The Contractarian Theory of Corporate Law: A Generation Later

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This essay and the symposium to which it is contributed mark the 20th anniversary of the publication of *Corporate Law* by Robert Clark.[1] Clark's book was an important force in bringing economic analysis to bear on issues of corporate law, a process that has transformed corporate law scholarship. At its broadest theoretical level, this transformation reconceived the corporation as a contractual entity and reconceived corporate law as a largely passive adjunct to the contracting process that creates a corporation. Clark, however, had doubts about this contractarian theory of the corporation and corporate law. Using his doubts as a point of departure, I take this opportunity to briefly assess the contractarian theory in light of twenty years of experience and a generation of scholarship. I conclude that while the contractarian theory was a useful starting point for economic analysis of corporate law, more recent research demonstrates that as a description of reality, or a basis for policy prescription, the theory falls short.

Corporate Law was published at a time when, as Clark observed a few years later, the "contractual theory of the firm . . . dominate[d] the thinking of most economists and economically oriented corporate law scholars."[2] The core innovation of the theory was to conceptualize the relationship between management and shareholders of a public

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1. ROBERT C. CLARK, CORPORATE LAW (1986).

2. Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1705 (1989). Clark refers to the "troubled dominance of one major model of the creation of norms—the contractual model—in academic thinking." *Id.* at 1704.

company as one of contract—a "corporate contract"—in which joint wealth would be maximized as a result of atomistic market-mediated actions.[3] The corporate contract consists of the terms of a corporation's charter and the corporate law the firm selects by virtue of incorporating in a particular state. The contractarian theory of the firm also implies a theory of the role of corporate law: corporate law should merely provide a set of default rules that managers may adopt on behalf of their firms, while leaving managers free to customize their companies' charters with legally enforceable rights and obligations. In the contractarian view, states are seen as competing with one another to attract incorporations by providing corporate law that offers value-enhancing default rules. During the period in which Clark was writing his book, Frank Easterbrook and Daniel Fischel published a series of articles that developed and applied this theory. Their work culminated in the other major corporate law book of the time, *The Economic Structure of Corporate Law.*[4]

Clark implicitly rejected the contractarian theory with respect to both the contractual nature of the firm and the role of corporate law. His book describes and analyzes corporate law as a regulatory regime. As he explains, the regime responds to problems inherent in three core attributes of the corporation: (a) limited liability, which can be used to shield shareholders from personal liability after they have externalized costs on third parties, particularly tort victims; (b) free transferability of shares, which creates the opportunity for securities fraud; and (c) centralized management, which creates an environment in which agency costs are inevitable.[5]

Where the law appears to be flawed, Clark proposes regulatory solutions. One of his central themes is that the law governing the duty of loyalty is ill-suited to public corporations, and that the law evolved to this suboptimal point as a result of courts applying a single set of loyalty rules to both public corporations and close corporations.[6] Clark argues, for example, that the corporate opportunity rule as it has evolved through court decisions has a degree of permissiveness and open-endedness that is well suited to close corporations, but poorly suited to public corporations, whose managers should instead be subject to a categorical prohibition on taking any business opportunities.[7] He argues that states should enact rules that impose such a restriction on managers of public companies.[8]

Clark expounds on these themes over the course of more than 800 pages, without even a nod toward basic contractarian precepts. He does not ask whether shareholders and managers do, or should, opt out of certain provisions of corporate law and instead customize their own legal relationships. Nor does he address the issue whether the law does, or should, allow them to do so. Regarding the ill effects of having public

3. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1-39 (1991).

4. *Id.* Because Easterbrook and Fischel are the primary expositors of the contractarian theory, I will use their statement of the theory as authoritative. To avoid the risk of excluding anyone, I will not attempt to list others who write within this framework.

5. These attributes, Clark explains, facilitated the private aggregation of capital from the American middle class to finance business enterprises for which technological and organizational economies of scale had become quite large. CLARK, *supra* note 1, at 2-4.

6. *Id.* at 29, 34.

7. *Id.* at 243-46.

8. CLARK, *supra* note 1, at 234-38.

corporations and close corporations operate under the same duty of loyalty rules, Clark does not comment on the fact that public companies have not, to any significant extent, tried to opt out of these poorly fitted rules by adopting charters with alternative rules.[9] To a devotee of the contractual view of corporate law, this fact would be taken as proof that the current rules are optimal. Clark also did not ask why state legislatures, in their headlong race to the top, had not already enacted solutions to this problem. Under the orthodoxy of the time, the fact that they had not done so would have been taken as further proof that Clark's concern was unfounded.[10]

A generation of scholarship, however, suggests that the contractarian theory is not, and never was, an accurate description of reality or a basis for policy prescription. The theory was based largely on perfect market assumptions and lacked empirical support. It nonetheless played an important role in the development of economically oriented corporate law scholarship by providing a conceptual starting point—a clearing of the analytic underbrush—for further work. In this respect, the contractarian theory is analogous to theories in financial economics that rely on perfect market assumptions and challenge economists to study the implications of relaxing those assumptions to better reflect reality.[11] Consider, for example, the Miller-Modigliani Irrelevancy Propositions that the choice of a debt-equity structure for a firm does not affect firm value. As economists have since shown, when one relaxes the perfect capital market assumption and introduces incomplete or asymmetric information, it becomes clear that debt can perform a value-influencing function as either a bonding or signaling mechanism. The contractarian theory has similarly challenged economically-oriented legal scholars to focus on market imperfections in the making of corporate contracts and on the role of corporate law.

Some of the work that has taken up that challenge can be traced back to doubts that Clark expressed regarding the contractarian view. This work includes empirical and theoretical studies that raise doubts regarding the optimality of corporate contracts and corporate law. This work does not, however, support the imposition of mandatory rules and would not, for example, support Clark's proposal for a regulatory fix of the corporate opportunity rules.

In the pages that follow, I examine two phenomena that reflect shortcomings in the contractarian theory. First, corporate governance structures and mechanisms are commonly adopted without contractual commitments to maintain them. They are not

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9. *Id.* at 188. Although the legal limits on a corporation's freedom to contract out of fiduciary duty are unclear, the opt out that Clark proposes for public corporations is *more* constraining than the rule imposed by corporate law. There is no doubt that corporations are free to contract in that direction—for example, by adopting a strict prohibition on the taking of any opportunity regardless of whether it is offered to the corporation.

10. There is no shortage of adherents to this view today. For the most recent invocation of this logic, see Stephen M. Bainbridge, *Response to Increasing Shareholder Power: Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) (arguing that the absence of mandates for majority voting in IPO charters or state law indicates that majority voting does not enhance firm value). As I explain below, this logical two-step is flawed and, standing alone, should not be taken seriously as support for social optimality of the status quo.

11. For a discussion of this pattern in the history of financial economics, see Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715, 717-20 (2003).

provided for by law, and management chooses not to include them in corporate charters when their companies go public. Consequently, these elements of corporate governance are not included in the legally enforceable "corporate contract," as defined in the contractarian theory. They may instead be enforced through non-legal economic or reputational sanctions. Second, corporate contracts reflect a high degree of uniformity. This uniformity appears both in the choice of Delaware as a state of incorporation and in corporate charters that, rather than fulfilling their contractarian role as the locus of innovative and customized corporate contracting, are instead "plain vanilla" documents that, by silence, invoke the default rules of corporate law. These phenomena suggest that at least some rethinking of the contractarian theory is warranted. The positive implication is that there are apparently impediments to contracting that may undermine the value-maximizing claim of the theory and the theory's minimalist view of corporate law. The normative implication is that a menu approach to the design of corporate law may be more effective in enhancing firm value than either the default rule structure that the contractarian theory prescribes or an approach of mandatory regulation.

I. A BRIEF REVIEW OF THE CONTRACTARIAN THEORY OF CORPORATE LAW)

The contractarian theory posits that the relationship between the managers and shareholders of a public corporation is contractual. The thesis begins with the now familiar logic by which market forces are expected to create optimal "corporate contracts," at the time a company initially goes public.[12] As owners of the company, entrepreneurs and other pre-IPO shareholders want their company's shares to command a high price when sold to the public.[13] The price at which the company's shares are sold will depend on the "promis[es]"[14] the pre-IPO entrepreneurs and shareholders make to the post-IPO public shareholders regarding governance arrangements the company will adopt once it is publicly held. Corporate contracts that include promises of effective corporate governance arrangements mean greater value to shareholders, which in turn means that investors will pay more for the company's shares in the IPO and in the secondary market thereafter. Consequently, the contractarian theory implies that corporations will go public with corporate contracts that provide for governance structures that are, in Easterbrook and Fischel's words, "most beneficial to investors, net of the costs of maintaining the structure."[15]

In the contractarian vision, managers adopt a corporate contract by first incorporating in a state that offers default rules best suited to it, and then by customizing their own governance arrangements to the extent necessary to maximize the firm's

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12. EASTERBROOK & FISCHEL, *supra* note 3, at 1-39.

13. More precisely, the pre-IPO entrepreneurs and shareholders will want to maximize the value of the firm at the time it goes public, which means they will want to maximize its equity value and private benefits of control.

14. EASTERBROOK & FISCHEL, *supra* note 3, at 4.

15. *Id.* at 5. Amendments to the corporate contract made after a company is publicly held could be viewed as problematic to the contractarian theory. Management may be able to propose a charter amendment and, because of rational apathy on the part of shareholders, get a majority of votes in favor even if the amendment is not in the shareholders' interests. The contractarian response is that the rules for amending the contract are terms of the initial contract when a company goes public and therefore can be expected to be value-maximizing ex ante. *Id.* at 33.

value.[16] This customization appears as "promises in the articles of incorporation."[17] Shareholders accept the contract by buying shares in the company and implicitly pricing the quality of the firm's governance commitments. The choice of a state in which to incorporate and the choice of charter terms are contractual because they establish rights and obligations that shareholders can enforce legally and that cannot be changed without a formal resolution of the company's board and a majority vote of its shareholders.[18] (Bylaw provisions are not part of the corporate contract to the extent that either the board or shareholders can amend them unilaterally.)

As Easterbrook and Fischel explain, the role of corporate law follows logically from the contractual nature of the public corporation. That role is to facilitate atomistic contracting. Firms are believed to be heterogeneous in their governance needs and are expected to adopt a diverse assortment of governance arrangements.[19] Entrepreneurs, therefore, must be free to customize their corporate contracts. All the law needs to do is provide "off-the-rack" contract terms that can be adopted, or not, to the extent they enhance a firm's value.[20] The contractarian thesis posits that there are no externalities in the contract between pre-IPO entrepreneurs and shareholders on the one hand, and post-IPO shareholders on the other, so there is no need for mandatory rules; market mediated individual choice will lead to socially optimal corporate contracts. Easterbrook and Fischel's theory of corporate law is both normative and positive: that corporate law *should* take this form; and that it "almost always" does.[21]

According to the contractarian view, the corporate contracting process is aided by competition among the states to provide corporate laws that tend to maximize firm value. States compete to attract incorporations, the story goes, in order to obtain revenues from franchise fees and to create business for the local bar. This competition leads state legislatures to enact enabling corporate laws that offer default rules designed to maximize the value of many firms and thereby save firms the trouble of customizing their own charter terms. Because firms are expected to be heterogeneous with respect to governance needs, some states are expected to compete to attract certain subsets of firms. Easterbrook and Fischel speculated that firms may be so diverse that fifty states may not be enough to provide a "menu" of corporate law rules.[22]

The result of the corporate contracting process, Easterbrook and Fischel said, is a flowering of diversity in the corporate contracts that firms adopt:

> Agreements that have arisen are wonderfully diverse, matching the diversity of economic activity carried on within corporations. Managers sometimes hold a great deal of the firm's stock and are rewarded for success through appreciation of their investments prices; other employees may be paid on a piece-work basis; sometimes compensation is via salary and bonuses. Corporations are

16. *Id.* at 6.

17. *Id.*

18. One loophole in the contract that the theory did not contemplate was that management could lobby the legislature of the state in which a company is incorporated to have a default rule changed in its favor. *See* Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 120-27, 131-39 (1987).

19. EASTERBROOK & FISCHEL, *supra* note 3, at 5 (stating "[n]o set of promises is right for all firms").

20. *Id.* at 34.

21. EASTERBROOK & FISCHEL, *supra* note 3, at 15.

22. *Id.* at 216.

> sometimes organized as hierarchies with the higher parts of the pyramid issuing commands; sometimes they are organized as divisional profit centers with loose or missing hierarchy.
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> . . .
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> The way in which corporations run the business, control agency costs, raise money, and reward investors will change from time to time within a firm . . . . The participants in the venture need to be able to establish the arrangement most conducive to prosperity, and outsiders are unlikely to be able to prescribe a mold for corporations as a whole or even a firm through time.[23]

If the contractarian theory is valid, then Clark's theory of poorly conceived duty of loyalty rules would make no sense. If an element of the duty of loyalty were poorly suited to public corporations, we would see public corporations writing charters in which they opt out of the troublesome rules and replace them with customized terms. If, for some reason, doing so would violate a mandatory feature of corporate law, competition among states would eliminate the mandatory roadblock in at least one state, and firms would reincorporate there—or, more likely, competition would lead all states to eliminate the roadblock. But is the contractarian theory a sufficiently accurate approximation of reality to rely on this logic?

II. DIVERSITY IN CORPORATE CONTRACTS?

The contractarian theory has turned out to be based largely on an entirely plausible, but in fact imaginary, world of contracting. There actually is no significant diversity in corporate contracts—that is, in either charter terms or in the corporate law rules that firms adopt via their incorporation choices. The diversity that exists is not contractual. And the contracts that exist are not diverse—not, at least, in any way that would indicate deliberate efforts to maximize firm value.

A. Diversity in Non-Contractual Commitments

It is true, as Easterbrook and Fischel say, that there is "wonderful diversity" among firms with respect to the use of certain corporate governance mechanisms and management structures.[24] But none of the arrangements that they list is *contractual* between management and shareholders. Sure, some managers hold a lot of stock in their companies, which has governance implications, but neither law nor charter terms require them to do so. Subject to insider trading rules, and internal company rules that management can change without a shareholder vote, managers can sell their stock at any time. And yes, managers have incentive compensation plans of various sorts, but the terms of those plans are not part of the corporate contract with shareholders. Indeed, some commentators argue that executive compensation plans are a unilateral abuse of

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23. *Id.* at 12-13.
24. *See id.* at 14-26.

shareholders at the hands of managers.[25] And some firms are hierarchical and some are not, but this surely has nothing to do with the contract between management and shareholders. These arrangements and others are important elements in a firm's governance structure and they are indeed diverse among firms, but they are not contractual in the sense the term is used in the contractarian theory.

Many important corporate governance structures and mechanisms have been commonly employed in practice but not included in the corporate contract (though some have been recently forced into the contract as a result of the mandatory rules associated with Sarbanes-Oxley). Among the items that have been excluded from the corporate contract—at least until Sarbanes-Oxley—are incentive pay regimes, board independence, board committee structures, board processes, use of a poison pill, rules for majority elections of directors, dividend policy, and debt equity ratios. It would clearly be infeasible to have the law or a charter provision govern some of these governance arrangements. The details of executive pay, dividend policy for common stock, and capitalization, for example, are probably noncontractible (meaning that the direct costs of drafting an effective state-contingent contract plus the cost of error would be prohibitive). But others, such as rules for board elections, board independence, board committee structure, and limitations on the use of a poison pill could be written into corporate charters with relative ease. Indeed, since Sarbanes-Oxley and the related changes to stock exchange rules, an independent board is mandatory as are certain board committees and a host of board processes and other matters. None of these arrangements, however, is found in corporate charters. [26]

As the widespread use of noncontractual governance arrangements suggests, exposing itself to legal enforcement is not the only way management can make a credible commitment to maintain a governance mechanism in the future.[27] If top managers have a lot of stock or stock-based compensation, governance commitments can be subject to non-legal enforcement. If, for example, a company were to change its rules for electing directors, its board structure, or its compensation policy in a way that would harm shareholder interests, the company's shares would presumably decline in value and management would pay a cost. In addition, to the extent the change is covered in the press, managers may suffer reputational costs as well. In some situations, these consequences may be as effective as legal enforcement in ensuring that management keeps its governance commitments, and they may be more cost-effective than legal enforcement.

The extent to which matters of governance are excluded from the corporate contract and left to non-legal enforcement is not accounted for in the contractarian theory—

25. Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

26. The current debate over majority voting for directors provides another example of rules that are being drafted and yet adopted as policy statements by boards rather than as charter or bylaw provisions. The attraction of the policy statement option to be the absence of legal enforcement except under broad fiduciary standards. For reasons that are unclear, there is little discussion of adopting these rules as charter amendments as opposed to bylaw amendments, but the assumption in the debate seems to be that if they are adopted as bylaw amendments, then the board cannot repeal them.

27. *See* Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619 (2001).

although the expansion of the concept of the "corporate contract" to include non-legal governance commitments is not inconsistent with the contractarian theory.[28] There are costs to legal enforcement that may lead firms to subject certain governance commitments to non-legal, rather than legal, enforcement. Those costs are not a focus of the contractarian theory because for the most part the theory is based on a near-zero transaction cost assumption.[29] Once one focuses on enforcement costs, however, questions arise that complicate the contractarian story. Why do firms choose to have some governance commitments subject to legal enforcement and others to non-legal enforcement? There are probably a number of answers, but one observation implies a partial answer taken up in the next section: corporate charters consist of a limited number of standardized provisions that closely track state law.[30] Firms innovate and customize non-legal governance arrangements, but they do not do so in the corporate contract as conceived in the contractarian view; they do not subject their innovation and customization to legal enforcement by shareholders.

B. Uniform Contracts

If the real world were consistent with the contractarian theory, we would see contractual innovation and customization reflected in a diversity of incorporation choices and corporate charter terms among public companies. It turns out, however, that diversity of this sort is minimal. The limited diversity that exists is not the result of efforts to maximize firm value.

1. Incorporation Choices

Recent empirical work has revealed that incorporation choices at the IPO stage are less diverse than the contractarian theory contemplates. Robert Daines was the first to investigate the nature and motivation of firms' incorporation choices at the time they go public. He analyzed the incorporation decisions of over 6,000 firms that went public between 1978 and 2000. He found that approximately fifty percent of those firms incorporated in Delaware, and that among firms that went public during the second half of his sample period, over seventy percent incorporated in Delaware.[31] Daines' most striking discovery, however, is that among firms that do not incorporate in Delaware, nearly all incorporate in their "home" state—the state in which they are headquartered. Ninety-five percent of firms that incorporated outside their home state choose Delaware, and on an asset-weighted basis, ninety-seven percent of firms choose Delaware.[32] The

28. Indeed, Easterbrook and Fischel's listing of diverse governance arrangements, quoted above, implies that at some level they were aware that at least some of the "corporate contract" that they envisioned was not contractual.

29. Transaction costs are recognized in a relatively trivial way in the contractarial theory. The writing of contracts is understood to entail drafting costs, which is why corporate law is needed to provide default rules.

30. For example, a charter might allow shareholder voting by written consent or it might prescribe a staggered board, each of which entails simply invoking a process explicitly permitted by state law. Or it might provide for indemnification "to the full extent permitted" by state law.

31. Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1592 (2002).

32. Using a different sample, Guhan Subramanian found a larger number. Excluding REITS and mutual funds, he found that ten percent of firms incorporated in a state other than their home state or Delaware. Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate*

combined share of Delaware's nearest four "competitors" for out-of-state incorporations is 0.6%.[33] Moreover, of the few firms that do not incorporate either in Delaware or in their home-state, most incorporate in a state in which they were previously headquartered, in a neighboring state, or in another state with which the firm has a similar geographic relationship.[34]

The widespread choice of Delaware as a state of incorporation may well reflect a judgment that Delaware law enhances firm value. Another article by Daines is consistent with that proposition.[35] But a firm's choice of its home state appears to be based on factors other than the content of that state's corporate law. Consider, for example, all firms headquartered in Oregon. About seventy percent of Oregon-headquartered firms incorporated in Oregon, but not a single non-Oregonian firm incorporated there. As Daines points out, it is not plausible that the Oregon-based firms are attracted to Oregon incorporation by virtue of Oregon corporate law, but that no firm located outside of Oregon sees the attraction.[36]

Daines' findings suggest that there is a home-state advantage independent of the content of a state's corporate law. He considers two possibilities. First, local lawyers may have their clients incorporate in their home states when they go public because home-state incorporation will help the lawyer retain the company as a client after its IPO. Daines' results support this hypothesis; firms represented by local law firms are much more likely to incorporate in their home state than are firms represented by national law firms. Second, home-state incorporation can provide an opportunity for a firm's management to lobby a state legislature when necessary to enact a corporate law that allows management to take an otherwise impermissible action. Daines finds support for this explanation as well.[37] This lobbying advantage, however, is unlikely to maximize firm value. The most well known examples are when managers ask the state legislature to pass a law that protects them from a hostile takeover.[38] This is not the sort of law-related benefit that contractarians envision as a value-maximizing motivation for an incorporation decision.

Daines also finds some evidence of law-related explanations for differences in the extent to which firms incorporate in their home states. States that have adopted the Revised Model Business Corporations Act and states that already have a large number of firms incorporated in them tend to retain more home-state incorporations.[39] These findings do not constitute ringing support for diversity in corporate contracts. As discussed below, the findings may instead reflect the fact that a state's corporate law increases in value simply as a result of the learning and network benefits that can accrue

and Antitakeover Overreaching, 150 U. PA. L. REV. 1795, 1818 n.95 (2002).

33. *Id.* at 1572-78.

34. *Id.* at 1598.

35. Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001). *But see* Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON & ORG. 32 (2004). Roberta Romano's work supports this conclusion as well. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985).

36. Daines, supra note 34, at 1576.

37. *Id.* at 1594-95.

38. *See* Romano, *supra* note 18, at 122-37 (examining the experience of Connecticut).

39. Daines, *supra* note 31, at 1596.

as a result of having many firms operate under the same law.[40] Delaware is an extreme case of this phenomenon. Other states, including Model Act states, may be lesser examples of the same phenomenon. One cannot, however, reject the possibility that differences in the content of state law make some difference in the ability of states to retain home-state incorporations.

Lucian Bebchuk and Alma Cohen conducted a study similar to Daines' and confirmed most of his results.[41] They, however, find another law-related explanation of home-state incorporation rates across states: states with several antitakeover statutes retain more incorporations than states with fewer antitakeover statutes.[42] Again, this finding is not the sort that contractarians should find comforting, since the weight of evidence supports the view that takeover defenses are not value-maximizing. But there is reason to doubt the strength of this result in the Bebchuk-Cohen study. First, Daines finds no such effect. To the contrary, when he controls for the state in which a firm is headquartered, he finds that antitakeover statutes are *negatively* correlated with in-state incorporation.[43] Daines reports, however, that this result is sensitive to model specification, and he discounts it.[44] Second, Bebchuk and Cohen did not control for headquarter state, which means their results overweight the incorporation choices of firms in large states. Third, they include in their regression several right-hand side variables that are either endogenously determined or that have no apparent theoretical relationship to the incorporation decision.[45]

Marcel Kahan also conducted a study of incorporation choice that casts doubt on the Bebchuck-Cohen finding that antitakeover statutes help states retain in-state firms.[46] He examines the impact of three factors on states' retention of in-state firms: (a) the presence or absence of antitakeover statutes; (b) the quality of state courts; and (c) a factor he terms "statutory flexibility."[47] Using a methodology that avoids the problems of the Bebchuk-Cohen study,[48] Kahan finds that antitakeover statutes have no impact on state retention rates, and that the quality of a state's court system has a positive effect.[49]

Kahan also finds that "statutory flexibility" has a positive effect on state retention

40. *Id.*; *see infra* text accompanying notes 68-80.

41. Lucian A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383 (2003); Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775 (2002); Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 YALE L.J. 553 (2002).

42. Guhan Subramanian also found that states with antitakeover statutes attracted incorporations. He found, however, that extreme antitakeover statutes had a repellant effect. Subramanian, *supra* note 32. These results are subject to same charge, discussed below, that Marcel Kahan leveled against Bebchuk and Cohen—that the incorporation choices of firms headquartered in large states have a substantial influence on the results.

43. Daines, *supra* note 31, at 1594 illus.7.

44. *Id.* at 1596-98.

45. For a full explanation of these methodological problems, see Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection* 23 (New York University Law and Economics Research Paper Series, Working Paper No. 04-017, 2004), *available at* http://ssrn.com/abstract=557869.

46. *Id.*

47. *Id.* at 10-16.

48. *Id.* at 5-7.

49. *Id.* at 32-33.

rates.[50] States with statutory flexibility are defined as those whose statutes provide: (a) authority to protect managers from liability for duty of care violations, at least at the level of Delaware Code section 102(b)(7); (b) the absence of mandatory director liability for loans to officers and directors; (c) the absence of mandatory cumulative voting; and (d) the absence of a mandatory two-thirds majority shareholder vote to approve a merger.[51] States that scored highly on this composite measure tended to retain more in-state incorporations. The impact of these rules on incorporation choice implies that the content of corporate law has some relationship to incorporation decisions. But this is hardly evidence of vibrant value-maximizing contractual decision making; a low score on this measure means that a state has failed to keep up with corporate law modernization trends over several decades.

A study entitled *The Myth of State Competition*, by Marcel Kahan and Ehud Kamar, however, makes it difficult to salvage even a scaled-down version of state competition.[52] Kahan and Kamar find that no state other than Delaware is running the race. They show that, for a variety of reasons, the potential gains to other states and their lawyers from increasing incorporations would be modest, and that those states actually make no effort to attract incorporations. They conclude that "state competition scholars have misconstrued the incentives of states to attract incorporations, misinterpreted their actions, misunderstood the economic and political barriers that states face, and arrived at mistaken conclusions about the market for incorporations."[53]

In sum, with respect to incorporation choice, the only evidence of firms selecting value-maximizing corporate contracts is the widespread choice of Delaware as a state of incorporation. There is no evidence that firms with different governance needs choose to incorporate in states that serve those needs. Nor is there any reason to believe that states attempt to attract such firms. The only diversity that exists with respect to incorporation choices are firms' choices of their own home states. But the evidence indicates that those decisions cannot be viewed as deliberate efforts to forge value-maximizing corporate contracts.

These studies also cast doubt on the existence of a race among the states to the top—or the bottom—in the production of corporate law. State competition is not essential to the contractarian claim that firms customize value-maximizing corporate contracts. To the extent that states fall short, the theory would say that firms could make up the difference by drafting effective governance mechanisms into their charters. Nonetheless, especially once one examines the shortfall between theory and reality, discussed below, with respect to corporate charters, the absence of state competition is significant.

2. Choice of Charter Terms

So, how much deliberate contracting occurs in the drafting of corporate charters? Not much. The only deliberate decision made is whether to protect management from hostile takeovers, either with a staggered board, a restriction on shareholder voting by

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50. Kahan, *supra* note 45, at 32.

51. *Id.* at 7-10.

52. Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002).

53. *Id.* at 685.

written consent, a restriction on shareholders' power to call a special meeting, or occasionally dual class stock. Otherwise, corporate charters are unremarkable documents, and contractual governance arrangements consist of those provided by law. The contractarian concern over mandatory law thus turns out to be beside the point; with these few exceptions, default rules are uniformly adopted.

There have been three studies of the charter terms that firms adopt at the time they go public.[54] Each of these studies focuses on the presence or absence of takeover defenses, and they do indeed find diversity along that dimension. All three studies find that a large number of firms have staggered boards and a large number do not.[55] Lesser forms of takeover protection, such as prohibitions on voting by written consent and limits on shareholders calling a special meeting, are common as well.[56] Dual class stock is used but not in large numbers.[57]

These articles do not address the question whether there are other sorts of diversity in charters, and no article has been written on that topic. However, as the co-author of one of these articles (and as the co-author with the job of reading and coding all the charters), I can attest that no other diversity existed in the 310 charters included in our sample. Furthermore, in addition to reading those 310 charters, I have read over 300 additional charters in connection with a study of antitakeover protection in spinoffs. There, too, no significant diversity exists except with respect to takeover defenses.[58] Corporate charters come in one flavor: plain vanilla.[59]

Diversity with respect to takeover defenses is not the sort of value-maximizing

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54. *See* Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83 (2001); John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301 (2001); Laura Casares Field & Jonathan M. Karpoff, *Takeover Defenses of IPO Firms*, 57 J. FIN. 1857 (2002).

55. The percentage of firms that go public with staggered boards appears to have increased over time. Field and Karpoff found that 36% of firms going public between 1988 and 1992 had staggered boards. Field & Karpoff, *supra* note 54, at 1861. Daines and I found that 43% of firms going public between 1994 and 1997 had staggered boards. Daines & Klausner, *supra* note 54, at 95. Coates found that in 1998 and 1999, 66% and 82% of firms, respectively, had staggered boards. Coates, *supra* note 54, at 1376. These findings are independently problematic for the contractarian theory.

56. Michael Klausner, *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755, 764 (2003).

57. Daines & Klausner, *supra* note 54, at 96.

58. Robert Daines & Michael Klausner, *Agents Protecting Agents: An Empirical Study of Takeover Defenses in Spinoffs* (Stanford L. & Econ. Olin Working Paper No. 299, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=637001 (finding managers of spinoffs are protected more than those of ordinary IPOs). One term that is occasionally present in the charters of firms that a parent company still controls but that has issued minority shares to the public is an allocation of business opportunities between the subsidiary and the parent. This suggests that at least in these firms the possibility of customizing the charter was considered, but actual customization was nonetheless limited.

59. I admit to leaving myself open to a quibble. There are occasional IPOs involving companies with unique governance structures. One example is Untied Airlines as it emerged from bankruptcy. *See* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 117-18 (1996). Another is MasterCard, Inc., which went public on May 25, 2006, with a highly customized governance structure that combined member-bank and public stockholders. *See* MasterCard, Inc., Registration Statement (Form S-1/A) (May 22, 2006), http://www.sec.gov/Archives/edgar/data/1141391/000119312506116564/0001193125-06-116564.txt. The experimentation with tracking stock is another example. But none of these examples reflects the sort of widespread customization that the contractarian view envisions.

diversity the contractarian thesis would predict.[60] Daines and I tested three hypotheses that could explain the presence of takeover defenses in IPO charters as value-maximizing. One was based on enhancing target bargaining power against bidders; one was based on reducing management myopia; and one was based on the presence of unusually high private benefits for managers. We found support for none of these hypotheses. Instead, we found support for the hypothesis that takeover protection is adopted for purposes of management entrenchment, apparently regardless of the extent of private benefits.[61] Thus, diversity with respect to the presence or absence of takeover defenses in charters does not support the contractarian expectation that heterogeneous firms will devise a diverse array of value-maximizing corporate contracts.

Moreover, among firms with takeover defenses, the defenses themselves are standardized; no customization occurs. Firms invariably adopt protections that are included in state statutes as default rules[62] or as options that a firm can select by designating so in its charter.[63] The closest firms come to customizing a charter term is to take a statutory term that is not included in the corporate law of the state in which they are incorporated, and to copy it into their charter. Even this, however, is rare.[64] No study has found any other form of customization in takeover protection. Most notably, no study has turned up a charter term at the IPO stage that *limits* management's discretion to adopt a poison pill—for example, by requiring that a pill not be triggered by certain offers designated as "qualified" or by requiring that a pill be approved by shareholders within a specified period of time. Qualified offer pills and shareholder approval of pills are commonly understood variations on the basic pill. It would not require a great leap of imagination or drafting skill to draft such a limitation into a charter.

These realities raise at least two questions. First, why is there such uniformity around default rules and statutory options? Second, why is the innovation and customization envisioned by the contractarian thesis absent?

III. WHY DO FIRMS CHOOSE UNIFORM CONTRACTS?

The studies described above strongly suggest that, among firms whose pre-IPO managers make deliberate decisions to choose a state of incorporation, the vast majority choose Delaware; and regardless of what state they choose, they adopt a plain vanilla

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60. *See* EASTERBROOK & FISCHEL, *supra* note 3, at 174 (managerial passivity in the face of a takeover bid maximizes firm value).

61. Daines & Klausner, *supra* note 54, at 95-110. Bebchuk and Stout have offered efficiency explanations of antitakeover protection in IPO charters. *See* Lucian A. Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713 (2003); Lynn A. Stout, *The Shareholder As Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667 (2003). I have explained elsewhere why their explanations are unconvincing. Michael Klausner, *Institutional Investors, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755 (2003).

62. For example, in some states, restrictions on voting by written consent and restrictions on shareholders' authority to call a special shareholders meeting are default rules; and in most states, state antitakeover statutes are default rules.

63. Staggered boards are an example.

64. *See* Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Examination* (Yale Law School Working Paper, on file with author) (examining the frequency of opting into or out of fair price statutes and writing them into charters where they are not available by statute). Even opting out of a statute allowing firms to do so is rare. *See* Daines & Klausner, *supra* note 54, at 95.

charter. Variation is limited to the presence or absence of a narrow range of standardized takeover defenses included in a firm's charter or provided by some states' corporate laws. That variation, however, does not appear attributable to value-maximizing contracting.

The explanation for uniformity in corporate contracts must lie in one of two places. First, perhaps firms are homogeneous with respect to the governance matters to which they legally commit, and Delaware default rules suit all firms equally. Second, and more likely, perhaps there are market imperfections that impede customization.

A. Does One Size Fit All?

One explanation for contractual uniformity may be that one size really does fit all—at least once one considers the extent to which firms adopt a diverse array of noncontractual governance arrangements. Although heterogeneity is central to the contractarian argument for contractual freedom, no one has set out a theory of heterogeneity—a theory that firms of certain types would maximize value by adopting particular contract terms.[65] One can, however, imagine the outlines of such a theory. The extent of a firm's exposure to product or capital market discipline might make certain governance structures less important. The extent to which a firm is covered by the financial press might also substitute for tight governance mechanisms. And the presence of a controlling shareholder would surely have an impact on a firm's optimal governance structure.

But even if one size fits all, one would still expect customization of contractual innovations. There have been many corporate governance innovations over the years. Some of these innovations have been widely recommended by governance experts and business associations,[66] some have been adopted by firms without contractual commitments to maintain them—that is, without including them in their charters—and some were ultimately adopted by the stock exchanges, the Securities and Exchange Commission, or Congress, and imposed on firms as mandatory rules. Examples include: independent boards, lead directors, separation of board chair and CEO, independent audit committees with oversight of audits, independent compensation committees, restrictions on management control of a poison pill, and majority voting. Unless there is an impediment to contracting, one would expect that at least *some* of these would have appeared in the charters of *some* firms at the time they go public. Yet it appears that none have. The fact that no firms legally pre-commit to any of these arrangements when they go public suggests the possibility that the explicit corporate contracting dynamic is not as vibrant as the contractarian theory assumes.[67] Transaction costs not contemplated in the contractarian theory may make innovation and customization of contractual governance

65. Baysinger and Butler offered a partial heterogeneity theory, arguing that state competition leads to a differentiation of the corporate law product such that some states offer "strict" law and some offer "liberal" law, and that firms with concentrated ownership are best served by state laws that are "strict" with respect to managerial discretion. *See* Barry D. Barysinger & Henry N. Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431, 457-60 (1985).

66. *See, e.g.*, Business Roundtable, Principles of Corporate Governance 2005, http://www.businessroundtable.org/pdf/CorporateGovPrinciples.pdf.

67. To say that *no* innovation has been adopted by *any* firm is obviously a risky statement that I cannot support. But none appeared in any of the studies cited above, and I am not aware of any secondary literature that reports such a provision in an IPO charter.

commitments unworkable—or at least less workable than noncontractual commitments.

B. Learning and Network Externalities as Impediments to Customization

In an article entitled, *Contracts, Elites, and Traditions in the Making of Corporate Law*, Clark argued that "traditions" can sometimes be a better source of rules than customized contracts.[68] He makes the point generally, with respect to all spheres of human conduct, and with respect to rules of corporate governance, where tradition consists of the rules embodied in the common law as it has evolved over the ages. Clark concludes that under some circumstances, courts should rule that traditions override customized charter terms in resolving disputes between shareholders and managers. He made this point in response to the contractarian argument that contractual freedom should be complete. That entire debate, however, turns out to be moot because firms choose to contract *into* statutory and common law rules, not out of them. That is, they adopt default rules rather than customized charter terms.

About a decade ago, Marcel Kahan and I explained this phenomenon in terms of learning externalities.[69] There is inherent uncertainty regarding how courts will apply and interpret any but the most simple legal rules, contract terms, or charter terms. This uncertainty is a cost of legal enforcement. As a legal rule or charter term is interpreted and applied in a variety of settings, however, the term acquires more content, and uncertainty regarding its application declines. As a result, enforcement costs decline. There will be less scope for plaintiffs to bring speculative suits and greater likelihood that suits will be disposed of by dismissal or settlement earlier in the litigation process. Expected litigation costs are therefore lower than they would be otherwise.[70] Perhaps more importantly, management will be less constrained by the risk of litigation.[71] For a firm instead to adopt a customized charter term or a less commonly used term, the inherent value[72] of that term would have to be great enough to outweigh these and other learning benefits. Consequently, when learning externalities are present, one possible result is uniformity in firms' choices of corporate contract terms.[73]

Learning externalities seem to go a long way toward explaining both Delaware incorporation and the plain vanilla charter. Especially with respect to open-ended terms, such as those that address many fiduciary issues, learning externalities can be significant. Delaware has accrued a large body of case law representing extensive, nuanced learning with respect to the application of fiduciary duties and other rules in a wide range of

68. Clark, *supra* note 2.

69. Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 719-25, 731-33 (1997).

70. A result of the settlement modeling literature is that the closer the parties' estimates of outcomes are the more likely they are to settle. STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 401-03 (2004).

71. For a more complete description of interpretative network externalities, see Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 775-79 (1995). Kahan and I also describe additional network benefits when a contract term is commonly used, including familiarity among lawyers and investors. *Id.* at 774-89; Kahan & Klausner, *supra* note 69, at 726.

72. "Inherent value" is the value of a term independent of the learning (or network) externalities that a firm obtains by adopting a term.

73. Other learning benefits include familiarity to lawyers, other professionals and investors. *See* Kahan & Klausner, *supra* note 69, at 723-24.

contexts. No other state comes close. With respect to charter terms providing for governance arrangements, there is by now a long history of firms subjecting themselves to the rules embodied in corporate law statutes and case law. Customized charter terms that would, for example, regulate elements of fiduciary duty are essentially nonexistent. This may be because corporate governance rules were historically mandatory or because the focal quality of default rules had an attractive force.[74] Whatever the explanation, the choice today is between a default rule that has accrued learning externalities and a customized charter term that has not.[75] A firm would have to find itself in a unique situation to conclude that, while the default rule suits all other firms, a customized alternative would achieve greater value.[76]

The uniformity produced by learning externalities can be socially suboptimal. As each firm adopts the standard term, that choice maximizes its value. In the aggregate, however, if firms are heterogeneous with respect to contractual governance needs, corporations in the aggregate might have achieved greater value over time if additional, alternative terms had been adopted in the past and had accrued learning externalities as well.[77] In addition, if a contractual innovation develops that would maximize the value of at least some firms in the future, once learning externalities accrue, there can be no assurance that the term will be adopted at the start. Thus, the presence of learning externalities disrupts the identity between perfect markets and social optimality that drives the contractarian logic.

If a charter term or default rule is expected to be commonly used in the future—regardless of whether it has been used in the past—it offers the benefit of future judicial interpretations. Marcel Kahan and I have referred to these future benefits as "interpretive network externalities"—basically future learning externalities.[78] In effect, future interpretations keep the term up to date as the business environment and business practices evolve. As a result, for any individual firm, litigation is less likely, and management will be less constrained by the risk of litigation. The larger the network of firms that use the same term over time, the more the term will be litigated in the future and the more frequently it will be interpreted and, in effect, updated. Consequently, there is value to adopting a term that is expected to remain in common use in the future.

If a firm were to adopt a customized term, judicial updating would not occur unless

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74. Klausner, *supra* note 71, at 828.

75. Even if a firm is incorporated in a state other than Delaware, that state's courts are likely to refer to Delaware case law to inform a decision, especially if there are no in-state precedents.

76. Such unique examples do exist. United Airlines and MasterCard are two examples. *See supra* text accompanying note 59.

77. It is also possible that even if firms are homogeneous in their governance needs, suboptimal terms will be widely adopted. *See* Kahan & Klausner, *supra* note 69, at 731-32.

78. For a full discussion of interpretive and other forms of network externalities in corporate contracts, see Klausner, *supra* note 71. The reason Kahan and I use the term network externally is that a good measure of whether these future benefits will accrue is the number of firms that currently use a particular contract term and the number of firms that are expected to use the term in the future. Just as the value of a computer operating system increases as more people use it and create network externalities, so too does the value of a charter term or a state's body of corporate law increase as more firms use the term.

Marcel Kahan and I have also argued that agency-cost related herd behavior and cognitive biases among lawyers can lead uniformity in contracts. *See* Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347 (1996).

a large number of firms eventually adopt the term as well. Updating, therefore, would have to occur by charter amendment. But, because of the contextual nature of judicial interpretations, charter amendments are not likely to be as cost-effective a means of updating as is free riding on judicial interpretations. For a firm to rely on amendments to update its charter as business practices and the business environment change, it would have to continually monitor the corporate governance landscape to see what new issues come up and in what contexts. It would then have to formulate language that is reasonably precise in order to avoid unnecessary litigation over the meaning of the amendment. Management would then have to explain the amendment to shareholders in order to obtain their votes and to do so in a manner that makes it clear that there is no hidden agenda involved, just straightforward updating. Finally, the firm would bear the cost of error—failures to update in time, updating with language that leads to unnecessary litigation, and updating with language that yields the wrong outcome in litigation. By adopting a commonly used term, the experiences of all firms operating in different settings are, in effect, pooled for the benefit of all. Some firms will find themselves at the forefront of testing the commonly used term, but the judicial interpretations that result will be available to all. This process provides a measure of timeliness and contextualization that would be difficult for a single firm to achieve by charter amendment. Furthermore, even before a term is widely litigated lawyers develop shared understandings of how the courts will apply the term, and they advice clients on the basis of these understandings. These shared understandings, which are common among Delaware lawyers for example, further enhance the value of commonly used terms. Consequently, the attraction of network externalities can deter customization and promote uniformity.

Henry Hansmann has recently suggested yet another source of network value in adopting a commonly used term, especially if the term is a default rule. He points out that because both management and shareholders must agree on a charter amendment, there may be a stalemate with respect to value-enhancing amendments that favor one group and disfavor the other. A firm may be unable to adopt such a value-enhancing amendment. In some settings, the courts may in effect provide the amendment by interpreting the board's fiduciary duty, for example, or some other element of the existing contract. Or the state legislature may provide the update by enacting a new rule. So long as a firm's charter is plain vanilla, or at least contains no customized term that contradicts the new rule, the rule will apply to all. The more firms there are that use a particular term, the more likely it is that the term will be litigated, and the more likely it is that the state legislature will enact an update. The attraction of this "delegated amendment" scenario depends on the value of customizing a charter term today, the likelihood that shareholders and management will be unable to agree on a value-enhancing amendment in the future, and the likelihood that the courts or state legislature will actually step in with a value-enhancing fix.

Absent unusual circumstances, once a charter term or a default rule has been commonly used in the past, the built up learning externalities make it attractive for current use, which means that it will probably continue to be used in the future. The prospect of widespread future use enhances its attraction. Thus, learning and network externalities coincide and are self-perpetuating. If a new default rule were to be enacted, meaning that no learning externalities are involved, perhaps customization would occur

among firms for which the rule is poorly suited. But the attraction of potential network externalities would lead firms to predict whether the default term or some initially customized term(s) would become commonly used in the future. Depending on the context, the default rule could have a focal quality that leads firms to adopt it in the expectation that it will become commonly used. This focal quality could arise even if a customized alternative would be inherently better.[79]

For all of these reasons, a plausible inference is that both learning and network externalities have played and continue to play a role in driving firms toward Delaware incorporation and the plain vanilla charter.[80] This uniformity is not necessarily socially suboptimal. But learning and network externalities are market imperfections in the contracting process between management and shareholders. The presence of market imperfections disrupts the contractarian theory's reliance on the theoretical relationship between competitive equilibrium and social optimality. Consequently, the status quo should not be viewed as presumptively efficient.

IV. IMPLICATIONS AND CONCLUSION

The contractarian theory purports to be based on the foundation built by Ronald Coase in *The Nature of the Firm*.[81] But, like other work in the Chicago School tradition, it is actually based in the "Coasean World" of zero (or nearly zero) transaction costs. The only transaction cost recognized in the contractarian theory is the cost of drafting charter terms. In this respect, the contractarian theory serves as a useful starting point. In terms of intellectual history, it has served as a transition from a prior body of corporate law scholarship that ignored all underlying economics to the scholarship of the past decade or so, which has focused more expansively on how transaction costs and other market imperfections affect corporate governance commitments and the role of corporate law. As Ronald Coase has since reiterated, this is the direction he had wanted to push economic analysis—toward the study of actual transaction costs and their effects, not toward the study of a heuristically useful but imaginary Coasean World that has no transaction costs.[82]

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79. *See* Klausner, *supra* note 71, at 799-800.

80. With respect to incorporations, there seems to be a reasonable consensus on this point. *See, e.g.*, Oren Bar-Gill, Michal Barzuza & Lucian Bebchuk, *The Market for Corporate Law*, 162 J. INSTITUTIONAL & THEORETICAL ECON. 134 (2006); Brett H. McDonnell, *Getting Stuck Between Bottom and Top: State Competition for Corporate Charters in the Presence of Network Effects*, 31 HOFSTRA L. REV. 681 (2003); Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559 (2002); Kahan & Kamar, *supra* note 52. With respect to charter terms, there is less written. *See* Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996). *But see* Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387, 516 (2001) (expressing doubt regarding impact of network externalities).

81. Ronald Coase *The Nature of the Firm*, 4 ECONOMICA 386 (1937) (reprinted in RONALD COASE, THE FIRM, THE MARKET AND THE LAW (1988)); *see* EASTERBROOK & FISCHEL, *supra* note 3, at viii.

82. In *The Firm, the Market and the Law*, Coase states:

> It would not seem worthwhile to spend much time investigating [a world with no transaction costs]. What my argument does suggest is the need to introduce positive transaction costs explicitly into economic analysis so that we can study the world that exists. This has not been the effect of my article.

RONALD H. COASE, THE FIRM, THE MARKET AND THE LAW 15 (1988).

By failing to account for transaction costs, the contractarian theory fails to explain the reality of either the content of firms' corporate governance commitments or the process by which those commitments are formed. With respect to legally binding commitments, transaction costs that stem from learning and network externalities, and perhaps other market imperfections, impede atomistic contracting and instead drive firms *en masse* toward incorporating in Delaware and adopting charters comprised of a limited and familiar set of highly standardized terms. Those same transaction costs and others affect the supply side of the corporate contract market as well. The reality is that states do not compete with one another for incorporations as the contractarian theory holds. For both of these reasons, the contractarian theory's expectation of diverse contract terms, individually designed to maximize the value of heterogeneous firms, is simply not borne out in the real world.

With respect to the role of corporate law, the contractarian theory falls short in its failure to recognize the attractive force of default rules, as reflected in the lack of customization or innovation in corporate charters. Although not conceived as such, corporate law functions largely as a system of voluntary standards, analogous to those in technical fields such as engineering and accounting. Default rules are voluntary, just as certain engineering and accounting standards are voluntary, but because they serve a coordination function whereby learning and network externalities are produced and shared, opting out is rare.

Consequently, as a normative matter, we should not rely on atomistic contracting as a source of corporate governance innovation or customization. Potential sources of innovation and customization lie elsewhere. One source is the extra-legal realm, where economic and reputational sanctions can enforce governance commitments. But to the extent that there is utility in legal enforcement of some commitments now left to non-legal remedies, corporate law can potentially perform a useful function. And it can do so without reverting to mandatory rules, which Clark and others viewed as the only alternative to contract. Corporate law can instead promote innovation and customization by providing menus of alternative governance structures that firms can adopt in standardized form by designating in their charters that they choose to do so. Examples of this approach in current corporate law are provisions in corporation codes that allow firms to opt into staggered boards and cumulative voting, and provisions that allow firms to opt into rules allowing shareholders to vote by written consent or to call a special shareholders meeting.. This approach to the design of corporate law could facilitate a balance between uniformity, diversity, and innovation in corporate contracts.[83] Clark's concern over the corporate opportunity rule, for example, could be addressed by enacting as a statutory option a more constraining rule. If Clark is right, firms might adopt this term when they go public despite the fact that they have not customize the term on their own.

83. For a more complete discussion of this menu approach, see Klausner, *supra* note 71, at 837-40.

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