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NOTES

EVALUATING THE NEW DIRECTOR EXCULPATION STATUTES

In 1985 Delaware enacted a statute[1] enabling corporations to adopt a novel species of charter provision: one that eliminates or limits a director's liability for breach of his fiduciary duty of care.[2] Since then, a large number of states have followed Delaware's example.[3] The statutes epitomize the tendency of corporation law toward what Professor Cary has labelled a "race for the bottom, with Delaware in the lead."[4] The "race" consists of states' competing efforts to generate revenue by enticing corporations' management to incorporate under their laws. As a principal means of enticement, states create a legal environment hospitable to management's interests.[5] The new statutes enhance their states' pro-management legal environment to a substantial degree, and in an unusually direct manner.

Cary pejoratively labels this race one "for the bottom" because, he believes, the resultant pro-management laws exploit shareholders. If Cary is correct, then the new statutes will cause more such exploitation than most race entries, for in permitting exculpation from the fiduciary duty of care, they permit removal of one of the two basic devices[6] expressly designed to protect shareholders from

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1 DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986); *see infra* note 64 and accompanying text.

2 The fiduciary duty of care "demands that top officers and members of the board of directors invest a certain amount of time and effort and exercise a certain level of skill and judgment in the operation of the firm." Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 927 (1983). Just how much care the duty demands is considered *infra* notes 23-54 and accompanying text.

The fiduciary duty of care is to be distinguished from the fiduciary duty of loyalty, which "requires that officers and directors put the interests of the stockholders ahead of their personal gain and subjects them to oversight in transactions involving conflicts of interest." *Id.* at 927-28. The distinction is not always sharp, however, in either theory or practice. *See infra* note 24 and accompanying text.

3 Most of these states have copied Delaware's statute virtually word for word. *See infra* note 65. For that reason this Note will focus on the Delaware version.

4 Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 705 (1974).

5 *Id.* at 705; Winter, *The Development of the Law of Corporate Governance*, 9 DEL. J. CORP. L. 524, 527 (1984) ("Historically, states have competed to attract corporate charters for revenue purposes and this competition has been the single greatest influence on the development of the law of corporate governance.").

6 The statute explicitly leaves in place the other device, the fiduciary duty of loyalty. *See infra* notes 64-69 and accompanying text.

management.[7]

But many recent corporation theorists dispute Cary's thesis. While agreeing that a race exists,[8] they instead conclude that the race's pro-management results serve both shareholder and management interests.[9] Shareholders do apparently find the new Delaware statute advantageous: Delaware corporations have rushed to adopt the newly permitted provision, and many out-of-state corporations have even re-incorporated in Delaware in order to do the same.[10] This Note considers why shareholders would vote to relinquish a valuable right, and whether it is desirable to permit them to do so.

One's evaluation of the statute's desirability will depend on one's judgment of how the "costs"[11] that the statute engenders compare to the costs of the common-law regime that the statute replaces.[12] Once fiduciary protection is discarded, only the workings of the marketplace will protect shareholders;[13] the statute's costs, then, will equal the extent of the pertinent market failures. Economists will have to undertake the tasks of identifying and measuring the latter;[14] this Note addresses the other side of the scale, undertaking to identify[15] the imperfections of the common-law regime.

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7 *See* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 221 (1932).

8 *See, e.g.*, Winter, *supra* note 5, at 527.

9 *See, e.g.*, Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259 (1980) (change in state of incorporation correlates with small positive excess returns); Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware Corporation Law*, 76 NW. U. L. REV. 913 (1982); Winter, *supra* note 5, at 527-28 ("[T]his competition among states leads to optimal rules governing the relationship of shareholders to corporations.... I would submit... that the race is to the top."). *See generally infra* notes 70-96 and accompanying text.

10 Powell, *Is It Safe to Go Back in the Boardroom?*, Newsweek, May 4, 1987, at 45, 46.

11 Analysts regularly translate problems into "costs" to facilitate the comparison of one problem with another. *See* A. POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 10 (1983) (One "standard assumption of economic analysis" is that "all benefits and costs can be measured in terms of a common denominator—dollars.") The device's conceptual utility should not, however, obscure its practical limitations; many costs, including the sacrifice of freedom of contract examined *infra* notes 133-88 and accompanying text, defy quantification. *See infra* notes 137-43 and accompanying text.

The degree of a cost is measured by the severity of a problem reduced by the unlikelihood of its occurrence. R. POSNER, ECONOMIC ANALYSIS OF LAW § 6.1, at 147 (3d ed. 1986).

12 The latter costs are discussed *infra* notes 100-88 and accompanying text.

13 *See infra* notes 64-96 and accompanying text.

14 *See* Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1980); *see also* Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983).

15 Measuring (as opposed to identifying) each of these costs presents a perhaps insurmountable empirical challenge. For example, to what degree do directors avoid risk for fear of personal liability? What amount of a corporations' profits are forgone as a result? *See* Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 n.10 (1985) ("[T]he concept of corporate managerial efficiency . . . is one for which there are no objective standards."); *see also* Easterbrook, *supra* note 14, at 547 ("We can-

As a foundation for that undertaking, Part I sets forth the common law of directors' fiduciary duty of care, with particular reference to the vagueness and confusion that pervade that doctrine.[16] Part II sets forth the mechanics of the new statute,[17] and sketches the workings of the market mechanisms that it relies upon to provide the shareholders' only protection against careless directors.[18] Part III identifies the costs, both practical and ideological, of the common-law regime, i.e., directors' behavioral inefficiency,[19] deterrence of individuals from assuming directorial responsibilities,[20] and infringement of shareholders' freedom of contract.[21] Part IV argues that the statute is desirable, because the gains that it effects by preserving shareholders' freedom of contract will outweigh any costs that market mechanisms will impose on some shareholders.[22]

I
The Common Law of Directors' Fiduciary Duty of Care

Exasperated dictum observes that "[t]he doctrine of the fiduciary relation is one of the most confused and entangled subjects in corporation law."[23] At the risk of lending more coherence to the field than it may deserve, the following discussion classifies the confusion on three levels: (1) the content of fiduciary duty; (2) formulating the duty of care into rules; and (3) applying the rules to individuals' conduct.

A. Content

Courts and others display confusion concerning the content of fiduciary duty by sometimes muddling the distinction[24] between its

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not measure [the size or existence of the purported gap between present and optimal governance structures] by comparing one firm against another, because each firm is a unique bundle of assets, prospects, and managers. We also cannot compare the price of, say, Apple Computer stock under optimal governance structures with its actual price.").

16 *Infra* notes 23-54 and accompanying text.

17 *Infra* notes 64-69 and accompanying text.

18 *Infra* notes 70-96 and accompanying text.

19 *Infra* notes 101-22 and accompanying text.

20 *Infra* notes 123-32 and accompanying text.

21 *Infra* notes 121-88 and accompanying text.

22 *Infra* notes 189-202 and accompanying text.

23 Geller v. Transamerica Corp., 53 F. Supp. 625, 629 (D. Del. 1943).

24 *See, e.g.*, R. Gilson, The Law and Finance of Mergers and Acquisitions 146 (Supp. 1987) (noting "frequent failure of courts and commentators in takeover settings to distinguish between the duty of care and duty of loyalty"); Scott, *supra* note 2, at 932 n.20 (giving example from ALI Corporate Governance Project of "the tangled thinking that pervades this subject"); *cf.* Fischel & Bradley, *The Role of Liability Rules and the Deriva-*

two branches, care and loyalty.[25] The two branches actually have little in common[26] except that the common law imposes them both upon caretakers (such as corporate directors) of others' property. The new Delaware statute affects only the duty of care, expressly preserving the fiduciary duty of loyalty.[27]

B. Formulation

Confusion pervades this second level, which concerns formulating the duty of care into a rule. The only certainty is that one must at least avoid negligence to escape breaching the duty.[28] Beyond that, the doctrine's uncertainties abound and compound. These uncertainties can be divided into three groups.

1. *The Nature of Simple Negligence*

Negligence is a notoriously slippery concept, haunted by "that factitious ghost, the 'reasonable man.' "[29] In attempting to define

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tive Suit in Corporate Law: A Theoretical and Empirical Analysis, 71 CORNELL L. REV. 261, 291 (1986) (focusing on boundary case and concluding that no sharp distinction exists).

One group of cases dramatizing the muddling of the care and loyalty branches involves the courts' acceptance of the business judgment rule as a defense to allegations of breach of the duty of loyalty. Properly understood, the business judgment rule (which insulates directors from the undesirable consequences of their decisions) applies only to allegations of breach of the duty of care. Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 111, 115-18 (1979). Examples from this group of cases are cited in Scott, *The Role of Preconceptions in Policy Analysis in Law: A Response to Fischel and Bradley*, 71 CORNELL L. REV. 299, 306 n.29 (1986). *See also* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1985) (business judgment rule is founded on principles of "care, *loyalty* and independence") (emphasis added); Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (applying business judgment rule to parent's self-interested decision to cause subsidiary to pay dividend); Arsht, *supra*, at 94 n.5 (noting Professor Folk's "[i]nexplicabl[e]" examination of the business judgment rule in connection with Delaware's conflict of interest statute.).

Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), discussed *infra* notes 119-22, was decided on duty of care grounds, but makes more sense as a duty of loyalty case.

> Although the court does not say so explicitly, the clear implication of the opinion is that Van Gorkom was looking out for Pritzker's interests rather than Trans Union's. As in most cases finding a violation of the business judgment rule, there are strong hints of breach of the duty of loyalty.

R. GILSON, *supra*, at 813.

25 *E.g.*, Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264 (2d Cir. 1984) ("A board member's obligation to a corporation and its shareholders . . . [is] generally characterized as the duty of care and the duty of loyalty".); Scott, *supra* note 2, at 927 (fiduciaries owe certain duties which "customarily fall into two broad categories: the duty of care and the duty of loyalty"); Scott, *supra* note 24, at 299 (referring to "[t]he centrality of that distinction"). *But see* Scott, *supra* note 2, at 932 ("[t]he distinction is not always sharp").

26 *See supra* note 2.

27 *See infra* notes 64-69 and accompanying text.

28 BLACK'S LAW DICTIONARY 930-31 (5th ed. 1979); 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1029, at 11 (1975).

29 L. HAND, THE BILL OF RIGHTS 39 (1958).

negligence, "[t]he utmost that can be done is to devise something in the nature of a formula";[30] even this task represents a "very difficult problem."[31] Courts usually use one of two formulae: that degree of care "that men of ordinary prudence exercise in regard to their own affairs"[32] or that "degree of care an ordinarily prudent man would exercise under similar circumstances."[33] Interpretation problems[34] pervade each of these formulae, and each will assign liability in sets of cases that do not exactly overlap.[35] Compounding these problems is the courts' tendency to declare other, conflicting formulae as well:

> Attempting . . . to define standards of duty, the courts have said, on various occasions, that corporate directors must exercise reasonable care and diligence; ordinary care and prudence; reasonable diligence and their best judgment; reasonable care and business judgment; reasonable intelligence; business discretion; ordinary skill, vigilance, judgment, and diligence.[36]

2. *How Simple Negligence Differs From Gross Negligence*

There is a "very real difficulty in drawing satisfactory lines of demarcation"[37] between the two standards. Gross negligence may not actually be, as one judge claimed, merely simple negligence "with the addition of a vituperative epithet,"[38] but the term does have "no generally accepted meaning."[39] In one sense, it describes

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30 W. KEETON, D. DOBBS, R. KEETON & D. OWEN, THE LAW OF TORTS § 32, at 173 (1984) [hereinafter W. KEETON].

31 *Id.* at 174.

32 3A W. FLETCHER, *supra* note 28, § 1037, at 32-33.

33 *Id.* § 1038; H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 622 (3d ed. 1970).

34 Just how prudent is the "ordinarily" prudent man? What are "his own affairs," and what would he do in them? What "circumstances" does the rule refer to and how "similar" must they be?

35 The own-affairs standard "is capable of adapting to changing times and changing notions of investment opportunity and risk taking, whereas the [similar-circumstances standard] is static. It imports conventional limitations for the preservation of capital and the avoidance of risk taking . . . ." Fleming, *Prudent Investments: The Varying Standards of Prudence*, 12 REAL PROP. PROB. & TR. J. 243, 246 (1977).

36 H. SPELLMAN, A TREATISE ON THE PRINCIPLES OF LAW GOVERNING CORPORATE DIRECTORS 532-33 (1931) (footnotes omitted).

37 W. KEETON, *supra* note 30, § 34, at 211.

38 Wilson v. Brett, 11 M. & W. 113, 116, 152 Eng. Rep. 737, 739 (1843). Compare Arthur Prentice Rugg's explanation of the difference between negligence, gross negligence and recklessness "as the difference between a fool, a damned fool and a goddamned fool." Bernard, *How to Get Through to Laymen*, 55 A.B.A. J. 45, 45 n.2 (1969).

39 W. KEETON, *supra* note 30, at 212; *see also* Grill v. General Iron Screw Collier Co., 35 L.R.C.P. 321, 324-25 (C.P. 1866), *quoted in* Arsht, *supra* note 24, at 120-21 n.119 ("I advisedly abstained from using a word to which I can attach no definite meaning and noone, as far as I know, ever was able to do so"). Prosser and Keeton write:

> Although the idea of "degrees of negligence" has not been without its

an actor's conduct: departure from due care that is extreme.[40] In another sense, it describes an actor's state of mind: recognition and disregard of a risk being taken.[41] The term has been used in both senses on the same page of a single state supreme court opinion.[42]

3. *Determining Which of the Two Standards Applies*

Delaware left this matter unresolved until as astonishingly late as 1984, when its supreme court decided that management need only avoid gross negligence.[43] Given corporate directors' need to plan their actions precisely, Delaware's long indecision on such an

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> advocates, it has been condemned by most writers, and, except in bailment cases, rejected at common law by most courts, as a distinction "vague and impracticable in [its] nature, so unfounded in principle," that it adds only difficulty and confusion to the already nebulous and uncertain standards which must be given to the jury.

W. KEETON, *supra* note 30, § 34, at 210 (footnotes omitted).

40 *E.g.*, Food Pageant, Inc. v. Consolidated Edison Co., 54 N.Y.2d 167, 172, 445 N.Y.S.2d 60, 62, 429 N.E.2d 739, 740 (1981) ("failure to exercise even slight care").

Conduct that a court might hold grossly negligent within this sense includes: (1) approving a sale of assets based only upon information provided in the course of a cursory oral presentation, *see* Tomezak & Wechsler v. Morton Thiokol, Inc., No. 7861, slip op. (Del. Ch. May 7, 1986); *cf.* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (discussed *infra* notes 119-22 and accompanying text); and (2) failing to learn of acquiring corporation's year-long commitment to purchase shares at a more favorable price than accepted, *see* Rabkin v. Hunt Chem. Corp., No. 7547, slip op. (Del. Ch. Dec. 4, 1986).

41 In this sense, gross negligence is equivalent to "recklessness," which is defined as "[t]he state of mind accompanying an act, which either pays no regard to its probably or possibly injurious consequences, or which, though foreseeing such consequences, persists in spite of such knowledge." BLACK'S LAW DICTIONARY 1142 (5th ed. 1979); *see, e.g.*, Williamson v. McKenna, 223 Or. 366, 391-92, 354 P.2d 56, 68 (1960) ("gross negligence" as used in statute "means reckless conduct").

42 Redington v. Pacific Postal Tel. Cable Co., 107 Cal. 317, 324, 40 P. 432, 434 (1895).

43 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

Prior to *Aronson*, Delaware's duty of care standard had been particularly murky. In Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963), for example, the Delaware Supreme Court formulated a standard of care rule that rang only of simple negligence ("that amount of care which ordinarily careful and prudent men would use in similar circumstances"), but then glossed that rule in gross negligence terms:

> If he has *recklessly* reposed confidence in an *obviously* untrustworthy employee, has refused or neglected *cavalierly* to perform his duty as a director, or has ignored either *willfully* or through inattention *obvious* danger sigus of employee wrongdoing, the law will cast the burden of liability upon him.

Id. at 130 (emphasis added). This language "muddies the waters." Veasey & Manning, *Codified Standard—Safe Harbor or Unchartered Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 928 (1980).

Other Delaware cases also employed diverse and imprecise articulations of the standard of care. *E.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 722 (Del. 1971) ("fraud or gross overreaching"); Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 887 (Del. 1970) ("gross and palpable overreaching"); Allaun v. Consolidated Oil Co., 147 A. 257, 261 (Del. Ch. 1929) ("reckless indifference to or a deliberate disregard of the stockholders"). *See generally Aronson*, 473 A.2d at 812 n.6.

important question is an unfortunate commentary on the common law of the fiduciary duty of care in that state.

Even Delaware's recent decision, welcome though it is, is of little help to planners, given the unclarity of the terrain that gross negligence occupies.[44] "Although it is now clear that the Delaware duty of care standard is not ordinary negligence but gross negligence, it is not clear precisely what that standard means."[45]

C. Application

Confusion is both most rampant and least desireable[46] at the stage of applying the duty-of-care rules to individuals' conduct. One reason for this lies in the cumulative nature of the two kinds of confusion examined above; the uncertainty of standards[47] yields uncertainty of results. "In truth, one cannot say whether a man has been guilty of negligence, gross or otherwise, unless one can determine what is the extent of the duty which he is alleged to have neglected."[48]

The other reason lies in the fact-bound, case-by-case manner in which courts make duty-of-care judgments. The United States Supreme Court has declared that "the question of negligence is . . . ultimately a question of fact, to be determined under all the circumstances."[49] And William Meade Fletcher observes that duty-of-care rules, however formulated, are of little practical use in answering this question of fact:

> In determining whether directors are liable for negligent misman-

44 *See supra* notes 30-42 and accompanying text.

45 1 R. BALOTTI & J. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.7, at 96 (1986). On the unclear meaning of duty of care standards, see generally *supra* notes 30-42 and accompanying text.

Nor have Delaware decisions been helpful in giving content to the newly-announced standard. Bayless Manning observes that there is still "virtually no law" on the "basic question[]" of "[h]ow apparently 'aberrational,' " or grossly negligent, a directorial decision may be before triggering liability. Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1, 3 (1985).

Even the landmark Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), the only reported Delaware decision explicitly holding directors liable for gross negligence, offers little concrete guidance. "The opinion is a recital of explicit and implicit do's and don'ts," from which is absent, however, any reliable rule concerning what actions are required or prohibited in a given context. Manning, *supra*, at 3, 8-14. *See generally infra* notes 119-22 and accommpanying text.

46 Reasons for the undesirability are given *infra* notes 101-88 and accompanying text.

47 *See* W. KEETON, *supra* note 30, § 34, at 210 ("nebulous and uncertain standards which must be given to the jury").

48 *In re* Brazilian Rubber Plantations & Estates, Ltd. [1911], 1 Ch. 425, 436, *quoted in* 3A W. FLETCHER, *supra* note 28, § 1034, at 30 (1986).

49 Bowerman v. Hamner, 250 U.S. 504, 512 (1919); Briggs v. Spaulding, 141 U.S. 132, 152 (1891).

> agement, the courts have been prone to use fine-sounding phrases in defining the duties of directors, and then proceed to decide the case without reference thereto—the rules laid down being such glittering generalities that the case could be decided either way thereunder without violating the rules.[50]

The difficulty lies in determining the meaning of words. The courts determine the meaning of "duty of care" by rule;[51] but at no point do courts ever determine the meaning of that rule, except on the unpredictable, case-by-case basis that Fletcher describes.[52] This is because "[c]ourts do not hear evidence as to what an 'ordinary prudent man' would do, either in the conduct of his own affairs or in the particular circumstances of the case. Nor do they often compare the facts of cases . . . ."[53] Thus, each trier of fact determines whether a defendant has breached his duty of care by comparing the defendant's conduct not with any truly objective measure, but rather only with his own individual notions of what constitutes "ordinary," "prudent," et cetera. " '[O]ur "excellent, but odious" friend—the ordinarily prudent person—never takes the stand to enlighten judges or juries . . . .' "[54]

One may wonder why the business community should find fault with the common-law system's unpredictability[55] when the same unpredictable, case-by-case process applies to duty-of-care adjudication in nonbusiness contexts as well,[56] and theorists voice no objection to the process there.[57] One explanation lies in the busi-

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50 3A W. FLETCHER, *supra* note 32, § 1029, at 12.

51 *See supra* notes 28-42 and accompanying text.

52 In effect, the content of the rules changes to accommodate each verdict. "[T]his standard of the reasonable man . . . enables the triers of fact . . . to express their judgment of what that standard is. . . ." RESTATEMENT (SECOND) OF TORTS § 283 comment c (1965).

See also W. KEETON, *supra* note 30, § 32, at 173 ("[T]he infinite variety of situations which may arise makes it impossible to fix definite rules [or *a fortiori* the content thereof] in advance for all conceivable human conduct.").

The factfinder's latitude creates difficulties for business planners. *See infra* notes 101-22 and accompanying text.

53 Nielsen, *Directors' Duties under Anglo-American Corporation Law*, 43 U. DET. L.J. 605, 612 (1966).

54 Veasey & Manning, *supra* note 43, at 931 (quoting A. HERBERT, MISLEADING CASES IN THE COMMON LAW 12 (7th ed. 1932)).

55 *See infra* notes 101-32 and accompanying text.

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> The application of this standard of reasonable conduct is as wide as all human behavior. There is scarcely any act which, under some conceivable circumstances, may not involve an unreasonable risk of harm. Even going to sleep becomes negligence when it is done on a railway track, or at the wheel of an automobile.

W. KEETON, *supra* note 30, § 33, at 193.

57 *See, e.g.*, RESTATEMENT (SECOND) OF TORTS § 328C comment b (noting uncritically that in jury questions "the same conclusion will not necessarily be reached in two identical cases"); W. KEETON, *supra* note 30, § 37, at 237 (determining negligence is for

ness community's greater felt need to evaluate the degree of risk it engages in; Professors Veasey and Manning point out that

> to equate the analyses in common negligence cases with those involving corporate decision-making overlooks the different values society assigns to the behavior under review. There seems to be no discernable bias, in common negligence cases, to encourage our perambulating friend to risk crossing the street. On the other hand, courts have traditionally favored freedom in corporate decision-making in response to society's encouragement of risk-taking enterprises.[58]

Another explanation lies in the business community's unique access to certain market mechanisms, detailed below,[59] which arguably protect shareholders better than does the common-law regime.

II
THE DELAWARE STATUTE'S MECHANICS AND THE REMAINING MARKET MECHANISMS OF SHAREHOLDER PROTECTION

A. The Statute's Mechanics

Delaware apparently enacted[60] its new statute to counter only one of the three costs[61] associated with the common-law regime: deterrence of individuals from assuming directorial responsibilities.[62] Delaware chose to alleviate this cost by permitting each corporation to set its own ceiling on the amount shareholders could recover in a duty-of-care lawsuit, instead of imposing a uniform ceil-

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the jury "because the public insists that its conduct be judged in part by the man in the street rather than by lawyers, and the jury serves as a shock-absorber to cushion the impact of the law").

58 Veasey & Manning, *supra* note 43, at 931-32.

59 *Infra* notes 70-96 and accompanying text.

60 No formal legislative history material for the statute exists. The Corporation Law Section of the Delaware Bar Association wrote the statute, and the legislature adopted it as written. Black & Sparks, *Analysis of the 1986 Amendments to the Delaware Corporation Law*, 3 Corp. (P-H) 311 (1986).

61 *See supra* text accompanying notes 19-21.

62
> The [1986] amendments [to Delaware's General Corporation Law] were prompted by a growing awareness by members of the Corporation Law Section of the Delaware Bar Association that directors' concerns about personal liability were causing Delaware corporations to lose, or to be unable to attract, qualified men and women to serve on their boards. These concerns were heightened by highly publicized lawsuits involving potentially ruinous recoveries against individual directors and were brought to a head by dislocations in the market for directors and officers liability insurance, which saw some corporations' insurance cancelled and almost all corporations experiencing dramatic increases in the cost of insurance coupled with cutbacks in the scope of coverage.

Black & Sparks, *supra* note 60, at 311. For an examination of the nature and the origin of this deterrent cost, see *infra* notes 122-23 and accompanying text.

ing on that amount. Those corporations that eliminate directors' duty-of-care liability altogether are, in effect, setting zero as their ceiling.[63]

The statute accomplishes this by adding an item to the list of provisions that a corporation's charter may contain. The statute permits

> [a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this Title [concerning willful or negligent stock repurchases and dividend payments]; or (iv) for any transaction from which the director derived an improper personal benefit . . . .[64]

The statute thus works no self-implementing change in a director's common-law duty; it merely enables a corporation to effect the change, if its stockholders so choose.[65]

Even when stockholders do adopt the specified charter provision, the duty of care itself remains in place; only a director's monetary liability for its breach is removed. Accordingly, shareholders retain equitable remedies such as recission and injunction.[66] The duty and its breach could also continue to bear on nonlitigation issues, such as the re-election or removal of directors.[67]

Further limiting the statute's impact are its four exclusions. Stockholders adopting the newly permitted charter provision waive their rights only against directors who, albeit careless, do act with

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63 *Id.*

64 DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986).

65 At least ten states have substantially identical statutes. ARIZ. REV. STAT. ANN. § 10-054(A)(9) (Supp. 1987); IDAHO CODE § 30-1-54(2) (Supp. 1987); IOWA CODE ANN. § 491.5(8) (West Supp. 1988); MASS. GEN. L. ch. 156B, § 13 (Supp. 1988); 42 PA. CONS. STAT. ANN. § 8364 (Purdon Supp. 1987); S.D. CODIFIED LAWS ANN. § 47-2-58.8 (Supp. 1987); TENN. CODE ANN. § 48-12-102 (Supp. 1987); TEX. REV. CIV. STAT. ANN. art. 1302-7.06 (Vernon Supp. 1988); UTAH CODE ANN. § 16-10-49.1 (Supp. 1987); WASH. REV. CODE ANN. § 23A.12.020 (Supp. 1987).

Oklahoma's statute is similar but self-implementing; it abolishes the duty of care except for those corporations that opt back *into* the common-law regime. OKLA. STAT. ANN. tit. 18, § 1006(B)(6) (West Supp. 1987).

In addition, several states have adopted modified duty statutes, setting forth directorial standards of care that differ from the common law. *See* Newcomb, *The Limitation of Directors' Liability: A Proposal for Statutory Reform*, 66 TEX. L. REV. 411, 443-46 (1987).

66 Del. Legis. Council's Synopsis, 65 Del. Laws ch. 289; CORP. COUNS. WEEKLY, July 8, 1986, at 2. On the availability of equitable remedies in derivative suits, see generally 13 W. FLETCHER, *supra* note 32, §§ 6027-6043.

67 CORP. COUNS. WEEKLY, July 8, 1986, at 2.

loyalty and in good faith, and who derive no improper personal benefit.[68]

Even at first blush, then, the statute permits little of the shareholder exploitation that Professor Cary fears;[69] at worst, shareholders will suffer the costs created by well-meaning directors who inadvertently act carelessly. Moreover, as argued immediately below, rational shareholders will remain largely protected from even that limited degree of harm.

B. Remaining Market Mechanisms of Shareholder Protection

Corporations, like trusts, are characterized by a "separation of ownership from control";[70] shareholders, like trust beneficiaries, cannot directly manage their property.[71] To prevent harm at the hands of a careless (or malicious[72]) director, they need, therefore, a form of indirect control. Corporation law, like trust law, has tradi-

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68 The statute is silent on whether it would shelter a director who is "reckless." *See supra* note 41. Presumably, reckless behavior would remain actionable under the statute's bad faith or duty of loyalty exceptions.

Indiana's director exculpation statute, which does not distinguish between the duties of care and loyalty, explicitly excludes protection for reckless conduct. IND. CODE ANN. § 23-1-35-1 (Burns Supp. 1987).

69 *See supra* text accompanying note 4.

70 *E.g.*, Fischel, *supra* note 9, at 916. This phrase is the usual label attached to the idea first put forth in A. BERLE & G. MEANS, *supra* note 7:

> The position of the owner has been reduced to that of having a set of legal and factual interests in the enterprise while [hired managers] are in the position of having legal and factual powers over it.

Id. at 113. Professors Demsetz and Lehn observe that

> Berle and Means's work was anticipated by Thorstein Veblen's (1924) volume, *The Engineers and the Price System.* Veblen believed that he was witnessing the transfer of control from capitalistic owners to engineer-managers and that the consequences of this transfer were to become more pronounced as diffusely owned corporations grew in economic importance. In the wake of this transfer of power, Veblen saw the end of the type of profit seeking he associated with capitalists, for he believed that capitalistic owners sought neither efficiency nor increased output so much as monopolistic restrictions to raise prices. The engineers, trained and acculturated to seek technological efficiency, would see to it that the production from the firms they now controlled would rise to higher and socially more desirable levels. The profits of monopoly would be sacrificed on the altar of efficiency.

Demsetz & Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155, 1173 (1985). Their data tend to refute the Veblen/Berle and Means forecast of shareholder detriment. *Id. See generally infra* note 82 and accompanying text.

71 *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1983) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . ."); REVISED MODEL BUSINESS CORP. ACT § 8.01(b) (1985) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors . . . .").

72 Because the new statute preserves common-law liability for breach of the duty of loyalty, *see supra* text accompanying note 64, director malfeasance other than carelessness need not be considered here.

tionally supplied that indirect control by imposing fiduciary duties.[73]

Recent theorists have questioned whether shareholders actually need the fiduciary duty of care after all, in light of certain market mechanisms that themselves protect shareholders to some extent.[74] "[A]re these the rules that stockholders really want and value, or are they arbitrary and wasteful judicial artifacts?"[75] Some conclude that abolishing the duty would not significantly harm its purported beneficiaries, the shareholders. "[V]ery little of any value would be lost by outright abolition of the legal duty of care and its accompanying threat of a lawsuit. Other incentives for an appropriate degree of care in corporate decisionmaking would . . . exist outside the courtroom to correct shortcomings."[76] A sketch of the major "other incentives" referred to follows.

The first incentive is the market for capital. Rational[77] investors

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73 Scott, *supra* note 2, at 927.

74 These protective mechanisms do not apply to close corporations because the mechanisms' efficacy depends on the existence of a ready market in the firm's stock. This limitation is not severe, however, because Berle and Means's "separation of ownership and control" is at worst a minor attribute of close corporations. *See, e.g.*, DEL. CODE ANN. tit. 8, § 342(a)(1) (limiting close corporations to 30 or fewer shareholders); L. SOLOMON, R. STEVENSON, JR. & D. SHWARTZ, CORPORATIONS: LAW AND POLICY 302 (1982) [hereinafter L. SOLOMON] ("shareholders of a close corporation are likely to think [of] themselves more as partners").

75 Goetz, *A Verdict on Corporate Liability Rules and the Derivative Suit: Not Proven*, 71 CORNELL L. REV. 344, 345 (1986); *see also* Scott, *supra* note 2, at 935 ("How critical is the legal duty of care to the monitoring of management's performance?").

76 Scott, *supra* note 2, at 937; *see* Fischel & Bradley, *supra* note 24, at 292:

> Many analyses of corporate law assume that liability rules enforced by derivative suits play a fundamental role in aligning the interests of managers and investors. We have shown that this widespread assumption is not supported by either the theory of liability rules, the available empirical evidence, or the structure of corporate law.

See also Demsetz, *A Commentary on Liability Rules and the Derivative Suit in Corporate Law*, 71 CORNELL L. REV. 352, 356 (1986)("workable substitute" for duty of care derivative suits); Weiss, *Economic Analysis, Corporate Law, and the ALI Corporate Governance Project*, 70 CORNELL L. REV. 1, 13-17 (1984) (endorsing Professor Scott's conclusions); *Edited Transcript of Proceedings of the Business Roundtable/Emory University Law and Economics Center Conference on Remedies Under the ALI Proposals: Law and Economics*, 71 CORNELL L. REV. 357, 368 (1986) [hereinafter *Edited Transcript*] (remarks of Professor Schwartz) (elimination of duty of care suits would not be "a great tragedy").

77 That people behave rationally, i.e., in their own best interest, is a "basic economic assumption." R. POSNER, *supra* note 11, § 1.3, at 15. It is also a philosophical premise. *See, e.g.*, F. HAYEK, THE CONSTITUTION OF LIBERTY 76 (1960) (allowing man freedom and responsibility "presupposes the capacity on men's part of rational action .... It presupposes a certain minimum capacity in them for learning and foresight, for being gnided by a knowledge of the consequences of their action").

The presumption of rationality provides a strong foundation for an ideology of autonomy: if individuals recognize and pursue that which is in their own interest, then government need not and should not intervene. Proponents of a more paternalistic ideology accordingly dispute the presumption of rationality. *E.g.*, Alexander, *Freedom, Coercion, and the Law of Servitudes*, 73 CORNELL L. REV. (forthcoming 1988) ("People do behave irrationally."). *See generally infra* notes 137-41 and accompanying text.

will only entrust their funds to firms in whose management they have confidence. Firms that are known to have careless directors will not attract investors, or will only attract them at a discounted price. The same applies to firms that have inadequate mechanisms for monitoring and making public the quality of their directors' ongoing performance.

Therefore, in order to attract capital,

> [m]anagers must select governance structures that ameliorate shareholders' rational concerus. Both managers and investors gain from effective governance. Managers do not want a structure that grants them "too much" autonomy, because investors who fear excessive corruption and ineptitude will bid down the price of shares.[78]

In order to secure their own financial well-being, then, firms themselves will exact adequate care of their directors.[79]

The second incentive is the market for the firm's product. Like the firm's investors, its directors want the firm's products to sell well and to generate profits, because the size of the firm's profits governs to some extent the size of its directors' compensation.

> After they have raised capital, the managers depend on the firms' profits for their salary and perquisites. Even if the managers' inside position gives them great ability to take advantage of the investors, they still find it advantageous to run the firms so as generally to maximize profits. Then there is a larger kitty into which they can dip. This may show up in the value of stock holdings and bonuses; in the longer run it controls salary as well.[80]

Indeed poor performance may not only stunt the careless director's compensation; it may cost him his job.[81] Compensating directors with shares of the firm's stock heightens this incentive.[82]

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78 Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J. L. & ECON. 179, 180; *see infra* notes 53-64 and accompanying text (discussing importance of bidding down price of shares).

79 *See generally* Easterbrook, *supra* note 14, and works cited *id.* at 543-44 n.4.

80 *Id.* at 554.

81 The careless director's job loss would result from a takeover of the firm by those who, in their own view and in that of shareholders, can run the firm more efficiently. *See infra* notes 83-89 and accompanying text.

82 Easterbrook, *supra* note 14, at 554-55; Demsetz, *supra* note 76, at 356 ("The structure of ownership in the modern corporation is itself a source of pressure for keeping management tied to sharehold interests.").

See also Demsetz & Lehn, *supra* note 70, which finds "no significant [empirical] relationship between ownership concentration and accounting profit rate, and especially no significant positive relationship. The data simply lend no support to the Berle-Means thesis [that management ownership of shares leads to exploitation of other shareholders]." *Id.* at 1175-76.

Demsetz also concludes "that shareholders have and use alternatives to the deriva-

The third incentive is the market for corporate control.[83] Outsiders who perceive[84] a firm as being managed inefficiently will seek to acquire control of it, by means of merger,[85] proxy contest,[86] or tender offer.[87] Shareholders often respond favorably to one of these takeover devices if they believe that the outsiders can in fact do a better job.[88] "Those who are best at running firms will enlarge the span of their control; those who falter will be replaced."[89]

The fourth incentive is the market for the firm's stock. Professional investors and investment advisors continuously monitor the performance of a firm and its directors. If the results of their monitoring reveal that the directors' conduct falls below the satisfactory degree of care,[90] they will sell their (or their clients') stock, causing the stock's price to fall.[91] That fall in stock price causes a series of responses which, as shown immediately below, brings into play all three of the market incentives examined thus far.[92]

To begin with, "the lower price makes it harder for the firm to raise new capital in competition against other firms with more dedi-

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tive suit." Demsetz, *supra* note 76, at 356. The alternatives to which Demsetz refers presumably include the market mechanisms sketched in this Part.

83 This concept was introduced in Manne, *supra* note 15, at 110; *see also* Easterbrook, *supra* note 14, at 564-70; Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169-74 (1981); Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978); Fischel, *supra* note 9, at 919; Jensen & Ruback, *supra* note 14; Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEG. STUDIES 251, 262-73 (1977).

84 This perception may arise from the stock market as well as from competitors' subjective evaluations.

> Share price, or that part reflecting managerial efficiency . . . measures the potential capital gain inherent in the corporate stock. The lower the stock price, relative to what it could be with more efficient management, the more attractive the take-over becomes to those who believe that they can manage the company more efficiently.

Manne, *supra* note 15, at 113. On the effects of the stock market generally, see *infra* notes 90-96 and accompanying text.

85 Manne, *supra* note 15, at 117-19.

86 *Id.* at 114-15.

87 *Id.* at 115-17.

88 Jensen & Ruback, *supra* note 14.

89 Easterbrook, *supra* note 14, at 564.

90 Because the monitors are professionals, one can expect their evaluations of directorial care to be relatively accurate with respect to the "optimality" discussed *infra* notes 98 & 110, especially in comparison to the uninformed evaluations made by juries. *See supra* notes 46-54 and accompanying text.

91 *See* Manne, *supra* note 83, at 112:

> As an existing company is poorly managed—in the sense of not making as great a return for the shareholders as could be accomplished under other feasible managements—the market price of the shares declines relative to the shares of other companies in the same industry or relative to the market as a whole.

92 *See supra* notes 78-89 and accompanying text.

cated managers, and this puts great pressure on managers to improve."[93] This "great pressure" springs from two factors. First, the market for capital is itself an incentive for directors to act with care.[94] Second, the market for capital affects the product and corporate control markets:[95]

> The higher the price of capital, the higher the firm's cost in making and supplying goods. The higher its cost, the less it can sell in competition with other firms that adopt superior management-control devices. It also makes less per sale. Lower profits mean diminished ability to divert benefits (and increased chance of replacement).[96]

A "diminished ability to divert benefits" means a limitation on directors' compensation—a product market effect. An "increased chance of replacement" means a loss of relative job security—a corporate control market effect.

To be sure, not even those who urge shareholders to rely exclusively on these market mechanisms contend that they are costless or flawless.[97] They contend only that the costs of these mechanisms are lower than those of the common-law regime.[98] This contention's truth hinges upon both empirical measurements[99] and value judgments of the market and common-law regime's relative ideological costs.[100]

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93 Easterbrook, *supra* note 14, at 556.
94 *See supra* notes 97-100 and accompanying text.
95 *See supra* notes 80-89 and accompanying text.
96 Easterbrook, *supra* note 14, at 556.
97 *See, e.g.*, Easterbrook, *supra* note 14, at 542:

> A warning. None of the competitive devices is costless or perfect. Indeed, all are quite costly, and all together leave room for occasional fraud and managerial slack. We live in an imperfect world. There is bound to be some divergence between investors' interests and managers' actions. The ALI's proposals [to strengthen fiduciary duties] rest on the view that if markets have costs and imperfections, then we need legal rules to overcome them. This is a non-sequitur. The observation that there are costs requires us to ask further questions. How large is the divergence? Can it be reduced by new legal rnles without incurring costs that exceed the benefits?

See also Baysinger & Butler, *supra* note 78, at 179 ("markets do not operate costlessly").
98 Many contend, specifically, that these market mechanisms will generate the "optimum" amount of shareholder protection: shareholders will sometimes be harmed by careless directors, but the amount of that harm will be less than it would have cost to prevent that harm. *See, e.g.*, Baysinger & Butler, *supra* note 78, at 180 (managers do not want "too much" autonomy and shareholders do not want "too much" control); The T.J. Hooper, 60 F.2d 737 (2d Cir. 1932) (L. Hand, J.).
99 *See supra* notes 14-15 and accompanying text.
100 *See infra* notes 133-43 and accompanying text; *see also infra* notes 156-65 and accompanying text.

III
Costs of the Common-Law Regime

The common-law regime imposes two types of costs: practical and ideological. The common law's vagueness causes the practical costs of inefficiency and loss of directorial talent; its officiousness causes the ideological cost of loss of shareholders' freedom of contract. By allowing shareholders to exculpate directors, the Delaware statute restores shareholder freedom of contract, and thereby permits them to cure the inefficiency and talent costs as well.

A. Difficulty in Planning and Behavioral Inefficiency

The common-law regime's unpredictability impedes directors' abilities to plan their corporations' actions. The vagueness of duty-of-care rules[101] and the case-by-case nature of duty-of-care adjudication[102] make it difficult for a director to feel secure in his decisions;[103] he cannot ever be sure that he has exercised adequate care unless the shareholders sue him and elicit a verdict.[104] The common-law system "actually encourages a substitution of the court's judgment for that of the defendant director."[105]

Directors' wariness of being second-guessed by courts forces

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101 *See supra* notes 28-45 and accompanying text.

102 *See supra* notes 46-54 and accompanying text.

103 What Confucius said concerning "incorrect" language captures the vague nature of duty-of-care doctrine and its damaging effect on business planning:

> If language is incorrect, then what is said does not concord with what was meant; and if what is said does not concord with what was meant, what is to be done cannot be effected. If what is to be done cannot be effected, then rites and music will not flourish. If rites and music do not flourish, then mutilations and lesser punishments will go astray. And if mutilations and lesser punishments go astray, then the people have nowhere to put hand or foot.

Confucius, The Analects bk. XIII, at 171-72 (A. Waley trans. 1938); *see also* Veasey & Manning, *supra* note 58 and accompanying text.

104 The time and expense of such a suit is, of course, itself also a cost of the common-law system.

105 Veasey & Manning, *supra* note 43, at 931.

This observation suggests a latent inconsistency between the common-law system and the business judgment rule. The business judgment rule insulates the merits of directors' decisions from judicial second-guessing if the business decision involves a breach neither of the fiduciary duty of loyalty nor of the fiduciary duty of care. Arsht, *supra* note 24, at 111. The primary reason for the rule is the courts' lack of competence to adjudicate a decision's merits. *Id.* But if the court cannot competently evaluate the product of a decision, how can it evaluate the process used to reach this decision? Leo Herzel and Leo Katz call this an "odd dichotomy" and "a very elusive distinction." Herzel & Katz, Smith v. Van Gorkom: *The Business of Judging Business Judgment*, 41 Bus. Law. 1187, 1190 (1986). Perhaps the jurisprudential rationales for the business judgment rule, when logically extended, call for courts to cease making duty-of-care judgments altogether. The Delaware-style exculpation statutes would thus not go far enough; a self-implementing statute such as Oklahoma's, *see supra* note 65, would be more defensible.

them to take inherently inefficient precautions. The precautions take two forms: (1) avoiding business risks and (2) building "paper shelters,"[106] or "following more costly and time-consuming decisionmaking procedures."[107]

1. *Avoiding Business Risks*

Directors who are subject to the fiduciary duty of care will avoid more innovation and risk than shareholders would like.[108] Given the nature of equity stock,[109] all shareholders would presumably encourage, to some degree,[110] "aggressive managers who are willing

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106 Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L.J. 895, 903.

107 Scott, *supra* note 2, at 936.

Professor Scott states with restraint that "[i]t is most doubtful whether [either of the two kinds of precaution] would be in the best interest of shareholders." *Id.* The Business Roundtable also recognizes both precautions, without Professor Scott's restraint:

> The last thing American business needs as it competes with its foreign counterparts is to be led by liability-shy directors whose major concern is to avoid risk, create "paper trails" and generally "cover" themselves.

STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS" 53 (1983).

108 This divergence of interests is particularly pronounced where diversified investors are concerned. Even directors who are *not* subject to the fiduciary duty of care will avoid more risk than diversified shareholders would like.

> Since corporate management has a larger stake in the survival [and freedom from derivative lawsuit] of a particular corporation than does a diversified shareholder—indeed, since management's viewpoint is closer to that of the undiversified shareholder, its self-interest may cause it to be too cautious so far as shareholders generally are concerned.

Winter, *supra* note 5, at 527; *see also Edited Transcript*, *supra* note 76, at 363 (remarks of Professor Manne) ("general risk averseness of managers"); *id.* at 364 (remarks of Professor Macey) ("managers can't really diversify").

109 Equity securities offer holders an unlimited profit potential in exchange for an unsecured risk that their investment will become worthless. L. SOLOMON, *supra* note 74, at 150-52. Debt securities, by contrast, offer holders only limited profit potential, in exchange for relative security of investment. *Id.* at 154-56.

110 The degree of risk that shareholders want directors to take varies not only according to each shareholder's risk preference, *see infra* note 134, but also according to the degree to which each shareholder is diversified.

Undiversified shareholders, being concerned with the net performance of each of their investments, will want directors to take only that amount of risk which is optimum for the corporation, i.e., the amount of risk at which favorable outcomes within the corporation will most substantially outweigh losses to the corporation from unfavorable outcomes:

> Many business decisions are made on the basis of suggestive but inconclusive information. Rational shareholders would not have it otherwise, however, for their welfare is maximized by decisions that yield the highest profits net of the costs of gathering information and making the decisions.

Easterbrook & Fischel, *supra* note 83, at 1196.

Diversified shareholders, by contrast, are concerned not with the individual performance of each investment but rather with the range of "all possible future values of their investment [portfolio]." Note, *The Regulation of Risky Investments*, 83 HARV. L. REV.

to take good-faith risks in the search for profits."[111] But the desire to avoid personal liability under the fiduciary duty of care will cause directors to avoid some such risks,[112] and err on side of undue caution[113] at the sacrifice of potential profits. As Professors Baysinger and Butler explain in a more general context:

> The benefits of enhanced legal controls . . . are offset by significant organizational costs. . . . At some point, increases in [shareholder constraints on management] will reduce shareholders' wealth by stifling innovation . . . . Under stricter corporate laws, the decreased risk of adverse managerial behavior is 'purchased' with the currency of increased likelihood of . . . managerial inertia.[114]

Under this type of inert management, shareholders profit less than they would have had their directors taken the optimum amount of risk. Thus, as Professor Manne observes, "You do good by punishing people for their mistakes, but you also do harm by preventing

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603, 617 (1970). From a diversified investor's point of view, "[e]ven a security which is quite risky taken alone may decrease total portfolio risk and, accordingly, be a more prudent purchase than a security which appears less risky by itself." *Id.* at 617-18. Diversified investors will therefore want certain corporate directors to take more than the optimum level of risk. *See* Winter, *supra* note 83, at 527; Fischel & Bradley, *supra* note 24, at 266.

The common-law regime may thus be relatively well-tailored to undiversified shareholders' desires, but this is no reason to retain it. "Given mutual funds and similar forms of diversified investment, the law need not give special protection to shareholders who refuse to reduce the volatility of risk by not diversifying." Winter, *supra* note 5, at 527.

111 Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993, 1993-94 (1978).

112 *See* Fischel & Bradley, *supra* note 24, at 265-66:

> Because most lawsuits follow poor outcomes, courts naturally tend to assume that such outcomes are a product of bad actions. This bias . . . can greatly discourage any risk taking by managers. . . . By definition, . . . risky projects can have poor outcomes; if managers are sued whenever decisions that were optimal ex ante turn out poorly ex post, they will tend to avoid risky projects.

See also West, *An Economist Looks at the ALI Proposals*, 9 DEL. J. CORP. L. 638, 643 ("[W]hat is most disturbing about the proposed principles [which include heightening of the duty of care] is that they could lead some companies to take less risk, and be less innovative."); Winter, *supra* note 5, at 526 (American Law Institute's proposed strengthening of the common-law duty of care "may create incentives for overcautious corporate decisions").

Judge Posner observes the same principle at work in the criminal law: "[S]ince criminal sanctions are severe, to attach them to accidental conduct (and *a fortiori* to unavoidable conduct) is to create incentives to steer clear of what may be a very broad zone of perfectly lawful activity in order to avoid the risk of criminal punishment." R. POSNER, *supra* note 11, § 7.5, at 221.

113 This caution is itself a cost to shareholders, distinct from the profits it causes directors to forgo. *See infra* notes 116-18 and accompanying text.

114 Baysinger & Butler, *supra* note 78, at 181-82.

them from taking any risk."[115]

2. *Building Paper Shelters*

Professor Conard brands this second form of precaution "diligence in creating an appearance of diligence in whatever decisions are made."[116] The precaution consists of directors' reluctance or refusal to make decisions unless supplied with exhaustive, expert opinions: accountants' certifications of the accuracy of financial statements, investment bankers' opinions as to the valuation of operations, engineers' analyses of production costs, lawyers' opinion letters, et cetera.[117]

Such behavior is clearly inefficient insofar as it causes unproductive expenditure of the corporation's time and money. Less obvious than this unproductivity, but at least as undesirable, is the risk of outright counterproductivity: the shelter-building tendency "would force managers to find and use consultants who tend more toward optimism than toward candor and illumination. In this way, the fear of liability may tend to degrade, rather than to elevate, the decisional processes of directors."[118]

The tendency of directors under the common-law regime to take shelter-building precautions can only be heightened by the Delaware Supreme Court's decision in *Smith v. Van Gorkom*.[119] That decision held directors of the Trans Union Company liable for gross negligence in approving a merger, partly because of the spareness of their decisionmaking procedure.[120] The court failed to recognize that "experienced and sophisticated" directors could "recognize and approve a good deal at the drop of a hat"[121] while safely dispensing with certain ordinary precautions. Other directors will in-

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115 *Edited Transcript*, *supra* note 76, at 363.

116 Conard, *supra* note 106, at 904.

117 *Id.* at 903-04; *see also* Herzel & Katz, *supra* note 105, at 1191:

> Such formalism has a lot of costs. Most obviously, it will mean more reliance on and more fees for lawyers, investment bankers, accountants, management consultants, and economists, and who knows, maybe sociologists, statisticians, psychologists, demographers, and population geneticists. . . . After all, every decision has untold consequences and ramifications.

See also West, *supra* note 112, at 642-43 (ALI's proposed heightening of duty of care would cause directors to "feel under even more pressure than now to protect their hind quarters," and would prompt "make work exercises whose only objective is to ward off second guessing and Monday morning quarterbacking.").

118 Conard, *supra* note 106, at 904.

119 488 A.2d 858 (Del. 1985).

120 The board approved the merger without the benefit of an investment banker's advice, after a meeting that lasted only two hours, and an oral presentation of the merger's merits that lasted only twenty minutes. *Id.* at 868-69. However, beneath these duty-of-care concerns lurk duty-of-loyalty concerns. *See supra* note 24.

121 Herzel & Katz, *supra* note 105, at 1189; *see also* Spiegel, *The Liability of Corporate*

tensify their own shelter-building precautions after seeing these business leaders punished for choosing not artificially to pad their decisionmaking process.[122]

B. Loss of Directorial Talent

The second practical cost of the common-law regime is its tendency to deter would-be directors from serving. Wary of incurring personal liability, current directors may either adopt relatively inactive roles[123] or resign altogether; prospective directors may decline proffered positions.

This deterrent effect is three-fold. First, even the best intentioned director will have difficulty acting within the confines of the common-law duty-of-care rules, because of those rules' unclarity.[124] He thus risks incurring liability due to an innocent misstep.[125] Second, even the director who succeeds in avoiding such missteps risks being held liable because of the courts' erratic verdicts.[126] "If a law is unclear, . . . [there is] a risk that legitimate conduct will be found to violate it."[127] And third, directors' liability insurance has become unavailable or prohibitively priced.[128] When available, this insurance mitigates the two previous deterrent factors.[129] One explana-

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Officers, 71 A.B.A. J., Nov. 1985, at 48, 52 ("'The court did not give proper credence to the experience level of the board.' ") (quoting Professor Donald Schwartz).

122 [One] effect of *Smith v. Van Gorkom* will be greater formalism on the part of the board, as it goes about the business of cultivating an aura of care, diligence, thoroughness, and circumspection. (As one director put it: "Prudence and diligence are no longer assumed but require a certain amount of posturing.").

Herzel & Katz, *supra* note 105, at 1191 (quoting R. MAUTZ & F. NEUMANN, CORPORATE AUDIT COMMITTEES: POLICIES AND PRACTICES 87 (1977)). The spate of articles published after the decision offers support for this forecast. *See, e.g.*, Manning, *supra* note 45; Spiegel, *supra* note 121.

123 *See* Conard, *supra* note 106, at 904 ("diligence in avoiding participation in crucial decisions").

124 *See supra* notes 24-45 and accompanying text.

125 Negligence liability depends upon conduct, not upon intent or other state of mind. W. KEETON, *supra* note 30, § 31, at 169 ("An honest blunder, or a mistaken belief that no damage will result, may absolve the actor from moral blame" but not from legal liability.). This also applies to one kind of gross negligence. *See supra* notes 37-42 and accompanying text.

126 *See supra* notes 47-49 and accompanying text.

127 R. POSNER, *supra* note 11, § 20.3, at 513; *see also* Fischel & Bradley, *supra* note 24, at 265 ("substantial error costs" of courts' duty-of-care decisions).

128 *Director Insurance Drying Up*, N.Y. Times, Mar. 7, 1986, at D1, col. 3; Wall St. J., July 10, 1985, at 1, col. 6.

Because the fiduciary duty of care can subject even the most careful director to adverse adjudication, *see supra* notes 124-27 and accompanying text, a director's rational response to the unavailiability of insurance will be to resign rather than intensify his care.

129 Lloyd's policy form insures directors against liability for any "wrongful act." J. BISHOP, LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE

tion given[130] for the current unavailability of directors' liability insurance is the growth of precisely those lawsuits that shareholder action under the new statute can eliminate.[131]

Unfortunately, the common-law regime deters the careful as much as it deters the negligent. Indeed, it may deter the careful even more strongly than it does the negligent; as Professor Conard points out, "[t]he quality of 'prudence,' so valued in a money manager, is highly incompatible with incurring risks of million-dollar [personal] liabilities."[132]

C. Infringement of Shareholders' Freedom of Contract

The third and arguably most siguificant cost of the common-law regime is ideological rather than practical. It lies in the fact that the fiduciary duty of care foists itself upon shareholders without regard to whether any given shareholder desires it.[133] Some shareholders, at least, do not desire it.[134] Forcing them to accept it not only forces

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app.-76 (1982 & Supp. 1986). This term is defined as including "any actual or alleged breach of duty, neglect or error." *Id.* at app.-78.

Delaware law permits corporations to purchase directors' liability insurance against all risks, including negligence. DEL. CODE ANN. tit. 8, § 145(g) (1983).

130 *Director Insurance Drying Up*, N.Y. Times, Mar. 7, 1986, at D1, col. 3.

131 In a shareholder action against directors of Wickes, Inc., one insurer paid out $25 million. Wall St. J., July 10, 1985, at 1, col. 6.

Observers predict that widespread shareholder action under the statute will ameliorate the insurance supply crisis by reducing directors' need to insure themselves against duty of care suits:

> Some companies . . . have lost outside directors because they couldn't find or afford liability insurance for them. That will probably happen less often in 1987 than in recent years, predicts John M. Nash, president of the National Association of Corporate Directors in Washington, D.C. This, he notes, is largely because Delaware . . . [has] modified [its] laws to make it possible for companies to indemnify directors against certain claims.

Firms May Find Insuring Boards is Getting Easier, Wall St. J., Jan. 13, 1987, at 31, col. 3; *see also* Delaware Liability Law Warmly Received, Predictions on Impact Remain Cautious, 18 Sec. Reg. & L. Rep. (BNA) 1309 (Sept. 12, 1986). It is interesting to observe Mr. Nash's tacit assumption that many corporations' shareholders will choose to take action under the new statute. As a basis for that assumption he must either believe that shareholders are irrational, or that they will rely on the market protection mechanisms outlined *supra* notes 70-96 and accompanying text.

132 Conard, *supra* note 106, at 903; *see also* West, *supra* note 112, at 642 ("[I]t's not surprising that more than a few people *of the calibre we would like to have on major corporate boards* look at [the ALI's proposed strengthening of the duty of care] and say, 'who needs it?' ") (emphasis added).

133 The fiduciary duty of care "arise[s] by operation of law and not by mere agreement of the parties." BLACK'S LAW DICTIONARY 1335 (5th ed. 1979); *see* Scott, *supra* note 24, at 300 ("ploy" of abolishing management's fiduciary duties by express contract "almost certainly would not be successful").

134 One can infer this from the shareholder action mentioned *supra* note 10 and accompanying text. Some would argue that such action does not necessarily reflect share-

upon them the practical costs identified above,[135] but also denies them their freedom contractually to exculpate directors.[136]

That freedom of contract is a value, and hence that its infringement is a "cost,"[137] is so widely accepted (albeit rarely articulated) that it may seem platitudinous;[138] the right to decide what one wants, and on what terms, is very simply a component of autonomy and hence of liberty.[139] This is not the place to rehearse the broad

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holder preference. *See infra* notes 168-88 and accompanying text for an analysis of this argument.

The varying degrees of shareholders' desire for fiduciary protection may stem from any of the following:

(a) Varying degrees of risk preference. ("A person is risk averse if he would pay less than $5 for a 50% chance of receiving $10; risk neutral if he would pay exactly $5; and risk preferring if he would pay more than $5." Fischel, *supra* note 9, at 918 n.30.).

(b) Varying degrees of willingness to rely on the market mechanisms for shareholder protection examined *supra* notes 70-96 and accompanying text.

(c) Varying costs of contracting for alternative means of protection. *See, e.g.*, Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 702 (1982) ("The existence of such 'off-the-rack' [fiduciary rules] reduces the costs of transacting and of enforcing restrictions on the agent's powers.").

135 *Supra* notes 101-32 and accompanying text.

136 "Fiduciary principles . . . leave small room for the notions of 'consent' or 'agreement' that govern the law of contract, even though the fiduciary arrangement generally originates in a consensual transaction." Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1407 n.15 (1985).

137 *See supra* note 11.

138 "As Whitehead noted, fundamental assumptions 'appear so obvious that people do not know what they are assuming because no other way of putting things has ever occurred to them.'" Cramton, *The Ordinary Religion of the Law School Classroom*, 29 J. LEGAL EDUC. 247, 247-48 (1978).

139 Hayek writes:

> It is one of the fundamental rights and duties of a free man to decide what and whose needs appear to him most important. . . . The recognition that each person has his own level of values which we ought to respect, even if we do not approve of it, is part of the conception of the value of the individual personality.

F. HAYEK, *supra* note 77, at 79; *see also* C. FRIED, CONTRACT AS PROMISE 20 (1981) ("[H]olding people to their obligations is a way of taking them seriously. . . . [R]espect for others as free and rational requires taking seriously their capacity to determine their own values."); M. FRIEDMAN, CAPITALISM AND FREEDOM 8 (1962) ("[F]reedom in economic arrangements is itself a component of freedom broadly understood, so economic freedom is an end in itself."); R. NOZICK, ANARCHY, STATE, AND UTOPIA 58 (1974) ("My nonpaternalistic position holds that someone may choose . . . to do to himself *anything*, unless he has acquired an obligation to some third party not to do or allow it.") (emphasis in original); *cf.* Allgeyer v. Louisiana, 165 U.S. 578, 589 (1896):

> The "liberty" mentioned in [the 14th] amendment means, not only the right of the citizen to be free from the mere physical restraint of his person, as by incarceration, but the term is deemed to embrace the right of the citizen . . . to pursue any livelihood or avocation; and for that purpose to enter into all contracts which may be proper, necessary, and essential to his carrying out to a successful conclusion the purposes above mentioned.

The fact that such *Lochner*-era reasoning has fallen into disfavor as constitutional doctrine does not impair its validity as an ideological position.

and rich debate between proponents of this value and proponents of the contrary value of sacrificing freedom of contract in order to promote sharing and commonality of interest among individuals.[140] One may simply observe that each set of values is defensible and has some place in the social order. As applied to the subject at hand, the Delaware statute promotes autonomy over commonality, whereas the common-law regime promotes the contrary.[141]

Whichever of the two values one holds more important, the "worth" of neither autonomy nor commonality in a given context is quantifiable. Such values "do not lend themselves to collective measurement which is acceptably objective and nonarbitrary."[142] One's inability to quantify them, though, does not obviate these costs' importance to one's evaluation of the new statutes' merits. "[U]nless

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140 *See, e.g.*, Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563, 563 (1982) ("paternalism" based on "empathy or love"); Atiyah, Book Review, 95 HARV. L. REV. 509, 527 (1981). Professor Atiyah wrote,

> The proposition that a person is always the best judge of his own interests is a good starting point for laws and institutional arrangements, but as an infallible empirical proposition it is an outrage to human experience. The parallel moral argument, that to prevent a person, even in his own interests, from binding himself is to show disrespect for his moral autonomy, can ring very hollow when used to defend a grossly unfair contract secured at the expense of a person of little bargaining skill.

Id. Professor Atiyah's comments are particularly pertinent to the notion, addressed *infra* notes 149-67 and accompanying text, that shareholder agreements to exculpate directors result from a disparity of bargaining power.

141 A simple model illustrates this. Suppose that A and B are shareholders of different corporations. Suppose further that the director of A's corporation is negligent, and the director of B's corporation is not. That is, A has invested foolishly and B has invested wisely. If both corporations' shareholders have adopted exculpation provisions, then A cannot recover damages for his director's negligence, and is seriously injured. B, on the other hand, is not only unaffected by A's loss; he also benefits from his director's increased efficiency. *See supra* notes 101-32 and accompanying text. Thus, the new statutes favor those who look out for themselves.

Under the common-law regime, by contrast, both corporations' directors operate under the threat of lawsuit. Investor A will sue to recover damages for his director's negligence; B will not sue. A thus recovers his loss, but B now is injured, because the director of his corporation has become too cautious. *See supra* notes 101-32 and accompanying text. Thus, under the common-law regime, B is forced to "share" A's loss, bearing some smaller costs so that A will not have to bear a larger cost alone.

142 Calabresi & Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1111 (1972). "Where is the price that reveals what people are willing to pay to avoid exposing children to pornography? How can the monetary value of corrective justice be measured? On what pseudo or implicit market is the societal distaste for voluntary slavery demonstrated?" Rizzo, *The Mirage of Efficiency*, 8 HOFSTRA L. REV. 641, 646 (1980); *see also* A. POLINSKY, *supra* note 11, at 123-24 (process of valuing nonstandardized goods is difficult). Professor Polinsky writes, "For example, suppose as a result of pollution someone is forced to move from his home. Although the market price of the home could be determined from the sales prices of similar homes, this price will not reflect the special attachment the person who lived there may have had for that location and that house." *Id.*

we claim that whatever cannot be (easily) quantified does not exist, they are indeed crucial."[143]

As a rule, in the domain of private arrangements, our legal system has favored not only freedom of contract over paternalism in general, but also the right in particular of individuals to exculpate others from negligence:

> It is quite possible for the parties expressly to agree in advance that the defendant is under no obligation of care for the benefit of the plaintiff, and shall not be liable for the consequences of conduct which would otherwise be negligent. There is in the ordinary case no public policy which prevents the parties from contracting as they see fit, as to whether the plaintiff will undertake the responsibility of looking out for himself.[144]

Moreover, this general rule has been held to encompass agent/principal relationships,[145] which of course are analogous to shareholder/director relationships.[146]

In arguing that shareholders should be allowed to choose for themselves whether to seek the fiduciary duty of care's protection, one presupposes that shareholders can, in fact, freely make such a choice. Two arguments are sometimes made that they cannot; neither, as is shown below, is persuasive. The first argument claims that shareholders suffer from a "disparity of bargaining power" vis-a-vis directors, and that a charter amendment adopted under the new statutes should therefore be held void as a matter of contract law.[147] The second argument broadly asserts that shareholders' voting power in general is inadequate, in theory or practice, to protect shareholders' interests.[148]

1. *Absence of Disparity in Bargaining Power*

It is true that some jurisdictions hold exculpatory clauses void "where there is such disparity of bargaining power between the parties that the agreement does not represent a free choice on the part of the plaintiff."[149] But this rule is not an exception to the freedom

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143 Rizzo, *supra* note 142, at 646.

144 W. KEETON, *supra* note 30, § 68, at 482 (footnote omitted); *Id.* at 482 nn.16-17; *see also* Annotation, *Validity of Exculpatory Clause in Lease Exempting Lessor from Liability*, 49 A.L.R.3d 321 (1986).

145 Griffiths v. Henry Broderick, Inc., 27 Wash. 2d 901, 182 P.2d 18 (1947).

146 *See, e.g.*, L. SOLOMON, *supra* note 74, at 27 (directors "act as representatives of the shareholders").

147 *See infra* notes 149-67 and accompanying text.

148 *See infra* notes 168-88 and accompanying text.

149 RESTATEMENT (SECOND) OF TORTS § 496B comment j (1965); *see also* Tunkl v. Regents of the Univ. of Calif., 60 Cal. 2d 92, 101, 383 P.2d 441, 446, 32 Cal. Rptr. 33, at 38 (exculpatory clause void where "the releasing party does not really acquiesce voluntarily in the contractual shifting of the risk").

of contract principle; to the contrary, it is that principle's logical corollary. A contract that is the product of such a disparity is not "free" at all, and so should not be enforced.[150] However, no such disparity exists between shareholders and directors.

In those jurisdictions that recognize disparity in bargaining power as a reason to void exculpatory clauses, its essential attribute appears to be an absence of feasible alternatives for the weaker party.[151] Three criteria used to void exculpatory clauses concern that absence: "practical necessity," "decisive advantage of bargaining strength," and "adhesion contract."[152] Applying each of these criteria will illustrate just how inapposite the line of argument is.

The first criterion is that "[t]he party seeking exculpation [be] engaged in performing a service of great importance to the public, which is often a matter of practical necessity for some members of the public."[153] The urgently sick do need medical care;[154] families in a tight housing market do need shelter;[155] but a prospective in-

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150 *See* Kennedy, *supra* note 140, at 577 ("To claim that freedom of contract doesn't take into account unequal bargaining power . . . is just wrong. Allowance for these situations is part of the very definition of the institution."); *cf.* F. HAYEK, *supra* note 77, at 77 ("The complementarity of liberty and responsibility means that the argument for liberty can only apply to those who can be held responsible. It cannot apply to infants, idiots, or the insane.").

151 This attribute would account for virtually all of the contexts in which exculpatory clauses have been held void: lessee exculpating lessor in tight housing market, Kay v. Cain, 154 F.2d 305 (D.C. App. 1946); patient exculpating hospital, Tunkl v. Regents of the Univ. of Calif., 60 Cal. 2d 92, 383 P.2d 441, 32 Cal. Rptr. 33 (1963); employee exculpating employer, Illinois Cen. R.R. v. Harris, 108 Miss. 574, 67 So. 54 (1914); users exculpating public utility, Collins v. Virginia Power & Elec. Co., 204 N.C. 320, 168 S.E. 500 (1933). *See also* RESTATEMENT (SECOND) OF TORTS § 496B illustration 5 (1977) (driver exculpating operator of only available parking lot).

The cases voiding exculpatory clauses on other grounds are either unpersuasively reasoned, *e.g.*, John's Pass Seafood Co. v. Weber, 369 So. 2d 616, 618 (Fla. Dist. Ct. App. 1979) (lessor "simply should not be permitted" to exempt himself from statutory duty), or arise from extenuating circumstances. *E.g.*, Taylor v. Leedy & Co., 412 So. 2d 763 (Ala. 1982) (willful failure to disclose latent defect); Wise v. Dawson, 353 A.2d 207 (Del. Super. Ct. 1975) (tortious misrepresentation).

152 Tunkl v. Regents of the Univ. of Calif., 60 Cal. 2d 92, 383 P.2d 441, 32 Cal. Rptr. 33 (1963); Henrioulle v. Marin Ventures, Inc., 20 Cal. 3d 512, 573 P.2d 465, 143 Cal. Rptr. 247 (1978). The quoted criteria are drawn from California cases merely because, as the most detailed and articulate on the subject, they provide the clearest and strongest challenge to this Note's argument.

The Delaware law on this subject (aside from the statute at issue) consists only of a narrow statute that voids exculpatory clauses in road construction contracts, DEL. CODE ANN. tit. 6, § 2704(a) (1974 & Supp. 1986), and Wise v. Dawson, 352 A.2d 207 (Del. Super. 1975). That case contains dictum that harmonizes with our statute, 353 A.2d at 208 (exculpatory clause "would possibly be effective in a contract action"), and finds the defendant liable only because of the extenuating circumstance of his tortious misrepresentation.

153 *Tunkl*, 60 Cal. 2d at 98-99, 383 P.2d at 445, 32 Cal. Rptr. at 37.

154 *Id.* at 92, 383 P.2d at 441, 32 Cal. Rptr. at 33.

155 *E.g.*, Kay v. Cain, 154 F.2d 305 (D.C. App. 1946).

vestor need not invest at all. Even less does he need to invest in any particular corporation's stock.[156] A prospective investor has endless alternatives—including buying stock in a corporation that has not exculpated its directors.

The second criterion is that "the party invoking exculpation possess[] a decisive advantage of bargaining strength against any member of the public who seeks his services."[157] Because the prospective investor has many alternatives, the firm has no bargaining advantage. Indeed, if either side does have such an advantage, it is the prospective investor: the market for capital[158] will prompt firms to attempt to supply the contract terms he wishes.

The third criterion is that the party seeking exculpation "confront[] the public with a standardized adhesion contract of exculpation, and make[] no provision whereby a purchaser may pay additional reasonable fees and obtain protection against negligence."[159] By contrast, the charter provision permitted by the statute will not be "standardized," on either an intra- or inter-corporation level. On the intra-corporation level, each corporation will have only one carefully considered exculpation provision. On an inter-corporation level, the wording and the extent[160] of various corporations' exculpation provisions will differ. Moreover, in further contrast to the third criterion, shareholders may indeed "pay additional reasonable fees and obtain protection against negligence"[161] simply by rejecting or repealing the charter provision, thereby reviving the common-law rules.[162] The "additional fees" would be "paid" in the form of the practical costs of the common-law regime.[163]

Moreover, three unique attributes of corporation law strengthen shareholders' bargaining position and further distinguish the shareholder/director context from those where courts

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156 A prospective investor has endless alternatives—including buying stock in a corporation that has not exculpated its directors.

157 *Tunkl*, 60 Cal. 2d at 99-100, 383 P.2d at 446, 32 Cal. Rptr. at 38.

158 *See supra* notes 97-100 and accompanying text.

159 *Tunkl*, 60 Cal. 2d at 100-01, 383 P.2d at 446, 32 Cal. Rptr. at 38 (footnote omitted); *cf.* McCutcheon v. United Homes Co., 79 Wash. 2d 443, 450 n.5, 486 P.2d 1093, 1097 n.5 (1971) (reserving decision on validity of an exculpatory clause in lease if supported by consideration of reduced rent).

160 The statute permits shareholder to either eliminate directors' liability or merely limit it. *See supra* text accompanying note 64.

161 *Tunkl*, 60 Cal. 2d at 100-01, 383 P.2d at 446, 32 Cal. Rptr. at 38.

162 Concerning the adequacy of shareholders' voting power, see *infra* notes 168-88 and accompanying text.

163 *See supra* notes 101-22 and accompanying text. Compare Professors Baysinger and Butler's metaphor of "the increased risk of managerial behavior being 'purchased,'" *supra* text accompanying note 114.

have invalidated exculpatory clauses.[164] First, shareholders have only limited potential losses: while a landlord's or doctor's negligence can cause boundless physical and monetary damages, a director's negligence can only cause monetary losses limited to the "victim's" investment.[165] Second, the market mechanisms for shareholder protection[166] resulting from the free transferability of shares, and the enormous market for them, generate surrogate protection against carelessness. Finally, unlike the uninformed tenant or patient, the investor is armed with exhaustive, SEC-mandated disclosures,[167] making him less likely to be taken advantage of in the bargaining process.

2. *Adequacy of Shareholder Voting Power*

Observers agree that shareholders do not exercise their proxy voting rights[168] as actively as they might.[169] They offer, however, conflicting explanations of this phenomenon. Some attribute the relative absence of shareholder participation to shareholders' perception that their vote is futile because the proxy system is weighted in favor of management. As Berle and Means put it, "The proxy machinery has thus become one of the principal instruments not by which a stockholder exercises power over the management of the enterprise, but by which his power is separated from him."[170] If this explanation were correct, then the freedom of contract argument for the new statutes[171] would lose its force, because shareholder approval of the newly permitted charter provision could not be considered a product of genuine shareholder choice. But a stronger argument, outlined below, indicates that the Berle and Means explanation is unfounded. The relative absence of shareholder participa-

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164 For cases invalidating exculpatory clauses, see *supra* note 151.

165 *E.g.*, W. KLEIN & J. COFFEE, BUSINESS ORGANIZATION AND FINANCE 135 (1986).

166 *See supra* notes 77-100 and accompanying text.

167 Securities Exchange Act of 1934, 15 U.S.C. § 78n (1982); 17 C.F.R. § 240.14a-1 to -102 (1987).

168 DEL. CODE. ANN. tit. 8, § 212 (1983). ("[E]ach stockholder shall be entitled to 1 vote for each share of capital stock held by such stockholder. . . . Each stockholder entitled to vote at a meeting of stockholders . . . may authorize another person or persons to act for him by proxy . . . .").

169 *E.g.*, SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 96TH CONG., 2d SESS., S.E.C. STAFF REPORT ON CORPORATE ACCOUNTABILITY 67 (Comm. Print 1980) [hereinafter SEC REPORT] ("absence of shareholder participation"; "shareholder apathy"); Easterbrook & Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395, 420 (1983) ("[m]anagers still are rarely displaced by voters; managers' recommendations on fundamental corporate changes, amendments of by-laws, or other matters are routinely followed; shareholders' proposals do well if they have 5 percent of the vote").

170 A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 129 (rev. ed. 1968); *see also* SEC REPORT, *supra* note 169, at 67.

171 *See supra* notes 133-44.

tion actually reflects rational shareholder choice, rather than some ill-defined shortcoming of the proxy system.

In disputing the Berle and Means position,[172] Professors Easterbrook and Fischel state sweepingly that "there is no reason why shareholders . . . should have any interest . . . in managing the firm's affairs."[173] This statement applies when management is acting in the shareholders' interest, because delegation to management is an efficient division of labor.[174] But the statement also applies when management is not acting in the shareholders' interest (as, opponents of the new statute would argue, when management pushes through a resolution adopting the newly permitted charter provision). The reason is that proxy voting is not the shareholder's only effective means of self-protection. As an alternative to voting, shareholders can either sell their shares or retain ownership and suffer whatever injury may result.[175]

The rational shareholder's choice among these three options depends on the relative costs and benefits of each.[176] The voting option may have high costs and low benefits; "Since time is a scarce resource, voting is inherently costly."[177] Shareholder voting consumes time and effort in reading and understanding the proxy solicitation materials,[178] evaluating their merits, and marking and returning the ballot.[179] Moreover, the benefits resulting from this

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172 Easterbrook and Fischel do not specifically address Berle and Means; rather, their attack focuses on a proponent of a more meaningful opportunity to participate in the proxy process.

173 Easterbrook & Fischel, *supra* note 169, at 420.

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> Delegation of authority enables skilled managers to run enterprises even though they lack personal wealth, and it enables wealthy people to invest even though they lack managerial skills. It reduces the risks that investors must incur, because it enables them to spread investments among many enterprises. Delegation also helps managers to pool enough capital to take advantage of available economies of scale in production, to reduce the costs of bargaining and contracting, and to obtain the benefits of productive information that must be used in secret or not at all.

Easterbrook & Fischel, *supra* note 134, at 700 (footnote omitted); *see also* A. BALLANTINE, CORPORATIONS § 1, at 4 (rev. ed. 1946); 1 A. SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 1-16 (E. Cannan ed. 1976) (exchange, even without planning, allows improvement in productive power); authorities cited in Easterbrook & Fischel, *supra* note 83, at 1170 n.26.

175 See A. HIRSCHMAN, EXIT, VOICE AND LOYALTY (1970) for a discussion, in a broader context, of the relative merits of each of the three options.

176 *See generally* A. DOWNS, AN ECONOMIC THEORY OF DEMOCRACY 260-76 (1957) (discussing conditions under which abstention is a rational choice).

177 *Id* at 265; *see also* Easterbrook & Fischel, *supra* note 169, at 402 ("Because voting is expensive, the participants in the venture will arrange to conserve on its use.").

178 This is no small task, given the complexity of most such solicitations. *See* 17 C.F.R. § 240.14a-3, -101 (1987) (specifying informational requirements of proxy solicitation).

179 *Cf.* A. DOWNS, *supra* note 176, at 265 (Political voting is not costless because "every act takes time. In fact, time is the principal cost of voting: time to register, to

voting effort may not be large: the gains to be had from a favorable election outcome must be discounted by the unlikelihood of obtaining that outcome.[180] Easterbrook and Fischel write:

> Each shareholder will recognize that his votes will not affect the outcome of any dispute unless he has a large bloc of shares. As a result, each shareholder's self-interest leads him to ignore the controversy; it is costly to become informed, and the cost produces little prospect of benefit. If each shareholder reasons in the same way, as he should, the managers of the firm will prevail in any contest about their operation of the company. And that is the pattern in the market.[181]

Given the small net incentives to vote, the shareholder's other two alternatives become more rational. Retaining ownership without voting is rational when the shareholder/decisionmaker anticipates only a small injury to the corporation from an adverse election outcome.[182] For example, even a shareholder who opposes exculpation can rationally retain his ownership and refrain from voting against the charter amendment, if the market mechanisms[183] protect him sufficiently.

The second alternative to voting, i.e., selling one's shares, is rational even when the shareholder/decisionmaker anticipates the injury to the corporation from an adverse election outcome to be large. For if the outcome that he considers adverse is at all likely to occur, then many other shareholders must consider that outcome favorable.[184] Under these circumstances, our decisionmaker can sell his shares to these other shareholders without discounting his price. "Any inclination toward disagreements among shareholders about how the company should be managed tends to be halted automatically, as one side will simply buy out the other."[185] The ease

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discover what parties are running, to deliberate, to go to the polls, and to mark the ballot.").

180 This unlikelihood inheres in the fact that the measure being voted upon will fail unless a majority (or in some instances more) of the shares are voted in its favor. *E.g.*, DEL. CODE ANN. tit. 8, § 242(b)(1) (requiring approval of "a majority of the outstanding stock entitled to vote thereon" for charter amendment to succeed).

One could reduce this unlikelihood by campaigning, but that would increase the costs of the voting option.

181 Easterbrook & Fischel, *supra* note 83, at 1171 (discussing the free-rider problem's inhibiting effect on shareholder voting).

182 A. DOWNS, *supra* note 176, at 265 ("minuscule" returu from voting effort does not render voting worthwhile); *see also* Manne, *Some Theoretical Aspect of Share Voting*, 64 COLUM. L. REV. 1427, 1429 (1964) ("[i]ndeed, the cost of informing themselves dictates the not irrational conclusion for many voters that abstention is their best policy").

183 *Supra* notes 77-100 and accompanying text.

184 Only if many shareholders consider the prospective outcome favorable will they intend to vote for it. And only if they intend to vote for it will it be likely to come about.

185 Manne, *supra* note 182, at 1445.

and ready availability of this "exit option through the stock market"[186] makes selling "the rational strategy for dissatisfied shareholders in most cases . . . ."[187]

To protect their interests, then, shareholders need not (and indeed where costs are high enough should not) actively participate in the proxy process. Those who assume that the relative absence of shareholder participation reflects an inadequacy of shareholder voting power ignore the "far more plausible explanation"[188] that shareholders use the alternative courses of action outlined here. Far from stifling shareholder freedom of choice, then, the proxy process simply allows shareholders the freedom to choose not to choose.

IV
Are the Statutes Desirable?

To decide whether the statutes are desirable is to decide how the costs they engender compare to the costs of the common-law regime. A rigorously empirical analysis would be unable to reach such a decision for two reasons. First, the practical costs of each system remain unquantified. Second, and more important, the ideological costs of each system defy quantification because by their nature they vary among individuals.

Anyone whose interest in the matter exceeds the merely scientific, however, must make such a decision upon less than complete data, as have the state legislatures. This writer, for one, has decided in the statute's favor. The costs of the common-law regime must exceed the costs engendered by the statutes, if only because the latter are so low. After all, the statutes permit exculpation for director misconduct of only a sharply limited kind;[189] directors' own self-interest will keep any resulting carelessness to a minimum;[190] some of the remaining lack of care will benefit the shareholder, not harm him;[191] and the shareholder has ample opportunity to dissociate himself, beforehand, should the situation portend a greater lack of care than he desires.[192]

It is true that some shareholders will fail so to dissociate themselves, and that as a result they will be injured, but the question is to what lengths society should go in order to prevent that injury.[193]

186 Easterbrook & Fischel, *supra* note 169, at 420.
187 *Id.*
188 *Id.*
189 *See supra* notes 64-69 and accompanying text.
190 *See supra* notes 70-96 and accompanying text.
191 *See supra* notes 101-32 and accompanying text.
192 *See supra* notes 133-88 and accompanying text.
193 Compare Professor Easterbrook's observation that not every cost should neces-

On this question the ideological issue[194] is crucial. No one disputes that to help one's neighbor is a virtue—but to force others to help one's neighbor, as does the common-law regime,[195] is surely a mixed virtue at best. This forced altruism is even less defensible where the neighbor's injury results only from his own inattention or misjudgment,[196] and where the costs of helping him to cure his mistake are significant.[197] If the ideology of commonality does not yield to autonomy under these circumstances, one wonders where it ever will.

This Note has demonstrated the crucial roles of both empirical and ideological considerations in evaluating the statutes' merits. Whatever one's position on the ideological issue, one should take account of the facts set forth here. The common law of the fiduciary duty of care is a knot of vague doctrine;[198] it causes directors to avoid an undue amount of risk,[199] it causes them to build unnecessary paper shelters[200] and deters others from serving at all,[201] and it imposes itself officiously upon its purported beneficiaries.[202] These costs represent the price of the duty of care's protection. The new statutes permit shareholders to decide for themselves whether they wish to pay that price, and thereby surely constitute an improvement over the common-law system.

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sarily be remedied; one should first inquire whether the remedy would be worse than the cost. Easterbrook, *supra* note 14, at 542 (quoted *supra* note 97).

194 *See supra* notes 137-41 and accompanying text.
195 *See* illustrative model *supra* note 141.
196 *See supra* notes 149-88 and accompanying text.
197 *See supra* notes 108-32 and accompanying text.
198 *See supra* notes 23-58 and accompanying text.
199 *See supra* notes 101-15 and accompanying text.
200 *See supra* notes 116-22 and accompanying text.
201 *See supra* notes 123-32 and accompanying text.
202 *See supra* notes 133-88 and accompanying text.