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The Economic Structure of Corporate Law

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The Fiduciary Principle, the Business Judgment Rule, and the Derivative Suit

We arrive at the relation between shareholders and managers, which holds center stage in the rest of this book. We focus in this chapter on the meaning and function of fiduciary duties and the business judgment rule. We also discuss the derivative suit, the usual method by which fiduciary duties are enforced.

The Functions of Fiduciary Duties

Corporate directors and other managers are said to be fiduciaries who must behave in upright ways toward the beneficiaries of fiduciary duties. Yet as Justice Frankfurter put it, "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary?"[1] The answers depend on why we should want to call a corporate manager a "fiduciary" in the first place.

Fiduciary principles are uncommon in contractual relations. Parties dealing at arm's length may bargain hard and enforce their deals to the letter, no matter how severe the consequences for the other side. We treat corporations as complex sets of contracts, so the reader is entitled to ask: how do fiduciary duties sneak into these contracts? Our answer, sketched in Chapter 1 and developed further in Chapter 3 (investors' voting rights), starts from the proposition that people cannot see the future well enough to resolve all contingencies ahead of time. Corporations are enduring (relational) contracts. Some persons' rights may be specified. Those of suppliers, laborers, and debt investors fall in this category. If contracts can be written in enough detail, there is no need for "fiduciary" duties as well. This point is well understood. Workers and bondholders alike must look to their contractual rights rather than invoke fiduciary claims.[2] The corporate contract locates the uncertainties in the holders of the residual claims—conventionally the equity investors. They receive few explicit promises. Instead they get the right to vote and the protection of fiduciary principles: the duty of loyalty and the duty of care. As we explained in Chapter 3, these attach to the residual claim because the holders of these claims bear the marginal risks of the firm and so have the best incentives to make the optimal investment and management decisions—not perfect incentives, just best. The only promise that makes sense in such an open-ended relation is to work hard and honestly. In other words, the corporate contract makes managers the agents of the equity investors but does not specify the agents' duties. To make such an arrangement palatable to investors, managers must pledge their careful and honest services.

When one person exercises authority that affects another's wealth, interests may diverge. The smaller the managers' share in the enterprise, the more the managers' interests diverge from the interests of those who contributed capital. This phenomenon exists in any agency relation. For example, a real estate agent on a 5 percent commission will not undertake even $10 worth of effort to improve the realized price by $100, because the agent reaps only $5 of this sum. The $10 effort, however, would be highly advantageous to the principal.

Divergence of interests may be controlled in several ways. There is the employment market: an unfaithful or indolent manager may be penalized by a lower salary, and a diligent one rewarded by a bonus for good performance. In addition, the threat of sales of corporate control induces managers to perform well in order to keep their positions. Finally, competition in product markets helps to control agents' conduct, because a poorly managed firm cannot survive in competition with a well-managed firm (other things being equal). These mechanisms reduce but do not eliminate the divergence of interests. They require extensive, costly monitoring so

1. SEC v. Chenery Corp., 318 U.S. 80, 85–86 (1943).

2. For example, Broad v. Rockwell Int'l Corp., 642 F.2d 929, 955–960 (5th Cir. 1981) (in banc) (managers must abide by contractual bargains with debt investors and disregard considerations of fairness). On the extent to which firms contract explicitly with debt investors, see Clifford W. Smith, Jr., and Jerold B. Warner, "On Financial Contracting: An Analysis of Bond Covenants," 7 *J. Fin. Econ.* 117 (1979).

that investors and others know how well the managers perform. And the mechanisms may be inadequate to deal with one-time defalcations, when the manager concludes that the opportunities of the moment exceed any subsequent penalties in the employment market.

Investors might try to deal with these problems by combining ever more elaborate contractual strictures with full-time monitors to look over the shoulders of managers. More contractual detail is an implausible solution; recall that the need for managerial discretion comes precisely from the high costs of anticipating all problems, contracting about them, and enforcing these contracts through the courts. As for monitors, who monitors the monitors? Full-time monitors are managers in all but name, and part-time monitors lack both the incentive to watch carefully and the information to determine how well others are performing their tasks.

The fiduciary principle is an alternative to elaborate promises and extra monitoring. It replaces prior supervision with deterrence, much as criminal law uses penalties for bank robbery rather than pat-down searches of everyone entering banks. Socially optimal fiduciary rules approximate the bargain that investors and managers would have reached if they could have bargained (and enforced their agreements) at no cost. Such rules preserve the gains resulting from the separation of management from risk bearing while limiting the ability of managers to give priority to their own interests over those of investors.

Fiduciary principles contain antitheft directives, constraints on conflict of interest, and other restrictions on the ability of managers to line their own pockets at the expense of investors. But these principles have limits that reflect the distinction between managerial practices that harm investors' interests and practices that simultaneously benefit managers and investors. For example, managers of a corporation are free to funnel business to another corporation in which they have an interest if the transaction is approved by disinterested directors or is "fair" (advantageous) to the firm. The fiduciary duty of a corporate director diverges sharply from the fiduciary duty of a trustee in this respect precisely because the interests of the principals are different.

Because the fiduciary principle is a rule for completing incomplete bargains in a contractual structure, it makes little sense to say that "fiduciary duties" trump *actual* contracts. Similarly it misses the point to say that managers may sacrifice the interests of investors to other ends, so long as investors are not hurt "too much." Presumably "too much" in this context means "by so much that investors start contracting around the rule." Because the reason for having a fiduciary principle in the first place is the high cost of specifying things by (express) contract, the suggested constraint denies the only function of the rule. Detailed contracting, costly enough at the outset of a venture, is almost impossible once a firm has been established. After the firm has raised necessary capital, investors have no practical way of revising the articles on their own to overcome intervening legal surprises. To use the fiduciary principle for any purpose other than maximizing the welfare of investors subverts its function by turning the high costs of direct monitoring—the reasons fiduciary principles are needed—into a shield that prevents investors from controlling managers' conduct.

Business Judgment and the Limits of Liability Rules

The fiduciary principle suggests that courts should routinely conduct wide-ranging inquiries to determine the bargain that managers and investors would have reached if transactions costs were zero. This sounds like the inquiry in tort law: the court would ask whether the costs of making a decision (taking a precaution) are less than the gains to be had (harms to be avoided), discounted by the probability of the gain (harm) occurring. Hearing tort cases, judges routinely make such calculations and impose stiff penalties on all who flunk felicific calculus. Yet judges invoke the "business judgment rule," a doctrine absolving managers of liability even though their conduct is negligent. Statements of the rule vary; its terms are far less important than the fact that there is a specially deferential approach.

Why both demand that managers maximize investors' wealth and then refuse to carry through with the demand by hitting managers in their wallets (a particularly appropriate place)? Behind the business judgment rule lies recognition that investors' wealth would be lower if managers' decisions were routinely subjected to strict judicial review.

Precisely why investors' wealth would not be maximized by close judicial scrutiny is less clear. The standard justifications are that judges lack competence in making business decisions and that the fear of personal liability will cause corporate managers to be more cautious and also result in fewer talented people being willing to serve as directors. These are helpful but not sufficient. They do not explain why the same judges who decide whether engineers have designed the compressors on jet engines properly, whether the farmer delivered pomegranates conforming to the industry's specifications, and whether the prison system adversely affects the mental states of prisoners cannot decide whether a manager negligently failed to sack a subordinate who made improvident loans. Nor do the standard explanations tell us why leading corporate managers to exercise caution is not beneficial in the same manner that threatening automobile drivers with liability (thus encouraging them to be more careful) is beneficial.

The business judgment rule must rest on something more. It reflects limits on the use of liability rules to assure contractual performance. We discuss below why liability rules have only limited usefulness as a governance mechanism in the publicly held corporation.[3]

Self-Enforcing Contracts

Many torts and breaches of contract are one-shot deals. Unless the legal system requires the parties to bear the costs they create, there will be too much negligence and too many broken contracts. Long-term relations of the sort that corporations create also provide opportunities to return costs to their creators without the aid of the legal system.

Repeat Transactions

Poor performance is rational, as managers see things, when current gains exceed the present value of future costs. The relation between gains and future costs depends in large part on the likelihood of repeat transactions. The higher the probability of repeat transactions, the greater the incentive to perform well. Consider itinerant vendors. They have no brand name to protect and seldom engage in multiple transactions with the same buyer, so they have strong incentives to misrepresent the quality of their wares in order to obtain a higher price; the present value of future costs of such conduct is likely to be small. The opposite case, a long-term relation in which each party gains from doing business with the other in the future, creates the opposite incentive. Losing the other's repeat business may be a penalty vastly exceeding the gains of misrepresenting performance today.

Managers of public corporations are repeat players in several respects. Firms need to raise money continually (debt must be rolled over even when the firm does not plan to sell new stock). Firms—meaning managers—repeatedly stand for scrutiny and pay a high price in capital markets for subpar performance. Managers also face scrutiny in labor markets. If sacked today, they may have trouble matching their income elsewhere. In the limit this "*ex post* settling up" in labor markets is alone sufficient to create proper incentives.[4] Even if managers need not regularly tap capital markets to raise funds, their wealth is tied to the value of the firm's securities and so reflects some of the value of their performance. As the present value of forgone compensation in future periods

3. Our discussion is in the spirit of much recent work showing how markets best courts in enforcing contracts between parties that have enduring relations. See Charles Goetz and Robert E. Scott, "Principles of Relational Contracts," 67 *Va. L. Rev.* 1089 (1981); Benjamin Klein and Keith B. Leffler, "The Role of Market Forces in Assuring Contractual Performance," 89 *J. Pol. Econ.* 615 (1981); Benjamin Klein and Kevin M. Murphy, "Vertical Restraints as Contract Enforcement Mechanisms," 31 *J. L. & Econ.* 265 (1988); Charles R. Knoeber, "An Alternative Mechanism to Assure Contractual Reliability," 12 *J. Legal Stud.* 333 (1983); Anthony T. Kronman, "Contract Law and the State of Nature," 1 *J. L. Econ. & Org.* 5 (1985); Lester G. Telser, "A Theory of Self-Enforcing Agreements," 53 *J. Bus.* 27 (1980); Oliver E. Williamson, "Credible Commitments: Using Hostages to Support Exchange," 73 *Am. Econ. Rev.* 519 (1983); Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations," 22 *J. L. & Econ.* 233 (1979).

4. Gary S. Becker and George J. Stigler, "Law Enforcement, Malfeasance, and Compensation of Enforcers," 3 *J. Legal Studies* 1 (1974); Eugene F. Fama, "Agency Problems and the Theory of the Firm," 88 *J. Pol. Econ.* 288, 295–306 (1980). Which is not to say that the method works perfectly. If inferior management is not discovered for some time after the event, it may be impossible to achieve a satisfactory *ex post* settling up given the time value of money.

increases relative to the current gains from poor performance, liability rules become less important.

The Efficiency of Information Markets

Markets in information are one way to induce people to act as if they are in a relation with repeat transactions, even when they are not. *Consumer Reports* supplies information to customers who have never dealt with the vendor. One who knows that the transaction with the first customer influences the second will treat the first better. Other markets are less powerful in reflecting news. For example, poor performance by a physician may cause a patient to go elsewhere, unless the patient equates the bad result with bad luck. Although the chance of losing business gives doctors some incentive to perform well, it is not much because the disease and treatment will not be perfectly replicated. Disappointed patients cannot look up a physician in *Consumer Reports* or sell shares in a physician short to communicate information to the market.

Managers of public corporations face a potent information market. Few markets are as efficient as capital markets. Poor performance leads the markets to respond in ways that bring the costs home to the managers. First, investors (both informed and uninformed) will pay less for shares. The more investors believe that their dollars will be used by those in control of firms in ways inconsistent with maximizing the value of the firm, the less they will pay for shares. To minimize this rational fear, those in control have incentives to adopt governance mechanisms that limit their discretion to benefit at investors' expense.

Second, accurate price signals in capital markets contribute to the efficiency of labor markets. Share price information provides a relatively low-cost method of evaluating the performance of corporate managers. Such information can be used (imperfectly) to set managers' compensation within the firm as well as to measure their opportunity wage in external labor markets.

Finally, capital markets facilitate the operation of the market for corporate control (on which see Chapter 7). Managers must perform well to keep share prices high; if they do not, they can expect to be replaced. The efficient operation of the capital, labor, and

takeover markets all raise the future costs of poor performance, thereby helping to assure contractual performance.

Firm-Specific Investments of Human Capital

Gains from exchange often do not depend on the identity of the other party to the contract. If *A* purchases wheat from *B*, who refuses to perform, *A* probably can purchase wheat of identical quality from *C* without difficulty. Neither *A* nor *B* has an investment specific to the transaction, and the gains from exchange thus do not depend on the continued presence of either party.

Not all contracts are of this type. Assume *A* contracts with *B* for the construction of a nuclear power plant. At the time the contract was entered into *B* was one of many contractors with the necessary expertise. Over time, however, it is likely that *B* will acquire certain skills and expertise specialized to this transaction. Other contractors who were once close substitutes for *B* now are decidedly inferior because they have not made the same transaction-specific investment.

Now assume that *B* breaches some term of the agreement. *A* is in a bind. If *A* fires *B* or causes *B* to walk off the job by suing *B*, the cost and expense of the plant might go up substantially because some other contractor will need to acquire the transaction-specific skills of *B*. *A* might well conclude that it is better off by continuing to deal with *B*, the breaching party, and avoiding these costs. Indeed, one of the striking findings of those who have studied contracts where transaction-specific investments are common is how rarely litigation is actually used to enforce contractual obligations.

Contracts involving labor have great potential for firm- or transaction-specific investments. Corporate managers frequently possess expertise and skills specialized to a firm. Changing managers is costly because the replacements lack equivalent firm-specific expertise—costly to the managers, too, for they must acquire specific capital to be useful elsewhere. Both sides try to avoid these costs, the threat of which induces both to perform well in the first place. Even if managers perform poorly in the short term, the incentive remains. Discharge (voluntary or induced by litigation) may be much less effective if it forces the costs to be incurred.

Gains from Breach

The larger the potential gains from misconduct or inattention, the more important are liability rules. A specter of civil liability (plus criminal penalties) is probably useful to deter large one-shot frauds. So the business judgment rule does not protect fraudulent conduct. In the main, however, managers' personal gains from negligent conduct are small, making the costs they bear without regard to the legal system quite sufficient.

Costly and Inaccurate Litigation

Although markets bring home to managers most of the costs of their suboptimal performance, they are imperfect. If the legal system offered a better (cheaper) way, courts should use their comparative advantage. Unfortunately, courts are less well suited to detecting and rectifying shortcomings in the boardroom than they are to detecting and rectifying shortcomings in product design—and they aren't very good at the latter.

Breach or Mischance?

Recall from the first portion of this chapter why there are fiduciary duties: because it is too costly to contract for every contingency. Courts experience the same costs as the contracting parties. True, courts view the subject after the events, so the range of questions is narrowed. But judges encounter most of the nagging questions of information and estimation that make it hard to agree *ex ante*. How can the court know whether a poor outcome of a business decision is attributable to poor management (inputs) or to the many other things that affect firms?

A decision is good to the extent it has a high *expected* value, although it may also have a high variance. To observe that things turned out poorly *ex post*, perhaps because of competitors' reactions, or regulations, or changes in interest rates, or consumers' fickleness, is not to know that the decision was wrong *ex ante*. Only after learning all of the possible outcomes, and the probability attached to each, could the court determine the wisdom of the decision at the time it was made. Occasionally the decision will be a howler, making inquiry easy. More often it will be hard to reconstruct possible outcomes. Businesses rarely encounter "sure things." Often managers must act now and learn later; delay for more study may be the *worst* decision; the market will decide whether the decision was good. Competition pares away the unsuccessful choices. Only in retrospect, observing which decisions were fruitful and which were not, can we say which was best. Yet because failure does not show that the decision was inferior when made, a court lacks the information to decide.

Costs of decision *ex post* will be highest precisely when it was also most difficult to contract *ex ante*. So when claims are made on the basis of the fiduciary principle—as opposed to a specific contract—courts are likely to lack essential tools of decision. This means that *ex post* settling up in markets has a comparative advantage over courts at enforcing the fiduciary principle *except* in the case of startling gaffes and large, one-shot, self-interested transactions. It should be no surprise, then, to learn that the business judgment rule confines courts to exactly these rare cases.

Because managers work in teams, and outcomes are strongly influenced by events external to the firm, a court is forced to examine inputs rather than outputs. Yet how is this to be done? Monitoring the effort or output of any individual manager is very costly; reconstructing it by testimony years later is both costly and inaccurate. It is difficult even to imagine using liability rules as a remedy for poor effort by managers, although lack of gumption is the single largest source of agency costs.

The problem of error costs is similar. Courts have as much difficulty as other outsiders in measuring managers' efforts or output. The court's difficulties are complicated by selection bias. Most lawsuits follow poor outcomes, and judges naturally assume that such outcomes are a product of bad actions. This bias can be a source of substantial error costs.

Relative Attitudes toward Risk

Because information is costly, a poor outcome may be equated with poor performance. Agents who are penalized for poor outcomes as well as poor performance tend to undertake projects with lower variance. Managers especially want to avoid risk because they cannot diversify the value of their human capital. Shareholders, however, readily diversify risk through capital markets. They want

managers to take the projects with the highest mean returns, which may entail high risk. (No pain, no gain.) Exposure to liability causes managers' incentives to diverge from the path of wealth maximization.

Even liability for loony decisions has costs. Damages hurt risk-averse managers more than they help risk-neutral investors. This difference creates opportunities for gains from trade. Investors may agree to release managers from liability in order to reduce risk and thus to reduce the amount that must be paid in compensation and insurance. Investors would contract to accept lower damages in exchange for lower salaries. They do this explicitly through absolution clauses and implicitly through insurance; the business judgment rule acts as an implicit contract with similar effects.

Natural Selection in Courts and Markets

We have stressed the role of incentive-compatible contracts—that is, arrangements that reward managers automatically for good performance and penalize them for bad. All this attention to managers' incentives slights another, equally interesting question: what are judges' incentives? However much judges want to decide cases "correctly," they do not receive extra pay for extra work or more astute estimates of market conditions. Inferior managers eventually are "selected out" by competitive process. Investors likewise are selected out, and markets therefore tend to value decisions accurately. Judges are neither chosen for business acumen nor fired or subject to reductions in salary if they err in assessing business situations. Judges also are accustomed to deciding cases on full records and may be too quick to blame managers who act—as often they should—in haste or on incomplete information. It is better to insulate all honest decisions from review than to expose managers and directors to review by judges and juries who do not face market pressures. The business judgment rule does this.

Derivative Litigation

Any comparison of markets' and courts' enforcement of the fiduciary principle must take into account how the judicial process works. The mechanism is the derivative suit. When the board of directors decides to bring (or not bring) an action against an officer

or director, this is a business judgment like any other. Derivative litigation attacks the propriety of this nonenforcement decision. Incentive-compatible devices attach weights to outcomes. Small benefits yield small rewards, large losses large penalties, and so on. So too with votes, which are tied directly to stakes and so improve incentives (see Chapter 3). A dominating characteristic of the derivative action is the lack of any link between stake and reward—not only on the judge's part but also on the plaintiff's.

Shareholders with tiny holdings can bring derivative actions. Holders of small stakes have little incentive to consider the effect of the action on other shareholders, the supposed beneficiaries, who ultimately bear the costs. If the action appears to be a positive net value project because of the possible recovery of attorneys' fees, an attorney will pursue it regardless of its effect on the value of the firm. (This suggests that the method of compensating attorneys and assessing costs will have a large influence on the costs and benefits of derivative litigation. For current purposes it is enough to know that no system of awarding attorneys' fees or assessing costs is perfect. However attorneys may be compensated, the value of managers' time cannot be recouped, no matter how frivolous the action.)

Sometimes the combination of uninterested nominal plaintiffs and interested attorneys produces striking effects. The spate of derivative suits in the 1970s challenging payment of baksheesh abroad, notwithstanding the profitability of the practice, shows how the lure of fees (or ideology) may lead to litigation inconsistent with investors' interests. Other conflicts are less apparent. Statutes typically require a majority, or at most two-thirds, of votes to approve mergers. Unanimous consent is not required because a demand for unanimity would create incentives for shareholders to behave strategically. Any shareholder, even if convinced the merger was beneficial and the terms fair, could refuse consent and hope to be bought off. A shareholder would reason that the cost imposed on all other shareholders (the premium forgone) would force the corporation to "buy" the shareholder's approval with some type of side payment. Such behavior is privately rational but wealth reducing. Derivative litigation can create some holdup power.

All problems of incentives to one side, there is the problem of access to information and expertise. Outsiders do not have access

to (or means to evaluate) knowledge within the firm. What looks like a hasty decision by corporate managers may simply reflect experience or an effort to avoid the expense of hiring outside experts. For instance, a seemingly self-interested decision to accelerate the exercise of a stock option may well be the most efficient method of awarding an increase in compensation. Paucity of information frequently makes it difficult for either plaintiffs or judges to determine which actions promote maximum value for the firm. In the end, then, derivative litigation is bound to fall short of any ideal conception of the role of the legal system.[5]

Applications

The Decline of the *Ultra Vires* Doctrine

In the nineteenth century, judges often treated corporate actions such as charitable contributions and expenditures on behalf of employees as beyond the power of the corporation, or *ultra vires*. Under modern corporate law, however, such actions are routinely upheld. The decline of the *ultra vires* doctrine is consistent with the principles that we have discussed.

Payment to a widow of a deceased employee, for example, may create goodwill among other employees and increase productivity. Similarly, charitable contributions may create favorable publicity for the firm and thus be an effective form of advertising. They may depict the firm as a "good citizen" and stave off regulation, and so on. Maybe not; maybe the manager causes the firm to give money to the opera so that it can afford to hire a singer the manager wants to hear. Contributions then are like perquisites, which courts also decline to investigate. You cannot tell in advance that a category of expenses always is antithetical to investors' interests. So courts

5. Data showing that derivative suits do not have significant effects on the price of stock strongly support this proposition. Daniel R. Fischel and Michael C. Bradley, "The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis," 71 *Cornell L. Rev.* 261 (1986). Data on the effect of changes in laws concerning derivative suits are mixed. Compare Elliott J. Weiss and Lawrence J. White, "Of Econometrics and Indeterminacy: A Study of Investors' Reactions to 'Changes' in Corporate Law," 75 *Calif. L. Rev.* 551 (1987), with Michael C. Bradley and Cindy A. Schipani, "The Relevance of the Duty of Care Standard in Corporate Governance," 75 *Iowa L. Rev.* 1 (1989). Note 4 in Chapter 8 discusses some of these studies.

now leave such questions to markets, again demonstrating conformity of law and economics.

The Distinction between the Duty of Care and the Duty of Loyalty

It is conventional to draw a sharp distinction between the duty of care (to act as a prudent person does in the management of his own affairs of equal gravity) and the duty of loyalty (to maximize the investors' wealth rather than one's own). Judges scrutinize alleged violations of the duty of loyalty more closely than alleged violations of the duty of care. The usual explanation for this dichotomous treatment is that the decisions tainted by a conflict of interest are entitled to less judicial deference than those that are not. Some have argued that the differences between the duty of care and the duty of loyalty are so fundamental that the latter should be strengthened and the former abolished.[6]

Ultimately, though, there is no sharp line between the duty of care and the duty of loyalty. What is the difference between working less hard than promised at a given level of compensation (a breach of the duty of care) and being compensated more than promised at a given level of work (a breach of the duty of loyalty)? Both are agency costs, conflicts of interest in an economic sense, that reduce shareholders' wealth. The existence of a conflict of interest, therefore, cannot explain the distinction between the duties of care and loyalty.

A satisfactory explanation for the distinction may be found in the differential payoffs from breach and policing. Duty-of-loyalty problems often involve spectacular, one-shot appropriations, of the "take the money and run" sort, in which subsequent penalties through markets are inadequate. Liability rules are most helpful when other mechanisms fail. A manager on the verge of retirement is not likely to be deterred from wrongdoing by the decline in his future wage. The duty of loyalty supplements market penalties for breach in those situations where the market penalties themselves might be insufficient. It is also easier for courts to detect appropriations than to detect negligence, so the costs of inquiry and error are lower.

6. See Kenneth E. Scott, "Corporation Law and the American Law Institute Corporate Governance Project," 35 *Stan. L. Rev.* 927 (1983).

Procedural but Not Substantive Review of Conflict-of-Interest Transactions

Managers must prefer investors' interests to their own in the event of conflict. That is the core of the duty of loyalty. Ordinarily courts require managers to prove that any conflict-of-interest transaction is "fair" to the firm—that is, that the firm receives a deal at least as good as it could have obtained in an arm's-length transaction with a stranger. That is a market test, again consistent with the contractual view of the firm.

Even this inquiry into market conditions is forgone when the transactions have been approved by independent monitors. Disinterested directors, for example, are proxies for investors and can be cheap substitutes for liability rules in assuring contractual performance. After all, the disinterested monitors have reputational interests of their own and face *ex post* settling up in labor and capital markets. Because they gain little from approving an insider's transaction, even a modest penalty in other markets makes them effective monitors. (Notice that we say "little" rather than "nothing." "Disinterested" directors are quite interested in maintaining the managers' esteem and places on the board, which are worth something.)

Corporate law has recognized this by allowing such directors to validate transactions that would otherwise be tainted by conflict of interest. Thus, a decision to resist a tender offer, dismiss a derivative suit, enter into a transaction with an interested director, or negotiate a merger with a related entity may be subject to a lower standard of judicial review if it is made by disinterested directors. These decisions allow firms to opt out of stricter standards of judicial review by adopting alternative governance mechanisms. Shareholder approval of a transaction can also lead judges to be more deferential in reviewing a transaction.[7]

Neither independent directors nor a shareholder vote necessarily *ensures* that a particular transaction will increase shareholders' wealth. Independent directors may be too uninformed to make intelligent decisions. Or maybe friendship in conjunction with directors' fees and a belief that the market won't notice "just this one time" lead them to play dead. Similarly, collective action problems may cause rational shareholders to vote in favor of a particular transaction even if it is wealth-reducing (see Chapter 3). For these reasons, courts have been unwilling to abdicate in favor of independent directors or shareholders. To say that approval by disinterested parties leaves *some* costs and risks is not to say that they are large; as we know that the costs and error rate of the legal system are large, the judicial role is correspondingly small.

7. See, for instance, Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985); Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983).

Indemnification and Insurance

Corporate law provides firms with flexibility in deciding whether to provide indemnification or insurance to managers for expenses incurred in litigation.[8] Firms commonly indemnify or insure corporate officers against litigation expenses and certain types of judgments. This contractual response, which many have criticized,[9] can be explained along the lines we have suggested. Indemnification and insurance allow firms to contract around liability rules when markets are cheaper than courts. These are *real* contracts and accordingly are enforced almost without exception.

Restrictions on Derivative Litigation

Our discussion of the poor incentive of small shareholders and their attorneys to maximize the value of the firm implies that legal rules should place restrictions on the ability to bring derivative suits. The demand requirement, the contemporaneous ownership rule, stat-

8. See 8 Del. Code §145(f) ("The indemnification provided by this section shall not be deemed exclusive of any other rights to which those seeking indemnification may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise"). Corporations also may purchase insurance for directors even where indemnification is prohibited. Ibid. at §145(g). Other states follow the same pattern. American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* 199–214 (Tent. Draft No. 10, 1990) (collecting statutes, decisions, and practices).

9. See Joseph Bishop, *The Law of Corporate Officers and Directors: Indemnification and Insurance* (1981). Bishop and others have argued that indemnification and insurance erode the deterrent effect of liability rules. As Charles Goetz points out, and as we contended in Chapter 2, insurers often may be the best monitors of managerial misconduct. "A Verdict on Corporate Liability Rules and the Derivative Suit: Not Proven," 71 *Cornell L. Rev.* 344, 349 (1986).

utes requiring plaintiffs to give security for expenses, and, perhaps most important, the ability of directors to terminate derivative suits by making ordinary business judgments about the costs and benefits of further litigation, all have this effect.[10]

Undoubtedly directors named as defendants in derivative suits do not exercise impartial judgment in deciding whether to sue themselves. Similarly, special litigation committees appointed by the managers will not be impartial. It is *also* true that there are real, and substantial, costs associated with the derivative suit, given the plaintiffs' incentives to behave strategically, the shortfall of information available to judges, and the opportunity costs of the managers' time devoted to defense. One cannot look at the costs of dismissal in isolation. Hence "structural bias" of the board—the reluctance of managers who are named as wrongdoers or special litigation committees appointed by such managers to take "enough" action—hardly demonstrates the need for more vigorous enforcement of derivative suits. That is only the half of it. Courts (and markets) regularly accept the decisions of interested managers—about salary, about the identity of the auditors, and so on. We must avoid the Nirvana fallacy, the comparison of imperfect markets against a mythical perfect judicial or regulatory scheme. Perfection dominates this choice, but it is not a real one.

The tough question is, which of two very imperfect classes of decision makers—managers allegedly involved in wrongdoing or the persons they seat on special litigation committees on the one hand; shareholders with a small economic stake in the venture represented by plaintiffs' attorneys and judges on the other hand—is more likely to make decisions that increase the value of the firm? There is no ready answer. Not surprisingly, different judges have reached different conclusions about when directors charged with wrongdoing can dismiss derivative suits.[11]

10. For descriptions of all of these rules and extensive discussion of the cases, see Deborah A. DeMott, *Shareholder Derivative Actions* (1987 & Supp. 1989). See also Starrels v. First National Bank of Chicago, 870 F.2d 1168, 1172–76 (7th Cir. 1989) (concurring opinion); Kamen v. Kemper Financial Services, Inc., 908 F.2d 1338 (7th Cir. 1990) certiorari granted, 111 S. Ct. (1990).

11. Compare Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979) (decision by independent members of special litigation committee to terminate derivative suit subjected to scrutiny under business judgment rule), with Miller v. Register & Tribune Syndicate, 336 N.W.2d 709 (Iowa 1983) (directors named as defendants cannot create special litigation committee to study whether derivative suit should be dismissed), Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (intermediate standard), with Alford v. Shaw, 358 S.E.2d 323 (N.C. 1987) (firm may dismiss action when its pursuit would injure the corporation, even though a majority of the board is "interested," but court must review the decision to do this), and Joy v. North, 692 F.2d 880 (2d Cir. 1982) (similar).

The Anomalous Duty to Be Informed

In *Smith v. Van Gorkom*[12] the Supreme Court of Delaware held that the business judgment rule applies only to decisions that are "informed." The court further held that managers who accepted a merger proposal at a large premium over the market price in an arm's-length transaction but who did not study the proposal or consult any outside experts breached their fiduciary duty to make an informed decision. It may be that this case is a specialty of tender offer law, which we will visit in Chapter 7.[13] Perhaps it establishes a special rule for last-period problems (the firm was to be acquired in the transaction). If *Van Gorkom* is a more traditional business judgment case, it is an outlier. In either event, it led to a big change in Delaware law: a provision in the corporate code, added in 1986, authorizing firms to eliminate damages liability in duty-of-care cases.[14] Here we find one of the most explicit acknowledgments of the role of contract in corporate law.[15]

It is not hard to see why the case produced such a swift and sweeping reaction. Judicial inquiry into the amount of information managers should acquire before deciding creates the precise difficulties that the business judgment rule is designed to avoid. Information is necessary for corporate managers to maximize the

12. 488 A.2d 858 (Del. 1985).

13. Jonathan Macey and Geoffrey Miller, "Trans Union Reconsidered," 98 *Yale L. J.* 127 (1988), treat it this way. Daniel R. Fischel, "The Business Judgment Rule and the Trans-Union Case," 40 *Bus. Law.* 1437 (1985), treats it as an ordinary business judgment case.

14. 8 Del. Code §102(b)(7). Other states have followed suit. Deborah A. DeMott, "Limiting Directors' Liability," 66 *Wash. U. L. Q.* 295 (1988), collects the permutations. See also American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* §7.17 (Tent. Draft No. 9, 1989) (recommending, in one of its few concessions to contract, that corporations be allowed to limit damages in duty-of-care cases to the manager's or director's income for the year of the delict).

15. Though not one without problems—the "latecomer term" difficulty, to which we return at the end of Chapter 6 when discussing the appraisal remedy.

value of the firm. But there is a limit to how much managers should know before making a decision. It would make no sense, for example, for a manager who has to decide whether to give his or her secretary a $10-a-week raise to commission a $100,000 study of secretarial compensation in the United States. Information is costly, and investors want managers to spend on knowledge only to the point where an additional dollar generates that much in better decisions. Exactly how much information to gather depends on such factors as how much the managers already know, the costs of obtaining additional information, the likely benefit of such information, and the variance of possible outcomes. Perhaps the Supreme Court of Delaware has changed course again, for in 1985 it remarked that "informed decision to delegate a task is as much an exercise of business judgment as any other."[16] Managers can delegate tasks to the market as easily as to investment bankers—and markets are cheaper.

The ultimate issue is who should decide how much information to acquire in advance of a business decision. Allowing shareholders to challenge business decisions that they say were not "informed" has the effect of substituting the business judgment of some shareholders, their attorneys, and a court for that of the managers. Because the managers have the best incentives (particularly when, in a case like *Van Gorkom,* they hold large blocs of the firm's stock), the legal process is distinctly inferior.

16. Rosenblatt v. Getty Oil Co., 493 A.2d 929, 943 (Del. 1985).

5

Corporate Control Transactions

The preceding chapters implicitly take "the firm" as a constant. Yet the only constant feature of corporate organization is change. Firms are in motion. They build new plants and enter or retreat from markets. They also change their own structure—setting up new divisions, entering or leaving markets, buying or selling plants, acquiring or being acquired, increasing and decreasing leverage, going public or private, selling stock or buying it back (generally or from particular investors). We call these changes "corporate control transactions."

Control transactions may make some investors rich while they leave others unaffected or poorer. For example, owners of controlling blocs may sell at a substantial premium, without any obligation to share the bounty with other shareholders. Firms may make "targeted" repurchases of shares, paying a premium to some investors while not offering the opportunity to others. Managers may arrange to take a corporate opportunity for themselves, with the consent of the directors, or may allocate an opportunity for a family of connected corporations to the firm that can make the most profitable use of it. Mergers set up in arm's-length bargaining may distribute the lion's share of the gain to one party, even though both parties to the merger are controlled by the same people.

Firms may alter internal structure and the structure of ownership as they please—or refuse to do so—subject only to the fiduciary standard. Managers who live up to the all-purpose duties of care and loyalty face few, if any, additional constraints. These doctrines, and the exceedingly limited judicial role they entail, have run into withering criticism from scholars demanding two kinds of change: an obligation to "share" the gains from corporate control transactions, and a prohibition against certain kinds of transactions. (Different critics put different transactions under the bans.)