]anagers of public corporations face a potent information market").

⁸⁷ See EASTERBROOK & FISCHER, *supra* note 24, at 10-12 (arguing that the corporation is a financing device and not otherwise distinctive and emphasizing that the status of a corporation as an entity is not significant).

independent of the implications of a clustering of transactions in a longitudinally extended set of agreements⁸⁸ is what matters. The contract model creates no characteristic set of scholarly questions implicated by institutional logic. Thus, the concessions that the contract model makes to non-conforming data need to be little more than *ad hoc* exceptions to the full explanatory power of contract. Indeed, these concessions can be seen as part of the contract view of the world, in that they are standard and general qualifications of the reach of voluntary solutions.⁸⁹ These concessions are not created by any unified explanation relating to the corporate form, but are formed through the working out of contract logic. The extent of the exceptions has nonetheless given critics an opening to minimize the overall explanatory power of the contract model. It has been suggested that the exceptions tell more of the story than does the core thesis.⁹⁰

2. *The Revision of the Contract Model*

Whatever the resolution of the assault on the intellectual substance of the contract model, the revision of the contract model presents itself in the indemnification example. There is a distinctive line of critique and defense. The critique is that, given its relative indifference to institutional detail, the contract model does not account especially well for institutional dynamics that create unusual institutional results in which contractarianism entertains little interest. Another critique of the contract model is that it lacks descriptive validity, in that overt contracting between management and shareholders has not been shown. The answer posited is that the contract theory of corporate law does not purport to describe concrete social settings.⁹¹ This is a response to the critique of

⁸⁸ See, e.g., EASTERBROOK & FISCHER, *supra* note 24, at 8-15 (emphasizing the longitudinal nature of corporate contracts).

⁸⁹ See EASTERBROOK & FISCHER, *supra* note 24, at 25-34 (discussing inefficient terms).

⁹⁰ See, e.g., Bratton, *supra* note 39, at 180-84 (describing the emphasis on contract that emerged in the 1980s, supplanting the anti-managerial paradigm).

⁹¹ Steven M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL

thinness—i.e., that the contractarian claim is so abstract as to disdain particulars that fail to nourish. This response is a blithe affirmation of the simplifying role of theory.⁹² The idea is that the theory, so long as it explains the primary phenomenon, does its job.

The critique of the contract model relating to a gap in its theoretical account of institutional logic and form, however, is more overtly concerned with a body of observations that appear to arise from the institutional setting that has been dismissed by contractarianism, and that might benefit from a theoretical framework, not just rationalizations of the limited concern of contract explanations. This critique is an overt challenge to the explanatory mission of contractarianism, where the thing to be explained has been unduly truncated. That is, the persistence of institutional forms that appear irrelevant under contract principles seems to call for a branch of the contract theory with an institutional mission. Contractarianism has addressed anomalous outcomes, such as the failure of the market for corporate control,⁹³ but has failed to explain the form taken by the corporation as an institution. While the proponents of the contract model might dismiss the details of institutional design⁹⁴ as unduly particular and of limited importance to the explanatory genius of their construct, it seems fair to comment that contractarianism does not account for the cultural manifestation in the world of the corporate construct. The contract model also does not account for: (1) the elements of law that set out the general outlines of the cultural phenomenon; (2) the format of corporate “folkways”;⁹⁵ and (3) the vocabulary in which

L. REV. 856, 883 (1997).

⁹² *Id.*

⁹³ See, e.g., Gregg A. Jarrell et al., *Market for Corporate Control: Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49, 64 (1988) (suggesting poison pills have a negative effect on stock prices).

⁹⁴ See generally Edward L. Rubin, *The New Legal Process, The Synthesis of Discourse, and the Microanalysis of Institutions*, 109 HARV. L. REV. 1393 (1996) (suggesting that a microanalysis of institutions will yield insights that expand the scope of economic inquiry). Rubin, however, treats law and economics as a potential source of an institutional focus.

⁹⁵ See John C. Coffee, Jr., *The Folklore of Investor Capitalism*, 95 MICH. L. REV. 1970, 1970 (1997) (suggesting that business community ideology, which contains non-economic factors, is overlooked by law and economics).

the corporation is situated. At a minimum, it seems fair to ask of contractarianism that it give a further explanation of the form of its bracketing of institutional specifics, at a level of theory, that accounts for the array of phenomena for which other explanations are demanded, the theoretical weight of the material bracketed and the types of theoretical level accounts that might be relevant to the contract theory.

One option for the proponent of the contract model may be to dismiss, as trivial, great swaths of corporate law and culture, which is an alternative not entirely out of sync with the tenor of other scholarship⁹⁶ and other views of the contemporary culture.⁹⁷ The argument, however, must be not that there is no set of observations that cluster around a set of practices that arise from institutional dynamics, but rather that they are quite explicitly unimportant even though much energy is expended on maintaining and rationalizing them. Indeed, the contractarian might argue that institutional practices are a fit subject for cultural studies, but not the concern of business law.

⁹⁶ See generally Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (positing a “triviality hypothesis” regarding state corporate law—i.e., all corporate law is trivial and allows corporations to set any form of governance rules).

⁹⁷ Post-modern approaches to forms of social expression are in some instances agnostic about the significance of any particular set of practices in terms of the discursive role that they play. Indeed, interpretations of popular culture go so far as to suggest that forms of entertainment have to a degree supplanted reality where “life [itself has become] the new fountainhead of images, narratives, stars and themes.” See NEAL GABLER, *LIFE THE MOVIE: HOW ENTERTAINMENT CONQUERED REALITY* 58 (1998). The idea that there are forums, both in the courts and within the corporation, where narratives of moral significance are produced and heard, may be itself primarily an image or a narrative of narrativity in which the narratives are not required, but only the celebration of their existence. Law and economics in corporate law may not be prepared to do much more than shrug off the phenomena of statutes serving as what one might call “echo narratives” because its ultimate subject is money, a matter that transcends the ephemera of texts that constitute a sort of movie of corporate life.

IV. CONSIDERING OTHER THEORETICAL ACCOUNTS OF THE APPARENT ANOMALIES OF DIRECTOR LIABILITY RULES

Other theoretical possibilities present themselves to account for the form that director liability in the form of both statutes and practice assumes. For instance, it is possible that corporate counsel preserve a regulatory form as a means to capture rents. A second analysis, linked to the team production model, focuses on the evolving role of the corporate board and its possible need both for a cushion from retaliation by the disparate interests within the corporation when it mediates and for the benefit to board decision making of corporate bodies with a mission of assessment and evaluation. Along similar lines but couched in terms of literary analysis and public relations theory, it is possible that the contentless form impounds aspiration to self-critique characteristic of complex contemporary organizations and is, thus, a useful form of organizational make-believe. Finally, and more ominously, one might consider that the law of director liability belongs in a post-modern world of discontinuities, discursive containment strategies and legal ornamentation demanded in a post-regulatory corporate code.

A. *The Rent-Seeking Model*

Focusing on the process of policy-making leads one to consider whether the trend in director exoneration statutes is best accounted for by a rent-seeking model⁹⁸ of corporate policy-making, which maintains a concern for the appearance of regulating director misconduct. The regulatory form of the statutes might be seen as a smokescreen to cover indifference on the part of corporate counsel to self-serving or excessive indemnification awards. The narrowly conceived self-interest of corporate lawyers is perhaps served by combining several interests. These include: (1) protection of their managerial clients through the enactment of favorable

⁹⁸ See BUTLER, *supra* note 8, at 107 (discussing rent-seeking).

legislation;⁹⁹ (2) protection of their own interest by perfecting the contract model used in actual practice by enacting “belt and suspenders” provisions in the corporate code that avert nasty surprises when contracts are not effective in protecting directors’ rights;¹⁰⁰ (3) generous provision for advance of expenses that pay legal fees and preserve client nerves; (4) acceptance of a default rule that requires explicit contracts for assurance of protection; (5) maintenance of a facade of procedural integrity that avoids full acknowledgment that the hypothetical contract freedom of shareholders has been exercised to eliminate most exposure of directors to scrutiny related to corporate liability-based standards of conduct; and (6) use of that facade of integrity as a mechanism to give board members reassurance that indemnification can be made legally and with protection from secondary lawsuits charging wrongful indemnification.¹⁰¹

⁹⁹ See generally MARK ROE, *STRONG MANAGERS, WEAK OWNERS: POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994) (discussing path dependency and the culture of legislation).

¹⁰⁰ A good example of a “belt and suspenders” provision that protects corporate counsel as well as corporate clients is the broadening of the meaning of indemnification in statutes that bless contract promises to indemnify. In response to a Delaware case that construed a promise of indemnification not to include advance of expenses, statutes have been revised to include the advance of expenses within the term indemnification for purposes of contract promises. See *supra* Part II.A, discussing gap-filling code provisions to protect directors from narrow interpretations of nebulous code provisions.

¹⁰¹ “The[] [boards] want to . . . [give indemnification] legally and make it the business judgment rule.” Telephone Interview with Cyril A. Moscow, Member, American Bar Association Committee on Corporate Law (Mar. 15, 1999). See also Eisenberg, *supra* note 1, at 1278-80 (describing the evolution of the corporate governance model toward a process-based monitoring model that the Delaware courts respect). One is struck most strongly, in considering the indemnification example, that procedural protections perform distinctly different functions for the court as opposed to the corporate managers and directors—i.e., the statutes that offer reassurance to judges of regularity and integrity also offer *pro forma* rituals of affirmance to inside corporate interests that in many instances (but not always) serve to protect directors from liability for good corporate decisions. But, the indemnification example seems the most veiled about its dual regulatory and ritualized purpose, because it is couched in a statute that purports to set outside substantive limits on the transaction subjected to procedural safeguards. The proceduralism impounds an expectation of analytic

Thus, the telltale sign of rent-seeking behavior would be the imposition of non-market solutions that restrict market logic from operating and that divert resources to those benefitting from the availability of rents. The form that rents appear to take in the

rigor and balance and a theory of substantive regulation, but ultimately it is widely understood as a means of accomplishing an assumed goal—indemnification—while giving protective coloring to the board. *See* Kuykendall, *supra* note 3, at 457 & n.32 (coining the phrase “exoneration canon” for the loose set of statutory and case law doctrines that point toward the award of financial protection to directors).

In contrast, the “conflict-of-interest” statutes, or “interested-director” statutes, impound no regulatory theory at all, leaving the matter of limits entirely to boards and courts. *See* WILLIAM L. CARY & MELVIN ARON EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* 684-88 (7th ed. 1995). These statutes are not necessarily understood as a facilitative means of blessing foregone conclusions. The openness of the question leaves room for expressive development of a theory of director interest and corporate structures of decision-making, whereas the indemnification regime tends to choke-off the articulation of a normative regime of indemnification and does not invite court scrutiny of corporate internal logic. *See* Kuykendall, *supra* note 3, at 510 (discussing the shift of practical authority to render adjudicative judgments from the courts to the corporation).

The indemnification example and the curious contradiction in purpose, or the process nominally framed to produce expressive efforts at self-scrutiny comparable to what a court might produce harnessed to a set of standards intended to produce an entitlement to exoneration in most cases, creates a deficient outcome. Kuykendall, *supra* note 3, at 510-12. This outcome is devoid of the type of effect on belief-systems that Professor Eisenberg has described as one of the key products of the system of corporate law and social norms. Eisenberg, *supra* note 1, at 1291. The indemnification culture in corporate law is dominated by a concern with financial outcomes and is increasingly disjoined from the aspirational or expressive function of corporate law. Indeed, it may be argued that it is worse than disjoined. Rather, the indemnification culture produces a regime of counterproductive discourse that rejects the expressive content of the system of corporate adjudication. *See* Kuykendall, *supra* note 3, at 507-12, 538-43, 570-77 (discussing the new standard of indemnification as an efficient avoidance of liability for corporate directors). The optimism of Professor Eisenberg’s portrait of self-enforcing social norms is reliant, to some extent, on the still somewhat robust regime of corporate liability in Delaware, which has not adopted the extent of exoneration of the Model Act, and to some extent on a notion that social norms, once implanted, can survive without the same mechanisms of expression that liability helps to generate.

regime of director liability is the demand for legal services created by a regulatory format—i.e., lawyers collect fees for a result that could be achieved far more directly¹⁰² and without the collection of rents by lawyers. The failure to mandate indemnification for persons discharging a socially necessary function in complex organizations benefits the corporate lawyers more than anyone else. An approach that requires an inefficient amount of private contracting for directors to be guaranteed protection and that requires procedures that empower lawyers to give specific grants of indemnification under generous permissions for corporate payments fails to extend directors the sufficient amount of protection and fails to guard the corporate fisc by adding to the fees of lawyers. The lawyers who write the law and superintend the rhetoric for director liability are the obvious principals in a rent-seeking model of director liability. The directors are just the source of a transactional cost opportunity. Directors are not the rent-seeking principals in the policy-making world of corporate law. Rent-seeking by corporate lawyers offers a robust explanation for the rationale underlying the half-hearted adoption of contract principles in a regulatory format. Arguably, it fits the data better than either the contract or anti-managerialist theories. The policy-making seems not to arise from a disinterested consideration of all the competing interests, but rather tends to serve narrow interests of various kinds.¹⁰³

¹⁰² See Kuykendall, *supra* note 3, at 520 (suggesting a direct route to protect directors from liability).

¹⁰³ In a prior article, I described the triumph of exoneration principles in the Model Act as “corrupting indemnification.” See generally Kuykendall, *supra* note 3. The reference to corrupting indemnification may have been mildly tendentious. The term, however, is not all oratory. It also describes, in a neutral fashion, a degeneration of the logic of the indemnification statutes from a matching of form (process integrity) and function (application of limits derived from aspirational norms) to a disjunction of form (process integrity) and function (protection of contract entitlement to indemnification and assurance of director protection from liability). The general conceptual understanding of the indemnification function has shifted away from that of a procedural format in which to express and guard norms to a line of defense against director liability on a par with exculpation and insurance. See Kuykendall, *supra* note 3, at 538-43 (arguing that the abolition of director liability lends itself to a sacrifice of the principle of accountability).

The problem with a rent-seeking explanation, however, is that the genius of human efforts embedded in social collaborations is not considered.¹⁰⁴ This skepticism about human motives overlooks the possibility that a complex arrangement may reflect a messy and partly successful effort to incorporate the result of human invention and culture—i.e., contract efficiency, or some other human artifact that serves general purposes.

B. *The Team Production Model*

A possible alternative explanation for the evolution of director exoneration statutes to a pre-regulatory and post-regulatory state of supervisory indecision might be the pressures on corporate counsel associated with the “team production” model of the corporate board of directors recently proposed by Professors Stout and Blair¹⁰⁵ and expanded by Professor Kostant by bringing attention to the role of corporate counsel.¹⁰⁶ The team production model posits that the board of directors functions as an arbitrator among the members of a corporate team tied to the corporation by the investments they have made that cannot be readily withdrawn.¹⁰⁷ Professor Kostant’s work adds to that vision by proffering practical questions about the role of corporate counsel in providing the information and intermediation needed for the board to do its work of reconciling the demands of the corporate team members.¹⁰⁸ While significant issues arise concerning the viability of the team production model, given the fact that corporate lawyers are

¹⁰⁴ See generally James Boyd White, *Economics and Law: Two Cultures in Tension*, 54 TENN. L. REV. 161 (1987) (questioning the imposition of the language of economics on cultural patterns).

¹⁰⁵ See generally Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) [hereinafter Blair & Stout, *Team Production*] (discussing the team production model).

¹⁰⁶ Peter C. Kostant, *Exit, Voice and Loyalty in the Course of Corporate Governance and Counsel’s Changing Role*, 28 J. SOCIO-ECONOMICS (forthcoming 2000) (on file with author).

¹⁰⁷ See Blair & Stout, *Team Production*, *supra* note 105, at 249-50 (discussing an alternative approach to the prevailing principal-agent model of the public corporation).

¹⁰⁸ Kostant, *supra* note 106.

themselves rational maximizers with goals independent of team members, this model carries with it possible explanatory power for the vexing form taken by the director exoneration statutes.

The statutes might be explained as the result of efforts by the corporate bar to remove the onus of financial liability from directors, whose tasks have evolved in a direction that partially resembles statecraft, while retaining formats that utilize mediating bodies with potential for assessment and evaluation of board performance. The vestige of regulation, tied to financial exposure in director exoneration statutes, might not be matched well to the role that a board, capable of disinterested adjudication, has played in *post-hoc* assessments of director performance. For example, the regulation in director exoneration statutes is not explained well by the board's role in contested corporate transactions where the board appears to defy shareholder preferences, nor is it explained well by shareholder wealth-maximizing principles. The reasons underlying the regulation, however, may be captured to some extent by the team production model. As the extent of exculpation and the enforceability of contract indemnification promises increases, the likelihood that a statutorily specified group would negatively scrutinize board conduct in a contested transaction decreases. This is best explained by the fact that the statutorily specified group has a small role to play given the greater capacity of a director to claim a status of entitlement to indemnification.¹⁰⁹ An expanded claim of entitlement displaces a process of respectful petition for the exercise of judgment by the specified group that must determine whether a director's conduct rises to a level that merits indemnification.¹¹⁰

The team production model may provide the rudiments that give an account of the policy reasons for maintaining the role of a statutorily specified group to assess and evaluate director conduct, even though directors are buffered from financial loss. The group may serve as the corporate conscience even without it withholding

¹⁰⁹ See *supra* notes 18-20 and accompanying text (discussing the requirement for a statutorily specified group charged with making indemnification decisions and the extent of freedom in granting directors indemnification based on rights found outside state corporate codes).

¹¹⁰ Kuykendall, *supra* note 3, at 514-15.

funds from miscreant directors' legal war chests. This is because the team production model, infused with an idea of reconciling interests bonded in an organizational setting, is institutionally compatible with the retaining of a form that aspires to self-examination by corporate boards. Indeed, according to commentators on Professor Kostant's work linking the team production model to the role of corporate counsel, the assessment and evaluation of director misconduct should be afforded greater scope than it has been afforded in any contemporary public corporation.¹¹¹ Rather than a cynical ploy to eliminate financial liability while maintaining an appearance of regulation, the somewhat labored compromises imbedded in the director exoneration statutes may be conceived of as a work in progress by a corporate bar struggling to find a role as a fiduciary-bonded steward of corporate institutional welfare. In some respects, there may be an evolution of corporate counsel's image of itself as a fiduciary of an entity that is comprised of disparate interests requiring a format of decision that mimics adversary logic, to the notion that it is a servant to one master made up of different parts benefiting from internal dialogue.¹¹²

Nonetheless, it is questionable whether the team production model provides a complete explanation for the form of director exoneration statutes. This model of statecraft applies to the boards at large public corporations¹¹³ and is not particularly well suited to the boards at the variety of intermediate business enterprises, where managerial errors are often made by the financial shark rather than the political neophyte or blunderer.¹¹⁴ One-size-fits-all

¹¹¹ See, e.g., Margaret M. Blair & Lynn A. Stout, *Response to Peter Kostant's: "Exit, Voice and Loyalty in the Course of Corporate Governance and Counsel's Changing Role,"* 28 J. SOCIO-ECONOMICS (forthcoming 2000) (on file with author) (emphasizing the relevance of negotiations, compromise, reputation, disclosure and public pressure in the team production model).

¹¹² Telephone Interview with Peter C. Kostant, Associate Professor of Law, Roger Williams School of Law (May 27, 1999).

¹¹³ See generally Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984) (discussing the real-world conduct of directors in large corporations).

¹¹⁴ See generally Eric W. Orts, *Shirking and Sharking: A Legal Theory of the Firm*, 16 YALE L. & POL'Y REV. 265 (1998) (explaining the problem of

director exoneration statutes seem ill-advised. Even for the large corporation for which the team production model matches the data well, the statutory retention of an independent body whose activities are triggered only by specific instances of board members' exposure to lawsuits¹¹⁵ and whose discretion is confined by contract commitments to directors is not well designed to perform the general monitoring of the quality of board performance called for by a commitment to an elevated board process of the kind Professor Dodd once described.¹¹⁶ In an information age,¹¹⁷ the benefits of process integrity and independence in a "team-production" corporate setting have less importance as a form of intervention in the loosely monitored arena of individual financial outcomes achieved by directors¹¹⁸ and much greater importance as a form of intervention in framing questions of corporate governance, in

sharking as well as shirking).

¹¹⁵ In a typical statutory provision, the role of the group chosen to supervise corporate responses to directors' requests for indemnification arises from the statutory requirement that indemnification may "be made [only] by the corporation . . . as authorized in specific cases upon a determination that indemnification . . . is proper in the circumstances." MICH. COMP. LAWS ANN. § 450.1564a(1) (West 1990 & Supp. 1999). While laws typically allow other contract arrangements to be made (*see, e.g., id.* § 450.1565(1) (West 1990)), the group chosen to supervise corporate responses to indemnification requests has no role in determining whether the contract arrangement serves the corporate interest or furthers the function of articulating corporate norms. Because corporations usually provide protection to their directors up to the fullest extent permitted by law, they are essentially free-riding on the lobbying and litigating successes that may occur in the future and avoiding any obligation to make internal policies that enhance accountability through the indemnification process.

¹¹⁶ *See generally* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932) (discussing the obligations of corporate trustees).

¹¹⁷ Melvin A. Eisenberg, Keynote Address at the Business Law Workshop, Association of American Law Schools, Washington, D.C. (May 2, 1998) (describing emerging infrastructures that influence institutional investors to be active in corporate governance matters).

¹¹⁸ *See* Brudney, *Corporate Governance*, *supra* note 58, at 1411-12 (describing managerial power to divert wealth to managers). *See also* Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 273 (1983) (concluding there is a lack of constraint by markets over individual excesses).

fashioning narratives of corporate events¹¹⁹ and in producing data that might serve as a basis for enriching the team approach to corporate governance.

Thus, if corporate code writers should take the team production model seriously as a source of insight about the corporate project, the aspects of the director exoneration statutes designed to bring process integrity to indemnification decisions should recede and be replaced by rules providing statutorily specified groups with broader evaluation and assessment powers. The trends of the last several years in the corporate governance movement already have created preliminary models for groups routinely charged with assessment and evaluation.¹²⁰ These groups mostly arise from pressures created by the desire for sound corporate practice, stock exchange requirements and by voluntarily imposed guidelines,¹²¹

¹¹⁹ Special litigation committees with a mission to assess and evaluate the need for corporate litigation are an example of a body created in response to the agency model of the corporation. *See, e.g., Zapata Corp. v. Maldonado*, 430 A.2d 779, 784-88 (Del. 1981) (permitting the court to fashion its own business judgment, but affording the special litigation committee a role in the dismissal of a derivative suit commenced on the basis that the board could not exercise business judgment itself to consider the appropriateness of such a derivative action); *Auerbach v. Bennett*, 393 N.E.2d 994, 1002-03 (N.Y. 1979) (applying the business judgment rule to the dismissal recommendation of the special litigation committee—i.e., the board group allowed to recommend dismissal of a suit against a tainted board). Given the adversarial events that require the use of the special litigation committee, those committees generate legal narratives guided by a conservative interpretation of the imperatives of the corporate enterprise. *See, e.g., Maldonado v. Flynn*, 485 F. Supp. 274, 285 (S.D.N.Y. 1980) (recognizing that a determination whether a lawsuit should be pursued “requires a balance of many factors, [including] ethical, commercial, promotional, public relations, employee relations, fiscal . . . [and] legal”). Special litigation committee narratives posit a corporation whose interests may not be well served by litigation. The narrative is heavily flavored by preferences for a trimmed down discursive process and disfavor for the uncontrolled discourse created by litigation. Discourse in litigation contexts is seen as costly, in part, because of the loss of corporate control over the premises and the content of corporate narratives.

¹²⁰ *See Eisenberg, supra* note 1, at 1278 (describing the shift from the managing to the monitoring board).

¹²¹ *See* JESSE H. CHOPER ET AL., *CASES AND MATERIALS ON CORPORATIONS* 8 (1995) (discussing board structure).

rather than by state corporate codes. The notion of independent board members¹²² also adds to the environment of assessment and evaluation in a context that fails to bond independence to shareholder primacy. Certainly, those who have pressed for independence on the board imagine it as a source of a larger view of the corporation, and not just as a means of purifying the agency function in a shareholder wealth maximizing model.¹²³ The functions that are emphasized in models of enhanced assessment and evaluation relate to corporate compliance with law, a concern that has less to do with agency concerns than it has to do with the corporation's role in society.¹²⁴ Retaining process integrity for the purpose of facilitating assessment without a close link to solving an agency problem is a good fit for other trends in corporate law, but does not provide a good explanation for maintaining such process integrity even in the face of the trend toward liberal indemnification of directors.¹²⁵

C. *Law and Literature, Public Relations and Post-Modern Theory*

A loosely related set of materials consisting of law and literature approaches to the study of legal texts, public relations models of modern organizations and post modern theory provide a rich source of interpretation of corporate indemnification statutes. Recent cultural commentary on the relation between public relations and a process of "self-investiture," by which corporations "elevat[e] themselves into an empyrean realm of abstraction,

¹²² See Eisenberg, *supra* note 1, at 1253-54 (arguing that directors are motivated by financial gain).

¹²³ See Steven M. H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163, 173 (1991) (discussing how stakeholder statutes are not stakeholder statutes in fact, but reminders to the corporate board to serve the entity).

¹²⁴ See *supra* note 48 (providing examples of statutes that limit or deny indemnification because of certain bad acts by directors or violations of applicable standards of conduct by directors).

¹²⁵ See Wallman, *supra* note 123, at 170-72 (arguing that corporate best interest refers to the corporation as an entity functioning within society). See also Bratton, *supra* note 39, at 212-15 (describing the mediative function).

purged of commercial motives,"¹²⁶ positions some portions of the corporate code as an extension of corporate image-making that lacks any other function relating to corporate interest. But, public relations reflect real concerns about good conduct. The purported effect of rhetoric on practice posits public relations as causing corporations to develop corporate cultures with aspirational content.¹²⁷ The forms of process integrity in the area of indemnification may be a reasonable social facsimile of a soul¹²⁸ or the statutory equivalent of judicial sermons on corporate law.¹²⁹ The director exoneration statutes warn of sermons to come by wagging a finger at the fearsome taking of accounts by the corporation and the courts. In essence, the law is acting as a go-between that delivers sham threats,¹³⁰ but directors fear the reckoning, nonetheless.

This conclusion arises from a view of social hypocrisy as the tribute vice pays to virtue at large. The remnants of regulation provide a degree of ritualized duty and conscience that a board should fulfill. The board's fiduciary duty requires that one believe that there is an appearance of a corporate mechanism to regulate directors. But, that corporate mechanism is really the celebration and defense from being abandoned as an ideal of the remnants of process integrity in state director exoneration statutes.¹³¹ Insincere remnants of regulation, however, may be seen as a shrine to the body of law that has given corporations a structure to their

¹²⁶ Fred Miller Robinson, *Run It Up the Flagpole: How Corporate America Got the Folks at Home to Salute*, N.Y. TIMES, Mar. 14, 1999, § 7 (Book Review), at 21 (reviewing WILLIAM L. BIRD, JR., "BETTER LIVING": ADVERTISING, MEDIA, AND THE NEW VOCABULARY OF BUSINESS LEADERSHIP 1935-1955 (1999); ROLAND MARCHAND, CREATING THE CORPORATE SOUL: THE RISE OF PUBLIC RELATIONS AND CORPORATE IMAGERY IN AMERICAN BIG BUSINESS (1999)).

¹²⁷ See *id.*

¹²⁸ See *id.*

¹²⁹ See Rock, *supra* note 5, at 1016.

¹³⁰ Kuykendall, *Comment on Kostant*, *supra* note 13. Of course, some interpretations suggest that the go-between is more credulous than the corporate principals.

¹³¹ Eisenberg, *supra* note 1, at 1253. See also Rock, *supra* note 5, at 1013 (proposing that Delaware cases act to transmit norms).

obligations that transcends contract and requires board members to assume a duty of care and loyalty.¹³² Our imaginations require more than private contracting parties able to liquidate personal risk. As with ancient physical shrines, the hollowed out remains of regulation in director exoneration statutes serve better than do new structures to evoke the meaning embodied in the artifact.

Post-modern analysis does not have a unified theory¹³³ and the subject of director liability is not the best place to summarize postmodern materials. One salient thesis of post-modernism, however, is that the predominant forces at work in society control discourse in a manner that invariably absorbs challenges into the prevailing system.¹³⁴ Post-modernism also emphasizes the discontinuities in discourse, the breakdown of the "subject" as a coherent image and the general fragmentation of perspective. The Internet has accelerated the impression that discourse consists of pastiches of text and image that are sometimes jarring and always arbitrary, at least, in part. Post-modernism is often associated with concerns about the determinacy of texts.¹³⁵ Yet, even clear texts may be read as an expression of post-modern discontinuities, suppression of terms and complications in reading the subject.¹³⁶ Legal text

¹³² See Rock, *supra* note 5, at 1011-16.

¹³³ STEVEN BEST & DOUGLAS KELLNER, *POSTMODERN THEORY* 4 (1991).

¹³⁴ See *id.* at 285.

¹³⁵ See RICHARD A. POSNER, *LAW AND LITERATURE: A MISUNDERSTOOD RELATION* 211-20 (1988) (explaining post-structuralism and attacks on the objective meaning of texts).

¹³⁶ The bias in favor of examining constitutional law in the law and literature movement, which has been noted by Professor Rock, *see* Rock, *supra* note 5, at 1016 n.15, has the additional effect of conflating issues about the reading of texts with questions of determinacy. Yet, the undertaking of describing a body of writing using literary analyses and methods as the organizing premise implicates far more than issues of determinacy. Rather, the whole social formation of a body of related texts is a complex collaborative product that can be read for many purposes besides assessing the clarity of its rules, or worrying about author's intentions as the source for interpretation of their meaning. Authors convey the texture of a world by striving to render a catalogue of that world's concerns and by choosing a language adequate to convey that catalogue of significance. Thus, bodies of law can be approached as a literary subject of sorts without concern for the specific, rule-centered meaning of the material.

exists for purposes other than giving clear commands—i.e., corporate statutes convey the form and function of the corporation.

Despite the power of state corporate codes to evoke dread, their text is post-modern. The director of the corporation is less contextualized than it was in prior treatments and, in certain respects, the class of corporate directors and managers is amorphous. The key feature defining the persona of the director in contemporary academic writing about liability is the exposure of the director to monetary loss that may be inefficiently priced. If rules on indemnification create a “dock” for directors, it is created without the director visible, except for the director’s risk of uncompensated loss. Even though one strain of writing about the director evokes fervor about the crushing of the powerless individual corporate director,¹³⁷ such writing does not successfully embody the character of financial liability. Nor is the powerless portrayal of the individual director’s ability to defend against the threat of liability convincing as narrative or as characterization. Thus, the regime of director liability is post-modern in the extent of its abstraction about directors upon whom its moral concerns are directed because there is dread without a human repository.

Without venturing into the larger themes of the end of history that veer between an optimistic account of an ideologically mature society not in need of politically charged interpretations and an account of a society in which technology is in charge,¹³⁸ one is certainly struck by the absence of any vivid picture of the “director” as a historical figure—i.e., a figure with a past and a future rather than a mere present and unembodied function. Despite the fact that director liability is concerned with a concretely situated set of individuals who might have stories that are compelling, the writing on director liability contains little analysis of those stories even though the audience of such writings—directors and lawyers—most likely would be interested in those stories.¹³⁹

¹³⁷ Kuykendall, *supra* note 3, at 451.

¹³⁸ BEST & KELLNER, *supra* note 133, at 275.

¹³⁹ In contrast to my observation about the lack of stories in an area of corporate law where the main topic is the moral assessment and punishment of persons, Professor Rock has argued that Delaware corporate law can be understood as a set of narratives through which corporate actors are instructed

In addition, discontinuities appear in the text of the director liability statutes that postulate form, but also remove substance. This is because the ultimate product is texts that have been moved around with the ease of the word processing functions of cutting and pasting, so that the theory underlying financial liability of directors may be used to justify legal outcomes, just as when the court posits a remedy of corporate litigation that necessarily imposes a cost on innocent shareholders.¹⁴⁰

The texts of director liability regulation and the related cultural and legal commentary are subject to post-modern readings. To the extent that a post-modern interpretation is persuasive, the search for the best policy answers is probably vain. Nonetheless, examining policy choices makes sense because of the insight one might gain into good policy choices, the clarification of existing policy through comparison with alternatives and the theoretical implications of the policy consensus against innovative changes in director liability rules.

V. POLICY ALTERNATIVES

Several policy alternatives exist that may ground the statutory scheme of director exoneration statutes in a conceptual conviction. Considering the array of policy choices available highlights the contrast between the extent to which policy-makers genuinely embrace a strongly contractarian view and the extent to which code-writers embed a more complex set of interests in corporate governance statutes.

in morally significant aspects of their calling as managers and directors. Rock, *supra* note 5, at 1013. In a work in progress on narrative, I argue that corporate law is characterized by an absence of narrative, the implications of which I continue to explore in that manuscript. See Mae Kuykendall, *Business Law and Narrative* (Nov. 16, 1999) (unpublished manuscript, on file with author).

¹⁴⁰ *Compaq Computer Corp. v. Horton*, 631 A.2d 1, 4-6 (Del. 1993) (holding that a shareholder's class action suit is not against a corporation's interests, in part, because directors may be required to pay damages if the corporation must pay damages to the shareholders).

A. *Frank and Open Deregulation, Giving Contract Its Due*

There are several possible approaches to deregulation. As a practical matter, deregulation always stops short of a full opt-out from the fiduciary duty owed by directors.¹⁴¹ But, indemnification is not the same as a release from fiduciary duty.¹⁴² This view is sharpened as commentators notice the increased gap between the standard of conduct and the standard of liability in corporate law.¹⁴³

1. *Subjecting Indemnification to General Corporate Standards*

One possible statutory approach is to allow ordinary corporate ground rules to govern the indemnification of directors for any conduct without articulating any indemnification-related statutory limitation whatsoever. It would not work simply to remove the indemnification statute because the initial rationale for indemnification statutes was to overrule common law cases that unrealistically barred all indemnification while limiting corporate power to exonerate fiduciaries.¹⁴⁴ One could draft, however, a one sentence indemnification section that provides: "Indemnification rules, and indemnification in specific cases, shall be made in good faith based upon the best interests of the corporation."¹⁴⁵

¹⁴¹ Coffee, *Opting Out*, *supra* note 57, at 924 (proposing that contract law supply equitable limitations on the opt-out from corporate law).

¹⁴² Kuykendall, *supra* note 3, at 447.

¹⁴³ See generally Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 *FORDHAM L. REV.* 437 (1993) [hereinafter Eisenberg, *The Divergence of Standards*] (emphasizing the separate functions of conduct and review standards); Chief Justice E. Norman Veasey, Supreme Court of Delaware, Remarks at the Business Law Workshop, Association of American Law Schools (Washington, D.C. May 2, 1998) (highlighting the diverging standards of rules of liability).

¹⁴⁴ CHARLES R. O'KELLEY, JR. AND ROBERT B. THOMPSON, *CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS* 371 (2d ed. 1996).

¹⁴⁵ Note that this would be consistent with Professor Rock's thesis about the actual content of Delaware corporate law. See Rock, *supra* note 5, at 1015 (describing the simplification of corporate law expressed as a general standard

Such a simple statement of the rule for director indemnification would displace sections that arguably have become overelaborate refinements of a tortured statutory path to liberalized indemnification practices. The standard underlying this rule overtly displaces the brittle and poorly expressed rule¹⁴⁶ and frees the corporate contract regime to serve the functions of general rule-making and evaluating of individual applications of directors pursuant to negotiated agreements. Objection to this rule by corporate lawyers on the basis of regulatory concerns would seem unpersuasive.

Thus, the question arises whether there is a coherent and principled objection under contract principles to a simple rule placing the indemnification decision within standard corporate logic. Seemingly, the contract concern would be to correct systemic contract failure. Because the contract argument posits that market discipline is generally adequate to check managerial shirking, concern for systemic failure does not lie on the side of rent-seeking excesses in indemnification. If indemnification decisions were made that lacked any corporate rationale and were not in good faith, the usual contract remedies would be available. Therefore, the concern for contract failure relates to shareholder opportunism abetted by the structure of corporate litigation. This concern might be alleviated, however, by the substantial protections in place that both limit litigation¹⁴⁷ and shut off liability.¹⁴⁸

2. *Treating Indemnification Grants as Conflict of Interest Transactions*

If using general corporate standards to make indemnification decisions were seen as sufficient, the state corporate codes already contain generic provisions that allow suspect transactions to trigger curative procedures. Provisions to approve conflict-of-interest transactions seem fully applicable. Like the indemnification

of good faith once proposed for Delaware and argued by Professor Rock to represent the actual content of the Delaware law).

¹⁴⁶ Rock, *supra* note 5, at 1017.

¹⁴⁷ See *supra* note 119 (discussing responses by corporations to limit litigation brought in the right of the corporation against directors).

¹⁴⁸ Veasey et al., *supra* note 7, at 402-03.

statutes, these provisions perform the dual function of protecting directors from charges of impropriety and of giving some degree of qualified protection to the corporate interest in having decisions made based on the entity's business purposes.¹⁴⁹ These provisions, however, are not tailored to the indemnification problem because they lack definitions of which directors should be considered interested if there is a lawsuit against some or all of the board. These provisions also do not elaborate on the whole notion of an "interest" for the other transactions.

A general loosening of these kinds of provisions seems appropriate within a contractarian conception of the corporation. Indeed, one might imagine these provisions as serving as a typical escape valve for corporate flexibility. Where statutory decision groups are specified, one might allow a final option of any decision-making process designed by the corporation in good faith to balance the interests of the shareholders in honest business decisions and the interests of the directors in prudent application of contract principles and vindication of contract expectations. Commentary might expand upon examples of the problems of appearance and the possible reality of decisional groups that have less ability to safeguard corporate interest. The tone of such commentary would be consistent with the principles of sound corporate governance¹⁵⁰ or the type of market-discipline striving for sound procedures that enhance monitoring at low cost. The contract model could be well served by an accompanying requirement of a corporate statement describing the rationale for the selection of the director liability decision-making group and the related process. The contract model would seem to be highly

¹⁴⁹ See GA. CODE ANN. § 14-2-861 (1994); IND. CODE ANN. § 23-1-35-2 (Michie 1999); N.C. GEN. STAT. § 55-8-31 (1999). See also O'KELLEY & THOMPSON, *supra* note 144, at 431 (reviewing the statutory attempts to "cleanse" conflict of interest transactions so that they can be reviewed under the business judgment rule).

¹⁵⁰ See generally THE BUSINESS ROUNDTABLE, STATEMENT ON CORPORATE GOVERNANCE (1997) (presenting "authoritative" understanding of sound corporate governance); NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, REPORT OF THE NACD BLUE RIBBON COMMISSION ON DIRECTOR PROFESSIONALISM (1996) (setting out business consensus on good board practices).

compatible with code provisions that provide a structured basis for innovation.¹⁵¹ Indeed, the code rules suffer from a disincentive to innovate or experiment because radical changes in heavily regulated specifics are always resisted by any group heavily invested in predictability of regulation.

3. *Treating Indemnification Grants as Compensation*

Another possibility that adds specificity to the code provisions governing indemnification in a contract model is to place them under a statement about compensation that is sometimes differentiated from the general provisions on conflict of interest transactions. Indemnification would be acknowledged as having a conflict of interest component, but would be given the benefit of presumptive regularity. Challenges to indemnification would require a special showing to be made, such as that it is unreasonable under the circumstances to prevent indemnification. This treatment of indemnification would be highly consistent with the insight that indemnification is a form of compensation. There should be no greater nervousness about shareholder suits when the corporation indemnifies generously than when it compensates in a similar fashion.

Compensation statutes generally provide a special status for decisions to grant compensation to directors, which strengthens the qualified statutory protection for self-interested director transactions that are approved by the board of directors after disclosure and recusal by the affected directors. The protection that the general conflict statutes provide to interested director transactions is worthwhile, but far from certain in scope, where the transaction has features that may arouse the vigilance of a court.¹⁵² Thus, statutes carve out director compensation for more liberal protection. In effect, the indemnification statute has evolved in a parallel fashion, but without the same conviction or clarity. Yet, the similarity in the matter at stake is undeniable.

¹⁵¹ *But see* Gordon, *supra* note 65, at 1569 (suggesting that code provisions help to signal shareholders that contract provisions are acceptable).

¹⁵² O'KELLEY & THOMPSON, *supra* note 144, at 431.

Both involve problematic interactions between the corporation and its custodians. The problematic feature has been resolved favoring optimistic adoption of contract reasoning. Challenges to compensation and indemnification are rare. In the case of indemnification, the disparity between the statute as a regulation and the corporate reality is far greater because the statute continues to embrace a key term of regulation while it stretches the regulatory boundary to which the term applies. While courts continue to embrace notions of regulatory policy limits on the enforceability of contracts to indemnify if they ignore the requirement of superintendency of conduct,¹⁵³ the growing reality is the irrelevance of superintendency in connection with director reimbursement. Within the contract model, the compensation model is perhaps the best suited to address agency costs. To avoid inserting in the implicit contract between shareholders and managers of corporations a partially defective regulatory term, but still raise a flag about the financial exoneration of directors, indemnification could be subjected to the same (weak) restraints as compensation.

4. *The Role of Corporate Counsel in a Contract Regime*

None of these alternatives would tend to emphasize the role of corporate counsel. In contrast, indemnification statutes often identify legal counsel, selected by prescribed means,¹⁵⁴ as an available mechanism to make the indemnification decision. A choice to use corporate counsel would be possible in a deregulation model, but indemnification would be conceived in a straightforward way as a corporate business decision subject to the requirements of contract commitments. Obviously, the advice of counsel might be sought both to make contracts and to implement pre-existing contracts. But, business judgments regarding the grant of discretionary indemnification may need little in the way of legal

¹⁵³ *Waltuch v. Conticommodity Serv., Inc.*, 88 F.3d 87, 95 (2d Cir. 1996).

¹⁵⁴ *See, e.g.*, ALA. CODE § 10-2B-8.55(b)(3) (1999); GA. CODE ANN. § 14-2-855(b)(2) (1994 & Supp. 1999); N.C. GEN. STAT. § 55-8-55(b)(3) (1999); S.C. CODE ANN. § 33-8-550(b)(3) (Law. Co-op. 1990) (providing for selection of counsel by disinterested directors or, alternatively, by the board).

counsel to be well informed. Thus, robust contracting minimizes legal fees.

B. Team Production as a Policy Alternative Looking Past Contract to Discourse

The contractarian policy alternative starkly highlights the uni-dimensional view of the corporation and its interests as assumed by a profit maximizing model. Under that view, all that the corporate system needs to generate is a workable system for investors to price corporate governance terms. Absent widespread and demonstrable failures of the market mechanisms to keep managers honest, standard board governance is sufficient. The expressive function that might be served by stricter limits administered by well counseled groups charged with maintaining corporate morality has little significance.

Even if the board should not carry appreciable financial risk for litigation arising out of indemnification decisions, assessment and evaluation might nonetheless remain a function properly tied to the corporate distribution of financial exoneration to directors. If exoneration is to be granted liberally, the award of monetary forgiveness could be conditioned on a summing up process, requiring self-scrutiny by the applicant and the policy councils of the corporation. Indeed, the corporation might well benefit from a standard diagnostic protocol that forces an open consideration of the merits and demerits of board conduct and extracts from the "determination" the expression of judgment associated with managing risk for the corporation and the director. Plainly, conceiving the corporation as transcending a mute toting up of profits and subtraction of agency costs is an approach that has appeal.

Federal law adopts an approach that forces discourse mediated by outside inputs about conduct as well as imposing the risk on directors of unreimbursed losses.¹⁵⁵ A disinterested body in today's world has a greater role in raising the level of discourse

¹⁵⁵ See KNEPPER & BAILEY, *supra* note 16, at 650-54 (describing the securities law limitations on the indemnification of corporate directors).

about board choices than it does in preventing improper payments. A more important contested site in contemporary accountability than financial outcomes, which are invariably subjected to risk-spreading of some kind, is discursive process.

Yet, if corporate discourse is to impound a capacity for self assessment, it should not be tied to the same framing language by which legal liability is established or rebutted, as is the case in the Model Act.¹⁵⁶ One could rewrite indemnification rules to function expressly as forums for the advancement of corporate standards and to take the forms of narrative reflections. A form that the statute might take is that of conditioning indemnification on the applicant's participation in a discursive effort at identifying the standards of conduct that have precipitated the need for exoneration and at assessing the claims of the various team members relating to the correct standard to be applied and the nature of the shortfall, if any, in the performance of a director. Such a forum would bear some degree of resemblance to the idea of a reconciliation approach, rather than a punitive approach, to public or political crimes. The advantage of the approach would be to remove the adversarial premises from the role of counsel and build up the counseling component. The corporate lawyer as tender and interpreter—i.e., as master narrator for corporate morality—would be given a formal recognition.¹⁵⁷ The likely result would be a more fruitful use of the corporate lawyer's intimate knowledge of corporate nuances, hard choices, untold stories and moral reasoning than arises from manipulation of presumptions, contract rights and board exposure to secondary suits for grants of indemnification. Given its grounding in the standard legal approach of substantive rules accompanied by protective procedures, the area of liability and exoneration is a prototypical arena for application of corporate counsels' skills in managing exposure to risk through indirection, obscuring and shaping of facts and minimizing of unruly narratives. Yet, the acknowledged aspiration of corporate law as a whole to bond managers to the corporation is not particularly well served by

¹⁵⁶ Kuykendall, *supra* note 3, at 471, 510-11.

¹⁵⁷ Kostant, *supra* note 106. See Rock, *supra* note 5, at 1064 (suggesting that Delaware corporate lawyers digest and apply stories told by the Delaware courts, but do not tell those stories to their clients).

process ground rules that point away from the production of robust narratives and improved articulation of standards.

A system for assessment and evaluation in the team production model may be designed to carry forward some of the function of determining groups to make indemnification decisions. As a result, aspects of the statutory scheme that might deserve retention include: (1) formality; (2) triggering events; (3) board composition or selection; and (4) use of corporate counsel for framing issues and for encouraging full disclosure and transparency.¹⁵⁸ Indemnification decisions may require the group charged to assess and evaluate the indemnity afforded to a corporate director, the questions that arise as to the wisdom of the contract provisions that granted a right to indemnification to a particular director, the events that created an indemnifiable legal transaction, the nature of the counter-pressures to which the board member may have been responding and the effect of constituent groups on the policy process. Vigilance relating to genuine financial fraud can be ceded to the ordinary application of contract principles, corporate conscience and outside monitoring. Moreover, if eligibility for indemnification is conditioned on satisfactory cooperation with the process of self-assessment and disclosure, the true conscienceless perpetrators of fraud are unlikely to participate. Nothing about the process of granting indemnification requires moral absolution because granting relief after a conclusion is reached that the conduct and personal self-assessment of a director does not meet corporate standards can be followed by denunciation and banishment.¹⁵⁹ The unseemliness of indemnification on the basis of a claim of entitlement without a mechanism that encourages acknowledgment of wrong-doing, sharp dealing, or inattention would be avoided if the indemnification process became an occasion for serious institutional reflection.

¹⁵⁸ Kostant, *supra* note 106.

¹⁵⁹ Note, *When Should Courts Allow the Settlement of Duty-of-Loyalty Derivative Suits?* 109 HARV. L. REV. 1084, 1097-1101 (1996) (proposing the resignation of directors as a condition for courts to approve derivative-suit settlements).

CONCLUSION

The complexity of director liability statutes makes them a good window into theories of corporate law. They demonstrate features of contract, regulation, public choice, the team production model of the corporation and theories of law as text. They enable contracts and fill in some gaps in contract. They place regulatory constraints on the extent of indemnification. They divert resources to lawyers and directors by giving lawyers a role that may do little to alter actual payments or raise standards. The process of writing and revising the statutes provides a focal point for lobbying on behalf of directors. The statutes protect directors from liability when they mediate among the demands of the team members in the corporation. Finally, these statutes function as texts that may primarily serve to convey symbolic meanings and to reassure corporate readers, rather than to give commands.

In some respects, the best conclusion that can be reached about the exoneration statutes is that they are overdetermined. They are texts that serve multiple functions to such an extent that no one function can be posited as the genius of the text. Rather, they appear to be an example in legal materials of a text that is self-referential and, therefore, is amenable to scrutiny as an artifact instead of as a legal document that governs a set of rights and obligations.¹⁶⁰ The exoneration statutes are a legal text that does not mainly function to govern its putative subject. First, contests over indemnification submitted to courts are rare¹⁶¹ and do not occur when the corporation and the director are in agreement. Second, in sophisticated corporations, the regime of director exoneration is designed to minimize the bite of the regulatory constraints by making generous use of the non-exclusivity outlet of contract.

¹⁶⁰ POSNER, *supra* note 135, at 214-15 (describing deconstruction and suggesting that legal texts differ from literary texts because of their differing purposes and techniques).

¹⁶¹ See Cheek, *supra* note 16, at 270 (noting the effect of allowing directors to grant indemnification to fellow directors).

With the exception of a lack of clarity about the extent of statutory provisions that make the statutes “not exclusive of other rights” of directors to indemnification, the texts are determinate. These statutes are not puzzling because of an elusive meaning, but because of an elusive function. To the extent that they contain indeterminacy, it seems to be a chosen feature of the text that resists clarification and for which corporate readers desire, not clarification, but the assurance that additional text will be supplied at a time in the future. The indeterminacy imbedded in the public policy encoded in the statutes is not a trigger for controversy over meaning. Rather, it is a sort of reassurance to readers, one that gives readers the opportunity as commentators to intimate good things about the text, but avoid details. It is an indeterminacy that shrugs off court interpretations as mainly serving to adjust the content of the indeterminacy and to provide confidence to readers that determinate content exists.¹⁶² The indemnification texts tolerate incoherence in the implicit public policy they advance because mandatory provisions require indemnification of directors who have committed bad acts¹⁶³ and permissive provisions are interpreted to prohibit indemnification absent a finding of good conduct.¹⁶⁴

The character of the indemnification statute renders it a corporate liturgy. The typical indemnification code appears in many ways to be a text that is mainly about itself, with many uses available to which any text might be put, including the use of being available for revision, for interpretations that primarily serve to remind us that the text exists and for corporate readers to possess a common text that expresses an idea that there is a forum for norms to be safeguarded. It is a text that serves to make a claim about its generative capacity, a source for norms to be expressed and developed and for discourse to enrich the corporation. It is a textual assertion of corporate normative richness that may, in fact, displace the development of normative richness by the function of

¹⁶² See generally *Waltuch v. Conticommodity Serv., Inc.*, 88 F.3d 87 (2d Cir. 1996) (demonstrating reader confidence).

¹⁶³ See *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138, 141-44 (Del. Super. Ct. 1974).

¹⁶⁴ *Waltuch*, 88 F.2d at 93-95.

the text as the signifier of, but not the command for, such a discourse.

Thus, the exoneration statutes are not a good match for a vision of an emerging corporate law drenched by the premises of the information society¹⁶⁵ in transparency, disclosure and discursive pressures that help to prevent an insular corporate culture from developing. Nonetheless, as a text, they contain the seeds of their own transformation. They carry in them the ideal of informational richness, disinterested inquiry and open review. They are in form positioned to enhance expressive normativity and to serve as a forum for the development of nuances of corporate interest in a team production model. To do so would require a recognition that the internal accountability function in corporations, where it is related to financial accountability, is more figurative than real. Contract largely governs the monetary exchanges with directors, while the statutes aspire to force corporate narratives. The narratives that are driven by tying an expressive function—i.e., the work of determining groups—to financial liability, however, are the narratives inspired by those under financial threat, and thus, are protective, stingy in spirit and counter to aspirations of transparency and normative growth.

The practice of director exoneration may be refashioned by using much of the same textual artifacts, but infusing them with new narrative directions. A sensible trade-off might be to condition grants of exoneration on the narratives of those asking for exoneration that provide credible accounts of the circumstances that required a request for exoneration. Thus, lawyers' skills could be used to press for full and nuanced accounts of disputed conduct with interpretations offered under the prism of varying conceptions of corporate interest. Determining groups might be charged with rendering provisional interpretations of controversial corporate events that are in a range of reasonable disputable behavior. The current outside limits of indemnification—i.e., no reimbursement of payments required for forms of simple theft—could be maintained, in part, through standard contract norms, but the large range of indemnifiable behavior could be taxed with a requirement of

¹⁶⁵ Eisenberg, *The Divergence of Standards*, *supra* note 143, at 437-38.

discursive engagement produced by an adversarial framework. Indemnification would become a good fit for a contract understanding of corporations as a monetary exchange and a social reading of them as institutional repositories. Theory would recognize a dual voice of monetary bargain and entity narrative.

Therefore, the procedures for indemnification could become one transmission belt for expressive norms in the efficient corporation and for the creation of affirmative corporate narratives by those who claim to speak the normative language of the corporate entity.