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THE DEBATE ON CONTRACTUAL FREEDOM
IN CORPORATE LAW

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Abstract

This paper will serve as the foreword to a Columbia Law Review symposium on contractual freedom in corporate law. My aim in this paper is to assess where the debate on contractual freedom in corporate law is now standing and where it might be going. To this end, I discuss the shape the debate has taken, the core issues, the types of arguments that have been made, and the areas in which more work should and is likely to be done on each of the two sides to the debate. Part I of the paper describes the challenge to corporate law theory that has been offered by the rise of the freedom-to-opt-out position. The resulting debate can be usefully divided, in my view, into two debates: one concerning contractual freedom in the charter amendment stage, and one concerning contractual freedom in the initial charter. Accordingly, Part II discusses and evaluates the debate on opting out by charter amendment, and Part III does the same for the initial charter stage. Finally, Part IV discusses the connection between the question of contractual freedom in corporate law and four other basic issues in the theory of the corporation---the nature of the corporation, the factors shaping its boundaries, the standard for determining the content of corporate law rules, and the selection of the institutions making these rules.

The subject of this symposium issue---to which this paper serves as an introductory essay---is contractual freedom in corporate law.¹ To what extent should corporations be allowed to opt out of the rules of corporate law by adopting charter provisions to that effect? That is, should any corporate law rules be mandatory, and, if so, which rules? This is a fundamental question in the theory and life of corporate law, and it has been in recent years increasingly attracting the theoretical examination that it deserves.

I should at the outset indicate where I stand in this debate and thus acknowledge the perspective from which this essay is written. I believe that certain substantial limits should be placed on opting out and that certain significant corporate law rules should be mandatory. I have already presented in detail in a recent article my views on the desirable limits on charter amendments.² And I have outlined my views on the reasons for limiting opting out at the initial charter stage in an earlier discussion paper.³

¹The articles in this issue were presented at a symposium on contractual freedom in corporate law, which was held at Columbia Law School on December 9 and 10, 1988. The conference was sponsored by the Columbia Law School Center for Law and Economics and was organized by Professor Jeff Gordon. In addition to the authors contributing to this issue, others who contributed papers or comments to the conference were Bernard Black, Ronald Gilson, Victor Goldberg, Joseph Grundfest, Bengt Holstrom, Reinier Kraakman, Christopher Stone, Michael Trebilcock, Oliver Williamson and myself.

²See Bebchuk, Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments, 102 Harv. L. Rev. 1820 (1989).

³See Bebchuk, Freedom of Contract and the Corporation: An Essay on the Mandatory Role of Corporate Law 50--62 (Harvard Program in Law and Economics Discussion Paper No. 46, 1988). I plan to develop this analysis fully in a subsequent paper.

My purpose in this introductory essay is to assess where the debate is now standing and where it might be going. To this end, I discuss the shape the debate has taken, the core issues, the types of arguments that have been made, and the areas in which more work should and is likely to be done on each of the two sides to the debate. Part I describes the challenge to corporate law theory that has been offered by the rise of the freedom-to-opt-out position. The resulting debate can be usefully divided, in my view, into two debates: one concerning contractual freedom in the charter amendment stage, and one concerning contractual freedom in the initial charter. Accordingly, Part II discusses and evaluates the debate on opting out by charter amendment, and Part III does the same for the initial charter stage. Finally, Part IV discusses the connection between the question of contractual freedom in corporate law and four other basic issues in the theory of the corporation---the nature of the corporation, the factors shaping its boundaries, the standard for determining the content of corporate law rules, and the selection of the institutions making these rules.

I. The Freedom-to-Opt-Out Challenge to Corporate Law Theory

Corporate law has always included a substantial body of mandatory rules.⁴ To be sure, as state corporate law has increasingly taken an "enabling" approach, the set of issues with respect to which opting out is possible has expanded. Both state

⁴See L. Friedman, A History of American Law 511--25 (2d ed. 1985).

and federal corporate law,⁵ however, still include many significant mandatory rules; indeed, such rules govern most of the important corporate arrangements.⁶

While it has long been taken for granted that corporate law has a substantial mandatory core, this feature of corporate law has in the last decade come under heavy theoretical attack. A significant camp in corporate law scholarship has put forward the proposition that corporations should largely be free to opt out of corporate law rules.⁷ The freedom-to-opt-out advocates start from the premise that corporations should be viewed as essentially a contractual creature, a "nexus of contracts."⁸

⁵I wish to emphasize that, while some of the contributors to this issue focus on state corporate law, the debate, and the arguments on both sides, are applicable to all the legal rules governing corporations, including the many important federal corporate rules.

⁶In particular, current law includes the following noteworthy mandatory elements: the federal rules concerning insider trading, proxies, disclosure to shareholders, and tender offers; the state rules concerning fundamental corporate changes (mergers, sales of the corporation's assets, dissolutions, and so on), the allocation of powers between shareholders and managers, certain procedural aspects of corporate decision making (such as quorum and notice requirements), and changes in the corporate charter and bylaws; and, finally, certain significant judge-made doctrines concerning the fiduciary duties of managers and controlling shareholders.

⁷See, e.g., R. Posner, *Economic Analysis of Law* 372 (3d ed. 1986); Carlton & Fischel, *The Regulation of Insider Trading*, 35 *Stan. L. Rev.* 857 (1983); Easterbrook & Fischel, *Voting in Corporate Law*, 26 *J.L. & Econ.* 395 (1983); Easterbrook & Fischel, *Corporate Control Transactions*, 91 *Yale L.J.* 698 (1982); Fischel, *The Corporate Governance Movement*, 35 *Vand. L. Rev.* 1259 (1982); Macey, *From Fairness to Contract: The New 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 *J. Legal Stud.* 251 (1977).

⁸On this view, the contractual entity is nothing more than a metaphor for a conglomeration of voluntary agreements among the various participants in the enterprise. On the contractual view of the corporation, see Alchian & Demsetz, *Production*,

They argue---and we will see that this argument is disputable---that the contractual view of the corporation implies that the parties involved should be totally free to shape their contractual arrangements. The primary function of corporate law, they suggest, should be to facilitate the private contracting process by providing a set of nonmandatory "standard-form" provisions, with private parties free to adopt charter provisions that opt out of any of these standard arrangements.

Because many important corporate rules are mandatory, the freedom-to-opt-out view has considerable practical implications. For example, the freedom-to-opt-out advocates have proposed allowing companies to opt out of all doctrines concerning managerial fiduciary duties⁹ and out of all insider trading rules.¹⁰ If such unconstrained freedom to opt out were granted,

Information Costs, and Economic Organization, 62 Am. Econ. Rev. 777 (1972); Fama & Jensen, Separation of Ownership and Control, 26 J.L. & Econ. 301 (1983); Jensen & Meckling, Theory of the Firm: Managerial 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); Williamson, Corporate Governance, 93 Yale L.J. 1197 (1984). The contractual approach goes back to Coase, The Nature of the Firm, 4 *Economica* (n.s.) 386 (1937).

For recent critical evaluations of the nexus of contracts view, see Bratton, The New Economic Theory of the Firm: Critical Perspectives from History, 41 Stan. L. Rev. 1471 (1989); Bratton, The "Nexus of Contracts" Corporation: A Critical Appraisal, 74 Cornell L. Rev. 245 (1989).

⁹See, e.g., Continuation and Discussion of Principles of Corporate Governance: Analysis and Recommendations, Tent. Draft No. 5, 63 A.L.I. Proc. 411--12 (1986) (comments of Judge Frank H. Easterbrook).

¹⁰See, e.g., Carlton & Fischel, *supra* note 7; Macey, *supra* note 7, at 58--63.

it presumably would bring significant change to corporate life.¹¹

The freedom-to-opt-out advocates have already had much influence. On the practical side, they have had an impact on the direction of law reform and law change. The American Law Institute Reporters, for example, recently proposed permitting opting out with respect to some significant issues.¹² The SEC recently requested comments on a proposal to provide companies with substantial freedom to opt out of federal takeover rules.¹³ And the state of Delaware recently permitted corporations to adopt charter provisions that eliminate or restrict director liability for breach of their duty of care.¹⁴

On the intellectual side, the freedom-to-opt-out advocates have had a substantial impact on corporate law scholarship and its agenda. The longstanding mandatory nature of American corporate law---and, to the best of my knowledge, the corporate

¹¹While most people would accept without question the importance of the issue under consideration, Bernard Black disputes this importance in an interesting and provocative unpublished paper. See Black, *Is Corporate Law Trivial?* (Columbia Law School working paper, Feb. 1989) (on file at the Columbia Law Review). Black's position stems from his more general view, which he develops in this paper, that corporate law is on the whole not that important. While I disagree with Black's general view, I wish here only to point out that even he would presumably agree with the view, which I develop in *Bebchuk*, *supra* note 2, at 1858--59, that the question of contractual freedom is one of the most important questions in corporate law (whatever the importance of this area of the law may be).

¹²See, e.g., *Principles of Corporate Governance: Analysis and Recommendations* Sec. 5.09 (Tent. Draft No. 7, 1987) (effect of a standard of the corporation); *id.* Sec. 7.17 (limitation on damages for certain violations of duty of care).

¹³See Concept Release on Takeovers and Contests for Corporate Control, Exchange Act Release No. 23,486 [1986--1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) p. 84,018 (July 31, 1986).

¹⁴See Del. Code Ann. tit. 8, Sec. 102(b)(7) (Supp. 1988).

law of all the other major market economies as well---can no longer be accepted without question and reflection. Corporate law scholars have had to wrestle with the freedom-to-opt-out view, and have been faced with the need to either accept it or give reasons for rejecting it. The articulation of the freedom-to-opt-out position has challenged scholars who support mandatory rules to put forward a systematic theory that provides a rationale for mandatory rules, as well as criteria for deciding which rules should be mandatory. Several articles working toward this goal have already been published,¹⁵ and several others appear in this issue.

Both sides of the debate are well represented in this issue. Frank Easterbrook and Daniel Fischel, who are leading and active spokesmen for the freedom-to-opt-out position, contribute an article in which they present and defend their view.¹⁶ Four other article contributors---Melvin Eisenberg,¹⁷ Jeffrey Gordon,¹⁸ John Coffee,¹⁹ and Robert Clark,²⁰---present views that

¹⁵See Bebchuk, *supra* note 2; Brudney, Corporate Governance, Agency Costs, and the Rhetoric of Contract, 85 Colum. L. Rev. 1403 (1985); Clark, Agency Costs Versus Fiduciary Duties, *in* Principals and Agents: The Structure of Business (J. Pratt & R. Zeckhauser eds. 1985); Coffee, No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies, 53 Brooklyn L. Rev. 919 (1988).

¹⁶Easterbrook & Fischel, The Corporate Contract, 89 Colum. L. Rev. _ (1989).

¹⁷Eisenberg, The Structure of Corporation Law, 89 Colum. L. Rev. _ (1989).

¹⁸Gordon, The Mandatory Structure of Corporate Law, 89 Colum. L. Rev. _ (1989).

¹⁹Coffee, The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role, 89 Colum. L. Rev. _ (1989).

are, to different degrees, critical of the freedom-to-opt-out position and supportive of mandatory rules. The issue also includes comments on these articles by Lewis Kornhauser,²¹ Ralph Winter,²² Fred McChesney,²³ Roberta Romano,²⁴ Jonathan Macey,²⁵ and Anthony Kronman.²⁶ Finally, the issue includes an article by Oliver Hart on the boundaries of the firm;²⁷ I shall later discuss how this question of boundaries relates to the question of contractual freedom which is the main subject of the issue.

Below, I evaluate the arguments of each of the debate's two sides, and assess where the debate is now standing. In so doing, I refer to those advocating a fairly general freedom to opt out as "deregulators," and to those supporting substantial limits on opting out as "regulators." I do not refer to the deregulators as contractualists or contractarians, as some of the contributors to this issue do, because I wish to avoid the implication that

²⁰Clark, Contracts, Elites, and Traditions in the Making of Corporate Law, 89 Colum. L. Rev. _ (1989).

²¹Kornhauser, Remarks on the Nexus of Contracts Approach to Corporations, 89 Colum. L. Rev. _ (1989).

²²Winter, The Race for the Bottom Revisited: A Comment on Eisenberg, 89 Colum. L. Rev. _ (1989).

²³McChesney, Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg, 89 Colum. L. Rev. _ (1989).

²⁴Romano, Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws, 89 Colum. L. Rev. _ (1989).

²⁵Macey, Courts and Corporations: A Comment on Professor John C. Coffee, Jr.'s The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role, 89 Colum. L. Rev. _ (1989).

²⁶Kronman, A Comment on Dean Clark, 89 Colum. L. Rev. _ (1989).

²⁷Hart, An Economist's Perspective on the Theory of the Firm, 89 Colum. L. Rev. _ (1989).

the deregulatory position follows from the contractual view of the corporation: as explained below, deregulators do not have a monopoly over the contractual view, and some of those putting forward a regulatory view pursue their analyses within the contractual framework.

II. The Debate on Contractual Freedom in Midstream

The debate on contractual freedom in corporate law should be viewed as two debates, not one. The questions of contractual freedom in the initial charter and in midstream (that is, after the corporation has been formed and its initial charter set) are different and require separate examination.

The importance and distinctiveness of midstream opting out have in the past been largely overlooked. For one thing, the law treats opting out at the initial charter and midstream stages in much the same way: in determining whether a certain opt-out charter provision is allowed, the law generally asks only what the provision says and not at what stage it was adopted. As to the literature, it has largely ignored the distinctiveness of midstream opting out. In discussing contractual freedom in corporate law, both deregulators,²⁸ and the first critiques of their position,²⁹ focused on opting out in the initial charter---the natural context for thinking about contractual freedom.

Similarly, when I first approached the subject, I also began by focusing on opting out in the initial charter as the

²⁸See, e.g., R. Posner, *supra* note 7.

²⁹See Brudney, *supra* note 15, at 1411--27; Coffee, *supra* note 15, at 936--50.

paradigmatic case. Examining the midstream case, however, I eventually concluded that it deserves separate and substantial attention. This conclusion arises from the recognition that the midstream case is, first, practically very important and, second, conceptually quite different. For these reasons, which I shall presently elaborate, I shall divide my evaluation of the arguments in this issue into those applicable to the charter amendment stage and those applicable to the initial charter stage. As I explain below, participants in the debate are coming to recognize the difference between the two stages, and the strength of the positions of the two sides of the debate differs markedly between the two stages at which opting out may take place. The arguments of the regulators are stronger concerning charter amendments than concerning initial charters; the arguments of the deregulators are stronger concerning initial charters than concerning charter amendments. Furthermore, the midstream case is where the arguments of the deregulators need most development, and the initial charter stage is where the regulators' arguments need most development.

Let me start by explaining why midstream opting out is practically very important. The consequences of allowing complete freedom to opt out by charter amendment are quite substantial and indeed might even be more significant than those of allowing opting out in the initial charter. At a minimum, the midstream case is sufficiently important to require deregulators--if they wish to advocate a world in which corporations generally have great freedom to opt out---to make a case for free opting out in midstream. To see this, suppose that we now adopt

a policy of complete freedom to opt out in the initial charter but not through charter amendments. For many years after the adoption of this policy, most companies will have been incorporated and fixed their initial charters prior to the adoption of 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, if the freedom-to-opt-out advocates wish to make unconstrained opting out available to most companies in the not too distant future, they must establish the case for unconstrained opting out by charter amendment.

Let me now explain why the arguments for limiting midstream opt-outs are conceptually different than those for limiting opt-outs at the initial charter stage.³⁰ Unlike initial charters, charter amendments cannot be viewed as contracts; consequently, one cannot rely on the presence of a contracting mechanism as the basis for upholding opt-out charter amendments.³¹ Furthermore, the amendment process is quite imperfect and cannot be relied on

³⁰I sketch below very briefly the argument that I fully developed in Bebchuk, *supra* note 2, at 1825--51.

³¹If the provisions of a contract---or, in particular, a corporate initial charter---are fully reflected in the price that the parties to the contract would accept, then the contracting mechanism will ensure that the efficient provisions will be chosen. With the charter's provisions fully reflected in the price, the party designing the charter would not be able to benefit from introducing any inefficient provision (even if the provision itself would provide this party with some direct benefit) and consequently would not do so. While the effectiveness of this contracting mechanism depends on the extent to which the charter provisions are fully reflected in the price that can be obtained in the initial offering for the stock, such mechanism is not at all present in the case of charter amendments. For a detailed discussion of this difference between initial charters and charter amendments, see Bebchuk, *supra* note 2, at 1825--29.

to preclude value-decreasing amendments. Although an amendment requires majority approval by the shareholders, voting shareholders do not have sufficient incentive to become informed. And although the amendment must be proposed by the board, the directors' decision might be shaped not only by the desire to maximize corporate value but also by the different interests of officers and dominant shareholders.

Rational and informed shareholders forming a corporation would recognize the desirability of an amendment procedure that permits charter changes without unanimous shareholder consent. But they also would recognize that allowing any given opt-out freedom might produce value-decreasing amendments and thus involve an expected cost. The expected cost of a given opting out freedom, as well as its expected benefit, would vary substantially depending on the type of issue involved and the circumstances under which the opting out would be done. An analysis of these expected costs and benefits suggests that the optimal arrangement---the one that rational and informed shareholders would wish to govern their future relationship---is one that, while allowing much midstream opting out, also places significant limits on it.³²

³²Specifically, my analysis showed that, in companies without a dominant shareholders, some limits are desirable with respect to amendments that (1) either would transfer significant value from shareholders to managers (significant relative to their effect on corporate value) or would directly weaken the force of market discipline on the managers, and (2) involve issues that are sufficiently similar across companies to enable a standard legal arrangement to perform reasonably. In addition, when a company has a dominant shareholder, some limits are desirable with respect to amendments that transfer significant value from minority shareholders to the dominant shareholder. See Bebchuk, *supra* note 2, at 1835--51.

The optimal arrangement thus involves an element of precommitment not to adopt in midstream, at least not in certain circumstances, opt-out provisions with respect to certain issues. This optimal arrangement is the one that the law should provide, at least in the absence of an explicit provision to the contrary in the initial charter. Even strong believers in free markets should accept this optimal arrangement as the default arrangement in the very common case in which such an explicit contrary provision is absent. Therefore, even supporters of a complete freedom to opt out in the initial charter, I suggest, should recognize that mandatory rules have a desirable role to play in midstream.

Looking at the articles in this issue, it appears that both regulators and deregulators now recognize, or are moving toward recognizing, that the midstream stage is different from the initial charter stage and presents the biggest problem for the freedom-to-opt-out view. Most of the contributors who advance regulatory views express special concern with respect to midstream opting out. Eisenberg focuses to a great degree on midstream opting out.³³ Gordon considers five alternative arguments for supporting mandatory rules and concludes that the strongest is the one based on the need to limit opting out in midstream.³⁴

And Coffee, who puts forward a standard for judicial scrutiny of opt-out provisions in general, notes that charter amendments present a "special problem" and includes in his standard an

³³See Eisenberg, *supra* note 17, at _.

³⁴See Gordon, *supra* note 18, at _.

element that applies only to charter amendments.³⁵

Looking at the deregulators' side of the debate, Easterbrook and Fischel have a short section on charter amendments that reflects their recognition of the difficulty that such amendments present for their view.³⁶ They acknowledge that the central argument with which they explain the optimality of nonintervention in privately adopted charter provisions is inapplicable to the charter amendment setting---that "[t]he mechanism by which entrepreneurs and managers bear the cost of unfavorable terms does not work---not in any direct way---[for charter amendments]." ³⁷ And they further recognize that the voting mechanism also cannot be relied on to prevent value-decreasing amendments. These observations lead them to accept that charter amendments must be viewed as "a potential problem in a contractual approach to corporate law."³⁸

Easterbrook and Fischel, however, are at this stage still unprepared to let the "potential" problem that they recognize affect their opposition to placing limits on opting out. They claim that, whatever problems may be involved in the charter amendment process, these problems should be addressed not by placing limits on the amendments that may be adopted, but rather by changing the amendment process (for example, by imposing more demanding voting requirements or by providing appraisal

³⁵See Coffee, *supra* note 19, at __.

³⁶Easterbrook & Fischel, *supra* note 16, at __.

³⁷*Id.* at __.

³⁸*Id.* at __.

rights).³⁹ They further suggest that the fact that such stricter procedural arrangements are not very common in initial charters indicates that even such arrangements are on balance undesirable.

Easterbrook and Fischel's brief answer clearly is not (and is not meant to be) a full and adequate answer to the problem they have recognized. To start with, existing initial charters have been fixed against a legal background that included significant substantive limits on opting out in midstream (as well as in the initial charter). Thus, even if these initial charters commonly do not impose procedural restrictions on midstream opting out, this fact does not imply that shareholders would not desire such restrictions if the existing substantive limits on midstream opting out were removed. More importantly, Easterbrook and Fischel do not provide a basis for holding that the possibility of stricter procedural requirements makes it unnecessary to consider substantive limits on opting out in midstream. There are reasons to believe that stricter procedural requirements cannot adequately address the imperfections of the

³⁹Id. at __. That stricter procedural requirements should be used to address whatever imperfections are involved in the amendment process is also suggested by Romano, *supra* note 24, at __, and by Trebilcock, Chapman & Daniels, *Comments on Bebchuk, Freedom of Contract and The Corporation*, at 11--13 (unpublished manuscript on file at the Columbia Law Review).

For deregulators like Easterbrook and Fischel to accept the need for a policy to address the imperfections of the charter amendment process, even a policy based on procedural requirements and appraisal rights, is a significant concession. Such an approach still would require identifying the issues and circumstances most likely to give rise to value-decreasing amendments. The most demanding procedural requirements presumably would be imposed with respect to these issues and circumstances. And note that making the adoption of a certain opt-out amendment quite difficult may be practically equivalent to barring it.

amendment process.⁴⁰ It is thus only natural to consider whether, at least with respect to some issues and circumstances, substantive limits would work better than procedural requirements.

Recognizing the problem that midstream opting out presents for their view, Easterbrook and Fischel downplay its importance. They devote to midstream opting out relatively little space in their article. And the answer they give to the imperfections of the amendment process---changing the amendment process---is discussed by them very briefly on the grounds that their aim "is not . . . to draft rules of law."⁴¹ Anyone who wishes to put forward a general position on contractual freedom in corporate law, however, must offer a fuller analysis of the midstream case. As explained above, opt-out amendments are practically very important; if corporate law rules were no longer mandatory, much of the resulting opting out would be done in midstream, by companies already in existence. Thus, those who argue against mandatory rules, as Easterbrook and Fischel do, must address fully all the problems involved in opt-out amendments.

My assessment is that midstream opting out presents a serious problem for the deregulatory position that deregulators will have to confront. They will have to recognize that the amendment process is substantially imperfect and that this imperfection is especially significant with respect to certain

⁴⁰For a detailed analysis as to why stricter procedural requirements cannot adequately address all of the imperfections of the amendment process, see Bebchuk, *supra* note 2, at 1852--58; see also Gordon, *supra* note 18, at _.

⁴¹See Easterbrook & Fischel, *supra* note 16, at _.

issues and circumstances. Consequently, if deregulators wish to maintain their view in favor of a general freedom to opt out, they will have to provide a full explanation as to why the imperfections of the amendment process do not warrant some limits on opting out. This task may keep the deregulators busy while the regulators develop their own arguments concerning opting out in the initial charter, which, as explained below, is the element of the regulators' position to which they now should direct much of their work.

III. The Debate on Contractual Freedom at the Initial Charter Stage

I have argued that midstream opting out is important and deserves much more attention than has been given to it in the past. But, although we should be careful not to focus almost exclusively on initial charters and attach to the midstream stage too little weight, we should also avoid the opposite mistake of giving too little weight to the initial charter stage. This, too, requires serious attention.

Let us look at the arguments on both sides with respect to opting out in the initial charter. It is in this context that the case for contractual freedom is the strongest. The deregulators' argument here is straightforward, the classic "freedom of contract" argument. The private parties involved, it is argued, know their interests best (or at least better than do public officials).⁴² Therefore, the price investors will be willing to pay for stock in an initial offering will generally

⁴²See id. at __.

reflect the initial charter provisions, and the party designing the charter will take this into account. Charter provisions will consequently tend to be the efficient, value-maximizing provisions. The deregulators are strengthened in their position by their perception that the corporate context is most fitting for the freedom of contract argument. The market for initial stock is viewed by them as quite competitive, with many sophisticated participants, and with many mechanisms that transmit and spread information.

Also familiar are the two general types of arguments that can be used to justify intervention in contractual terms---the externalities argument and the imperfect information argument. Thus, what regulators need to do is to apply these general arguments to the corporate context either as they are or in some special form.⁴³ Either way, much work is necessary to show that the arguments have weight when made in the corporate context. As explained below, while deregulators have done some of the needed work, substantial work still needs to be done until all the plausible externality and imperfect information arguments are fully developed.

1. Externality Arguments. --- If significant externalities can be shown to exist, then the case for intervention can be established in a relatively noncontroversial way. In the

⁴³The arguments that Gordon develops, for example, are special forms of the standard arguments. The two arguments for limiting opting out in the initial charter that Gordon finds plausible are what he calls the "public good" and "innovation" arguments. See Gordon, *supra* note 18, at _____. Gordon's public good argument, discussed *infra* notes 45--46 and accompanying text, is a special form of the externalities argument, while his innovation argument is a special type of the imperfect information argument.

presence of externalities, the privately agreed upon terms might be socially inefficient as the contracting parties would not take into account the effect on third parties; mandatory terms might consequently move us closer to social optimality. The externalities argument is less controversial than the imperfect information argument because it makes a much more modest assertion about the existing market imperfection.⁴⁴ But, although the theoretical structure of the externalities argument is clear and noncontroversial, its applicability and persuasiveness depend on showing that certain definite and substantial externalities are present in the corporate context.

Some of the participants in this issue do suggest the existence of certain externalities. Gordon points out that any opting out of a standard provision imposes a negative externality on other parties who use the standard provision because they would have fewer precedents to rely on.⁴⁵ While this reasoning is valid in theory, its practical weight, as Gordon recognizes, is quite limited. For while any use of a standard charter provision does confer a positive externality on other users (and, conversely, any opting out produces a negative externality), the size of this externality seems to be small relative to the interests of the contracting parties.⁴⁶

⁴⁴The externalities argument assumes only that transaction costs and monitoring and enforcement problems make it impossible for the existing externalities to be adequately addressed by voluntary agreements between the affected third parties and the contracting parties.

⁴⁵See Gordon, *supra* note 18, at _.

⁴⁶Indeed, the positive externalities created by standardization seem to be much larger with respect to the features of many technical products---such as VCRs or certain

Therefore, the most effective externality argument is not that any charter opting out creates a negative externality, but rather that opting out with respect to certain specific corporate arrangements produces sufficiently significant externalities to warrant intervention in these arrangements. Actually, Easterbrook and Fischel themselves make such arguments, and view them as the only reason for accepting some exceptional mandatory rules.⁴⁷ In particular, Easterbrook and Fischel point out that decisions not to reveal certain corporate information and decisions to resist takeovers involve significant externalities, which may justify making mandatory rules concerning disclosure and resistance to takeovers.⁴⁸ Also, Kornhauser discusses the possibility that some shareholder-manager arrangements have externalities with respect to bondholders.⁴⁹ Still, more analysis of this kind is in my view called for. Regulators should make a substantial effort to identify and assess the magnitude of all the externalities produced by corporate law arrangements.

2. Imperfect Information Arguments. --- Because many existing mandatory rules (for example, with respect to certain fiduciary duties) do not seem to involve any substantial externalities, the imperfect information argument seems to be the

types of communication and computer systems---and still their magnitude does not appear sufficiently substantial to warrant mandatory intervention in these products' features.

⁴⁷See Easterbrook & Fischel, *supra* note 16, at __.

⁴⁸See *id.* at __.

⁴⁹See Kornhauser, *supra* note 21, at __.

main possible justification for these rules. The argument is that the buyers of stock in a company's initial offering rationally elect not to study and assess fully many aspects of the company's charter. Consequently, because the expected effects of some charter provisions often are not fully reflected in the average price that can be obtained for stock in an initial offering, the initial charters produced by the market often might not be value-maximizing.

Most regulators indeed seem to believe that significant problems of imperfect information afflict the market for initial charters. Brudney, Clark, Coffee, Eisenberg, and I have all expressed such a belief, though we differ in our views as to the scope of mandatory rules that the informational problem warrants.⁵⁰ Gordon believes that the informational problem is not substantial in general, but even he suggests that this problem is substantial---and possibly justifies some mandatory rules---with respect to "innovative" terms.⁵¹

While regulators have thus put forward the imperfect information argument, they have not sufficiently developed or substantiated the elements of this important argument, and I therefore wish to explain briefly what needs to be done. The first element that needs to be more fully worked out is a systematic analysis of the quality of the initial charters produced by the market. Deregulators do not dispute that shareholders are not perfectly informed. The dispute is over the

⁵⁰See Brudney, *supra* note 15, at 1411--27; Clark, *supra* note 20, at __; Coffee, *supra* note 19, at __; Eisenberg, *supra* note 17, at __; Bebchuk, *supra* note 3, at 50--62.

⁵¹See Gordon, *supra* note 18, at __.

degree of this imperfection and over its consequences for the charters produced by the market. Is the problem similar in severity to the markets for products such as drugs, in which it is widely thought that mandatory intervention is warranted,⁵² or is it closer in nature to the problems that exist concerning the many products with respect to which mandatory terms seem undesirable?

In discussing the severity of the informational problem, deregulators do not dispute that, for many shareholders, it would not be rational to invest in assessing many complex or small charter provisions. Deregulators believe, however, that there are various market mechanisms that address this imperfect information problem. In particular, they believe that capital markets operate in such a way that, if many buyers are informed, sellers will be induced to behave as if all buyers were informed; that underwriters push toward the introduction of value-maximizing provisions; that issuers are significantly disciplined by reputational concerns; and that many market professionals distribute information (and even more would do so if repealing mandatory rules created a need for their services).⁵³

My own thinking on this subject has led me to conclude that, while these mechanisms do greatly improve the quality of provisions produced by the market, they do not adequately address the informational problem with respect to certain charter terms. To establish such a conclusion, however, it will be necessary to provide a systematic analysis of the limitations of all the

⁵²See, e.g., Clark, *supra* note 20, at __.

⁵³See, e.g., Trebilcock, Chapman & Daniels, *supra* note 39.

market mechanisms on which deregulators rely. Regulators should therefore put forward such an analysis to establish the first element of their imperfect information argument.⁵⁴

Furthermore, even if regulators do establish that the provisions privately adopted fall considerably short of the value-maximizing provisions, they will still have to supply the second important element of the imperfect information argument. Even if the privately adopted provisions are suboptimal, it remains to be shown that the mandatory provisions would be better. If the mandatory rules are adopted through a deliberative process by public officials (be they legislators, judges, or agency executives), regulators should evaluate how the quality of the chosen rules compares with that of the provisions produced by the market. At a minimum, regulators should identify those issues with respect to which public officials can be expected to do relatively well.⁵⁵

In examining the quality of the standard legal terms relative to the opt-out provisions produced by the market, one

⁵⁴One step in this direction is provided by the analysis of underwriters in Bebchuk, *supra* note 3, at 57--58, which shows that the presence of underwriters does not eliminate the informational problem. This step is a limited one, however, because the presence of underwriters is only one of several mechanisms on which deregulators rely and which should all be analyzed.

⁵⁵Some initial criteria for approaching this question are put forward in Bebchuk, *supra* note 3, at 60--62. I suggest that public officials can design rules relatively well when the issue is one that does not vary significantly in its structure and optimal remedy from company to company. I also suggest that the quality of the provisions produced by the market is especially problematic when the issue involves a potential transfer between the party designing the initial charter and the buying investors, and when the issue is complex or novel and/or has limited effect on corporate value. See also Clark, *supra* note 20, at _.

should also consider the possibility, raised and discussed by Clark, that some of the standard legal arrangements are adopted not through a deliberative process but rather as the product of tradition.⁵⁶ What Clark has in mind are rules that have been developed through a long process to which many individuals contributed, though none had a full and critical awareness of the rationale behind the rule. Clark points out that the effectiveness of such processes may significantly vary from one area of the law to another, and he identifies and discusses the general advantages and disadvantages of such processes. A detailed study of these advantages and disadvantages in the corporate context will enable us to make a better assessment of the quality of those corporate arrangements that are the product of tradition.

IV. The Debate on Contractual Freedom and Other Corporate Law Debates

The question of contractual freedom is a basic question in the theory of corporate law, and it is thus natural to expect it to be connected to other basic questions in the theory of the corporation and of corporate law. In particular, I discuss below the connections between the contractual freedom question and four other important and often debated issues: (1) the nature of the corporation; (2) the boundaries of the corporation; (3) the content of corporate rules; and (4) the selection of the institutions making corporate law.

⁵⁶See Clark, *supra* note 20, at __.

A. The Nature of the Corporation

As already noted, an important question in corporate law theory is whether the corporation should be viewed as a contractual being---a nexus of contracts. The contractual view of the corporation is now well accepted among economists, and many corporate law scholars---including all those who advance the deregulatory view---subscribe to it.⁵⁷ Other corporate law scholars, however, view the use of the contractual framework of analysis and the contractual language as incorrect and even misleading.⁵⁸

At first glance, one may be inclined to think that the debate on the contractual view of the corporation and the debate on contractual freedom in corporate law are inextricably linked, and that the resolution of the former determines the resolution of the latter. For one thing, the deregulators seem to think that their freedom-to-opt-out position follows directly from the contractual view. And, furthermore, some regulators attack the freedom-to-opt-out position by taking issue with the contractual view of the corporation.

In fact, the debate on opting out is not connected to the debate on the contractual view of the corporation in the way that it initially seems. Accepting the contractual view does not entail accepting any particular position on mandatory rules. In particular, one may accept the contractual view of the

⁵⁷See generally sources cited supra note 8.

⁵⁸See, e.g., Brudney, supra note 15, at 1407--10; Clark, supra note 15, at 61.

corporation and at the same time reject the freedom-to-opt-out position and support a substantial number of mandatory rules. This position is indeed the one that I personally hold: I believe that the contractual view provides a useful and illuminating framework of analysis, and I also believe that the law should have a substantial mandatory role. In my papers I have therefore used the contractual framework to state my reasons for supporting mandatory rules.⁵⁹ Similarly, this symposium includes, alongside some articles by regulators that do not (at least not fully or explicitly) subscribe to the contractual view,⁶⁰ an article by Jeff Gordon that analyzes arguments for mandatory rules within the contractual framework.⁶¹

In sum, the deregulators do not have a monopoly over the contractual framework of analysis. Those who accept and use this framework should not feel that this framework by itself requires them to take either a deregulatory or regulatory position on mandatory rules.

B. The Boundaries of the Corporation

Economists have long sought to explain what determines the size and boundaries of firms---what determines which activities take place within a firm and which take place in the market, between firms.⁶² In his contribution to this issue, Oliver Hart

⁵⁹See, e.g., Bebchuk, *supra* note 2; Bebchuk, *supra* note 3.

⁶⁰See, e.g., Eisenberg, *supra* note 17.

⁶¹See Gordon, *supra* note 18.

⁶²The question was first put forward in Coase, *supra* note 8, at 393--94.

surveys and contrasts the various theories that economists have developed for approaching this question, including a recent theory to which he has prominently contributed.⁶³

At first glance, the question of boundaries seems somewhat unrelated to the subject of contractual freedom to which the other articles in this issue are devoted. While Hart's paper discusses what determines the boundaries of the firm, the other articles examine an aspect of what happens, as it were, within these boundaries. While Hart's question---what explains the actual boundaries of firms---is descriptive, the other articles examine a normative question---whether the law should impose mandatory terms on the arrangements that govern within these boundaries.

Upon consideration, however, one notices that the question addressed by Hart is connected to the question of contractual freedom. First, both questions arise from the contractual view of the corporation---they come to mind naturally once the corporation comes to be viewed as a contractual being. If the corporation is a contractual being, then the question of contractual freedom directly arises. Similarly, if the corporation is a contract of a particular kind, then it is natural to ask why some activities are organized by this contract while others are organized by different, market contracts.

A second connection between Hart's question and the question of contractual freedom is that an analysis of either requires making some assumptions about matters concerning the other. The existing boundaries of corporations are in part a function of the

⁶³Hart, *supra* note 27.

legal rules that govern corporations. And in seeking to determine the optimal design of the rules for corporations, we must make, at least implicitly, some assumptions about the pattern of corporate size. Such assumptions are necessary because the choice of the optimal rules depends on a variety of factual and institutional factors that in turn depend on the governed corporations' size and other size-related aspects.⁶⁴

C. The Content of Corporate Law Rules

For any given corporate rule, it is of course important not only whether it is mandatory but also what it says. Even if the legal rule serves only as a default arrangement, the design of this default arrangement is important. Thus, a basic question is what standard should be used in designing corporate law rules. Several contributors to this issue, including Easterbrook and Fischel, Coffee, Gordon, and Kornhauser, express views on what this standard should be.⁶⁵ Below, I discuss the connections between the contractual freedom debate and the question of the standard for designing rules. In particular, I suggest that, in contrast to what is generally supposed, the standard for designing nonmandatory rules should significantly differ from that for designing mandatory rules.

The standard endorsed by many corporate law scholars, both

⁶⁴As noted, the size itself is in part a function of the governing rules. Therefore, at least in theory, when we examine a given legal change, we should consider not only the existing pattern of size but also the pattern that would arise if the change were implemented.

⁶⁵See Easterbrook & Fischel, *supra* note 16, at __; Coffee, *supra* note 19, at __; Gordon, *supra* note 18, at __; Kornhauser, *supra* note 21, at __.

deregulators and regulators, is that of hypothetical contracting.⁶⁶ According to this standard, we should identify and adopt as the legal rule the arrangement that rational and fully informed parties would have adopted ex ante. This standard is directly connected to the contractual view of the corporation, which also gives rise naturally to the contractual freedom question. Although the considered standard is couched in terms of hypothetical contracting, it overlaps with the standard of efficiency. Rational and fully informed parties would agree ex ante on the value-maximizing arrangement: for, given the full information assumption, all provisions would be reflected in the price, and so no party would be able to benefit from introducing a value-decreasing provision.

The issues highlighted in the present debate have significant implications for the questions of whether and when the standard should be applied and, if applied, how it should be applied. To begin with the latter question, it is worth emphasizing that, to the extent that an application of this standard is warranted, such application would often have to take into account the problems of information, collective action and monitoring highlighted by the present debate.⁶⁷ In a hypothetical, ex ante contracting, rational and fully informed parties would recognize that, ex post, problems of information, monitoring and collective action would arise, and they would take these problems into account in adopting an arrangement. For example, in considering the arrangement that such parties would

⁶⁶See, e.g., Easterbrook & Fischel, *supra* note 16, at __.

⁶⁷See Kornhauser, *supra* note 21, at __.

wish ex ante to impose on future charter amendments, it is important to recognize that, as discussed earlier, these parties would be aware and would fully take into account the imperfections of the charter amendment process.

Let me now turn, however, to the more important question of whether and when the hypothetical contracting standard should be used. At first glance, it appears that the question of which standard to use in designing a given rule and the question of whether to make the rule mandatory can be independently answered. We should first choose the "best" arrangement, it may be argued, and then decide whether the chosen arrangement will be mandatory. This intuitive argument, however, is incorrect. As I explain below, the appropriate standard for designing a rule may well depend on whether the designed rule is going to be mandatory, and the hypothetical contracting standard is more appropriate for designing mandatory rules than for nonmandatory rules.⁶⁸

To see this point, consider public officials who must choose for a legal rule either arrangement A or B. Suppose that, in comparison with B, A's direct effect would be a gain for the managers and a loss for the shareholders. Suppose further that the officials judge A as more likely to be the efficient arrangement. To be concrete, suppose that the officials' estimate is that there is a 51% chance that A is the efficient arrangement and a corresponding 49% chance that B is the efficient arrangement (with the size of the efficiency gain being the same in the two cases). Thus, because in the officials'

⁶⁸The point made below is based on my work in progress on the choice of default terms for corporate arrangements (and for contracts in general).

judgment A is the arrangement more likely to be chosen ex ante by fully informed parties, it is the arrangement recommended by the hypothetical contracting standard.

If the chosen arrangement is going to be mandatory, then efficiency would be indeed served by the officials' choosing A. Because opting out of the chosen arrangement will not be possible, the officials must assume that this arrangement will govern even if the alternative arrangement is actually the efficient one. And given the officials' judgment that A is more likely to be efficient, choosing A is preferable on an expected value basis.

If the chosen rule is not going to be mandatory, however, the officials' calculus should be different. They should now also take into account how their choice between A and B will affect the likelihood that, if they happen to choose inefficiently, their choice will be "corrected" by an opt-out amendment. As already emphasized, the process of midstream opting out by existing companies involves certain identifiable, systematic imperfections. In particular, because amendments must be proposed by the directors whose interests do not perfectly overlap with the maximization of corporate value, an efficient amendment would be more likely to be adopted if its direct effect on the directors is favorable than if it is unfavorable. Thus, in the considered case, if B is chosen and the efficient arrangement is actually A, the chances that the directors will propose and get adopted a correcting opt-out will be much higher than if A is chosen and the efficient arrangement is actually B. It follows that the officials' choosing B as the default

arrangement may well produce a higher overall chance of companies' ending up with the efficient arrangement.

Thus, in choosing a nonmandatory default rule between two arrangements, none of which is clearly or generally superior, officials should give some preference to the arrangement less favorable to managers or dominant shareholders, because this arrangement has better chances of being corrected by an opt-out amendment in the event that the officials' choice is actually inefficient. The desirable standard for officials to apply is not one based solely on whatever information they may have about the comparative efficiency of the alternative arrangements (and thus the likelihood that they would be chosen ex ante by fully informed parties). Rather, officials should use a refined standard that, in addition to this information, also takes into account, and seeks to counter, the systematic biases of the opting-out process in favor of amendments beneficial to managers and dominant shareholders.

While a detailed examination of this approach is a task that is beyond the scope of this Essay and that I will pursue elsewhere, the above discussion is sufficient to establish that a rule's design should depend on whether opting out is going to be allowed. And when we decide to make a given rule nonmandatory, we should not forget that, while we have concluded that allowing opting out is on the whole desirable, the allowed opting-out process is unlikely to be perfect and to realize all its potential gains. Given this recognition, the design of such nonmandatory rules should be made with sensitivity to the imperfections of the amendment process, imperfections that the

contractual freedom debate has done much to highlight.⁶⁹

D. The Selection of the Institutions Making Corporate Law

A major question in corporate law scholarship concerns the selection of the institutions making corporate law. One important choice concerns the extent to which corporate law should be made on the state level and the extent to which it should be made on the federal level. Furthermore, whether the rules governing a corporate issue are to be made on the state or

⁶⁹Finally, I wish to note that, while applying the hypothetical contracting standard to the design of mandatory rules is supported by considerations of efficiency, even such application may be viewed by some as problematic. As is suggested by the fact that the standard is defined by reference to hypothetical contracting and not to efficiency per se, the attractiveness of the standard is presumably not based solely on efficiency considerations. The hypothetical contracting element suggests that the chosen arrangement is not only efficient and thus in the parties' collective interest, but also in each party's individual interest, and that the choice thus does not create a problem of redistribution or fairness. As explained below, however, using the standard to design a mandatory rule may involve such a problem if, as the present debate highlights, the parties' information at the time of the actual contracting was imperfect.

Suppose that officials must choose for a mandatory rule between A and B, that A is the efficient arrangement, and that, in comparison with B, A's direct effect is to produce a loss for the shareholders and a gain for the managers. If the shareholders were fully informed at the time of the initial offering about the chosen rule and its consequences, choosing A would not involve a redistribution problem; the stock price would fully reflect the choice of A, and the shareholders would not be made worse off by it. If the shareholders are imperfectly informed about the consequences of the chosen rule, however, then choosing A may make the shareholders worse off in comparison with choosing B. In particular, if the shareholders ignore or underestimate the loss that A will impose on them, then the stock price will not fully reflect this loss, and thus, in comparison with choosing B, choosing A will produce a redistribution from the shareholders to the managers. To be sure, we may still wish A to be chosen if we attach sufficient weight to efficiency considerations. But we should be aware that, once the presence of imperfect information is recognized, applying the hypothetical contracting standard to design mandatory rules may well have redistributive consequences.

federal level, we still must choose whether they would be determined by legislators, agencies or courts. This latter choice would affect not only the kind of expertise that would be used in devising the rules, but also whether the rules would operate only in an ex ante, general way, or also in an ex post, particularistic way.

At first glance, it might seem that the question of institutional selection and the question of contractual freedom should be analyzed separately. Whether rules are mandatory or not, we would presumably always wish to make the institutional selection in the best way possible and to have the rules determined by those institutions most likely to do the job well. And in examining the question of contractual freedom, we should presumably take as given the rules made by the selected institutions, and only ask ourselves whether and to what extent these rules should be mandatory.

As explained below, however, the two questions are connected, and it is thus valuable that some of the contributors to this issue discuss questions of institutional selection. Coffee, and consequently Macey, who comments on Coffee's article, focus on the special role of the judiciary in making corporate law.⁷⁰ Several contributors---including Easterbrook and Fischel, Eisenberg, Gordon, Romano, and Winter---discuss in one way or another the fact that much corporate law is made by states competing to attract corporations.⁷¹

⁷⁰See Coffee, *supra* note 19, at __; Macey, *supra* note 25.

⁷¹See Easterbrook & Fischel, *supra* note 16, at __; Eisenberg, *supra* note 17, at __; Gordon, *supra* note 18, at __; Romano, *supra* note 24, at __; Winter, *supra* note 22, at __.

It may therefore be worthwhile to note what in my view are some of the main connections between the contractual freedom and institutional selection questions. To start with, the importance of the question of institutional selection depends very much on the extent to which corporate law rules are mandatory. Clearly, when a corporate law issue is to be governed by a mandatory rule, the quality of that rule---and thus the selection of the institution making that rule---is of greater significance.

Second, our answer to the question of contractual freedom might depend on our assessment of the choice we have made concerning the institutional selection question. Whether we would like a given corporate issue to be governed by a mandatory rule depends not only on our evaluation of the imperfections involved in the opting-out process, but also on our assessment of the quality of the standard rule chosen by public officials. This latter assessment depends in part on our judgment as to how good a job will be done by the law-making institution we have chosen.

Finally, I wish to highlight the important connection between the contractual freedom question and one significant feature of the actual institutional choice that American corporate law has traditionally made---namely, that much corporate law is made on the state level, with states competing to produce laws that will attract corporations. The existence of state competition means that any mandatory rule adopted in a given state is less mandatory than it might initially seem. To the extent that other states have a different rule, opting out

can be done by reincorporation.⁷² Thus, for the rules of state corporate law, the meaning of making a rule mandatory may be only to make opting out more difficult rather than impossible.

The fact that state competition weakens the mandatory force of mandatory state rules has implications for both deregulators and regulators. For deregulators, this fact is encouraging. Indeed, because deregulators usually believe that state competition works well, they should believe that, if a state were to adopt a mandatory rule undesirable to its corporations, other states would usually provide the desired opt-out options. Thus, other things being equal, the existence of state competition should make deregulators more willing, as far as state corporate law is concerned, to accept mandatory rules.

Conversely, the existence of state competition may cause regulators concern. They may wish certain state rules to be mandatory and worry that state competition weakens the mandatory force of these rules. The question that regulators need to examine is whether, and to what extent, their support of mandatory rules is in tension with state competition (of which some of them do approve). In particular, regulators should consider whether their view entails limiting not only opting out but also state competition. For example, would they wish a state that limits opting out by charter amendment on a given issue to limit also the extent to which such opting out can be achieved through reincorporation? This is a difficult question which regulators must confront.

⁷²See, e.g., Romano, *supra* note 24, at _.

V. Conclusion

Within the law of corporations, the question of limits to contractual freedom is one of great theoretical and practical importance. It is a question with which every scholar of corporate law must wrestle. As I have attempted to show in this essay, the articles in this issue should give readers a sense of the complexity and richness of the subject, a picture of the arguments and the strong and weak points of both sides, and some basis for forming their own judgment on this question. With all respect to the contributors to this issue and to those who have earlier contributed to the subject, it appears that much thinking still needs to be done---on the part of both regulators and deregulators---and I have sought in this essay to point out the main areas in which such thinking is especially warranted.