

ARTICLE

OPTING ONLY IN: CONTRACTARIANS, WAIVER OF LIABILITY PROVISIONS, AND THE RACE TO THE BOTTOM

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ABSTRACT

This paper will test the core claim of scholars in the nexus of contracts tradition—that private ordering as a process of bargaining creates optimal rules. We do this by analyzing empirical evidence in the context of waiver of liability provisions. These provisions allow companies to eliminate monetary damages for breach of the duty of care through amendments to the articles of incorporation. With all states allowing some form of these provisions, they represent a good laboratory to examine the bargaining process between management and shareholders. The contractarian approach would suggest that shareholders negotiate with management to obtain agreements that are in their best interests. If a process of bargaining is at work as they claim, the opt-in process for waiver of liability provisions ought to generate a variety of approaches. Shareholders wanting a high degree of accountability would presumably not support a waiver of liability. In other instances, shareholders might favor them in order to attract or retain qualified managers. Still others would presumably want a mix, allowing waiver but only in specified circumstances.

Our analysis reveals that the diversity predicted by a private ordering model is not borne out by the evidence with waiver of liability provisions for Fortune 100 companies. All states permit such provisions and in the Fortune 100, all but one company has them. Moreover, they are remarkably similar in effect, waiving liability to the fullest extent

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permitted by law. In other words, one categorical rule was merely replaced by another, dealing a significant blow to the contractarian thesis.

INTRODUCTION

The contractarian¹ strain of corporate law scholarship treats corporations as a nexus of contracts, allocating rights and obligations to the various constituencies that make up the legal fiction that is the firm.² It eschews a “one size fits all” approach to regulation and instead favors the use of enabling provisions that allow companies to opt in or opt out. Unlike categorical rules imposed by the state, market actors can engage in private ordering and bargain for the most efficient arrangements.³ Contractarians argue that the state possesses no advantages vis-à-vis market actors in crafting rules of the game. To the extent that the state prescribes mandatory rules, they are likely to come with significant costs that could have been avoided had the parties been allowed to design their own rules.

Whatever the precise formulation of the view, contractarians, in the end, place an almost talismanic faith in private ordering and on the market as the final arbiter of efficiency. While private ordering will not ineluctably lead to greater efficiency, the market can be counted on to weed out the inefficient. In contrast, the inefficiencies arising from categorical rules are not susceptible to the same correction mechanism.

As a corollary to this approach, contractarians characterize the evolution of corporate law as a race to the top.⁴ Under state law, categorical rules have

1. Professor Bebchuk prefers to label them “deregulators” writing that calling them contractarians implies that their arguments are rooted in “the contractual view of the corporation.” Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1399 (1989) [hereinafter Bebchuk, *The Debate on Contractual Freedom*]. He points out that “deregulators do not have a monopoly over the contractual view.” *Id.*

2. The “nexus of contracts” concept apparently is first alluded to in Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310-11 (1976) (noting a “nexus of a set of contracting relationships”).

3. The rise of this view is generally traced to the University of Chicago and the law and economics movement. See Charles R.T. O’Kelley, *The Entrepreneur and the Theory of the Modern Corporation*, 31 J. CORP. L. 753, 755 (2006) (“Disciples of the Chicago School of Law and Economics controlled the agenda. Their swift rise to dominance coincided with the ascendancy in corporation law of a new hegemonic paradigm, founded on the view that the corporation is a nexus-of-contracts—a consensual ordering of relations generally to be governed by private ordering and not government regulation.”).

4. See Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 255-58 (1977). In an influential recent article, Professor Mark Roe refutes the state competition argument claiming that the possibility of federal intervention clouds a pure “race.” See Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588, 602-03 (2003).

gradually been replaced with enabling provisions, sometimes by transferring authority from shareholders to the board of directors, and sometimes through shareholder and board approval mechanisms. The system, therefore, allows companies to opt in or opt out of particular legal regimes, freeing managers to negotiate and engage in the most efficient arrangements.⁵

This Article examines an aspect of the contractarian approach to corporate law. The approach presupposes some ability of shareholders to “negotiate” with management to obtain agreements that are in the collective best interests of both groups. Presumably, the mechanism for asserting these interests in many cases is the ability to vote for or against a decision by management. This might occur, for example, where management can opt in or out of a regulatory regime through an amendment to the articles of incorporation. The need for shareholder approval would cause some companies not to seek the opt-in or opt-out authority and for others to limit the terms of the opt-in or opt-out regime in order to garner sufficient support. In other words, the regime would reflect “bargaining” between shareholders and management with the goal of achieving the most efficient relationship. If indeed some bargaining transpires between the competing interests, some degree of variance in practice would be expected.⁶

While bargaining between competing interests is plausible in theory, in reality the management domination of the approval process and the severe problems of collective action confronted by shareholders make it all but impossible.⁷ As a result, the process of management submitting matters to shareholders cannot accurately be characterized as bargaining in any meaningful sense of the term. It is management that drafts the proposal, management that has the authority to initiate the proposal, management that decides the most propitious moment to put forth the proposal, and management that has the corporate treasury at its disposal to ensure adoption of the proposal. Moreover, once passed, shareholders typically lack the authority to initiate repeal.⁸ The consequences are stark: once management obtains adoption, the provision remains in place, irrespective of the wishes of shareholders, until management decides to initiate a change.

This Article examines whether the core claim of contractarians—that private ordering as a process of bargaining creates optimal rules—is borne out by the empirical evidence in the context of waiver of liability provisions. These

5. See Bebchuk, *The Debate on Contractual Freedom*, *supra* note 1, at 1397 (“The primary function of corporate law, they suggest, should be to facilitate the private contracting process by providing a set of nonmandatory ‘standard-form’ provisions, with private parties free to adopt charter provisions that opt out of any of these standard arrangements.”).

6. This is not to say that an efficient result that applies equally to all companies and all kinds of shareholders and managements should not be replicated in all companies. But for this to happen, it must be shown that the uniform result is the most efficient arrangement possible in all or most situations. If such a uniformly efficient arrangement cannot be crafted, variance is inevitable.

7. Bebchuk, *The Debate on Contractual Freedom*, *supra* note 1, at 1411-12.

8. Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 835, 836 (2005).

provisions allow companies to eliminate monetary damages for breach of the duty of care through amendments to the articles of incorporation.⁹ With all states allowing some form of these provisions, they represent a good laboratory to examine the bargaining process between management and shareholders.¹⁰

The choice of waiver of liability provisions for study is particularly appropriate because they exemplify a contractarian approach to regulation. They were a reaction to purported problems created by a mandatory approach and allowed companies to opt out of a regime that imposed liability on managers for breach of the duty of care.¹¹ Moreover, as amendments to the articles, they require the assent of both managers and owners. The outcome, therefore, presumably results from negotiations between these two groups and ought to be a good example of private ordering by contract.

If a process of bargaining is at work as the contractarians claim, then the opt-in process for waiver of liability provisions ought to generate a variety of approaches. Shareholders wanting a high degree of accountability would presumably not support a waiver of damages. In other instances, shareholders might favor them in order to attract or retain qualified managers. Still other shareholders would presumably want a mix, allowing waivers only in specified circumstances.

In fact, as the analysis shows, none of the diversity predicted by a private ordering model appears in connection with waiver of liability provisions. They are permitted by every state and are used by all but one Fortune 100 company.¹² Moreover, they are remarkably similar in effect, waiving liability to the fullest extent permitted by law. In other words, one categorical rule was merely replaced by another, with no evidence that a categorical waiver of liability was any more efficient than a categorical rule imposing liability. At the same time, the change benefited management, suggesting that the motivation was not efficiency but self-interest of one of the groups involved. Moreover, whatever one might think about the benefits of private ordering and bargaining, the evidence suggests that it is not taking place in the waiver of liability context.

This Article briefly reviews the position of contractarians in the debate on the evolution of corporate law. The Article then examines the impetus for waiver of liability provisions which, contrary to claims, was not from the excesses of *Smith*

9. DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2006 & Supp. 2009).

10. Delaware originated the opt-in model, whereby companies could reduce liability by affirmatively amending their articles of incorporation. Indiana, some months earlier, adopted the first opt-out model, whereby the statute eliminated monetary damages for grossly negligent behavior by the board of directors but allowed companies to opt out of the regime in their articles of incorporation. See Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209, 221-22 (2006) [hereinafter Romano, *The States as a Laboratory*].

11. *Smith v. Van Gorkom*, 488 A.2d 858, 893, 898 (Del. 1985), overruled by *Gantler v. Stephens*, 965 A.2d 695, 713 n.54 (Del. 2009).

12. See Appendix, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1088414 (follow “download” hyperlink at top of page).

*v. Van Gorkom*¹³ but from a disguised attempt to pass along some of the costs of Directors and Officers' (D&O) insurance to shareholders. Thereafter the Article analyzes the waiver provisions actually adopted by the Fortune 100 to determine whether the variance predicted by the bargaining model has occurred. Finally, the piece ends with some observations and identifies some of the reforms necessary to implement a private ordering model.

I. A BRIEF EXEGESIS ON THE NEXUS OF CONTRACTS AND THE RACE TO THE BOTTOM

A widespread view in the academy is that corporations are best analyzed as a "nexus of contracts."¹⁴ As Professor Eisenberg notes, "[u]nder the nexus-of-contracts conception, the body of shareholders is not conceived to own the corporation. Rather, shareholders are conceived to have only contractual claims against the corporation."¹⁵ The corporation is created by a "nexus of reciprocal arrangements,"¹⁶ and the role of the law should be to facilitate this contracting process.¹⁷ Managers, owners, and others bargain for the most efficient relationships, which are ones that uniquely reflect the interests of the particular parties involved.

While recognizing that managers have self-interested motivations to pursue their aims at the expense of the shareholders, contractarians rely on the "invisible hand" to constrain such behavior.¹⁸ Investors will punish self-interested behavior

13. 488 A.2d 858 (Del. 1985), *overruled by* Gantler v. Stephens, 965 A.2d 695, 713 n.54 (Del. 2009).

14. William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 409 (1989). For a critical view, see Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1407-10 (1985).

15. Melvin A. Eisenberg, *The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 825 (1999).

16. *Id.* at 822. Professor Eisenberg writes that the nexus-of-contracts conception . . . neither can nor does mean what it literally says. In ordinary language, the term contract means an agreement. In law, the term means a legally enforceable promise. Pretty clearly, however, the nexus-of-contracts conception does not mean either that the corporation is a nexus of agreements or that it is a nexus of legally enforceable promises.

Id.

17. Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) [hereinafter Easterbrook & Fischel, *The Corporate Contract*] ("The corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy. No one set of terms will be best for all; hence the 'enabling' structure of corporate law.").

18. *Id.* at 1419 ("Managers may do their best to take advantage of their investors, but they find that the dynamics of the market drive them to act as if they had investors' interests at heart. It is almost as if there were an invisible hand.").

by discounting the securities issued by those companies, thus presenting an effective incentive for managers to act in ways that maximize shareholder welfare.¹⁹ Over a period of time companies having poor governance arrangements will be weeded out by the market, and those exhibiting optimal arrangements will thrive.²⁰ Contractarians, therefore, favor enabling provisions where parties can opt-in or opt-out and eschew the one-size-fits-all approach of categorical rules.²¹ Corporate law, in this framework, should merely provide a set of default rules.²²

The opposition to categorical rules has influenced the view of contractarians on the evolution of corporate law. The paradigmatic example is Delaware—where companies choose to incorporate there because of its expert judiciary,²³ sophisticated bar,²⁴ and a commitment to maintaining a climate for private ordering.²⁵ Contractarians view corporate law as a good that states are competing to supply and that companies choose because of the efficiency of the legal regimes offered. They characterize the predominance of companies incorporated in Delaware as a race to the top²⁶ rather than to the bottom.²⁷

19. *See id.*

20. *Id.*

21. *See generally* Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599 (1989); E. Norman Veasey, *The Stockholder Franchise is Not a Myth: A Response to Professor Bebchuk*, 93 VA. L. REV. 811, 825 (2007).

22. Easterbrook & Fischel, *The Corporate Contract*, *supra* note 17, at 1444-45. This begs the question as to why parties could not come up with their own arrangements in the absence of any demonstrably unique advantages that the state enjoyed in crafting such rules. Default rules could be crafted by private parties themselves. All that is required for the elimination of repeat drafting cost is that one party (or an industry group) publishes its draft, which can then be copied by all other parties to the extent that they are efficient. If corporate law's function is only to supply default rules, it would seem that it is of very little relevance. This would hardly explain the enormous expenditure of resources by state agencies in crafting them or of contractarians in studying them.

23. Veasey, *supra* note 21, at 817 (noting "Delaware's enabling statutory model, with a unique overlay of expert judicial case law").

24. *See id.*

25. This view was excoriated by William Cary over three decades ago, but it has been perniciously hard to displace. *See* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 701 (1974) ("[A] pygmy among the 50 states prescribes, interprets, and indeed denigrates national corporate policy as an incentive to encourage incorporation within its borders, thereby increasing its revenue.").

26. *See* Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 919-20 (1982); Ralph Winter, *Private Goals and Competition Among State Legal Systems*, 6 HARV. J.L. & PUB. POL'Y 127, 129 (1982).

27. There tends to be an all or nothing approach in discussing this issue. A race to the bottom may explain some corporate law reforms but certainly not all. *See generally* J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L.

With evidence mounting that Delaware's legislature was captured by management interests,²⁸ the race to the top theory has taken a beating.²⁹ The pro-management capture, has, for obvious reasons, maintained Delaware's preeminent position as the supplier of corporate law, despite copycat legislation from other states.³⁰ With Delaware resolutely engaging in an almost continuous process of eliminating categorical rules,³¹ the opportunities for private ordering have increased, and corporate law has inexorably moved away from the mandatory approach.³²

For a time, contractarians comfortably took an uncompromising view on the need for, and benefits from, enabling provisions.³³ Private ordering did not always have to result in a more efficient arrangement so long as the market stood poised to weed out those that were inefficient.³⁴ The contractarian universe

REV. 317 (2004) [hereinafter Brown, *The Irrelevance of State Corporate Law*]; Ralph K. Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526 (1989).

28. Delaware benefits financially from its pro-management bias. See Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1753-54 (2006). Professor Hamermesh writes that "[r]evenue from the state corporate franchise tax alone has in recent years constituted over twenty percent of the state's budget, a fact of which Delaware legislators are intensely aware." *Id.*

29. See William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1925-48 (1995); Roberta S. Karmel, *Is it Time for a Federal Corporation Law?*, 57 BROOK. L. REV. 55, 91-96 (1991).

30. One theory suggests that Delaware courts create indeterminacy in their case law as a strategic choice to make it difficult for other states to copy, which explains why it is not possible for other states to effectively compete with it. See Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1927-28 (1998); see also Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85, 112 (1990).

31. See the article by Delaware Chancellor William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993) (noting that the contractarian model is now the "dominant legal academic view"). The best example may be the elimination of the prohibition on discriminating among shareholders of the same class. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 (Del. 1985). Delaware was the first state to permit companies, in their charter, to waive liability for directors. For the international perspective on this, see ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD PRINCIPLES OF CORPORATE GOVERNANCE 20 (2004), available at <http://www.oecd.org/dataoecd/32/18/31557724.pdf> ("All shareholders of the same series of a class should be treated equally.").

32. Some have taken the position that the state law requirements are largely enabling, with the remaining categorical rules "trivial." See generally Bernard S. Black, *Legal Theory: Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990).

33. Contractarians relied upon the market, specifically hostile takeovers, for corporate control. For a criticism of this reliance, see generally J. Robert Brown, Jr., *In Defense of Management Buyouts*, 65 TUL. L. REV. 57 (1990).

34. Thus, even fiduciary duties should be subject to private ordering. See Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65

posited that those entering into inefficient arrangements would be penalized by the market through lower share prices.³⁵ The market for corporate control,³⁶ specifically hostile takeovers, would ensure that inefficient managers would be eliminated.³⁷ Thus, irrespective of the number of inefficient arrangements, only the efficient would survive.

The view was always simplistic. But in any event, the mechanism can no longer be relied upon to police the efficiency of arrangements arising out of private ordering. Hostile tender offers have disappeared from the landscape.³⁸ No longer able to show the ineluctable elimination of inefficient bargains, contractarians were forced to argue that the enabling approach in Delaware somehow resulted in greater aggregate efficiency. That is, while conceding that some managers and owners enter into inefficient arrangements, arrangements that would not necessarily be eliminated by market forces, the enabling approach, in the aggregate, produced more efficient behavior.³⁹

There is little evidence to support this sweeping conclusion. Some contractarians have pointed to a handful of event studies purporting to show that share prices increased upon reincorporation in Delaware.⁴⁰ This ostensibly

WASH. L. REV. 1, 32 (1990) [hereinafter Butler & Ribstein, *Opting Out of Fiduciary Duties*] (stating that “the fundamentally contractual nature of fiduciary duties means that they should be subject to the same presumption in favor of private ordering that applies to other contracts”).

35. See generally Brown, *supra* note 33.

36. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-14 (1965).

37. Of course, there is one substantial exception: contractarians did not favor broad managerial discretion in the area of antitakeover tactics. See Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target’s Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1201-03 (1981).

38. Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168, 1177-78 (1999) [hereinafter Bebchuk & Ferrell, *Federalism and Corporate Law*]; Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 890-91 (2002) [hereinafter Bebchuk et al., *The Powerful Antitakeover Force*].

39. Bebchuk et al., *The Powerful Antitakeover Force*, *supra* note 38, at 890-91.

40. See Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1781 (2002) [hereinafter Bebchuk et al., *Does the Evidence Favor State Competition*]. Some scholars attempt to show that particular categories of issuers benefit from incorporation in Delaware. For example, they argue that IPOs of Delaware companies receive increased valuation. See Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1571-72 (2002). But if it were that clear that incorporating in Delaware improved shares prices, all similarly situated companies would do so, and they do not. See Bebchuk et al., *Does the Evidence Favor State Competition*, *supra*, at 1789 (“While Daines’s study makes an impressive effort to control for as many parameters as possible, including type of business and firm size, it nonetheless remains true that if in a group of seemingly identical firms, some firms incorporate in Delaware and others do not, there must be omitted variables that produce this differential behavior. This is all the more true if it is supposed that one choice produces a

represented the market's judgment that Delaware's law was more efficient than the alternatives.⁴¹ The studies, however, do not make a strong case. The results are inconsistent⁴² and focus on short term results.⁴³ They do not offer a view on the long term impact.⁴⁴ They also conflict with the facts on the ground. To the extent re-incorporation results in a predictable increase in share prices, the impetus for engaging in the transaction ought to come from financial experts. In fact, the literature indicates that re-incorporations were promoted by lawyers, not investment bankers.⁴⁵ Finally, corporate law reform often has managerial self-interest at its core rather, than efficiency.⁴⁶

The debate over enabling versus categorical rules surfaced with a vengeance in the commentary surrounding the adoption of the Sarbanes-Oxley Act of 2002 (the Act) providing a judgment of sorts on the approach.⁴⁷ The Act summarily rejected the contractarian approach, adopting a host of categorical rules.⁴⁸ The

substantial increase in firm value and the other does not.”).

41. William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303, 327-29 (1997).

42. See Bebchuk et al., *Does the Evidence Favor State Competition*, *supra* note 40, at 1791-92 (“These six studies . . . present a rather mixed picture. Roberta Romano’s study, the earliest and most influential of the six, found a positive abnormal return of 4.18%. However, three of the subsequent five studies found abnormal returns in the vicinity of 1%, and two of the subsequent five studies, including the most recent event study which used the largest sample size, did not find an abnormal return that differed from zero in a statistically significant way.”) (footnotes omitted).

43. See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2384 n.76 (1998) [hereinafter Romano, *Empowering Investors*].

44. *Id.* Similarly, during the takeover era, the tendency was to note the short term value of acquisitions to the bidder (generally neutral) without attempting to assess the longer term impact. See Brown, *supra* note 33, at 87.

45. See Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 472 (1987) (stating that “the rules that Delaware supplies often can be viewed as attempts to maximize revenues to the bar, and more particularly to an elite cadre of Wilmington lawyers who practice corporate law in the state”).

46. Not all corporate law reforms are explainable as a product of the race to the bottom. See generally Brown, *The Irrelevance of State Corporate Law*, *supra* note 27. One reform that is explainable, however, is the widespread adoption of waiver of liability provisions. These provisions benefit management by including in the articles, a provision that eliminates monetary damages for breach of the duty of care. Nonetheless, in the last twenty years, a remarkably short period of time for legal reform, all fifty states put some type of reduced liability provision in place. While a possible example of “private ordering,” these provisions have become ubiquitous, suggesting that they are not in fact a result of individual negotiation. Moreover, even if a waiver were necessary to attract the most efficient management in a particular case, the provision applied to all subsequent managers. Thus, these provisions essentially result in shareholders indefinitely ceding away damages for mismanagement irrespective of the particular management involved.

47. Sarbanes-Oxley Act of 2003, 15 U.S.C. §§ 7201-7266 (2006). The Act preempts a number of state law provisions and imposes a series of mandatory requirements.

48. See generally J. Robert Brown, Jr., *Criticizing the Critics: Sarbanes-Oxley and Quack*

response was a fusillade of criticism and invective, with at least one scholar labeling the Act “quack corporate governance,”⁴⁹ a judgment offered hardly before the ink was dry.⁵⁰ Yet as the stock market hit record highs and the number of fraud actions fell, the evidence suggested that the categorical approach in fact improved the integrity of the capital markets.⁵¹

But the contractarian approach had an even greater fundamental problem in that it simply assumed the conditions necessary for private ordering. Proponents had little to say about the disparate bargaining positions of managers and owners, the problems of collective action and, most critically, the management’s monopoly to initiate the process of, or changes to, the opt-in or opt-out process.⁵² In other words, the opt-in or opt-out provisions did not allow private ordering.⁵³

II. PRIVATE ORDERING AND WAIVER OF LIABILITY PROVISIONS

A. Overview

Delaware became the first state to adopt an “opt-in” approach to waivers of liability in 1986.⁵⁴ The provision allowed companies to insert into their articles of incorporation provisions that waived monetary damages for breaches of the duty of care.⁵⁵ These provisions had to be approved by both directors and shareholders, presumably giving rise to a bargaining process.

Corporate Governance, 90 MARQ. L. REV. 309 (2006).

49. See generally Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

50. These criticisms are discussed and largely dismissed. Brown, *supra* note 48, at 309.

51. See Stanford Law School Securities Class Action Clearinghouse, <http://securities.stanford.edu/> (last visited Feb. 25, 2009) (reporting a ten-year low in the number of securities fraud suits brought in 2006). The number of suits increased in 2007 but still represented the third lowest total since the adoption of the Private Securities Litigation Reform Act (PSLRA) in 1995. *Id.*

52. See Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U.L. REV. 489, 492 (2002) [hereinafter Bebchuk & Hamdani, *Optimal Defaults*] (“To be sure, a charter amendment requires a vote of shareholder approval. Such votes, however, take place only on amendments initiated by management. Management thus has an effective veto power over charter amendments. As a result, for any level of shareholder support, corporations are much more likely to adopt amendments management favors than amendments management disfavors.”).

53. This may be a result of what Professor Bebchuk calls “network externalities.” Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 890 (2005).

It is advantageous for a company to offer an arrangement that is familiar to institutional investors, that facilitates pricing relative to other companies, that is backed by a developed body of precedents and judges familiar with the arrangement. Conversely, companies are discouraged from adopting arrangements that are unconventional and radically different from those in other companies.

Id.

54. See DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2006 & Supp. 2009).

55. See *id.*

The provisions replaced a categorical rule with an enabling provision, the very sort of arrangements contractarians favor.⁵⁶ Enabling provisions permitted private ordering, facilitating greater efficiency.⁵⁷ By requiring shareholder and management approval, the contractarian thesis would predict a multitude of variations in waiver of liability provisions, each designed to promote efficiency.⁵⁸

As the data shows, these “benefits” have not materialized. There has been no evidence of bargaining and no evidence of true private ordering. Instead, one categorical rule has merely replaced another. In other words, the empirical evidence shows implementation of a “one-size-fits-all” approach, the very thing that contractarians vehemently oppose.⁵⁹ The only difference is that the new

56. Ann E. Conaway Stilson, *Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors’ Duties to Creditors*, 20 DEL. J. CORP. L. 1, 7 n.16 (1995) (“Accordingly, contractarians support enforcement of corporate provisions which eliminate or restrict managerial duties and liabilities.”); see also Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1781-82 (2001).

57. See Henry N. Butler & Larry E. Ribstein, *The Contract Clause and the Corporation*, 55 BROOK. L. REV. 767, 776 (1989) [hereinafter Butler & Ribstein, *The Contract Clause*] (“Corporate terms are, in fact, efficiently priced in these markets. It follows that improving the terms of a corporate contract—by adding or deleting fiduciary duties where appropriate—will positively affect the price of the corporation’s securities. This gives a control purchaser the opportunity to profit by changing the terms of the contract.”).

58. As Roberta Romano has said:

State law is an enabling approach. It is a set of default rules. Sometimes firms opt out of them and sometimes they opt in, and I think that reflects the essential variation in firms about what they think is the best governance structure, the best Board of Directors for each firm, so we tailor it.

Transcript of Roundtable Discussions Regarding the Federal Proxy Rules and State Corporation Law at 26, Securities and Exchange Commission (2007), available at <http://www.sec.gov/spotlight/proxyprocess/proxy-transcript050707.pdf>; see also Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1272 (1999) (“Stated another way, from a nexus-of-contracts perspective, because firms consist of a complex web of contractual relationships, firm behavior depends critically on what those contracts provide. In turn, the contract provisions themselves depend on the outcome of the bargaining process that takes place between the contracting parties.”).

59. The numbers here are too great to cite thoroughly. Suffice it to say that it is the view of Stephen Bainbridge at UCLA. See Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 891 n.177 (1997) (book review) (“As such, a one-size-fits-all state-sanctioned code of behavior cannot fit everyone and may not fit anyone.”); Stephen M. Bainbridge, *Corporate Decisionmaking and the Moral Rights of Employees: Participatory Management and Natural Law*, 43 VILL. L. REV. 741, 775 (1998) (“As a result, legislative action is likely to take on a one-size-fits-all approach, which in turn is unlikely to fit anyone.”); see also Henry N. Butler, *Smith v. Van Gorkom, Jurisdictional Competition, and the Role of Random Mutations in the Evolution of*

categorical rule favors managers over shareholders.

Further, it is arguable that the waiver of liability provision is not in the nature of a default rule at all. As Professor Eisenberg notes, “[t]he standard methodology for establishing the content of a default rule is that the rule should have the content that the affected parties would have agreed upon if they had costlessly negotiated on the matter.”⁶⁰ If this is indeed the test of a default rule, it would be strange to suppose that shareholders would negotiate with management to absolve directors of liability for breaches of their fiduciary duties. If the rule was that directors were personally liable for breaches of the duty of care, but the more efficient rule was that they should not be personally liable, the parties would contract around the rule to reach a more efficient outcome. Bargaining around the rule can only occur when transaction costs are low. If the transaction costs are high, then the parties would be forced to live with the inefficient categorical rule imposing personal liability. In such scenarios, a default rule absolving directors of personal liability would make sense.

Would such a rule be more efficient? Shareholders would sue directors individually or jointly, and shareholders could elect to sue those with the deepest pockets. These directors would have to sue the others for contribution. In this circumstance, individuals with significant personal resources would decline directorships so the board would be comprised of individuals with little or nothing at stake, possibly even by individuals who are in serious debt. Personal liability is of little avail because a successful shareholder would collect nothing. Furthermore, if personal liability were the rule, even good candidates who are mired in debt might shirk directorships, which would uninjure shareholders by forcing them to accept less than ideal candidates as directors.

Waiver of liability is clearly not the only option. It is entirely possible to externalize some of these risks—whether it is by insurance, limitations of liability, or selective waivers. If true bargaining was at work, one would expect to see a range of these outcomes, with the most efficient being replicated. What we have, instead, is waiver of liability to the fullest extent allowed by the law.⁶¹ This leads to the conclusion that the provisions are pro-management categorical rules, rather than efficient default rules that the parties themselves might have designed had they been negotiating with low contracting costs. It is curious that contractarians have no problem with categorical rules when they are pro-management.

There is not any evidence that the new categorical rule results in greater efficiency. The provision was adopted not because of the reasoning in *Smith v. Van Gorkom*,⁶² at least not overtly. Instead, the perceived “crisis” in D&O

Corporate Law, 45 WASHBURN L.J. 267, 277 (2006); Butler & Ribstein, *Opting Out of Fiduciary Duties*, *supra* note 34, at 46; Romano, *Empowering Investors*, *supra* note 43, at 2427-28.

60. Eisenberg, *supra* note 15, at 833.

61. See, e.g., Dell Inc., Restated Certificate of Incorporation, http://public.thecorporatelibrary.net/charters/cha_13349.htm (last visited Mar. 9, 2009).

62. 488 A.2d 858 (Del. 1985), *overruled by* *Gantler v. Stephens*, 965 A.2d 695, 713 n.54 (De. 2009).

insurance, something that was well in process long before the court opted to enforce the duty of care, induced the change. In other words, the ostensible reason for waiver of liability provisions was to intervene in the market for D&O insurance, presumably to lower the costs. There was no evidence that the approach taken by the Delaware legislature was necessary, would have any significant impact on the market for D&O insurance, or was likely to result in greater efficiency than allowing for the inevitable market correction. In fact, almost as the ink dried on the legislation, the D&O “crisis” ended.⁶³ At the same time, while having little or no impact on D&O insurance, the provisions benefited managers by reducing their exposure to liability.

B. Waiver of Liability: An Exegesis

D&O insurance had, by the 1980s, become a fixture in the corporate board room. As the decade opened, however, a “crisis” occurred.⁶⁴ In renewing their policies, companies often found that the costs had risen sharply, the exclusions had increased, and the amount of coverage was reduced.⁶⁵ There were various reasons for the crisis, including traditional cycles that affected all types of commercial insurance.⁶⁶

63. Even Romano acknowledges that by “late 1987, the D & O insurance market was no longer in turmoil.” Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1156 (1990) [hereinafter Romano, *Corporate Governance*].

64. Some have questioned whether “crisis” is an appropriate term, at least with respect to the allegations that the shifts in the insurance market affected the pool of qualified candidates willing to serve on the board. See Elizabeth A. Nowicki, *Not in Good Faith*, 60 SMU L. REV. 441, 478-79 (2007).

65. See Dennis J. Block et al., *Advising Directors on the D&O Insurance Crisis*, 14 SEC. REG. L.J. 130, 130-31 (1986) (“The market for directors and officers . . . liability insurance is currently in a state of crisis. Premiums are skyrocketing, deductibles are increasing at an extraordinary rate, coverage is shrinking, and more and more insurance companies are terminating their D&O programs. At the same time, policy durations are becoming shorter, and the policies themselves have an increasing number of exclusions.”) (footnotes omitted); see also Michael D. Sousa, *Making Sense of the Bramble-Filled Thicket: The “Insured vs. Insured” Exclusion in the Bankruptcy Context*, 23 EMORY BANKR. DEV. J. 365, 375 (2007) (“For example, 50% of the corporate respondents to a survey released in 1987 and conducted by the actuarial and insurance consulting firm the Wyatt Company reported that their directors and officers liability insurance premiums had been recently increased by 300% or more; 27% of the respondents reported deductibles increased by 300% or more; and 27% of the respondents reported that their maximum coverage had been reduced by 50% or more.”).

66. In hindsight, it is clear that the insurance market goes through periodic boom and bust cycles, and a bust cycle occurred during this time period. See Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors’ & Officers’ Liability Insurance Market*, 74 U. CHI. L. REV. 487, 507 (2007) (“The D&O insurance market went through this ‘hard’ phase in the mid-1980s and again in 2001-2003. More recently, the D&O insurance market has been shifting to the ‘soft’ phase.”) (footnotes omitted). These boom and bust cycles are “correlated” with other business cycles. *Id.* at 506.

One development that did not explain the “crisis,” however, was the Delaware Supreme Court’s decision in *Van Gorkom*. For much of this century, the duty of care in Delaware led, what one commentator labeled, a “humble existence.”⁶⁷ However, “comatose” was perhaps a more apt description. Delaware courts simply did not find violations of the duty of care. Directors confronted little or no risk of liability for ordinary business decisions. Only suits alleging conflicts of interest had any realistic hope of success.⁶⁸

This placid state of affairs was disrupted by the Delaware Supreme Court’s decision in *Smith v. Van Gorkom*.⁶⁹ The court found the business judgment rule inapplicable to an “uninformed” board.⁷⁰ The directors found themselves in the unusual position of having to show the fairness of the transaction in which they received no personal benefit. The case ultimately settled for more than \$23 million,⁷¹ an amount paid not by the directors but by Jay Pritzker, the acquirer, and the D&O insurance policy.⁷²

67. Stephen J. Lubben & Alana Darnell, *Delaware’s Duty of Care*, 31 DEL. J. CORP. L. 589, 590 (2006).

68. Delaware courts are still unwilling to find violations of the duty of care. In the period 1980 until 2004, research uncovered only five derivative and twelve direct actions against outside directors that went to trial. Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1064-66 (2006).

69. 488 A.2d 858 (Del. 1985), *overruled by* *Gantler v. Stephens*, 965 A.2d 695, 713 n.54 (Del. 2009).

70. *Id.* at 889. The directors of Trans Union appeared beholden and under the influence of Van Gorkom, who wanted the merger approved so that he could sell his interest before retiring. *See id.* at 865-66, 869. The case was not brought under the duty of loyalty because Van Gorkom got a benefit shared by the other stockholders, a Delaware crafted exception. *Id.* at 872-73. As two commentators noted before the case was decided, “courts have proven remarkably reluctant to impose liability where no element of self-dealing or personal benefit was present.” John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 317 (1981).

71. *See* Stephen A. Radin, *The Director’s Duty of Care Three Years After Smith v. Van Gorkom*, 39 HASTINGS L.J. 707, 719 (1988) (“The court accordingly remanded the case for a determination of the fair value of the Trans Union shares at the time of the board’s decision, and for an award of damages to the extent that the fair value exceeded \$55 per share. The case was settled prior to such a determination for \$23.5 million, amounting to approximately \$1.87 per share. The settlement was conditioned upon a \$10 million payment by either Trans Union’s or the individual directors’ insurance carrier; most of the remaining \$13.5 million was contributed by the Pritzker company that had acquired Trans Union.”) (footnotes omitted).

72. *Id.*; *see also* Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom after Van Gorkom*, 41 BUS. LAW. 1, 1 n.a1 (1985) (editor’s note) (“[A]n agreement was reached to settle the Van Gorkom litigation by the payment of \$23.5 million to the plaintiff class. Of that amount, a reported \$10 million, the policy limit, is to be provided by Trans Union’s directors and officers liability insurance carrier. Although the group which acquired Trans Union in the disputed acquisition was not a defendant, according to a newspaper account nearly all of the \$13.5 million balance will be paid by the acquiring group on behalf of the Trans Union defendant directors.”);

The decision drew an outcry from corporate America⁷³ and fueled loud criticism.⁷⁴ Some complained that the case applied a negligence rather than gross negligence standard, a characterization hard to justify on the facts.⁷⁵ Others saw dire consequences, asserting that qualified persons would be unwilling to serve as directors of public companies.⁷⁶ Law and economics scholars denounced the categorical nature of the decision.⁷⁷

In fact, the criticisms were overwrought. There was little chance that *Van Gorkom* would presage a broad reexamination of, or change in, the duties of directors. For one thing, the case was decided by a 3-2 margin,⁷⁸ a departure from the usual display of unanimity in fiduciary duty cases. For another, the case involved a pseudo-loyalty claim, which perhaps explained the heightened scrutiny.⁷⁹ Third, the threatened uncertainty was exaggerated.⁸⁰ The case made

see also Black et al., *supra* note 68, at 1067 (“The settlement was for \$23.5 million, which exceeded Trans Union’s \$10 million in D&O coverage. The public story is that the acquirer, controlled by the Pritzker family, voluntarily paid the damage award against the directors, and the Pritzkers asked only that each director make a charitable contribution equal to ten percent of the damages exceeding the D&O coverage (\$135,000 per person).”).

73. *See* Sarah Helene Duggin & Stephen M. Goldman, *Restoring Trust in Corporate Directors: The Disney Standard and the “New” Good Faith*, 56 AM. U. L. REV. 211, 231 (2006) (“The court’s decision shook the foundations of the corporate world.”); Fred S. McChesney, *A Bird in the Hand and Liability in the Bush: Why Van Gorkom Still Rankles, Probably*, 96 NW. U. L. REV. 631, 631 (2002) (“Considered a legal disaster in 1985, it is judged no less disastrous today.”) (footnote omitted).

74. *See, e.g.*, Radin, *supra* note 71, at 707-08.

75. *See* Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1445 (1985) [hereinafter Fischel, *The Business Judgment Rule*]; Manning, *supra* note 72, at 1.

76. The “evidence” was almost entirely anecdotal. *See* Faye A. Silas, *Risky Business: Corporate Directors Bail Out*, 72 A.B.A. J. 24, 24 (June 1986). A study during the period by Korn/Ferry reported that twenty percent of “companies reported that qualified candidates had refused an invitation to serve as directors in 1985.” *Id.* Thus, for example, two prominent lawyers in Delaware justified the state’s waiver of liability provision in part because of the difficulty companies were having attracting qualified candidates to the board. *See* R. Franklin Balotti & Mark J. Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5, 18 (1987). Their support? *Id.* at 9 n.18 (citing Laurie Baum & John A. Byrne, *The Job Nobody Wants*, BUS. WK., Sept. 8, 1986, at 56; *Business Struggles to Adopt as Insurance Crises Spreads*, WALL ST. J., Jan. 21, 1986, at 31; WALL ST. J., Aug. 26, 1986, at 32.).

77. Fischel, *The Business Judgment Rule*, *supra* note 75, at 1455 (labeling decision as “one of the worst decisions in the history of corporate law”).

78. *Smith v. Van Gorkom*, 488 A.2d 858, 893, 898 (Del. 1985), *overruled by* *Gantler v. Stephens*, 965 A.2d 695, 713 n.54 (Del. 2009).

79. *Id.* at 874 (“The directors (1) did not adequately inform themselves as to Van Gorkom’s role in forcing the ‘sale’ of the Company and in establishing the per share purchase price. . . .”). The sale to Pritzker was engineered by Van Gorkom, the CEO of Transunion. *Id.* at 866-67. Stepping down as CEO and chairman, Van Gorkom wanted to sell the company as a way of cashing

no new law,⁸¹ did not second guess the board, and relied on a relatively objective element of the business judgment rule.⁸²

Most importantly, the decision arose in Delaware.⁸³ There was no reason to believe that a decision perceived as anti-management would somehow become a mainstay of the corporate governance process. Indeed, Delaware courts quickly isolated the decision and limited its impact.⁸⁴

Van Gorkom created consternation in the boardroom but did not significantly contribute to the D&O insurance crisis, which was already well underway.⁸⁵

out his large ownership interest. *Id.* at 865-66. Because, however, he was to receive a benefit in the sale that was shared by all stockholders, the Delaware courts categorically excluded consideration under the duty of loyalty. *See* *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 722 (Del. 1971).

80. Instead, the decision merely required that the file contain sufficient paper to support the decision, often in the form of a fairness opinion. *See* Andrew Ross Sorkin, *Mergers: Fair Should Be Fair*, N.Y. TIMES, Mar. 20, 2005, at 36.

81. The court repeated that shareholders had the burden of overturning the presumption of the business judgment rule and that the applicable standard was gross negligence. *See* Dennis R. Honabach, *Smith v. Van Gorkom: Managerial Liability and Exculpatory Clauses—A Proposal to Fill the Gap of the Missing Officer Protection*, 45 WASHBURN L.J. 307, 322 (2006) (“In short, despite the hysteria of the moment, directors were no more at risk after *Van Gorkom* than they ever were before.”); *see also* Morton Moskin, *Trans Union: A Nailed Board*, 10 DEL. J. CORP. L. 405, 406 (1985) (“The *Trans Union* court did not depart from the established rules.”).

82. *See* Mark J. Lowenstein, A. Fleischer, Jr., G. Hazard, Jr., and M. Klipper, *Board Games*, 15 DEL. J. CORP. L. 135, 138 (1990) (book review) (“The lasting practical effect of *Smith* may be, at best, that directors more carefully document the reasons that they proceeded as they did. Corporate counsel are likely to integrate the teachings of *Smith* in their standard advice for corporate board meetings to remove any doubt that the board action was properly approved. One cannot conclude from *Smith* that directors will exercise greater control over senior management or more independence from it. The real question following *Smith* is whether the courts will cut through this formalism when director action is challenged and the board can demonstrate the due deliberation called for by *Smith*.”) (footnote omitted).

83. *See* Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 647 (2004) (“Although *Van Gorkom* raises the specter of potentially limitless personal liability for directors, the decision was an aberration in Delaware jurisprudence and has been almost uniformly criticized. No subsequent Delaware decision has premised director liability on a breach of the duty of care.”) (footnotes omitted).

84. *See* Rachel A. Fink, *Social Ties in the Boardroom: Changing the Definition of Director Independence to Eliminate “Rubber-Stamping” Boards*, 79 S. CAL. L. REV. 455, 487 (2006) (“Similarly, the Delaware Supreme Court weakened the stringent *Unocal* and *Revlon* duties through subsequent decisions, just as it had done after the first wave of proshareholder decisions.”) (footnote omitted).

85. *See* Honabach, *supra* note 81, at 324 (“The causes for the increased rates were multifold, but it became a popular, yet misguided, sport to point to the *Van Gorkom* decision as a major contributing cause.”). Thus, Romano notes that: “Many factors contributed to the market’s turbulence, including the expansion of directors’ liability. The most important case in this regard

Indeed, an argument could be made that, if anything, the case encouraged greater diligence by directors in the boardroom and should have reduced liability and the cost of coverage.⁸⁶ Nonetheless, it was no coincidence that waiver of liability provisions followed quickly in the aftermath of the decision.

C. Section 102(b)(7)

The consternation caused by *Van Gorkom* threatened Delaware's pro-management position. Not lost on the Delaware bar and legislature, the Council of the Corporation Law Section of the Delaware State Bar Association set to work on a legislative response. That Indiana passed a statute designed to reduce liability no doubt increased the pressure on Delaware to act.⁸⁷ Rejecting a number of other approaches,⁸⁸ the Council ultimately settled on what was to become Section 102(b)(7).⁸⁹ Relying on an "opt-in" approach, the provision

was a 1985 Delaware decision, *Smith v. Van Gorkom*." Romano, *The States as a Laboratory*, *supra* note 10, at 220 (footnote omitted). Given the reasons noted above, *see supra* notes 83-84 and accompanying text, and the fact that *Van Gorkom* was decided in 1985, only a year before the "crisis" ended, it is inaccurate to suggest that this decision played a significant role in the "crisis." Romano herself is forced to concede that "*Van Gorkom* was decided after the D & O crisis is thought to have begun, so it is best considered a contributing, rather than causal, factor for the market disruption." Romano, *The States as a Laboratory*, *supra* note 10, at 221 n.25.

86. See William T. Allen, *Ambiguity in Corporation Law*, 22 DEL. J. CORP. L. 894, 898 (1997) ("[C]ertainty . . . also creates the risk that agents—such as corporate management—might deploy such well-defined rules cleverly (and technically correctly), but with the purpose in mind not to advance long-term interests of investors, but to pursue some different purpose Thus, at least in that corner of contract law occupied by corporation law, clarity itself may be thought to be a qualified good, not an unqualified good.").

87. James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207, 1209 (1988) ("The first state to respond to the developments of the mid-1980s was Indiana, in April 1986, followed by Delaware in June.").

88. Balotti & Gentile, *supra* note 76, at 9 n.21 ("Among the proposals considered and rejected were amending § 145(b) to permit indemnification of judgments or amounts paid in settlement of derivative suits, amending § 145(g) to permit wholly-owned 'captive' subsidiaries to provide 'insurance' to the parent corporation, providing a statutory 'cap' for personal liability of directors, and providing an automatic statutory exemption from certain types of liability."). Other models were adopted in the early years. Roberta Romano has a thorough discussion of the development of these provisions. See Romano, *The States as a Laboratory*, *supra* note 10, at 220-23.

89. Support for the approach could only be found in a turn of the century case in England, upholding a charter provision waiving liability. See E. Norman Veasey et al., *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399, 403 (1987) ("The concept of a provision in the certificate of incorporation limiting or eliminating the liability of directors was not without precedent. Some scholars had suggested that the certificate of incorporation of Delaware corporations could be amended to limit or eliminate liability of directors without enabling legislation under existing law by analogy to trust law in an old English Chancery decision that appeared to sanction a corporate charter provision limiting

authorized companies to insert into their articles a provision that essentially allowed for the waiver of monetary damages against the board for violations of the duty of care.⁹⁰ In other words, companies could absolve their directors for grossly negligent behavior.⁹¹

Despite the temporal proximity to *Van Gorkom*, the legislative history of the provision indicated that the impetus was the “crisis” in the D&O insurance market:

Section 102(b)(7) and the amendments to Section 145 represent a legislative response to recent changes in the market for directors’ liability insurance. Such insurance has become a relatively standard condition of employment for directors. Recent changes in that market, including the unavailability of the traditional policies (and, in many cases, the unavailability of any type of policy from the traditional insurance carriers) have threatened the quality and stability of the governance of Delaware corporations because directors have become unwilling, in many instances, to serve without the protection which such insurance provides and, in other instances, may be deterred by the unavailability of insurance from making entrepreneurial decisions. The amendments are intended to allow Delaware corporations to provide substitute protection, in various forms, to their directors and to limit director liability under certain circumstances.⁹²

Aware that the “crisis” was economic in nature (reflecting increased costs of insurance), the legislature attempted to link the reform to improved governance. Waiver of liability provisions would ensure a steady supply of qualified directors.⁹³

liability.”). The Chancery case mentioned is *In re Brazilian Rubber Plantations and Estates, Ltd.*, (1911) 1 Ch. 425.

90. DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2006 & Supp. 2009). The provision allowed companies to “eliminate or limit personal liability of . . . directors . . . for violations of a director’s fiduciary duty of care.” Commentary on Section 102(b)(7), S. 533, 133d Gen. Assembly 2, 65 Del. Laws ch. 289 (1986).

91. Veasey et al., *supra* note 89, at 402 (“In essence, the new legislation permits a corporation, by a provision in its certificate of incorporation, to protect its directors from monetary liability for duty of care violations, i.e., liability for gross negligence.”).

92. Balotti & Gentile, *supra* note 76, at 9 (quoting the synopsis accompanying Senate Bill No. 533, proposing the legislative amendments); *see also* Leo Herzl, *Relief For Directors*, FIN. TIMES (London), July 17, 1986, § 1, at 11 (“The immediate cause for the enactment of the new Delaware statute is a sharp change, adverse to directors, in the market for director and officer (D and O) liability insurance.”).

93. Herbert S. Wander & Alain G. LeCoque, *Boardroom Jitters: Corporate Control Transactions and Today’s Business Judgement Rule*, 42 BUS. LAW. 29, 40 n.57 (“The Delaware legislature has responded to the increased judicial scrutiny of the boardroom (particularly the *Van Gorkom* decision) and to the dramatic reductions in available directors’ and officers’ liability insurance.”); *see also* Duggin & Goldman, *supra* note 73, at 231-32 (“The legislative history of the

The rationale was suspect, solving a problem in the D&O insurance market that either did not exist or could have been more appropriately corrected by the market.⁹⁴ First, it presupposed that the insurance “crisis” resulted from an increased risk of liability⁹⁵ under the duty of care, an unproven assumption at the time⁹⁶ that ultimately proved incorrect.⁹⁷ Second, there was every reason to

statute is sparse, but it is clear that the legislature’s objective was to undo a decision that many believed would discourage qualified people from serving as corporate directors.”); James L. Griffith, Jr., *Director Oversight Liability: Twenty-First Century Standards and Legislative Controls on Liability*, 20 DEL. J. CORP. L. 653, 688 (1995) (“Most commentators attribute enactment of section 102(b)(7) to the Delaware Supreme Court’s decision in *Smith v. Van Gorkom*. There is no direct evidence in the legislative history to support such a contention. Rather, the General Assembly seemed concerned that director and officer insurance was becoming unavailable and, as a result, the best directors would not serve on the boards of Delaware corporations.”) (footnotes omitted).

94. David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491, 497 (2004) (“Delaware did not become the center of American corporate law by ignoring the needs and worries of corporate directors.”).

95. The number of law suits against directors apparently doubled between 1974 and 1984. Romano, *Corporate Governance*, *supra* note 63, at 1158; *see also* Griffith, *supra* note 93, at 688 n.210 (“First, the market was probably already in the early stages of an unavailability crisis, as government regulation was on the rise, and government and private lawsuits were around every corner.”).

96. Premiums began to escalate even before the Delaware Supreme Court’s decision in *Van Gorkom*. *See* Griffith, *supra* note 93, at 688 n.210. Yet oddly, Romano notes that the D&O insurance market had “changed dramatically” by 1984, with “premiums skyrocketing at the same time that coverage was shrinking and deductible increasing.” Romano, *The States as a Laboratory*, *supra* note 10, at 220. She notes that “many factors” contributed to this increase, “including the expansion of directors’ liability” and describes *Van Gorkom* as “[t]he most important case in this regard.” *See id.* However, *Van Gorkom* was decided in 1985, after the dramatic change, and even Romano acknowledges that the crisis had largely passed by 1986, shortly after the decision was rendered. *See id.* at 221 n.25 (“It should be noted that *Van Gorkom* was decided after the D&O crisis is thought to have begun, so it is best considered a contributing, rather than causal, factor for the market disruption.”).

97. During the period, for example, the costs of insurance increased for other types of liability, which suggests that the problem was industry-wide. Romano, *Corporate Governance*, *supra* note 63, at 1161 (“D & O insurers did not respond to the enactment of limited liability statutes by lowering premiums, although the vast majority of corporations that had the opportunity to opt for these new regimes did so.”); *see also* Roberta Romano, *What Went Wrong with Directors’ and Officers’ Liability Insurance?*, 14 DEL. J. CORP. L. 1, 31-32 (1989) [hereinafter Romano, *What Went Wrong*] (“Insurers did not respond to the enactment of these statutes by reducing 1987 policy rates, although many firms acted immediately to amend their charters.”). Romano, who clearly favored the provisions, came up with two possible explanations. “First, the statutes in most states do not exempt from liability claims for breach of the duty of loyalty, violation of federal securities laws, and breach of the duty of care by directors who are also officers.” Romano, *Corporate Governance*, *supra* note 63, at 1161. In other words, *Van Gorkom* and the duty of care had little

believe that the problem would be short-lived,⁹⁸ with the market, in time, establishing a new equilibrium.⁹⁹ In fact, by 1987, the “crisis” was largely over.¹⁰⁰

The purported concern over corporate governance was never established. While some anecdotal “evidence” indicated a growing number of resignations,¹⁰¹ the evidence was never marshaled to show that this resulted from problems in the D&O insurance market or that adequate replacements were unavailable.¹⁰² Indeed, some of the evidence suggested that directors quit not because of a threat of liability but because, in the aftermath of *Van Gorkom*, they had to work harder.¹⁰³ Moreover, even if the pool had declined, companies had a ready mechanism for correcting the imbalance: increasing directors’ fees.¹⁰⁴

The adoption of waiver of liability amounted to an overbroad response to the purported concerns about “uncertainty” in the application of the duty of care. The issues arising out of *Van Gorkom* could have been addressed in a narrower fashion,¹⁰⁵ focusing, for example, on the basis for establishing an informed decision.¹⁰⁶ The provision, however, went beyond the purported problems created

impact on the D&O policies. “Second, and perhaps more important, the statutes’ effectiveness will depend on how courts interpret them.” *Id.*

98. As insurance companies proved better able to assess the risks associated with D&O insurance, premiums would presumably stabilize and additional carriers would enter the market. This is apparently what occurred. *See Romano, The States as a Laboratory, supra* note 10, at 221 n.25.

99. *See Baker & Griffith, supra* note 66, at 507 (“The tightening of underwriting standards accompanies a ‘hard market’ in which premiums and, after a lag, underwriting profits, rise. Increased underwriting profits, of course, spur competition, whether from new entrants or established companies seeking to increase market share, and competition leads to another ‘soft market’ of loosening of underwriting standards and declining profits. The process is described as cyclical because each market condition contains the seed to generate the other.”) (footnote omitted).

100. *See Romano, What Went Wrong, supra* note 97, at 2 (“The turbulent conditions in the D&O insurance market persisted until mid-1986, when the rate of cost escalation and capacity reduction declined. While many corporations reported having difficulty in securing D&O insurance coverage in 1986, only a small number failed to resolve the problem.”).

101. *Id.* at 1-2; *see also* Kristen A. Linsley, Comment, *Statutory Limitations on Directors’ Liability in Delaware: A New Look at Conflicts of Interest and the Business Judgment Rule*, 24 HARV. J. ON LEGIS. 527, 531 (1987) (noting that concern that qualified individuals would be unwilling to serve as directors after *Van Gorkom* led to enactment of Delaware’s Section 102(b)(7)).

102. For an excellent discussion of the paucity of data on this issue, *see* Nowicki, *supra* note 64, at 478-79.

103. *See* Silas, *supra* note 76, at 24.

104. *Id.*

105. The legislature could, for example, have increased the circumstances when directors could rely on the CEO or market price in making informed decisions.

106. For those companies putting in place a waiver of liability provision, actions seeking to impose liability for breach of the duty of care could be summarily dismissed. As the Delaware

by the decision, eliminating liability even in circumstances where no uncertainty existed.¹⁰⁷

In other words, the Delaware legislature adopted waiver of liability provisions to cure an insurance “crisis” that was short-lived, and likely structural, in order to prevent adverse consequences which were unproven for boards of directors. Rather than fix the perceived concerns with *Van Gorkom* through a narrowly tailored approach, Delaware’s legislature opted for an overbroad solution that exonerated directors for breach of the duty of care in all circumstances. In short, it was a provision designed less to solve a real governance problem and more to use the surrounding din as cover to reduce director liability.

Waiver of liability did not, therefore, restore the D&O insurance market. It did, however, restore Delaware’s pro-management position, something that had taken a beating in the aftermath of *Van Gorkom*. The “crisis” was little more than a cover for a substantial, pro-management change in fiduciary obligations.¹⁰⁸

Even as the insurance crisis dissipated, other states passed copycat legislation. By corporate law reform standards, the speed with which other states fell in line was nothing short of remarkable.¹⁰⁹ Within a few years of the new millennium,

Supreme Court noted in *Emerald Partners v. Berlin*, 787 A.2d 8 (Del. 2001),

unless there is a violation of the duty of loyalty or the duty of good faith, a trial on the issue of entire fairness is unnecessary because a Section 102(b)(7) provision will exculpate director defendants from paying monetary damages that are exclusively attributable to a violation of the duty of care.

Id. at 92; see Lubben & Darnell, *supra* note 67, at 591 (“We answer the first question by tracing the waning of the duty of care—a rule that now requires little more of a director than a ritualistic consideration of relevant data. Today, after the director engages in this ritual, her decision will not violate the duty. In short, the classic duty of care no longer exists in Delaware.”); see also Malpiede v. Townson, 780 A.2d 1075, 1096-97 (Del. 2001).

107. Thus, for example, the “best interests of shareholders” is met by any rational purpose. See, e.g., J. Robert Brown, Portnoy v. Cryo-Cell: *Vote Buying, Manipulation of the Voting Process, and the Race to the Bottom—The Last Word*, <http://www.theracetothetobottom.org/preemption-of-delaware-law/portnoy-v-cryo-cell-vote-buying-manipulation-of-the-voting-p-3.html> (Feb. 14, 2008, 06:15 MST).

108. Which at least, in part, explains why so many commentators continue to ascribe the reform to an attempt to overturn *Van Gorkom*. See Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 14 (2005) (“The passage of 102(b)(7), in other words, was the legislature’s affirmation of the principle that the judiciary would stay out of corporate governance, provided that the board did not behave disloyally or, as the statute added, in bad faith.”).

109. For at least some, the insurance crisis was the ostensible justification. See generally James J. Hanks, Jr., *State Legislative Responses to the Director Liability Crisis*, 20 REV. SEC. & COMMODITIES REG. 23 (Feb. 11, 1987). Eventually, that could no longer be the explanation. See Douglas M. Branson, *Recent Changes to the Model Business Corporation Act: Death Knells for Main Street Corporation Law*, 72 NEB. L. REV. 258, 271 (1993) (“Thus, in response to a temporary problem, a liability insurance crunch that had affected most forms of liability insurance, and not

all states had some version of waiver of liability.¹¹⁰ A modest number of states chose an “opt-out” approach, eliminating monetary damages for breach of the duty of care but allowing companies to reinstate damages through amendments to the articles.¹¹¹ The vast majority of states, however, followed the Delaware model and relied on an “opt-in” approach.¹¹²

What could be the reasons? Not the D&O insurance crisis; that was over.¹¹³ Not efficiency. Instead, the statutes were designed to prevent companies from moving to Delaware.¹¹⁴ Whatever Delaware’s motivation, other states adopted comparable provisions not because of improved governance or efficiency,¹¹⁵ but because the statutes benefited management and avoided re-incorporation, even though some evidence suggested harm to shareholder values.¹¹⁶

D & O coverage alone, most American legislatures let themselves be goaded into adopting a permanent change to bedrock common law.”) (footnote omitted).

110. Romano has reported that it took only fourteen years for forty-nine states to adopt some form of liability limitation. See Romano, *The States as a Laboratory*, *supra* note 10, at 224.

111. See *id.* at 222-23.

112. See *id.*

113. In time, however, even Delaware stopped using the insurance crisis as the justification. See William T. Allen et al., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 462-63 (2002) (“That statute, which was enacted in direct response to *Van Gorkom*, permits certificates of incorporation to contain a provision that exculpates directors from damages liability for breaches of the duty of care. That statute thus restored most of the liability protections afforded by a consistently applied gross negligence standard.”); see also *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1166 n.18 (Del. 1995) (stating that “[t]he statute was, in fact, a legislative response to [the Supreme Court of Delaware’s] liability holding in *Van Gorkom*”).

114. Romano, *The States as a Laboratory*, *supra* note 10, at 224 (“Commentaries by practitioners in several states refer to concern that firms would reincorporate if the state did not adopt a limited liability statute similar to the Delaware provision.”). Romano also contends that the provisions were adopted because of “the perceived insurance crisis.” *Id.* at 221. States that followed on the heels of Delaware could perhaps claim with a straight face that they acted in response to the perceived crisis. However, surely such a claim would be stretching credulity for those acting several years later.

115. Some have tried to argue that these provisions arose not out of self-interest, but efficiency. Roberta Romano notes that the provisions are “uniformly approved by shareholders” and that the evidence “suggests that investors find the Delaware approach attractive.” *Id.* at 224. Having the provisions, she surmises, is “consistent” with “attracting higher quality outside directors.” *Id.* at 224-25. Interestingly, she has apparently abandoned other rationale used in the past to argue that these provisions are really beneficial. See Romano, *Corporate Governance*, *supra* note 63, at 1156 (“But the most popular reform, limited liability statutes, most likely will prove to be beneficial for shareholders, by eliminating a class of lawsuits where insurance payouts defray legal costs rather than compensate shareholders, and any deterrent effect is quite problematic.”).

116. See generally Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care*

III. THE CORPORATE RESPONSE

The conclusion that Delaware authorized waiver of liability provisions to restore its pro-management reputation does not necessarily preclude a finding of increased efficiency.¹¹⁷ The Delaware model relied upon an opt-in approach, which theoretically allows owners and managers to bargain for the most efficient arrangements.

In practice, however, this has not been the case.¹¹⁸ The “opt-in” approach used by the Delaware statute places exclusive authority in the hands of management to institute a waiver of liability provision and to draft the appropriate language. Structured as amendments to the articles, only the board can initiate the change.¹¹⁹ The monopoly over initiation effectively bars shareholders from opting back into the default regime.¹²⁰ Management, therefore, can pick the most

Standard in Corporate Governance, 75 IOWA L. REV. 1 (1989) (discussing how legal rules and economic forces interact to facilitate corporate prosperity). See also Honabach, *supra* note 81, at 312 (“Some also believe that both the enactment of section 102(b)(7) and the individual corporate decisions to add an exculpatory provision to corporate charters resulted in a loss of shareholder value.”). As for attracting outside directors, there is simply no evidence that companies have trouble attracting these types of directors, with or without waiver of liability provisions. With expanded indemnification, D&O insurance (no more crisis there), and director fees that can run over a half a million dollars, it cannot be argued with a straight face that, absent waiver of liability, a large public company would have trouble obtaining enough qualified outside directors.

117. The repeal on size limits just before the turn of the nineteenth century may have arisen from self interest but resulted in improved efficiencies.

118. See McChesney, *supra* note 73, at 648-49 (“As shareholders confronted the implications of *Van Gorkom*, a second development was predictable. In the contractarian model, faced with a decision that swept away existing contracts between shareholders and their management, competing state legislatures would seek to restore the value-maximizing status quo ante. Delaware’s imposition of an inefficient law (one whose costs exceeded its benefits) created a profit opportunity for politicians in other states to install rules guaranteeing that *Van Gorkom* could not happen in their jurisdictions. That competition would force Delaware to mitigate the effects of the inefficient rule it created.”).

119. *But see* North Dakota Publicly Traded Corporations Act, N.D. CENT. CODE ANN. §§ 10-35-01 to -33 (Supp. 2007) (providing shareholders of public companies with the right to initiate amendments to the articles of incorporation).

120. See Bebchuk & Hamdani, *Optimal Defaults*, *supra* note 52, at 502 (“On most important issues, corporate law requires companies wishing to opt out of a default arrangement to do so by amending their charters. Charter amendments, in turn, require approval by shareholders representing a majority of the outstanding shares. Shareholders can only act, however, on the basis of proposals put forward by the board of directors. Shareholders can never initiate charter amendments, and the board thus enjoys a veto power over such amendments.”) (footnote omitted). This is critical. Even if management is eventually replaced, the new set of directors would presumably want to retain the waiver of liability provision and would, therefore, be unlikely to initiate an opt-out process. It should be noted that Pennsylvania allows the provision to be included in the bylaws which may permit shareholder initiation. See 15 PA. CONS. STAT. ANN. § 513 (West

propitious moment to make a proposal, and, once in place, shareholders cannot initiate repeal.¹²¹ Finally, as the proponent, it is management that drafts the language in the waiver provisions.¹²²

The adoption process, predictably, contains no element of bargaining or private ordering. Instead, it is a management-dominated process.¹²³ Given the benefits to management resulting from adoption, its control over the process, and the inability of shareholders to initiate repeal, it is difficult to see the opportunities for bargaining and private ordering.¹²⁴ Instead, one could reasonably predict that over time all companies would put these provisions in place¹²⁵ and all provisions would waive liability to the fullest extent permitted by law.¹²⁶

With these predictions in mind, let us turn to the empirical evidence. Many authors have already noted the popularity of waiver of liability provisions.¹²⁷ No

1995).

121. Bebchuk & Hamdani, *Optimal Defaults*, *supra* note 52, at 503 (“For our purposes, what is critical is only that there are impediments to reversing a default arrangement favored by managers and that such an arrangement thus might not be reversed even if the arrangement is value decreasing and the transaction costs of changing it are small. The problem is that default arrangements favoring managers are likely to ‘stick.’”).

122. See Rutheford B. Campbell, Jr., *Corporate Fiduciary Principles for the Post-Contractarian Era*, 23 FLA. ST. U. L. REV. 561, 585 (1996) (“Relatedly, one should not forget that managers control the process by which such opting out terms are constructed, implemented, and priced. Managers or their agents typically bear responsibility for drafting the opt-out provisions, and typically managers establish the process through which the corporation or the corporate constituencies ‘consent’ to the opt-out provisions.”).

123. Others have noted the problem with suggesting that a corporation is a nexus of contracts negotiated by the relevant parties. See Brudney, *supra* note 14, at 1412 (“It stretches the concept ‘contract’ beyond recognition to use it to describe either the process of bargaining or the arrangements between investors of publicly held corporations and either theoretical owners first going public or corporate management. Scattered stockholders cannot, and do not, negotiate with owners who go public (or with management—either executives or directors) over hiring managers, over the terms of their employment, or over their retention.”).

124. See Archer-Daniels-Midland Co., Definitive Proxy Solicitation Material (Form DEF 14A) (Sept. 25, 1996) (“RESOLVED: The shareholders of Archer Daniels Midland Company urge the Board of Directors to take such action as is necessary to provide for directors personal monetary liability for acts or omissions that constitute a breach of a director’s fiduciary duty of care resulting from gross negligence.”).

125. See McChesney, *supra* note 73, at 649 (“Shareholders have overwhelmingly responded to the opportunity by adopting the director-protecting charter amendments permitted by these new statutes. So has been restored the status quo ante in corporate law: virtually a zero-chance of liability for directors in duty-of-care cases.”).

126. Thus, for example, management with surly shareholders ready to oppose the provisions might wait until reincorporation when shareholders will be denied a straight up or down vote on the provision.

127. As commentators have noted: “According to one treatise, in the year after enactment of

one, however, has studied the phenomenon systematically.¹²⁸

We have chosen as the initial universe for examination the Fortune 100 in the United States.¹²⁹ Of that group, ninety-nine are incorporated under state law. Freddie Mac, a federally incorporated entity, is the only exception.¹³⁰ Of the remainder, sixty-five are incorporated in Delaware, five in New York,¹³¹ four in New Jersey,¹³² Minnesota,¹³³ and Pennsylvania,¹³⁴ three in Ohio,¹³⁵ Washington,¹³⁶ and North Carolina,¹³⁷ two in Illinois,¹³⁸ and Massachusetts,¹³⁹ and one in

the section, 4,206 charter amendments or restated certificates of incorporation containing director liability provisions were filed in Delaware. The 13,697 new certificates of incorporation were filed with these provisions.” Lubben & Darnell, *supra* note 67, at 600 n.74 (citing 1-6 Delaware Corp. L. & Prac. § 6.02 n.58 (2004)); *see also* Lawrence A. Hamermesh, *Why I Do Not Teach Von Gorkom*, 34 GA. L. REV. 477, 490 (2000) (finding that “[c]harter provision enabling statutes like Delaware’s section 102(b)(7), moreover, have been almost universally implemented by corporations to which such laws apply”).

128. *But see* Bradley & Schipani, *supra* note 116, at 62 (stating that of a sample of 593 Delaware firms “it appears that 94% (559/593) of Delaware firms amended their articles of incorporation in accordance with section 102(b)(7)”).

129. *Fortune 500: Our Annual Ranking of America’s Largest Corporations*, FORTUNE, Apr. 30, 2007, available at http://money.cnn.com/magazines/fortune/fortune500/2007/full_list/. For a list of the companies and the status of their waiver of liability provisions, see Appendix, *supra* note 12.

130. As of 2007, Freddie Mac was number 50 in the Fortune 100. The articles of incorporation for Freddie Mac are in the statute. *See generally* Federal Home Loan Mortgage Corporation Act, <http://www.freddiemac.com/governance/pdf/charter.pdf> (last visited Mar. 9, 2009).

131. N.Y. BUS CORP. LAW § 402 (McKinney 2003).

132. N.J. STAT. ANN. § 14A:2-7 (West 2003).

133. MINN. STAT. ANN. § 302A.251 (West 2004 & Supp. 2008).

134. 15 PA. CONS. STAT. ANN. § 513 (West 1995). Pennsylvania allows the provision to be included in the bylaws.

135. *See* OHIO REV. CODE ANN. § 1701.59(D) (West 1994 & Supp. 2008) (requiring clear and convincing proof “that the director’s action or failure to act involved an act or omission undertaken with deliberate intent to cause injury to the corporation or undertaken with reckless disregard for the best interests of the corporation.”). The provision does allow a corporation to opt out. *Id.* (“This division does not apply if, and only to the extent that, at the time of a director’s act or omission that is the subject of complaint, the articles or the regulations of the corporation state by specific reference to this division that the provisions of this division do not apply to the corporation.”).

136. WASH. REV. CODE ANN. § 23B.08.320 (West 1994).

137. N.C. GEN. STAT. ANN. § 55-2-02 (West 2000 & Supp. 2008).

138. 805 ILL. COMP. STAT. ANN. 5/2.10 (West 2004).

139. MASS. GEN. LAWS ANN. ch. 156B, § 13 (West 2005).

Virginia,¹⁴⁰ Maryland,¹⁴¹ California,¹⁴² and Wisconsin.¹⁴³

Some of these states do not require charter provisions to “opt-in” to the liability waiver. In such states, the corporate code raises the level of culpability necessary for the imposition of damages, with companies allowed to “opt-out.” This is true in Ohio and Wisconsin.¹⁴⁴ Virginia imposes a cap but also allows elimination of liability in the articles.¹⁴⁵ The rest (other than Freddie Mac) mimic the Delaware model, with some variations in language.¹⁴⁶

Among the non-federally incorporated, non-mutual companies,¹⁴⁷ only one, Pepsi Co., did not have a waiver of liability provision.¹⁴⁸ Pepsi was incorporated in Delaware in 1919 and re-incorporated in North Carolina in 1986.¹⁴⁹ The bylaws do provide for indemnification rights “to the full extent permitted by law.”¹⁵⁰

Our study of the articles of these companies shows that all waive liability to the maximum extent permitted by law. Several companies¹⁵¹ have a bare bones version of the clause containing the following language: “A director of the Corporation shall have no personal liability to the Corporation or its stockholders for monetary damages for breach of his fiduciary duty as a director to the full extent permitted by the Delaware General Corporation Law as it may be amended from time to time.”¹⁵² The others generally repeat the language in the statute, providing that directors shall not be liable for monetary damages with some listed exceptions. Some specifically reference recklessness, while others prohibit

140. VA. CODE ANN. § 13.1-870.1 (2006 & Supp. 2008)

141. MD. CODE ANN., CORPS. & ASS'NS § 2-405.2 (West 2002).

142. CAL. CORP. CODE § 204 (West 1990).

143. WIS. STAT. ANN. § 180.0828 (West 2002 & Supp. 2008). Like Ohio, Wisconsin permits a company to opt out of this provision.

144. See OHIO REV. CODE ANN. § 1701.59(D) (West 1994 & Supp. 2008); WIS. STAT. ANN. § 180.0828 (West 2002 & Supp. 2008).

145. See VA. CODE ANN. § 13.1-870.1 (2006 & Supp. 2008).

146. We have assembled the statutory provisions governing waiver of liability from all fifty states. See Appendix, *supra* note 12.

147. Four of the companies in the top 100 are mutual companies: Liberty Mutual Insurance Group, State Farm, Mass Mutual, and New York Life. At least one, however, has a waiver of liability provision in the bylaws. See Appendix, *supra* note 12.

148. Pepsico, Amended and Restated Articles of Incorporation, <http://www.pepsico.com/Investors/Corporate-Governance/Amended-and-Restated-Articles-of-Incorporation.aspx> (last visited Mar. 9, 2009).

149. See Pepsico, Our History, 1986, http://www.pepsico.com/Company/Our-History.aspx#1986.page_3 (last visited Mar. 9, 2009).

150. Pepsico, By-Laws, Article III, § 3.7, <http://www.pepsico.com/Investors/Corporate-Governance/By-Laws.aspx> (last visited Mar. 9, 2009).

151. These include Bank of America, Dow, Cisco, Exxon-Mobil, Boeing, Goldman Sachs, Hewlett-Packard, Home Depot, JP Morgan Chase, Newscorp, Sears, Time Warner, and Disney.

152. Countrywide Financial Corp., Quarterly Report (Form 10-Q), at 4 (May 7, 2004).

repeal.¹⁵³ With respect to liability for directors, none of the Fortune 100 purport to waive liability in some reduced fashion.¹⁵⁴

IV. ANALYSIS

What explains this curious uniformity? The data shows that one categorical rule has been replaced with another. While the old rule allowed for damages in the case of a breach of the duty of care, the adoption of an “opt-in” approach to monetary damages simply resulted in everyone opting in. The results show none of the diversity that private ordering predicted.¹⁵⁵

153. For example, Comcast’s clause states:

No person who is or was a Director shall be personally liable, as such, for monetary damages (other than under criminal statutes and under federal, state and local laws imposing liability on directors for the payment of taxes) unless the person’s conduct constitutes self-dealing, willful misconduct or recklessness. No amendment or repeal of this Article ELEVENTH. . . .

Comcast, Restated Articles of Incorporation of Comcast Corporation, <http://www.cmcsk.com/phoenix.zhtml?c=118591&p=irol-govArticles> (last visited Mar. 9, 2009).

154. In fact Dell’s articles of incorporation contain indemnity provisions in addition to waiving liability:

[The] corporation shall, to the fullest extent permitted by law, indemnify any and all officers and directors of the corporation, and may, to the fullest extent permitted by law or to such lesser extent as is determined in the discretion of the Board of Directors, indemnify any and all other persons whom it shall have power to indemnify, from and against all expenses, liabilities or other matters arising out of their status as such or their acts, omissions or services rendered in such capacities. The corporation shall have the power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the corporation would have the power to indemnify him against such liability.

Dell Inc., *supra* note 61.

155. The data is in contrast with evidence from a study of the charter provisions of companies listed on the Sydney Stock Exchange prior to the enactment of mandatory rules in 1936 conducted by Professor Whincop. See Michael J. Whincop, *An Empirical Analysis of the Standardisation of Corporate Charter Terms: Opting Out of the Duty of Care*, 23 INT’L REV. L. & ECON. 285, 285 (2003). He examined 150 charters and found that “[m]ost companies opt for a limited indemnity which does not extend to damages for negligence and adds little to the director’s ‘default’ indemnity rights.” *Id.* at 291. The evidence is markedly different from our results and shows that, given the variance, it might be reflective of some bargaining:

Liability releases are often qualified, but in standardised ways. The principal qualifications refer to “wilful default” or “dishonesty,” 43.3% of the charters are qualified by reference to wilful default; 39.3% refer to “dishonesty”; 6% refer to both in the alternative. Only three liability releases were unqualified and none of these

The data shows that companies do not opt-in in the waiver of liability context.¹⁵⁶ This is because of the difficulties imposed on shareholders who might want to engage in some type of negotiations. Thus, realities on the ground make change difficult despite the presence of activist shareholders. Many of these difficulties are systemic.

First, only management has the authority to propose an amendment to the articles of incorporation. Directors can pick the most propitious time to propose a matter to shareholders. The authority goes much further, however, than the power to propose. To the extent management perceives any prospect of losing a vote, it has a variety of tactics that it can deploy to affect the outcome. One example is *Mercier v. Inter-Tel (Del.), Inc.*,¹⁵⁷ where a special committee of the board sought approval of a merger.¹⁵⁸ When, shortly before the meeting, it became clear the proposal would fail, the committee authorized an adjournment.¹⁵⁹ This occurred despite overwhelming opposition to adjournment of the meeting from shareholders.

Second, waiver of liability provisions can be implemented without the benefit of a direct shareholder vote. The provisions may be in the articles when the company goes public.¹⁶⁰ In other cases, they may be inserted into the articles when the company re-incorporates, leaving shareholders with approving the entire transaction, not each individual provision in the articles. Waiver of liability provisions may also be approved in companies with controlling shareholders, making the opinions of the minority shareholders irrelevant.

Third, even when submitted for approval, shareholders confront the usual bevy of collective action problems.¹⁶¹ They lack information, often a

included the broadest form of release.

Id. at 292. The study did find, however, that “a minority of companies opt for a more expansive indemnity, wide enough to include liability for negligence, . . . [except] that the indemnity is not available where the liability arises from the director’s ‘wilful default.’” *Id.* at 291-92. Unlike the U.S. evidence, Professor Whincop finds that the Australian evidence shows that “terms contracting around the standard of care do not appear to be systematically unfair to stockholders. On the contrary, they are specifically directed to the areas where the imposition of liability seems least efficient (such as liability for business judgments and the defaults of other agents).” *Id.* at 307.

156. See data in Appendix, *supra* note 12 (showing uniformity).

157. 929 A.2d 786 (Del. Ch. 2007).

158. *Id.* at 798-99, 802-03.

159. *Id.* at 798-99.

160. Bebchuk & Hamdani, *Optimal Defaults*, *supra* note 52, at 499 (“At the IPO stage, the provisions of the charter are chosen by the party, or parties, (the ‘founder’) that takes the company public.”).

161. Bebchuk, *The Debate on Contractual Freedom*, *supra* note 1, at 1401 (“Although an amendment requires majority approval by the shareholders, voting shareholders do not have sufficient incentive to become informed. And although the amendment must be proposed by the board, the directors’ decision might be shaped not only by the desire to maximize corporate value but also by the different interests of officers and dominant shareholders.”).

consequence of rational apathy.¹⁶² To oppose management they would need to lobby other shareholders, which is both expensive and difficult due to the proxy rules.¹⁶³

Fourth, there are a number of reasons why shareholders are less likely to oppose waiver of liability provisions. One is the NIMBY phenomenon.¹⁶⁴ Another is path dependence.¹⁶⁵ Yet another is the “me-too” phenomenon, which occurs when one board has a waiver of liability provision to fall back on so every other board clamors for the same. With the provisions universally in place, shareholders would have to accept the consequences of denying the waiver to their management while all other large companies, including competitors, have the waiver in place.

Fifth, shareholders typically want to maintain positive relations with management, preferring to “vote with their feet” when dissatisfied. Thus, they will not oppose management on every proposal, even if they have reservations. In other words, opposition comes with costs attached. Given the insignificance of the duty of care under Delaware law, these costs likely outweigh the benefits that could result from opposition.¹⁶⁶

Directors might be made nervous by a provision that differs from those of

162. Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1574-75 (1989) (“A diffuse group of public shareholders must evaluate this claim against the possibility that the amendment is merely ‘wealth-neutral,’ because all or almost all of the gain inures to the insiders, or ‘wealth-reducing,’ because it will transfer cash flow or control from public shareholders to insiders. In these circumstances, shareholder voting as a means of evaluating and consenting to a proposed charter amendment is fraught with severe problems, in particular, collective action problems in acquiring and disseminating information among shareholders, and strategic behavior by insiders that amounts to economic coercion. Thus insiders can exploit their advantages to obtain approval even for wealth-reducing amendments.”) (footnote omitted).

163. Most of the provisions were adopted back in the 1980s and early 1990s, at a time when investor activism was not as developed.

164. NIMBY or “Not In My Back Yard” occurs when directors oppose attempts to remove waiver of liability provisions claiming that even if the idea is a good one, it is a reform that is not needed in their company.

165. See Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347, 349 (1996). Kahan and Klausner suggest that

corporate contract terms can frequently offer “increasing returns” as more firms employ the same contract term. Value arises from the common use of a contract term . . . [A]s the use of a term increases, it becomes significantly more attractive (at least up to a critical point), and its attraction becomes self-perpetuating.

Id. at 348 (footnote omitted). This results in standardization which is “a form of path dependence.” *Id.*

166. Shareholder opposition surfaces mostly in the context of matters that affect economic interests. Shareholders will, therefore, be more likely to support changes that address issues of entrenchment and mismanagement. Shareholder proposals that most often pass over the opposition of directors typically address anti-takeover devices or majority vote systems.

other companies. In such cases, our evidence might explain the persistence of “suboptimal uniformity.”¹⁶⁷ The suboptimal rule waiving liability to the fullest extent allowed by the law has become uniform because learning or network externalities are significant, especially because waiver of liability provisions are drafted and proposed at the insistence of management. Given the agency cost, lawyers on the management payroll are unlikely to draft provisions that are against the interests of management, even if such provisions are in the management interests of shareholders.

CONCLUSION

The nexus-of-contracts approach is a worthy theoretical framework for the examination of issues relating to corporate governance. This is particularly true in emphasizing the importance of private ordering in the regulatory process. The usefulness, however, breaks down when the approach is used to explain the relationship between shareholders and management. There is little evidence in practice that the relationship between shareholders and managers can be accurately characterized as a process of private ordering. Instead, when the law defers to private ordering, the result is that management is allowed to impose on shareholders a categorical rule that embodies its self-interest. In the context of waiver of liability provisions, this approach has resulted in one categorical rule being replaced by another—precisely the opposite of what contractarians desire.

Thus, it would seem that the contractarian approach does not offer an adequate explanation for the situation with regard to waiver of liability provisions. Based on our evidence, the managerial model might offer better predictive power. Management would always want the reduced liability. Given learning and network effects, over time, such provisions would become universal. Management would also want protection to the fullest extent permitted. This would yield provisions consistent with the evidence that we have presented.

The evidence is consistent with a race to the bottom. The waiver of liability provisions were not designed to solve a corporate governance problem, but were intended to benefit management. Because management controls the re-incorporation process, they could move the company to Delaware to take advantage of reduced liability. Other states quickly mimicked Delaware’s approach, not because it promoted good governance or efficient behavior, but because it prevented corporate flight to Delaware.

To have anything approaching an effective system of bargaining, the shareholder voting process must be meaningful.¹⁶⁸ Management must know that shareholders have the ability to veto or overturn an opt-in or opt-out decision. Therefore, there must be substantial reform of the shareholder voting process.

167. See Kahan & Klausner, *supra* note 165, at 352-53 (noting “it is possible for a suboptimal term to become standardized from the start and remain so. [Or], a term may become standardized and widely used even if it would be optimal for some firms to adopt an alternative term”).

168. Thus, we disagree with Professor Bainbridge, *see supra* note 59, that the nexus of contracts theory compels an approach to corporate governance that requires a weakening of shareholder authority.

These reforms need to do several things. First, shareholders need authority equal to that of management to initiate an opt-in or opt-out process or to change a prior decision. To do this, all opt-in or opt-out provisions either need to be in the bylaws (with shareholders receiving explicit authority to initiate, change, or repeal the bylaws) or, in the articles of incorporation with the authority to initiate an amendment to the articles.¹⁶⁹

Second, shareholders need to be given far broader authority to propose changes to the arrangements that constitute the nexus of contracts in any particular company. There are substantial areas of governance that are off-limits to shareholders. These typically arise in the context of proposals that could affect the management of the company. The argument that shareholders should not be allowed to micromanage the diurnal functioning of the company has been raised as the bogey to limit shareholder empowerment in areas that, at best, involve de minimis interference in the actual management of the company. Shareholders might condition support for a management inspired opt-in or opt-out proposal on management support for additional shareholder authority, such as an advisory vote on executive compensation.

Third, steps need to be taken to solve some of the collective action problems that impede the shareholder approval process. These issues generally relate to organization and cost. Cost issues arise most clearly in the need to solicit proxies, an expensive and time consuming process. Liberal access to the company's proxy statement for shareholder proposals would be one way to reduce costs associated with collective action.

169. At least one state in narrow circumstances has given this authority to shareholders. *See* North Dakota Publicly Traded Corporations Act, N.D. CENT. CODE ANN. §§ 10-35-01 to -33 (Supp. 2007).

