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What Default Rules Teach Us About Corporations; What Understanding Corporations Teaches Us About Default Rules

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ESSAY

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ABSTRACT

This Essay addresses corporate law's Default Rules, which allow corporations to waive their directors' liability for damages for breach of their fiduciary duty of care. Most large corporations have adopted such a waiver. This Essay distinguishes Private Contracts from Public Contracts. Public Contracts include legislation, referendums, and votes on specific outcomes, such as union members' votes on the contracts that their representatives agreed upon with management. This Essay shows that the courts view corporations and corporate articles as Public Contracts. In some Public Contracts gap-filling rules limit the scope of the Public Contracts to the information that the voters received before they voted. In waiver cases, however, the courts do not limit the scope of the waivers to the information that the voting shareholders received before they voted for the waivers. The Essay suggests that courts should follow Public Contract gap-filling rules and interpret the waivers as limited to the circumstances in which the voters voted, and the information they received before the voting.

INTRODUCTION

This Essay addresses two questions. First, what can we learn about the nature of corporations from the Default Rules that the courts have developed with respect to the reduced remedies for the directors' breach of their duty of care? I call the reduction of the remedies Waivers. Second, in light of the nature of the corporations as reflected in judicial rules, how could the courts improve the gap-filling default rules that they applied in connection with the Waivers?

In Part I discuss default rules and gap-filling rules for public and private contracts. Part II discusses the difference between public and private contracts. Part III demonstrates that the courts treat corporations as public contracts. Part IV poses the question of who cares about the different status of a corporation? Part V proposes to limit the scope of the Waivers to the relevant information the voters received before they voted for the Waivers.

The Two Kinds of Default Rules. This Essay deals with two kinds of default rules that govern corporate directors' duty of care. One kind of default rule is the statutory default rule that permits corporate shareholders to reduce the remedies for directors' breach of their duty of care. The other kind consists of the gap-filling rules that the courts use in interpreting the statutory default rules and includes the interpretation of the corporate articles, which waive some aspects of the duty. To avoid confusion, the statutory default rules will be called Permissive Default Rules. The gap filling rules will be called Gap-Filling Rules or Gap Fillers.

Waiver of damages remedy for the directors' breach of fiduciary duty of care. I chose to focus on the Waiver in part because of the recent corporate scandals. In many corporations the directors failed to inquire about signs of problems. In many other corporations the directors opened the door to unethical and legal violations, and failed to strictly supervise the managers' actions thereafter.[1] The Chief Executive Officers (CEOs) of these corporations selected the candidates to for their boards and viewed the directors' main function as advisory. Generally, advice and supervision do not match well. Advice assumes that the CEO can take the advice or leave it. Supervision leaves the final decision to the board, and allows the board to direct and overrule the CEO's choice. In the 1990s, these boards took the advisory role more seriously than the supervisory role.[2] In addition, it is unclear that wrong-doings in large corporations have not persisted to this very day.

Most importantly, large corporations affect the nation's economy and financial system. They have become cross-border private governments. External police cannot reach far into these mammoth organizations, and internal policing by the boards has been weak. To be sure, the reach of the directors' policing is limited. Yet, they can have some supervisory impact. For example, a sensitive board could discover accounting problems. If management reported a 40% loss, and a month later, management showed the board a loss of 20%, and a few weeks later the losses disappeared and gains began to appear, the directors could ask for an explanation. They might then find that the amazing growth of profit was due to a change in accounting. Had the board been delighted with the sharp and magical change of fortune, and not sought evidence of the reasons, it would not have met its duty of care.

The history of the Default Rule on the Waiver. Regardless of whether the directors were sleeping at the helm or rejoicing in the corporations' performance without questions, the directors of large corporations have been shielded by a waiver of damage remedies for breaching their duty of care, as stated in the Corporate Articles. The story of these waivers is well known. In 1985, the Delaware Court decided the case of *Smith v. Van Gorkom.*[3] The court held that the directors did not pay sufficient attention and did not adequately study the proposed purchase of the corporation. In fact, they approved a contract unseen. Therefore the court held that the directors did not meet their duty of care. One could speculate on whether the court did in fact change its interpretation of the directors' duty of care. One could speculate that the court's motives were to tighten the directors' duty of care only with respect to mergers and acquisitions of their corporations.[4] At that time, however, the decision was deemed to signal a heightened judicial scrutiny of the directors' supervision. Corporate management was alarmed. The premiums on Directors & Officers insurance rose.

The Delaware legislature responded to management's concerns by amending corporate law. Rather than reducing the level of the breach of duty of care or the remedies for such a breach, Delaware converted the rule concerning this duty into a default rule. It allowed corporations to limit the damages against directors who breached their duty of care.[5] Professor Lucian Bebchuk noted that "the path taken by Delaware and those other states was the desirable one. Had the lenient arrangement been set as default, shareholders might well have been unable to amend the charter to opt out of it, even if it turned out to be the arrangement they disfavored."[6] Thus, it was better for the law to maintain the higher standard and offer an opportunity to reduce it. Corporate directors, who hold the key to amending the Corporate Articles, would be interested in a Waiver and would seek the shareholders' approval for it. They did.

Most states followed Delaware's lead and adopted similar legislation.[7] Some states reduced the directors' liabilities subject to the shareholders' vote for "opting out," or directly provided a partial waiver of the directors' liabilities.[8]

Learning about the nature of corporations by the kind of Gap-Filling rules. When a question arises about the nature of the Corporate Articles and the Permissive Default Rules, or the extent of the permissible Waiver, courts use Gap-Filling Rules. To fashion Gap-Filling Rules and Permissive Default Rules in any situation, not just in corporate law, courts must first define the relationships among the parties. Underlying all judicial interpretations are assumptions about the nature and terms of the relationships that they address. Gap-Fillers for the terms of family relations, for example, are quite different from Gap-Fillers for the terms of business relations. Reneging on a promise to marry is interpreted differently from reneging on a business deal. That is why before the rules can be fashioned and applied, the courts must be clear about the nature of the relationships to which they apply.

Are corporate relationships Private Contracts, or Public Contracts Similar to legislation). For the past thirty years the corporate form of organization and the relationships between the shareholders, the directors and the officers of a corporation was characterized as an "aggregation of Contracts."[9] The concept and the name were imported from the discipline of economics.[10] The changes in the management's duty of care were cast as the shareholders' contractual consents to an amendment of the Corporate Articles.

The idea of a contract was not born in modern economics. It existed in philosophy and the social sciences and had different meanings in the works of Hobbes, Kant, Locke, and Rousseau.[11] Contract, however, is a legal category as well, and in the law it has a more specific meaning and applicable rules. Applying the law of contract to a relationship among the corporate shareholders, directors and officers simplifies on the one hand, but distorts on the other hand. It provides just one familiar model of relationship, which makes it easier to apply to all situations. It distorts because the model does not fit all relationships and brings about inappropriate results. I argue here that corporations are not treated as Private Contracts. Rather, the rules that are applied to them are the rules that govern Public Contracts, such as the rules that are applied to legislation.

Yet, what are the differences between Public Contract and Private Contract? After all, both types are relationships among at least two persons (with few exceptions). Both are voluntary relationships. Both share the concept of an accord, harmony, and a notion of a common pattern of behavior among willing parties. Both share an idea of a commitment, and binding reciprocal promises. Both Public Contract and Private Contract are governed by rules of entry into the relationship and exit from the relationship. Both impact third parties that did not participate in the relationships. And both provide some flexibility for changing the governing terms of the relationships. Therefore, it seems that there are no reasons to apply to both the same Gap-Filling interpretative rules.

And yet, the fundamental differences between Public and Private Contracts appear in each feature that they share. With few exceptions, Public Contracts are not personal. Parties enter the relationships by qualification rather than upon the other parties' consent. In contrast, Private Contracts are personal and entering parties must be accepted by all the other parties. The form of the parties' agreement differs. Public Contracts are based on consensus; Private Contract -- on consent. And the amendment of their terms follows these different modes of agreement as well.

Generally, Public Contracts have more impact on third parties than Private Contracts have. Further, most Public Contracts are negotiated and designed by the representatives of the parties rather than the parties themselves. These representatives have far more control over the matters they manage. In fact, both corporate directors, who provide the shareholders with the text on which they will vote, and political representatives who establish the terms of the Public Contracts, usually without soliciting the voters' direct approval of the text, need to muster a consensus of the voters at one point, but are not subject to the approval of each and every one of the voters. These representatives are expected to commit to the enterprise rather than to the particular voters who chose them. In contrast, most Private Contracts are negotiated by the parties. If the parties use personal representatives, the representatives are subject to the control of the parties that chose them.

Approvals of Public Contracts can involve a vote for specific provisions, such as the Waiver in the Corporate Articles, especially if the shareholders will forego the right to claim damages from the directors who fail in their duty of care. A comparison with the situation of union members, however, is instructive. Union members have elected representatives that negotiate with management on the union's behalf. There is no legal requirement for union members to vote on the contracts that their representatives have concluded with management on behalf of the unions,[12] although ratification of contracts may be required in the unions' constitutions or under certain other conditions.[13] The representatives of the union are treated similarly to agents.[14] However, this union's Public Contract is not frozen on the date of signature. Rather, it is subject to on-going, continuous adjustments, by negotiations or arbitration among the union representatives and the management. Thus, if the parties did not contemplate new events, the door is open to either party to demand reconsideration of the terms of the relationship. Therefore, the parties are in a continuous mode of re-negotiation.

Corporate relationships typically fit Public, not Private, Contracts. Shareholders and managers enter the relationships without the consent of the other parties to the corporate relationships, but by qualifying for entry. The directors make their decisions according to the good of the corporation and not according to the interests or dictates of the shareholders that voted for them. Shareholders' decisions, including their approval of Waivers, are reached by a consensus and not by consent, and the directors initiate the votes and write the text.

A view of the Gap-Filling Rules tells us that the courts do not treat the terms of the relationships among directors, officers and shareholders as Private Contracts. Rather they treat the relationship among these parties as Public Contracts. An examination of the differences between Private Contracts and Public Contracts teaches us that courts limit the Waiver to the extent allowed in the Default Rule. Courts look to the "legislative history" of the statutory Default Rule and the Corporate Articles. That is not their approach to Private Contracts.

Is the Gap-Filling Rule applied by the courts the optimal rule for the Corporate Articles that contain the Waiver? In fashioning Gap-Filler rules, not only the legislative history plays a significant role, but also the text. If the text and the legislative history relate to each other. If the text is limited and specific, the legislative history legislative history should relate to the limited and specific text.

A waiver of fiduciary duties, just as the waiver of any entitlement, whether quantified or not, requires a specific description of the circumstances in which such a waiver would apply. Voters are not prescient. Even if they receive true information of today's reality and the purpose of the Waiver, they do not know how much the Waiver will cost them in other circumstances in the future.

Like all judicial Gap-Fillers, the courts attempt to foresee the voters' expectations. In the case of waiver of fiduciary duties, however, the legislative history can clarify the voters understanding, intentions, and expectations. The legislative history of Waivers is the reasons and information that the voters have received and are likely to have based their vote.

Therefore, I conclude that the courts should further limit the scope of Waivers to the information and reasons that the shareholders received before they voted to approve the Waivers, and to the circumstances in which the Waivers were granted. If the circumstances surrounding the voting have changed materially, the directors should renew and refresh the effect of the waiver by seeking the shareholders' votes after disclosing to the shareholders information about the new environment. If the courts signal such a requirement, the directors of most corporations may have the incentives to do so on a regular basis. The directors, the shareholders and the courts would benefit from clearer and more predictable rules in this area.

PART I: PERMISSIVE DEFAULT RULES AND GAP-FILLING RULES FOR PRIVATE AND PUBLIC CONTRACTS

The Nature of Permissive Default Rules

This Essay deals with two kinds of default rules. One kind of default rule is a rule from which the parties are allowed to “contract out.” The Uniform Commercial Code and corporate laws offer default rules of this sort.[15] These rules are binding on the parties unless the parties expressly agree on different terms in their relationships. This is the type of default rule that relates to the remedies that apply to the directors’ violations of their duty of care. Similarly, the U.S. constitution offers default rules for legislation, maintaining the rules so long as Congress does not provide otherwise.[16] These are the “Permissive Default Rules.”

The second type of a default rule is a rule used to fill in gaps in the parties’ agreements, when their text is silent about a particular situation that has arisen. As H.L.A. Hart recognized, "our relative ignorance of fact" and "our relative indeterminacy of aim" require what I call a “Gap-Filling Rules.”[17] No text is truly unambiguous. The Gap-Filling Rules enter the stage after the parties have established the terms of their agreements, and is sometimes referred to as "implied-in-law."[18]

Both Permissive Default Rules and Gap-Fillers involve actions by the parties to the relationships. However, in the case of Permissive Default Rules the parties react to a rule promulgated by an authority and either tacitly accept or “correct” the rule. In the case of Gap-Filling Rules, the authority reacts after the parties have established the terms of the relationship. In such a case a third party—usually the judiciary—uses Gap-Filling Rules to interpret the terms of the parties’ relationship.

Gap-Filling Rules for Private Contract and Public Contracts

The purpose of Gap-Fillers that interpret Private Contracts and Public Contracts is similar. In both cases the interpreter seeks to discover the parties’ intent and speculates on how they would have answered the question at hand before they entered into the Private or the Public Contract relationships, had they been aware of the circumstances that have arisen later. But that is where the rules applicable to the two types of relationships part ways.

Gap-Filling Rules For Private Contract. Gap-Fillers for Private Contracts derive from the express terms of the Contract, signaling the motivations and incentives of each party and their possible attitude towards the unanswered question that arose from their dealings. These Gap-Fillers could derive from the presumed parties’ understanding, or from the general practice in the particular area, on the assumption that the parties would have acted as many others in the same position would have acted.[19] Thus, if the situation was not provided for in the Private Contract and not anticipated by the parties, the courts will look to the “omitted term”[20] to discover the parties’ intention.

For the purpose of this discussion, three points are important.

(1) In general, when applying Gap-Filling Rules to Private Contracts, *the courts do not resort to the previous negotiations among the parties.*[21] Contracts may be *explained or supplemented* by the course of the parties' dealing (later performance, after the contract was signed).[22]

(2) Generally, *the interpretation of the text ignores the parties' different bargaining power,*[23] except when the process which led to the Contract was faulty, for example, when a party was induced to enter into the agreement by fraud, undue influence, or duress.[24]

(3) I*f neither parol evidence nor canons of constructions resolve the matter, the courts turn to concepts such as "good faith," "fairness," and "policy."*[25]

Thus, in general, Gap-Filling Rules applicable to Private Contracts ignore the parties' negotiations before they entered into the Contract, ignore the parties' disparate bargaining positions, and apply as a last resort, notions of good faith, fairness and policy.

Gap-Fillers for Public Contracts. In contrast to Gap-Filling Rules for Private Contract, in which the courts will not peek to uncover the parties' negotiation before the Contract was concluded (with the few exceptions mentioned above), in applying Gap-Filling Rules to Public Contracts, such as legislation, the reverse seems to be the main source of interpretation. Unless the courts determine that the text is unambiguous, the interpretation of Public Contracts often draws on the "legislative history."[26] Private Contract Gap-Filling Rules are based on the courts' assumption about the parties' possible reactions to the conflict, or other extraneous circumstances after the parties entered into the Private Contract relationship.[27] In contrast, Public Contract Gap-Filling Rules are usually drawn from the opinions of the parties and others expressed in legislative hearings and congressional reports before the legislation was passed.[28] Similarly, in the context of the U.S. Constitution, the statements of the founding fathers before the adoption of the constitution are closely examined.

If Corporate Articles were treated as Private Contracts, the courts would refrain from examining any decisions of the directors and any materials that were sent to the shareholders before the vote was taken. But if the Corporate Articles are treated as Public Contracts, the courts may well draw on precisely this source of information.

In contrast to most Private Contract situations, the parties' representatives in Public Contract situations, such as elected representatives, usually prepare the text presented to the voters. Only in special kinds of referendums do voters prepare the text. In most cases the voters can seek a court decision on the exercise of their representatives' powers, as well as on the meaning of the text. This challenge can include attacks on the authority of the voters and the State in the context of a referendum.[29] In the context of Public Contracts adopted by union members, changes are continuously made by the representatives of the union members and the management. Hence, litigation in this area focuses on the authority of the union representatives.[30] Generally union representatives may make changes in the unions' Public Contracts, regardless of whether the union members voted on the contracts. That is because the union representatives and the management have an on-going relationship in which they can re-negotiate the contracts if unanticipated events have occurred or the environment has changed.

In contrast to union officers, corporate directors do not act as exclusive representatives of the shareholders. Shareholders do not have representatives to negotiate on their behalf with the directors or with management. The Waivers are not negotiated, but rather presented to shareholders on a "take it or leave it" basis, and there are no mechanisms to review the Waiver in light of new circumstances.

PART II. COURTS' DEFAULT RULES FOR CORPORATE DIRECTORS' DUTY OF CARE

Courts Interpret the Default Rule Concerning Corporate Directors' Duty of Care and the Corporate Articles as Public Contracts

Corporate Articles that contain a Waiver have opted-out of the corporate law rule. The authority on which these Corporate Articles is based is the Default Rule in the corporate statute. Had the corporate laws been silent about the directors' duty of care, the common law rule would have applied and imposed a duty of care on the directors. It is unclear whether and to what extent the common law duty of care is a Default Rule. In any event, state legislatures have found it in their wisdom to restate the common law rule in the statutes as an unconditional rule. Only later did the legislatures change the rule into a Default Rule which allowed them to contract out of the common law. [31]

When the shareholders amended the Corporate Articles to adopt Waivers, the courts interpreted the Waivers as they interpret Public Contracts. The courts focused on the Permissive Default Rules that allowed the Waiver and on the limitations that the rules imposed. Then the courts examined the facts of the cases to determine whether the directors' behavior of which the shareholders complained, fell within or outside the Default Rules and Corporate Articles,[32] that is, whether the directors were sheltered by the Waiver. The "legislative history," so to speak of the Corporate Articles could draw on the intent of the management and the shareholders, as articulated in the proxy statements, the shareholders' reports and other corporate documents, and perhaps in shareholders' opinions. Indeed, there are cases in which the plaintiffs sought a court determination of whether the disclosure to the voting shareholders was truthful or misleading under the securities acts.[33] These decisions parallel the attack on the integrity of the voting process, and were limited to the truth of the disclosed information. But if the process was not contaminated by misleading statements, the courts did not go any further. They did not interpret the Corporate Articles in light of the true information that the voters received, and did not limit the permissible range of the Waiver in the Default Rules and the Corporate Articles to the actual facts on which the voters relied when they voted to amend the Corporate Articles. So long as the facts were true, the facts did not provide the boundary to the permissible Waiver.[34]

Thus, in general, while the courts will not allow access to evidence of the parties' negotiations before the Private Contract was signed,[35] they will resort to "legislative history" before the Public Contract -- the legislation -- is passed.[36] The Public Contract Gap-Filling Rule focuses on what the parties would have said had they been asked or had they faced the situation at hand.[37] The legislative Gap-Filling Rule focuses on the problems that led to the legislation, and the information that led to the solutions.[38]

The reason for this distinction relates to the process by which the two kinds of relationships—Private Contracts and Public Contracts -- are established. Private Contract parties can start negotiations on one deal and end up with another. They are less bound by a pre-determined process than Public Contract parties, and the history of their negotiation provides a less reliable source of evidence about their intentions than the legislative history of a Public Contract. The legislative history of Corporate Articles' Waiver is procedurally similar to that of legislation, and perhaps even more focused than legislation. That is because the Waivers involve not merely conflict of interest transactions, but the remedy which shareholders could claim for breach of fiduciary duties. In that respect the Waivers are similar to union Public Contracts.

What Can We Learn From These Default Rules and Gap-Filling Rules About the Nature of the Corporation and the Directors' Liabilities?

Default Rules and Gap-Fillers can signal the type of relationships to which the rules apply. For example, the Uniform Commercial Code allows parties to design their entire relationship for themselves, regardless of the Code's provisions. In contrast, the rules concerning the directors' duty of care allow the Corporate Articles to provide the diectors with a Waiver only within limited parameters. This difference is reflected in the judicial Gap-Filling Rules.

When the parties depart from the Uniform Commercial Code's provision, the courts focus on the parties' agreement, and use Gap-Filling Rules to which they resort in interpreting Private Contracts. That is because the courts classify the parties' relationship to which the Code applies, as a contract relationship. In contrast, when corporations adopt Waivers in the Corporate Articles, the Gap-Filling Rules that the courts apply are similar to the rules applied to Public Contracts (legislation). These courts use these rules both to the corporate statutes and indirectly to the Corporate Articles that were amended to include the Waiver. The courts focus on the statutes and the limits they impose.[39] In addition, the courts examine the truth of the proxy information that the voters received but do not limit the scope of the Waiver to that information. In this last examination, the courts seem to determine whether the voters received truthful information. The inquiry, however, stops at truth of information. The information that the voters received, is not factored into the Gap-Filling rule to determine the scope of the Waivers.

The differences between Gap-Filling Rules in Private and Public Contract can tell us about the differences between the relationships to which these rules apply, including the identity of those who produced the text and the process by which the text was produced. This inquiry can thus lead to a description of the relationship among the parties to a corporation.

PART III: PUBLIC AND PRIVATE CONTRACTS

What are the differences between Private and Public Contract? They are similar in many respects, and yet, the fundamental differences between Private Contracts and Public Contracts appear on each of these similar features. These differences also highlight the status of corporations as Public Contracts.

The Personal Nature of Private Contracts As Compared to Public Contracts

A fundamental feature of a Private Contract is that it is a personal relationship.[40] The contract involves specified, known, and identified parties. These parties need not share the same characteristics or desires, although they share a desire to enter into the relationship for the sake of the ultimate result that they believe benefits them. Each party is expected to know and choose the party with whom it deals. At the foundation of the Private Contract is an assumption that each party will not deal with other parties that it did not choose. To be sure, there are transactions in which the parties do not know each other, such as trading in the securities markets. However, in such cases, the parties know the intermediary, the broker, dealer, or underwriter, who represents both parties.

A number of consequences result from this feature. The number of the parties to a Private Contract (or their representatives) is relatively limited. The limitation may depend on the reasonable burden that people can bear in gaining information about the other parties or their representatives, with whom they might wish to contract. Another consequence of the personal nature of a Private Contract is that generally, no one can join the relationship without the consent of all the other parties. This feature of personal choice of the other party may be blurred at the fringe of the category. For example, historically, borrowers could choose their lenders and no lender could transfer his rights against the borrower to another person without the borrower's consent. That made sense when the creditor could inflict enormous harm on the debtor who failed to pay, such as, demanding that the debtor be imprisoned. When the rights of the creditor became less draconian, the limits on the creditor's right to transfer the debt owed to them were relaxed.[41]

Similarly, a claim to personal services is not transferable because the personal component of the services is very strong. Yet, on this score as well, the rules may be more relaxed. A client of a large law firm may insist that a certain lawyer will represent him in court. The client is not presumed to object that the brief will be prepared by associates whom he does not know, so long as the associates act under the supervision of the lawyer of his choice.

Directors and officers of corporations are not entirely precluded from delegating some of their duties, but may not fully delegate all their responsibilities. In fact, the law prohibits them from selling their office or fully delegating their functions.[42] Private

Contracts can involve institutions as parties. We buy from, and sell to, corporations. We deposit money in banks, and appoint banks as trustees. We do not know, nor choose, the persons with whom we deal. Yet, these relationships are limited to the institutions of choice. They are as intensely personal or as thinly personal as they would be among individuals. Thus, people may be less concerned whether they buy the same item from Filene's or Macy's in Boston but would not be willing to lose their power to choose a trustee bank or even the bank as their debtor to deposit their money.

Private Contracts may involve unknown parties when the contracts entitle such parties to inherit the Private Contract rights. But these unknown contingent parties are fairly easily ascertainable, and become parties only upon proof of the occurrence of a specific event. Therefore, the personal aspect of a Private Contract is not absolute but is the starting point of any Gap-Fillers.

Public Contracts do not involve fixed specific parties that are identified in advance. Rather, Public Contracts are open to individuals that share certain characteristics. While in Private Contract the choice is of particular parties, in a Public Contract the choice of membership is by the qualifications that the potential members must have. These qualifications include, for example, residence or citizenship, or qualification for a profession or a trade, or holding shares in a corporation, or qualifying by age or prestige for a club membership, or a housing project. The membership could be limited in numbers, but in publicly held corporations the number of members is limited by the number of shares that the corporations have issued. Therefore, Public Contracts are impersonal, even if the number of participants is small, and even if the participants know each other.

In the case of a publicly held corporation, a shareholder who joins the group has become a party to the Public Contract within the corporation. Entry as a party to this contract does not depend on the choice or decision of the other parties but rather on the terms of the entry, which are set in advance. To the extent that these terms are binding and are not changed, a party can join whether the other parties to the Public Contract like it or not, and whether they know who the new party is or not. It is not the consent of others but qualifications that determine membership. Thus, the identity of the parties to a Public Contract is not necessarily known nor fixed when the parties enter into the relationship or later on. In this sense, a Public Contract is impersonal.

Consent v. Consensus

Private and Public Contracts differ in the type of concurrence that binds the parties. To be binding, Private Contract parties must *consent* to the terms of the contract and to any changes in these terms.[43] Consent in the Private Contract sense assumes that the parties were free of duress, undue influence, fraud, mistake, and other circumstances that would limit the ability of the parties to exercise their free will in binding themselves to the terms of the contract. Therefore, a mistake, incapacity, fraud, and other limitations on free will can excuse a party to the Private Contract from performing under the contract.[44]

While Private Contract requires consent of the contracting parties, Public Contract requires consensus. The difference is similar to the difference between signing a Private Contract and voting in a referendum, or shareholders' meeting or union members' voting on an agreement with management. If a party to a Private Contract withholds consent, the contract cannot be concluded. In a referendum, a sufficient number of participants can bind the rest. In addition, parties to a Private Contract can suggest any change, and gain the others' consent. In contrast, members to a Public Contract are more limited in their ability to initiate changes in the terms of the contract. Their power to do so depends on the provision which authorizes them to initiate or to demands changes.[45]

In most cases, the parties to a Private Contract have some contact with one other, directly or through agents. Private Contract law entitles them to seek information from the other parties to the relationship before the contract is executed.[46] However, if a party seeks information, the other party must disclose the truth, and a contracting party must disclose information it knows the other party is relying on.[47] If the parties relate through intermediaries, for example, as in the case of the securities markets, the law requires the sellers to provide the buyers with information and adopts steps to ensure that the information is true. Thus, consent in the Private Contract sense is based on the assumption that each party knows and understands the terms of the contract.

In contrast, not all persons who are deemed to be members of the Public Contract express their consent to its specific terms. In this type of contract the binding consent is a *consensus.* In light of the number of the parties in a Public Contract and in order to avoid a stalemate not everyone has the right to veto the terms of the relationship to which the majority consented. Thus, a decision by a certain percentage of members can bind all members. In sum, in contrast to a "consent" in Private Contract, the parties to Public Contracts express a "consensus."

While consent is a clear expression of an agreement by specified parties to all the terms, in the Public Contract, a consensus is less defined and specific. It denotes a compromise.[48] A consensus may exist even when the parties do not consent to all the specific terms of the relationship but prefer to stay within the relationship rather than leave. A consensus has more negative implications than a positive consent. It signals that the parties have expressed no strong opposition to the terms of the Public Contract rather than that they expressed a strong commitment to the terms. Years ago the Internet community of "techies" adopted a motto that rejected "kings and presidents" as well as voting and emphasized a consensus (with respect to technical matters).[49] This motto indicates not only the open door to changes but also the open door to participants. When the number of participants is unknown or very large, and the purpose of the group is to expand and to change its terms of commitment, a consensus is more suitable for such group than consent.

Knowledge of the relationship's terms is important to render the parties obligated under the terms of Private Contracts. In contrast, "ignorance of the law," that is, the terms of the Public Contract, "is no excuse" to violation of the law.[50] Knowledge of the rules in a Public Contract is not required. Even knowledge of the terms of entry into the group may not be necessary for a person to be bound by the group's rules. So long as the parties entered into the group subject to the Public contract, the applicable Public contract terms would apply to them. Most parties to the Public C~~c~~ontract are not the "founding fathers." They join an existing relationship whose terms are fixed and to which they may or may not agree. Thus, to be bound by Contract requires knowledge of the contract terms and freedom to accept an obligation. To be bound by a Public contract requires no knowledge of the contract terms and affords little freedom to accept the obligation. A child is not bound by a Private Contract. A baby and sometimes even an unborn child are bound by the terms of a Public contract and benefit from its terms.

Entry and Exit

Both Private and Public Contracts are governed by entry and exit rules. To enter the relationship, the parties depend on the explicit consent of any and all other existing parties. Private Contract parties cannot withdraw without the consent of the other parties to the Contract, except when the Contract specifically provides for withdrawal. Even death does not allow the parties to terminate many types of Contracts. Unless the Contract requires the active involvement of the party that passed away, the duties under such Contracts pass to the estates of the deceased parties.[51]

Entry and exit into the Public Contract is far more flexible, depending on the qualification of the parties and sometimes on their decision to enter or exit. Thus, in most cases entry and exit are not dependent on the consent or permission of other existing parties. While parties to a Private Contract cannot enter and leave at will, parties to a Public Contract can enter and leave the relationships far more easily, depending on the conditions attached to both entrance and exit. In most cases a shareholder is not bound to the corporation and can sell his shares, regardless of the consent of the other shareholders.[52] A person can leave the state and generally cease to be bound by its rules.

A Public Contract, however, can impose conditions on entry and exit depending on the consent of a select group of people. In a condominium association, for example, a number of residents may have to agree to a new owner; in a club, entry may depend on the recommendations of two or more members. Entry may depend on payment; exit may depend on payment of the debts due. Generally, however, the conditions are known in advance and are more objective, while in a Private Contract the conditions may be known in advance but depend more on the desires of the membership. A Public Contract applies to a more transient population, so long as the members of the population qualify for entry into the group.

The Impact on Third Parties

The impact of Private Contract on third parties is fairly limited. Those who did not "sign up" are rarely bound by the Contract. The impact of the Public Contract on third parties is far greater. Those who qualify for membership in a group may be bound by the terms of the Public Contract, whether or not they have agreed to be subject to the terms of the Public Contract, and even if they did not know of the existence of the Public Contract. Public Contracts involve communities, whose members and their families and dependents could be bound by the terms of these Public contracts without their will or knowledge.

Amendment of the Terms of the Relationships

The differences between the two types of relationships lead to different ways in which the terms of the relationships are amended. Generally, Private Contract terms change by the explicit consent of all the parties to the Contracts.[53] The legitimacy of the change is based on the parties' consent. Generally, Public Contract terms change by the consensus of the parties that are parties at the time of the change. That date may differ from the original date of the Public Contract or from the date in which new members have joined the relationship. In Public Contract, the changes of the terms are usually effected either by the representatives of the parties, such as Congress, or by the votes of a certain percentage of the parties, such as the shareholders, and voters in a referendum.[54]

A similar distinction applies to the changes pursuant to express Default Rules. If the law offers a Default Rule for a Private Contract, all the parties to the Contract must consent to the deviation from an existing Contract. In contrast, if the Constitution contains a rule as a Permissive Default Rule, Congress can change the rule. If a Permissive Default Rule allows for a referendum, then the citizens are authorized to change the rule prospectively by another referendum. Most Permissive Default Rules in corporate law are of the referendum kind. The representatives of the shareholders offer the changes and the shareholders vote on the changes by a consensus.[55] In some cases, however, a certain percentage of the shareholders may initiate the vote themselves.[56] Professor Lucian Bebchuk suggested a referendum on some governance rules, in light of the changes that have occurred since the shareholders approved the rules.[57] He followed the referendum model.

The distinctions that are described above stem rationally and naturally from the different number of participants and the circumstances in which the relationships among the parties arose and are going to be terminated. In fact, the distinctions must exist. These distinctions lead to different default rules.

PART IV. WHO CARES ABOUT THE DIFFERENT STATUS OF CORPORATIONS?

Why Complicate Matters? Everything is Contract

Arguably, there is no need to complicate matters since everything can be explained and treated as Contract. After all, even if an investor in a share did not explicitly agree to the terms of the Corporate Articles, he would likely have agreed to them, had he been asked.[58] The answer is that names and differences matter a great deal. Law is not determined solely by the speculative agreement of the parties. It is also organized by categories, presumably – always presumably – a set of rules that the parties would have agreed to had they been asked and had they known the circumstances of the particular situation. Thus, law is divided into criminal law, constitutional law, tort, Private Contract and Public Contract. To be sure, each category is based on the assumption that if the parties had been asked they would have opted for the rules contained in the category. Gap-Fillers of the constitution are not the same Gap Fillers for child custody nor the same as those for Private Contract. Simplicity is desirable, but not if it erases too many fundamental details and leads to inappropriate results.

Corporate Articles and the Waiver concern the relationship between the shareholders and the directors. Directors hold their power and discretion in trust. The relationship is not a Private Contract, although some of it may belong to that category. Yet, a breach of a Private Contract does not carry with it the stigma of a breach of trust. A beach of promise is not as pernicious as the misappropriation of what is given in confidence. Further, the remedies for a breach of promise do not include the remedy of accounting for ill-gotten gains but only damages (and restitution, which does not parallel accounting for profits).[59]

To be sure, if courts view corporations as Private Contracts, they could achieve the same results as if they viewed corporations as Public Contracts. The court could apply a Gap-Filling Rule to contain a requirement that the directors (and other fiduciaries) disgorge their profits.[60] Such an approach would arguably maintain the current fiduciary law rule. No so. The source of the rules will change. There would be no rule that requires the directors to account for their profits. There would be a Gap-Filling interpretation of a Private Contract that would impose this requirement. Most importantly, the basis for the rule will change.

A crucial difference between Private and Public Contracts is in the view of the parties' relationship. Private Contract is based on promises, consent, and bargaining. Public Contract is based on power and property held in trust for the benefit of others. That is the spirit and nature of political and corporate democracy. Under the current category, the money and power entrusted to directors never, not even for a second, becomes theirs. Private Contract subverts this view. If corporate relationships were governed by Private Contract then the money would be passed to the directors, subject to their promises to behave properly. Arguably property law could also be deemed to be a Private Contract because most people would agree to its rules. Yet we do not put them under the same umbrella. That is because the relationships are different.

In sum, the category of Private Contract does not fit either the reality of corporate relationships nor the law which should be applied to people who handle other people's money. This is especially so with respect to rules that apply to corporate directors and officers.

Corporations Have Evolved into Public Contracts

Daniel Boorstin describes the evolution of the groups that crossed to the American West. At first, small groups attempted to cross on their own. They did not survive. They were killed by wild beasts and by the Indians. For self-protection, they formed larger groups. But members of the groups were unruly and posed dangers to each other. To protect themselves from each other, the groups formed a government. They chose a leader and established a "constitution," and a jury. They purchased their food and necessities together to gain economies of scale. The enforcement of the rules was brutal. Serious violators were discarded and left to die. The groups were open both ways. People could join and leave, for example, when they found land that they liked and decided to settle.[61] Upon reaching their destinations on the West Coast the groups dissolved. Corporations of today share many of the features of the groups that crossed to the West. While the West Coast groups shared a broad spectrum of activities and responsibilities, both their members and today's corporations' shareholders share economic and business purposes. While members of the West Coast groups committed to behave and share in servicing their communities, the members of today's corporations commit their money the corporation.

More importantly, the constitutions and rules of both groups represent Public, not Private Contracts. Today's shareholders vote on their Corporate Articles like the West Coast Groups' referendum model. In both cases the voters decide on rules that are proposed by their boards, or leaders, or representatives. Both groups make their group decisions by consensus rather than the consent of each member. Membership in both groups is subject to qualifications, but is open rather than subject to the consent of the other members. In both groups members can leave freely, subject to rules that apply to all members. Thus, the West Coast groups and today's corporations are governed by Public, and not by Private Contracts.

Public Contracts Waiving Fiduciary Duties

Those who entrust their money to fiduciaries (entrustors) have a right to rely on the fiduciaries to act for the entrustors' benefit.[62] If the fiduciaries seek gain from their control of the entrustors' money or entrusted power, the fiduciaries may seek the entrustors' consent, provided the fiduciaries fully inform the entrustors. This condition is designed to change the position of the parties and alert the entrustors to the change. It puts the fiduciaries and the entrustors in a position of parties that negotiate at arms' length.[63] In a true one-to-one relationship the information is given directly. In a Public Contract environment, all parties must receive the information, and a consensus rather than consent, must be reached.

Under fiduciary law, the entrustors' permission for fiduciaries to benefit from the fiduciary relationship is meaningful only if the entrustors have full information about the benefits and the consequences to the entrustors. That information is usually linked to a particular transaction. General waivers do not offer the entrustors adequate information about the waivers' possible consequences for them. Therefore, such waivers are not sufficient to relieve the fiduciaries of their duties.[64] If an entrustor does not know how much he could lose from future conflicted transactions, how can he give an informed consent? In fact, under the Uniform Trust Act the consent to conflict of interest transactions can be recognized only after the trustee has violated the law. [65] In other cases the required information is with respect to a specific transaction. The same requirement of specificity applies in Public contracts that involve fiduciary relationships. For example, the Supreme Court held that the publisher of an investment advisory newsletter is a fiduciary of the subscribers, and must disclose to them his possible conflict of interest.[66]

We noted that the courts examine the truth of the information that the shareholders received before they voted on the Corporate Articles. The disclosure requirement and its accuracy only partly reflect the rules of fiduciary law. That is because the current Gap-Filling Rules relating to the Corporate Articles do not require specificity and allow a general waiver of the directors' duty of care, limited by the interpretation of the Default Rule. Thus the Gap-Filling Rules are related to the text of the Default Rules or to the truth of the disclosure, but not to the specific transactions to which the waiver would attach. I argue that the current Gap-Filling rules have not gone far enough, and that the limitations on Waivers should be tightened. As mentioned, Gap-Fillers are judicial speculation on the intent of the parties. How, then should Gap-Filling rules be fashioned in this context?

PART V: A BETTER AND MORE PRECISE GAP-FILLING RULE

If the Corporate Articles Represent a Public Contract, and if the Articles Contain Waivers of Fiduciary Duties, How Should the Courts Interpret These Waivers?

Because the Corporate Articles are Public Contracts, they can be binding by a consensus, provided the Articles were enacted in compliance with the required process and did not exceed the boundaries allowed by corporate law. Judicial interpretation of the corporate Default Rule and its limits would continue --as they do -- in interpreting other Public Contracts. In such a case the legislative history of the corporate law and the legislative history of the Corporate Articles should play a part.

Yet, how should the Waiver be treated in such a case? One answer is to render the Corporate Articles on the waiver to the situation that led to the Default Rule, that is, the situation in *Smith v. Van Gorkom.* In such a case the waiver would not apply to many of the situations that arose in the 1990s and that might persist even today. This Gap-Filling Rule, however, would not allow the corporations and their shareholders to move from that fixed environment at the time in which the shareholders voted on the Corporate Articles. And yet, there is little in the legislative history of the corporate Default Rule to suggest that the courts would be bound to such a rigid interpretation. On the other hand, it is unclear that the legislatures intended to eliminate the fundamental principles of fiduciary law, even though the legislatures set limitations on the scope of permissible waivers. To allow for some flexibility for both the directors and shareholders, Gap-Filling Rules should permit changes in the scope of the waivers, as well as provide directors with incentives to seek the shareholders' votes for such changes. This principle suggests an interpretation that combines the rules of fiduciary law with the limits of the legislatures' Default Rule.

But how can the Corporate Articles be narrowed? Should the courts look to the environment at the time of the adoption of the Articles? Not necessarily. When the Corporate Articles contain a Waiver, the waiver should be *limited to the circumstances that existed when the shareholders voted for the Waiver*. The duty of care as stated in the corporate statutes would continue to apply in those circumstances that are not covered by the Corporate Articles.

Public Contracts Involving Direct Impact on the Voters

One purpose of Gap-Filling Rules is to reduce uncertainty for the parties. Uncertainty -- at least in the case of Corporate Articles that contain the Waiver -- could be greatly reduced if the full legislative history of the Corporate Article would be considered and followed as a guide. This principle is especially important in the case of the Waiver.

When Public Contracts involve a more direct impact on the voters, the Public Contract requires a referendum. It is not surprising that in some states taxation is subject to a referendum. It should not be surprising if Public Contracts that contain a waiver of fiduciary duties of corporate management, should require a detailed "legislative history." In such cases shareholders should vote not only on principles of waiving their rights against imprudent or careless directors but also on the specific situations in which the directors behaved carelessly. It is only when the specific situations are outlined that the voters would know what they are waiving.

The legislative history of Corporate Articles during the Van Gorkom era is different from the legislative history during the Enron Era. Shareholders may be ready to forego the directors' carelessness in a case such as the Van Gorkom case, but not in a case such as the Enron case. When they vote in the circumstances of Van Gorkom case, and they had no information about a situation, such as the Enron case, they should not be assumed to have agreed that the Waiver they voted for would cover directors in an Enron situation.

Therefore, the legislative history of Waivers is contained in the materials that the voting shareholders received before they voted such as the proxy materials, which solicit the proxies for the vote on this subject. These materials should state with an acceptable degree of specificity the situations, which the Waiver would cover.

But might not this rule increase uncertainty? The managers might not know before the fact where the line would be drawn between issues subject to the waiver and those that are not. The answer is: The most specific waivers are those that are granted after the fact. The shareholders can evaluate the directors' actions and failures to act, and can then approve an informed waiver. If the corporate statutes allow the corporation to opt out of the statute and establish a stricter duty of care, the chances are that the directors will not call upon the shareholders to take advantage of such a Default Rule to reduce the directors' protection from liability. But if the Corporate Articles contain Waivers, which may not sufficiently cover situations that the directors desire to be covered, then the directors will have great incentives to bring the issues back to the shareholders for review and re-iteration.

Because the management will have an incentive to limit the remedies for its breach of fiduciary duty of care, management could offer an amendment whenever the shareholders are asked to vote for the directors or for other matters. The scope of such a later approval will depend on the general interpretation of the statutory Default Rule as well as on the materials that the shareholders received before they voted the previous time, when they approved the Corporate Articles. The more often and the more specific the shareholders' approval of the Waiver is, the more informed the shareholders would be, and the stronger the Waiver should hold. The process is likely to result in more uniform judicial Gap-Filling Rules. The information that the shareholders receive before approving the Corporate Articles containing the Waivers can guide the courts in determining the scope of the Waivers. This development in turn could provide more certainty and predictability for the shareholders and their directors.

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[1] In re Walt Disney Co. Deriv. Litig., 825 A.2d 275 (Del. Ch. 2003); Tittle v. Enron Corp. (In re Enron Corp. Sec., Deriv. & "ERISA" Litig.), 284 F. Supp. 2d 511 (S.D. Tex.2003) (interim litigation).

[2] See Tamar Frankel, Trust and Honesty, America's Culture at a Cross Road (forthcoming, Oxford University Press).

[3] 488 A.2d 858 (Del. 1985).

[4] William T. Allen & Reinier Kraakman, *Commentaries and Cases on the Law of Business Organization* 513 (Aspen 2003) ("In hindsight, however, *Smith* has come to seem much more like a precursor of the great Delaware takeover cases of the mid-1980s, and especially of *Revlon*.).

[5] Act of June 18, 1986, 65 Del. Laws 544 (1986) (codified as amended at DEL. CODE ANN. tit. 8, § 102(b)(7) (2001)).

[6] Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution,* 96 NW. U.L. REV. 489, 493 (2002).

[7] *See* ALA. CODE § 10-2B-2.02(b)(3) (1999); ALASKA STAT. § 10.06.210(1)(N) (Michie 2004); ARIZ. REV. STAT. ANN. § 10-202(B)(1) (West 2004); ARK. CODE ANN. § 4-27-202(B)(3) (Michie 2001); CAL. CORP. CODE § 204(a)(10) (West 1990); COLO. REV. STAT. § 7-108-402 (2003); CONN. GEN. STAT. ANN. § 33-

636(b)(4) (West Supp. 2004); GA. CODE ANN. § 14-2-202(b)(4) (LexisNexis 2003); HAW. REV. STAT. ANN. § 414-33(b)(4) (Michie 2004); IDAHO CODE § 30-1-202-(2)(d) (Michie 1999); 805 ILL. COMP. STAT. ANN. 5/2.10(b)(3) (West 2004); IOWA CODE ANN. § 490.202(2)(d) (West Supp. 2004); KAN. STAT. ANN. § 17-6002(b)(8) (1995); KY. REV. STAT. ANN. § 271B.2-020(2)(d) (Michie 2003); LA. REV. STAT. ANN. § 12:24(C)(4) (West Supp. 2005); ME. REV. STAT, ANN. tit. 13-B, § 202(2)(d) (West Supp. 2004); MD. CODE ANN., CORPS. & ASS'NS § 2-405.2 (1999); MASS. GEN. LAWS ch. 156B, §13(b) (1½) (2002); MICH. COMP. LAWS ANN. § 450.1209(1)(c) (West 2002); MINN. STAT. § 302A.251(4) (2004); ANN. MISS. CODE § 79-4-2.02(b)(4) (West Supp. 2004); MO. ANN. STAT. § 351.055(2), (3) (West Supp. 2005); MONT. CODE ANN. § 35-1-216(2)(d) (2003); NEB. REV. STAT. § 21-2018(2)(d) (1997); NEV. REV. STAT. § 78.037(1) (2003); N.H. REV. STAT. ANN. § 292:2(V-a) (1999); N.J. STAT. ANN. § 14A:2-7(3) (West 2003); N.M. STAT. ANN. § 53-12-2(E) (Michie 2003); N.Y. BUS. CORP. LAW § 402(b) (McKinney 2003); N.C. GEN. STAT. § 55-2-02(b)(3) (2003); N.D. CENT. CODE § 10-19.1-50(5) (2001); OKLA. STAT. ANN. tit. 18, § 1006(B)(7) (West Supp. 2005); OR. REV. STAT. § 60.047(2)(d) (2003); 15 PA. CONS. STAT. § 1713 (1995); R.I. GEN. LAWS § 7-1.1-48(a) (6) (1999); S.C. CODE ANN. § 33-2-102(e) (Law. Co-op. 1990); S.D. CODIFIED LAWS § 47-2-58.8 (Michie 2000); TENN. CODE ANN. § 48-12-102(b)(3) (2002); TEX. CORPS. & ASS'NS CODE ANN. art. 1302-7.06(B) (Vernon 2003); UTAH CODE ANN. § 7-7-3.1 (Supp. 2004); VT. STAT. ANN. tit. 11A, § 2.02(b)(4) (1999); VA. CODE ANN. § 13.1-692.1(A) (Michie 1999); WASH. REV. CODE ANN. § 23B.08.320 (West 1994); W. VA. CODE ANN. § 31D-2-202 (Michie 2003); WIS. STAT. ANN.§ 180.0828 (West 2002); WYO. STAT. ANN. § 17-16-202(b)(iv) (Michie 2003).

[8] FLA. STAT. ANN. § 607.0831 (West 2004); IND. CODE ANN. § 23-1-35-1(e) (West Supp. 2004); OHIO REV. CODE ANN. § 1701.59 (Anderson 2004); 2 William E. Knepper and Dan A Bailey, Liability of Corporate Officers and Directors, ch. 16 (7th ed. 2002) 16-3-4, §16.03.

[9] *See, e.g.,* FRANK T. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 15-17 (1991) (stating that the "corporate venture" is made up of contracts, including agreements in the articles of incorporation and agreements with employees, suppliers, and contractors). *See, also*, Henry Hansmann, *The Ownership of Enterprise* 18 (1996) (describing the firm as "a nexus of contracts," by which he means that the "firm is in essence the common signatory of a group of contracts" among various factors of production). This model's origins fairly can be traced to Nobel Prize laureate Ronald Coase's justly famous article on the nature of the firm. *See* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA (N.S.) 386 (1937). As no less an authority than former Delaware Chancellor William Allen has acknowledged, contractarianism is now the "dominant legal academic view." William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993).

[10] *See, e.g.,* William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal,* 74 CORNELL L. REV. 407, 415-17 (1989).

[11] Michel Rosenfeld, *Contract and Justice: The Relation Between Classical Contract Law and Social Contract Theory,* 70 IOWA L. REV. 769, 847 (1985)

[12] 29 U.S.C. S 185(b) (Any labor organization which represents employees in an industry affecting commerce as defined in this chapter and any employer whose activities affect commerce as defined in this chapter shall be bound by the acts of its agents…."

(e) For the purposes of this section, in determining whether any person is acting as an "agent" of another person so as to make such other person responsible for his acts, the question of whether the specific acts performed were actually authorized or subsequently ratified shall not be controlling."); see also

20 Williston on Contracts § 55:18 (4th ed.) (citing *O'Neill v. Air Line Pilots Ass'n, Intern.,* 886 F.2d 1438 (5th Cir. 1989), cert.112 L. Ed. 2d 14 (1990) and judgment rev'd on other grounds, 499 U.S. 65, (1991); *Talbot v. Robert Matthews Distributing Co.*, 961 F.2d 654, 22 Fed. R. Serv. 3d 331 (7th Cir. 1992*); Merk v. Jewel Food Stores Div. of Jewel Companies, Inc.*, 945 F.2d 889 (7th Cir., 1991)).

[13] 20 Williston on Contracts § 55:18 (4th ed.), *citing N.L.R.B. v. Auciello Iron Works, Inc.*, 980 F.2d 804 (1st Cir. 1992*); O'Neill v. Air Line Pilots Ass'n, Intern*., 886 F.2d 1438 (5th Cir. 1989), cert. granted, 498 U.S. 806, 111 S. Ct. 37, 112 L. Ed. 2d 14 (1990) and judgment rev'd on other grounds, 499 U.S. 65,(1991); *Ackley v. Western Conference of Teamsters*, 958 F.2d 1463 (9th Cir. 1992); *N.L.R.B. v. Auciello Iron Works, Inc.*, 980 F.2d 804 (1st Cir. 1992); *N.L.R.B. v. Roll & Hold Div. Area Transp. Co*., Inc., 957 F.2d 328 (7th Cir. 1992).

[14] *Central States Southeast and Southwest Areas Pension Fund v. Kraftco, Inc*., 799 F.2d 1098 (6th Cir. 1986) (even if ratification of the contract is required, ratification may be waived by the union); *Central States Southeast and Southwest Areas Pension Fund* v. *Kraftco, Inc*., 799 F.2d 1098 (6th Cir. 1986) (citing *NLRB v. Truckdrivers, Chauffeurs & Helpers, Local Union No. 100*, 532 F.2d 569, 571 (6th Cir.), cert. denied, 429 U.S. 859, 97 S.Ct. 160, 50 L.Ed.2d 137 (1976)); *NLRB v. International Union of Elevator Constructors Local No. 8*, 465 F.2d 974, 975 n. 1 (9th Cir.1972). *Central States Southeast and Southwest Areas Pension Fund v. Kraftco, Inc*., 799 F.2d 1098 (6th Cir. 1986) (union representatives have apparent authority to enter into an agreement without necessity of ratification, siting *Kitchen Fresh, Inc. v. NLRB,* 716 F.2d 351, 355 (6th Cir.1983). *Goclowski v. Penn Central Transportation Co.* 571 F. 2d 747 at 759).

[15] *See, e.g.,* U.C.C. § 2-305 (2004) (price); *id.* § 2-307 (single delivery); *id.* § 2-308 (place for delivery); *id.* § 2-309 (time for shipment or delivery); *id.* § 2-310 (time for payment); DEL. CODE ANN. tit. 8, § 223 (2001 & Supp. 2004) (providing procedure for filling vacancies and newly created directorships "[u]nless otherwise provided in the certificate of incorporation or bylaws"). One could add a third type of default rule in which the parties are required by an authority to fill in blanks on certain subjects, such as the requirements in corporate law (e.g., to establish a financial structure and main office address). This Essay does not deal with this kind of default rule.

[16] U.S. CONST. art. X ("The powers not delegated to the United States by the Constitution, not prohibited by it to the States, are reserved to the States respectively, or to the people.").

[17] H.L.A. HART, THE CONCEPT OF LAW 125 (1961).

[18] Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent,* 78 VA. L. REV. 821, 822-23 (1992) (That this is the prevailing wisdom of contract theory is evidenced by the fact that scholars as disparate as Ian Macneil, Subha Narasimhan, and Charles Fried adhere to it. Recently, however, in an almost imperceptible shift, the rhetoric of gap-filling has been increasingly supplanted by a new and powerful heuristic device: the concept of default rules. This concept has been employed by an ideologically diverse group of contract theorists including Ayres and Gertner, Goetz and Scott, Coleman, Heckathorn, and Maser, Haddock, Macey, and McChesney, and Douglas Baird, David Charny, Richard Craswell, Richard Epstein, Clayton Gillette, and Jason Johnston.). *Id.* at 823-24 (footnotes omitted).

[19] JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS § 3.17, at 527 (5th ed. 2003) (usage). The Second Restatement of Contracts states, "Express terms, course of performance, course of dealings, usage of trade are weighted *in that order* (emphasis added)." UCC Article 2A §207(2) states "The express terms of a lease agreement and any course of performance, as well as any course of dealing and usage of trade, must be construed whenever reasonable as consistent with each other; but if that construction is unreasonable, express terms control course of performance, course of performance controls both course of dealing and usage of trade, and course of dealing controls usage of trade."

[20] Id. § 3.14, at 162-63.

[21] *See Id.* § 3.2, at 124 (5th ed. 2003) (stating that parol evidence rule provides that final agreement that is in writing and is binding contract supersedes prior negotiations or tentative agreements). A writing intended as a final agreement may not be *contradicted* by parol evidence. Both the court and the Uniform Commercial Code take this approach. At common law "course of performance" is usually called "practical construction." *Id.* § 3.17, at 169. Since course of performance occurs after the contract was signed, the parol evidence rule does not prevent it from adding additional terms. *If an additional term is so added, "the issue is modification or waiver."* The parties' terms may be explained or supplemented "by evidence of consistent additional terms unless the court finds the writing to have been intended also as a complete and exclusive statement of the terms of the agreement."

[22] Under the parol evidence rule "[A] writing intended by the parties to be a final embodiment of their agreement should be protected from certain kinds of evidence." Calamari and Perillo, § 3.2, at 124-25. *See also id.* at 126. The Uniform Commercial Code provides that "Terms with respect to which the confirmatory memoranda of the parties agree or which are otherwise set forth in a writing intended by the parties as a final expression of their agreement with respect to such terms as are included therein may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement but may be explained or supplemented (a) by course of dealing or usage of trade (Section 1-205) or by course of performance (Section 2-208); and (b) by evidence of consistent additional terms unless the court finds the writing to have been intended also as a complete and exclusive statement of the terms of the agreement."

Parol evidence is admissible to show defects in contract formation, including (a) that the writing was not intended to be operative (i.e., a final agreement); (b) the failure of an express condition to occur; (c) fraud; (d) mistake; (e) illegality or unconscionability; and (f) absence of consideration. Calamari and Perillo, § 3.7(a)-(f), at 143-48. This rule applies to the UCC as well. *Id.* § 3.7(g), at 148.

[23] *See* JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS § 3.14, at 165 (5th ed. 2003) (stating that in determining meaning of a disputed term, courts rarely consider relative bargaining power). Even so, the party that prepared the text can set up the parameters as a basis for discussion and in many cases has more legal talent at its disposal. Therefore, the meaning of the terms is determined against the party that prepared the draft.

[24] Under the parol evidence rule "[A] writing intended by the parties to be a final embodiment of their agreement should be protected from certain kinds of evidence." Calamari and Perillo, § 3.2, at 124-25. *See also id.* at 126. The Uniform Commercial Code provides that "Terms with respect to which the confirmatory memoranda of the parties agree or which are otherwise set forth in a writing intended by the parties as a final expression of their agreement with respect to such terms as are included therein may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement but may be explained or supplemented (a) by course of dealing or usage of trade (Section 1-205) or by course of performance (Section 2-208); and (b) by evidence of consistent additional terms unless the court finds the writing to have been intended also as a complete and exclusive statement of the terms of the agreement." Parol evidence is admissible to show defects in contract formation, including (a) that the writing was not intended to be operative (i.e., a final agreement); (b) the failure of an express condition to occur; (c) fraud; (d) mistake; (e) illegality or unconscionability; and (f) absence of consideration. Calamari and Perillo, § 3.7(a)-(f), at 143-48. This rule applies to the UCC as well. *Id.* § 3.7(g), at 148.

[25] *Id.* at 163.

[26] *See* 2A NORMAN J. SINGER, STATUTES AND STATUTORY CONSTRUCTION § 48.03, at 422-31 (6th ed. 2000) (noting role of pre-enactment legislative history in statutory interpretation).

[27] JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS § 3.17, at 527 (5th ed. 2003) (usage).

[28] *See* 2A SINGER, *supra* note __, § 48.06, at 440-41 ("Committee Reports represent the most persuasive indicia of congressional intent in enacting a statute."); *id.* § 48.10, at 453 ("In the federal courts statements of members of the committee or of interested parties at the hearing have been considered as aids to determining the legislative intent.").

[29] *See, e.g.,* Albano v. Attorney Gen., 769 N.E.2d 1242 (Mass. 2002) (determining whether petitioners have authority under state constitution to add provision defining marriage).

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[31] *See* Tamar Frankel, *Fiduciary Duties as Default Rules,* 74 OR. L. REV. 1209, 1210-11 (1995).

[32] See generally, 3A Fletcher Cyclopedia of the law of Private Corporations, (Rev. Vol. Jennifer L. Berger, TCarol A Jones and Britta M. Larsen 2002) § 1047 at 87-88, Id. Cumulative Supp. 2004 §1101 ("If corporate directors breach the duty of care intentionally, knowingly, or in bad faith, director protection statutes will not shield them form personal liability."); 2 William E. Knepper and Dan A Bailey, Liability of Corporate Officers and Directors, ch. 16 (7th ed. 2002); Dennis J. Block, Nancy E. Barton, and Stephen A Radin, The Business Judgment Rule 114-124 (4th ed. 1993, Supp. 1994).

[33] *See, e.g.,* Stroud v. Grace, 606 A.2d 75, 85 (Del. 1992).

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[35] PERILLO, *supra* note __, § 3.2, at 124 ("[I]n determining the content of the contract, earlier tentative agreements and negotiations are inoperative").

[36] *See* 2A SINGER, *supra* note __, § 48.03, at 422-31.

[37] PERILLO, *supra* note __, § 3.13, at 158.

[38] *See* 2A SINGER, *supra* note __, § 48.01, at 408-09 ("Extrinsic aids consist of background information about circumstances which led to the enactment of a statute, events surrounding enactment, and developments pertinent to subsequent operation.").

[39] *See, e.g.,* Emerald Ptrs. v. Berlin, 787 A.2d 85 (Del. 2001).

[40] Tamar Frankel, *The Legal Infrastructure of Markets: The Role of Contract and Property Law,* 73 B.U. L. Rev. 389, 402 (1993); 4 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 856, at 403 (1951) (stating that historically, a contract right "was a personal relation that was incapable of delivery").

[41] John Edward Murray, Jr., Murray on Contracts, § 135, at 912-15 (4th ed. 2001).

[42] *See* ROBERT CHARLES CLARK, CORPORATE LAW § 11.4.2, at 480-81 (1986) (officer's sale of office); FRANKLIN A. GEVURTZ, CORPORATION LAW § 4.11, at 274-28 (2000) (officer's inattention to subordinates).
[43] Consent is defined in MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 246 (10th ed. 1999) as (intransitive verb) "to give assent or approval" and (noun) "compliance in or approval of what is done or proposed by another" or "agreement as to action or opinion."
[44] *See* JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS §§ 8.1-.17, at 284-312 (5th ed. 2003) (capacity of parties); *id.* §§ 9.1-45, at 313-409 (misconduct or mistake).
[45] *See, e.g.*, MASS. GEN. LAWS ch. 53, § 22A (1990) (Form 1 within the section is the form for a "petition for referendum"; Form 2 is for an "initiative petition"); CAL. ELEC. CODE §§ 9001-9010 (West 2003).
[46] The nineteenth-century doctrine of *caveat emptor,* that "purchasers buy at their own risk,"is still generally valid in transactions between merchants. BLACK'S LAW DICTIONARY 215 (7th ed. 1999).
[47] 7 JOSEPH M. PERILLO, CORBIN ON CONTRACTS, § 28.20, at 91-92 (rev. ed. 2002).
[48] MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 246 (10th ed. 1999): "a general agreement," "the judgment arrived at by most of those concerned," "group solidarity in sentiment and belief."
[49] Tim Berners-Lee, *The World Wide Web and the "Web of Life"* (1998) (quoting Dave Clark: "We have no kings or presidents. We believe in rough consensus and running code"), http://www.w3.org/People/Berners-Lee/UU.html (last visited Dec. 17, 2004).
[50] *See, e.g.,* Bryan v. United States, 524 U.S. 184, 195 (1998) (noting "traditional rule" that "ignorance of the law is no excuse").
[51] *See* JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS § 13.7, at 527 (5th ed. 2003).
[52] *See* JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS § 14.08, at 396 (2d ed. 2000) (stating that shares are freely transferable in the absence of restrictions). Some countries do not permit waiver of citizenship, viewing the citizens as blood members of a family. The United States, in contrast, allows waiver of citizenship. *See* Alexander T. Aleinikoff, *Theories of Loss of Citizenship,* 84 MICH. L. REV. 1471, 1484 (1986) (stating that citizenship is a right and that expatriation is a waiver of this right).
[53] *See generally* PERILLO, *supra* note __, § 5.14, at 242-47 (discussing modification of contracts).
[54] A referendum vote can depend on a first text, and invites the parties to approve or disapprove the text. Another form of a referendum allows a certain percentage of the voters to propose a rule and invite the rest of the voters to vote on it.
[55] *See, e.g.,* DEL. CODE ANN. tit. 8, § 242(b)(1) (2001) (providing procedure for charter amendment; directors must first "adopt a resolution setting forth the amendment proposed," then either call a special meeting or direct thai it be considered at the next annual meeting); *see also* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power,* 118 HARV. L. REV. 833, 844 (2005).
[56] *See, e.g.,* DEL. CODE ANN. tit. 8, § 109(a) (2001) (granting shareholders power to amend bylaws; power may be conferred upon directors but shareholders may not be divested of power); *see also* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power,* 118 HARV. L. REV. 833, 845 (2005). However, the bylaws may not be inconsistent with the charter. DEL. CODE ANN. tit. 8, § 109(b) (2001); *see also* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power,* 118 HARV. L. REV. 833, 845 (2005) ("[T]he bylaws . . . are subordinate to the charter.").
[57] Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power,* 118 HARV. L. REV. 833, 865-75 (2005).
[58] Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 Yale L. J. 698, 702-703 (1982) ("Socially optimal fiduciary rules approximate the bargain that investors and agents would strike if they were able to dicker at no cost. . . . To say that fiduciary principles require equal (or even fair) treatment is to beg the central question—whether investors would contract for equal or even roughly equally treatment.").
[59] Restitution under contract is distinguishable from accounting for profit. The promisee's *reliance interest* is defined as the recovery that would "attempt to put the *promisee back in the position in which the promisee would have been had the promise not been made.*" 1 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 2.1, at 77 (3d ed. 2004) (used if the promisee incurred a detriment in reliance on the promise]

The promisee's *restitution interest* is defined as the recovery that would "attempt to put the *promisor back in the position in which the promisor would have been had the promise not been made.*" *Id.* [used "[i]f the promisee conferred a benefit on the promisor in the course of the transaction"). Courts "have generally declined to require the party in breach to disgorge gain resulting from that party's breach." 3 *id.* § 12.20a, at 338.

[60] Henry N. Butler and Larry E. Ribstein, Opting Out Of Fiduciary Duties: A Response To The Anti-Contractarians, 65 Wash. L. Rev. 1 (1990).

[61] *See* DANIEL J. BOORSTIN, THE AMERICANS: THE NATIONAL EXPERIENCE 49-90 (1965).

[62] Tamar Frankel, *Fiduciary Law,* 71 CALIF. L. REV. 795, 825 (1983) (citing Vai v. Bank of Am Nat'l Trust & Sav. Ass'n, 364 P.2d 247, 252-53 (Cal. 1961)).

[63] *Id.* at 826 (citing 2 AUSTIN WAKEMAN SCOTT, THE LAW OF TRUSTS § 173 (3d ed. 1967); RESTATEMENT (SECOND) OF TRUSTS § 379 comment c (1957)).

[64] Tamar Frankel, *Fiduciary Law,* 71 CALIF. L. REV. 795, 821 (1983) (citing cases).

[65] UNIF. TRUSTS ACT, § 18, 7B U.L.A. 466 (1937) (allowing a beneficiary of "full legal capacity and acting upon full information" to relieve a trustee of any duties other than those imposed by sections 3, 4, and 5); see *id*. § 3, at 446 (prohibiting loan of trust funds to self or certain affiliated or related parties); *id*. § 4, at 447 (allowing corporate trustee to deposit funds with self under some circumstances); *id*. § 5 (prohibiting buying or selling of trust property to or from self or certain affiliated or related parties).

[66] SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963) (requring the advisers to disclose that he holds the stock that he recommends and will sell the stock shortly after the market will rise-presumably on the basis of his recommendation. This is a practice called "scalping").