

LIMITING CONTRACTUAL FREEDOM IN CORPORATE LAW: THE DESIRABLE CONSTRAINTS ON CHARTER AMENDMENTS

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In this Article, Professor Bebchuk takes issue with the increasingly influential view that companies should be completely free to opt out of corporate law rules by adopting appropriate charter provisions. He argues that the contractual view of the corporation, on which supporters of free opting out rely, offers substantial reasons for placing limits on opting out. Professor Bebchuk focuses on opting out done by charter amendment, after a company has been formed, and highlights the differences between opting out by charter amendment and opting out in the initial charter. Analyzing the informational and collective action problems involved in the charter amendment process, he concludes that the case for placing limits on opt-out amendments is so compelling that even strong believers in free markets should recognize the need for such limits. Professor Bebchuk also provides criteria for determining the issues with respect to which, and the circumstances under which, opting out by charter amendment should be prohibited or restricted.

THIS Article concerns a central question of the law of corporations: what limits, if any, should police the freedom of companies to opt out of the rules of corporate law? In particular, I focus on opting out in midstream — that is, opting out after the company has been formed and its initial charter has been set. I demonstrate that, beyond whatever reasons we may have for limiting opting out in the initial charter, substantial additional reasons exist for limiting opting out in midstream. Indeed, I argue that the case for limiting midstream opting out is so compelling that even strong believers in free markets and nonintervention in contractual arrangements should recognize the need for substantial constraints on such opting out. And I provide a framework of analysis for identifying the desirable limits on midstream opting out.

The proposition that companies should be largely free to opt out of corporate law rules has been put forward by an important and

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increasingly influential school of scholars.¹ The advocates of freedom to opt out start from the view that the corporation is a contractual creature, a "nexus of contracts."² This view of the corporation, they argue, implies that the parties involved should be generally free to shape their contractual arrangements. The function of corporate law, they claim, should be to facilitate the process of private contracting by providing a set of "standard-form" provisions.³ These standard-form provisions should not be mandatory; private parties should be free to adopt charter provisions opting out of them.

The issue under consideration is not only one of great theoretical significance but also one with considerable practical implications. Although state corporation statutes take an "enabling" approach to many issues, both state and federal law governing corporations always have included a significant body of mandatory rules.⁴ 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, sales of the corporation's assets, dissolutions, and so on), the allocation of power between shareholders and managers, certain procedural aspects of corporate decisionmaking, and changes in the corporate charter and bylaws; and, finally, certain significant judge-made doctrines delineating the fiduciary duties of managers and controlling shareholders.⁵

¹ Leading and active spokesmen of this view are Judge Easterbrook and Professor Fischel. See Easterbrook & Fischel, *The Corporate Contract* (forthcoming in F. EASTERBROOK & D. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (Harvard University Press)) [hereinafter Easterbrook & Fischel, *The Corporate Contract*] (manuscript on file at Harvard Law School Library); 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). The view has many other important subscribers. See, e.g., R. POSNER, *ECONOMIC ANALYSIS OF LAW* 371-72 (3d ed. 1986); R. WINTER, *GOVERNMENT AND THE CORPORATION* (1978); Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) [hereinafter Winter, *State Law*].

² On this view, the corporate entity is nothing more than a metaphor for a conglomeration of a series of voluntary agreements among the various participants in the enterprise. On the contractual view of the corporation, see Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Cheung, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1 (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); and Williamson, *Corporate Governance*, 93 YALE L.J. 1197 (1984). The contractual approach goes back to Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

³ See Easterbrook & Fischel, *Voting in Corporate Law*, *supra* note 1, at 401-02.

⁴ See, e.g., L. FRIEDMAN, *A HISTORY OF AMERICAN LAW* 188-201 (2d ed. 1985); J. HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES* 56-57 (1970).

⁵ For a description of these rules, see R. CLARK, *CORPORATE LAW* (1986). Insider trading

Thus, the freedom-to-opt-out view implies a fundamental change in corporate law. Its advocates have argued, for example, for allowing companies to opt out of all insider trading rules⁶ and out of all doctrines concerning managerial fiduciary duties.⁷ If the advocated unconstrained freedom to opt out were to be granted, it would likely bring dramatic change to corporate life.

The freedom-to-opt-out advocates have already much influenced the way in which corporate law questions are approached. Their view has gained many adherents, and has had in recent years an impact on many scholars and public officials that do not explicitly or fully subscribe to it. The American Law Institute Reporters, for example, have proposed allowing opting out with respect to some significant issues.⁸ The Securities and Exchange Commission has requested comments on a proposal to provide companies with substantial freedom to opt out of federal takeover rules.⁹ And the state of Delaware has allowed corporations to adopt charter provisions limiting or eliminating the personal liability of directors for a breach of their duty of care.¹⁰

I argue in this Article that endorsing a complete freedom to opt out does not follow, as its advocates believe, from the contractual view of the corporation. Indeed, the contractual view of the corporation offers strong reasons for placing significant limits on the freedom to opt out. In particular, I show that there are such reasons for limiting opting out in midstream.¹¹

I have chosen to focus on opting out by charter amendment for two reasons. First, from a practical point of view, the consequences of complete freedom to opt out by charter amendment might well be

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 § 3.4.

⁶ See, e.g., Carlton & Fischel, *supra* note 1.

⁷ See, e.g., 63 A.L.I. PROC. 411-14 (1987) (comments of Judge Frank Easterbrook).

⁸ See, e.g., A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS OF RECOMMENDATIONS § 6.03 & § 7.17 (Tent. Draft No. 7, 1987).

⁹ See Concept Release on Takeovers and Contests for Corporate Control, SEC Release No. 23,486, Fed. Sec. L. Rep. (CCH) ¶ 84,018 (July 31, 1986).

¹⁰ See DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988).

¹¹ My approach to the subject differs from that of the three authors who, in recent years, have attempted to evaluate critically the freedom-to-opt-out position. See 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 55 (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). These authors do not focus on the important case of opting out in midstream, and do not work within the contractual framework in the way this Article does.

Additional criticism of the freedom-to-opt-out position will appear in a symposium issue on contractual freedom in corporate law that will be published in Volume 90 of the *Columbia Law Review*.

much more substantial than those of allowing opting out in initial charters. 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 to come, 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 sizable 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 foreseeable future, they must establish the case for opting out through charter amendments.

Second, the case for limiting opting out is strongest in the charter amendment stage. The process of opting out in midstream is significantly different from that of opting out in the initial charter, and the case for intervention in each stage differs accordingly. In my view, there are, within the contractual view of the corporation, good reasons — primarily the presence of imperfect information and externalities — for placing substantial limits on opting out in the initial charter; and I plan to analyze these reasons in detail on another occasion.¹² But the validity of these reasons — or at least their practical significance — is likely to encounter significant disagreement. It is therefore important to show that there are additional and strong reasons for limiting opting out in midstream — reasons that should convince even strong believers in free markets and nonintervention in contractual arrangements.

Part I highlights the differences between opting out by charter amendment and in the initial charter. Unlike initial charters, charter amendments, which do not require unanimous consent by all shareholders, cannot be viewed as a contract. Consequently, one cannot rely directly on the presence of a contracting mechanism as the basis for upholding opt-out charter amendments.

Part II describes and discusses the possible justifications for opt-out amendments under the contractual view of the corporation. Although a charter amendment cannot be viewed as a contract, the process producing the amendment can be authorized as an integral part of the initial corporate contract. Because the need for future changes can be anticipated when the corporation is formed, the corporate arrangement provides a procedure for making changes without unanimous consent. The central question for our purposes is which opt-out amendments may be adopted using this procedure. Even

¹² In doing this, I plan to build on the arguments for limiting opting out in the initial charter that I presented in an earlier, discussion paper version of this Article. See L. Bebchuk, *Freedom of Contract and the Corporation: An Essay on the Mandatory Role of Corporate Law* 50–62 (Discussion Paper No. 46, Program in Law and Economics, Harvard Law School, August 1988) (on file at Harvard Law School Library).

advocates of nonintervention in the provisions of initial charters must confront this question, because a default arrangement must be chosen to govern the many cases in which the initial charter does not deal explicitly with the question. I argue that to answer this question we must identify the optimal arrangement that rational and informed parties forming a corporation would *ex ante* wish to adopt with respect to the scope of allowed opt-out amendments. Regardless of one's view of the process producing initial charters, all should accept this optimal arrangement as the standard arrangement governing in the very common case when the initial charter does not include an explicit provision to the contrary. One's view on the process producing the initial charters would affect only his view of whether it should be possible for initial charters to opt out of this standard legal arrangement.

In order to identify the optimal arrangement concerning opt-out amendments, it is necessary to analyze the expected costs and benefits of allowing opting out with respect to any given issue. Accordingly, Part III examines the expected costs. Allowing opt-outs with respect to an issue might lead to the adoption of value-decreasing opt-out amendments. Although an amendment requires approval by a shareholder vote, voting shareholders generally have little incentive to become informed. And although the amendment must first be proposed by the board of directors, the board's 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. The expected cost of allowing opting out with respect to a given issue depends on certain aspects of the issue and the circumstances under which the amendment is adopted.

Part IV in turn considers the expected benefits that might be generated by 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 will differ from issue to issue, depending on parameters which the analysis identifies.

Part V draws conclusions about the optimal arrangement concerning the scope of allowed opt-out amendments. It appears that this arrangement would allow substantial opting out, because there are important issues with respect to which expected benefits from allowing opting out outweigh expected costs. But this arrangement would also impose substantial limits on opting out, because there are important issues with respect to which the reverse is true. Part V identifies the parameters that are relevant to determining the desirable limits on opting out in midstream, and uses this framework of analysis to comment on the limits imposed by existing law. Part V also explains that changes in the existing charter amendment process — in partic-

ular, introducing appraisal rights or stricter procedural requirements — would not eliminate the imperfection of this process and thus also the need for limits on opt-out amendments.

My aim, I wish to emphasize, is not to put forward a specific and detailed list of the issues with respect to which opting out in midstream should be limited. Rather, I seek first to demonstrate the existence of a significant set of such issues and, second, to identify the factors that are relevant to determining whether a given issue belongs to this set. This analysis of the relevant factors will provide a framework that can be used to determine, for any given corporate law arrangement, whether opting out of it by charter amendment should or should not be allowed.

Finally, it is also worth noting that this Article is confined to publicly traded companies as opposed to close corporations. The processes producing and amending the corporate contract in publicly traded corporations should be analyzed separately because the informational and collective action problems that afflict shareholders in such corporations are substantially different in nature, or at least in magnitude, from those existing in close corporations.¹³

I. THE DIFFERENCE BETWEEN CHARTER AMENDMENTS AND THE INITIAL CHARTER

This Part discusses the differences between the initial charter stage and the charter amendment stage and the differences between opting out at either stage. Because a charter amendment cannot be viewed as a contract, opting out in midstream cannot be defended in the same way as opting out in the initial charter. In particular, the proposition that contractual freedom is warranted for contracts formed in the absence of externalities and informational asymmetries is at most applicable to the initial charter — but not to opting out in midstream. Section A explains that, if a certain perfection of the process producing the corporate contract is assumed, the contract proposition can provide a basis for allowing opting out in the initial charter. Section B shows why such arguments cannot be made with respect to opting out in midstream.

A. *The Contract Proposition and the Initial Charter*

As noted above, in my view the process producing initial charters suffers from significant informational imperfections¹⁴ and externali-

¹³ Cf. Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997 (1981).

¹⁴ "Informational imperfections" refers to situations in which one or more of the parties do not have some information available to others about the existence and future consequences of some contractual provisions.

ties.¹⁵ To highlight the difference between charter amendments and the initial charter, however, it is useful to assume in this Part that the process producing initial charters is free of informational imperfections and externalities. Given this assumption, freedom-to-opt-out advocates would have strong reasons for supporting an opting-out freedom in the initial charter. In doing so, they would be able to rely on the general proposition that, in the absence of informational imperfections and externalities, the contractual freedom of parties should not be limited.

This general proposition can be based on considerations of efficiency. Economic theory suggests that, under the assumed conditions, parties left free to design their contractual arrangements will adopt efficient terms — terms that will maximize the size of the contractual pie available for division among the parties.¹⁶ Efficient terms will be chosen because no party will be able to benefit from, and thus will not have an incentive to introduce, an inefficient provision — even if the direct effect of the provision favors that party. Given that informed parties would take each provision into account in valuing the contract and determining the contractual price that they will accept, any provision reducing the size of the contractual pie could make no party better off.

To illustrate this point, consider an entrepreneur who sets up a company, writes its initial charter, and sells all or some of the company's shares to others. The entrepreneur would be unable to benefit from introducing any provision that is not value-maximizing even if the provision itself provides the entrepreneur with some direct benefit. Suppose, for example, that the entrepreneur expects to be the first manager and that a given provision would generate 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. Thus, the entrepreneur's interest would not be served by adding this provision.

The provisions chosen by the entrepreneur, then, would be value-maximizing. The entrepreneur would take into account the effect of each provision on the shareholders' interests even though actual negotiations concerning these provisions may never take place. The crucial element is that of pricing: a provision's effect on shareholders' interests would be fully reflected in the price that informed buyers would be willing to pay the entrepreneur for the company's shares.¹⁷

¹⁵ An "externality" includes those effects of the initial charter's terms on parties other than those to the corporate contract.

¹⁶ See, e.g., Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466 (1980); Shavell, *The Design of Contracts and Remedies for Breach*, 99 Q.J. ECON. 121 (1984).

¹⁷ Another way to explain why the value-maximizing provisions would be chosen is by

The above reasoning implies that efficiency would be served by leaving the parties free to choose the initial charter's terms. Free to choose terms, the parties will choose the value-maximizing terms; thus, legal intervention limiting this freedom cannot possibly improve on the terms privately chosen. Indeed, if public officials lack the information assumed to be available to the parties, then legal limitations might prevent the use of value-maximizing terms; and legal intervention in such cases would reduce the size of the contractual pie.¹⁸

What function, then, is left to corporate law with respect to the initial charter? The law's only function is to provide background, default rules that would apply only when the parties do not specify otherwise.¹⁹ By providing such a standard-form contract, the law enables parties to reduce the transaction costs involved in drafting terms. To best serve this function, public officials should determine — and provide as the standard, default terms — those terms that rational and informed parties would most likely view as value-maximizing.

Thus, assuming perfection of the process producing the corporate contract is sufficient to establish the case for freedom to opt out in the initial charter. As explained below, however, this assumption in no way establishes the case for unconstrained opting out through charter amendments.

B. The Absence of a Contracting Mechanism in Charter Amendments

Assuming again that the process producing the initial charter is free of informational imperfections and externalities, consider a company that adopts an opt-out provision through the charter amendment

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.

¹⁸ It should be noted that, although the general contract proposition discussed above is primarily based on efficiency considerations, it is also consistent with certain notions of fairness. In the absence of informational imperfections, the adopted value-maximizing terms might be viewed as being consented to by all the parties who knowingly and voluntarily entered into the contractual arrangement. Furthermore, in the absence of informational imperfections, the value-maximizing terms are optimal not only from the perspective of maximizing the contractual pie but also from the perspective of the individual interests of each of the parties to the contract, for no party can benefit from having any other provision than the value-maximizing one. Thus, because imposing a mandatory term cannot benefit any of the parties involved, mandatory terms cannot be justified as being aimed at protecting or benefiting some party in light of some fairness or distributive justice considerations.

¹⁹ See R. POSNER, *ECONOMIC ANALYSIS OF LAW* 79–85 (3d ed. 1986).

procedure established by state corporation statutes.²⁰ Will we have the same reasons for believing that the provision will be value-maximizing as in the case of a provision adopted in the company's initial charter? This section explores that question and concludes with a negative response.

To be sure, I shall consider in Part III other possible reasons — in particular, the requirements of board proposal and majority approval in a shareholder vote — for expecting amendments to be value-maximizing; and I shall show that these requirements cannot be relied on to prevent value-decreasing amendments. What should be established at the outset, however, is that the contract mechanism which is present at the initial charter stage — and which ensures the efficiency of any opt-out provisions 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 provision *X* in a company's initial charter with its adoption through a charter amendment from the perspectives of the shareholders and of the party designing the provision. Looking first at the shareholders' perspective, consider an investor who values the company's stock at \$99 with provision *X* but at \$100 without *X*. If *X* is adopted at the initial charter stage, the investor can take *X* into account when deciding whether to buy shares. Because *X* is introduced before he parts with his money, it cannot reduce the value of anything that he owns. He will buy shares only if the required price does not exceed \$99 a share. In contrast, adopting *X* through a charter amendment after the investor has purchased shares would reduce the value of shares he already owns. He would suffer the adverse consequences of *X* without being compensated for the \$1 loss in value by a reduction in the shares' purchase price; he would be unable to undo the purchase transaction and get some of the purchase price back. To be sure, he would be able to sell his shares on the market. However, by selling on the market at this stage (either after the amendment is passed or when the passage of the amendment is already anticipated), he would likely get a price at least partly reflecting the amendment's effect and would thus be unable to escape the amendment's adverse consequences.

The difference from a shareholder's 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 a shareholder was free not to buy shares may be used to say that he has (implicitly) consented

²⁰ See, e.g., MODEL BUSINESS CORP. ACT § 10.03 (1985 & Supp. 1987); CAL. CORP. CODE § 903 (West 1977); DEL. CODE ANN. tit. 8, § 242(b) (1983); N.Y. BUS. CORP. LAW § 803 (McKinney 1986 & Supp. 1987).

to *X*. In contrast, when *X* is adopted through a charter amendment, such an implicit consent cannot be said to exist. In particular, such an implicit consent cannot be inferred from a shareholder's not selling his shares. For, as explained above, by selling his shares on the market, the shareholder would be unable 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. If adding *X* would lower the value of shares to the shareholders by \$1 a share, then the entrepreneur would be able to get \$1 less for each share sold. In contrast, if the directors of the company secure adoption of *X* through a charter amendment, they will not automatically have to bear the \$1 reduction in share value experienced by the shareholders. To be sure, I shall in Part III consider various market incentives that might cause the directors to pay attention to such a reduction in share value. The important point for present purposes, however, is that the charter amendment case lacks 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, charter amending is not equivalent to contracting, and the contract proposition cannot provide a possible basis for allowing opt-out amendments. What justification, then, can be given for such amendments within the contractual view of the corporation?

II. SEEKING AUTHORIZATION FOR CHARTER AMENDMENTS

Because charter amendments cannot be viewed as contracts, they can be justified within the contractual view of the corporation only by grounding them in the initial corporate contract. Section A of this Part explains why establishing a procedure for making charter changes without unanimous agreement is an important part of existing corporate contracts. Section B examines the question of which amendments may be adopted using this procedure and shows that fully answering it requires identifying the arrangement that rational and informed parties would wish to adopt *ex ante* with respect to this question. As Section B explains, even those who view the initial charter as perfect would choose to use this optimal arrangement as the default arrangement in the very common case in which the initial charter does not include a provision to the contrary. Section C summarizes the importance of identifying the optimal arrangement for

persons with different views on the process producing initial charters, and it outlines the steps needed to identify the optimal arrangement.

*A. The Need for a Procedure for
Charter Change Without Unanimous Consent*

The initial charter, which incorporates all the default legal arrangements from which it does not opt out, provides arrangements to govern the relationships among the shareholders and officers of the corporation. When a corporation is formed, it can be anticipated that in the future some changes in these arrangements may well be value-maximizing. Corporations are long-living creatures functioning in an ever-changing environment. New needs, novel situations, and additional information may well make somewhat different arrangements more efficient than those initially established. Therefore, even assuming that the initial charter provided the best arrangement for the time of the charter's adoption, there would be potential for improvement as long as the charter is not what economists refer to as a complete contingent contract.²¹

Although there is a potential for value-increasing changes, any given value-increasing change would be quite unlikely to take place if unanimous consent by all shareholders were required. In a large public corporation, it would be extremely difficult, if not impossible, to reach and communicate effectively with each and every shareholder. Moreover, even if all shareholders are indeed reached, one or more may engage in holdout behavior: a shareholder who recognizes the change as value-maximizing might nonetheless deny his consent in an effort to extract some extra benefit to himself in return for his critical consent.

Therefore, it would be value-maximizing for parties forming a corporation to establish as part of their contractual relationship a procedure that would enable at least some changes without unanimous consent. Such a procedure, involving approval by a shareholder majority of a proposal by the corporation's board, is indeed established

²¹ A complete contingent contract is one that explicitly lists any possible future state of the world (an almost infinite list) and provides for each state the arrangement that would be best for it. See K. ARROW & F. HAHN, *GENERAL COMPETITIVE ANALYSIS* 122-26 (1971). By definition, as the future unfolds, such a contract would provide the optimal arrangement in each and every contingency. A complete contingent contract, however, is a completely theoretical construct. Even when initial charters are formed without externalities and informational asymmetries, they are generally incomplete for several reasons. First, explicitly dealing with a given contingency involves transaction costs, and it will not be worth incurring them if the contingency is not sufficiently important or likely. Second, the existence of some contingencies is not even realized at the time of the initial charter. Finally, while the existence of other contingencies is realized, it is anticipated that their occurrence will not be observable or verifiable by courts, and consequently no arrangement can be made conditional on their occurrence.

by state corporation statutes.²² Because state statutes establish the existence of this procedure as a mandatory term, it is part of the corporate contract of all existing companies.

Freedom-to-opt-out advocates presumably favor allowing companies to adopt in their initial charter a different amendment procedure than that established by state statutes. If this approach is adopted, then somewhat different procedures for charter change (all likely to involve less than unanimous consent by the shareholders) might be adopted by some companies in the future. Part V will consider the implications that a different procedure — whether adopted by state statute or by initial charter provisions — would have for my conclusions concerning the appropriate limits on opt-out amendments. For now, however, this Article accepts as given the existing procedure of a board proposal followed by a shareholder vote.

B. The Unavoidable Question of the Default Rule

Given the existing procedure for charter amendments, the question still remains: which opt-out amendments may be adopted using this procedure? The existence of a procedure does not necessarily mean that it can be used for all issues and in all circumstances. As this section explains, the question of which opt-out amendments may be adopted through the amendment procedure is not an easy one even for those who believe that the process producing initial charters is sufficiently perfect to warrant total contractual freedom in the initial charter stage. In particular, even for holders of this view, fully answering this question requires identifying the optimal arrangement that rational and informed parties would have adopted *ex ante* with respect to this question.

To see this point, let us assume that the process producing initial charters is sufficiently perfect so that all of the provisions in initial charters should be viewed as value-maximizing and upheld by public officials. Given this assumption, we should follow whatever arrangement the initial charter provides to decide which opt-out amendments may be adopted using the amendment procedure. Any charter amendment that is authorized by a provision in the initial charter should be upheld; and any amendment that is not authorized by an initial charter provision should be disallowed.

This proposition does not end the discussion, however, but only begins it. In 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

²² See state statutes cited *supra* note 20.

initial charter does not include a provision explicitly addressing this issue.

Suppose that an initial charter does not have a provision explicitly dealing with 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 must provide a reading of the initial charter — that is, a default arrangement governing the issue. For any given corporate law rule, the law must establish whether, in the absence of an explicit initial charter provision on the issue, opting out of this rule through a charter amendment is allowed. To understand the significance of this question and how it should be approached, it is useful to consider first existing companies and then companies that will be formed in the future.

1. *Existing Companies.* — The resolution of the default rule or charter interpretation question is of critical importance to opt-out amendments of existing companies. Suppose that we now adopt, in a sharp break from the past, a policy of granting companies complete freedom to opt out in the initial charter. And consider the numerous companies that have been formed and have had their initial charters fixed 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 prevail at least for some time. The parties setting up these companies presumably did not bother to address explicitly the question whether they would wish to enable opt-out amendments concerning insider trading rules if opting out of these rules became permissible.

Thus, we face an unavoidable question of interpretation. What arrangement should the initial charters of these existing companies 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 critical 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 the class of all companies formed prior to adopting this policy, a class that 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 negative. Because the initial charters of these companies were 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: on a closer look, two possible interpretations may be given to the absence in the initial charter of a provision explicitly addressing the issue. First, this silence might represent 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 represent a lack of desire to place any additional limits on opting out of insider trading rules beyond the 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 nonmandatory approach to insider trading rules or did not consider this contingency to be sufficiently likely to be worth the effort of explicitly addressing it in the initial charter. Either way, the approach suggested by the theory of contracts for this question of interpretation is to determine, and use as the default interpretation, the optimal *ex ante* arrangement — that is, the arrangement that the parties would have chosen *ex ante*, at the time of adopting the initial charter, had they considered and addressed the issue in a rational and fully informed way.²³

2. *Future Companies.* — Supposing again that we now adopt a policy of complete freedom to opt out in the initial charter, consider charter amendments by companies formed in the future. Suppose that the initial charter of such a company does not opt out of the insider trading rules — and does not 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 must 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 often include explicit provisions on the issue. But even though the default question would presumably not arise as commonly as with companies formed prior to the adoption of the new policy, it might well arise with respect to many companies. In answering 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 viewed *ex ante* as value-maximizing by rational and fully informed parties.

²³ See R. POSNER, *supra* note 19, at 82.

C. Identifying the Optimal Arrangement: Why and How

Identifying the optimal arrangement with respect to the scope of allowed opt-out amendments is thus essential even for those who support complete nonintervention in the provisions of initial charters. Holders of this view still need a default arrangement to govern the scope of allowed opt-out amendments in the numerous companies whose initial charter does not explicitly opt out of the default arrangement.

Identifying the optimal arrangement is of even greater importance to those who believe that the process producing the initial charter is sufficiently imperfect to warrant intervention in the terms of initial charters. Holders of this view might consider adopting the identified optimal arrangement not only as a default arrangement but also as a mandatory term in corporate contracts. That is, they may wish to limit the ability of companies to opt out of this arrangement in their initial charter.

Thus, regardless of one's view of the process producing initial charters and the appropriate policy towards initial charters, identifying the optimal arrangement is necessary at least in order to provide a standard default arrangement to govern the numerous cases in which the initial charter does not include an explicit provision to the contrary. The possible disagreement concerns only the extent to which initial charters may opt out of this standard arrangement. Because one's answer to this question depends on one's view concerning the appropriate policy toward initial charter provisions, this question is outside the scope of this Article's analysis. What the analysis henceforth focuses on is identifying the features of the optimal arrangement concerning the scope of allowed opt-out amendments.

Before embarking on this task, some preliminary remarks may be useful. The optimal arrangement might be contextually contingent — that is, it may turn on the specific issue and circumstances involved. The value-maximizing arrangement might involve limiting opting out with respect to issue *X* but not with respect to issue *Y*. Similarly, the value-maximizing arrangement might involve limiting opting out with respect to issue *Z* in circumstances *A* but not in circumstances *B*. Furthermore, regarding any opting out on a given issue and in given circumstances, the optimal arrangement is not limited to all-or-nothing determinations; an arrangement may provide limits falling short of strict prohibition. Finally, the information we have may not enable us to determine with certainty the exact contours of the value-maximizing arrangement concerning certain issues — but we would have to do our best.

In the following Parts, I shall seek to determine the parameters of the value-maximizing arrangement. When rational and informed parties seek to determine *ex ante* the desirability of allowing opting out

with respect to a given issue, they must consider the expected costs and benefits of 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 identify the optimal limits, if any, that should be placed on opt-out amendments, we should understand the factors that determine the expected costs and the expected benefits of allowing opting out with respect to a given issue in given circumstances. Parts III and IV examine these expected costs and benefits respectively.

III. THE COSTS OF ALLOWING OPT-OUT AMENDMENTS

Allowing opt-out amendments with respect to a given issue might involve an expected cost because 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 have seen that the contracting 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 majority in a shareholder vote.²⁴ Thus, in order to determine whether — and, if so, when — the process might produce value-decreasing amendments, I examine below two questions: (1) will proposals for value-decreasing amendments, if submitted for shareholder approval, ever obtain such approval?, and (2) will such amendments ever be proposed by the board of directors?

Before examining these two questions, we should distinguish among 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 often includes executives of the company and independent directors, and companies differ in how influence is divided among the directors.²⁵ Because this division of influence is not all that relevant for our purposes, I shall use “managers” to refer generally to those persons on the board or in the company’s management corpus who produce the board decision to bring an amendment to a shareholder vote.

Second, in analyzing the potential for value-decreasing amendments, it is important to distinguish between situations in which, at the time the opt-out amendment is adopted, the company does and does not have a dominant shareholder, one holding enough shares to

²⁴ See state statutes cited *supra* note 20.

²⁵ See, e.g., H. GENEEN, *MANAGING* 250–61 (1984); Brudney, *The Independent Director — Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982).

exert effective control. Whether or not a company has a dominant shareholder when it is formed, it may or may not have a dominant shareholder at any given point in its future.²⁶ Thus, to the extent that such a shareholder's presence affects the potential for value-decreasing amendments, the optimal arrangement concerning opt-out amendments may apply different rules according to whether the company has a dominant shareholder at the time of adopting the opt-out amendment. The analysis below first assumes that the company does not have a dominant shareholder, in which case there is presumably some separation of ownership and control. In section C at the end of this Part, I discuss separately the potential for value-decreasing amendments in those situations where the company does have a dominant shareholder that effectively controls the board's decisions.

A. The Shareholder Approval Requirement

Suppose that the managers of a given company bring to a shareholder vote a proposal for a value-decreasing amendment. Will the requirement of shareholder approval ensure that the value-decreasing amendment be defeated? As explained below, the answer is no. To be sure, the requirement of shareholder approval is not worthless; on the contrary, it serves an important purpose. Some value-decreasing proposals might occasionally be defeated. More importantly, many conspicuously value-decreasing amendments that could benefit the managers would not even be proposed because of the high likelihood that they would not gain approval. The key point, however, is that many other value-decreasing amendments would not be prevented by the shareholder approval requirement.

The main problem with the shareholder voting mechanism is the lack of information. Even those who believe that shareholders purchasing stock are generally well-informed must recognize that, in the case of many proposals for value-decreasing amendments, most voting shareholders do not know whether the proposed amendment is value-decreasing or value-increasing.

Of course, some value-decreasing amendments would easily be recognized as such by shareholders if they were proposed. Such identification would be especially likely when the issue is both significant in value and possible to assess at a very small cost. For example, shareholders presumably would identify as value-decreasing, and vote against, an amendment that would allow managers to purchase any

²⁶ In the case of a company that does not have a dominant shareholder when it is formed, a dominant shareholder might emerge later on as a result of a tender offer or a series of privately-negotiated and open-market purchases. Similarly, in the case of a company that does have a dominant shareholder when it is formed, this shareholder might later liquidate its controlling block.

fraction of the corporation's assets at a minimal price or an amendment that would preclude any acquisition of the company. The nature of many value-decreasing amendments, however, would not be so evident and could only be discovered through some investment in the acquisition and processing of information. With respect to such proposed amendments, most shareholders would rationally elect to remain ignorant — they would lack sufficient incentive to make the necessary investment in the acquisition and processing of information. Any shareholder holding a small stake in the company recognizes that his vote is highly unlikely to be pivotal and thus to affect his interests.²⁷ Such a shareholder does 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).

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. A buyer purchasing stock has a much greater incentive to make an informed buying decision than does a voting shareholder to make an informed voting decision. The decision whether to buy shares will certainly affect the decisionmaker's interests. In contrast, the decision on how to vote has a very small chance of affecting the decisionmaker's interests, because the decisionmaker's vote is highly unlikely to be pivotal. This distinction explains why even those who believe that shareholders will fully inform themselves when initially buying stock must recognize that voting shareholders commonly remain imperfectly informed.²⁸

Note that, in a vote on a charter amendment, small shareholders will often lack adequate information even if there are some large, informed shareholders who have acquired and assessed the information bearing on the desirability of the amendment. Such large shareholders are often unlikely to disseminate effectively their information to the smaller, uninformed shareholders. First of all, even if such dissemination could be effective, the larger shareholders often would

²⁷ The probability of casting the decisive vote is small even for shareholders who hold such a relatively significant block as one or two percent of the company's stock. See Chamberlain & Rothschild, *A Note on the Probability of Casting a Decisive Vote*, 25 J. ECON. THEORY 152 (1981). Needless to say, the probability is smaller yet in the typical case of shareholders who hold smaller percentages.

²⁸ The rational ignorance described above may be seen as a collective action problem. 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 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, as is often the case with public goods, the shareholders will produce a suboptimal amount of this good. For a discussion of the collective action problem in voting in general, see M. OLSON, *THE LOGIC OF COLLECTIVE ACTION* (2d ed. 1971). For a discussion of the problem in the special case of corporate voting, see R. CLARK, *supra* note 5, § 9.5, at 390-96.

lack the incentive to engage in it; for they would bear all the costs of the dissemination even though its benefits would be shared by all the shareholders. Furthermore, even if large shareholders attempted to disseminate information to other shareholders, the dissemination would often be ineffective; as explained above, small shareholders might not have an incentive even to read materials sent to them. And, of course, the anticipation that attempted dissemination would be ineffective might prevent large shareholders from attempting it in the first place.

Note also that the rational ignorance problem is not eliminated by the opportunity that shareholders might have to draw inferences from the stock market reaction to an amendment proposal. It might be argued that when a value-decreasing amendment is proposed, the company's market price will drop, the shareholders will then realize that the amendment would be value-decreasing, and they will consequently vote against it. But, on a closer look, both theory and empirical evidence suggest that this argument is not valid.

To begin with, it often would be difficult for shareholders to discern the market's reaction to an amendment proposal. Market prices change continuously and significantly in response to the flow of new information about the company, the industry, and the economy. Thus, because the price changes that accompany the proposal also reflect the market's assessment of changes other than the proposal, it may well be difficult to isolate the market's estimate of the potential effect of the proposed amendment. Such isolation is made even more difficult when, as frequently occurs, the market becomes aware of the possibility of the proposal gradually and its reaction to it is not wholly contained in one or several daily price changes.

Furthermore, it is inconsistent with investor rationality for inferences drawn from price drops to eliminate the rational ignorance problem. Suppose that proposals for value-decreasing amendments were generally accompanied by price drops, and that these price drops generally led shareholders to realize that the proposed amendments were value-decreasing and to defeat them. In such a case, there would be no reason for the price to drop in the first place — for it would be expected that the value-decreasing amendment would not pass. That is, a price drop accompanying a value-decreasing proposal will be rational only if the market views as possible the approval of the value-decreasing amendment by the shareholders.²⁹

²⁹ In economic terminology, the situation in which a value-decreasing amendment is accompanied by a market decline and subsequently (and possibly as a result) fails to obtain a shareholder approval is not an equilibrium. The only possible equilibrium consistent with a price drop is that in which the amendment is accompanied by a price drop because of the anticipation, which must be fulfilled in equilibrium, that the amendment would (at least with some probability) pass.

That accompanying price drops do not necessarily lead to subsequent failure to gain shareholder approval is confirmed by the empirical evidence. In recent years many proposals for antitakeover amendments have been accompanied by reductions in stock price and nonetheless have been approved by shareholders.³⁰

Having concluded that, with respect to many value-decreasing amendments, shareholders do not know whether the amendment would be value-decreasing or value-increasing, the question remains why the uninformed shareholders would vote for them rather than against them. Consider a shareholder choosing a voting strategy for the set of those proposals about which he is unsure whether they would be value-decreasing or value-increasing. The shareholder will recognize that he must make his voting decisions without being able to distinguish the value-decreasing proposals in the set from the value-increasing ones. Consequently, voting against any one of the proposals in the considered set would be a rational choice only if most of these proposals were value-decreasing. But the interests of shareholders and managers sufficiently overlap on many issues so that the shareholder can reasonably expect most proposed amendments to be value-increasing. In this situation, the shareholder's rational course of action is to vote uniformly in favor of these proposals, recognizing that, in the absence of any limits on the possible amendments, a significant fraction of the proposed amendments might be value-decreasing.

In sum, while some proposals for value-decreasing amendments would be identified by shareholders as such, the shareholders would remain rationally ignorant about many others. This rational ignorance would not be eliminated by the presence of some informed shareholders or by the market's price reactions. And this rational ignorance would lead the shareholders to approve value-decreasing proposals.

Finally, although in my view the main reason why shareholders might approve a value-decreasing amendment is their lack of information, an additional reason is worth noting. Even when the shareholders identify a proposed amendment as value-decreasing, they might sometimes vote for it due to a distorted choice problem.³¹ To get the shareholders to approve the proposal, the managers may use their control over the corporate agenda and over the company's policy. For example, management might couple the proposal with another measure that the shareholders independently desire or it might threaten to follow a policy that is less desirable to the shareholders if the proposal is not approved. If the tie is credible and the overall

³⁰ See Jarrell & Poulsen, *Shark Repellents and Stock Prices: The Effects of Antitakeover Amendments Since 1980*, 19 J. FIN. ECON. 127, 141-54 (1987).

³¹ The problem of distorted choice in shareholder voting has been recently described and stressed by Professor Jeffrey Gordon. See Gordon, *Ties That Bind: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CALIF. L. REV. 3, 39-60 (1988).

package is more desirable than the alternative, then it would be rational for the shareholders to vote in favor of an amendment that they know would be value-decreasing by itself. In such a case, the shareholders would obviously be better off if such an amendment were not possible.³²

B. Market Discipline and the Requirement of Board Approval

Although the shareholder approval requirement will not prevent the adoption of value-decreasing amendments whose undesirability to shareholders is not quite conspicuous, it remains to consider the possibility that managers will never elect to propose such value-decreasing amendments. Managers' decisions are obviously shaped by the incentives and constraints provided by the different markets affecting them. Freedom-to-opt-out advocates usually hold the view that the different markets in which the company and its managers operate exert powerful incentives for managers to maximize the company's value.³³ Therefore, they might wish to argue, these market incentives should discourage managers from proposing value-decreasing amendments. As I explain below, however, although market discipline would likely discourage managers from bringing certain kinds of value-decreasing amendments, it would not have such an effect on other types of value-decreasing amendments.

In analyzing the managers' decisions, it is useful to distinguish between opt-out amendments that involve a potential transfer between shareholders and managers and those that do not. Where an issue does not involve a potential transfer, there is no conflict between manager and shareholder interests and thus no reason for managers to propose a value-decreasing amendment. The managers, who are at least somewhat concerned about share value, would have no reason to prefer such an amendment. For this reason, the analysis below focuses on issues that potentially involve a transfer between shareholders and manager. Clear examples of these kinds of issues are insider trading and self-dealing. With respect to such "redistributive" issues, there is a concern that the managers would propose an amendment that transfers value to themselves 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

³² It might be asked whether market incentives would not preclude such behavior on the part of the managers. But the same reasons that will be described below as to why market discipline might not discourage managers from initiating some value-decreasing proposals also explain why this market discipline would not prevent them from trying to get these proposals approved by using their power over the corporate agenda and over the company's policy.

³³ See, e.g., Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1984) (arguing that markets provide incentives for managers to act in investors' interests).

shareholder value, operating through the various mechanisms of market discipline, would be sufficient to discourage the managers from proposing the amendment.

The analysis below shows that the effectiveness of market discipline in discouraging managers from proposing value-decreasing amendments depends on the size of the transfer involved (the redistributive element) relative to the reduction in overall value (the efficiency element). An "insignificantly" redistributive issue is one in which the redistributive element is very small relative to the efficiency element — for example, one in which the potential direct transfer to the manager is \$1 while the effect on total share value is a much greater \$1000. A "significantly" redistributive issue, in contrast, is one in which the redistributive element is significant relative to the efficiency element — for example, one in which the potential direct transfer to the managers is, say, \$200, while the effect on total share value is, say, \$1000. As should be clear from this example, the classification of an issue as significantly redistributive does not require that the potential transfer exceed the potential efficiency effect; the transfer effect must only constitute a significant fraction of the efficiency effect.

As explained below, market forces are likely to be effective in discouraging proposals for value-decreasing amendments with respect to most insignificantly redistributive issues. However, they might well be ineffective with respect to value-decreasing amendments that are either significantly redistributive or operate to weaken the market constraints themselves. To reach this conclusion, I shall examine in turn each of the markets that affects managerial decisions.

1. *Managerial Labor Markets.* — The managerial labor market induces managers to be concerned about the effect of their actions on share value and on shareholders' interests. First, managerial compensation schemes tie managers' wealth to the success of the company, both by providing them with increased compensation when the company is successful and by providing them company stock as compensation (thus resulting in the managers' holding a significant fraction of their wealth in their company's stock).³⁴ Second, the success of the company affects the managers' prospects for future employment and promotion, both within and outside their firm.³⁵

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

³⁴ See *id.* at 558–64; Jensen & Zimmerman, *Management Compensation and the Managerial Labor Market*, 7 J. ACCT. & ECON. 3, 4–5 (1985); Raviv, *Management Compensation and the Managerial Labor Market: An Overview*, 7 J. ACCT. & ECON. 239, 240 (1985).

³⁵ See Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980).

other things are equal or even at a small cost to themselves — to avoid a reduction in share value. Thus, they might discourage managers from bringing value-decreasing amendments that are only slightly redistributive. 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. As explained below, they do not make managers wish to avoid all value-decreasing amendments.

Because reductions in share value might occur independently of managerial failure, the managerial labor market operates in a way that penalizes managers for declines in share value only to a limited extent.³⁶ Indeed, empirical evidence indicates that, when a company's total stock market value increases, the CEO's annual salary and bonus increase on average by an amount equal to only 0.002% of the change in the company's total value, and that the CEO's total pay-related wealth increases by only 0.037% of the change in the company's total value.³⁷ The evidence also indicates that the median stock holdings of CEOs are 0.25%, and that 80% of these CEOs hold less than 1.38% of their company's stock.³⁸

Because a reduction in share value will commonly have such a limited adverse effect on managers' compensation and inside holdings, a value-decreasing amendment that is significantly redistributive might well be in the best interests of the managers. Consider, for example, an amendment that would produce a loss of \$1,000,000 in the company's total stock market value and a direct gain of \$200,000 to the managers. It seems likely that the managers would favor the amendment because the \$200,000 direct benefit would substantially exceed the amendment's adverse effect on their compensation and inside holdings.

Similarly, it seems that the possible effects on future employment and promotion would not discourage the managers from wishing to have a significantly redistributive value-decreasing amendment. Al-

³⁶ Given that the reduction in share value need not be the result of the managers' actions, and that managers are risk-averse, the optimal managerial compensation scheme would not penalize managers drastically for any reduction in share value, which might depend in part on random factors beyond their control. See Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74, 82 (1979); Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 BELL J. ECON. 55 (1979). Similarly, because future employers realize that share value is only a "noisy" signal of the managers' ability, reductions in share value will generally not result in drastic reduction in future employment prospects. See Fama, *supra* note 35, at 298-300.

³⁷ See M. Jensen & K. Murphy, *Performance Pay and Top Management Incentives* 4-5 (Harvard Business School Working Paper 88-059, May 1988) (on file at Harvard Law School Library). The increase in the CEO's pay-related wealth includes not only the increase in the compensation in the year in which the change in value takes place but also the estimated positive effect on the compensation in future years.

³⁸ See *id.* at 46.

though poor performance of a company does increase somewhat the risk of dismissal of top managers, the evidence is that this risk is still very small.³⁹ And for most top managers, the issue of future employment in other companies is not a significant concern because they are likely to stay in their company until retirement.⁴⁰

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

2. *Market for Corporate Control.* — The market for corporate control increasingly has become 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 that is valuable to them, the prospect of a takeover might well make them more concerned about share value.⁴¹

Clearly, because the takeover threat makes managers wish to avoid unnecessary reductions in share value, it might well contribute to discouraging managers from bringing proposals for value-decreasing amendments that are only slightly redistributive. But, again, the takeover threat can hardly be relied on to align perfectly the interests of the managers and the shareholders. As explained below, it is

³⁹ See Coughlan & Schmidt, *Executive Compensation, Management Turnover, and Firm Performance: An Empirical Investigation*, 7 J. ACCT. & ECON. 43, 60-64 (1985); Warner, Watts & Wruck, *Stock Prices and Top Management Changes*, 20 J. FIN. ECON. 461 (1988); Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431 (1988). Because CEOs are rarely openly fired, researchers looked at all cases in which a CEO departed before retirement age for certain reasons (assuming that some such departures were camouflaged dismissals). Even looking at the most poorly performing firms (bottom 10%), the researchers found that the likelihood of a CEO departure before retirement age was small, and that the effect of a decrease in performance on the likelihood of departure was quite small. For example, looking at the difference between the median performing firm and a firm at the bottom 20% in terms of performance, Weisbach found out that the chance of departure increased by 0.7% (from 4.9% to 5.6%), see Weisbach, *supra*, at 443; Warner, Watts, and Wruck found that it increased by 0.8% (from 11.6% to 12.4%), see Warner, Watts & Wruck, *supra*, at 478; and Coughlan and Schmidt found that it increased by 2.8% (from 7.7% to 10.5%), see Coughlan & Schmidt, *supra*, at 64. And note that a decline from median performance to a performance at the bottom 20% is quite substantial (larger than one might think would result from most value-decreasing amendments).

⁴⁰ See M. Jensen & K. Murphy, *supra* note 37, at 34-35 (stating that most departing CEOs leave their positions only after reaching normal retirement age).

⁴¹ 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, 112-13 (1965). See also Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1165-74 (1981) (emphasizing the role of tender offers in disciplining managers).

unlikely to discourage managers from proposing value-decreasing amendments that are significantly redistributive.

As the market for corporate control operates, any limited reduction in share value would not necessarily lead to a takeover but rather would commonly only increase its likelihood by a small amount.⁴² 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 (say, 0.1%), the resulting increase in the probability of a takeover is likely to be quite small. Therefore, if the amendment is significantly redistributive and will, say, produce a direct benefit of \$200,000 to the managers, the resulting very small increase in the probability of a takeover will not discourage the managers from bringing the amendment to a shareholder vote.

Moreover, the market for corporate control will not discourage value-decreasing amendments that significantly reduce the power of this market. To be sure, other things equal, any reduction in share value might increase 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 will reduce this very threat, and the likelihood of a takeover will likely be smaller with this value-decreasing amendment than without it.

3. *Market for Additional Capital.* — 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, and it has been argued that this consideration induces managers to behave in a value-maximizing way.⁴³ Although existing shareholders are already "stuck," potential shareholders are not, and they will take value-decreasing managerial actions into account in deciding whether or not to buy shares in the company. Thus, it might be argued that the desire to raise more equity in the future will discourage managers from bringing proposals for value-decreasing opt-out amendments.

⁴² Whether a takeover will occur depends on whether the value of the company in the eyes of some potential buyer exceeds the sum of the company's total market price, the expected premium that would be necessary for a takeover, and the expected transaction costs involved in such a takeover. The likelihood that the company's value in the eyes of the potential buyer is just slightly above this threshold sum, so that a small reduction in the company's market price would be necessary and sufficient for satisfying the above condition, is generally quite small.

⁴³ See Winter, *State Law*, *supra* note 1, at 275.

On a closer look, however, it appears that the market for additional equity will not provide managers with different types of incentives to bring only value-increasing amendments beyond those incentives that have already been discussed. A value-decreasing amendment would not impede the company's ability to raise additional equity. To be sure, assuming that buyers of stock are fully informed, they will take the amendment into account in deciding how much the offered shares are worth. But they will 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 will only have to offer a larger number of shares for the same amount of capital, which will reduce the stake of the existing shareholders.

Thus, the main effect that should be considered would be not in preventing expansion but in reducing the value of the existing shareholders' shares. This reduction in share value is undesirable to the managers only because of the managerial labor market and the market for corporate control, which we have already discussed. The market for additional equity thus does not impose any significantly different disincentives to proposing value-decreasing amendments.

Finally, the effect of the market for additional equity is even weaker than discussed above because extra capital can commonly be obtained in the form of debt rather than equity. As long as a charter amendment does not change the riskiness of the company's debt, which should usually be the case, the amendment would not change the cost of debt. However, even if the cost of debt would increase, this rise would not prevent expansion but would only reduce the value of the existing shareholders' shares, thus creating at most the type of incentives that have already been analyzed.

4. *Product Market*. — A final possible constraint on management is that created by the competition in product markets.⁴⁴ If management acts inefficiently, the argument goes, it will not be able to compete effectively in product markets, and consequently the company's business will contract or perhaps even fail. In particular, it might be argued that such a concern might discourage managers from proposing value-decreasing amendments.

Clearly, product market competition might discourage some inefficient behavior — for example, some managerial lack of effort that would provide managers with little pleasure but could result in large business failure. The product market, however, can hardly be relied on to prevent managers from proposing value-decreasing amendments, especially when the amendments are significantly redistributive. For

⁴⁴ See Easterbrook, *supra* note 33, at 557; Hart, *The Market Mechanism as an Incentive Scheme*, 14 BELL J. ECON. 366, 367 (1983).

one thing, many opt-out amendments would not affect the operational efficiency of the company. They will not affect the cost at which the company produces but rather will operate on the level of financial distribution — largely affecting only the way in which the value produced by the company is divided among managers and shareholders.

Moreover, product markets are often not perfectly competitive.⁴⁵ Most large companies operate in markets that are either oligopolistic or monopolistically competitive. The significant slack present in such markets will enable managers to have value-decreasing amendments. They will have an especially strong incentive to use the slack for such a purpose when the value-decreasing amendment is significantly redistributive, so that the transfer to managers is substantial relative to the efficiency loss (and thus to the potential effect on product market competitiveness).

C. 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 to the public shareholders than benefit to the controller). Examples of opt-outs that produce a substantial transfer from public shareholders to the controller are: an opt-out amendment that enables the controller to receive favorable treatment (i.e., more than its pro rata share) in corporate distributions or in a liquidation; an opt-out amendment that eliminates appraisal rights or otherwise lowers the compensation required in a freezeout of the public shareholders; and an opt-out amendment that, by weakening the fiduciary duties of the controller and the managers, enables the controller to divert value from the company to itself.

If such opt-out amendments are allowed, then it is clear that neither the requirement of shareholder vote nor the operation of market forces would prevent them. To begin with, the presence of a dominant shareholder would make the shareholder approval requirement even less effective than in a company without a dominant shareholder.⁴⁶ The controller often will be able to gain the necessary

⁴⁵ See generally J. TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 277-303 (1988) (discussing competitive and imperfectly competitive markets).

⁴⁶ See Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974).

approval simply by voting its own shares. Even if the controller's own shares are insufficient in number, the controller's hold of the proxy machinery will usually enable it to gain easily the extra votes necessary for the requisite majority.

Similarly, the requirement of board approval would hardly be effective in preventing value-decreasing amendments that are capable of transferring a significant value from the public shareholders to the controller. 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 not be relevant, because a takeover by tender offer would not be possible. Similarly, the managerial labor market will not discourage the managers from bringing such value-decreasing amendments; in fact, the managers can only expect increased compensation and higher chances of being retained if they act in a 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 because it would likely lead to inefficient decisions regarding whether to distribute a 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.

IV. THE BENEFITS OF ALLOWING OPT-OUT AMENDMENTS

I now wish to examine the potential benefits from allowing opt-out amendments with respect to a given issue. These expected benefits arise from the possibility that allowing such opting out would produce value-increasing amendments. The opt-out freedom might be used to replace a standard legal arrangement with an opt-out amendment that 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, the extent to which the legal arrangement is likely to fall short of the best arrangement that private parties could design. The potential for improving upon the legal arrangement will be most substantial when the problem requiring resolution varies significantly from company to company and when the desirable solution depends on particular features of each company that are better known to the parties involved than to public officials. On the other hand, the potential

improvement is likely to be limited, or nonexistent, 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 significantly superior information about the desirable arrangement. For example, the problems involved in taking a corporation private do not seem to vary significantly in their basic structure from company to company, and it is therefore likely that the desirable arrangement is at least roughly the same for many companies.

That there is substantial potential for improving upon the legal arrangement governing an issue, however, is a necessary but not a sufficient condition for there to be a substantial benefit from allowing opt-out amendments. The amendment process also must be likely to realize this potential for improvement. Consider an issue that is strongly redistributive from shareholders to managers, directly affects the strength of market discipline, or 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 value-increasing.

For example, consider 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 efficient arrangement. For the opting-out freedom might in fact be used by a dominant shareholder to pass a value-decreasing amendment that would produce a significant transfer to this shareholder — rather than adopt the value-increasing arrangement, which might benefit the controller to a lesser extent.

V. THE DESIRABLE LIMITS ON OPT-OUT AMENDMENTS

This Part uses the preceding analysis to draw conclusions about the features of the desirable arrangement with respect to opting out in midstream. Section A suggests that, taking the existing amendment procedure as given, the optimal corporate arrangement includes certain significant limits on opting out in midstream. Section B considers some of the implementation issues that arise in designing these limits. Section C examines whether certain changes in the existing amendment procedure — in particular, introducing appraisal rights or stricter procedural requirements (such as supermajority approval or periodic ratification) — could provide a good substitute for limits on opting out in midstream; it concludes that they would not. Finally, Section D discusses the practical significance of the limits on opting out in midstream.

A. The Undesirability of Complete Opting-Out Freedom

Taking as given the existing procedure for opting out in midstream, let us consider the optimal arrangement with respect to the scope of opt-out amendments that may be adopted using this procedure. This arrangement is the one that rational and informed parties forming a corporation would wish to impose on their contractual arrangement. As explained below, such parties would likely identify certain opt-out amendments with respect to which they would not wish to have complete opting-out freedom.

Rational and informed parties would recognize that allowing opt-out amendments with respect to a given issue might produce value-decreasing amendments. 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 any given opt-out amendment would depend on various circumstances, such as whether the company does or does not have a dominant shareholder at the time of the amendment. The expected costs will also depend on various features of the issue involved. 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-outs will be small or nonexistent. But with respect to many other issues, the potential for value-decreasing opt-out amendments would be considerable. This will be the case, in particular, when a value-decreasing amendment is strongly redistributive in favor of the managers, weakens the constraints imposed on the managers by market forces, or transfers significant value from minority shareholders to a dominant shareholder.

Rational and informed parties would also recognize that allowing opt-out amendments with respect to a given issue might also yield a benefit. Part IV has identified the factors that determine the size of this expected benefit. The expected benefit might well be substantial when the issue is not significantly redistributive, and when the problem requiring resolution and its optimal solution are likely to vary considerably over time and across cases and to be understood better by private parties than by public officials. The expected benefit from allowing opting out, however, will be small with respect to many other issues. In some cases, the potential for improving upon the legal arrangement is limited, because the standard 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 standard legal arrangement.

The optimal limits, if any, with respect to any given opt-out freedom, depend on the balance of the above expected costs and

expected benefits. Now it is clear that allowing some opting out is desirable — 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 (1) either redistribute significantly from shareholders to managers (or controlling shareholders) or directly weaken the force of market discipline, and that (2) are sufficiently similar across companies to enable a standard legal arrangement to perform satisfactorily.

As I have said, my goal is not to put forward a list of issues with respect to which opting-out freedom is undesirable, but rather to delineate the relevant considerations in making this choice. But it is worth noting that, at least at first glance, many of the rules that are currently mandatory seem to satisfy the criteria of the theory put forward here for when complete opting-out freedom is undesirable. Consider, for example, the rules that govern managerial fiduciary duties with respect to self-dealing.⁴⁷ These rules deal with issues that seem to be substantially redistributive: the potential transfer from shareholders to managers is fairly significant relative to the potential efficiency effect. Furthermore, these issues seem fitting for a general analysis of the problem and its remedy.

Similarly, consider the rules governing managers' fiduciary duties in the face of an hostile tender offer.⁴⁸ That current law treats this issue in a mandatory way appears consistent with the prescriptions of the theory developed here. 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 pro rata division of corporate distributions and liquidation proceeds, and the rules providing minority shareholders with appraisal rights in freeze-out mergers.⁴⁹ 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 himself. Therefore, if opting out is allowed, the controller will effect the adoption of an opt-out arrangement facilitating such a transfer, even if this opt-out arrangement is inefficient.

Of course, one might accept my view of the relevant parameters but differ on the list of issues that call for limits on opting-out freedom.

⁴⁷ See generally R. CLARK, *supra* note 5, §§ 5.1–5.4, at 159–89.

⁴⁸ See generally *id.* § 13.6.3, at 579–88.

⁴⁹ See Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CALIF. L. REV. 1072, 1076–106 (1983).

As emphasized earlier, however, my interest is not in the specific constitution of this list, but rather in the general conclusion that has been established: that, at least given the existing amendment procedure, there are certain significant issues and circumstances with respect to which midstream opting out should be constrained.

B. Designing the Limits on Midstream Opt-Outs

Although the main concern of this Article to demonstrate the desirability of limits on midstream opting out rather than in the exact details of implementation, it might still be useful to note briefly some of the implementation issues that arise in designing these limits. One question that arises is institutional. With respect to any given issue, which legal institution should be charged with the role of shaping the standard legal arrangement governing the issue and with selecting those aspects of this arrangement from which opting out in midstream should not be possible? The options include legislatures (federal or state), courts, and agencies.⁵⁰

A related question concerns the timing and generality of the limitations imposed. The limitation may be adopted in an *ex ante* and general way — that is, applying to future amendments by all companies (or a large set of them). Indeed, such an *ex ante*, general drawing of limitations is the only one possible if the limitations are to be drawn by a legislative body. However, when the limits are to be imposed by a court or an agency, they may be imposed also in an *ex post*, particularistic way. For example, the limit imposed on opt-outs with respect to a given issue or circumstances may consist of a requirement that any amendment be subjected to a substantive review by a court before becoming valid.

The question of institutional selection and the questions of timing and generality of the limits should be examined within the framework of analysis provided in this Article. We should seek to identify how rational and informed parties, forming a corporation and wishing to maximize the expected value produced by the amendment process, would desire to resolve these questions. No doubt the questions are important and deserve to be the subject of scholarly debate. But for the purposes of this Article — which are to demonstrate the desirability of limits on midstream opting out — these questions are secondary. Whether the limits should be drawn *ex post* or *ex ante*, by legislatures, courts, or agencies, of foremost importance is the need to draw them.

Another significant aspect of the process of designing the limits is that their choice should not be made once and for all. It may be

⁵⁰ Some might even wish to include in this list of institutional alternatives the possibility of delegation to some professional self-regulatory body. See Coffee, *supra* note 11, at 970-74.

desirable to revise the chosen limits from time to time for two reasons. First, the optimal limits themselves might well change. The optimal limits depend, as we have seen, on the expected costs of the charter amendment process, and the degree to which this process is imperfect depends on various aspects of the capital markets that are likely to change over time. For example, the imperfections of the amendment process would be lessened if institutional investors became much more involved in collective action aimed at intensively studying amendment proposals and disseminating the results. Second, in assessing the expected costs and benefits of any opting-out freedom, we must rely on our best estimates at the time of design. Thus, even assuming that the optimal limits themselves do not change over time, in time we still might have to revise the limits chosen by us because we may well acquire novel information bearing on the identity of the optimal limits.

Finally, we must pay attention to the complex issue of effective enforcement. To the extent that we limit opt-out amendments, we also should place limits on certain transactions that might be used by companies to circumvent the imposed constraints. For example, a company might seek to adopt an opt-out arrangement *X* not by amending 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 amendments, it is necessary to place similar limitations on transactions that are practically equivalent, though formally different, from charter amendments.

C. Can Appraisal Rights and Stricter Procedural Requirements Serve as Substitutes for Limits on Opting Out?

Thus far we have seen that, taking the existing process for mid-stream opting out as given, the optimal arrangement for the scope of allowed opting out includes substantial limits. It might be argued, however, that the imperfections of the amendment process can be satisfactorily addressed by changes in the amendment procedure — in particular, by establishing appraisal rights or approval requirements — and that, with such improved process, the optimal arrangement for the scope of allowed opting out would no longer include substantial limits.⁵¹ As this section explains, however, it does not appear possible

⁵¹ Cf. Easterbrook & Fischel, *The Corporate Contract*, *supra* note 1, at 32–33 (suggesting that stricter procedural requirements can be used to address whatever imperfections might afflict the amendment process); Trebilcock, Chapman & Daniels, Comments on Bebchuk, Freedom of Contract and the Corporation (unpublished manuscript on file at Harvard Law School Library) (arguing that supermajority requirements and appraisal rights are the natural remedies for imperfections that the amendment process might have).

to change the amendment procedure in a way that would adequately address the imperfections of the amendment process.

1. *Appraisal Rights*. — In a corporate merger, dissenting shareholders who oppose the merger have appraisal rights aimed at providing them with the value of their shares in the absence of the merger.⁵² Similarly, it might be suggested that, whenever a charter amendment is adopted, dissenting shareholders should have appraisal rights designed to provide them with the value of their shares in the absence of the amendment. Such rights, it might be argued, would create a pricing mechanism that would serve a screening function, deterring value-decreasing amendments but not value-increasing ones. Consequently, the argument concludes, limits on opting out would not be necessary.

Consider how appraisal rights would work. After an amendment is proposed dissenting shareholders will have to file for appraisal by a certain filing date, which may be after the adoption of the amendment or prior to it (in which case the appraisal will proceed only if the amendment is approved). Let NAV denote the No-Amendment-Value that shares would have at the filing date assuming that the company would never be governed by the amendment. Filing shareholders will be asserting their desire to get NAV, and, subsequent to the filing date, the court will estimate NAV. Filing shareholders will then have their shares redeemed by the company for the court's estimate of NAV; or, alternatively, filing shareholders will retain their shares and will get from the company the difference between the court's estimate of NAV and the market price of their shares at the filing date.⁵³

The question is whether appraisal rights can be designed to perform their desired screening function with appropriate precision. Specifically, it is necessary to determine whether appraisal rights can be designed so that, first, they would discourage the bringing of value-decreasing amendments — including, in particular, those whose adoption would decrease corporate value by only one or two percent — and, secondly, would at the same time not discourage the adoption of any value-increasing amendments. As explained below, the answer to this question is negative.

Even assuming that courts can estimate NAV precisely, appraisal rights would not perform as desired. First, for many value-decreasing

⁵² On the appraisal available to shareholders in a corporate merger, see V. BRUDNEY & M. CHIRELSTEIN, *CASES AND MATERIALS ON CORPORATE FINANCE* 647–67 (3d ed. 1987); and R. GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 905–12 (1986).

⁵³ Of course, under this alternative version, if the court's estimate of NAV is below the stock market price of the shares at the filing date (because the amendment is value-increasing), then filing shareholders will have to pay this difference to the corporation (and presumably should put a deposit upon filing the appraisal to facilitate such a payment).

amendments, it is far from clear that a substantial fraction of the shareholders will file for appraisal. Because of the rational ignorance problem, the fraction of shareholders voting against a value-decreasing amendment might often be quite small or even nonexistent. Moreover, even those shareholders who vote against the amendment may not all file for appraisal — especially if they estimate that the amendment's effect on value is likely limited — because of the costs that they will have to bear to use their appraisal rights.⁵⁴

Second, even when the managers expect that the adoption of a given value-decreasing amendment would lead to the filing for appraisal by a substantial plurality of the shareholders, this expectation will not necessarily discourage the managers from proposing the amendment. Suppose that a given amendment would decrease a corporation's value by 1% and that, in the absence of appraisal, the managers will propose this amendment because it is sufficiently redistributive. Now consider whether the managers will be deterred by the presence of appraisal assuming that they expect the adoption of the amendment to result in the filing for appraisal by 25% of the shareholders. The filing shareholders' appraisal rights will enable them to escape the 1% loss produced by the amendment. The cost of their use of their rights, however, will not be borne by the managers but rather by the other shareholders. Thus, the consequence of the use of appraisal by some of the shareholders will be that the other shareholders will lose not 1% but rather 1.33%. But if shareholders' losing 1% was not going to discourage managers from proposing the amendment, it is not clear that shareholders' losing 1.33% would.⁵⁵

Finally, and most importantly, although the above discussion assumed that courts can accurately estimate NAV, they cannot — and this inability has severe consequences for the effectiveness of appraisal rights as a screening device. Clearly, even relatively small estimation errors would undermine the effectiveness of appraisal rights. When

⁵⁴ Filing for appraisal would necessarily involve transaction costs and court costs. Furthermore, if the appraisal rights are designed so that filing shareholders will have their shares redeemed for the court's estimate of NAV, then the use of appraisal would necessarily involve liquidating one's position in the company, which may be costly to a shareholder for two reasons. First, liquidating will create an immediate tax liability that continuing to hold the stock would defer. Second, the shareholder might wish to continue to hold stock in the company for investment reasons; and although the shareholder can use the appraisal consideration to repurchase shares of the company, the transaction costs involved might wipe out the potential gain from the appraisal.

⁵⁵ To be sure, the above amendment would be deterred if the appraisal compensation were required to come at the direct expense of the managers themselves. But such a requirement would discourage managers from bringing some value-increasing amendments. As explained below, courts cannot estimate NAV precisely. Consequently, managers bringing a value-increasing amendment would confront the risk of a monetary loss to themselves if the court makes a sufficiently significant error in the direction of overestimating NAV.

the error is in the direction of overestimating NAV, the rights might discourage the adoption of value-increasing amendments. When the error is in the direction of underestimating NAV, it would weaken whatever deterrence effect the appraisal might have with respect to value-decreasing amendments.

Assessing courts' ability to estimate NAV with precision must begin from the premise that they cannot directly measure the effects of amendments on corporate value. This premise must be accepted by any discussion of appraisal as a substitute for limits on midstream opting out. For if courts or other public officials could estimate such effects precisely, then we would have no reason to be even slightly concerned about their placing limits on opt-out amendments, and we thus would have no reason to consider the cumbersome mechanism of appraisal as a substitute for such limits.

Thus, the question is whether courts have access to some very good proxy for the directly unobservable value of NAV, and the answer appears to be no. For example, suppose that the filing date is prior to the vote on the amendment, and that courts use for their estimate of NAV the company's stock price at the filing date. Even though the filing date is prior to the adoption of the amendment, the stock price will presumably reflect the market's recognition that the amendment will be likely adopted. Thus, the amendment's effect will be reflected in this stock price, and it should not in an estimate of NAV.

To take another example, consider the possibility of courts' using for their estimate of NAV the company's stock price prior to the announcement of the amendment proposal.⁵⁶ Between the pre-announcement date and the filing date, the company's value is likely to be affected by developments having nothing to do with the proposed amendment. If these developments are negative, shareholders might well file for appraisal even if they regard the amendment itself as value-increasing; and if the developments are positive, then shareholders might well not file for appraisal even if they view the amendment as value-decreasing. Appraisal rights can work only if the value given to filing shareholders is equal to the price of their shares at the filing date with the sole change required to adjust this price to the no-amendment scenario. This value cannot be represented by the company's stock price at any date prior to the filing date.

In sum, it appears that appraisal rights cannot be designed to serve as a mechanism that would deter effectively value-decreasing amendments but not value-increasing ones. Such rights thus do not

⁵⁶ Note that news about the proposed amendment might leak to the market prior to the proposal's formal announcement. Thus, to get a stock price that certainly does not reflect the anticipated effect of the amendment, one would have to go even earlier, which would worsen the problem discussed below.

present an adequate way for addressing the imperfections of the amendment process.

2. *Stricter Procedural Requirements.* — It might be suggested that the imperfections of the amendment process can be addressed by replacing the existing requirement that amendments be approved once by a simple majority of the shareholders with stricter, more demanding approval requirements. I now wish to examine briefly whether such procedural changes are called for and, if so, whether their adoption would make placing significant limits on midstream opting out no longer desirable.

To identify the optimal arrangement with respect to the approval procedure, we should use a framework of analysis similar to the one that I have used to identify, given the existing approval procedure, the optimal arrangement with respect to the scope of allowed opt-outs. In choosing an approval procedure for charter amendments, rational and informed parties forming a corporation would wish to adopt that procedure which would likely maximize the expected value of the amendments that the procedure would produce. Thus, in examining a stricter procedural requirement, such parties would assess whether, and by how much, it would make less likely the passage of value-decreasing amendments as well as whether, and by how much, it would make less likely the passage of value-increasing amendments.

Clearly, any revision in the amendment procedure might well require some revising of our conclusions about the optimal arrangement concerning the scope of allowed opt-outs; for the optimal arrangement concerning scope can be identified only for a given amendment procedure. In particular, any procedural tightening might well warrant some, possibly small, loosening of the optimal limits on the scope of allowed opt-out amendments — and vice versa. The important question, however, is whether any procedural change that seems a reasonable candidate for adoption would change the nature of the optimal arrangement concerning the scope of allowed opt-outs so much that it would no longer include substantial limits on opting out.

One major and natural way in which the approval procedure may be tightened is by requiring that an amendment be approved by a supermajority rather than by a simple majority. In examining this possibility, we should first recognize the clear undesirability of any supermajority requirement that is close to unanimity. Because many shareholders, aware of the very small effect of their vote, are unlikely to bother to participate in any corporate vote, a demanding supermajority requirement, one of ninety percent for example, would make it difficult to adopt even quite desirable amendments. Furthermore, such a supermajority requirement would likely give an undesirable veto power to some shareholders.

What should be considered, then, is the possibility of raising the decisive fraction from a simple majority up to some level reasonably

below unanimity, for example, two-thirds or three-quarters. Such a change might prevent the adoption of some value-decreasing amendments that would pass under a requirement of a simple majority. This would happen in those cases in which the value-decreasing nature of an amendment is evident to a substantial plurality — but not to a majority — of the shareholders. But such a change would not eliminate the need for some limits on opting out in midstream. As Part III has explained, with respect to many value-decreasing amendments, the great majority of shareholders, including institutional investors, would not have sufficient incentive to become well informed about the proposal. In the case of these value-decreasing amendments, not even as much as one-third or a quarter of the shareholders will be adequately informed about the amendment. The problem, in essence, is that there is no supermajority level that would be at the same time not so high to make quite difficult the adoption of many value-increasing amendments yet high enough to ensure that the fraction of informed shareholders would be sufficient to block most value-decreasing amendments.

The other main procedural change that should be considered is to require that amendments not be adopted once and for all but rather that they be periodically ratified by the shareholders.⁵⁷ Again, this change is one that might be helpful in some cases — specifically, those in which the value-decreasing nature of a provision is not initially evident but may well become so over time. For example, the effects of certain antitakeover amendments are likely to be better recognized by the investment community now than when these amendments were first introduced. However, even if we conclude that the benefits from this change exceed its operational costs and decide to adopt it, limits on opting out would still be desirable. With respect to many value-decreasing amendments, there would be no reason why shareholders would become less poorly informed over time. Therefore, the requirement of periodic ratification would only add costs but do little to prevent these amendments.

In sum, the possibility of adopting at least in some cases the stricter approval requirements considered above deserves serious attention, because such requirements may be useful in preventing some value-decreasing amendments. If such procedural changes are made, they would require refining the optimal arrangement for the scope of allowed opt-out amendments. But these changes would not improve the amendment process to the point that significant limits on midstream opting out would be unnecessary. Whether or not the optimal

⁵⁷ For a consideration of such a proposal in the context of antitakeover amendments, see ADVISORY COMM. ON TENDER OFFERS, SEC., REPORT OF RECOMMENDATIONS 36-37 (1983), reprinted in Fed. Sec. L. Rep. No. 1028 (CCH extra ed. July 15, 1983).

arrangement includes stricter procedural requirements than at present, it does include such limits.

D. The Significance of the Issue

Before concluding, a brief note should be made of the practical importance of the limits on midstream opting out. Some critics might agree that the optimal arrangement includes limits on midstream opting out but disagree over the significance of the issue. They might argue that, even though the lack of constraints would be value-decreasing, the reduction in value — and thus also the benefit from the limits designed to prevent it — are quite limited. As the analysis of the voting process in Part III has acknowledged, value-decreasing amendments that would reduce corporate value quite substantially would be unlikely to be adopted even in the absence of limits because their value-decreasing nature would likely be evident. Therefore, it might be argued, the value-decreasing amendments that would be adopted in the absence of limits would be largely ones reducing corporate value by a limited amount, say, one or two percent of the corporation's value. Consequently, the argument goes, the benefit from limits is of this order of magnitude, and such effects on value are not all that critical to the corporate sector's performance and success.

In my view, however, the arrangement constraining midstream opting out is a subject to which corporate law scholars should pay much attention. To begin with, the arrangement's effect on corporate value is not all that limited. First, even assuming that, in companies without a dominant shareholder, shareholders would be unlikely to approve value-decreasing amendments reducing value by a substantial amount because the value-decreasing nature of such amendments would be evident, this is not the case for companies with a dominant shareholder; in such companies, the evident value-decreasing nature of an amendment might well not prevent it from being adopted if the amendment serves the interests of the controlling shareholder. Second, even assuming that, in the absence of limits, adopted value-decreasing amendments would reduce the corporation's value by no more than one or two percent, we must recognize that companies might adopt more than one such amendment and that there is a cumulative effect. Third, while one percent of any company's value does not represent a substantial chunk of society's resources, one percent of the total value of all publicly traded corporations in the United States is about thirty billion dollars.⁵⁸ Thus, any arrangement that affects this total

⁵⁸ On April 20, 1989, The Wilshire Associates Equity Index — the total market value of all New York Stock Exchange, American Stock Exchange, and Over-the-Counter issues was 3018 billion dollars. See *N.Y. Times*, Apr. 21, 1989, at D7, col. 3.

value by even as little as one or two percent has an effect on society's resources of a very substantial absolute value.

Moreover, in any event, even if one regards the arrangement's described effect on social resources as not too great, effects of such an order of magnitude are generally what we can hope for from an optimal shaping of a corporate law arrangement. Beyond the existence of the corporate form and some of its basic features, other corporate law aspects — including aspects that greatly occupy corporate law scholars and the relevant public officials — affect total corporate value only to a limited extent. The optimal design of a given corporate law arrangement generally cannot aim at greatly increasing corporate value and is not, as it were, what would matter in the economic competition with Japan. This observation, however, does not imply that we should not be concerned about corporate law arrangements and corporate law reform. As noted above, small-percentage effects on total corporate value do represent a substantial amount of societal resources. The above observation only implies the need for a realistic sense of perspective of what the optimal design of a corporate law arrangement can hope to attain. With such a perspective, designing the arrangement governing the scope of allowed opt-out amendments clearly presents a very significant question for corporate law.

VI. CONCLUSION

Because corporations are long-living entities that function in a dynamic world, a great deal of corporate private ordering is done in midstream, after the company has been formed and its initial charter set. This Article has focused on such midstream opting out, and has highlighted the differences between it and opting out in the initial charter. In particular, I have shown that, regardless of one's view concerning opting out in the initial charter, there are strong reasons for placing substantial limits on opting out in midstream.

Rational and informed parties forming a corporation would recognize the desirability of a charter amendment procedure that enables charter changes without unanimous shareholder consent. But they would also recognize the imperfections of this procedure, as neither the requirement of a shareholder vote nor the requirement of a board proposal can be relied on to preclude value-decreasing amendments. Consequently, the optimal arrangement that such parties would wish to adopt with respect to opt-out amendments is one that places significant limits on opting out in midstream. 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. Because even strong believers in free markets should accept this optimal arrangement in the common case when such an explicit contrary provision is

absent, they should recognize that mandatory corporate law rules have an important role to play in midstream.

Having shown the desirability of limits on midstream opting out, this Article has also identified the factors that determine the desirable limits. 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 task of drawing the limits on private ordering in corporate law.

