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FIDUCIARY DUTIES AS RESIDUAL CLAIMS: OBLIGATIONS TO NONSHAREHOLDER CONSTITUENCIES FROM A THEORY OF THE FIRM PERSPECTIVE

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INTRODUCTION

This Article intends to reconcile two competing paradigms within the law and economics model of corporate governance. The first paradigm, which has its intellectual origins in the work of Ronald Coase,[1] holds that the modern, publicly held corporation is a nexus of contracts among the company's various contributors. The term "nexus of contracts" has become a revolutionary banner that has "transformed not only our understanding of the law, but the law itself."[2]

The nexus-of-contracts approach to corporate law offers a simple lesson: one should not view corporations as particularized forms of trusts or as fictitious creatures of state law. Rather, according to the law and economics perspective that the nexus-of-contracts approach to corporate law exemplifies, one should view the corporation as a "complex set of explicit and implicit contracts," and corporate law as enabling "the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy."[3] In other words, one should view the corporation as nothing more than a set of contractual arrangements among the various claimants to the products and earnings generated by the business. The group of claimants includes not only shareholders, but also creditors, employee managers, the local communities in which the firm operates, suppliers, and, of course, customers.

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† J. DuPratt White Professor of Law and Director, John M. Olin Program in Law and Economics, Cornell Law School. This essay is dedicated to Professor Mel Eisenberg of the University of California, Berkeley. Many of the thoughts it contains were inspired by my interchanges with Mel during the law and economics break-out session of the Association of American Law Schools' 1998 Conference on Business Associations. Professor Eisenberg probably does not share, and certainly is not responsible for, the views expressed in this essay. Likewise, he is not responsible for errors contained herein.

1 *See* R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

2 Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449, 1449 (1989).

3 Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989).

The core insight of this nexus-of-contracts paradigm is that contract defines each participant's rights, benefits, duties, and obligations in the corporate endeavor. This insight, in turn, implies that one should not give any class of claimants preference over any other. Instead, each claimant or a group of claimants deserves to receive only the exact benefits of the particular bargain that it has struck with the firm, no more and no less. What claimants have bargained for, however, may differ enormously from firm to firm, depending on a complex set of exigencies.[4]

The nexus-of-contracts approach to the corporation appears to be strongly at odds with the second paradigm of corporate governance. The second paradigm represents both the standard law and economics view and the view reflected in traditional state and corporate law rules; it posits that corporations and their directors "owe fiduciary duties to shareholders and to shareholders alone."[5] Commentators advance a variety of arguments to support this second paradigm. For example, some argue that needless complexity would result if corporations were required to serve the interests of groups other than shareholders. Specifically, corporate practitioners often argue that if directors must serve constituencies other than shareholders,

> [t]he confusion of . . . trying to . . . require directors to balance the interests of various constituencies without according primacy to shareholder interests[ ] would be profoundly troubling. Even under existing law, particularly where directors must act quickly, it is often difficult for directors acting in good faith to divine what is in the best interests of shareholders and the corporation. If directors are required to consider other interests as well, the decision-making process will become a balancing act or search for compromise. When directors must not only decide what their duty of loyalty mandates, but also to whom their duty of loyalty runs (and in what proportions), poorer decisions can be expected.[6]

Scholars who approach this issue from a law and economics perspective reach the same result as the corporate bar. Those scholars argue that corporations should maximize value for shareholders and shareholders alone because shareholders, as residual claimants, have

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[4] For example, investors in riskier firms should expect higher rates of return on their investments to compensate them for this additional risk. Workers with highly specialized skills or whom labor unions represent may be able to command higher levels of compensation than other workers. Similarly, suppliers or customers with better bargaining power, better negotiating skills, or better lawyers may be able to obtain better rates of return than similarly situated claimants in other firms.

[5] Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 23 (1991).

[6] ABA Comm. on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2269 (1990).

the greatest incentive to maximize the value of the firm. As Easterbrook and Fischel observed:

> As the residual claimants, the shareholders are the group with the appropriate incentives . . . to make discretionary decisions. The firm should invest in new products, plants, etc., until the gains and costs are identical at the margin. Yet all of the actors, except the shareholders, lack the appropriate incentives. Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertaking of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion.[7]

Thus, one seemingly cannot reconcile the two paradigms. The nexus-of-contracts approach to corporate law posits that one can decompose the corporation into a complex set of contractual relationships. Consequently, under this approach, everything is up for grabs or, at least, subject to negotiation. Constituencies such as workers, bondholders or other creditors, customers, suppliers, and managers ought to be able to contract for the right to be the exclusive (or, at the very least, the partial) beneficiaries of corporate fiduciary duties. After all, if a corporation is simply a complex web of contracts, the various participants to the corporate venture should be able to contract among themselves to obligate the directors to serve broad societal interests, the interests of the firm's workers, or the interests of any other nonshareholder constituency.

By contrast, everything is not up for grabs with respect to fiduciary duties. There is a single one-size-fits-all solution; the parties should write the corporate contract such that the shareholders always win. The notion that shareholders are the exclusive beneficiaries of a corporation's fiduciary duties is fundamentally at odds with the idea that a corporation is merely a nexus of contracts, with no set of claimants having any a priori rights in relation to any other.

This Article seeks to reconcile these two competing corporate law paradigms. My thesis is quite radical. Simply put, fiduciary duties are not all that they appear to be. They can be (and frequently are) modified by contract. Thus, contrary to popular wisdom, the notion that shareholders are the exclusive beneficiaries of fiduciary duties is the *default* rule rather than the mandatory rule. One can reconcile the tension between the shareholder-primacy paradigm and the nexus-of-contracts paradigm if one recognizes that the shareholders can consent to waive the shareholder-primacy paradigm. Because sharehold-

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7 Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403 (1983).

ers are at the top of the contract heap, the nexus-of-contracts paradigm subsumes the shareholder-primacy paradigm.

I also will argue that this issue has generated confusion because nonshareholders rarely find it in their interest to contract with shareholders to vary the shareholder-primacy default rule. However, in certain contexts, such as bankruptcy, circumstances change, and the interests of shareholders are subordinated to the interests of other constituencies.

Part I provides a fuller description of the nexus-of-contracts paradigm in corporate law. Part II provides an economic analysis of corporate fiduciary duties to shareholders and juxtaposes these insights with the nexus-of-contracts approach presented in Part I. Part III presents the Article's basic thesis: the nexus-of-contracts paradigm subsumes the shareholder-primacy paradigm, and provides examples of this theory in action. In Part III, I also provide my perspective on the implications of this analysis for the broad issue of corporate social responsibility. A brief conclusion follows.

I
THE NEXUS-OF-CONTRACTS APPROACH

The nexus-of-contracts approach to the modern, publicly held corporation produces three important and related insights about corporate law. The first is that shareholders' rights and duties are (or should be) defined by contract. The second is that corporate law should be "enabling" rather than mandatory. The third is that no particular set of outcomes is best for all firms. Rather, each firm must find the specific set of contractual obligations that best suits its shareholders.

As Oliver Hart observed, each type of business organization, including the corporation, "represents nothing more than a particular 'standard form' contract."[8] Indeed, the very justification for having different types of business organizations is to permit investors, entrepreneurs, and other participants in the corporate enterprise to select the basic organizational design they prefer from a menu of standard-form contracts. It is possible (though difficult) to imagine a legal system in which the various initial constituencies of a business venture (equity claimants, fixed claimants, managers, entrepreneurs) create new contracts that establish the core features of their business (limited liability, legal "personhood," indefinite life, freely transferable shares) *ex nihilo* each time they form a new corporation. The virtue of the standard-form arrangement characteristic of modern corporate

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8 Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757, 1764 (1989).

law is that it is "convenient"; it reduces transaction costs by allowing the participants in the corporate enterprise to take advantage of an arrangement that suits the needs of investors and entrepreneurs in a wide variety of situations.[9]

Corporate law should be enabling rather than mandatory because there are limits to the cookie-cutter approach reflected in the standard-form rules that constitute state corporate law. Specifically, different firms have different needs, and different firms conduct their businesses in a very wide variety of contexts. If corporate law were not enabling, the various claimants to the cash flows could not customize the standard-form rules to meet their particular needs.

Significantly, this analysis implies that no particular set of contractual outcomes is ideal for every firm. Perhaps the best way of illustrating this implication is with reference to the core characteristics of the modern corporation. As noted above, at its most elemental level, the standard-form contract for corporations consists of four features: limited liability, legal personhood, indefinite life, and freely transferable shares. It is possible, however, and even common in certain contexts for firms to dispense with these key features to suit their interests.

For example, with respect to limited liability, shareholders in closely held firms commonly sign personal guarantees of indebtedness to give their firms access to bank credit. Their willingness to guarantee demonstrates that even the "core feature" of limited liability can be waived by contract.

Similarly, the corporate feature of legal personhood simply means that the corporation "has a name in which it may transact [business] and be sued."[10] Because the corporation's constituents can negotiate separately with not only all of the parties with whom it transacts business, but also those with whom it litigates, this term is also infinitely malleable. Moreover, modern corporate statutes specifically provide that the incorporators can alter this feature at will. The power to sue and be sued, like other general corporate powers, is modified by the Model Business Corporation Act's enabling language "[u]nless its articles of incorporation provide otherwise,"[11] and thereby openly invites incorporators to modify the corporate contract's terms to meet their individualized needs.

The same analysis applies to the corporate feature of infinite life. People who form a corporation not only may stipulate a finite existence for their firm,[12] but also may dissolve the corporation after its

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9 *See id.*

10 Easterbrook & Fischel, *supra* note 3, at 1426.

11 Model Bus. Corp. Act § 3.02 (1998).

12 *See id.*

formation, even if the original charter envisioned perpetual existence for the company.[13]

Finally, the core feature of free transferability of shares can be contracted around as well. The Model Business Corporation Act makes free transferability a default rule by stipulating that "[t]he articles of incorporation, bylaws, an agreement among shareholders, or an agreement between shareholders and the corporation may impose restrictions on the transfer or registration of transfer of shares of the corporation."[14] Thus, all of the core features that characterize the corporation fit easily into the nexus-of-contracts paradigm because one can easily vary or waive each by contract. Certain other corporate law rules, however, are mandatory, and it is not obvious that one can waive these rules by agreement. However, as Roberta Romano observed in a penetrating analysis of ostensibly mandatory rules, "[t]he rules that are identified as 'mandatory' in practice have very little in common with the ordinary understanding of that term. They are either easily—and legally—side stepped, or they pose nonbinding constraints because there is no burning demand to deviate from them."[15] Rules in this category include the provision for annual election of directors, the prohibition on delegating to committees the decision to approve a merger, the limitation on dividend payouts, the demand requirement in derivative suits, the requirement that shareholders vote on mergers, and the existence of shareholder appraisal rights. As Romano showed, these rules are far more malleable than has been suggested.[16]

Moreover, the enabling elements of corporate law permit a firm to structure a transaction in a certain way to avoid liability or reincorporate in more permissive states to reach a desired outcome. By reincorporating, firms opt out of one set of corporate laws and opt into another. Likewise, firms can change their organizational form to achieve a desired outcome or to avoid a legal provision they find undesirable. Firms can go private or public, change from mutual to stock form, or become a limited liability company or a partnership if they feel one of these organizational forms provides a better result for the participants in the corporate venture.

Another striking example of the power of the nexus-of-contracts paradigm is reflected in state law statutes that permit corporations to limit or eliminate personal liability of directors for monetary damages

13 *See id.* §§ 14.02-.03.

14 *Id.* § 6.27(a).

15 Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599, 1599 (1989); *see* Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 544 (1990) (arguing "that, appearances notwithstanding, state corporate law is trivial").

16 *See* Romano, *supra* note 15, at 1599-1602.

arising from a breach of their fiduciary duty of care.[17] As Robert Clark pointed out, "[t]o this limited extent, a corporation will be allowed to ask its shareholders to vote to 'opt out' of the otherwise applicable judge-made rules of fiduciary duty."[18]

Thus, the nexus-of-contracts approach provides a powerful analytical device for conceptualizing the modern corporation. Not surprisingly, the "theory now dominates the thinking of most economists and most economically oriented corporate law scholars who focus at all on the theory of the corporation."[19]

It is also important to recognize, however, that the nexus-of-contracts paradigm is purely descriptive. It is a positive, not a normative, tool. To say that the firm is a nexus of contracts is only the beginning of the analysis because this paradigm tells us nothing about the substance of these contracts. The theory provides no information about either what provisions are (or should be) contained in the standard-form contracts or what provisions are (or should be) waived and by whom. As Jensen and Meckling observed in their seminal article on the subject of capital structure, "the 'behavior' of the firm is like the behavior of a market; i.e., the outcome of a complex equilibrium process."[20] Stated another way, from a nexus-of-contracts perspective, because firms consist of a complex web of contractual relationships, firm behavior depends critically on what those contracts provide. In turn, the contract provisions themselves depend on the outcome of the bargaining process that takes place between the contracting parties.

There are two possible ways to reconcile the nexus-of-contracts paradigm with the rival paradigm positing that corporations owe fiduciary duties to shareholders and to shareholders alone. The first possibility is the existence of a "corner solution." A corner solution is one in which the solution to every problem is the same. Thus, one might reconcile the nexus-of-contracts paradigm with the shareholder-primacy paradigm because in every single situation, shareholders and the other participants in the corporate enterprise mutually agree that the interests of the nonshareholder constituencies should be subordinated to the interests of the shareholders.

The second possibility is that the ideal of shareholder primacy is a myth. Under this reconciliation, the nexus-of-contracts paradigm reigns supreme because the idea of shareholder primacy, like the other elements of corporate law described above, is merely a default

17 *See* MODEL BUS. CORP. ACT § 2.02(b)(4) (1998).

18 Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1704 (1989).

19 *Id.* at 1705.

20 Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976).

rule that the parties can, and frequently do, vary to suit their particularized needs. The following section considers each of these possibilities in turn and concludes that no corner solution exists and that the default rule of shareholder primacy can be varied by contractual arrangement. In fact, under a wide variety of situations, shareholders and nonshareholder constituencies mutually agree that shareholder claims should be subordinated to the claims of nonshareholders. Therefore, I conclude that even fiduciary duties are, at their core, contractual in nature.

II
Fiduciary Duties to Shareholders

Commentators extensively have discussed the question of why shareholders are the exclusive beneficiaries of directors' fiduciary duties.[21] The economic justification for having fiduciary duties at all is that "[f]iduciary duties are the mechanism invented by the legal system for filling in the unspecified terms of shareholders' contingent [contracts]."[22] However, one cannot jump from the fact that fiduciary duties serve a gap-filling function in the law to the conclusion that shareholders should be the exclusive beneficiaries of such duties. One needs an additional step.

Easterbrook and Fischel maintain that one can justify making shareholders the exclusive beneficiaries of directors' fiduciary duties because of the shareholders' unique status as residual claimants.[23] Because shareholders are residual claimants, they receive the benefits—and incur the costs—associated with marginal, or discretionary, corporate decisions.[24] Thus, according to Easterbrook and Fischel, unlike shareholders who are residual claimants, nonshareholder constituencies, as fixed claimants, are indifferent to most corporate decisions. Corporations still will be able to meet their contractual obligations to the other constituencies regardless of whether corporate decisions turn out well or not. In other words, every decision a corporation makes affects shareholders' wealth, but far fewer decisions will affect, for example, the ability of the firm to meet its payroll or its obligations to bondholders.

Thus, the essence of the corner-solution argument is that fiduciary duties flow to shareholders because shareholders are the corporate constituency that values those duties most highly. The problem

21 *See, e.g.*, ABA Comm. on Corporate Laws, *supra* note 6, *passim*; Easterbrook & Fischel, *supra* note 7, at 403; Jonathan R. Macey & Geoffrey P. Miller, *Corporate Stakeholders: A Contractual Perspective*, 43 U. Toronto L.J. 401 (1993).

22 Macey & Miller, *supra* note 21, at 407.

23 *See* Easterbrook & Fischel, *supra* note 7, at 403.

24 *See id.*

with this argument is that one can easily imagine situations in which nonshareholder constituencies will be concerned as much as, if not more than, shareholders about the outcomes associated with a particular corporate decision. Take, for example, a large publicly held company with many highly diversified, small-stakes shareholders. Suppose further that this company has a workforce comprised of people with undiversified, firm-specific skills. A firm-specific skill is a job skill that is specific to a particular job.[25] Firm-specific skills, by definition, cannot easily be transported from one job to another because these skills are of value only to the firm with which they are associated. Under this set of assumptions, one easily can imagine that workers who possess only firm-specific skills would be harmed far more than shareholders by layoffs, plant closings, and other corporate decisions that would cause the workers to forfeit the value of their investments in firm-specific human capital.[26]

Thus, while Easterbrook and Fischel are correct that for a wide range of issues corporate decisions concern shareholders alone, this observation will not be true with respect to all issues. For many issues, workers and local communities, not to mention customers, suppliers, and managers, will care much more deeply about the decision than shareholders. Thus, the corner-solution argument, which posits that fiduciary duties flow exclusively to shareholders because they value them most highly and therefore will *always* contract for them, seems clearly wrong.

III
Contracts Versus Fiduciary Duties

One should view the arguments made above about firm-specific human capital investment from the perspective of the nexus-of-contracts paradigm. Clearly, workers care deeply about issues such as job security. A theory that argues that workers value job security and high wages less than shareholders value competitive returns on their equity investments is highly implausible. It stands to reason that workers should be able to contract ex ante for job security and competitive wages. Of course, the fiduciary duties owed to shareholders do not prevent workers from bargaining for and obtaining an agreement with respect to these and other employment issues.

The point here is that one can contract away fiduciary duties to shareholders. Consequently, despite the appearance of intractability,

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25 *See* Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & Econ. 297, 315 (1978).

26 For a more complete explanation of human capital investments and their relation to fiduciary duties, see Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 Duke L.J. 173, 188-97.

fiduciary duties are simply another default rule that shareholders and nonshareholder constituencies can customize as they please. Fiduciary duties only operate in the shadow of the express contractual arrangements that nonshareholder constituencies have with the firm. For example, banks, bondholders, and other fixed claimants commonly negotiate contractual protections for themselves. These provisions seriously impair the ability of shareholders to use the cash flows generated by a firm in a manner in which the shareholders can benefit at the expense of fixed claimants.[27]

Corporations in search of capital routinely agree to restrict their ability to make investments, loans, or other extensions of credit as a condition to receiving funds from lenders. Additionally, when shareholders grant secured credit, they voluntarily agree to subordinate their claims to specific assets to certain creditors. Similarly, firms routinely restrict their ability to make dividend payments to shareholders to obtain access to bond markets.

Thus, as with contracts with workers, contracts between shareholders and firms routinely subordinate the claims of shareholders to those of nonshareholder constituencies. These contracts clearly impede the freedom of directors and managers to maximize shareholder wealth. One response to this argument is that these restrictions on the ability of corporations to maximize shareholder value are consistent with the shareholder-primacy paradigm because all of these contracts benefit shareholders in the end. Shareholders are willing to bargain with workers to give them job security and better wages because doing so allows them to attract and retain better workers, and thereby increases profitability. Presumably, shareholders only would approve wage packages and job security commitments to the extent that the benefits of these agreements in the form of higher worker productivity equal or exceed the costs in the form of higher operating costs.

Similar logic applies to other fixed claimants such as bondholders and lenders. For example, corporations often provide fixed claimants with security interests in corporate assets or agree to restrictions on dividend payments or investments. These agreements benefit shareholders by increasing the availability of credit and lowering the cost of borrowing. In other words, shareholders price the promises they make to nonshareholder constituencies. Shareholders will make such promises only to the extent that the benefits of making these promises outweigh the costs. The same argument applies to fiduciary duties themselves. Just as shareholders must weigh the costs and benefits of making promises to nonshareholder constituencies, so too must non-

27 *See* Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

shareholder constituencies weigh the costs and benefits of fiduciary duties.

A simple example illustrates this point. Imagine two firms, *X* and *Y*. The firms are identical in every way, except that firm *X* grants shareholders the benefits of the fiduciary duties of care and loyalty, while firm *Y* operates in a legal system in which it owes fiduciary duties to the employees rather than to the shareholders. Both the workers and the shareholders in firm *X* would be better off than the workers and the shareholders in firm *Y* if the shareholders in firm *X* are willing to pay the workers a sum that is greater than the value of these fiduciary duties to the workers in order to obtain the benefits of these fiduciary duties. Consistent with the nexus-of-contracts perspective, in which the firm's bargains result from a complex equilibrium process, shareholders will enjoy the benefits of fiduciary duties to the extent that they value the benefits associated with these fiduciary duties more than other corporate constituencies.

One can illustrate this point with reference to what Professor Coffee accurately has described as "extraordinary departures" from typical patterns of corporate behavior.[28] For example, in *Union Trust Co. of Maryland v. Carter*,[29] the court approved a charter provision that deprived shareholders of voting rights for the first six years of the corporation's life and prevented the shareholders from removing the directors named in the original articles of incorporation from office.[30]

One also can conceptualize these arguments in terms of the shareholders' ability to contract away their fiduciary duties. Cases that involve the fiduciary duty of care provide the simplest examples. Shareholders can waive their fiduciary duty of care through ex ante contracting. Take, for example, the classic case of *Meinhard v. Salmon*.[31] In that case, the court held that Salmon breached his fiduciary duty to Meinhard by pursuing a business project (the development of a valuable parcel of real estate in midtown Manhattan) without first offering his business partner Salmon the opportunity to participate in the venture.[32] The case is controversial because, as the dissent points out, Meinhard and Salmon were not all-purpose partners, but rather joint venture partners in a real estate development covering some of the same space.[33] Furthermore, the subsequent venture did not begin until after the joint venture between Meinhard and Salmon had termi-

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28 John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1630 (1989).

29 139 F. 717 (W.D. Va. 1905).

30 *See id.* at 725-26.

31 164 N.E. 545 (N.Y. 1928).

32 *See id.* at 547.

33 *See id.* at 550 (Andrews, J., dissenting).

nated.[34] According to the dissent, Salmon's duties to Meinhard should have ended when the joint venture ended.[35]

Writing for the majority, Justice Cardozo maintained that, at a minimum, Salmon should have disclosed the new opportunity to Meinhard so that Meinhard could have had the opportunity to make his own offer.[36] The majority's approach seems justified on the ground that the business opportunity in dispute had been extended to Salmon in his capacity as a joint venturer.[37] Moreover, the opportunity arose while Salmon had an ongoing fiduciary duty to Meinhard.

From the perspective of this paper, the interesting question in *Meinhard v. Salmon* is whether the case would have turned out differently if the parties had a pre-existing agreement with respect to the disclosure of new opportunities. Suppose, for example, that Meinhard and Salmon's joint venture contract specified that their business relationship was to terminate at the end of the joint venture period and that Salmon was under no obligation to extend future business opportunities of any kind to Meinhard or even to inform Meinhard of such opportunities. Under these hypothetical facts, the case would have come out differently because the agreement would have defined the contours of the duties that Salmon owed to Meinhard. In other words, the fiduciary duty of loyalty that Salmon owed to his partner Meinhard was not intractable. He could have altered it by contractual agreement.

This is a startling claim. Commentators routinely assert that, regardless of whatever one may say about the duty of care, the duty of loyalty is nonwaivable.[38] As Mel Eisenberg pointed out, virtually all statutes that permit corporations to limit or eliminate personal liability of directors for simple duty-of-care violations contain provisions that explicitly exclude from their coverage duty-of-loyalty violations by either directors or officers.[39]

However, the corporate opportunities doctrine

> is the law's attempt to regulate circumstances in which a corporate officer or director may usurp new business prospects for her own account without first offering them to the firm. The doctrine—a

34 *See id.* at 546.

35 *See id.* at 552 (Andrews, J., dissenting).

36 *See id.* at 547.

37 *See id.* at 546.

38 *See* AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.19 reporter's note 5 (1992).

39 *See* Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1470 n.43 (1989).

> subspecies of the fiduciary duty of loyalty—has been a mainstay in the corporations law of virtually every state for well over a century.[40]

Even law and economics scholars routinely characterize the corporate opportunities doctrine as a mandatory rule rather than a default rule. For example, Ian Ayres and Rob Gertner claim that firms can contract to increase the scope of their fiduciary duties, but not to limit the scope of such duties.[41] It does seem, though, that parties can "craft[ ] an express definition of a 'corporate opportunity'" by agreeing in advance to permit a director or other fiduciary to pursue a particular activity.[42] Moreover, even if the corporation and the fiduciary have not agreed in advance (for example, at the time the corporation hires the fiduciary) to permit the fiduciary to pursue a particular opportunity, the fiduciary may still avail herself of that opportunity by disclosing the opportunity to the firm and obtaining the firm's permission to pursue the opportunity.[43] If the fiduciary fails to obtain permission prior to exploiting the opportunity, however, "any authorization, approval, or ratification by the firm is voidable, and an appropriation of the project by the agent constitutes a breach of fiduciary duty."[44] In other words, the corporate opportunities doctrine, which is a component of the fiduciary duty of loyalty, "is, fundamentally, little more than a default mechanism for allocating property rights between a corporation and those who manage it."[45]

The same analysis holds true for rules related to another important component of the duty of loyalty: the rules related to directors' conflict-of-interest transactions. Historically, transactions between corporations and their directors were automatically voidable at the wish of the corporation.[46] This legal rule proved incompatible with the needs of many corporations, however, because countless situations arose in which transactions between directors and the corporation were in the best interests of the corporation. For example, cash-strapped businesses sometimes turn to directors for loans. Directors would be unwilling to make such loans if the corporation could void the terms of the accompanying loan agreements after credit had been extended.

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40 Eric Talley, *Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine*, 108 YALE L.J. 277, 279 (1998).

41 *See* Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 743 (1992).

42 Talley, *supra* note 40, at 287 n.20 (citing American Inv. Co. v. Lichtenstein, 134 F. Supp. 857 (E.D. Mo. 1955), as an example of a court permitting parties to craft such terms).

43 *See id.* at 288.

44 *Id.*

45 *Id.* at 280.

46 *See* ROBERT CHARLES CLARK, CORPORATE LAW § 5.1 (1986).

The current law solves the problem of director conflict-of-interest transactions by establishing a default rule against these contracts, but permitting such transactions to go forward if disinterested directors (or shareholders) approve them after full disclosure of both the existence of the conflict of interest and the specifics of the transaction being contemplated.[47] Thus, as with the corporate opportunities doctrine, the law regarding directors' conflict-of-interest transactions is enabling and permissive rather than mandatory and inflexible.

Nevertheless, do all corporate law rules really fit so easily under the nexus-of-contracts umbrella? Are there certain corporate actions, such as stealing, that are clearly outside the realm of contract? The answer to these questions lies in understanding what is meant by the term "stealing." Stealing necessarily involves wrongful conduct. However, if one obtains the permission of the owner, there can be no theft. Consequently, a corporation cannot "permit" a fiduciary to steal things.

Somewhat more formally, the analytical confusion on this issue stems from an inability to distinguish between ex ante and ex post waivers of the duty of loyalty. The law does not permit ex post waivers because such waivers would constitute a breach of contract or worse; however, the law does permit ex ante waivers of fiduciary duties.

This analysis has interesting implications for the way that we view the relationship between shareholders and nonshareholder constituencies. Over a wide range of issues, of course, the interests of shareholders do not conflict at all with other stakeholders. In those areas where conflicts do arise, bargaining results. Nonshareholder constituencies can bargain for and obtain virtually anything they want ex ante, that is to say, at the time they enter their relationship with the company. Later, however, the nonshareholders are more or less at the mercy of the shareholders because only the shareholders as residual claimants can avail themselves of net earnings not already earmarked for other groups.

In other words, and this is the point to which the Article has been building, fiduciary duties are themselves a form of residual claim. Extending fiduciary duties to shareholders simply creates a legal environment in which nonshareholder constituencies are free to contract with the company as they wish ex ante. However, after these nonshareholder constituencies have secured whatever contractual protections for themselves that they can procure (e.g., bond covenants, restrictions on dividend payments, wage concessions, or long-term employment agreements), the shareholders are entitled to the residual. Critically, in this context, the residual does not mean residual *cash*

47 *See* MODEL BUS. CORP. ACT § 8.62 (1998).

flows. Instead, the concept of the residual claim captures the idea of residual *legal rights*. Just as the standard default terms of corporate law provide that shareholders are entitled to the firm's residual cash flows after they have paid the fixed claimants, so too are shareholders entitled to the residual legal rights that remain after the nonshareholder constituencies have reached their own agreements with the corporation.

Conclusion

The purpose of this Article has been to identify and then resolve an apparent tension between two of the dominant intellectual paradigms in corporate law. The first paradigm holds that fiduciary duties are the exclusive domain of shareholders. The second paradigm holds that the corporation is best conceptualized as a nexus of contracts among the firm's various stakeholders. These paradigms seem at odds; one cannot consistently claim that the corporation is defined by the contractual relationships that exist among shareholders, employees, managers, suppliers, customers, creditors, and others, while simultaneously arguing that these contractual provisions must always subordinate the claims of nonshareholder constituencies to the claims of the shareholders because shareholders are the exclusive beneficiaries of nonwaivable fiduciary duties.

This Article advanced two competing ways to reconcile the tension between the nexus-of-contracts paradigm and the shareholder-primacy paradigm. First, the Article considered the possibility that the two paradigms are compatible because no situations exist in which either shareholders or nonshareholder constituencies would find it in their interests to agree that shareholders should subordinate their claims to those of the nonshareholder constituencies. This explanation proved implausible because there are many situations in which nonshareholder constituencies might value a particular contractual right or protection more than shareholders value it.

One can better reconcile the tension between the idea that fiduciary duties are exclusive and nonwaivable and the idea that the corporation is a nexus of contracts by noting that shareholders can, in fact, waive fiduciary duties by ex ante agreement. In other words, the fiduciary duties of care and loyalty are themselves no more than default mechanisms for allocating property rights between shareholders and nonshareholder constituencies. Parties can make deals ex ante to change the default terms described by fiduciary duties. Corporate law establishes procedural rules to assure that the ex ante agreement meets standard contractual prerequisites such as requiring relative parity of bargaining power and forbidding fraud in the inducement. Beyond that, parties are free to make deals that carve into the fiduciary rights of shareholders. Shareholders can modify the terms of fiduciary duties both by crafting particularized definitions of fiduciary duties and by expressly providing that officers and directors can engage in certain actions, even if such actions clearly would breach the fiduciary duties in the absence of such an agreement.

This Article has shown that the concept of fiduciary duties is subordinate to the nexus-of-contracts conception of the corporation because, like other aspects of the relationship between shareholders and nonshareholder constituencies, shareholders can tailor their rights and duties by agreement. In fact, from a contractual perspective, rather than simply having their claims subordinated to those of the shareholders, nonshareholder constituencies can contract with the firm for protections that almost certainly will inconvenience shareholders in the future. Long-term employment contracts and restrictions on dividend payments provide two examples of this phenomenon.

This leads to the final point of the Article. Because shareholders are residual claimants, the fiduciary duties owed to shareholders are, themselves, nothing other than a special form of residual claim. Shareholders are entitled to the residual legal rights that other constituencies have not reserved for themselves by contract ex ante, just as they are entitled to the cash flows generated by the firm, unless some other constituency has negotiated to obtain those cash flows ex ante.

One core premise of law and economics (the nexus-of-contracts approach) posits that all claimants to a corporation's earnings, goods, and services are created equal. Another core premise of law and economics posits that one particular class of claimants, the shareholders, deserves special treatment. This Article has reconciled the tension between these two seemingly inconsistent claims. This resolution helps advance our conception of the corporation as well as our understanding of the contractual nature of fiduciary duties. The nexus-of-contracts paradigm remains the core principle for organizing our thoughts about the corporation. Although fiduciary duties are also important, these fiduciary duties are fundamentally contractual in nature because shareholders and nonshareholder constituencies can customize them by agreement.