were replaced by generalized corporation acts, state confirmation is still required in order to legally effect a corporate structure.[444]

With the historical concept of the corporation being a concession of the state, anti-contractarians consider certain regulatory provisions to be untouchable, that is, these provisions may not be waived or modified by private ordering. The most important of the provisions is the directors' fiduciary obligations to shareholders. In this respect, contractarians and traditionalists are in direct conflict. Perhaps the case which brought this debate into clearest focus was the Delaware Supreme Court's unprecedented opinion in *Smith v. Van Gorkom*.[445] In that case, the court

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[444]Although state corporate law relaxed the requirements for incorporation, evidence of distrust continued. For example, in Louis K. Liggett Co. v. Lee, 288 U.S. 517, 557 (1933), Justice Brandeis, in referring to the later-enacted general incorporation laws, stated: "The removal by the leading industrial States of the limitations upon the size and powers of business corporations appears to have been due, not to their conviction that maintenance of the restrictions was undesirable in itself, but to the conviction that it was futile to insist upon them." *Id.* at 557 (Brandeis J., dissenting).

Contractarians dispute this line of reasoning for several reasons. For example, contractarians note many limitations upon corporations which have been abolished by modern corporate codes, including former limitations on mergers, limitations on the size of corporations, and the demise of the doctrine of ultra vires. Butler & Ribstein, *supra* note 432, at 9. *See, e.g.*, Act of Mar. 10, 1899, ch. 273, § 54, 21 Del. Laws 445, 461 (requiring a supermajority (two-thirds) for corporations to merge and thus limiting the size of corporations).

Anti-contractarians counter these examples with references to modern statutory restrictions on the payment of dividends and stock repurchases as well as the practical explanation for the decline of the doctrine of ultra vires which focuses upon the lack of necessity for limiting corporate purposes. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 170, 173 (1991 & Supp. 1993) (imposing limits on the payment of dividends and stock repurchases). In addition, anti-contractarians note other "mandatory" corporate provisions, including stockholder voting rights and fiduciary duties. Butler & Ribstein, *supra* note 432, at 10.

As to these latter examples, the contractarians respond that voting rights and, in some circumstances, fiduciary duties are more accurately described as contractual. Butler & Ribstein, *supra* note 432, at 10. For example, if corporation A chooses to merge with corporation B, corporation A could deny voting rights to A's shareholders simply by forming a wholly-owned subsidiary which would effectuate the merger. As to fiduciary duties, contractarians refer to the decision in Donahue v. Rodd Electrotype Co. of New England, Inc., 328 N.E. 2d 505 (Mass. 1975), in which the Massachusetts Supreme Court granted an "equal opportunity" right to minority stockholders in a close corporation for the repurchase of their shares. Butler & Ribstein, *supra* note 432, at 10-11. Contractarians interpret *Donahue* as recognizing an implied duty on majority stockholders in a small business to not take advantage of minority shareholders through share repurchases where the minority stockholders have no ready market for their stock. *Id.* at 10-11. To the contractarians, imposition of such an implied duty is either consistent with the actual expectations of the majority and minority stockholders or is appropriate judicial drafting where the parties failed to specifically address the transaction in question but would have done so had they considered the dilemma. *Id.* at 11.

[445]488 A.2d 858 (Del. 1985).

found inside and outside directors liable for breaches of their fiduciary duties of care.[446] In response to the *Van Gorkom* opinion, the Delaware legislature amended its corporate code to permit charter amendments which eliminate or limit personal directorial liability in certain situations.[447]

For purposes of this article, the theoretical debate between contractarians and traditionalists is whether the fiduciary duties of corporate managers should be subject to private contract or whether these duties should be mandatory and hence inviolable. Consideration of this debate is significant to the discussions which follow because present insolvency and dissolution law is grossly non-uniform, ambiguous, and replete with common law equity doctrines. As a result, directors and stockholders currently subject to staggering personal liability may, under a contractarian analysis, elect to eliminate their respective liabilities for acts or transactions which, in good faith, are sanctioned during insolvency, dissolution, or liquidation.[448]

B. *Identifying the Competing Constituents to Corporate Assets Upon Insolvency or Dissolution and the Relationship of Corporate Theory to a Reasoned Resolution of the Conflict*

Business and business law focus upon all participants who are necessary to the success of a business. Therefore, the law of business regulates lenders, employees, suppliers, managers, consumers, and owners. Of these indispensable constituents to the business, however, only the owners are protected by traditional corporate law. Yet, upon insolvency or dissolution of the corporate enterprise, owners, as well as

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[446] *Id.* at 864.

[447] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1993). The § 102(b)(7) charter amendments are not available for the elimination or limitation of director liability where: (1) the breach is of a director's duty of loyalty; (2) the alleged acts or omissions were not in good faith, involved intentional misconduct, or resulted from a knowing violation of law; (3) involved an unlawful payment of dividend or an unlawful stock purchase or redemption; or (4) the director derived an improper personal benefit. *Id.*

Delaware was not the first to draft a limitation upon director liability by charter amendments. In 1982 the American Law Institute (A.L.I.) first proposed a liability limitation in its PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 7.06 (Tentative Draft No. 1, 1982). The current proposal appears in PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.17 (Tentative Draft No. 9, 1989).

[448] The remaining theoretical discussion focuses solely upon the publicly-traded corporation because a legitimate argument could be posed that adoption of a contractarian model does not align itself with corporate governance issues in closely-held corporations.

non-equity participants, compete for rights in business collateral. The following discussion examines the rights of these competing constituents to business assets from contractarian and traditional corporate governance perspectives.

1. A Contractarian Perspective

The contracting parties to corporations typically include lenders, suppliers, employees, managers, consumers, bondholders, and equity holders. An analysis of these general contractual relationships, as viewed from a contractarian position, follows.

a. *Lenders*

Lenders are those parties who extend credit to the corporation in return for a note and security agreement collateralized by corporate assets. These lenders are often first lien holders who take priority over all other creditors. These parties are usually sophisticated lenders who contract with the corporation upon their own terms. From a contractarian perspective, these parties are able to protect themselves through superior bargaining power and negotiation of first liens. Further protection is afforded by the corporation's duty to perform the contract terms in good faith. Consequently, a corporate fiduciary duty adds little to the protections available to lenders via their private agreements with corporations.

b. *Suppliers and Employees*

Suppliers and employees are creditors of the firm who provide services or goods to the business. In most instances these parties sign form contracts or reach agreements with corporations based upon oral understandings[449] or past business practices. In the event of insolvency

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[449]Of course, contracts for services for more than one year and contracts for the sale of goods for the price of $500 or more are subject to the statute of frauds. *See, e.g.*, U.C.C. § 2-201 (1989). Section 2-201 provides:

> [a] contract for the sale of goods for the price of $500 or more is not enforceable by way of action or defense unless there is some writing sufficient to indicate that a contract for sale has been made between the parties and signed by the party against whom enforcement is sought or by his authorized agent or broker.

Id. § 2-201(1). But see U.C.C. § 2-201(3) which allows enforceability of a contract which does not satisfy the writing requirement for the statute of frauds in certain circumstances. *See also* RESTATEMENT (SECOND) OF CONTRACTS § 131 (1981) (stating the general requirement for

or dissolution, these parties are considered general unsecured creditors of the firm who take on a pro rata basis after secured creditor claims are satisfied.[450] These parties are contractually protected in the sense that goods and services are being provided to the business on a continual basis and the corporation has undertaken to perform the contract terms in good faith.[451] Where contract terms are silent regarding a disputed performance, commercial codes may provide gap-filling solutions.[452] Under contractarian theory, a corporate fiduciary duty does not advance these parties' interests because the creation of such a duty cannot place these contracting parties ahead of, or in parity with, secured creditors — the only resolution that would secure the employees' and suppliers' expectation of payment.

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writings); *id.* § 115 (stating the writing requirement for surety agreements); *id.* §§ 125-129 (stating the writing requirement for contracts for the sale of lands, tenements, or any interest therein).

Two well-recognized exceptions to the writing mandate of the statute of frauds are part performance of the contract and promissory estoppel. *See, e.g.*, Hickey v. Green, 442 N.E.2d 37 (Mass. App. Ct. 1983) (applying equitable estoppel exception); Remilong v. Crolla, 576 P.2d 461 (Wyo. 1978) (applying estoppel exception).

[450]*In re* Jeanes Mechanical Contractors Co., 32 B.R. 657, 659 (Bankr. W.D. Ky. 1983).

[451]*See* U.C.C. § 1-203 (1989) (providing "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement"); RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) (stating that "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement"). Additionally, because employees and suppliers provide a continuous and necessary service and/or benefit to the firm, a corporation in financial distress likely will pay these parties out of operating capital in order to preserve the continuous supply of goods and services which are critical to the life of the corporation.

[452]*See, e.g.*, U.C.C. § 2-305 (1989) (allowing for enforceability of a contract despite an open price term); *id.* § 2-308 (allowing enforceability despite the absence of a specified place for delivery of goods); *id.* § 2-309 (allowing enforceability despite absence of specific time provisions regarding shipment or delivery of goods); *id.* § 2-310 (allowing enforceability despite an open term regarding time for payment or the running of credit).

c. *Corporate Management*

Managers of the business include inside[453] and outside[454] directors as well as non-director officers.[455] Directors obtain their authority to conduct the business affairs of the firm through an annual stockholder vote[456] and serve, therefore, at the discretion of the equity owners.[457] Officers, on the other hand, generally derive their authority either from the corporation's bylaws or resolutions of the board of directors.[458] From a contractarian view, director duties are defined by the firm's certificate of incorporation and bylaws as well as state corporate law.[459] Directors thus take office with notice of the terms of their "contract" with the corporation. Directors directly influence the terms of their contractual arrangement with the firm to the extent that this contract may be modified during a director's tenure through an amendment to the corporation's charter.[460] On the other hand, where charter amendments are proposed by management, such modifications generally take effect only upon an informed stockholder vote.[461] Upon insolvency or dissolution, director obligations are generally considered administrative

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[453]Inside directors are those who have a personal financial stake in the firm. A common example of an inside director is one who is an officer of the corporation and receives a salary from the business. Another common example is a director who owns a substantial percentage of the outstanding stock of the corporation. In each of these situations, the director is faced with a potential conflict of interest either where a directorship is at stake or where creditors will take priority over equity owners.

[454]Outside directors are those who do not have a personal financial stake in the firm.

[455]Officers are agents of the corporation who are, most often, granted their offices either from the corporation's bylaws or from directorial resolutions. *See, e.g.*, DEL. CODE ANN. tit. 8, § 142 (1991). Non-director officers are responsible for the day-to-day management of the firm and thus are held to the same fiduciary duties as directors. Indeed, corporate common law suggests that the judicial scrutiny accorded to the conduct of officers may be more stringent than that accorded to the conduct of directors. *See* A. Gilchrist Sparks, III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 BUS. LAW. 215 (1992).

[456]*See, e.g.*, DEL. CODE ANN. tit. 8, § 211(b) (1991) ("annual meeting of stockholders shall be held for the election of directors on a date and at a time designated by or in the manner provided in the bylaws").

[457]HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 192 (3d ed. 1983).

[458]*Id.* § 219.

[459]*Id.* § 207.

[460]*Id.*

[461]*See, e.g.*, DEL. CODE ANN. tit. 8, § 242 (1991); 3 MODEL BUSINESS CORP. ACT §§ 10.01-.03 (1994). Two common director charter provisions are those which limit or eliminate director liability in some circumstances, DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1993), and those which provide indemnification for directors, *id.* § 145.

expenses of the corporation such that director expenses and costs are treated as priorities in the distribution of corporate funds.[462] Some equity limitations will subordinate these debts where appropriate.[463]

Officer contracts are traditionally negotiated by directors and are specific to the nature of the officer's position as well as the officer's business experience.[464] Officer contracts are thus private agreements that reflect greater bargaining among the parties. From a contractarian perspective, officers are protected against greed and arbitrariness by the common law contractual duty of good faith and fair dealing imposed on the performance and execution of their contract.[465] In addition, most officers obtain their office through some personal contact with the appointing directors. As a consequence, officer and director contracts do not reflect typical "creditor" relationships with the firm. In the event of insolvency or dissolution of the corporation, officer liabilities, like director obligations, are considered administrative expenses and thus accorded priority in the scheme of distributions.

A substantial body of empirical evidence on corporate management suggests that the responsibility of long-range planning for the firm should lie with the board of directors while responsibility for day-to-day decision making should be vested in the officers.[466] Ostensibly the purpose for the division of management responsibility is to minimize infighting among managers.[467] In addition, separation of management decision making and implementation of management decisions provides an internal mechanism for monitoring management conduct.[468] According to the contractarian

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[462]Pepper v. Litton, 308 U.S. 295, 306-08 (1939).

[463]In *Pepper v. Litton*, the United States Supreme Court articulated the "Deep Rock Doctrine" which allows courts, in the exercise of their equity jurisdiction, to subordinate the claims of officers, directors, and stockholders to the claims of outside creditors. *Id.* at 307-09. In an extreme case, the Deep Rock Doctrine permits the disallowance of an otherwise valid inside debt. *Id.* at 309.

[464]Butler & Ribstein, *supra* note 432, at 26-27.

[465]*See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

[466]*See* ALFRED D. CHANDLER, JR., STRATEGY AND STRUCTURE: CHAPTERS IN THE HISTORY OF INDUSTRIAL ENTERPRISE (1962); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 281 (1985) (confirming the importance of the multidivisional structure in the success of a corporation); OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 36-54 (1975) (providing a more in-depth analysis of the multidivisional corporate structure). *See also* David J. Teece, *Internal Organization and Economic Performance: An Empirical Analysis of the Profitability of Principal Firms*, 30 J. INDUS. ECON. 173, 173 (1981) (concluding that a decentralized and divisionalized internal structure of a firm has been shown to enhance firm performance).

[467]*See* Butler & Ribstein, *supra* note 432, at 25.

[468]*See, e.g.*, *id.* at 25-26; WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 469, at 281.

theory, management contracts, including executive compensation packages, may be structured to resolve any conflict between management self-interest and stockholder interest.[469] For example, executive incentives may include stock options, stock appreciation rights and bonuses for superior management achievements.[470] In this way, management is compensated according to benefits that accrue directly to equity owners.[471]

d. *Consumers*

Consumers arguably comprise the largest percentage of contractual relationships with the corporate entity and reflect the principal source of profit to the firm.[472] Consumers of corporate products generally contract for the purchase of goods through dealers or other participants in the chain of product distribution.[473] As a result, consumers do not typically contract directly with the corporate manufacturer.[474] The contract which does exist between consumers and manufacturers arises from provisions in the Uniform Commercial Code that impose warranties on contracts for the sale of goods.[475] Although these warranties are subject to

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[469]*See* Butler & Ribstein, *supra* note 432, at 25.

[470]*See id.* at 26.

[471]Opponents of the contractarian position emphasize studies which indicate that firm performance is not accurately reflected in executive salaries. *See* John C. Coffee, Jr., *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 943-44 (1988) (citing MICHAEL C. JENSEN & KEVIN J. MURPHY, ARE EXECUTIVE COMPENSATION CONTRACTS STRUCTURED PROPERLY? 3-14 (Managerial Economic Research Center, University of Rochester Working Paper, June 1987)). These critics thus minimize, or wholly ignore, a contractual analysis of the role of the management structure in guarding against management misconduct. To these critics, non-director officers are mere pawns of directors and therefore are ineffective to protect shareholder interests. Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1421, 1429, 1430 n.72 (1985).

[472]*See* THE ECONOMIST, GUIDE TO GLOBAL ECONOMIC INDICATORS 42 (1994) (showing that in 1990, the Gross Domestic Product (the leading economic indicator for consumer purchasing power) of the United States was $5.392 trillion).

[473]*See* Bratton, *supra* note 445, at 1488 (discussing briefly the historical origins of the chain of product distribution).

[474]The Uniform Commercial Code addresses, in part, the privity of contract issue in § 2-318. This section only resolves the issue regarding the necessary privity of persons related to the purchaser of the good; however, the issue of privity with the manufacturer through the distribution chain is left to case law. *See* U.C.C. § 2-318 official cmt. 3 (1989).

[475]*See* U.C.C. §§ 2-314 to -315 (1993) (setting forth the implied warranties of merchantability and fitness for a particular purpose).

modification or elimination in appropriate circumstances,[476] such limitations will be voided if a court finds the limitations to be unconscionable[477] or to fail of their essential purpose.[478] In the situation of insolvency or dissolution of a corporate manufacturer, consumers often find their claims barred either by dissolution statutes of limitation[479] or for lack of standing where the injury is not manifest within the corporate survival interval post-dissolution.[480] The dilemma of late-maturing product defects has thus provided the impetus for dissolution reform because consumers are unprotected by contract once a corporation dissolves or becomes insolvent.[481]

e. *Bondholders*

Bondholders are creditors of the firm who provide financing necessary to the business. They neither vote for the board of directors nor share an equity interest in the firm.[482] Instead, contract law and traditional bond covenants protect bondholder interests.[483] For example, the three basic attributes of bonds — maturity date, interest, and face or par value — are generally set forth in a contract referred to as a "trust

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[476]*See id.* § 2-316 (setting forth the requirements for the exclusion or modification of warranties).

[477]*See id.* § 2-719(3) ("Consequential damages may be limited or excluded unless the limitation or exclusion is unconscionable. Limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable but limitation of damages where the loss is commercial is not.").

[478]*See id.* § 2-719(2) (stating that "[w]here circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this Act").

[479]*See, e.g.*, 3 MODEL BUSINESS CORP. ACT § 14.07 (1994) (setting forth a five-year statutory bar for claims unknown at the time of dissolution).

[480]*See, e.g.*, DEL. CODE ANN. tit. 8, § 278 (1991) (setting forth a three-year survival period post-dissolution during which claims do not abate against or be abated by the corporation).

[481]Contractual remedies for late-maturing products liability claimants have been proposed by economists and academics. *See, e.g.*, Sarlitto, *supra* note 27 (examining the relationship between successor liability doctrine, legislative reform, and late-maturing products liability claims); Roe, *supra* note 27 (examining the contractual role of successor liability to compensate future unknown claimants to a dissolved corporate manufacturer). *See also* William M. Landes & Richard A. Posner, *Legal Precedent: A Theoretical and Empirical Analysis*, 19 J.L. & ECON. 249, 269-70 (1976) (presenting an economic perspective of the uncertainty inherent in valuing unknown claims).

[482]ROBERT HAMILTON, CORPORATIONS, INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 321-22 (1990).

[483]LARRY RIBSTEIN, BUSINESS ASSOCIATIONS § 11.07 (1990).

indenture."[484] The trust indenture is a standard form contract which contains several covenants to protect bondholder expectations regarding management decision making.[485] The purpose of these covenants is to minimize corporate decisions that tend to transfer wealth from bondholders to stockholders or other creditors.[486] Customary bond covenants include restrictions on future unsecured long-term debt,[487] limitations on the declaration and payment of dividends,[488] and restraints on secured debt (known as a negative pledge clause).[489] Covenants which are uncommon to indenture contracts, but which substantially protect bondholder interests, are constraints on the sale or disposition of assets[490] and restrictions on future investments.[491] In the event of insolvency or dissolution of a corporation, bondholders are considered general unsecured creditors of the firm who take pro rata after claims of secured creditors are satisfied.[492] The contractarian doctrine thus considers bondholder interests to be protected by contract both through express indenture terms regarding rights on default by the debtor firm and by the common law contractual duties of good faith and fair dealing in the performance and execution of those terms.[493]

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[484]The trust indenture is a contractual relationship between the corporate issuer and a trustee for the benefit of bondholders. *See* ARTHUR S. DEWING, THE FINANCIAL POLICY OF CORPORATIONS 172-75 (5th ed. 1953). The contract sets forth the rights and obligations of the issuer and bondholders and is subject to modification by a majority vote of the bondholders. *Id.*

[485]*See Committee on Developments in Business Financing, ABA Section of Corporation, Banking and Business Law, Model Simplified Indentures*, 38 BUS. LAW. 741-43 (1983).

[486]AMERICAN BAR FOUNDATION, COMMENTARIES ON INDENTURES 369-70 (1971) [hereinafter COMMENTARIES].

[487]*Id.*

[488]*Id.* at 402.

[489]*Id.* at 350. A negative pledge clause typically limits a company's ability to incur additional mortgage debt. This pledge by the firm assures its unsecured bondholders that no mortgage debt will be created which would obtain priority over the pre-existing unsecured bond obligation. The negative pledge clause, however, only relates to the firm's fixed assets. *See* Stilson, *supra* note 248, at 338-39 & n.34.

[490]COMMENTARIES, *supra* note 489, at 423.

[491]*Id.* at 458. *See* Stilson, *supra* note 248, at 339.

[492]Under federal bankruptcy law, the order of priorities is (1) secured creditors, (2) enumerated priority creditors, (3) unsecured creditors, and (4) equity investors. 11 U.S.C. § 507 (1988). A bondholder whose interest is protected by a mortgage or a lien on specific corporate property would be classified as a secured creditor. Otherwise, the bondholder would be treated as a general unsecured creditor. *See* Stilson, *supra* note 248, at 349-50.

[493]*See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981). *See also* Stilson, *supra* note 248, at 343.

f. *Stockholders*

Stockholders, unlike all the participants to the business discussed above, are investors who provide capital to the corporation in return for an equity position in the firm. These investors, in initial stock offerings, enter contracts whereby the stockholder promises to pay for stock in return for the seller's promise to sell the stock. Under traditional corporate principles, this contract is fully executed upon the receipt of legal consideration for the securities and the delivery of same to the prospective shareholder. Once the purchasing investor becomes an owner of record, she is entitled to all corporate rights accorded by the law of the firm's state of incorporation.

Under a contractarian perspective, the shareholder/corporation relationship is considered contractual in nature as stockholders are entitled to draft mechanisms which will protect against management misconduct.[494] As such, directorial fiduciary duties and remedies for breach of those duties are considered a part of the *contractual* safeguards that shareholders are free to negotiate.[495] Stockholders who purchase their equity interest in the public markets after a waiver of director duties is imposed by first tier investors are protected against managerial abuse by their choice of investing in this, as opposed to another, corporation. The second tier investors also obtain the benefit of lower priced stock where managers are exempt from fiduciary duties.

Although contractarians consider stockholders to be somewhat synonymous with consumers, stockholders remain the risk bearers of the corporate enterprise.[496] Hence, a contractarian analysis ostensibly considers the stockholder/corporation contract to be a promise by the stockholder to pay the specified contract price in return for a promise by the corporation to transfer the owner's name upon the corporate books and to continuously provide the stockholder with all corporate rights which flow from stock ownership.[497] One difficulty of such an analysis is that most investors today do not purchase directly from the corporate issuer. Instead, investors purchase their equity investments on the public markets through underwriters or broker-dealers who often hold the securities in the name of the financial intermediary on behalf of the

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[494]*See* Butler & Ribstein, *supra* note 432, at 28-32.

[495]*See id.* at 32 (noting that fiduciary duties are fundamentally contractual in nature).

[496]Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON U. L. REV. 99, 107 (1989) (stating that "shareholders . . . are the primary risk bearers of the corporation").

[497]*Id.* at 106-08 (explaining contractarian view on the issuance of stock).

customer.[498] In this situation, the corporation has no direct relationship with the stockholder. In fact, the corporation is often unaware of the shareholder's position as a beneficial owner of the company's stock. In this setting, the beneficial stockholder of a publicly-held corporation is not in privity of contract with the issuer and thus is in a situation analogous to a consumer of corporate products. If, however, the stockholder establishes a direct relationship with the issuing corporation by demanding that stock be issued in her name, that stockholder will be paid at dissolution or insolvency only after all other claims are satisfied.

2. A Traditional Corporate Governance Perspective

Under the traditional fiduciary model of corporate governance, directors only owed duties to equity owners.[499] The entity theory of corporate management also recognized the historical concept of the corporation as a concession of the state.[500] Current academic support for the historic model of fiduciary governance is espoused by the traditionalists who consider the modern corporation either not to be a contract at all among the firm's constituents or, at least, to require some *de minimis* governmental regulation in order to protect corporate stockholders from ambitious managers.[501]

Adherence to a traditionalist perspective will require resolution of the concerns introduced in the preceding hypothetical. It will also mandate a reexamination of trust, tort, and contract law theories employed by courts to define the relative rights and liabilities of firm managers. Currently, corporate statutes are inadequate to resolve the issue of contractual modification or elimination of liability for managers of corporations, limited partnerships, and limited liability companies. A *contemporary theory* of business organization must therefore be adopted. The choice is clear — statutory regulation (according to traditionalist theory) or freedom of contract (according to contractarian dogma).

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[498] *See supra* note 43 for an explanation of the present indirect holding system of corporate securities for publicly-traded corporations. *See also* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1435 (1989) (noting generally that many people hold stocks through third party investors).

[499] *See supra* text accompanying note 9 (discussing briefly the historical development of the corporation and directorial fiduciary duties).

[500] *See supra* text accompanying notes 444-48.

[501] *See supra* text accompanying notes 450-53 (discussing the anti-contractarian theory of corporate governance).

C. *Observations and Commentary on the Conflicting Theoretical Principles of Corporate Governance at Dissolution and Insolvency*

It seems clear that the law of corporate insolvency and dissolution is, at present, director-unfriendly in the sense that corporate management is making decisions during a period of firm distress which may subject the directors to staggering personal liability. This specter of culpability results from ambiguity in the legal definition and consequences of "insolvency" and "dissolution." Present corporate law is vague as to when insolvency occurs, what classes of "claims" or "liabilities" result in insolvency, and whether a fiduciary duty to non-equity constituents is created at the moment of insolvency.

Traditional precepts of corporate governance extend directorial obligations into the post-dissolution winding-up interval. During this period, corporate managers retain possession of firm property. Directors must surmise, however, whether fiduciary duties (as opposed to contractual obligations) are owed to all stakeholders in the firm notwithstanding the nature of the claimants' underlying financial interests. Directors managing a firm in dissolution must also determine which duties gain ascendancy in the event of a conflict in constituent interests. Managers must also foresee *ad hoc* judicial applications of historic equitable doctrines to permit directorial decisions concerning corporate plans for dissolution to be set aside. Moreover, such decisions may result in personal liability. Further uncertainty is created by patchwork judicial interpretations of the internal affairs doctrine.

Generally, stockholders own and indirectly manage the corporation through equity securities of common stock. It is indisputable that direct control of the corporate entity resides in a board of directors.[502] Due to the independence of the corporate enterprise from its owners, corporate law imposes fiduciary obligations upon management to safeguard equity owners from the potential greed and mismanagement of directors. These fiduciary principles arise because the stockholders relinquish direct control over their investment in the corporate entity.[503]

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[502]*See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1991) (providing, in part, that "the business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors).

[503]Partnership law similarly imposes fiduciary obligations on partners who manage partnership property. Whether the fiduciary obligation of general partners presently articulated in case law is a partnership obligation or a contractual duty is somewhat unclear.

In addition to corporate owners and management who supply necessary start-up capital and management expertise for a foundling entity, creditors, employees, lenders, and consumers of the firm are vital to the entity's success. Historically courts regarded consumers as contract creditors and thus persons unprotected by corporate fiduciary obligations. The apparent predicate to this principle is that creditors retain control, directly or indirectly, over the terms of their bargain with a corporation. Stockholders, however, typically abandon their right of control to directors. The general statement of contract versus corporate protection based upon relinquishment of control is not universal.

Present corporate law permits a unity of ownership and management interests in statutory close and membership corporations without a corresponding tail of personal liability.[504] Similarly, closely- and publicly-held corporations may elect to include charter amendments which limit or curtail directorial liability for breaches of fiduciary obligations.[505] Further, modern practices of trading and settling securities transactions in publicly-held corporations create an indirect system of corporate ownership with the consequence that corporate management is not truly acting on behalf of the corporation's owners.[506] Finally, the assumption that contract claimants exercise control in the bargaining process ignores the reality that many suppliers, employees, and consumers are without leverage to bargain on equal terms.

Notwithstanding the contract-corporate composition of a business, corporation law presently allows management to take action that maximizes shareholder interests at the expense of non-constituent interests.[507] At insolvency or dissolution, a conflict between these constituent (equity) and non-constituent (creditor) interests in corporate assets ensues. A clear resolution of the conflict is difficult because both insolvency and dissolution are reversible "events". The directors' dilemma is how to best fulfill their converging corporate and contractual duties. Directorial frustration is exacerbated where the corporate enterprise knows, or has reason to know, of contingent or future unidentifiable claimants.

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[504] *See, e.g.*, DEL. CODE ANN. tit. 8, § 351 (1991) (providing that "[t]he certificate of incorporation of a close corporation may provide that the business of the corporation shall be managed by the stockholders of the corporation rather than by a board of directors").

[505] *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1993).

[506] *See supra* text accompanying note 503.

[507] The three most common examples of shareholder maximization are dividend payments, investment choices, and the investment of surplus capital. *See* Ileen Malitz, *On Financial Contracting: The Determinants of Bond Covenants*, FIN. MGMT., Summer 1986, at 18.

To date, corporate law has addressed these contrasting expectations through *ad hoc* applications of the equitable trust fund doctrine and through the articulation of a "fiduciary duty" to creditors which trumps that owed to stockholders. Whether this fiduciary duty arises from, and is co-extensive with, the common law contractual duty of good faith and fair dealing *or* whether this duty is an independent corporate fiduciary obligation occurring at dissolution or insolvency is not apparent.

1. A Contract Perspective Regarding the Rights of Creditors to Corporate Assets Upon Firm Distress or Dissolution

Under contract law, every contractual commitment creates an implied duty of good faith and fair dealing in the performance and execution of the parties' agreement.[508] Since the implied duty attaches after contract formation, contract law provides no good faith protection to contract constituents in the bargaining or negotiating process.[509]

In the corporate setting, the contractual duty of good faith inheres in every non-constituent agreement with a corporation. Hence, the duty of good faith attaches to contractual commitments between corporate management and firm suppliers, lenders, consumers, debt holders, employees, and officers. Parties to corporate contracts may well foresee insolvency or dissolution and, therefore, remedies or priorities among claimants are likely terms for negotiation and contract inclusion. Whether the parties to the exchange have equivalent bargaining power regarding insolvency or dissolution protections depends upon the nature of the contractual exchange as well as the relative sophistication of the parties.[510]

The contractarian view of corporate law suggests that the modern publicly-held corporation is but a series of such contracts among the stakeholders of the corporation.[511] Recall that contracting parties are, under contract theorem, competent to contract well, to contract poorly or to not contract at all concerning event risks. As a consequence, contractarians consider corporate fiduciary duties to be redundant in the preservation of stakeholder interests. In the event that stakeholders fail to negotiate a remedy for a disputed performance, contractarians would

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[508]RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); U.C.C. § 1-203 (1989).

[509]*See, e.g.*, Market St. Assocs., Ltd. Partnership v. Frey, 941 F.2d 588, 593-94 (7th Cir. 1991) (stating that the question of good faith is one of performance and not one of formation).

[510]Certainly contract law presupposes a freedom to contract well, poorly, or not at all. Therefore, to the extent a party considers contract risks to exceed their potential benefits, that party will refrain from a contractual commitment.

[511]*See* Butler & Ribstein, *supra* note 432, at 7.

resolve any contractual impasse within the parameters of the implied contractual duty of good faith and fair dealing. In essence, contractarians reject any argument that a corporate fiduciary duty to creditors or stockholders is either necessary or advantageous given the economics which drive a corporate enterprise.[512]

2. Contract Versus Corporate Duties to Firm Creditors

Notwithstanding the contractarians' disapproval of fiduciary obligations, a contractual duty to creditors appears, on its face, to be co-extensive with the two primary corporate fiduciary obligations, that is, the duties of care and loyalty. If so, continued debate on the source of a creditor duty is moot. If not, further analysis is required. Assuming ambiguity, an examination of the contract-corporate obligations is required.

The traditional duty of care is articulated as an obligation of directors to inform themselves, prior to making a business decision, of material information reasonably available to them which bears upon the matter under consideration to be followed by a management decision which is discharged with requisite care and good faith.[513] The corporate duty of loyalty is articulated as an affirmative obligation by firm management to protect the interests of the corporation and a duty to refrain from conduct that may advantage the directors, either personally or economically, to the detriment of stockholders or the corporate enterprise.[514] Under certain circumstances, the duty of loyalty may include a duty of disclosure by management in good faith.[515]

The contractual duty of good faith seems to provide the analog for the corporate fiduciary obligation of care. For example, a contractual performance executed in good faith comports with the corporate imperative of good faith. Both duties arise subsequent to the formation of the alliance which creates the good faith commitment and each mandates a continued good faith execution of the terms of that relationship. In this sense, stockholders, like suppliers, employees,

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[512]Economists basically suggest that judicial or regulatory intervention in the private ordering of corporate contracts simply increases agency costs which costs are then transferred to consumers, contract constituents, and stockholders.

[513]Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

[514]Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987).

[515]*See* Hoover Indus. v. Chase, No. 9276, 1988 Del. Ch. LEXIS 98, at *6-7 (Del. Ch. July 13, 1988), *reprinted in* 14 DEL. J. CORP. L. 332, 338 (1989).

lenders, and consumers, freely enter, via contract, into an association which has foreseeable risks and benefits.

Two distinctions between these seemingly parallel duties must, however, be raised. First, the contract which placed equity ownership in stockholders is fully executed upon the settlement of the purchase and sale of the underlying security.[516] As such, any further right which must be performed in good faith by the issuing corporation, its directors, or controlling shareholders in favor of minority stockholders, arises under *corporate* law because of the now existent stockholder-corporate union.[517] Those ensuing rights were not, however, articulated or defined under the original stockholder-corporation *enabling contract*. Non-stockholder contracts, by contrast, arguably delimit the performances which are owed by the contracting parties within the limits of the contractual commitment itself. In addition, non-constituent contracts are often executory for some interval.

Second, the corporate requirement of good faith imposes an obligation that a director inform herself of all material information bearing upon a management decision prior to effecting the requisite good faith investment determination for the firm. By necessity, the corporate duty of information attaches to those continuous management decisions which occur *after a stockholder becomes a record owner* of the issuer's equity securities. Conversely, in contract law, the duty to inform oneself is not a necessary element to a bargained-for contractual *performance* given the likelihood that the parties negotiated contract terms with full or material knowledge of all factors which comprised the contractual duty to be executed. Therefore, it is arguable that the encumbrance of a corporate duty of good faith in favor of creditors provides an additional safeguard of directorial information-gathering after contract formation. Where the corporate-creditor bond arises only upon insolvency or dissolution, however, this additional increment of protection provides no security, or priority, of payment upon distributions of corporate assets. Indeed, the common law duty of absolute priority of creditor interests over those of equity holders affords a fairer guarantee of payment under contractual commitments.

The contractual duty of fair dealing similarly yields an adequate analog to the corporate prohibition on decision making in self-interest. The duty of fair dealing requires some degree of honor and vigilance by the contracting parties in the execution of the terms of the subject

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[516] U.C.C. § 8-301 (1977).

[517] *Id.*

agreement.[518] Where a party to a contract chooses to deal unfairly or in bad faith vis-à-vis a required performance, the promisee of that performance is entitled to contract relief in the form of damages, specific performance, or other equitable policing techniques.[519] Although the contractual duty of fair dealing may not impose a stringent disclosure mandate upon the parties to the commitment, it provides a similar *remedy* to that of the corporate duty of loyalty.

An argument could be presented that the imposition of a corporate prohibition on self-dealing in favor of creditors provides protections otherwise unavailable under the creditor-corporate contract. Specifically, the respective corporate and contractual duties of loyalty accord protection solely to the contracting parties. The duty arises under corporate law between stockholders and their issuing corporation and under contract law between creditors and the corporate enterprise. If the creation of a corporate duty of loyalty to creditors is interpreted to grant preference to creditor interests over those of stockholders in management decision making, then creditors have indeed acquired an investment maximization which is unwarranted by the allocation of risks evidenced by the creditor-corporation contract.

3. A Contractual Viewpoint of Stockholders and Consumers to Publicly-Held Corporations

Corporate holdings which are not easily compartmentalized within the contractual paradigm are those of consumers and stockholders of publicly-held corporations. Today, sixty to eighty percent of the outstanding stock of all publicly-traded corporations in the United States is held of record by the Depository Trust Corporation (DTC).[520] As such, a vast majority of equity securities in this country are owned of record by one (or a few) institutional investors or by smaller investors who hold their investments through financial intermediaries. The impact of this indirect system of holding, trading, and settling securities transactions and significant stock ownership by a single financial intermediary is the

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[518]RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); U.C.C. § 1-203 (1989).

[519]*See supra* note 521.

[520]DTC is a limited purpose trust company which is organized pursuant to the laws of the State of New York for the sole purpose of acting as a depository of shares for its clients — some 600 broker-dealers and banks. Of the securities held of record by DTC, one entity, The California Pension Fund, is the single largest shareholder of publicly-traded stock in the United States.

absence of a direct relationship between the "true," or beneficial, owners of stock and the issuing corporation.

From a contract perspective, the contract which established the indirect (or beneficial) ownership of these equity holdings was one negotiated between the purchasing consumer and her broker. The broker thereafter entered into a direct holding relationship with DTC by purchasing, for its client, the requested securities in a contractual transaction with a selling financial intermediary. The entity whose name appears as owner of record of those securities is DTC, not the selling financial intermediary, the purchasing broker, or the ultimate buyer whose acquisition interest in the securities generated the trade. What necessarily results is a tripartite agreement: a commitment between the purchasing client and her broker and a commitment between the broker and the selling financial intermediary. The initial client-broker contract is likely to be established on the broker's terms as reflected in the broker's form contract. To the extent the broker fails to perform the contract, principles of contract law will permit the purchasing client to challenge any unfairness in the form contract.[521] If the financial intermediary fails to perform the requested trade, the broker has a similar contract remedy for non-performance. The obvious difference between the client-broker and broker-financial intermediary contracts is the level of bargaining power and expertise of the parties to the commitments. Like the purchasing consumer, however, the acquiring broker may invoke equitable policing arguments against a non- or mis-performing financial intermediary.[522]

Because stock ownership in this country no longer resembles the direct purchase transactions of the late nineteenth and early twentieth centuries, stockholders, like other non-equity constituents, are without corporate fiduciary security. In this sense, it seems illogical to grant a corporate duty to creditors (whose investment interests are solely contractual) where beneficial owners of stock are left only with contract remedies for breach of their equity investment expectations.[523]

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[521]U.C.C. § 2-302 (1989). Contract law permits the policing of contractual commitments on the basis of lack of bargaining power in adhesion contracts as well as fundamental precepts of unconscionability. E. ALLAN FARNSWORTH, CONTRACTS § 4.26 (2d ed. 1990).

[522]Of course, in addition to contract protections, consumers, broker-dealers, and financial intermediaries have alternative methods of recovery for non- or mis-feasance by the other party to a securities contract. Those alternatives primarily lie in federal securities regulation — most prominently the trading regulations of the 1934 Securities Exchange Act.

[523]Of course, federal securities laws provide safeguards to stockholders and debt owners which are unavailable to other contract constituents where those constituents cannot characterize their relationship with a corporate entity as an "investment contract." *See* SEC v. Howey, 328 U.S. 293, 298 (1946) (defining an "investment contract" as a contract, transaction, or scheme

The other corporate constituent which is not easily compartmentalized within the contractual paradigm is that of consumers. Consumers, like stockholders, often purchase corporate "goods" through market intermediaries. Where the goods are sold by merchants and a consumer is ultimately injured by the goods or the goods fail to perform as implicitly guaranteed, warranty claims generally provide redress for the aggrieved buyer.[524] Actions against the manufacturer of the goods are also available despite the absence of privity between the consumer and the manufacturer.[525]

The contractual relationship, whether direct or implied, between these parties fails to provide relief for consumers who are injured by defective products placed in the market by a now defunct manufacturer. If the selling merchant is without fault in the ensuing consumer injury, recourse is typically denied against defunct corporate manufacturers. Imposition of a corporate fiduciary duty to these claimants is unavailing in the absence of legislative directives which create present rights in future unknown tort victims.[526] Finally, the sole difference between consumers of goods and consumers of stock in publicly-held corporations lies in the temporal relationship of the consumer vis-à-vis the corporate enterprise.

D. *The Resolution*

It is suggested that states must make a reasoned choice between the two opposing theories of corporate governance. Due to the development of the modern, indirect holding system for securities, a contractual perspective of the corporation more accurately reflects reality. The obvious impact of a contractarian regime on the duty to creditors is that such an obligation would be modifiable by negotiation and enforceable by contract. The issues concerning the parameters of provisions analogous to section 102(b)(7) and the respective 1101 sections would, therefore, be mooted. Likewise, obligations of disclosure, trust duties, and tort and contract responsibilities — articulated in several recent Delaware decisions — would be regulated under the general rubric of

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which induces a person to (1) invest money, (2) in a common enterprise, (3) with the expectation of receiving profits therefrom, (4) which are to come solely from the efforts of others).

[524]*See* U.C.C. § 2-314 (1993) (granting an implied warranty of merchantability in all contracts for the sale of goods). *But see id.* § 2-316 (permitting the limitation or modification of warranties).

[525]U.C.C. § 2-318 (1989).

[526]Whether present dissolution reform necessarily resolves the dilemma of future unknown claimants is addressed *supra* text accompanying notes 154-93.

contract amendment. *Ad hoc*, uneconomic applications of the trust fund doctrine would also cease. Finally, the abuses of fraud, overreaching, duress, and unconscionability in corporate/consumer contracts would remain under the aegis of contract theorem.

Alternatively, if adherence to traditionalist theory is anticipated, then the corporate duty to creditors must be forsaken for the contract obligations of good faith and fair dealing. The equitable trust fund doctrine must also be rejected as anachronistic. Such a resolution serves five purposes. First, it permits market negotiation between issuers and creditors to the firm without the implicit creation of a corporate windfall to creditors at dissolution or insolvency. Second, it licenses contractual moderation of liability tailored to the needs of the contracting parties that is enforced and policed by contract theorem. Third, it obviates the ambiguity of present dissolution statutes as well as the cases interpreting "corporate insolvency." Fourth, it creates economic savings through predictability in the dissolution process. Fifth, it retains the cardinal corporate principle that directors, not creditors, manage corporate assets. To achieve the clarity and predictability of these goals, however, equitable doctrines such as the trust fund theory must be permitted an honorable demise.

V. CONCLUSION

Presently directors are rendering decisions during corporate demise that affect claimants throughout the country and which subject management to astounding personal liability. Former statutory dissolution law was inadequate to guide directors through the intervals preceding and following a corporation's death. Consequently, states either amended their dissolution legislation to address this inadequacy or created judicial doctrines to resolve competing claims to corporate assets at dissolution or insolvency.

Unfortunately, current statutory reform, in particular Delaware's sections 280 through 282, contains significant obstacles to efficient and predictable corporate terminations. In order to instill greater predictability into the statutes and thus incentive for directorial use, four refinements are necessary: (1) clear legislative direction that statistically possible claims of whatever maturity are not "claims or obligations" in an insolvency sense but present only a class of claimants for whom notice and representation is required for purposes of posting future security for compensation; (2) an independent claims assertion date that would be judicially imposed subsequent to notice to and hearing for interested parties; (3) a scheme of priority among classes of claimants which

abandons rote application of temporal parity for all claimants to corporate assets; and (4) clarification that sections 280 through 282 constitute summary dissolution actions such that issues tangential to a dissolution would be stringently narrowed to those involving sufficiency of security.

In addition, the corporate duty to creditors should be rejected as anachronistic to our law. Creditor protection should thereafter revert to the realm of contractual duties and obligations as well as commercial security devices.

Finally, judicial re-examination of the traditional fiduciary paradigm is necessary to align twentieth century developments in corporate equity ownership with historic concepts of corporate fiduciary duties. In particular, the contractarian model of corporate governance should be embraced as that which most closely aligns with the manner in which corporate enterprises conduct business. Due to the regulatory vestiges of traditional corporate law, however, a fiduciary duty to stockholders alone should be retained throughout the viability and death of the corporate persona. To the extent a contractarian perspective would permit contractual elimination of fiduciary duties, such perspective is recommended as both economically efficient and reflective of present equity holdings in this country. Such a theoretical decision on corporate governance, is, however, one which must be *decided* by the corporate bench and bar and *not left to deduction* on an *ad hoc* basis.