FREEDOM OF CONTRACT AND THE CORPORATION: AN ESSAY ON THE MANDATORY ROLE OF CORPORATE LAW

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Abstract

Many of the central rules governing corporations -- for example, the rules concerning fiduciary duties, insider trading, fundamental corporate transactions, and some corporate procedures -- are mandatory and companies cannot opt out of them by adopting an appropriate charter provision. An important school of corporate law scholars, however, argues that this mandatory approach should be discarded. These scholars advocate, with growing influence on legal scholars and public officials, that companies should be completely free to opt out of any corporate law rule.

This essay examines and rejects the case for complete opting-out freedom in corporate law. The case for such opting-out freedom does not follow, as its advocates believe, from accepting that the corporation is essentially a contractual undertaking. I show that, within the contractual view of the corporation, there are strong reasons for providing corporate law with a mandatory role. And I provide a framework of analysis for determining the issues with respect to which, and the circumstances under which, opting out should be prohibited or restricted.

I. INTRODUCTION

The concern of this essay is with a central question of the law governing corporations: what should be the limits, if any, to the freedom of companies to opt out of the rules of corporate law? I take issue with the arguments that have been made in favor of giving companies a complete freedom to opt out. I show that there are strong reasons for a mandatory role of corporate law. And I provide a framework for analyzing the desirable scope of mandatory rules in this area of the law.

The proposition that companies should be completely free to opt out of any corporate law rules has been put forward by an important and increasingly influential school of scholars.[1] The freedom-to-opt-out advocates start from the view that the corporation is essentially a contractual creature, a "nexus of contract."[2] This view of the corporation, they argue, implies

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1. Leading and active spokesmen of this view are Judge Easterbrook and Professor Fischel. See, e.g., Easterbrook & Fischel, Voting in Corporate Law, 26 J. of L. & Econ. 395 (1983); Easterbrook & Fischel, The Corporate Contract, Ch. I of their The Economic Structure of Corporate Law (forthcoming from Harvard University Press); Easterbrook & Fischel, Corporate Control Transactions, 91 Yale L.J 698(1982); Fischel, The Corporate Governance Movement, 35 Vand. L. Rev. 1259 (1982). The view has many other important subscribers. See, e.g., R. Posner, Economic Analysis of Law 292-93 (2nd ed., 1977); R. Winter, Government and the Corporation (1978); Carlton & Fischel, The Regulation of Insider Trading, 35 Stan. L. Rev. 857 (1983); Macey, From Fairness to Contract: The Direction of the Rules Against Insider Trading, 13 Hofstra L. Rev. 9 (1984); Winter, State Law, Shareholder Protection, and the Theory of the Corporation, 6 Journal of Legal Studies 251 (1977).

2. On the contractual view of the corporation, see Alchian & Demsetz, Production, Information Costs, and Economic organization, 62 American Economic Review 777 (1972); Fama & Jensen, Separation of Ownership and Control, 26 J. L. & Econ. 1 (1983); Jensen & Meckling, Theory of the Firm: Managerial

that the parties involved should be totally free to shape their contractual arrangements. Given the contractual view of the corporation, they claim, the sole function of corporate law should be to facilitate the process of private contracting by providing a set of "standard-form" provisions. But these standard-form provisions should in no way be mandatory; private parties should be totally free, if they so choose, to adopt charter provisions opting out of any of these standard arrangements.

The issue under consideration is not only of great theoretical significance but also one with considerable practical implications. Although the law governing corporations adopts an "enabling" approach with respect to many issues, it has also always included a significant body of mandatory rules.[3] In particular, current law includes the following noteworthy mandatory rules: the federal rules concerning insider trading, proxies, disclosure to shareholders, and tender offers; the rules established by state corporation statutes concerning fundamental corporate changes (mergers, liquidations, and so on) and concerning changes in the corporate charter and bylaws; and certain significant judge-made doctrines concerning the fiduciary

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Behavior, Agency Costs, and Ownership Structure, 3 J. Fin. Econ. 305 (1976); Klein, The Modern Business Organization: Bargaining under Constraints, 91 Yale L. J. 1521 (1982); and Williamson, Corporate Governance,93 Yale LO. J. 1197 (1984). The contractual approach goes back to Coase, The Nature of the Firm, 4 Economica 386 (1937).

[3]. See, e.g., L. Friedman, A History of American Law 188-95 (2nd ed., 1985); H. Hurst, The Legitimacy of the Business Corporation in the Law of the United States (1970).

duties of managers and controlling shareholders.[4]

Thus, the freedom-to-opt-out view implies a fundamental change in corporate law. The advocates of this view would eliminate the mandatory nature of all existing mandatory rules. Applying their general view, they have argued, for example, for allowing companies to opt out of all insider trading rules[5] and out of all doctrines concerning managerial fiduciary duties.[6] It can be expected that, if the advocated unconstrained freedom to opt out were to be granted, it would be used in many cases and would bring dramatic change to corporate life.

The freedom-to-opt-out advocates have already had much influence on the way in which corporate law questions are approached. Their view has gained many adherents, and indeed has had an impact even on many scholars and public officials who do not explicitly or fully subscribe to this view. The American Law Institute Reporters, for example, have recently proposed allowing opting out with respect to some significant issues.[7] The SEC has recently requested comments on a proposed approach to takeover regulation that would provide companies with substantial freedom

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[4]. For a description of these rules, see R. Clark, Corporate Law (1986). Insider trading rules are described in @8, proxy rules in @9.2, disclosure rules in @17.2, state rules concerning fundamental changes in @10, and judge-made rules concerning fiduciary duties in @3-@5.

[5]. See, e.g., Carlton & Fischel, supra note 1; Macey, supra note 1.

[6]. See e.g., ALI, Proceedings of the 63rd Annual Meeting 412-1 (1987) (comments of Judge Frank Easterbrook).

[7]. See, e.g., ALI, Principles of Corporate Governance: Analysis of Recommendations @7.17 (Tent. Draft No. 7, 1987).

to opt out of federal takeover rules.[8] And it has become common for commentators proposing corporate law arrangements to emphasize that companies may be allowed to opt out of the proposed arrangements.

The freedom-to-opt-out advocates believe, as already noted, that their position necessarily follows from the contractual view of the corporation. I aim in this essay to show that this is not the case. Analyzing the processes which produce the corporate contract and changes in it, I seek to demonstrate that there are, within the contractual view of the corporation, strong reasons for placing significant limits on the freedom to opt out.[9]

The analysis of this essay is divided into two parts.

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[8]. See SEC Release No. 23,486, Fed. Sec. L. Rep. @84,018.

[9]. My approach to the subject is different from that of three important articles which have in recent years attempted to evaluate critically the freedom-to-opt-out position. See Brudney, Corporate Governance, Agency Costs, and the Rethoric of Contract, Colum. L. Rev. (1985); Clark, Agency Costs Versus Fiduciary Duties, in Principals and Agents: the Structure of Business (J. Pratt & R. Zeckhauser, eds., 1985); and Coffee, No exit? Opting Out, The Contractual theory of the Corporation, and the Special Case of Remedies, The Second Pomerantz Lecture, 45 brooklyn Law review 1 (1988). Like Brudney and Clark, I support a significant body of mandatory rules, but I reach this conclusion in a different way from theirs. Brudney and Clark seek to show the limitations of the contractual view of the corporation, while I attempt to show that, fully accepting the contractual view, there are good reasons for limiting the freedom to opt out. As to Coffee, the position he puts forward is substantially different from the positions of Brudney Clark and myself, as he is much less in favor of mandatory rules.

While I do not know of any published article which has taken the approach of this essay, I know that Professor Jeffrey Gordon of Columbia Law School has been working independently on a project with a similar goal, viz., to provide a basis for mandatory rules within the contractual view of the corporation. In the preliminary partial draft that I have seen, Gordon pursues a line of analysis that is substantially different from that developed in this essay.

Section I, which constitutes the main part of the analysis, considers opt-out provisions which are adopted by companies already in existence -- that is, through amendments to the company's initial charter. Allowing such opt-out amendments is quite important to the freedom-to-opt-out position. As will be explained, however, the case for limiting such opting out in midstream is especially strong. In particular, I will show that, even if one believes that the process producing the initial charter is perfect and that opting out in the initial charter should be thus unrestricted, there are still strong reasons to limit opt-out charter amendments.

When a company is formed, it can be anticipated that, although allowing opt-out amendments in the future might well produce value-increasing amendments, it cannot be relied on to produce only value-increasing amendments. Although amendments cannot be passed without being approved by the board and by a shareholder vote, problems of collective action, information and monitoring make the amendment process quite imperfect. As a result, allowing opt-out amendments with respect to a given issue (say, insider trading) might be used by managers or dominant shareholders to adopt amendments that serve their interests but which are value-decreasing. Consequently, the optimal arrangement concerning opt-out charter amendments appears to be one that would allow opting out with respect to certain issues, concerning which allowing future flexibility can be expected to be beneficial overall, but would also limit opting out with respect to certain other issues, concerning which the costs of such

flexibility would likely outweigh its benefits. Such an arrangement, with certain limits on opt-out amendments, is the one that rational and informed parties forming a corporation would likely wish to apply to future charter amendments. And therefore, in the absence of explicit provision to the contrary in the initial charter (as is commonly the case with existing companies), this is the arrangement that the law should provide.

Section II considers opt-out provisions which are included in a company's initial charter. There are good reasons, I suggest, for establishing certain limits on adopting such provisions even at the initial charter stage. While the process producing the initial charter is perhaps less problematic than that producing charter amendments, it is still an imperfect process. Evaluating the consequences of all the provisions of the initial charter is a highly complex and costly task. Consequently, buyers of stock, including very sophisticated buyers, make their purchases without perfect information about these provisions. In the presence of such imperfect information, the party designing the initial charter might well have incentives to include some opt-out provisions that, because not fully appreciated by buyers, would benefit the party even though they are value-decreasing. Consequently, certain legal intervention, limiting the choice of terms with respect to certain issues, might well produce terms superior to those that would arise in the unconstrained market.

My aim, I wish to emphasize, is not to put forward a specific and detailed list of the issues that should be governed

by mandatory rules. Rather, I wish, first, to demonstrate the existence of a significant set of such issues and, second, to identify the factors and parameters that are relevant to determining whether a given issue should belong to this set. This analysis of the relevant factors and parameters will provide a framework of analysis that can be used to examine whether any given corporate law arrangement should or should not be mandatory.

Before proceeding, it is worth noting that the companies with which this essay is concerned are publicly traded companies. The informational and collective action problems that afflict shareholders in publicly traded corporations are substantially different in nature, or at least magnitude, from those existing in a close corporation. Therefore, in examining the processes producing the corporate contract and changes in it, it is useful to analyze publicly traded corporations separately from close corporations.[10]

II. OPTING OUT BY CHARTER AMENDMENT

This Section, which constitutes the main part of this essay, concerns opting out by charter amendment -- that is, opting out by companies already in existence. I have chosen to focus on opting out by charter amendment for two reasons. First, from a practical point of view, the consequences of allowing complete freedom to opt out by charter amendment might well be much more

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10. Cf. Brudney & Clark, A New Look at Corporate Opportunities, 94 Harvard Law Review 998 (1981).

substantial than those of allowing opting out in the initial charter. To see this, suppose that we now adopt a policy of complete freedom to opt out in the initial charter but not through charter amendment. For quite a few years after the adoption of this policy, most of the publicly traded companies will be companies which were formed and had their initial charter fixed prior to the time of adopting this policy. The policy would have no effect on this large set of companies, which would presumably include the bulk of the largest companies in the country. Thus, the freedom-to-opt-out advocates must establish the case for opting out through charter amendment if they wish to have, in the foreseeable future, unconstrained opting out available to most companies.

Second, the case for freedom to opt out is the weakest--and the case for a mandatory role of the law is correspondingly the strongest -- in the context of charter amendments. While Section III will show that there are reasons for limiting opting out even in the initial charter stage, this Section will show that there are substantial additional reasons, beyond those present in the initial charter stage, for limiting opting out through charter amendment. To focus on these reasons, I shall grant in this Section that there should be complete freedom to opt out in the initial charter stage. In particular, I shall use in this Section the strong assumption (which will be dropped in Section III) that the contracting process producing the corporate contract is perfect. Given this strong assumption, freedom of opting out in the initial charter would be indeed desirable. But,

as the analysis below shows, even under this strong assumption, it is desirable to place limits on opting out through charter amendment.

Because of the length of this Section's analysis, it will be useful to summarize at the outset the main steps in the argument of this Section. Subsection A starts by describing the crucial difference between opting out in the initial charter and in charter amendments. The initial charter, and the legal arrangements it incorporates, is the corporate contract. Thus, we can apply to this contract the general proposition that, assuming that all the parties to a contract are fully informed, all the contract's provisions will be value-maximizing and in the parties' joint interest. In contrast, a charter amendment, which does not require a unanimous consent among all the parties involved but rather only a board proposal approved by a shareholder vote, is not a contract. Consequently, we cannot rely directly on the presence of a contracting mechanism as the justification for upholding opt-out charter amendments.

Section B describes and discusses the only possible justification for opt-out amendments within the contractual view of the corporation. While such amendments are not a contract themselves, they may be authorized by the corporate contract, i.e., the initial charter. Because the parties forming the corporation might anticipate the future need for changing the initial charter, they might agree, as part of the corporate contract, on an arrangement under which the charter may be amended without unanimous consent. Thus, any question as to

whether a given opt-out amendment (say, concerning insider trading) should be allowed turns on whether such amendment is authorized by the initial charter. Resolving this question is of course easy when the initial charter includes an explicit provision on this issue. But, as will be seen, the important question that the law must resolve is how to interpret the corporate contract in the absence of such an explicit provision. Because initial charters have generally not included such a provision, this choice of a "default" rule is of great practical importance and would largely determine the scope of allowed opt-out amendments.

According to the contractual view of the corporation, this important default rule should be chosen by seeking to determine the arrangement that rational and fully informed parties to an initial charter would likely view as value-maximizing. Such parties would anticipate that allowing opting out in the future with respect to a given issue might involve both expected costs and benefits, and they would wish to allow such opting out if and only if they estimate the expected benefits to exceed the expected costs.

Section C describes the expected costs involved in allowing opting out with respect to a given issue. Such opting out freedom might lead to the adoption of value-decreasing opt-out amendments. Although an amendment requires approval by a shareholder vote, the voting shareholders can be expected commonly to be rationally little informed; and although the amendment must be first proposed by the board of directors, the

board decision might be shaped, in spite of the operation of various market forces, not only by considerations of value-maximization but also by the often different interests of managers and dominant shareholders. This expected cost of allowing opting out with respect to a given issue substantially depends on various aspects of both the issue and the circumstances under which the amendment is adopted, and the analysis identifies these relevant aspects.

Section D describes the expected benefits involved in allowing opting out with respect to a given issue. Because the standard legal arrangement governing the issue might fall short of the efficient arrangement, such opting out freedom might produce value-increasing opt-out amendments. This expected benefit differs from issue to issue, and the analysis identifies those parameters that determine the size of this expected benefit.

In light of the analysis of the preceding subsections, subsection E finally draws conclusions concerning the optimal arrangement that should govern opt-out amendments, at least in the absence of an explicit initial charter provision to the contrary. It appears that this arrangement would allow substantial opting out, because there are important issues with respect to which the expected benefits from allowing opting out seem to outweigh the expected costs, but would also impose substantial limits on opting out, because there are important issues with respect to which the expected costs from allowing opting out seem to exceed the expected benefits. Subsection E

also identifies the aspects of an issue which are relevant to determining whether it should be governed by mandatory rules, and it uses this framework analysis to comment on the limits on opting out that existing law imposes.

A. Charter Amendments and the Initial Charter

The freedom-to-opt-out advocates base their case on the proposition that, when fully informed parties make a contract, their contractual freedom should not be limited.[11] As explained below, even assuming that the requisite full information is present when the corporate contract is formed, this proposition does not have the same implications for opting out through charter amendment that it has for opting out through the initial charter.

1. The Contract Proposition and the Initial Charter

(a) The Proposition

Consider fully informed parties who enter into a contractual arrangement. By fully informed party is meant a party that has full information about the future consequences of any contractual

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[11]. This statement of the proposition implicitly assumes that the contract does not involve third-party effects (externalities). I shall throughout this paper assume that the corporate contract is one that does not involve such externalities. The potential presence of externalities might provide additional reasons for mandatory rules beyond the reasons put forward in this paper. I plan to analyze the issue of externalities and its implications for mandatory rules in future work. For some discussion of the externalities issue, see Easterbrook & Fischel, Mandatory Disclosure, 70 Va. L. Rev. (1984).

provision. Economic theory suggests that, if left free to choose the terms of their contractual arrangement, fully informed will choose efficient, value-maximizing terms -- terms that will maximize the size of the contractual pie available for division among the parties.[12] These value-maximizing terms will be optimal not only from the perspective of the parties' joint interest in maximizing the contractual pie, but also from the perspective of the individual interests of each of the parties involved.

To see why efficient terms will be chosen, it is sufficient to point out that no party will wish to introduce an inefficient provision even if the direct effect of the provision favors that party. Suppose, for example, that a given provision in a purchase contract would produce a direct benefit of $1 to the seller (say, by removing certain liability that the seller might otherwise face) but would cost the buyer $2. Given the assumption that the buyer is fully informed and is thus fully aware of the consequences of the provision, adding the provision would be equivalent from the buyer's perspective to raising the purchase price by $2. Thus, getting the provision would be equally difficult for the buyer to getting a $2 raise in the contract price -- and the seller would definitely prefer the latter, as the provision would provide him with a direct benefit of only $1. Thus, given the parties' full information, and the possibility of

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12. See, e.g., Shavell, The Design of Contracts and Remedies for Breach, 99 Quarterly Journal of Economics 121 (1984); Shavell, Damage Measures for Breach of Contract, 11 bell Journal of Economics 466 (1980).

adjustment in price, any term reducing the size of the contractual pie would make every party worse off, and, conversely, any value-maximizing term would be in each party's interest.

From the above reasoning, the proposition that the parties to the contractual arrangement should be free to choose their terms directly follows. Free to choose terms, the parties will choose the value-maximizing terms; thus, legal intervention limiting the choice of terms cannot possibly improve on the terms privately chosen. Indeed, if public officials are not fully informed about the parties' interests (as the parties themselves are in this section assumed to be), the legal limitations might prevent the parties from using the value-maximizing terms; and the legal intervention might in such a case make the parties worse off by reducing the size of the contractual pie.

What function, then, is left to the law in this situation? The law's only function is to provide background, default rules that would apply when the parties do not specify otherwise.[13] By providing such a standard-form contract, the law would enable parties to save on the transaction costs involved in drafting terms. To serve this function best, public officials designing the standard-form terms should determine -- and provide as default terms -- those terms that fully informed parties would be most likely to view as value-maximizing.

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[13]. See R. Posner, Economic Analysis of Law (3rd ed., 1986), pp. 79-85.

(b) Implications for Initial Charters

As already noted, I assume in this Section that full information is indeed present in the contracting process that produces the corporate contract. Given this factual assumption, it follows immediately from the contract proposition, as the advocates of freedom-to-opt-out argue, that the terms of the initial charter of any given corporation will be value-maximizing. Given the full information of all parties involved, no party would be able to benefit from, and would thus not wish to have, any provision that is not value-maximizing.

In particular, an entrepreneur that sets up a company, designs its charter, and sells all or some of its shares to others, would be unable to benefit from any provision that is not value-maximizing even if the provision will provide the entrepreneur with some direct benefit. Suppose, for example, that the entrepreneur expects to be the first manager and that a given provision would produce a benefit of $1 to the first manager but would produce a cost of $2 to those who buy shares from the entrepreneur. Given that these buying shareholders are aware of the consequences of the provision, the price that they would be willing to pay for the shares would be $2 less if the provision were to be included than if it were not. And thus the entrepreneur's interest would not be served by adding this provision.

The provisions chosen by the entrepreneur, then, would be the value-maximizing ones. The entrepreneur would fully take into account the provisions' effect on the shareholders' interests

even though there might well be no negotiations concerning these provisions between the entrepreneur and the shareholders. The crucial element is that of pricing: a provision's effect on the shareholders' interests would be fully reflected in the price that the fully informed buyers of stock would be willing to pay the entrepreneur for the shares.[14]

Thus, since the provisions of initial charters that are privately chosen will be the value-maximizing ones, constraining the choice of such provisions cannot improve the situation of any of the parties involved. Indeed, if public officials are not fully informed about the parties' interests (as the parties themselves are at this stage assumed to be), the provisions fixed by the officials might differ from the value-maximizing ones, and the legal intervention might in such a case make the parties worse off. Hence, the strong assumption that is used in this Section, concerning the perfection of the process producing the corporate contract, is sufficient to establish the case for freedom to opt out in the initial charter. But, and this is something to which the freedom-to-opt-out advocates have failed to pay sufficient attention, this assumption does in no way establish the case for freedom to opt out through charter amendments.

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[14]. Another way to explain why the chosen provisions would be the value-maximizing ones is by viewing the shares sold by the entrepreneur as a product and viewing any given provision of the initial charter as a feature of this product. When the potential buyers of a product are fully informed about each feature of the product, it will be in the producer's interest to make an efficient choice of all the product's features.

2. The Difference Between Charter Amendment and Contracting

Consider a company that adopts a an opt-out charter amendment through the amendment procedure established by state corporation statutes -- that is, having the proposal submitted by the board of directors to a shareholder vote in which the requisite majority approval is obtained.[15] Do we have the same grounds to believe that the provision would be value-maximizing as we would have if the provision were adopted in the company's initial charter? As explained below, the answer is negative. To be sure, I shall later consider other possible reasons why the amendment might be expected to be value-maximizing; in particular, I shall examine the possibility that the requirements of approval first by the board and then by a shareholder vote would prevent any value-decreasing amendments. But it should be established at the outset that the contract mechanism that is present at the initial charter stage -- and which assures the optimality of any given opt-out provision in an initial charter-- is not present at the charter amendment stage and thus cannot be relied on to ensure that each opt-out amendment is value-increasing.

Compare the adoption of a provision X in the initial charter of a given company with its adoption through a charter amendment -- from the perspective of both the shareholders and the party designing the provision. Consider first the perspective of the

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15. See, e.g., Model Business Corporation Act, @10.03; California Corporations Code @903; Delaware General Corporation Law @242(b); New York Business Corporation Law @803.

shareholders, and suppose that the value of a share to the shareholders is $99 with provision X but $100 without X. Adopting X at the initial charter stage enables the shareholders to take X into account when deciding whether to buy shares. Since x is introduced before they part with their money, it cannot reduce the value of anything that they own. They would buy shares only if the required price does not exceed $99 a share, which is how much the shares are worth to them given the presence of X. In contrast, adopting X through a charter amendment would face the existing shareholders of the company with a reduction in value of the shares that they have already purchased. The shareholders would suffer the adverse consequences of X without being compensated by a reduction in the shares' purchase price; they would be unable of course to undo the purchase transaction and get some of the purchase price back. To be sure, they would be able to sell their shares on the market. But by selling on the market at this stage (either after the amendment is passed or when the passage of the amendment is already anticipated), they would only get $99 a share and would thus still fully bear the adverse consequences of the charter amendment.[16]

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[16]. The described difference from the shareholders' perspective between adoption in the initial charter and adoption through charter amendment may also be described using the metaphor of consent. When provision X is adopted in the initial charter, the fact that the shareholders are free not to buy shares is sometimes used to say that they have (implicitly) consented to X. In contrast, when X is adopted through a charter amendment, such an implicit consent cannot be said to be present. In particular, such an implicit consent cannot be inferred from the shareholders' not selling their shares. For, as explained above, by selling their shares on the market, the shareholders would not be able to escape the adverse consequences of X.

Now Consider the difference between adopting X in the initial charter and adopting it through a charter amendment from the perspective of the party designing the provision. In the case of the initial charter, the entrepreneur that sets up the company and puts X in the initial charter fully internalizes the effect of X on the shareholders' interests. Because adding X would lower the value of shares to the shareholders by $1 a share, the entrepreneur would be able to get $1 less for each share sold. In contrast, when the directors of the company lead to the adoption of X through a charter amendment, they would not automatically have to bear the $1 reduction in share value experienced by the shareholders. To be sure, I will later consider various market incentives that might lead the directors to pay attention to such a reduction in share value. But the important point for our purposes is that, whatever other effects on the directors' interests are present in the charter amendment context, we do not have the direct effect that is present in the initial charter case -- where the contracting mechanism ensures that any reduction in shareholder value would be accompanied by a dollar-for-dollar reduction in the value held by the party designing the provision.

In sum, the contract proposition does not imply that any opt-out charter amendment is value-increasing. Charter amendment, we have seen, is not equivalent to contracting. What justification, then, can be given to such provisions within the contractual view of the corporation? The only way to justify such provisions is to ground the charter amendment process in the

initial charter. To the extent that the charter amendment procedure is authorized in the initial charter, and only to that extent, it should be upheld.

B. The Initial Charter as Basis for Charter Amendments

The assumption used in this Section, concerning the perfection of the contracting process, implies, as we have seen, that all provisions in the initial charter are value-maximizing and should be held valid. This include, of course, provisions setting rules concerning charter amendments. Thus, a charter amendment which is authorized by a provision in the initial charter should be upheld; given the perfection of the contracting process, the introduction of the provision into the initial charter implies that, at the time of the initial charter, the parties must have viewed allowing such a charter amendment as value-maximizing.[17] Conversely, if the initial charter prohibits or limits certain charter amendments, this prohibition or limitation should be upheld.

Thus, as long as we impose no limit on initial charter provisions, we should allow those opt-out amendments -- and only those amendments -- that are authorized by the initial charter. This does not end the discussion, however, but only starts it. In

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[17]. Note that this does not necessarily mean that the parties believed that any charter amendment made under this provision is bound to be value-increasing. The parties might well have contemplated the possibility that, in some contingencies, the provision might be used to adopt a value-decreasing amendment. But the parties must have believed that on the whole the authorized charter amendments would be desirable.

some cases the mandate of the initial charter is clear; for example, the initial charter might include a provision explicitly authorizing or prohibiting an opt-out amendment with respect to insider trading. But then there are the cases -- which, as explained below, are likely to be both numerous and important-- in which the initial charter does not include a provision explicitly addressing the issue.

Suppose that a given initial charter does not have a provision explicitly addressing the possibility of an opt-out amendment concerning insider trading. Should we read the initial charter as not authorizing such an amendment? Or should we read the initial charter as not prohibiting, and thus as permitting, such an amendment? Here the law needs to provide a reading of the initial charter -- or, in other words, a default rule governing the issue. That is, the law must decide, with respect to any given legal rule, whether, in the absence of an explicit initial charter provision on the issue, opting out of this rule through a charter amendment would be possible. To understand the significance of this question and how it should be approached, it is useful to focus first on existing companies and then on companies that will be formed in the future.

1. Existing Companies

The resolution of the above question of charter interpretation is clearly of critical importance with respect to opt-out amendments of existing companies. Suppose that we now adopt, sharply breaking from the past, a policy of granting

companies complete freedom to opt out in the initial charter. And consider the many companies that have been formed and fixed their initial charter prior to the adoption of this new policy. At the time these companies were formed, opting out, either by charter amendment or in the initial charter, was prohibited with respect to many issues -- for example, insider trading and self-dealing -- and it could have been reasonably expected that this legal approach would be likely to prevail at least for some time. Thus, the parties setting up these companies presumably did not bother to address explicitly the question of whether, if it were legally possible for companies to allow opt-out charter amendments with respect to insider trading rules, they would wish to enable such amendments in their company. As a result, the initial charters of these companies presumably do not include provisions explicitly addressing such a contingency.

Thus, we face an interpretation issue. What is the arrangement that the initial charters of these existing companies should be understood to have established concerning opt-out amendments with respect to, say, insider trading? Should these initial charters be read as authorizing or not authorizing such amendments? The answer to such questions is of course important to the scope of opting out that would be allowed. If the answer to such questions is often negative, then, in spite of the policy of allowing any opt-out provisions in initial charters, there would be significant limitations on opting out by all the companies formed prior to adopting this policy, which for quite some time would include most public corporations.

Now it might be tempting for some who wish to limit charter amendments to claim that the answer to all such questions should be unequivocally in the negative. Since the initial charter of these companies was formed when it seemed likely that opting out of insider trading rules would be mandatorily precluded, it might be argued, these initial charters should be read as including the premise that this state of affairs would continue. This argument, however, is not convincing; for, on a closer look, there are two possible interpretations that may be given to the absence in the initial charter of a provision explicitly addressing the issue. First, this silence might be interpreted as representing satisfaction with the handling of this issue by the then prevailing law -- and thus as not authorizing opting out by charter amendment. Alternatively, this silence might be interpreted as representing a lack of desire to place any additional limits on opting out of insider trading rules beyond those limits imposed by the law prevailing at the time of adopting the initial charter.

Clearly, if the drafters of the initial charter had addressed the issue explicitly, they would have made our job easy. Why didn't they? Presumably they either did not contemplate the possibility that the law would adopt a non-mandatory approach to insider trading rules or they considered this contingency to be sufficiently remote so that it was not worth the effort of explicitly addressing it in the initial charter. Either way, the approach suggested by the theory of contracts to such a question

of interpretation is as follows.[18] We should try to determine, as well as we can, what would have been the arrangement that the parties would have likely adopted ex ante, at the time of adopting the initial charter, had they considered and addressed the issue in a rational and fully informed way. That is, we should seek to identify which arrangement would have been viewed ex ante as value-maximizing by parties who are rational and fully aware of the benefits and costs of allowing opt-out charter amendments.

2. Future Companies

Supposing again that we now adopt a policy of allowing complete freedom to opt out in the initial charter, consider charter amendments by companies that will be formed in the future. Suppose that the initial charter of such a company does not opt out of the insider trading rules, nor does it include a provision explicitly authorizing or prohibiting charter amendments opting out of insider trading rules. Should the initial charter be read as authorizing or prohibiting such a charter amendment?

Such questions of interpretation will frequently arise and will have to be resolved. To be sure, given that these future companies will be formed after the new policy with respect to opting out in the initial charter is adopted, the initial charters of such companies might frequently include explicit provisions on the issue. But although the default question would

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[18]. See R. Posner, supra note 13.

not arise as uniformly as with companies formed prior to the adoption of the new policy, it would probably still arise with respect to many companies. In approaching this question of interpretation, the principle suggested by the theory of contracts is the one that we have already encountered. We must determine which arrangement with respect to such charter amendments would be likely viewed ex ante as value-maximizing by rational and fully informed parties.

3. The Issues to be Determined

Thus, even assuming that, in accordance with the assumptions used in this Section, we adopt a policy of complete freedom of opting out in the initial charter, the extent of charter amendment that should be allowed, especially with respect to existing companies, will depend on the resolution of an interpretation question. We will have to choose the default arrangement that will govern the scope of allowed opt-out amendments in companies whose charter does not explicitly address the issue. And, to this end, we must determine the arrangement that would be likely viewed ex ante as value-maximizing by rational and fully informed parties.

Needless to say, we may conclude that the optimal arrangement that such parties would wish to adopt differs from issue to issue. It might be that a value-maximizing arrangement would impose some limits on charter amendments with respect to issue X but not with respect to issue Y. Note also that the arrangement with respect to any given issue might not be limited

to either allowing or prohibiting an opt-out amendment; the optimal arrangement might allow opt-out amendment with respect to a certain issue but only under certain circumstances or only in one of several designated ways.[19] Also, we may not be able to determine with certainty which arrangement would be value-maximizing with respect to a certain issue -- but we would have to do our best.

In the following subsections, I shall seek to determine the parameters of the value-maximizing arrangement. When rational and fully informed parties try to estimate ex ante the desirable scope of opting out with respect to an issue X, they would have to consider the expected costs and benefits from allowing such opting out. Allowing opting out with respect to X would be value-maximizing if and only if the expected benefits from it exceed the expected costs. Thus, to understand the optimal limits, if any, that should be placed on opt-out amendments, we should try to understand the factors that determine the expected costs and the expected benefits involved in allowing opt-out amendments with respect to a given issue.

C. The Costs of Allowing Opt-out Amendments

Allowing opt-out amendments with respect to a given issue X might involve an expected cost because, as rational and informed parties may anticipate, the opting-out freedom might produce a value-decreasing amendment. To assess the potential for value-decreasing amendments, we must examine the amendment process. We

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[19]. Cf. Coffee, supra note 9.

have seen that the mechanism that precludes the adoption of any value-decreasing provision in the initial charter is not present at the charter amendment stage. But are there other mechanisms? As already noted, charter amendments must be proposed by the board of directors and then approved by a vote of shareholder approval.[20] Thus, to examine whether -- and, if so, when -- the process might produce value-decreasing amendments, I shall examine below the following two questions: (1) will proposals for value-decreasing amendments, if brought for shareholder approval, ever obtain such approval?, and (2) will such amendments be ever proposed by the board of directors?

Before proceeding to examine these two questions, it is necessary to distinguish between several possible situations concerning the management and control of a given public company at the time of a charter amendment. First, the board of directors is often made of officers and independent directors. Companies differ in how influence is divided between these groups.[21] Since this issue is not all that relevant for our purposes, I shall refer below by "managers" to those people in the board or the company's management corpus who produce the board decision to bring an amendment to a shareholder vote.

Second, to analyze the potential for value-decreasing opt-out amendments, it is important to distinguish between situations in which, at the time of adopting the opt-out amendment, the

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[20]. See state statutes cited in supra note 15.

[21]. See, e.g., H. Geneen, Managing 250-61 (1984); Brudney, The Independent Director - Heavenly City or Potemkin Village, 95 Harv. L. Rev. 597 (1982).

company does and does not have a dominant shareholder. Whether or not a company has a dominant shareholder when it is formed, it may or may not have such a dominant shareholder at any given point in its future.[22] Thus, to the extent that the potential for value-decreasing amendments is affected by the presence of a dominant shareholder, the optimal arrangement concerning opt-out amendments may apply different rules depending on whether the company has a dominant shareholder at the time of adopting the opt-out amendment. I shall below first pursue the analysis assuming that the company does not have a dominant shareholder, in which case there is presumably a division between ownership, which is divided among a dispersed body of shareholders, and control, which is at the hands of the managers. I shall at the end of this subsection discuss separately the potential for value-decreasing charter amendments in those situations in which the company does have a dominant shareholder that effectively controls the board's decisions.

1. The Shareholder Approval Requirement

Suppose that the managers of a given company bring to a shareholder vote a proposal for a value-decreasing amendment, say, with respect to self-dealing. Will the requirement of shareholder approval ensure that the value-decreasing amendment

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22. With respect to a company that does not have a dominant shareholder when it is formed, such a shareholder might emerge later on as a result of a tender offer or a series of privately-negotiated and open-market purchases. With respect to a company that does have a dominant shareholder when it is formed, this shareholder might later on liquidate its controlling block.

be defeated? As explained below, the answer is negative. To be sure, the requirement of shareholder approval is not worthless; it might occasionally defeat some proposals for a value-decreasing amendment or discourage the bringing of such proposals. But it is far from being a reliable mechanism that can preclude with a substantial degree of likelihood the adoption of a given board proposal for a value-decreasing amendment.

The voting mechanism suffers from a problem of information. With respect to most proposals for charter amendments, most shareholders do not have sufficient incentive to acquire and assess the information bearing on whether the amendment would be value-increasing or value-decreasing. Any shareholder holding a small stake in the company recognizes that his vote is highly unlikely to be pivotal and thereby affect the vote's outcome and in turn his interests. Thus, he would generally not have sufficient reason to acquaint himself with the proposal, even if the cost of doing so is fairly small (say, spending a couple of hours reading the proxy materials).

This problem of the voting mechanism may be described as a collective action problem.[23] The possible benefit that might be produced by a shareholder's voting in an informed way -- a potentially better outcome of the vote -- would be enjoyed by all the shareholders. But the costs of the shareholder's becoming

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[23]. For a discussion of the collective action problem in voting in general, see A. Downs, An Economic Theory of Democracy (2d ed. 1971); A. Hirschman, Exit, Voice, and Loyalty (1970); M. Olson, The Logic of Collective Action (2d ed. 1971). For a discussion of the problem with respect to the special case of corporate voting, see R. Clark, supra note 4, at 390-396.

informed, however limited, would have to be borne by the shareholder himself. The shareholder's acquiring and assessing information is thus a public good; and the shareholder would not, as is often the case with public goods, produce an optimal amount of this public good.[24]

Note that the lack of information by small shareholders would usually be consistent with the presence of some larger shareholders who have acquired and assessed the information bearing on the desirability of the amendment. It might be initially thought that such large shareholders would disseminate their information to the smaller, uninformed shareholders. But such dissemination is usually unlikely to take place. To start with, even if such dissemination could be effective, the larger shareholders might often lack the incentive to engage in it. For they would have to bear fully the costs of the dissemination even though the benefits of it would be enjoyed by all the shareholders. Furthermore, even if such dissemination were to occur, it would often be ineffective; for, as explained above,

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24. Finally, it is worthwhile to compare the information that is rational for shareholders to acquire when voting with the information that is rational for them to acquire when buying shares. Recall that our assumption throughout this Section is that buying shareholders are fully informed, that is, that they have sufficient incentive to acquire information. It is thus necessary to explain why this assumption does not imply that the shareholders will also have full information in the voting context. The reason for this is that a buyer purchasing stock has much greater incentive to make an informed buying decision than a voting shareholder has incentive to make informed voting decision. The decision whether to buy will certainly affect the decision-maker's interests. In contrast, because the decision-maker's vote is highly unlikely to be pivotal, the decision on how to vote has a very small chance of affecting the decision-maker's interests.

small shareholders might not have an incentive even to read materials sent to them (in which case, the anticipation that a dissemination would be ineffective would prevent it from being attempted in the first place).

Thus, in the great majority of cases, most of the shareholders voting on a proposed charter amendment will have not acquired and assessed the information necessary to determine whether the amendment would be value-maximizing. To be sure, there are some exceptions: there might be cases in which most of the shareholders are large, and in which the issue is both quite significant in value and extremely easy to assess (for example, a drastic anti-takeover amendment that practically precludes a takeover). But such cases are clearly the exception and not the rule.

In most cases, then, the shareholders would not have the information that is necessary to distinguish between value-decreasing amendments and value-increasing amendments. As a result, the shareholders might well approve an amendment that is value-decreasing.[25]

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25. One might wonder why the shareholders do not vote against all amendments -- given the chance that, if they vote affirmatively, they might approve a value-decreasing amendment. Voting uniformly against proposals would be rational if most submitted proposals were value-decreasing. But, as explained below, the interests of shareholders and managers sufficiently overlap on many issues so that most proposed amendments might well be value-increasing. In this situation, and given that the imperfectly informed shareholders cannot discriminate between value-increasing and value-decreasing proposals, the rational course of action for shareholders is to vote uniformly in favor of proposed amendments, as the empirical evidence indicate they indeed do.

Finally, while I think that the main reason that shareholders might approve a value-decreasing amendment is their

2. Market Discipline and the Requirement of Board Approval

We have seen that, if the managers bring a proposal for a value-decreasing charter amendment whose undesirability to the shareholders is not too conspicuous, the amendment is likely not to obtain shareholder approval. The question to be considered now is accordingly whether the managers will ever elect to bring such proposals for value-decreasing amendments. The managers' decisions are obviously shaped by the incentives and constraints that are provided by the operation of the different markets affecting them. The freedom-to-opt-out advocates usually belong to the camp of those who believe that the different markets in which the company and its managers operate exert powerful incentives on the managers to behave in a value-maximizing way.[26] They might be thus inclined to argue, in particular, that these market incentives would discourage managers from ever proposing value-decreasing amendments. Below I therefore examine the

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lack of information, it is worth noting another reason that has been suggested in the literature. It has been suggested that management might be able, if it so wishes, to lead shareholders to approve a value-decreasing amendment even if the shareholders know that the amendment is value-decreasing. Management's control over decisions affecting the shareholders' interests, so the argument goes, might enable it to tie an amendment proposal to a "carrot" or a "stick" which would distort shareholders' choice. That is, management can couple the proposal with another measure which the shareholders independently desire or it might credibly threaten to follow a policy which is less desirable to the shareholders if the proposal is not approved. See Gordon, Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice, 75 Ca. L. Rev. (1988).

[26]. See, e.g., Easterbrook, Managers' Discretion and Investors Welfare: theories and Evidence, 9 delaware Journal of Corporate Law 540 (1984).

operation of the various markets which may affect the managers' decision. I conclude that, although market discipline would likely discourage managers from bringing certain kinds of value-decreasing amendments, it would not have such an effect with respect to other kinds of value-decreasing amendments.

The issues with respect to which an opt-out amendment might be adopted may be roughly divided into two groups: those that do not involve a potential transfer, and thus a conflict of interest, between the shareholders and the managers; and those that do involve such a potential transfer. Where an issue does not involve a potential transfer, there is no reason for the managers to propose a value-decreasing amendment. For the managers, who are at least somewhat concerned about share value, would have no reason to prefer such a value-decreasing amendment.

For this reason I shall limit myself below to issues which, at least potentially, involve a transfer between shareholders and managers, that is, issues with such a distributive element. Clear examples are the issues of insider trading and self-dealing. With respect to such "redistributive" issues, there is present a concern, which market incentives are supposed to check, that the managers would propose an amendment that transfers value to them even though the amendment is value-decreasing. The question is whether, even though such an amendment would directly benefit the managers, its adverse effect on shareholder value, operating through the various mechanisms of market discipline, would be sufficient to discourage the managers from proposing the amendment.

As I shall explain below, the effectiveness of market discipline in this regard much depends on the size of the transfer involved (the distributive element) relative to the reduction in overall company value (the efficiency element). A "weakly" distributive issue is one in which the distributive element is small relative to the efficiency element -- that is, one in which the potential direct transfer to the manager is, say, $1 while the effect on company value is much greater, say, $1,000. A "strongly" distributive issue, in contrast, is one in which the distributive element is large relative to the efficiency element -- for example, one in which the potential direct transfer to the managers is, say, $900, while the effect on the company value is, say, $1,000.

As explained below, market forces might well be effective in discouraging proposals for value-decreasing amendments with respect to most issues that are weakly distributive. But, as will be shown, they are unlikely to be effective with respect to value-decreasing amendments which are either strongly distributive or operate to weaken the market constraints themselves. These conclusions will be reached on the basis of an analysis of the various markets.

(a) Managerial Labor Markets

It has been argued that the way in which the managerial labor market operates induces managers to be concerned about the effect of their actions on share value and shareholders' interests. First, managerial compensation schemes are often tied

in one way or another to the prospects of the company.[27] Second, the success of the company affects the prospects of the managers for future employment in the managerial labor markets.[28]

There is no question that these features of the managerial labor market contribute to the alignment of shareholders' and managers' interests. These market features lead the managers to prefer -- when other things are equal or even at a small cost to themselves -- that a reduction in share value be avoided. Thus, they might discourage managers from bringing value-decreasing amendments which are weakly distributive.

But it is equally clear that these features of the managerial labor market do not perfectly align the interests of the managers and the shareholders. They do not operate in a way that makes the managers wish to avoid any reduction in share value regardless of the size of the direct private benefit to them. Because reductions in share value might have nothing to do with managerial failure, the managerial labor market operates in a way that managers are penalized on reduction in share value only to a limited extent.[29] As a result, a value-decreasing

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27. See Easterbrook, supra note 26, at 558-564; Jensen & Zimmerman, Management Compensation and the Managerial Labor Market, 11 J. Acct. & Econ. (1985); Raviv, Management Compensation and the Managerial Labor Market: An Overview, 7 Journal of Acct. & Econ. 239 (1985).

28. See Fama, Agency problems and the Theory of the Firm, 88 J. Pol. Econ. 288 (1980).

29. This is due to the fact that the reduction in share value need not be the result of the managers' actions. Therefore, given that managers are risk-averse, the optimal compensation scheme of managers would not penalize them drastically against any reduction in share value, which might depend in part on random factors beyond their control. See Holmstrom, Moral Hazard

amendment that is sufficiently strongly redistributive might well be well in the interests of the managers.

Finally, it is important to note that some value-decreasing amendments would not be discouraged by the discipline of the managerial labor market because they would, by their very operation, counterbalance or even reduce the power of this market discipline. In particular, it is relevant to note amendments that directly operate to increase the managers' compensation package or to increase the likelihood that the managers would be able to stay at their current job.

(b) Market for Corporate Control

The market for corporate control has become increasingly viewed as exerting significant disciplinary force over managers. When share value goes down, the company becomes more vulnerable to a takeover. Because the takeover might wrest from the managers the control which is valuable to them, the prospect of a takeover might make them more concerned about share value.[30]

Clearly, since the takeover threat makes managers wish to

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and Observability, 10 Bell Journal of Economics 74 (1979); Shavell, Risk Sharing and Incentives in the Principal and Agent Relationship, 10 bell Journal of Economics 55 (1979. Similarly, because future employers realize that the share value is only a "noisy" signal of the managers' quality, it will not be the case that any given reduction in share value will result in drastic reduction in future employment prospects. See Fama, supra note 28.

30. The importance of the takeover threat in inducing managers to be concerned about shareholders' interests was first pointed out by Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110 (1965). See also Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Har. L. Rev. 1161 (1981).

avoid unnecessary reductions in share value, it might contribute to discouraging managers from bringing proposals for weakly redistributive value-decreasing amendments. But, again, the takeover threat can hardly be relied on to align perfectly the interests of the managers and the shareholders. Therefore, as explained below, it is unlikely to discourage managers from proposing value-decreasing amendments that are strongly distributive.

As the market for corporate control operates, any limited reduction in share value increases the likelihood of a takeover only to a limited extent. The likelihood that the limited reduction in share value would produce a takeover, which would not have occurred otherwise, is small.[31] For example, when a charter amendment reduces the value of a large company by $1,000,000, which is a fairly small fraction of the company's total value, the resulting increase in the probability of a takeover is quite small. Thus, if the amendment is strongly distributive and would, say, produce a direct benefit of $800,000 to the managers, the resulting increase in the probability of a takeover would not discourage managers from bringing the amendment to a shareholder vote.

Finally, the market for corporate control might well not

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[31]. Whether a takeover will occur depends on whether the value of the company in the eyes of some potential buyer exceeds the market price plus the expected premium that would be necessary for a takeover plus the expected transaction costs that would be involved in such a takeover. The likelihood that the company's value is just slightly above this threshold value, so that a small reduction in the company's value would make the above condition satisfied, is likely to be small.

discourage value-decreasing amendments that operate to reduce significantly the very power of this market. To be sure, any reduction in share value might increase, other things equal, the probability of a takeover. But with respect to such amendments, other things are not equal: their direct effect in reducing the effectiveness of the market for corporate control might be sufficiently dominant so that, in spite of the accompanying reduction in share value, the likelihood of a takeover with the amendment is smaller than without it. For example, in considering a value-decreasing amendment that insulates managers from tender offers, the managers are unlikely to be deterred by the threat of a takeover, for the amendment would reduce this very threat, and the likelihood of a takeover would likely be smaller with this value-decreasing amendment than without it.

(c) Market for Additional Capital

The managers might well be interested not only in maintaining their control (that is, avoiding a takeover) but also in expansion. Thus, the managers might contemplate the need to return to the equity markets. It might be argued that this consideration induces managers to behave in a value-maximizing way.[32] While existing shareholders are already "stuck", future shareholders are not, and they will take managerial actions into account when buying shares in the company. Thus, it might be argued that the desire to raise more equity in the future would

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[32]. See Winter, supra note State Law, Shareholder Protection, and the Theory of the Corporation, supra note 1.

discourage managers from bringing proposals for value-decreasing opt-out amendments.

On a closer look, however, it appears that the market for additional equity would not provide managers with a different type of incentives not to bring value-decreasing amendments beyond those incentives that have been already discussed. Having a value-decreasing amendment would not impede the company's ability to raise capital. To be sure, assuming that buyers of stock are fully informed, they would take the amendment into account in deciding how much the offered shares are worth. But they would be willing to buy the shares for the appropriate price. Thus, the adoption of the value-decreasing amendment would not prevent the managers from raising any amount of capital. They would only have to offer a larger number of shares for this amount of capital, which would reduce the stake with which the existing shareholders would remain.

Thus, the main effect that should be considered would be not in preventing expansion but in reducing the value of the existing shareholders' shares. That this reduction in share value is undesirable to the managers is due to the operation of the managerial labor markets and the market for corporate control, which we have already discussed. Thus, for the purposes of our discussion, the market for additional capital does not impose any significantly different disincentives to proposing value-decreasing amendments, beyond those disincentives that have been already discussed.

(d) Product Market

It is often suggested that competition in product markets constrains management.[33] If management acts inefficiently, so the argument goes, it will not be able to compete effectively in product markets, and consequently the company might contract or perhaps fail. In particular, it might be argued that such a concern might discourage managers from proposing value-decreasing amendments.

There is no question that product market competition might discourage some inefficient behavior -- say, a managerial idleness that would provide managers with little pleasure but could result in large business failure. As explained below, however, the product market can hardly be relied on to prevent managers from proposing value-decreasing amendments, especially when the amendments are strongly redistributive.

For one thing, most opt-out amendments would not affect the operational efficiency of the company. They would not affect the cost at which the company would produce. They would operate on the level of financial distribution -- largely affecting only the way in which the value produced by the company would be divided among managers and shareholders. For example, opting out that would enable Ford's managers to take a larger fraction of the company's earnings -- say, by allowing certain insider trading gains -- would likely have little effect on the prices at which

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33. See Easterbrook, supra note 26, at 557; Hart, the Market Mechanism as an Incentive Scheme, 14 Bell Journal of Economics 366 (1983).

Ford would be able to produce cars.

Second, product markets are often not perfectly competitive. Most large companies operate in markets that are either ogopolistic or monopolistically competitive.[34] In such markets, a significant slack is present. Such slack would enable managers to have value-decreasing amendments. They would especially use the slack for such a purpose when the value-decreasing amendment is strongly redistributive, so that the transfer to managers is substantial relative to the efficiency loss (and thus to the potential effect on product market competitiveness).

3. Companies with a Dominant Shareholder

Thus far, we have examined the potential for value-decreasing amendments in companies that do not have a dominant shareholder. Let us now consider the somewhat different case in which a dominant shareholder is present. As explained below, in such a case, opt-out amendments that would produce a significant transfer from the public shareholders to the controller would likely take place, even if the amendments are value-decreasing (i.e, would produce a greater loss for the public shareholders than the benefit produced for the controller). Examples of opt-outs that would produce a substantial transfer from public shareholders to the controller are: an opt-out amendment that would enable the control to receive a more favorable treatment (i.e., more than its prorata share) in corporate distributions or

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[34]. See J. Tirole, The Theory of Industrial Organization (1987).

in a liquidation; an opt-out amendment that would eliminate appraisal rights or otherwise lower the compensation required in a freezeout of the public shareholders; and an opt-out amendment which, by weakening the fiduciary duties of the controller and the managers, would enable the controller to divert value from the company to itself.

If such opt-out amendments are allowed, then it should be clear that neither the requirement of shareholder vote nor the operation of market forces would prevent them. To start with, the presence of a dominant shareholder would make the shareholder approval requirement even much less effective than in the case of a company that does not have a dominant shareholder.[35] The controller will often be able to gain the necessary approval simply by voting its own shares. And even if the controller's own shares will be insufficient in number, the controller's hold of the proxy machinery would usually enable it to gain easily the extra votes necessary for the requisite majority.

As to the requirement of board approval, it again would be hardly effective in preventing value-decreasing amendments that are capable of transferring a significant value from minority shareholders to the controller. Clearly, market forces would do little to discipline the directors not to bring such amendments to a shareholder vote. The market for corporate control, for example, would be clearly irrelevant, given that a takeover by tender offer would not be possible. Similarly, the managerial

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35. See Brudney & Chirelstein, Fair Shares in Corporate Mergers, 88 Harv. L. Rev. 297 (1974).

labor market would not discourage the managers from bringing such value-decreasing amendments; indeed, the controller would be expected to reward the managers for acting in way that would serve the controller's interests.

To see the potential for value-decreasing amendments in the context of a concrete example, consider an opt-out amendment that allows giving the controller a disproportionate share of dividend distributions and liquidation proceeds. Such an amendment might well be value-decreasing -- it would likely lead to inefficient decisions regarding whether to distribute dividend or whether to liquidate. But it is clear that, in the absence of any limitations on adopting such an amendment, a controller who has a majority interest would likely have such an amendment adopted.

D. The Benefit of Allowing Opt-out Amendments

I now turn to examining the benefits that would be foregone if opt-out amendments with respect to a given issue are prohibited. The expected benefit from allowing such opting out arises of course from the possibility that it would produce value-increasing amendments. The opting out freedom might be used to replace a legal rule which does not provide the value-maximizing arrangement with an opt-out amendment which will move the company closer to the value-maximizing arrangement. The question to be examined concerns the issues and circumstances with respect to which such an expected benefit is likely to be substantial.

In evaluating the expected benefit from allowing opt-out

amendments with respect to a given issue, we should first assess the potential for improving upon the legal arrangement governing the issue -- that is, assess the extent to which the legal arrangement is likely to fall short of the best arrangement that private parties could design. The potential for improvement upon the legal arrangement might be substantial when the problem requiring resolution varies significantly from company to company and when the desirable solution depends on particular features of each company which are better known to the parties involved than to public officials. Clearly, while the potential for improvement is likely to be substantial with respect to many issues, this is not the case with respect to many other issues. In particular, the potential improvement is likely to be limited, or non-existent, when the problem requiring resolution is sufficiently uniform across companies, the appropriate arrangement is also sufficiently uniform across companies, and private parties do not have a significantly superior information about the desirable arrangement. For example, the problems involved in insider trading or in going private do not seem to vary significantly in their basic structure from company to company, and it is therefore likely that, whatever the desirable arrangement is, it might well be the same for many companies.[36]

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[36] In assessing how far the legal arrangement is likely to be from the value-maximizing arrangement, some inferences may be made if it is the case that, at the time that the initial charter was formed, opting out of this legal arrangement was possible. Suppose that opting out was possible but that the initial charter did not opt out. Then we should presume that the legal arrangement is fairly satisfactory -- unless we have reasons to believe that (i) the issue is sufficiently dynamic for the optimal arrangement to change significantly over time, or

That there is substantial potential for improving upon the legal arrangement governing an issue, however, is only a necessary condition -- and not a sufficient condition -- for there to be a substantial expected benefit from allowing opt-out amendments with respect to this issue. A question that must still be examined is whether the amendment process is likely to realize this potential for improvement. Consider an issue that is strongly redistributive from shareholders to managers, or that directly affects the strength of market discipline, or that is redistributive from minority shareholders to a controller. In such a case, as we have seen, allowing opting out might lead to a value-decreasing amendment even if there exists a certain opt-out amendment that would be significantly value-increasing.

For example, consider the issue of freezeouts of minority shareholders, and suppose that the prevailing legal arrangement falls substantially short of the efficient arrangement. Allowing opt-out amendments with respect to freezeouts might not lead to the adoption of the value-increasing arrangement. For the opting out freedom might be used by a dominant shareholder to pass a value-decreasing amendment that would produce a significant transfer to itself -- rather than pass the value-increasing amendment that might benefit the controller to a lesser extent.

(ii) the legal arrangement was not satisfactory even at the time of the initial charter but at that time the issue was of sufficiently small importance (or of sufficiently small likelihood to arise) and things have changed in this respect.

E. The Desirable Limits on Opt-out Amendments

We have set out in this Section to identify the arrangement that should govern opt-out amendments in the absence of any initial charter provision to the contrary. The sought arrangement is the one that rational and fully informed parties to an initial charter would likely identify as value-maximizing and therefore wish to adopt. The analysis of the preceding sections, which can now be put together, enables us to understand how such rational and fully informed parties would reason.

Rational and informed parties would realize that allowing opt-out amendments with respect to a given issue might produce value-decreasing amendments. They would recognize that in many cases the requirements of approval by the board and by a shareholder vote would be insufficient to preclude such value-decreasing amendments. The expected cost of allowing opting out with respect to a given issue would depend on various features of the issue involved and on various circumstances, such as whether the company does or does not have a controller at the time of the opt-out amendment; and the preceding analysis has identified the parameters that determine the size of this expected cost. With respect to many issues -- in particular, issues that do not involve a significant transfer between shareholders and managers or between minority shareholders and the controlling shareholder -- the expected cost of allowing opt-out amendments would be small or non-existent. But with respect to many other issues, the potential for value-decreasing opt-out amendments would be considerable. This would be the case, in particular, when a

value-decreasing amendment is strongly redistributive in favor of the managers, or weakens the constraints imposed on the managers by market forces, or, in the presence of a controlling shareholder, transfers significant value from minority shareholders to the controller.

Rational and informed parties would also recognize that allowing opt-out amendments with respect to a given issue might also carry with it an expected benefit. And the preceding analysis has identified the factors that determine the size of this expected benefit. The expected benefit might well be significant in many cases: for example, when the issue is not distributive, and when the problem requiring resolution and its optimal solution are likely to change substantially over time, vary significantly across cases, and be better understood by private parties than by public officials. The expected benefit from allowing such opting out, however, might also be small with respect to many other issues. In some cases, the potential for improving upon the legal arrangement is limited, because the legal arrangement is unlikely to fall significantly short of the best arrangement that private parties could adopt; and, furthermore, in some cases, granting an opting out freedom cannot be counted on to realize whatever potential may exist for improving upon the prevailing legal arrangement.

The optimal limits with respect to any given opt-out freedom, if any, depend on the balance of the above expected costs and expected benefits. Now it is clear that some opting out should be allowed -- for example, with respect to issues that

involve little or no transfer from shareholders to managers or controlling shareholders. But it is equally clear from the analysis that it is highly unlikely that, with respect to all issues and circumstances, the expected benefit from allowing opting out exceeds its expected cost. In particular, limits seem desirable with respect to issues that (i) are either strongly redistributive from shareholders to managers (or controlling shareholders) or ones directly weakening the force of market discipline, and that (ii) are sufficiently similar across companies to enable a satisfactory performance by a standard legal arrangement.[37]

As I said, my goal is not to put forward a list of issues that should be mandatory but rather to delineate the relevant considerations. But it is worth noting that, at least at first glance, many of the rules that are currently mandatory seem to be ones with respect to which, according to the theory developed in this section, opt-out amendments should be prohibited or restricted. Consider, for example, the rules that govern managerial self-dealing or insider trading. These rules deal with issues that seem to be strongly redistributive: the potential transfer from shareholders to managers is fairly significant

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37. It is important to note that, to the extent that we wish to place limits on opt-out amendments, we also need to place limits on certain transactions which may be used by companies to circumvent these limits on opt-out amendments. For example, a company might seek to opt out of x not by changing its charter to include provision x but by merging into a dummy corporation whose charter is identical except for including the provision x. Thus, to have an effective enforcement of the desirable limitations on opt-out charter amendments, it would be necessary to place similar limitations also on transactions that are practically equivalent, though formally different, from charter amendments.

relative to the potential efficiency effect. Furthermore, these issues seem fitting for a general analysis of the problem and its remedy.

Or consider, to take another example, the rules governing managers' fiduciary duties in the face of an hostile takeover. That current law treats this issue in a mandatory way may be supported by pointing out to a dimension of the issue that we have seen argues in favor of limiting opting out: the issue is one that directly and significantly affects the disciplinary force of the market for corporate control.

As a final example, consider the rules that protect the value given to minority shareholders in various corporate distributions and fundamental transactions -- in particular, the rules requiring prorata division of corporate distributions and liquidation proceeds, and the rules providing minority shareholders with appraisal rights in freezeout mergers. In the absence of such rules, a controlling shareholder would be able to use such transactions to effect a substantial transfer from the minority shareholders to itself. Therefore, if opting out is allowed, the controller would lead to the adoption of an opt-out arrangement facilitating such a transfer, even if this opt-out arrangement is inefficient.

Of course, someone might accept my view of the relevant parameters, but differ from me on the composition of the list of issues with respect to which opt-out amendments should be prohibited or restricted. But, again, my interest is not in the specific constitution of the list, but rather in the general

conclusion that this Section has established: that, in the absence of an explicit initial charter provision to the contrary, ceratin limits should be placed on opt-out amendments. This is the case, we have seen, even if we were to believe that the process producing the initial charter is perfect and that opting out in the initial charter should be therefore totally unrestricted.

III. OPTING OUT IN THE INITIAL CHARTER

Thus far I have assumed, in order to focus on the additional problems presented by opting out through charter amendments, that any opting out authorized in the initial charter should be upheld. This Section will discuss the problems presented by opting out in the initial charter and, in light of these problems, the mandatory role that the law should play with respect to initial charters' terms.

To focus on the additional problems presented by charter amendments, Section II has assumed that the contracting process producing the initial charter is perfect -- in particular, that all the parties involved are fully informed about the consequences of all the charter's provisions. If the contracting process is perfect, then it follows that any opting out in the initial charter is value-increasing. As this Section explains, however, this assumption of perfect process does not generally hold when public corporations are formed. To have full information, recall, means to be fully aware of all the future consequences of each provision of the charter. And there are

reasons to believe that, at least with respect to some issues, buyers of stock do not have such full information about the initial charter's provisions.

Subsection A discusses in general legal intervention and mandatory terms in contracts made without perfect information. In the presence of imperfect information, the terms privately chosen might differ from those that are value-maximizing, and intervention fixing some contractual terms might sometimes be desirable. Subsection B then discusses the extent to which the initial charters might be affected by the presence of imperfect information, the ways in which legal intervention, fixing some charter terms, might address these informational problems, and, finally, the factors and parameters that should determine the issues with respect to which mandatory rules are desirable.

A. Intervention and Imperfect Information

According to the contract proposition discussed in the preceding Section,[38] fully informed parties who enter into a contractual arrangement should be left free to choose its terms. Under such circumstances, the terms chosen by the parties would be value-maximizing and in the parties' joint interest. Thus, there is no potential for improving upon the terms chosen by the parties, and legal intervention may only worsen the parties' situation (if the chosen mandatory terms differ from the value-maximizing ones that the parties would have adopted).

When not all parties are fully informed, however, the terms

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[38]. See supra subsection II.A.1.

privately chosen might not be value-maximizing. Under perfect information, recall, no party would be able to benefit from a value-decreasing provision that directly benefits this party; for those other parties that are adversely affected by the provision would be aware of these adverse effects and the contract price would have to be adjusted appropriately. But under imperfect information -- and, in particular, when a given party is unaware of, or at least underestimates, the adverse effect of a given value-decreasing provision on him -- the party directly benefitting from the provision might have an incentive to include the value-decreasing provision in the contract.

Thus, when buyers are imperfectly informed about certain contractual terms, the terms privately chosen would not be value-maximizing. This fact by itself, however, does not imply the desirability of legal intervention that would fix contractual terms. Whether such intervention would be desirable depends on how the information possessed by public officials setting the mandatory terms compares in quality with the imperfect information possessed by the buyers.

Thus, although legal intervention which fixes terms is not warranted in every instance in which buyers are imperfectly informed (which is almost always the case to some extent), it is warranted in those instances when public officials are better informed about the effects of the term to be fixed than are buyers.[39] Such instances might well be in the minority; in most

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[39]. See Spence, Consumer Misperceptions, Product Failure, and product Liability, 64 Review of Economic Studies 561 (1977).

kinds of purchase contracts, the needs and interests of buyers sufficiently vary so that they can assess better than can public officials what would be the effects of contractual terms on these needs and interests. But although such cases are presumably not in the majority, they likely exist in a significant number.

To take a concrete example, few would doubt that some standard-fixing intervention is desirable with respect to medical drugs -- say, to rule out this or that component or restrict its use. While there might be argument concerning the desirable scope of such regulation, few, I think, would argue that there should be complete freedom to opt out of regulatory standards in the case of medical drugs. Drugs are such an easy case because they present a situation in which the information possessed by public officials concerning the effect of certain features on consumers is clearly superior to that possessed by the consumers themselves.

With respect to certain features of drugs, it is clear that most consumers will have very little information about them; it would be prohibitively costly for consumers to acquire and assess a significant amount of information about the consequences of these features. In contrast, much more information about these features can be acquired and assessed by public officials. There can be no question that the information that public officials will come to possess will be superior to that which individual consumers will come to have.

Note that the above intervention in drugs' features, which seemingly limits consumers' choices, is clearly in the consumers'

interests. Consumers presumably recognize that each of them cannot individually assess the effects on their interests of certain features of the purchased drugs. Thus, they would benefit from hiring collectively an agent that would assess the effects of these features and would make the choices for them. Collective action and coordination problems, however, make it impossible for consumers to act collectively to hire, and monitor the performance of, such an agent. Therefore, it is desirable for consumers that public officials step in and fulfill the choosing role of such an agent.

Although the above example of medical drugs is an especially easy one, it is clearly not unique. It illustrates the general proposition that, when buyers are less informed about a certain contractual feature than public officials can become, then the interests of efficiency (and of the buyers) would be served by the officials' making some of the choices for the buyers -- that is, by the officials mandating some contractual terms.

B. Intervention in Initial Charters

Let us now turn from intervention in the presence of imperfect information in general to the particular context of initial charters. I shall first show that buyers of stock are likely to be imperfectly informed about some features of initial charters. I shall then examine the way in which some legal intervention might improve upon the terms reached in the unconstrained market, and shall also discuss the considerations that should determine the scope of this intervention.

1. The Presence of Imperfect Information about Charter Provisions

A share of stock in a company that is being formed is a product with great complexity whose value depends on many factors. Some of these factors are the provisions of the company's initial charter. Now, understanding and assessing the consequences of many provisions is a complex task. And it might well be rational for buyers not to make the investments necessary to perform this task.

In determining how much to spend on information acquisition, a rational buyer of stock will compare the costs of acquiring the information with the benefit of having the information in terms of improving the buyer's investment decision.[40] The buyer would not spend up to the point in which the buyer would have full information about the consequences of any given aspect of the company or of its initial charter. The buyer would only spend up to the much earlier point in which the marginal benefit of extra information, in terms of improving his investment decision, equals the marginal cost. Indeed, for many investors, who are going to invest a limited amount in the company's shares in any event, it would not be worth even to read carefully the initial charter, not to speak about studying the consequences of its various provisions. But even with respect to relatively large investors, it might well be not worth their while to study provisions whose consequences are complex.

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40. See Gilson and Kraakman, Mechanisms of Market Efficiency, 70 Va. L. Rev. (1984).

Consider, for example, an investor who estimates that the effect of a given provision concerning self-dealing on the company's value would be on the order of 1/4 of a percentage point -- that is, that achieving full information about this provision would enable the buyer to know whether the value is x or x*1.0025 (where x is some number). And suppose that, if the buyer knew that the value is only x, the buyer would buy only $1,000,000 worth of stock instead of $1,250,000. In this case, the benefits of the information are not greater than $250,000 * 0.0025, which is $625. And is seems that this potential benefit might well be lower than the cost of estimating accurately the full consequences of the self-dealing provision. (This amount would only buy, say, four hours of an associate in a large law firm.)

Thus, with respect to many provisions, buyers would be imperfectly informed. The extent to which buyers' information would be imperfect depends on two factors. First, it depends on how complex it would be to understand the provision's effects; the investment required to study this issue fully is likely to be greater when the issue is more complex or when the issue is novel so past experience provides little guidance. Second, the smaller the provision's effect on the company's overall value, the smaller the benefits of acquiring more information about the provision's consequences, and the less information will be acquired. Thus, buyers' information would be especially imperfect with respect to issues whose evaluation is complex and whose bearing on the company's value is limited.

2. Note on Investment Bankers

An argument that is often made is that the presence of underwriters protects buyers of stock and provides them with a reliable signal concerning the quality of the initial charter's provisions.[41] The underwriter, so the argument goes, will have an incentive to study the charter provisions and will have an incentive to bargain for the optimal provision. The underwriter, as it were, will represent the interests of the buyers of stock.

To examine this argument, consider an entrepreneur that takes a company public and that must decide whether to include a charter provision X which would (holding the price of stock fixed) produce a transfer of .1% of the company's value from the buying shareholders to entrepreneur. And suppose that, left to their own efforts, individual buyers will not identify this effect of the provision X. Would the presence of an underwriter, which we can assume knows the effect of X, lead the entrepreneur not to include X in the company's charter?

The answer is negative, because the underwriter would have no incentive to prevent the inclusion of X. In examining the underwriter's incentives, analysts have suggested two reasons why the underwriter might care about the shareholders' interests. First, the underwriter commits itself to purchasing the shares if the public does not, and this commitment gives the underwriter an incentive to make the stock more appealing to the public. But if, by hypothesis, the public investors are no aware of the effects

41. See, e.g., Gilson & Kraakman, supra note 40, at x.

of X, the inclusion of X would not affect the salability of the stock, and therefore the underwriter would have no reason to object to it. That is, the interests of the underwriter, as far as the underwriting commitment is concerned, is solely to cater to the market's demand which is based on the potential buyers' information -- and not to act on the basis of the underwriter's own superior information concerning X.

Second, it is often said that the underwriter has a valuable reputation, and that the underwriter would defend the interests of buyers of stock to prevent a damage to its reputation. Whether this reputation element would provide the underwriter with an incentive to oppose X, however, is far from clear. To start with, what the presence of a reputable underwriter is argued to guarantee to buyers is only that provisions are not misleading or unconventional or shady in any way -- but not that it does not include non-optimal provisions (which might indeed be quite common). Furthermore, the same reasons why market participants are unaware of the suboptimality of X when the company goes public are likely to continue to hold in the future, which again suggests that the underwriter's reputation is unlikely to be hurt by the inclusion of X.

3. The Role of Mandatory Rules

Thus, buyers of stock, we have seen, are likely to have substantially imperfect information with respect to some charter provisions. As a result, those who set up the company might not choose the value-maximizing provision with respect to an issue.

They might instead choose a different provision which would be preferable to them because it would produce a transfer to them which buyers of stock would not see or would at least underestimate. [42]

Given that buyers are imperfectly informed with respect to many charter provisions -- to an extent that differs from issue to issue -- the question is how the buyers' information compares with the information possessed by public officials. There are reasons to believe that, at least with respect to some issues, public officials can acquire sufficiently good information to choose terms that would be superior to those arising in the unconstrained market.

The main advantage that public officials have is their ability to devote larger resources than would any investor to study and identify the value-maximizing arrangement concerning a given issue. As we saw, each investor would be willing to spend only a fairly limited amount on such a study, because the private benefit to the investor from the study would be limited. This advantage of public officials can be stated in terms of the public good nature of the information under consideration. The information about whether a given provision would be value-maximizing is a public good for all the potential buyers of the company's stock. And no private party would have an incentive to

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[42]. Discuss the argument that it is enough for some buyers to be perfectly informed for sellers to act as if all buyers are so informed. Explain why the presence of some such buyers cannot generally be relied on to induce such behavior on the part of sellers.

acquire a significant amount of this information.[43] But public officials, not affected by such private calculus, would be able of course to spend considerable resources on producing this public good.

Of course, not with respect to all issues on which buyers are imperfectly informed would public officials be able to choose terms superior to those privately chosen in the unconstrained market. In examining whether public officials are likely to do better than the unconstrained market with respect to a given issue, we must look at both (i) the factors that determine how far the privately chosen terms are likely to be from the value-maximizing arrangement, and (ii) the factors that determine how far the legally chosen terms are likely to be from this value-maximizing arrangement. These relevant factors can be briefly described as follows.

First, there are the factors that determine how imperfectly informed buyers of stock are likely to be with respect to the provision governing the issue. This will depend on (i) the complexity and novelty of the issue, and (ii) the size of the provision's effect on share value. The more complex and novel the issue, and the smaller its effect on share value, the less the information that buyers of stock would rationally elect to acquire about the provision.

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43. Each private party would only acquire it to the extent justified by the party's own use of it. And this problem would not be eliminated by private parties' acquiring information for sale to others; for it would be difficult for sellers of such information to prevent buyers of the information from reselling or transferring it to others.

Second, there are the factors that determine the likelihood that the party that sets up the initial charter (the "entrepreneur") would use imperfect information on the part of the buyers of stock to choose an arrangement differing from the value-maximizing one. The extent to which this is likely depends on the extent to which the issue is one that potentially involves a substantial transfer from the buyers of stock to the entrepreneur. That is, is there a significant redistributive element? Of course, if the potential redistributive element is insignificant, the entrepreneur would likely elect to put in the value-maximizing provision in spite of the buyers' imperfect information. Some issues -- say, concerning certain corporate procedures -- largely lack such a redistributive element, and with respect to them the entrepreneur would likely choose the value-maximizing provision regardless of how imperfectly informed the entrepreneur presumes the buyers to be. But some other issues -- say, self-dealing rules in a case in which the entrepreneur expects to manage the company after it is formed -- do have a substantial redistributive element. With respect to such issues, the entrepreneur might directly and significantly benefit from a value-decreasing provision, and thus, in the presence of imperfect information, the entrepreneur might have a significant incentive to put such a provision in.

Finally, there are the factors that determine the extent to which the provision chosen by public officials is likely to fall short of the value-maximizing arrangement. The arrangement designed by public officials is likely to compare well with that

which private parties can design when the issue is one that does not vary significantly in it structure and optimal remedy from company to company. Clear examples of such issues: the question of whether managers should be allowed to waste or steal corporate assets; the question of whether the managers should be allowed to decide upon a merger without shareholder approval; and the question of whether future directors should be chosen by the shareholders or rather may be chosen by the preceding directors.[44]

In sum, there are reasons to believe that there are issues with respect to which it would be beneficial for public officials to fix or limit the terms of initial charters. If investors could organize and overcome free-rider and coordination problems, they would likely hire an agent who would spend significant resources to determine the value-maximizing provisions and subsequently make choices for them. But free-rider and coordination problems make it impossible for investors to act collectively to hire, compensate, and monitor such an agent. Therefore, it is desirable that public officials step in and fulfil the role of such an agent.[45]

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[44]. Add note on the fact that private parties' information might be especially imperfect with respect to issues that are novel (rather than ones that have been around for a while). In such a case, private parties do not have yet the information that they often gain from experience, and, because of the public good problem, no private party would likely have a sufficient incentive to spend considerable resources on studying the new issue. (Relate to issues in takeovers.)

[45]. Add note comparing the set of issues with respect to which the law should limit opting out in the initial charter and the set of issues with respect to which the law should limit opting out through charter amendment.

IV. CONCLUSION

Most of the central rules governing corporations -- for example, important rules concerning fiduciary duties, insider trading, fundamental corporate transactions, and some corporate procedures -- are mandatory. An important school of corporate law scholarship has been arguing, however, that this mandatory approach should be discarded. Members of this school have been advocating, with growing influence on legal scholars and public officials, that companies should be totally free to opt out of any corporate law rule.

This essay has examined the case for complete opting-out freedom in corporate law and it has found it wanting. The case for such freedom does not follow, as its advocates believe, from accepting that the corporation is essentially a contractual undertaking. I have shown that, within the contractual view of the corporation, there are strong reasons for providing corporate law with a mandatory role.

The case for placing limits on opting out is especially strong with respect to opting out by charter amendment. Even if we were to adopt a complete freedom of opting out in the initial charter, we should not establish, in the absence of an explicit provision in the initial charter to the contrary, a complete freedom of opting out by charter amendment. The amendment process is quite imperfect, because neither the requirement of board approval nor the requirement of a shareholder vote can be relied on to preclude value-decreasing amendments. Consequently, the optimal arrangement concerning opt-out amendments, and the one

that shareholders should be presumed to wish in the absence of an explicit provision to the contrary in the initial charter, is one that includes certain limits on opting out in midstream.

Even with respect to opting out in the initial charter, there are good reasons for placing limits on such opting out. The case for free opting-out in the initial charter hinges on informational assumptions which are unlikely to hold with respect to all provisions in initial charters. Because investors, including sophisticated ones, are likely to be imperfectly informed about many charter provisions, there are issues on which the terms fixed by public officials would likely be superior to those that would arise in the unconstrained market.

Having shown that mandatory rules are desirable, I have also attempted to identify the factors that should determine with respect to which issues, and under what circumstances, opting out should be prohibited or restricted. Some of these identified factors bear on the expected costs of a given opting-out freedom, and some of these factors bear on its expected benefits. I hope that this framework of analysis will prove useful in the future to scholars and public officials as they confront the recurring and important choice of whether a given corporate law arrangement should or should not be mandatory.