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# A NEW DIRECTION FOR STATE CORPORATE CODES

MARK J. LOEWENSTEIN\*

## INTRODUCTION

State corporate statutes at the end of the twentieth century face three related challenges. The principal challenge stems from the increasing popularity of the philosophy that state corporate codes should be more "enabling" and contain fewer "mandatory" provisions.<sup>1</sup> That is, the state should permit the organizers of corporations and their investors the maximum freedom to shape the terms of the corporation's governance. Those parties, some argue, are better situated than the state to choose a scheme of corporate governance that will allow the firm to maximize the individual wealth of the participants.<sup>2</sup> Implicit in this argument is the premise that wealth maximization is preferable to any other goal of private law.<sup>3</sup> As this philosophy, sometimes

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1. See Douglas M. Branson, *The Death of Contractarianism and the Vindication of Structure and Authority in Corporate Governance and Corporate Law*, in PROGRESSIVE CORPORATE LAW 95 (Lawrence E. Mitchell ed., 1995) ("[T]he mandatory content of corporate law is minimalist when compared to the near sumptuary laws that some corporate statutes in the past contained.").

2. See *infra* notes 29-30 and accompanying text. This argument is developed at length in FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 1-39 (1991), and it is also the basis for a rich literature in the law reviews. See, e.g., William W. Bratton, Jr., *The 'Nexus of Contracts' Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989); Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON L. REV. 99 (1989); see also Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

3. The goal of wealth maximization is not unchallenged. See David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, in PROGRESSIVE CORPORATE LAW 1 (Lawrence E. Mitchell ed., 1995) (discussing the communitarian view, which "focuses on the sociological and moral phenomenon of the corporation as community, in contrast to the individualistic, self-reliant, contractarian stance that dominates current academic discourse in corporate law"). This challenge to wealth maximization finds expression in "other constituency statutes" that permit, or require, the directors to consider the impact of their decisions on nonshareholders. See, e.g., CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1996) ("shall"); IND. CODE ANN. § 23-1-35-1(d) (Michie Supp. 1996) ("may"). See generally Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV.

characterized as a "contractarian" philosophy, gains dominance, state legislators will be hard-pressed to justify existing or new mandatory provisions in corporate codes.<sup>4</sup> In fact, the most recent draft of the Model Business Corporation Act reflects this trend toward enabling acts and, while many mandatory provisions remain,<sup>5</sup> their future is in doubt.<sup>6</sup>

The second challenge facing state corporate law is the increasing number of alternative forms of business organization from which organizers of a business can choose.<sup>7</sup> In recent years, states have adopted legislation authorizing the creation of a number of new forms of business organization, such as limited

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121 (1991); Steven M. H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163 (1991).

4. Professor Branson has declared that the "contractarian movement peaked." Branson, *supra* note 1, at 95. Professor Branson seems to dance on a grave not yet dug. The ABA Revised Model Business Corporation Act, which in his view embodies a strong enabling bias, continues to gain acceptance by state legislatures. And the recent action by the Colorado legislature, which amended Colorado's version of the Revised Model Business Corporation Act to remove two mandatory provisions, demonstrates that at the grass-roots level contractarianism is very much alive. See *infra* notes 56-66 and accompanying text.

5. See, e.g., REVISED MODEL BUS. CORP. ACT § 8.01 (requiring a corporation to have a board of directors, unless there are 50 or fewer shareholders, in which case the articles may specify an alternative mechanism for governance), §§ 8.05 and 8.06 (limiting the terms of directors to three years if the board is a staggered board and to one year if not), §§ 7.01 and 8.03 (requiring a corporation to hold an annual meeting for the election of directors), § 8.30 (listing the standards of conduct for directors), § 8.42 (listing the standards of conduct for officers), § 16.02 (granting the shareholder rights to inspect and copy certain corporate books and records), § 16.20 (requiring a corporation to furnish annual financial statement to shareholders), § 10.03 (amending articles only upon the consent of the holders of a majority of the outstanding shares), § 14.02 (allowing dissolution of corporation voluntarily only upon the consent of the holders of a majority of the outstanding shares), § 13.02 (giving shareholders the right to dissent and receive the fair value of their shares in the event of certain mergers, share exchanges, sale of substantially all of the corporate assets and amendments to the articles of incorporation), and § 10.20 (retaining the shareholders' right to amend the corporation's bylaws) (1984).

6. See Douglas M. Branson, *Recent Changes to the Model Business Corporation Act: Death Knells for Main Street Corporation Law*, 72 NEB. L. REV. 258 (1993).

7. In 1995 the Colorado General Assembly added to the list of alternatives by passing statutes permitting the creation of registered limited liability partnerships and registered limited liability limited partnerships. See COLO. REV. STAT. §§ 7-60-101 to -154 (1996). See generally Robert R. Keating et al., *Limited Liability Partnerships and Other Entities Authorized in Colorado*, 24 COLO. LAW. 1525 (1995). In addition to these entities, business trusts and cooperatives have enjoyed a resurgence of interest.

liability companies,<sup>8</sup> limited liability partnerships,<sup>9</sup> limited liability limited partnerships,<sup>10</sup> and limited partnership associations.<sup>11</sup> These entities were initially created to allow their owners to combine the limited liability features of a corporation with the favorable pass-through tax treatment of a partnership. But they are also attractive to business organizers who do not necessarily seek the advantages of pass-through taxation because these entities provide more organizational flexibility than does the traditional corporation. This greater flexibility is a reflection of the same pressures that have moved corporate law away from mandatory provisions.

The third challenge comes from the Internal Revenue Service ("Service"), which has promulgated the so-called check-the-box regulations. Effective January 1, 1997, these regulations permit unincorporated associations, such as those noted above, to choose to be taxed as partnerships without regard to the four-factor test that the Service traditionally has employed.<sup>12</sup> Prior to these new regulations, an unincorporated association was taxed as a corporation if it had a preponderance of the four "corporate characteristics": (1) continuity of life, (2) centralization of management, (3) liability for entity debts limited to the entity's assets, and (4) free transferability of ownership interests.<sup>13</sup> Some state statutes establishing new business entities were drafted in a way to ensure that entities organized under them would fail the test and thus be treated as partnerships for federal income tax purposes. In light of the Service's check-the-box regulations, the states will likely remove these limitations from their codes, thereby increasing the attractiveness of these entities to business organizers and further eroding the dominance of the corporate form.

As these three challenges show, the ready alternative of flexible unincorporated associations will only speed the evolution

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8. See, e.g., COLO. REV. STAT. §§ 7-80-101 to -1101 (Supp. 1996).

9. A limited liability partnership is a general partnership in which the partners are not liable for the debts and obligations of the partnership and that has registered pursuant to COLO. REV. STAT. § 7-60-144 (Supp. 1996).

10. A limited liability limited partnership is a limited partnership in which the general partners are not liable for the debts and obligations of the partnership and that has registered pursuant to COLO. REV. STAT. § 7-60-144 (Supp. 1996).

11. See, e.g., COLO. REV. STAT. §§ 7-63-101 to -117 (Supp. 1996).

12. See Treas. Reg. §§ 301.7701-2 to -3 (1997).

13. See Treas. Reg. § 301.7701-2 (as amended in 1993).

of the corporation statute away from mandatory provisions, and the statutes governing these various forms of business entities will become indiscernible from one another. Indeed, some have argued that the natural evolution of current trends will and should result in a single business entity statute that would afford the greatest amount of flexibility to the organizer of a new business.<sup>14</sup> In this essay, I offer an alternative course of action for the legislature. The evolution I have described should result in two distinct business entities: one would be the corporation—with traditional mandatory provisions—and the other would be a flexible, limited liability entity—without mandatory provisions.

This proposal acknowledges that both the traditional corporation and a flexible business entity have their advantages. The traditional corporation provides the investing community with a familiar business entity and with investor protections ranging from the imposition of well-established fiduciary duties on managers to the assurance that fundamental changes in the investment cannot occur without the investors' consent. A purely enabling statute, on the other hand, promotes the value of contractual freedom and provides the state's entrepreneurs an alternative to organizing the business under the laws of another, more liberal, jurisdiction. Investors in the traditional corporation can rely on the protection of mandatory provisions, while investors in an entity created under a purely enabling statute would be on notice to examine the terms of the governing document.<sup>15</sup>

This proposal is also based on a vision of a post-modern world in which the move to a single, purely enabling statute would soon be followed by a move back to mandatory provisions. The mandatory provisions that are currently a part of the typical corporate code can be traced back to abuses that occurred in their

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14. Evidence of this trend can be found in a bill, which would provide for a uniform standard of fiduciary duties for all business entities, recently introduced in the Pennsylvania legislature. See S. 1506, 180th Leg., Spec. Sess. (Pa. 1996).

15. To be sure, these statutes would have to include default provisions when the governing documents are silent on an issue. But whether these default provisions should mirror the mandatory and default provisions of the corporate code or, alternatively, whether they should be based on some other criterion—such as provisions that would likely be agreed to by the parties dealing at arm's length—is a question beyond the scope of this article.

absence.<sup>16</sup> If a state provided only an enabling statute, and abuses were to occur—which they surely would—the legislature would likely respond to public pressure and restore mandatory provisions. The result in this post-modern world would be that the law would afford neither a purely enabling statute nor a comprehensive mandatory statute. No one would be happy, and the experience of recent years, in which the corporate code has undergone numerous revisions, or tinkering, would be repeated.<sup>17</sup>

In the next two sections of this essay, I will discuss the justifications for mandatory terms and, looking to Colorado law, an example of how a state legislature has responded to the trends I have noted above. The essay concludes with a discussion of the proposal that the traditional corporation be retained.

## I. MANDATORY PROVISIONS AND THE GOAL OF EFFICIENCY

All corporate statutes have limited liability for investors in the enterprise.<sup>18</sup> The reason for this feature is an assumption that an environment in which investors bear no liability beyond the amount invested if the enterprise fails will enhance capital formation and, hence, economic activity. Beyond this, corporate statutes tend to be enabling statutes that give the organizers of the entity considerable discretion in shaping the terms of corporate governance.<sup>19</sup> Presumably, organizers will choose the most economically efficient form of governance.

Given the pervasiveness of limited liability and the apparent justification for it, as well as the freedom provided by the modern enabling statute, one might conclude that the driving force behind

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16. For instance, in 1994, when the Colorado General Assembly adopted the Colorado Business Corporation Act, it added a provision, not found in the Colorado Corporate Code or in the Revised Model Business Corporation Act, to protect shareholders from being squeezed out without compensation in a reverse stock split. See COLO. REV. STAT. § 7-113-102(2.5) (Supp. 1996). The legislature was reacting to a transaction in which such an abuse occurred.

17. In recent years, significant amendments to the Colorado corporate law occurred in 1987, 1990, 1994, and 1996. In 1994 the Colorado legislature adopted the Colorado Business Corporation Act, which was a substantial amendment to the earlier Colorado Corporation Code.

18. Limited liability is also a feature of the alternative organizational forms previously discussed. See *supra* notes 8-11 and accompanying text. For a brief philosophy of limited liability, see Theresa Gabaldon, *Experiencing Limited Liability: On Insularity and Inbreeding in Corporate Law*, in PROGRESSIVE CORPORATE LAW 111, 112-14 (Lawrence E. Mitchell ed., 1995).

19. See *supra* notes 1-6 and accompanying text.

the corporate statute is the desire to encourage capital formation and economic efficiency. But a close examination of a typical state corporate code reveals that these goals are often tempered by provisions that further other, possibly conflicting, policies. For instance, many states have provisions in their corporate codes that permit<sup>20</sup> or, in at least one instance, require<sup>21</sup> directors to consider the interests of constituencies other than shareholders in making business decisions.<sup>22</sup> Because shareholders are the residual claimants in the corporate framework, and their interests are served only by maximizing profits, these statutes, in effect, permit the board to pursue a course of action that is not profit maximizing, or not economically efficient. It is thus impossible to reconcile the existence of such provisions with the idea that corporate codes solely seek to serve one purpose; shareholder wealth maximization is tempered by other policy goals.

Because the typical corporate statute reflects inconsistent policies, no policy is well-served. For example, if the corporate statute in jurisdiction A protects other constituencies while the limited liability company act in jurisdiction A does not, or while the corporate statute of jurisdiction B does not, the organizers of the business enterprise may well opt for one of the latter two alternatives, thereby defeating the ability of the legislature of jurisdiction A to realize its goal of other constituency protection.

In addition to the inclusion of some provisions that appear on their face to serve conflicting policy goals, many provisions of the typical state corporation law might be classified as of doubtful efficiency. In other words, fully informed investors and corporate promoters might not include the provision in their contract if they had full freedom of contract. For instance, many corporate statutes provide that shareholders may act without a meeting only when there is unanimous written consent of the sharehold-

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20. Since the 1980s, 29 states have adopted such statutes: Arizona, Connecticut, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Massachusetts, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, New Mexico, New York, Ohio, Oregon, Pennsylvania, Rhode Island, South Dakota, Tennessee, Virginia, Wisconsin, and Wyoming. See Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 27 n.56 (1992).

21. See CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1996).

22. See *supra* note 3.



ers.<sup>23</sup> The rationale for requiring unanimous, as opposed to majority, consent is an apparent distrust of actions taken by shareholders without a meeting; legislators fear that the minority shareholders might somehow be taken advantage of if they cannot voice their concerns at a meeting of shareholders.

It is possible, however, that if investors and organizers contracted with regard to such a provision, they would conclude that it is more efficient to permit shareholders owning a majority of outstanding shares to act without a meeting by written consent.<sup>24</sup> Again, those deciding which state to choose for the jurisdiction of incorporation might prefer the state that allows informal shareholder action by less than unanimous written consent, all other things being equal. Of course, it is possible that the contracting parties would voluntarily choose a provision that matched the state-mandated one. But the possibility that they would not choose a matching provision raises the question of why the state mandated the provision in the first instance. If the parties affected by the provision do not want it, why does the state insist upon it? And if the parties, freely contracting, would prefer the state-mandated provision, then why should the state bother to mandate it?

It is against this background that the debate over mandatory versus enabling statutes has taken place. The search for a coherent and persuasive philosophy to justify mandatory terms is not a search through wholly uncharted waters. Indeed, corporate law scholars have actively debated this question for more than a decade and, like most academic debates, no consensus has emerged. At the one extreme, alluded to above, is the contractarian philosophy that no mandatory terms are justifiable; it trumpets the value of giving the participants in the corporate enterprise—managers, shareholders, creditors, employees—the maximum freedom to fashion their relations in the way they choose. In brief, this philosophy holds that the state is ill-situated to mandate the terms of corporate governance, especially in comparison with the parties who risk their capital or liveli-

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23. It is not sufficient under these statutes for shareholders holding a majority of the stock to approve the action by written consent, even though they would have sufficient votes to approve the action at a shareholders' meeting. *See, e.g.*, REVISED MODEL BUS. CORP. ACT § 7.04 (1985); COLO. REV. STAT. § 7-107-104 (Supp. 1996).

24. The Delaware corporate law so provides. *See* DEL. CODE ANN. tit. 8, §§ 216, 228 (1991).

hoods on the terms. An essential assumption of this philosophy, as it concerns corporate governance, is that the market for corporate stock will price the terms of governance.<sup>25</sup> If shareholders are disadvantaged by these terms, the price of the stock will be correspondingly lowered to the disadvantage of the promoters of the enterprise. The promoters thus will bear the financial burden of unfair terms.<sup>26</sup>

When one sails away from a purely contractarian view of the corporation, as most scholars do, the waters become murky. While these scholars agree that the state should mandate certain terms, they vary widely on what should be mandated and often either demonstrate a great reluctance to articulate a standard, or articulate a standard too vague to be of much usefulness to a lawmaker. For instance, in 1989, the *Columbia Law Review* held a symposium, entitled "Contractual Freedom in Corporate Law,"<sup>27</sup> to answer, in the words of the foreword to the symposium, these questions: "To what extent should corporations be allowed to opt out of the rules of corporate law by adopting charter provisions to that effect? That is, should any corporate law rules be mandatory, and, if so, which rules?"<sup>28</sup>

The first contribution to this symposium is an article by Judge Easterbrook and Professor Fischel, stating the contractarian argument in its strongest terms.<sup>29</sup> They thus answer the first question by saying that corporations should be free to fully opt out, and thereby moot the second question. The remaining articles all seem to start from the presumption that some mandatory terms are appropriate, but only one author, Professor Eisenberg, attempts to offer a coherent standard for what terms

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25. See EASTERBROOK & FISCHEL, *supra* note 2, at 17.

26. See *id.* ("To obtain an (inefficient) right to divert opportunities [the manager] must pay in advance."); see also Eugene Fama, *Random Walks in Stock Market Prices*, FIN. ANALYSTS J., Sept.-Oct. 1965, at 55 (supporting a strong version of the efficient market hypothesis). Professor Fama seems to have backed away from the idea that the market efficiently prices "suboptimal governance" provisions. See Eugene Fama, *Efficient Capital Markets II*, 46 J. FIN. 1575 (1991) (expressing some skepticism). See generally Uriel Procaccia, *Crafting a Corporate Code from Scratch*, 17 CARDOZO L. REV. 629, 639-40 n.38 (1996).

27. See Symposium, *supra* note 2, at 1395.

28. Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

29. See Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989).

ought to be mandatory.<sup>30</sup> The other contributors either seek to rationalize the appropriateness of mandatory terms,<sup>31</sup> or describe the role of the judiciary in an environment in which mandatory terms are of marginal importance.<sup>32</sup> Unfortunately, Professor Eisenberg's valiant effort is both flawed and too vague to be of much use to a lawmaker.

While generally accepting the contractarian philosophy, Professor Eisenberg insists on two important qualifications. First, in closely held corporations, the law must operate as it does in the typical contract, providing relief where a party has been unfairly taken advantage of or where one party has engaged in opportunistic behavior that was not reasonably anticipated.<sup>33</sup> Second, in publicly held corporations, the market cannot be trusted to fairly price negotiated terms of corporate governance. Thus, mandatory terms are necessary to protect against the overreaching that would otherwise take place.<sup>34</sup>

These ideas are interesting, though ultimately impractical. Professor Eisenberg's highly abstract formulation does not provide sufficient guidance to even the most conscientious legislator. For instance, Eisenberg states that shareholders of closely held corporations should not be able to "relax materially the fiduciary rules set by law," because shareholders are unable to anticipate the consequences of such actions.<sup>35</sup> He thus implies, I believe, that the shareholders should not be able to waive the liability of directors for violations of the fiduciary duty of care, yet he notes that a number of states permit the shareholders to do just that.<sup>36</sup> He makes no attempt to square these statutes with his general principle, and expresses no opinion as to whether these statutes represent sound public policy. In short, on this critical question of mandatory versus optional provisions, Eisenberg demurs.

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30. See Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989).

31. See, e.g., Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989).

32. See Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703 (1989); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989).

33. See Eisenberg, *supra* note 30, at 1463-70.

34. See *id.* at 1471-1515.

35. *Id.* at 1469.

36. See *id.* at 1477.

With respect to publicly held corporations, Eisenberg focuses on the need for mandatory rules to limit the "positional conflicts" of top management.<sup>37</sup> By positional conflicts, he means, among other things, actions top managers may take to enhance their personal power, prestige, and wealth at the expense of shareholders without engaging in actions that would normally be considered a conflict of interest.<sup>38</sup>

Professor Eisenberg identifies two types of rules that should be mandatory: fiduciary rules and "core structural rules."<sup>39</sup> Professor Eisenberg pays particular attention to core structural rules because these rules address positional conflicts. Thus, he writes:

[C]ore structural rules should require mechanisms for accountability and disclosure for top executives, shareholder approval of certain transactions, and appraisal rights for certain transactions, but they should not regulate the content of corporate transactions. Because mandatory rules generally should not regulate the content of transactions, distributional rules should generally be enabling, except as required to protect the interests of creditors.<sup>40</sup>

After announcing this general principle, Eisenberg reviews the typical menu of mandatory rules under state law, and "mandatory rules" under federal securities laws for companies registered under section 12(g) of the Securities and Exchange Act of 1934 and, where applicable, under the New York Stock Exchange Rules. On the basis of this review, he reassuringly concludes that "to a significant extent, these are just the mandatory rules that corporation law should contain."<sup>41</sup>

On close examination, this conclusion is anything but reassuring. In the course of reviewing mandatory state law

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37. *Id.* at 1480.

38. *See id.* at 1472. Professor Eisenberg gives these examples:

They may seek to increase corporate size as a way to maximize their power, prestige, and salary, even if an increase in corporate size does not increase shareholder wealth. They may seek to maximize the cash and other resources that they command, even when distributions to the shareholders would be more efficient. They may diversify the firm as a means to reduce the riskiness of their human-capital investments, even when diversification of the firm is not in the interest of shareholders.

*Id.*

39. *Id.* at 1480.

40. *Id.* at 1481.

41. *Id.* at 1485.

provisions, Eisenberg notes the varying approaches of the states, Delaware being the least regulatory and California among the most regulatory, with a marked difference between those states. Given that range, and Eisenberg's vague endorsement of the current state of the law, it becomes clear that his general pronouncements on what should be mandatory are largely useless to the conscientious legislator. A lawmaker would have little help in deciding, for instance, whether the corporate code should provide an appraisal remedy in the event of a charter amendment. Delaware does not provide one, the Revised Model Business Corporation Act does provide one, and Professor Eisenberg cites both with approval.<sup>42</sup>

Unlike most who question the contractarian approach, Professor Eisenberg at least attempts to articulate some guiding principles. Others who share his skepticism of the contractarian philosophy can be classified into two schools of thought. The first school argues that mandatory terms in corporate codes do not detract from the corporation's ability to maximize profits and may, in fact, enhance that ability.<sup>43</sup> Adherents to the second school maintain that maximization of corporate profits, to the exclusion of the other, possibly competing goals, is not the appropriate policy for the law to achieve, and that the nature of the modern corporation is such that parties other than shareholders have a stake in corporate decisions. The interests of these other stakeholders, they argue, are entitled to consideration.<sup>44</sup>

Neither school has been successful in articulating a practical test for determining where to draw the line between enabling and mandatory rules. A representative of the first school, Professor Gordon, rationalizes the existence of mandatory rules as arising from a defect in the bargaining process that characterizes the contractarian philosophy.<sup>45</sup> He suggests that the most likely

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42. See *id.* at 1482-83.

43. See, e.g., Gordon, *supra* note 31, at 1549. Professor Gordon takes the view that if private wealth maximization is the goal of corporate law, that goal is best reached with a mix of optional and mandatory legal rules. *But cf.* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985) (arguing that the contractarian approach is unlikely to maximize shareholder wealth and is more likely to enhance management's ability to engage in opportunistic behavior); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879 (1988) (expressing doubts about the wisdom of allowing firms to contract out of fiduciary duties).

44. See, e.g., Millon, *supra* note 3.

45. See Gordon, *supra* note 31.

explanation for mandatory terms is what he calls the "opportunistic amendment hypothesis"—that mandatory rules protect shareholders against management-proposed charter amendments that advantage managers at the expense of shareholders.<sup>46</sup> The mandatory nature of these rules is a state-provided guarantee that has the effect of making the securities more marketable, thus accomplishing a goal of the contractarians in a more efficient manner.

Professor Gordon's explanation is unpersuasive. While it may be true that mandatory rules protect against some forms of opportunism, they hardly protect against all forms. For instance, mandatory rules generally do not restrict managerial opportunism in the realm of antitakeover devices that do not require shareholder approval, such as poison pills.<sup>47</sup> More importantly, drawing the lessons from the hypotheses, Gordon provides this guidance to legislators: in deciding whether to make a specific term optional, "the legislature should assume that the insiders will use the opt-out right in the manner most favorable to them and ask whether, nevertheless, public shareholders are better off on average."<sup>48</sup>

This guide is hardly a beacon of light to the legislator—it is not always apparent what is most favorable to the insider. The matter of informal shareholder action is a good illustration. Would insiders prefer that shareholders be able to act informally with only majority consent? Insiders would prefer majority consent if they knew, *ex ante*, that they would be seeking shareholder approval, but not if an insurgent group of shareholders would be seeking shareholder approval to oust them from office. Because of that uncertainty, corporate managers probably would prefer a regime in which they were immune from surreptitious shareholder action, and thus would opt for a unanimous consent rule. But the Colorado legislature viewed the situation quite differently, sensing that informal shareholder action by majority consent posed a threat *by* insiders, not against them.<sup>49</sup>

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46. See *id.* at 1573.

47. See Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599 (1989) (criticizing Gordon's article).

48. Gordon, *supra* note 31, at 1598.

49. This insight is based on the author's conversations with a key Colorado legislator, then Senate majority leader Tim Foster.

Moreover, the law of most states, Colorado among them, does not differentiate between closely held corporations and publicly held corporations.<sup>50</sup> It seems fair to assume that the shareholders and managers of most closely held corporations would prefer to allow shareholders to act informally by majority consent. The convenience factor is considerable. But what about publicly held corporations? If my assumption about managerial preferences is correct, then the opposite is true. To accommodate Gordon's philosophy, then, the legislature would have to provide different mandatory rules, depending on the nature of the corporation—not a happy turn of events.

My point is not to criticize the thoughtful work of Professors Gordon and Eisenberg, but rather to illustrate the difficulty—or impossibility—of trying to articulate a coherent rationale for mandatory rules. Similar criticism can be leveled against those who believe corporate law should further values other than profit maximization. Scholars writing from this perspective generally advocate that law ought to further values such as trust and communitarianism.<sup>51</sup> How this translates into the terms of a corporate code is utterly unclear.

Despite these analytical difficulties, mandatory rules surely have a place in corporate law, from a theoretical perspective as well as from a practical perspective. As a theoretical matter, the contractarian view rests heavily on the questionable assumption that the market will accurately price the terms of corporate governance.<sup>52</sup> The “market” for stock of closely held corporations is nonexistent and it is therefore inappropriate to consider it an accurate pricing tool for such stock. Indeed, the investors in the stock of closely held corporations need the fiduciary protections of mandatory provisions because of the degree of trust that they place in promoters; they generally cannot anticipate the many ways in which that trust can be tested.<sup>53</sup>

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50. Some states have special provisions that may be elected by close corporations. See, e.g., DEL. CODE ANN. tit. 8, §§ 341-356 (1991 & Supp. 1994 & Pamph. 3 1996). See generally F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS: LAW AND PRACTICE § 1.18 (1986).

51. See Millon, *supra* note 3.

52. See EASTERBROOK & FISCHER, *supra* note 2, at 17-22.

53. See Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 572 (1990) (“Close corporation investors also will often lack the base of experience to envision the many ways that conflict may arise over a long time period, and thus may misvalue fiduciary protections.”); Eisenberg,

Even for the stock of a company going public, one must question whether the market will accurately price the governance terms. As a preliminary matter, many such offerings are small, not attracting the sophisticated investors who might influence the pricing on the basis of governance terms.<sup>54</sup> More fundamentally, serious questions have been raised as to whether the stock market is as efficient as once supposed in pricing information, especially information of this sort.<sup>55</sup> An institutional investor whose investment horizon is short may undervalue a charter provision that seems to have remote, long-term effects. Finally, even if the offering is large, and sophisticated investors are buying, it requires a leap of faith to assume that these investors will spend the time necessary to study and evaluate what may seem like arcane points of corporate governance. Some may, but some may not, with the result that the market may not operate efficiently even in this best case scenario.

As a practical matter, mandatory terms respond to perceived unfairness in an unregulated market. They represent a rational legislative response to political pressures. Trying to craft a corporate code without mandatory provisions would be like trying to design a tea kettle without a vent for steam: it may look neat, but it won't work.

The Colorado approach to mandatory terms is typical. The corporate code contains a number of mandatory provisions, but recent amendments to the code demonstrate the legislature's ambivalence about them. The next section demonstrates that Colorado, like many other jurisdictions, has produced a hybrid corporate code that pleases neither those who advocate shareholder protection nor those who prefer complete freedom of contract.

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*supra* note 30, at 1464-66 (arguing that close corporation investors underestimate such risks).

54. See Black, *supra* note 53, at 571 n.83 (citing a study by Ibbotson, Sindelar & Ritter, *Initial Public Offerings*, 1 CONTINENTAL BANK J. APPLIED CORP. FIN. 37 (1988) (indicating that a majority of the firms with an initial public offering during the period 1975 to 1984 had annual sales under \$5,000,000)).

55. Evidence of the efficiency of the market in this regard is lacking. See Eisenberg, *supra* note 30, at 1502 nn.192-96 and sources therein; see also *supra* note 26.



## II. THE COLORADO LEGISLATIVE APPROACH

The Colorado legislature has faced the issue of adding or deleting mandatory terms several times in recent years; three examples highlight the dilemma. First, the Colorado Business Corporation Act, which was enacted in 1994, included a provision, based on the Revised Model Business Corporation Act, that would have allowed a shareholder to dissent from certain amendments to the corporation's articles of incorporation and receive the appraised value of the shareholder's stock.<sup>56</sup> In 1996, the Colorado legislature repealed this provision based on testimony from members of the bar that the provision inhibited the ability of Colorado corporations to raise capital because venture capitalists objected to it.<sup>57</sup> The objection of the venture capitalists apparently stemmed from their perception that they may need charter amendments to enhance future financing opportunities, and the possibility of dissenters' rights would add to the cost of such financings.<sup>58</sup> This inadequacy in Colorado law in turn might prompt Colorado corporations to reincorporate in Delaware, which has no comparable provision. Thus, a mandatory provision originally intended to protect the interests of minority shareholders who could not or did not bargain for veto rights over charter

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56. See COLO. REV. STAT. § 7-113-102(2) (1994) (repealed 1996). The appraisal rights provision stated:

A shareholder, whether or not entitled to vote, is entitled to dissent and obtain payment of the fair value of the shareholder's shares in the event of:

(a) An amendment to the articles of incorporation that materially and adversely affects rights in respect of the shares because it:

(I) Alters or abolishes a preferential right of the shares;

(II) Creates, alters, or abolishes a right in respect of redemption of the shares, including a provision respecting a sinking fund for their redemption or repurchase; or

(b) An amendment to the articles of incorporation that affects rights in respect of the shares because it:

(I) Excludes or limits the right of the shares to vote on any matter, or to cumulate votes, other than a limitation by dilution through issuance of shares or other securities with similar voting rights; or

(II) Reduces the number of shares owned by a shareholder to a fraction of a share or to scrip if the fractional share or scrip so created is to be acquired for cash or the scrip is to be voided under section 7-106-104.

*Id.* The Colorado Business Corporation Act replaced the Colorado Corporate Code.

57. In discussing this legislative history, the author relies on conversations with members of the Colorado Bar Association who were present at the legislative hearings.

58. And, presumably, the corporation would be unable to undertake any charter amendments without the consent of the venture capitalist.

amendments, as venture capitalists typically do, was abandoned in favor of a policy that furthered the interests of highly sophisticated institutional investors.<sup>59</sup>

In a second significant 1996 amendment to the Colorado Business Corporation Act, the legislature also eliminated the right to dissent and seek appraisal in the event of a merger, share exchange, or disposition of substantially all of the corporation's assets, if the corporation's shares are publicly traded.<sup>60</sup> The rationale for this change, which alters a long-standing provision of Colorado law, is that shareholders dissatisfied with the transaction can sell their shares in the public market and thus do not need the protections of the dissenters' rights provisions. And, like the amendment that eliminated the right to dissent from charter amendments, this amendment favors venture capitalists who wish to minimize the costs of transactions of which they approve and, incidentally, conforms Colorado law to Delaware's. Again the interests of the less-sophisticated shareholder have been adversely affected because some mergers, share exchanges, or assets sales may be viewed dimly by the market, causing the price of the corporation's publicly traded stock to decline after the announcement of the transaction. The dissenting shareholder is stuck with this lower, post-announcement price, while under the earlier version of the statute, that shareholder would have been entitled to receive the fair value of his stock "excluding any

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59. The official comment to the Revised Model Business Corporation Act explained the rationale for granting dissenters' rights under these circumstances:

The reasons for granting a right to dissent in these situations are similar to those granting such rights in cases of merger and transfer of assets. The grant of these rights increases the security of investors by allowing them to escape when the nature of their investment rights is fundamentally altered or they are compelled to accept cash for their investment in an amount established by the corporation. The grant also enhances the freedom of the majority to make changes, because the existence of an escape hatch makes fair and reasonable a change that might be unfair if it forced a fundamental change of rights upon unwilling investors without giving them an alternative.

REVISED MODEL BUS. CORP. ACT, § 13.02 cmt. 1(4) (1985).

From a philosophical perspective, affording dissenters' rights in these circumstances is appealing. It acts as a check against management opportunism and presents one of the strongest cases for mandatory terms. See Gordon, *supra* note 31, at 1586.

60. See COLO. REV. STAT. § 7-113-102(1.3) (1994 & Supp. 1996). The amendment, like the first example, reflects the legislature's propensity to conform Colorado law to Delaware's, which has contained a similar provision since 1967. See DEL. CODE ANN. tit. 8, § 262(b) (1991 & Supp. 1994 & Pamph. 1 1996).

appreciation or depreciation in anticipation of the corporate action."<sup>61</sup>

The third example, involving a core fiduciary duty of directors, is perhaps the most troubling. Responding to the 1985 decision of the Delaware Supreme Court in *Smith v. Van Gorkom*,<sup>62</sup> which imposed liability on corporate directors for breaching their fiduciary duty of due care, the Delaware legislature amended its corporate code to provide relief from the decision. As amended, the Delaware code allows a Delaware corporation to remove the liability of directors for breaches of the duty of care by so providing in its articles of incorporation.<sup>63</sup> Many other states,<sup>64</sup> including Colorado, quickly followed suit.<sup>65</sup> The shift in the potential liability of directors was as striking as it was sudden.

The 1996 amendments to the Colorado Business Corporation Act and the earlier legislative determination to allow Colorado corporations to limit the liability of directors for breaches of the duty of due care have thus removed three "mandatory" provisions from the law, provisions that by their terms applied to all Colorado corporations and could not be altered by charter provision or otherwise. The principal motivating force behind all three amendments—that Colorado law ought not impose economic costs on Colorado domestic corporations if the Delaware code does not—may be a standard of sorts, but is not a very convincing one.

Meeting the competitive challenge means that the Colorado legislature will always be in a reactive mode, and the corporate

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61. COLO. REV. STAT. § 7-113-101(4) (1994 & Supp. 1996).

62. 488 A.2d 858 (Del. 1985).

63. See DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1994). The certificate of incorporation may contain

a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of [the duty of due care], provided that such provision shall not eliminate or limit the liability of a director . . . for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.

*Id.*

64. By the middle of 1988, less than two years after the Delaware legislature adopted its opt out provision, at least 30 states had enacted laws similar to Delaware's. See James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207, 1210 (1988).

65. Colorado amended its law in 1987 to add the opt out provision. See COLO. REV. STAT. § 7-108-402 (Supp. 1996).

statute will be revised frequently, thereby adding uncertainty to the law.<sup>66</sup> Moreover, the legislature will be unable to enact any new mandatory provisions because of the fear that the statute would be at an immediate competitive disadvantage. Finally, it means, at bottom, a loss of sovereignty when the laws of a state are essentially dictated by the laws of another state. Indeed, it is incumbent upon a legislature to articulate convincing policy reasons for its legislative actions. If there was a persuasive reason for granting shareholders dissenters' rights in the event of certain amendments to the articles of incorporation, these reasons ought to remain persuasive even if the Delaware legislature decides the issue differently.

It is fair to conclude that Colorado corporate law, like the law of other states, lacks a coherent philosophy. It is like a ship adrift, subject to the tides and winds of the moment. In 1994, the Colorado legislature provided a new protection to minority shareholders. Two years later, it amended this protection out of existence. Yet the threat of abuses that prompted the protection in 1994 is still present. There is a need for a stable and predictable corporate law that provides protections to minority shareholders. At the same time, the demands that state law provide greater freedom of contract will persist. The next section sets forth a proposal to address both of these demands.

### III. A RECOMMENDATION AND CONCLUSION

From a practical perspective, the debate surrounding mandatory rules tends to minimize the historical significance of the corporate form and the value attached by individual investors to that form. Investors in the corporate form likely know that they are not liable for the debts of the corporation, that they have the right to elect directors, that directors are their fiduciaries, and that they have the right to vote as a condition to the implementation of certain fundamental changes to their investment. In short, much of what is mandatory in corporate law has been internalized in the investment decision of shareholders. The large body of law, case law as well as statutory, and the accumulated judicial experience in resolving disputes on the basis of this law, are of value and worth preserving. Replacing this law with

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66. See *supra* note 17.

private contract creates transaction costs that must be weighed against the purported benefits.

Nevertheless, it is unrealistic to assume that a state legislature would ignore the pleas that the state corporate statute "keep pace" with the law elsewhere. Thus, I make these two recommendations:

1. If the state continues the corporate form, it should do so in its traditional form, with the traditional duties of care and loyalty and the shareholder protections, such as dissenters' rights, that have long been a part of the corporate form. Because there are alternatives to incorporation, the legislature should reconsider shareholder protections that have been sacrificed over the years to meet the challenges of more flexible statutes enacted elsewhere.

2. The contractarian viewpoint ought to find its expression in alternatives to incorporation, which ought to provide maximum freedom of contract. Thus, one investing in a corporation would be able to rely on certain traditional protections, while one investing in, say, a limited liability company would know that this was a custom-made entity, which may not even impose duties of care and loyalty on the managers.

This formulation would allow the continuation of the corporate form as it has been known. It would reduce transaction costs because investors will not have to obtain, read, and analyze documents such as a corporation's charter and bylaws before deciding to invest. This would also mean the end to the legislature's tinkering with corporate statutes, tinkering that is transforming the meaning of the term "corporation" from an entity with certain characteristics to an entity with evolving and changing characteristics.<sup>67</sup> Under this approach, corporations would remain entities with certain immutable mandatory terms; all other business entities would be contractarian in nature. I would also suggest that only entities formed under the corporate code could use the name "corporation," or its abbreviation, thus indicating to investors that the protections of the corporate code are available.<sup>68</sup>

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67. See *supra* note 17.

68. Both corporations and limited liability companies could use the words "company" or "limited" in their abbreviations in their names.

In light of the check-the-box regulations adopted by the Service,<sup>69</sup> state legislatures should reexamine the statutes authorizing the formation of noncorporate entities with a view to consolidating these statutes. Since the pass-through tax status would be assured, provisions such as those that limit the duration of the entity can be safely removed.<sup>70</sup> Organizers who prefer a limited duration can easily provide for it in the organizing documents. When these and other mandatory provisions are removed, the differences among the various noncorporate business entity statutes will not be significant. For instance, a consolidated statute might simply provide that ownership interests in the entity are freely transferable except as otherwise provided in the governing agreement or document. If the organizers of the entity prefer to limit the voting rights of secondary purchasers, as many limited partnership agreements presently do, this can be provided easily enough.

More controversially, a consolidated statute might provide that the managers of the entity owe fiduciary duties of due care and loyalty to the owners, unless the governing agreement provides otherwise.<sup>71</sup> It is tempting to preserve the duty of loyalty as an immutable characteristic in any situation in which a principal employs an agent, but such temptations should be resisted. The corporate form will retain the duty of loyalty, and if parties desire to dispense with it, they should have the freedom to do so under a consolidated statute.<sup>72</sup> Indeed, the Restatement (Second) of Agency has long recognized the freedom of a principal

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69. See *supra* notes 12-13 and accompanying text.

70. The Colorado limited liability company statute provides that unless the operating agreement otherwise provides, the LLC dissolves upon the death, retirement, resignation, expulsion, bankruptcy, or dissolution of a member of the LLC, unless the remaining members unanimously consent to continue the business of the LLC. See COLO. REV. STAT. § 7-80-801(1)(c) (Supp. 1996). In the absence of tax considerations, a more sensible provision would likely mirror the corporate model: the duration of the LLC is perpetual, unless the operating agreement otherwise provides.

71. Under the Uniform Limited Liability Company Act ("ULLCA"), the operating agreement cannot eliminate the duty of loyalty, but may "identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable." ULLCA § 103(b)(2)(I) (1995). Similarly the operating agreement may modify the duty of due care, but cannot "unreasonably reduce" it. ULLCA § 103(b)(3) (1995).

72. The Delaware limited liability company act, for instance, does not provide any standards of conduct for managers or members. The parties are free to set forth applicable terms. See DEL. CODE ANN. tit. 6, §§ 18-303, -405 (1993 & Supp. 1994).

and agent contracting with one another to dispense with fiduciary duties.<sup>73</sup> Thus, a consolidated statute would be a simple enabling statute with default provisions that might mirror the analogous corporate provisions, or reflect some other value, such as the provisions to which fully informed parties bargaining at arm's length would agree.

The change would also simplify the lives of the business bar, and benefit clients. Now faced with an array of choices, the typical lawyer is at pains to decide whether a limited liability company, limited liability partnership, limited liability limited partnership, old-fashioned corporation, or some other business entity would best serve the client's needs. Subtle differences among the various statutes authorizing these entities, such as what documents need to be filed with the state and when, add unnecessarily to the complexity of a business law practice.

Clients would benefit in at least two ways. First, the choice of entity would be more clear to the client, who could then make a more informed decision than is likely under current law. Second, with cleaner, simpler statutes, the cost of legal services should decline, and the quality should improve.

What is proposed here, in short, is a brave new world of business entities, which includes an experiment in the efficacy of the contractarian model, with the continuing safety net of the traditional corporate model. The two competing forms would soon gain a reputation in the investment community. The competitive advantages of the contractarian model may or may not be realized when put to the market test. Investors may shy away from limited liability companies if stories of abuse materialize. On the other hand, if such entities prove to be superior vehicles for making profits, as contractarians insist, then the entities will prevail in the marketplace. It will not take long for the results of this competition to become known.

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73. For instance, the phrase "unless otherwise agreed" qualifies the agent's duty to account for profits. See RESTATEMENT (SECOND) OF AGENCY § 388 (1958). Other fiduciary duties are similarly qualified. See generally J. Dennis Hynes, *Fiduciary Duty and RUPA: An Inquiry into Freedom of Contract*, 58 LAW & CONTEMP. PROBS. 29, 44 (1995).

